THE DOLLAR RESCUE OPERATIONS AND THEIR DOMESTIC IMPLICATIONS

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HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-FIFTH CONGRESS

SECOND SESSION

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THE DOLLAR RESCUE OPERATIONS AND THEIR DOMESTIC IMPLICATIONS

THURSDAY, DECEMBER 14, 1978

Congress of the United States,
Subcommittee on International Economics
of the Joint Economic Committee,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:32 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (cochairman of the subcommittee), presiding.

Present: Representatives Reuss, Hamilton, Brown of Ohio, and Fenwick.

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director; Lloyd C. Atkinson, Thomas F. Dernburg, Dianne Kahn, George D. Krumbhaar, Jr., L. Douglas Lee, Katie MacArthur, Paul B. Manchester, and Robert Ash Wallace, professional staff members; Mark Borchelt, administrative assistant; and Robert H. Aten, Stephen J. Entin, and Mark R. Policinski, minority professional staff members.

Opening Statement of Representative Reuss, Cochairman

Representative Reuss. Good morning. The subcommittee will be in order for our hearings on the dollar rescue operations.

These will be the last hearings of the Joint Economic Committee in the 95th Congress. I know that Chairman Bolling and all members of the committee join with me in expressing our deep debt of gratitude to Senator John Sparkman, a dedicated public servant, whose retirement from Congress brings to an end 31 years of service to the Joint Economic Committee. Senator Sparkman is the last remaining original charter member of the committee. When he retires, he will divide his time between Washington, D.C. and Huntsville, Ala., where he intends to open a law firm with his grandson. We all wish him every future success.

On November 1, the administration announced its dollar rescue operations. This included an austere budget policy and a shrinking budget deficit, tighter monetary policy, and joint intervention in support of the dollar with West Germany, Japan, and Switzerland, to which we committed $30 billion of our own resources.

Because of the drastic drop in the dollar's external value last summer and fall, drastic steps were clearly necessary. This committee has thus supported the administration's actions as an emergency measure. So far the erosion of the dollar has been checked and, on the average,

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10 percent of its external value against other leading currencies has been restored. Two questions of large importance will dominate these hearings.

1. On the domestic side, can the dollar rescue program, combined with our domestic anti-inflation program, be fine-tuned sufficiently so as to avoid recession, or at least a shortfall in growth that could bring unneeded hardship and inequity at home, and set in motion a self-defeating switch of foregin capital away from our shores?

I can see at least four hazards in the present program:

(a) Budget austerity could fall disproportionately on programs to aid the structurally unemployed and our cities, so that dollars instead might go for programs like military spending and space. Is a military overkill potential, and the undertaking now of postponable scientific probes in outer space, really going to enhance the well-being and security of the American people, if the risk is that Newark and Cleveland and Detroit and Los Angeles will once again be the scene of civil strife?

The teenage unemployment rate, currently mired in the 35–40 percent range, is bound to get worse if the economy slows significantly in 1979. Teenage unemployment, primarily a structural problem, is thus cruelly compounded by an overall slowdown.

(b) The current dollar rescue program apparently entails tighter money and higher interest rates than would be necessary simply to fight domestic inflation. Higher interest rates, it is argued, will lure foreign capital here and thus improve our balance of payments.

The factual basis for this belief is hard to find. It seems much more likely that an unnecessarily tight money policy will seriously slow down research and development, and investment in plant and equipment—both needed for increased productivity, which in turn is the soundest method of fighting inflation.

With Germany's inflation for next year predicted at 2 to 3 percent, and ours at 7 percent or more, supertight money could simply lead to greater pressure on the dollar, and see the departure from these shores of foreign capital destined for either our stock market or for direct investment here. Would it not be better, then, to confine monetary tightness to that needed to fight domestic inflation, and not to try to use an extra dollar of it to "defend the dollar"?

(c) Our intervention in the last month has already absorbed billions and recent figures released by the Federal Reserve show that interventions can involve substantial monetary loss to this country, more than $400 billion in this year alone and more than $1 billion in the 1970's. In fact, we can intervene until our cupboard is bare—and go further in debt to get the marks and yen with which to intervene—yet not really rescue the dollar, especially if there is a $700 billion overhang in the Eurodollar market, as many analysts allege.

We should explore, therefore, whether even our short-term program should not include measures to sterilize some part of this overhang—if it exists—and thus reduce the incentives of holders to dump dollars.

Specifically what about the proposal of Governor Xenophon Zolotas of the Bank of Greece and others to float medium-term Treasury obligations, denominated in dollars, to the Eurodollar commercial banks, with the Treasury sterilizing the proceeds? This would remove

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the volatile marginal amount from the overhanging pool during the critical years immediately ahead, and could well insulate the world from additional inflationary pressures.

In this connection I addressed a letter to the Secretary of the Treasury on November 24, asking for his views on the proposal and the Secretary was good enough to write me a compendious letter, dated December 13, giving Treasury's views which are stated in Secretary Blumenthal's letter. I think it is useful to have these two positions out on the table for public examination and debate, and I accordingly ask unanimous consent that my letter of November 24 and the December 13 reply by Secretary Blumenthal be made a part of the record at this point.

[The two letters referred to, together with a third letter subsequently supplied for the record, follow:]

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., November 24, 1978.

HON. W. MICHAEL BLUMENTHAL,
Secretary of the Treasury, Department of the Treasury,
Washington, D.C.

DEAR SECRETARY BLUMENTHAL: I believe that our current dollar rescue operation is appropriate and helpful.

In addition to the measures for defending the dollar included in the United States program, a proposal suggested at the International Monetary Fund meeting in Washington last September 26 by Governor Xenophon Zolotas of the Bank of Greece merits, in my judgment, serious consideration. Under the proposal, the U.S. Treasury would issue non-negotiable medium-term—six months to, say, five years—obligations denominated in dollars to leading commercial Euro-dollar banks. The obligations would be available to such Euro-dollar banks as agreed not to switch dollar deposits in the United States to Europe for the purpose of buying these special obligations. The obligations would carry a floating interest rate linked to the three or six month London Interbank Offer Rate (LIBOR).

Dr. Zolotas envisages that the scheme might also include central banks as purchasers. Since they now traditionally keep reserves in negotiable Treasury obligations presently paying a lower interest rate than LIBOR, their participation would be based on a percentage of the growth of their dollar reserves following the date of announcement that the Treasury would undertake the proposal. To reduce the Euro-dollar over-hang, the Treasury would place the dollars received for the special obligations in a sterilized account, similar to our existing Exchange Stabilization Fund.

Issuance of these special obligations would be discontinued as soon as the Euro-dollar over-hang is perceived as no longer causing appreciable dollar instability.

The great advantage of the Zolotas proposal is that instead of letting our deficits continue to pile up abroad, and then attempting to intervene to steady the dollar with German marks or Japanese yen obtained by the United States by swaps, or by sales of obligations denominated in foreign currencies (both contemplated portions of our present proposal), we put a damper on our deficits in the first place. While the LIBOR interest rate would be slightly more costly for us than the rates charged under swaps or obligataions denominated in foreign currencies, the dollar-denominated obligations would not contain the risks of loss to the United States through dollar depreciation inherent in both swaps and sales of obligations denominated in foreign currencies. Furthermore, interest received on the proposed dollar denominated obligations by subsidiaries of U.S. banks would be subject to U.S. taxation when repatriated.

I believe that the Zolotas proposal would be a useful substitute for all or part of the proposed swaps and foreign-currency obligations. I shall appreciate your giving me your views on it when you appear at our Joint Economic hearing on December 14.

Sincerely,

HENRY S. REUSS,
Member of Congress.

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THE SECRETARY OF THE TREASURY,
Washington, D.C., December 13, 1978.

Hon. HENRY S. REUSS,
House of Representatives,
Washington, D.C.

DEAR MR. REUSS: You have asked me to comment during my December 14 testimony on a proposal made by Governor Zolotas of the Bank of Greece for the issuance abroad of special U.S. Treasury dollar-denominated securities. I would like to comment in some detail and am taking the liberty of responding to your request by letter. Please feel free to include this letter in the record of the hearings.

Briefly, Governor Zolotas suggested at the IMF/IBRD annual meetings last September that the Treasury sell medium-term, non-negotiable, dollar-denominated, variable interest rate securities to leading commercial banks in the Euromarket and perhaps to foreign central banks. The purpose, as expressed by Governor Zolotas, would be to "offset" the U.S. balance of payments deficit by absorbing dollars held abroad, presumably in order to reduce the possibility of moves by foreign holders of dollars to diversify into other currencies. Governor Zolotas proposed that transfers of dollars out of the United States for purchase of these securities be subject to some form of control, and that purchases by central banks be limited. The proceeds of the securities would be placed in a special sterilized account, in order to avoid an expansionary monetary impact in the United States.

In general, I do not feel this proposal would be a desirable or effective means of dealing with the exchange market situation, for the following reasons.

First, it is important to bear in mind that the amounts of dollars which can enter the exchange markets are not limited to existing foreign holdings, and an effort to "fund" a relatively small portion of those holdings could not be expected to have much effect on the exchange markets. American residents can convert their dollars into foreign currencies, and both foreigners and Americans are free to borrow dollars and sell the proceeds in the exchange market at times when real or psychological market factors are adverse for the dollar. Thus the suggested approach would not be an effective way of eliminating possible pressures on the dollar.

Second, I believe the proposal mistakes cause and effect by confusing the existence of foreign dollar holdings with the more fundamental reasons which motivate currency diversification. Foreign-held dollar balances are not an independent source of dollar instability, but a source which can come into play when the underlying U.S. economic conditions and balance of payments position are unstable. Foreign holders of dollars respond to the same factors as domestic holders of dollars or holders of any other currency—performance and prospects for growth, inflation, relative interest rates, trade and current account positions, etc.—and our policy efforts must be directed at these underlying factors.

Third, Governor Zolotas envisages some technique of limiting transfers of dollars out of the United States to purchase the U.S. securities. Given the very large variety of channels for flows of dollars, direct and indirect, I see no practicable way to achieve such limitations. Voluntary undertakings would not be enforceable or effective, and—given the potential damage of such controls to the U.S. and world economies—we would not want to consider implementation of exchange or capital controls to make such limitations effective.

Fourth, the proposal to "sterilize" the proceeds of these securities would, in effect, mean that the borrowed funds would not be available to the Treasury as part of its financing operations. The U.S. monetary authorities have a variety of instruments for offsetting any expansionary effects of such issues, and there would be no need for such sterilization. Moreover, the U.S. domestic money supply is not significantly affected by a transfer of dollars from foreign to U.S. ownership.

Fifth, various elements of the proposal suggest that it could be very costly to the United States. In order to have any discernible impact on the exchange markets, the proposal might require Treasury borrowings abroad on a very large scale. The foreign institutions involved are already free to invest in the wide range of available Treasury securities, and it is clear that they would have to be given a relatively attractive yield to induce them to purchase these non-marketable securities. And sterilization of the proceeds would mean there would be no

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offsetting reduction in domestic Treasury borrowing to carry out our regular debt management operations. It is true that the borrowings would entail no risk of exchange loss—or gain—to the United States, but because of the above factors, they could well involve significantly higher total costs to the United States than borrowings we are undertaking under swap arrangements and foreign currency denominated securities.

Sixth, the Zolotas proposal does not put a "damper" on our balance of payments deficits, which you suggest is its principal advantage. The proposal is a technique of financing the deficits while they continue, and Governor Zolotas makes clear in his statement that he believes a comprehensive policy—involving "drastic" anti-inflationary monetary and fiscal policies in the United States as well as stronger growth performance abroad—is needed to correct the U.S. balance of payments situation and strengthen the dollar.

The measures announced by the United States on November 1 are part of a comprehensive approach to improving U.S. economic performance in a way that will promote our basic economic objectives. The specific measures announced on that date are also designed to correct a situation in the exchange markets which was damaging to those objectives and which could not be tolerated any longer. The foreign currency obtained under the $30 billion program can be used directly to improve the exchange market situation, as needed in light of specific exchange market developments, and I believe this approach will have a much more selective, immediate and forceful impact than would attempts to absorb some portion of existing foreign dollar holdings through issuance of the securities proposed by Governor Zolotas.

Although I regard it unlikely, some types of overseas dollar issue by the Treasury may prove to be desirable at some point in terms of our international monetary or debt management objectives, and we will continue to keep this possibility under review. However, in terms of dealing with the situation faced by the United States this fall, I do not believe the proposal by Governor Zolotas would provide a realistic or effective alternative to the program announced November 1, including the foreign currency borrowings, or to our broader efforts to correct U.S. economic problems.

Sincerely,

W. MICHAEL BLUMENTHAL.

BANK OF GREECE, THE GOVERNOR,
Athens, Greece, January 5, 1979.

Hon. HENRY S. REUSS,
Cochairman, International Economics Subcommittee,
U.S. House of Representatives, The Capitol,
Washington, D.C.

MR. COCHAIRMAN: In your letter to Secretary W. Michael Blumenthal, dated November 24, 1978, you asked him to comment on my proposal for the issuance abroad of dollar-denominated securities, in order to deal with the current pressures on the U.S. dollar. The Secretary's answer to your letter reflects in my opinion some misunderstanding of my views. I therefore feel I should state my position [1] once again and describe the areas of agreement and disagreement.

There is, I believe, agreement on several important points. The difficulties the dollar is experiencing in foreign exchange markets arise mainly from the relatively high rate of inflation in the United States over a long period of time, which largely contributes to the trade and current account deficits. It follows that the remedy needed must first and foremost include appropriate monetary and fiscal policies in the United States and concerted action by the monetary authorities of the principal industrial nations. It should be noted in this connection that the anti-inflation program recently announced by the U.S. Administration is in the right direction and I wish it every success. Nevertheless, until it produces the desired results, the U.S. balance of payments deficit is likely to continue, all the more so after the price increases recently decided by OPEC.

In this context, my proposal was conceived as a temporary measure to alleviate pressure on the dollar "until the underlying economic conditions in the U.S. economy are substantially improved". Unlike borrowing in foreign currencies, it does not rely on market intervention only in times of crisis, but

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[1] See my Statement at the Annual Meeting of the IMF on Sept. 26, 1978.

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stresses the need for the orderly mopping up of excess dollars whenever this is considered necessary. Therefore, it can be presumed that, because it would operate before the need for central bank intervention arises, much smaller amounts will be required compared with the Secretary's scheme of borrowing for intervention purposes by issuing bonds denominated in foreign currencies.

The latter scheme allows the surplus dollars to depress foreign exchange markets and it mops them up only after the damage has been done, by intervening to support the dollar with borrowed foreign exchange resources. Protracted support for the dollar on too large a scale might aggravate the pessimism prevailing in foreign exchange markets, especially if the United States had to replenish repeatedly borrowing facilities negotiated with other countries. Moreover, an unduly heavy reliance on foreign debt, indeed for the first time in U.S. history, could further undermine confidence and generate speculation. Inter alia, there might conceivably be an outflow of dollars from the United States for speculative purchases of the securities denominated in foreign currencies, which are being sold as part of Mr. Blumenthal's package to finance market intervention.

In contrast, I propose the issue abroad of securities denominated in dollars. Sales of such bonds would deal with the problem at its root, since they woulld absorb the surplus dollars directly, before they cause trouble in foreign exchange markets. My scheme does not eliminate the need for occasional market intervention to support the dollar, but this need would be significantly reduced. Only if this scheme were adopted, would the amount of $30 billion being raised through the swaps, the use of SDRs and drawings from the I.M.F. prove to be sufficient for such interventions in the foreseeable future. Consequently, the mobilization of additional bonds denominated in foreign currencies would be unnecessary.

Let me now comment on a number of the Secretary's specific objections. In the first place, he feels that if my scheme were implemented, it would be necessary to improve capital controls in order to make sure that the bonds I am proposing would not be purchased with funds sent out of the United States. I have already suggested that the securities issued would be nonmarketable and available exclusively to a select circle of Eurobanks. Special agreements with each of the eligible banks would prevent any transfers of funds from the United States. Anyhow, the danger of such transfers would be much greater in the case of Secretary Blumenthal's securities, given that U.S. residents would have a speculative motive to buy them. Hence the need for mandatory controls would be much stronger. Yet the safeguards imposed so far appear to have been very weak. According to press reports, German commercial and savings banks wishing to buy such securities were required to pledge only that they would not resell the securities to Americans (what about Germans and others?), at least not for a certain period of time.

Second, Mr. Blumenthal took exception to my idea that the proceeds of the dollar bonds should be sterilized. However, I still think that these proceeds should not be allowed to increase the money supply and effective demand in the United States. But I would not object to their being spent, if domestic borrowing were reduced by an equal amount, or if monetary instruments were used, as suggested by the Secretary, to offset any expansionary effects of the proceeds of the bonds. Actions of this nature would virtually constitute sterilization.

Third, although Eurodollar rates are admittedly higher at present than comparable rates of strong currencies, the final cost of the scheme I am proposing can only be determined after changes in exchange rates are taken into consideration. The experience of the last few years indicates that interest costs are more than offset by changes in exchange rates. Moreover, my scheme not only eliminates foreign exchange risks, but also considerably reduces the need for foreign borrowing. As I have already indicated, by controlling the additional dollar outflows, speculation would be dampened and confidence in the dollar bolstered. Consequently, this scheme would prove to be less costly for the Treasury than borrowing in foreign currency bonds.

Fourth, the Secretary argues that my proposal amounts merely to a financing technique and does not agree with you, Mr. Chairman, that it might put a damper on the U.S. balance of payments deficit. I myself thought of it mainly as a method of dealing with the current difficulties of the dollar in foreign exchange markets. In addition, if this were achieved. it would also contribute to an improvement in the psychological climate and have an important effect on U.S. balance of payments developments.

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I noted with interest that, in the last paragraph of his letter, Mr. Blumenthal, despite his objections, states that: "Although I regard it unlikely, some types of overseas dollar issues by the Treasury may prove to be desirable at some point in terms of our international monetary or debt management objectives, and we will continue to keep this possibility under review."

If you think it would be useful, Mr. Chairman, please feel free to include this letter in the record of the hearings on the "Dollar Rescue Operations and Their Domestic Implications."

Yours sincerely,

XENOPHON ZOLOTAS.

Representative REUSS. (d) How far are we willing to drive the value of the dollar by our intervention? Since an increase in the value of the dollar favors the export industries of Germany, Japan, and Switzerland and harms our own export- and import-competing industries, how and where do we stop before we "support ourselves" out of our export markets? Does the administration have in mind some "reference" or "target zone" rates of exchange to determine when and how it ought to intervene? Are we abandoning our commitment to floating exchange rates?

The second large question before us is: On the international side, can we afford to continue the dollar as the world currency, shoring it up by endless interventions that disregard the instability inherent in the world economy, and in the enormous apparent dollar overhang?

The present system continues to tempt us to print more dollars so that we may live and invest beyond our means. Every indication is that the other countries of the world are fed up with what the late General DeGaulle called "this exorbitant privilege." The new European Monetary System is but one example of their effort to render themselves independent of our bootstrap-lifting of our international monetary power.

For the sake of our own economy, and of a stable and orderly world, we should now take the lead—at the Guadeloupe Summit meeting in January, in the International Monetary Fund, in negotiations over the new European Monetary System, and on all fronts—to gradually relinquish our key currency role, and to move instead toward a basket-of-currencies unit under the aegis of a reinvigorated IMF.

Flexible exchange rates are not, in my judgment, what has brought us to our troubles. In the face of disparate growth and inflation policies among the world's economies, floating is the only realistic exchange rate regime that permits each country the kind of flexibility it needs to realize its domestic goals without at the same time creating major problems for other countries. Once the world economy gets the "fundamentals" in line, stable exchange rates will follow.

Many people allege that the current dollar problems stem from the existence of the huge volume of dollar-denominated assets in the hands of foreigners—a portion of which are "unwanted," and therefore a source of the downward pressure on the dollar. If this is a source of the problem, intervention is a very weak weapon to use to rectify it. This issue should be settled by providing an international currency to supplement the dollar, not through United States and foreign intervention in foreign exchange markets.

What is needed is some sort of substitution account in the IMF whereby foreign monetary authorities not wishing to hold so many dollars may turn in their unwanted dollars for enlarged and rechris-

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tened special drawing rights. This would relieve pressure on the dollar, help stem world inflation, and allow flexible exchange rates to perform their proper adjustment role for the long period between now and the millennium when countries will have learned to coordinate their macroeconomic policies in a manner consistent with the smooth functioning of our international monetary system.

This country, unfortunately, still appears to cling to the idea that the dollar's key currency role must not be diluted. We have thrown cold water on proposals for a new parallel key currency which can partially substitute for the dollar, as recently as at the meeting of the Interim Committee of the IMF in Mexico City last May. The basic reforms were outlined by the IMF executive directors in their 1972 report, and by the Committee of Twenty in 1974, but were unfortunately jettisoned in Jamaica in 1976.

This country must take the lead in suggesting that the time has come to deal with the disease that is destroying the international monetary system, and to go beyond the bandaid process of intervention.

I am delighted to welcome my colleagues, Representatives Hamilton and Brown of Ohio. Welcome back.

Do you have anything to present at this point?

Representative HAMILTON. No.

Representative BROWN of Ohio. I will await the Secretary's statement.

Representative REUSS. Mr. Secretary, we appreciate your being with us this morning. I want to congratulate you on your recent trip in which, as I understand it, you talked with the Kremlin about trade and similar matters that help in the erection of peace, and then in Bucharest where you visited to congratulate President Ceausescu on turning back increased military spending demands, citing Romanian domestic economic considerations as the reason why they should not increase their military spending.

I think you did a good job in both places. Incidentally, is there any chance of getting Ceausescu over here to give us the same advice? That might be helpful.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, SECRETARY OF THE TREASURY

Secretary BLUMENTHAL. Mr. Reuss, Mr. Ceausescu was in this country in April of this year. I have no idea when he will be returning. But I would like to express my appreciation to you and to the members of your committee for inviting me to appear here and providing me an opportunity to deal with the very important questions that you have raised in calling this hearing.

I have submitted to you and to the members of the committee, Mr. Reuss, a prepared statement which I would like to submit for the record in its entirety, given the importance of the issue and the importance moreover of not being misunderstood.

Representative REUSS. Without objection, your entire statement will be received, and we would be pleased to have you present it either verbatim, or go beyond it or eliminate some things, but your prepared statement will be in the record.

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Secretary BLUMENTHAL. In the interest of time, I will present parts of it verbatim, but parts of it I will merely summarize.

Let me say at the outset that it is, of course, clear that the actions which the President initiated on October 4, but more importantly on November 1, were intended to deal with the interrelated problems of inflation and the dollar.

There was clearly a situation that had gotten out of hand. There was a question of whether or not this country had the resolve to deal with the problem of inflation which is the No. 1 economic problem of this country, and there was a question of whether or not we would take action to counter what had become totally irrational conditions in the exchange markets relating to the dollar.

We appreciate your support, your committee's support in this effort as it was announced. I think the results have been positive and I think that the actions that have been taken should allay any doubts as to our resolve with regard to the basic objectives that I have stated, for we have now committed the major tools of economic policy in an interrelated fashion to the task of unwinding inflation as well as to insuring that instability and speculative activity, which have become totally excessive and divorced from the underlying fundamentals, are stopped.

Let we say that there will be no waivering and no waffling in our determination to continue this policy. We feel strongly that until we succeed, we cannot assure the kind of economic goals which I am sure you and the President share. The economic goals of seeing stable expansion of our economy and assuring the benefit of that expansion on a fair and equitable basis is important to all sectors of our society.

Mr. Reuss, I will not go in any detail or read the description of the economic situation faced within the United States at the time at which this action was taken. I think it is laid out clearly in my prepared statement in summary fashion. I will, of course, be glad to answer questions about it.

Let me just make this point.

We were facing a situation in which, domestically, inflation was accelerating at a rate that was clearly completely excessive. We began with a situation in which inflation was already ingrained in our economy, steadily moving upward from the 1960's into the 1970's, with some occasional downturns, but really with a continuing upward pressure, with wages chasing prices and prices, in turn, chasing wages even during periods of relative economic slack.

Given the good expansion of economic activity in the last 2 years during the Carter administration, we now begin to see signs of tightening in the economy, demand-pull signs, with industrial capacity moving higher, with rates of unemployment for critical categories of workers becoming very low, and the market becoming very tight, and, therefore, additional inflationary pressures growing.

At the same time we began to see very, very clearly the feedback effect of a declining dollar on the domestic inflation rate and we learned the vicious cycle in which we were caught between these two phenomena. We estimate the decline in the dollar, which was in part due to the observation by others of accelerating inflation in the United States, has added at least 1 percentage point to the rate of inflation and possibly more. That added inflation indeed led to greater weak-

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ening of the dollar and, in turn, a kind of vicious circle began to accelerate. It is not only that depreciation caused import prices to rise in the United States, adding to inflation, but depreciation provided a kind of umbrella under which domestic prices for products that are competitive with imports and intermediate products, are also raised and in this way the cycle is perpetuated.

The foreign exchange markets did react very adversely to this situation. In the month of October the dollar declined sharply against all major currencies, therefore raising the specter of further inflation down the road from this factor. The dollar fell by 6 percent against the Swiss franc in 1 month alone, 7 percent against the Japanese yen, by 12 percent against the German mark. On a trade weighted average basis the dollar fell by 8 percent. All told, in the 13 months preceding the November 1 initiative, the dollar had fallen 38 percent against the Swiss franc, 34 percent against the yen, and 26 percent against the Deutsch mark.

So we clearly had a situation on our hands where even though the fundamentals were beginning to improve, this kind of situation was perpetuating itself and making any effective measures to deal with domestic inflation a very, very difficult task for the President and for the administration.

Let me briefly mention the improvement in the fundamentals that were clearly becoming apparent.

We had a budget deficit of $66 billion in 1976 representing 4.4 percent of GNP. The President is in the process of preparing a budget for fiscal year 1980 which he has said and did say on October 24, would have a deficit of $30 billion or less, which would represent somewhere in the range of 1 percent of GNP, and which clearly puts into view the possibility of moving toward balance in the budget in the period beyond that.

Representative Brown of Ohio. Could you give us the intervening figures also, 1977 and 1978?

Secretary Blumenthal. I will submit the precise figures for the record.

Representative Brown of Ohio. Just generally.

Secretary Blumenthal. I believe that the figure—I am going from memory now, sir—I think for fiscal 1979 we estimate a budget deficit of somewhere around $40 billion. For the period fiscal 1978, I believe the budget deficit was $48.5 million; and for fiscal 1977, it was $45 billion.

So it was $66 billion in fiscal 1976, $45 billion in fiscal year 1977, $49 billion in fiscal year 1978, and $39 billion for the fiscal year in which we are now in, and $30 billion or less is the target that the President has publicly stated for the budget he will submit next month.

In spite of that reduction, and the very tight fiscal policy that underlies it, confidence had eroded in the international markets to such an extent that any improvements in the underlying situation were being ignored. This included the energy legislation which had been passed, which we estimate in 1979 alone will mean a reduction in import requirements, because of the natural gas part of it, by at least 500,000 barrels a day. But more importantly, the market ignored that the current account and trade balances of the United States were substantially im-

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proving, from a current account deficit of some $17 billion this year to an expected figure of as low as $6 or $7 billion next year.

Despite all of these factors, the dollar continued to decline along the lines that I have indicated. It is in that situation and that context that the administration decided to act and act forcefully. I will not go into the details of precisely what that action was. It is indicated in my prepared statement.

May I merely say that it represents a coordinated, comprehensive, and interrelated set of actions which deal both with the goal of fighting inflation in the United States by instituting a very tight fiscal and monetary policy, to complement the voluntary cooperation of labor and management and business, and stopping this deteriorating situation in the exchange markets which had become a part of our inflation problem.

Let me then turn to the results of these measures. We are gratified that the reaction to these measures has been good. I believe that there now is a realization among governments and in the financial community as well as in the general public, that the U.S. Government is determined to deal effectively and decisively with our economic problems, that we will act to bring inflation under control, that we will strengthen the dollar at home and abroad. In my travels, both to the Middle East and more recently, as you indicated, to Germany, to England, to the Soviet Union, to Romania, wherever I went, I found a sense that we have taken charge of dealing with these problems and a sense of satisfaction, both publicly and privately, that we seem to be on the right track.

This regeneration of confidence in the dollar rests on the measures announced on November 1 and the reaffirmation by the President of his determination to exercise fiscal austerity. Let me repeat, that the President intends his 1980 budget to be tight with a deficit of $30 billion or less, and that a balanced budget is now a realistic goal for years thereafter.

Coordinated with this thrust on the fiscal side is increasing restraint being exercised by monetary policy. Monetary policy is a responsibility of the Federal Reserve and it should stay that way, but the administration has a view as to how it should be managed. That view is that monetary policy has to dovetail with tight fiscal policy. Monetary policies must be kept tight until inflation has been brought under control.

In concert, the major tools of economic stabilization will be used in support of the President's wage-price deceleration program to attack the causes, not just the symptoms, of inflation.

It is too early, of course, to see a reflection of recent policy actions in the statistics on inflation, but we have seen a change in the confidence exhibited in the financial markets. The stock market has recovered some of its October losses, as have the prices on long-term securities. In fact, though some short-term rates have risen nearly a full percentage point since the November 1 announcements, interest rates on long-term instruments have remained relatively unchanged. This suggests an improvement in inflationary expectations over the longer term.

Some apprehensions are being expressed that the program may become too effective and throw the economy into a recession. There are

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risks, to be sure; economic forecasting is at best an imprecise art. But certainly the risks of recession with the program are far less than the certainty of recession if inflation were allowed to accelerate unchecked. Indeed, the program we have launched is the best guarantee of avoiding recession.

Although recent inflation rates have been in or near the double-digit range, the economy remains fundamentally strong and in good balance. Real economic growth so far this year has been almost 4 percent, and there are few distortions in the composition of output.

Employment continues to grow at an exceptionally strong rate. The most recent data on retail sales show that consumers are still in a buying mood. Inventories remain in balance with sales. The flow of new orders for durable goods—particularly for nondefense capital goods—is high and order backlogs are rising.

Housing activities continue at a high rate of over 2 million new starts. The introduction of a new financial instrument, the money market certificate, has enabled thrift institutions to compete for funds and maintain the supply of funds in mortgage markets. Exports, particularly of manufactured goods, have been rising substantially while our imports, other than of petroleum, have been rising more slowly.

Mr. Reuss, these are not the symptoms of a sick economy unable to sustain momentum under the weight of fiscal and monetary restraint. Rather, these are the signs of a strong economy approaching the realistic limits of resource capacity which needs and can afford some moderation in pace. May I say here that I had an opportunity just last night to visit with a wide range of chief executives from major American corporations, who are in town for a meeting of the Business Council. While it is certainly an unscientific sampling procedure. I did my own private sample in talking to a good many of them as to their view on where their own business is and where it is going, and I must say that virtually uniformly these chief executives of major corporations in every area of economic activity, told me that business is good, that they are confident that the prospects are encouraging, that they read in the paper that certain forecasting organizations are forecasting a recession, but they cannot see it. They can't see it in the ring of the cash register and they can't see it in terms of incoming orders for capital goods. They can't see it in terms of the labor markets or in any other way.

I think that is somewhat encouraging in terms of the impact of these kinds of programs on the future of the economy.

The President, however, intends to bring inflation down and to keep it down. He realizes that this is the only sure way to maintain an increase in the standard of living for all Americans, especially the poor and the elderly who depend on fixed incomes. We cannot at this stage in the economy opt for growth at the expense of inflation. Restraint on the monetary and fiscal fronts must now be pursued to assure real growth later. Fortunately the economy is strong and able to stand the discipline required.

It is apparent that this commitment to responsible economic management is beginning to take hold. We are beginning to see a change in tone, a modification in expectations in the foreign exchange and domestic money markets. As the full realization of the extent of our

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measures and the degree of our determination to persevere spreads, I believe we will see further dollar strength in the markets.

In summary, Mr. Reuss, the response here and abroad to the measures announced November 1 has been very encouraging. The announcement has been interpreted rightfully as a signal that we are determined to deal effectively and decisively with inflation, which is our primary economic problem, and so maintain the strength of the dollar. That interpretation is correct. We are fully committed, we will persist as long as is necessary to control inflation. We will exercise tight budgetary restraint, maintain responsible monetary policies, implement effective wage-price guidelines and work for stable, orderly conditions in the foreign exchange markets.

This is the right way and the only way to achieve our basic economic goals.

Mr. Reuss, let me now turn to addressing some of the specific concerns which you have raised. The first involves our intervention objectives.

The shift in intervention practices announced on November 1 was aimed at correcting a particular situation. Our objective is to restore order and a climate in the exchange markets in which rates can respond to the economic fundamentals, in this case to the improved outlook for the fundamentals that underpin the dollar's value. We are not attempting to peg exchange rate or establish targets, or push the dollar beyond levels which reflect the fundamental economic and financial realities.

On the subject of the competitive position of U.S. exports, let me make one thing absolutely clear. There are those who feel that continuing decline in the dollar is good for trade. This is a dangerous misconception. The United States does not need to pursue dollar depreciation to buy market position. To have argued on October 30 or to argue now for more dollar depreciation as a way of correcting our trade deficit is a simplistic and nonsensical view that could force a collapse of an open capital and trading system. The administration firmly rejects such tactics.

Second, Mr. Reuss, you ask in the press release that announced these hearings why differentials in interest rates between the United States and other strong countries would be any more effective now than before in attracting capital. The answer lies in investor expectations about the future. The key to attracting investment is to offer investors a real rate of return. While nominal interest rates have been high in the United States, inflation has rendered them negative in real terms. If investors are being offered the promise of less inflation and a real return on their investments, it should be easier to attract the capital needed to finance our current account deficit.

Third, your staff has questioned the Treasury decision to issue $10 billion of foreign currency denominated bonds.

To reiterate, the Treasury did announce its intention to issue up to $10 billion in securities denominated in foreign currencies. The first of these issues—for DM2.5 to DM3 billion—will be issued tomorrow. In fact, the amount will be just slightly in excess of the equivalent of $1.6 billion. We plan a Swiss franc issue in January and we are also giving consideration to a yen denominated borrowing in Japan in 1979.

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It is important to realize that these securities are being issued only for the purpose of acquiring foreign currencies for the intervention effort. They are not intended as an effort to "mop up" unwanted dollars. They are being sold only to residents of the country issuing the currency in which the securities are denominated. We are seeking to minimize the extent to which purchasers switch out of dollars to effect these purchases.

There were important reasons for including foreign currency denominated securities in our package. The issuance of securities with, in case of DM, 3- to 4-year maturities, provides us with additional foreign currency resources, for a longer time period, and gives assurance to the market that the United States will not be pressured to reverse its intervention operations too soon because of its need to accumulate the foreign currencies needed to repay swaps. In addition, the issuance of these securities demonstrates that we are firmly committed to strengthening of the dollar over time and that we will use all means at our disposal.

With the issuance of foreign currency-denominated notes, there is the potential for exchange rate gains and losses. The calculation of the total "cost" of such borrowing must take into account the interest rate differential between domestic and foreign markets, as well as possible gains and losses because of exchange rate changes. Of course there is a risk. But the alternative cost to the economy of failing to move with adequate and comprehensive measures constituted an even greater risk. If you will permit me, this is a case of being penny-wise rather than pound-foolish. The importance of assembling a comprehensive and credible package to strengthen the dollar justifies the lesser risk we have assumed.

Finally, there is the question of the role played by the IMF in our November decision. The actions we took on November 1 were fully in keeping with our obligation "to assure orderly exchange arrangement and to promote a stable system of exchange rate * * *" by "fostering orderly economic growth with reasonable price stability." Since part of the November 1 package consisted of a reserve tranche drawing from the IMF and sales of SDR's, we, of course, discussed these plans with the Fund management prior to the announcement.

The U.S. program was also explained subsequently to the IMF Executive Board in connection with activation of the general arrangements to borrow (GAB) for financing part of the U.S. drawing. The proposal was supported by the IMF and the GAB participants. On December 13 the Board discussed the U.S. program in more detail, under IMF surveillance procedures, and expressed support for the U.S. action.

Mr. Reuss, you have also asked whether the IMF has undertaken to reduce the key currency status of the dollar. And questions have been raised as to whether reduction or elimination of the dollar's role as a reserve currency would remove pressure on the exchange rate and make domestic restraint less necessary.

Let me make two points. First, any such fundamental change in the international monetary system would have far-reaching effects on other parts of the system and could not be considered in isolation. Nor could such a restructuring of the system be simply mandated by the

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IMF. It would require detailed study and negotiation, looking toward arrangements that would be acceptable to all countries.

We would need to know what system we would be moving to before dismantling the one we have. There were extensive studies of possible changes in the monetary system earlier in this decade, many of which would have meant a sharply reduced reserve role for the dollar. Ultimately, none of these changes appeared practical or widely desired. I stress this point not because we are unwilling to consider change, but because the full implications of such change need to be recognized and assessed.

Second, the United States is going to be in difficulty if it continues to run an inflationary economy, regardless of the reserve role of the dollar, and no reform of the system can obviate the need for us to pursue policies of restraint to counter inflation, or to maintain a reasonably strong external position.

As international economic and financial relationships evolve, the role of the dollar can be expected to evolve to reflect changes in underlying economic realities. There is widespread agreement on progressive development of the SDR's role in the system, and other currencies may also take on a larger role. But such changes will come about gradually over an extended period of time and they must come about in an orderly manner.

As a practical matter, the dollar will continue to play an important role in international monetary relationships for the foreseeable future if the world is to continue to achieve growth and progress. Accordingly, it is our duty to manage the dollar in a manner which benefits its central role in the system. This is precisely what President Carter, Chairman Miller, and colleagues intend to do.

Thank you very much.

[The prepared statement of Secretary Blumenthal follows:]

Prepared Statement of Hon. W. Michael Blumenthal

INTRODUCTION

Mr. Chairman, it is a particular pleasure to appear here today to discuss the actions announced by the President, Chairman Miller and myself on November 1, 1978 to strengthen the dollar at home and abroad. The actions were taken in the context of persisting inflation and financial market conditions—domestic and international—which reflected doubts about the determination of this Administration to stop inflation and defend the value of the dollar.

Our actions should allay these doubts. We have committed the major tools of economic policy to the task of unwinding the inflation that has plagued us for the past decade. Let there be no mistaking our determination: there will be no waffling and no wavering. We intend to persist because controlling inflation is absolutely essential to the achievement of the social and economic goals which are at the core of President Carter's policies.

Obviously, the dramatic circumstances in which the November actions were taken should not overshadow the very important measures taken earlier to deal with our fundamental economic problems. Each of these measures must be seen as part of an integrated array of policies. Any one of them alone is not sufficient, but together I believe they do the job.

THE ECONOMIC SITUATION WE FACED IN OCTOBER

Even with the full force of economic policies addressing the inflation problem, it will not be an easy or a painless task to reduce inflationary pressures. Inflation has become deeply ingrained in our society, and in the expectation on which private sector decisions are based. And as inflation has persisted and accelerated,

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there is the threat of adding demand-pull pressures to the worst elements of cost-push forces.

In the early stages of recovery from the 1974–75 recession, the persistence of a high underlying rate of inflation, despite significant slack in resource utilization, reflected largely a pattern of wages-chasing-prices-chasing-wages. As the recovery from the recession continued, and as inflation persisted, an overall environment of inflationary expectations was fostered, with the expectation of further inflation distorting costs, prices, the structure of production, and decisions on saving and investment.

To the intensifying expectation of further inflation have been added some signs that real presures on resource availability may be emerging—scattered signs to be sure, but still troublesome. The economy has maintained strong momentum since the winter lull of 1977; real growth has averaged close to a 4 percent annual rate this year, and in some sectors of the labor market and in some industries, demands have begun to press on available resources. While the overall unemployment rate has remained close to 6 percent during much of the year, unemployment among skilled workers and others characterized as part of the "prime labor force" has declined. For example the unemployment rate for married men, at 2.5 percent, is not far above the rate during most previous periods of peak labor demand. Non-union wages have been rising more rapidly this year than unions wages, reflecting both the strength of demand factors in the labor market and the increased minimum wage. The employment rate (the ratio of people employed to the working age population) continues to rise.

While industrial capacity utilization overall has remained in the area of 85 percent—leaving some margin for expansion—capacity limits are approaching for some industries. Moreover, the official statistics may be overstating the extent of spare capacity that can be utilized in a cost-effective manner.

It has become increasingly clear that, in recent months, the economy has entered the zone of resource utilization within which demand pressures are more easily translated into rising prices. Thus, there is a danger of adding demand-pull to the existing cost pressures.

Moreover, the inflation has incorporated a new "feedback" mechanism: as the rise in domestic prices weakened the dollar, this has resulted in higher prices for imported goods and through an "umbrella effect," in higher prices for many domestic products competing with imports. Perhaps as much as one full percentage point of inflation this year reflects the effects of the depreciation of the dollar, and this has given the inflationary spiral a further turn.

The combination of inflationary expectations, emerging demand pressures and the domestic price effects of a weakening dollar have been reflected in an acceleration in the underlying rate of inflation. Over the past three months, wholesale prices rose at about 10½ percent annual rate; even excluding food, the rate was near 8 percent. Consumer prices rose at nearly a 9 percent rate in the last three months, at a 9½ percent annual rate excluding food. The growing pessimism about inflationary prospects was reflected in financial markets. Stock prices fell precipitously in the last two weeks of October, and prices of long-term debt instruments also declined.

In the foreign exchange market, severe and persistent disorder and excessive declines in the dollar were undermining our efforts to control inflation and were adversely affecting the climate for continued investment and growth in the United States. In the month of October the dollar declined sharply against virtually all major currencies. The dollar fell against the Swiss franc by 6 percent, the Japanese yen by 7 percent, and the German mark by 12 percent. The trade-weighted dollar fell by 8 percent. All told, in the 13 months preceding the November 1 initiative the dollar had fallen 38 percent against the Swiss franc, 34 percent against the yen and 26 percent against the DM.

As November approached, it became clear that the market was failing to take account of the improvements that were being made in the underlying conditions that determine the dollar's value. The Administration had inherited a budget deficit of over $66 billion in 1976 or roughly 4.4 percent of GNP; it was paring the budget for 1980 to $30 billion or below, roughly 1 percent of GNP. Energy legislation had been passed which would result in savings of at least 500,000 barrels per day by 1979 from levels that might otherwise be expected. The volume of trade flows had begun to reflect improvements in our competitive position. The trade balance of the United States had receded to a $31 billion annual rate in the second and third quarters of the year from a $45 billion rate in the

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first and was heading further down. The nation's surplus on investment income and other service transactions had grown sharply. The outlook for the current account was dramatically improved, allowing us to predict with confidence that it would drop by 50 to 60 percent from the $17 billion in 1978 to as little as $6 billion in 1979. And to reinforce these trends the President had instituted a determined anti-inflation program and an enhanced national export effort. Yet the dollar continued to be sold. The psychology of the market during the month of October was such that these favorable developments in underlying economic conditions, and Administration statements reaffirming its determination to follow through on our anti-inflation program, were unable to halt a wave of pessimism about the prospects for the dollar.

The consequences of a continued deterioration of the dollar were grim. The precipitous decline of the dollar threatened to erode our anti-inflation effort. Foreign official and private portfolio managers were already showing signs of selling off U.S. securities and would have been tempted to sell more, further disrupting the stock and bond markets. Dollar holders abroad would have been encouraged to sell more of their outstanding dollar holdings for assets denominated in other currencies. The OPEC countries would have been pressured to substantially raise oil prices to recoup excessive dollar losses. The world economy—indeed, the whole world financial system—would have been impaired—and with it, the economy of the United States. The leadership of this nation in world affairs, political as well as economic, would have been severely damaged.

We could not tolerate this situation. Firm action was needed to strengthen the dollar both at home and abroad.

OUR NOVEMBER 1 ACTIONS

Thus, on November 1 we took the direct and forceful measures that were needed. You are familiar with the specific measures announced on that date. They entailed:

A $3 billion increase in reserve requirements on large certificates of deposit and a rise in the discount rate by a full 1 percent;

An increase in Treasury's monthly sales of gold to at least 1½ million ounces per month, starting with this month's auction;

A decision to join with Germany, Switzerland and Japan in closely coordinated exchange market intervention;

The mobilization of $30 billion in DM, Swiss francs and yen to finance that portion of the intervention undertaken by U.S. authorities.

The U.S. financing involves an approximate doubling of Federal Reserve swap lines with the central banks of Japan, Germany and Switzerland, to a total of $15 billion; U.S. drawings on the IMF of $3 billion; U.S. sales of about $2 billion of Special Drawing Rights; and issuance by the Treasury of foreign currency denominated securities in amounts up to $10 million.

Most of the foreign currency resources have already been mobilized. The increase in the central bank swap lines took effect immediately on announcement. Drawings on the IMF in Deutsche Marks and Japanese yen amounting to the equivalent of $2 billion and $1 billion were made on November 6 and 9. We sold about $1.4 billion equivalent in SDR's for Deutsche Marks and yen on November 24. The first tranche of DM-denominated securities, about $1¼ to 1½ billion will be issued tomorrow.

By so massing a sizable and broad reaching pool of resources, we intend to signal to the world that the dollar had been pushed too far and that the U.S. authorities were determined to correct the situation.

THE RESULTS OF OUR MEASURES

Mr. Chairman, reaction to our measures has been good. I believe there is a realization among governments and in the financial community as well as in the general public, that the U.S. government is determined to deal effectively and decisively with our economic problems—that we will act to bring inflation under control; that we will strengthen the dollar at home and abroad.

This regeneration of confidence in the dollar rests on the measures announced November 1 and on the reaffirmation by the President of his determination to exercise fiscal austerity. Let me repeat that the President intends his 1980 budget to be tight, with a deficit of $30 billion or less. A balanced budget is now a realistic goal for the years thereafter.

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Coordinated with this thrust on the fiscal side is the increasing restraint being exercised by monetary policy. Monetary policy is the responsibility of the Federal Reserve and it should stay that way. But the Administration has a view as to how it should be managed. Let me make clear our view. It is that monetary policy has to dovetail with tight fiscal policy. Monetary policy must be kept tight until inflation has been brought under control. In concert, the major tools of economic stabilization will be used in support of the President's wage-price deceleration program to attack the causes, not just the symptoms of inflation.

It is too early, of course, to see a reflection of recent policy actions in the statistics on inflation. But we have seen a change in the confidence exhibited in financial market behavior. The stock market has recovered some of its October losses, as have the prices of long-term securities. In fact, though some short-term rates have risen nearly a full percentage point since the November 1 announcement, interest rates on long-term instruments have remained relatively unchanged. This suggests an improvement in inflationary expectations over the longer term.

Some apprehension is being expressed that the program may become *too* effective and throw the economy into recession. There are risks to be sure—economic forecasting is at best an imprecise art—but certainly the risks of recession *with* the program are far less than the *certainty* of recession if inflation were allowed to accelerate unchecked. Indeed, the program we have launched is the best guarantee for avoiding recession.

Although recent inflation rates have been in, or near, the double-digit range, the economy retains fundamental strength and good balance. Real economic growth so far this year has been almost 4 percent and there are few distortions in the composition of output. Employment continues to grow at an exceptionally strong rate. The most recent data on retail sales show that consumers are still in a buying mood. Inventories remain in good balance with sales. The flow of new orders for durable goods—particularly for nondefense capital goods—is high and order backlogs are rising. Housing activity continues at a high rate of over 2 million new starts; the introduction of a new financial instrument—the money market certificate—has enabled thrift institutions to compete for funds and maintain the supply of funds in mortgage markets. Our exports, particularly of manufactured goods, have been rising substantially while our imports—other than of petroleum—have risen more slowly.

These are not the symptoms of a sick economy, unable to sustain momentum under the weight of fiscal and monetary restraint. Rather, these are signs of a strong economy approaching the realistic limits of resource capacity which needs and can afford some moderation in pace.

The President intends to bring inflation down and keep it down. He realizes that this is the only sure way to maintain and increase the standard of living for all Americans, especially the poor and the elderly who depend on fixed incomes. We cannot at this stage in the economy opt for growth at the expense of inflation. Restraint on the monetary and fiscal fronts now must be pursued to assure real growth later. Fortunately the economy is strong and able to withstand the discipline that is required.

It is apparent that this commitment to responsible economic management is beginning to take hold. We are beginning to see a change in tone, a modification in expectations in the foreign exchange and domestic money markets. As the full realization of the extent of our measures and the degree of our determination to persevere spreads, I believe we will see further dollar strength in the markets.

In summary, Mr. Chairman, the response here and abroad to the measures announced November 1 has been very encouraging. The announcement has been interpreted rightfully as a signal that we are determined to deal effectively and decisively with the inflation which is our primary economic problem and to maintaining the strength of the dollar. That interpretation is correct. We are fully committeed. We will persist as long as is necessary to control inflation. We will exercise tight budgetary restraint, maintain responsible domestic monetary policies, implement effective wage-price guidelines, and work for stable, orderly conditions in the foreign exchange markets. This is the right way, and the only way, to achieve our basic economic goals.

Mr. Chairman, let me now turn to addressing some specific concerns.

The first involves our intervention objectives.

The shift in intervention practices announced on November 1 was aimed at correcting a particular situation. Our objective is to restore order and a climate in the exchange markets in which rates can respond to the economic funda-

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On the subject of the competitive position of U.S. exports, let me make one thing absolutely clear. There are those who feel that continuing decline in the dollar is good for trade. This is a dangerous misconception. The United States does not need to pursue dollar depreciation to buy market position. To have argued on October 30 or to argue now for more dollar depreciation as a way of correcting our trade deficit is a simplistic and nonsensical view that could force a collapse of an open capital and trading system. The Administration firmly rejects such tactics.

Second, Mr. Chairman, you ask in the press release that announce these hearings why differentials in interest rates between the U.S. and other strong countries would be any more effective now than before in attracting capital. The answer lies in investor expectations about the future. The key to attracting investment is to offer investors a real rate of return. While nominal interest rates have been high in the United States, inflation has rendered them negative in real terms. If investors are being offered the promise of less inflation and a real return on their investments, it should be easier to attract the capital needed to finance our current account deficit.

Third, your staff has questioned the Treasury decision to issue $10 billion of foreign currency denominated bonds.

To reiterate, the Treasury did announce its intention to issue up to $10 billion in securities denominated in foreign currencies. The first of these issues—for 2½ to 3 billion DM—will be issued tomorrow. We plan a Swiss franc issue in January and we are also giving consideration to a yen denominated borrowing in Japan in 1979.

It is important to realize that these securities are being issued only for the purpose of acquiring foreign currencies for the intervention effort. They are not intended as an effort to "mop up" unwanted dollars. They are being sold only to residents of the country issuing the currency in which the securities are denominated. We are seeking to minimize the extent to which purchasers switch out of dollars to effect these purchases.

There were important reasons for including foreign currency denominated securities in our package. The issuance of securities with, in case of DM, three to four year maturities, provides us with additional foreign currency resources, for a longer time period, and gives assurance to the market that the United States will not be pressured to reverse its intervention operations too soon because of its need to accumulate the foreign currencies needed to repay swaps. In addition, the issuance of these securities demonstrates that we are firmly committed to strengthening of the dollar over time and that we will use all means at our disposal.

With the issuance of foreign currency-denominated notes, there is the potential for exchange rate gains and losses. The calculation of the total "cost" of such borrowing must take into account the interest rate differential between domestic and foreign markets, as well as possible gains and losses because of exchange rate changes. Of course there is a risk. But the alternative cost to the economy of failing to move with adequate and comprehensive measures constituted an even greater risk. If you will permit me Mr. Chairman, this is a case of being penny-wise rather than pound-foolish. The importance of assembling a comprehensive and credible package to strengthen the dollar justifies the lesser risk we have assumed.

Finally, there is the question of the role played by the IMF in our November decision. The actions we took on November 1 were fully in keeping with our obligation "to assure orderly exchange arrangement and to promote a stable system of exchange rate * * *" by "fostering orderly economic growth with reasonable price stability." Since part of the November 1 package consisted of a reserve tranche drawing from the IMF and sales of SDRs, we of course discussed these plans with the Fund management prior to the announcement. The U.S. program was also explained subsequently to the IMF Executive Board in connection with activation of the General Arrangements to Borrow (GAB) for financing part of the U.S. drawing. The proposal was supported by the IMF and the GAB participants. On December 13 the Board discussed the U.S. program in more detail, under IMF surveillance procedures, and expressed support for the U.S. action.

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Mr. Chairman, you have also asked whether the IMF has undertaken to reduce the key currency status of the dollar. And questions have been raised as to whether reduction or elimination of the dollar's role as a reserve currency would remove pressure on the exchange rate and make domestic restraint less necessary.

Let me make two points. First, any such fundamental change in the international monetary system would have far-reaching effects on other parts of the system and could not be considered in isolation. Nor could such a restructuring of the system be simply mandated by the IMF—it would require detailed study and negotiation, looking toward arrangements that would be acceptable to all countries. We would need to know what system we would be moving to before dismantling the one we have. There were extensive studies of possible changes in the monetary system earlier in this decade, many of which would have meant a sharply reduced reserve role for the dollar. Ultimately, none of these changes appeared practical or widely desired. I stress this point not because we are unwilling to consider change but because the full implications of such change need to be recognized and assessed.

Second, the United States is going to be in difficulty if it continues to run an inflationary economy, regardless of the reserve of the dollar, and no reform of the system can obviate the need for us to pursue policies of restraint to counter inflation, or to maintain a reasonably strong external position.

As international economic and financial relationships evolve, the role of the dollar can be expected to evolve to reflect changes in underlying economic realities. There is widespread agreement on progressive development of the SDR's role in the system, and other currencies may also take on a larger role. But such changes will come about gradually over an extended period of time and they must come about in an orderly manner. As a practical matter, the dollar will continue to play an important role in international monetary relationships for the foreseeable future if the world is to continue to achieve growth and progress. Accordingly, it is our duty to manage the dollar in a manner which befits its central role in the system. This is precisely what President Carter, Chairman Miller and I intend to do.

Representative Reuss. Thank you, Secretary Blumenthal, for a very incisive and helpful statement.

We will now proceed under the 10-minute rule.

Until very recently, the U.S. scenario for our international monetary troubles was to say to the Germans and Japanese, "Why don't we all have a forward moving growth rate, and why don't you two fellows grow a little more" which they, in general, agreed to do. But quite recently, Prime Minister Elect Ohira of Japan said that there won't be any increased stimulus measures for 1979, which constitutes a departure from their growth targets; and OECD has disclosed that Germany is unlikely to reach its targeted growth rate.

Now we come along and say—I am not saying this is right or wrong, just what is happening—we come along and say, OK, we are going to pursue austerity and check our growth rate in order to get a grip on inflation at home and a wobbling dollar abroad.

Does this not mean, in effect, that the three great industrial powers have gone from a "let's all grow" policy, to a let's all—I won't say stagnate—but "let's all grow a lot less" policy?

Secretary Blumenthal. I don't believe so, Mr. Reuss. The Japanese indicated in Bonn at the summit meeting that they were setting a rate of 7 percent for growth in real terms, which, of course, is very, very fast. They will not, as I understand it, reach that target.

Our estimate is that they may reach 5 or 5½ percent in real terms; 5 or 5⅕ percent is not, by my definition, "stagnation." I think it is a positive and substantial rate of growth.

Now, our concern is that it isn't fast enough to help in correcting the imbalances that have existed internationally. That is why we wel-

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comed the goal of 7 percent. But certainly even a shortfall from that is not really an example of stagnation.

Similarly, the Germans are expecting in 1979 a real rate of growth of almost 4 percent, and compared to the stagnating level of German economic activity a year ago, that, too, represents an encouraging trend in the right direction.

As to the United States, we had been growing very rapidly. As you know, we came out of the worldwide recession, more quickly than the others in an earlier period. We are slowing down and we should slow down, in order to deal with this inflation problem because if we don't deal with it now, we are going to have a worse situation on our hands later and will really then have the risk of a recession substantially increased.

So, I would say what has happened is that there has been a change in the pattern. We were growing faster, the other two countries were growing more slowly. Now the other countries are accelerating and we are slowing down and that will be one of the reasons why the external situation is likely to be much more favorable to exchange markets.

Representative Reuss. Thank you.

In response to our question about our Government's intention with respect to intervention in foreign exchange markets, you give a very clear answer in your statement: "We are not attempting to peg exchange rates or establish targets or push the dollar beyond levels which reflect the fundamental economic and financial realities."

And you also state, "Our objective is to restore order and a climate in the exchange markets in which rates can respond to the economic fundamentals."

I find that an admirable statement. My question is: As a result of the November 1 program, have we now reached approximately those levels?

Secretary Blumenthal. This is a delicate area, for the one thing one must not do is to be too precise in public about that kind of situation because it is almost certain to be misunderstood or misinterpreted.

Certainly there has been much less disorder and speculation and chaos in the markets than prior to November 1, and we have been encouraged by the upward movement in the value of the dollar from the levels that had been reached, which were totally unrelated to underlying realities.

We will watch the situation carefully, but I don't think it would be fruitful for me to indicate whether a particular level at a particular point of time is the right level.

We have a system in which movement will occur; I have indicated that we think the American economy is strong and healthy. I have indicated the improvements in our external accounts and the strong measures being taken domestically on inflation.

I think these are all factors that indicate strength of the economy, and I think the markets will reflect that.

Representative Reuss. Mr. Secretary, in my communications with you prior to the hearing I indicated my vigorous support for the idea of getting started right now on some kind of a substitution account in the International Monetary Fund so that central banks aren't so almost exclusively dependent on the dollar as key currency. The sub-

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stitution account is not, in heaven's name, intended to replace the dollar, but to take some small part of the $700 billion overhang, or whatever amount it is, out of the market if that is what people want to do with it.

You very forthrightly answered toward the end of your statement that you were not favorably disposed toward the idea, which is quite consistent with what the Treasury has been saying in Mexico City and other places. Since this is likely to be the subject of an ongoing and friendly debate between us, let me make sure that I am not being misunderstood, and I am not sure that I am being understood correctly.

In your prepared statement you say, speaking about the points I have raised, "Questions have been raised as to whether reduction or elimination of the dollar's role as the reserve currency"—let me be clear, I am talking about a reduction, not an elimination, God forbid—"would remove pressure on the exchange rate and make domestic restraint less necessary."

Well, that is just the opposite of what I have in mind. What worries me about the present system is that, as must be evident to all of us, there is precious little domestic restraint. We are in the enviable position enjoyed by no other country in world history so far as I know of being able to print dollars thereby enabling us to live beyond our means and invest abroad beyond our means.

The removal of what DeGaulle called the exorbitant privilege, or at least partial removal of it, would, I should think, impose a very sensible restraint on us.

So I am hopeful that the discussion could proceed clearly in the recognition that there are those of us who think it would be a good thing for this country to put before the people at Guadalupe, the people at the IMF, and so on, the idea that we are quite willing, and wouldn't have our noses bent out of joint one bit to accept an international SDR-type, ECU-type currency, as a partial replacement for the dollar. We think that that wouldn't be a bad idea at all.

The suggestion of a substitution account is not advanced by me as a method of making domestic economic monkeyshines easy; I want to make them more difficult.

Secretary BLUMENTHAL. If I could make a few comments, Mr. Reuss. I would begin by saying that the goal of making domestic economic monkeyshines as difficult as possible is one that you and I share, and I suspect that my good friend and colleague, Chairman Schultze, who has just arrived, would enthusiastically endorse that goal as well.

I think first of all the foreign dollar holdings—the so-called overhang—is in itself such a massive number that it tends to obscure the underlying facts. I think it is important to bear those in mind. Also, the $700 billion figure for the eurocurrency market is a gross figure; it is not a net figure.

We estimate that roughly half of that represents obligations owed by some foreign entities to other foreign entities or individuals.

We further estimate that the remaining $300 billion, which are amounts owed by Americans to foreigners, is offset by an amount somewhat greater of claims by Americans on foreigners, albeit in less liquid form.

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Second, I think the point needs to be made that it is not the overhang which is causing or has caused in the past the instability of the dollar and the decline of the dollar unrelated to the fundamentals and the chaotic conditions that were created. The owners of those resources react in the same way as you and I would react, and that is they react in terms of their expectations as to the fundamentals of the U.S. economy.

If they see us acting responsibly domestically, following the kind of economic policies that I have described this administration is following, then the fact that there is this free international capital market out there is not really a deterrent.

If they see us with the deteriorating situation—declining current account, a declining trade balance, inflation rising, and the United States pursuing a policy of growth-come-what-may—there is going to be trouble for us whether you have 300, 500, or 700 out there, or whether you have no overhang out there.

Now, as to the substitution account, itself, central banks—which under that proposal, as I understand it, would be exchanging dollars for SDR's—represent a relatively small cause of the volatility in the exchange markets in the past.

The far greater reason for that volatility is the private dollar holdings and not the central bank or the official ones.

So the substitution account in and of itself would not really deal with the volatility question either.

Having said that and bearing in mind that we want to have an open world capital market and that the United States is a big factor in the system, we do not object to an orderly evolution; in fact, we favor, as you do, an orderly evolution of the international monetary system in a direction that may, over time, lead to a decreased role of the dollar as the central currency in the world.

We do believe that this is not something that can be ordained. We do believe that that is something that countries can't get around and make a decision on and then will it.

Given the size and importance of the United States in the world. this is something that has to evolve over time. We are not stonewalling this; we are not trying to prevent it. We merely recognize that for a long time to come we will have to play a central role, the dollar will continue to be very important, and that we have to conduct ourselves domestically and internationally, and in an interrelated way, accordingly.

Representative REUSS. My time is up, and I am slightly more encouraged by what you just said.

I would add to that that I can't see a better way of getting foreign monetary authorities more relaxed than to express a willingness to consider some method whereby, if they wish, they could diversify some of their risk and not be in a position where their rewards for being good soldiers for holding dollars is that the dollar did that which it did last August, September, and October, when a lot of central banks sustained very discombobulating-looking paper losses. Some more on this later.

Congressman Brown.

Representative BROWN of Ohio. Thank you, Mr. Reuss.

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Mr. Secretary, I am not sure that you can please both Mr. Reuss and me this morning because I am one who believes that we may have to take a little bit of a bruising next year in order to avoid a catastrophe that may just flatten us out atlogether later on.

I would like to talk about the psychological factors here for just a minute.

You know we were told by the President earlier this fall—and I guess others in the administration—that if we passed an energy bill the problems of the dollar would be largely resolved, and we passed that energy bill of October 15, and during the next week the dollar collapsed somewhat more rapidly than it had previously.

Then we were told that if we just simply put in voluntary wage and price controls, he told us that on October 24, that that would resolve the problem, and in the week that followed that first speech on voluntary wage and price controls the dollar collapsed at a record rate.

It wasn't until you took the steps on November 1—am I correct—that this thing really began to turn around?

Secretary BLUMENTHAL. Yes.

Representative BROWN of Ohio. So the original information in your statement was incorrect; right?

Secretary BLUMENTHAL. No; that the dollar began to appreciate after November 1 is correct. But the original information was not correct.

In the first place, sir, I don't really believe anyone said that if Congress passes the energy bill the problem of the dollar would be largely resolved. I certainly never said that. I don't recall——

Representative BROWN of Ohio. I think a lot of chief executive officers who called early in August to discuss whether there should be an energy bill——

Secretary BLUMENTHAL. I think what we said and what I continue to believe to be the case is that, first of all, failure to pass the energy bill would have had a very serious additional negative consequence on foreign exchange markets.

Second, that passing the energy bill and thus bringing about a reduction both immediate and eventually even greater in the foreign exchange resources needed to import oil into this country, will be a positive factor. It will be one of the pluses, but certainly not that that would resolve the dollar situation.

Representative BROWN of Ohio. Let's talk about a couple of the other psychological factors.

You mentioned there was a $66 billion deficit in 1976, the year in which we were recovering from perhaps the worst recession that the country has experienced since the thirties. And I recall that President Ford recommended a deficit figure of about $45 billion for 1977.

Could you tell me what President Carter recommended that year?

Secretary BLUMENTHAL. For 1977 the deficit, if I remember correctly, was $44 billion.

Representative BROWN of Ohio. But President Carter recommended 58, as I recall.

Secretary BLUMENTHAL. The original budget was higher because at that point we had an 8-percent rate of unemployment in the United

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States, we had a situation developing in which it looked as if the economy would be in increasing difficulty. The stimulus program that the President then initiated resulted in a reduction of unemployment from 8 percent to 5.8 percent. When he saw that there was additional strength in the economy, he reduced the budget by virtue of asking the Congress to cancel the idea of the then-discussed $50 rebate.

And, by virtue of these decisions which President Carter made, we came in with a budget deficit that was slightly below what had been recommended by President Ford just before leaving office.

Representative BROWN of Ohio. And as another factor, bureaucracy couldn't spend the money fast enough, as I recall, they had a shortfall in spending.

In 1978 what deficit was recommended?

Secretary BLUMENTHAL. Well, that's been true for some time, it's either that they couldn't spend it or that they overestimated.

Representative BROWN of Ohio. What was the recommendation for deficit by the administration in 1978?

Secretary BLUMENTHAL. In 1978 the recommended deficit, I believe, was $60 billion.

Mr. SCHULTZE. $61, or $60 to $61 billion.

Representative BROWN of Ohio. So, we wound up recommending the same high-level deficits that we had, and the dollar began to deteriorate.

Now, unfortunately, we didn't achieve those deficits, and I guess for their benefit fortunately the Germans and the Japanese didn't buy off on our suggestion that they try to inflate their economies in the same pattern that we were following.

Let me turn to a comment in the opening statement of the chairman:

> We can intervene until our cupboard is bare—and go further in debt to get the marks and yen with which to intervene—yet not really rescue the dollar, especially if there is a $700 billion overhang in the Eurodollar market.

I have heard that figure described to be anywhere from $400 to $700 billion. I have been using $600 billion. Do you have any idea what actually is correct?

Secretary BLUMENTHAL. I think $600 or $700 billion for the Eurocurrency market, on a gross basis, is probably accurate. Since it is an open market, nobody can tell for sure.

Representative BROWN of Ohio. Let's talk about some of the steps that were taken on November 1.

With reference to the sale of gold, aren't we really putting ourselves a little bit in the position of the farmer who is selling off some of his land or seed corn? Perhaps not quite that, but at least he is selling off the woodlot principle in order to sustain the situation for a while? Isn't that about right?

Secretary BLUMENTHAL. I don't really think so. We have, I believe, 275 million ounces of gold. We have been importing gold into the United States. We are thus using some of our own gold and selling it, instead of importing. That has a positive impact on our balance of trade, our current account. That strengthens the dollar. I think that is a sensible policy. It's utilizing an asset to substitute what we would otherwise be paying out in the way of importing gold.

Representative BROWN of Ohio. So we are paying with assets, in effect, rather than income?

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Secretary BLUMENTHAL. Well, we have all ranges of resources.

Representative BROWN of Ohio. We have to because we don't have the income to pay with. Isn't that essentially correct?

Secretary BLUMENTHAL. It's always open to us to use our resources. You can say the same thing for the drawing on our reserve position in the IMF. It's there for that purpose.

Representative BROWN of Ohio. Let me go to that, to the mobilization of the $30 billion and so forth. Aren't we, in effect, like the person who has made credit purchases and has to refinance at the bank? Aren't we, in effect, merely putting off the day of reckoning by some of these other steps, those which you have described in your prepared statement? Aren't those merely refinancing methods?

I refer to:

> * * * a decision to join with Germany, Switzerland, and Japan in closely coordinated exchange market intervention; * * * the mobilization of $30 billion in deutsche mark, Swiss francs and yen to finance that portion of the intervention undertaken by U.S. authorities.
>
> The U.S. financing involves an approximate doubling of Federal Reserve swap lines.

Now, I have been told that the Federal Reserve staff suggests that when we swap currencies with Germany, the Germans to some extent use the dollars to buy Treasury bills and then the Treasury spends the dollars.

So they go right back into circulation.

Isn't it true that the swap arrangements are used only to handle disorderly trading of dollars and that the real longrun condition of the dollar depends on the monetary policies of the Federal Reserve System?

Secretary BLUMENTHAL. The real longrun condition of the dollar, you are quite right, depends on the fundamental conditions and outlook for the U.S. economy, which involves, of course, monetary policy, fiscal policy, overall economic policies, and policies related to the dollar.

As I indicate in my prepared statement, there is a close interrelationship between these policies. The particular measures to which you refer and which are listed in my prepared statement are part of an integrated program.

They are designed to stabilize the currency and reduce the inflationary impact of a declining dollar, as tight fiscal and monetary policy works within these United States.

Representative BROWN of Ohio. Now, the other day Alan Greenspan and Michael Evans of Chase Econometrics appeared before the Joint Economic Committee and said we would be very lucky to hold the deficit next year, even if the President sets the $30 billion target, to $50 billion.

I agree our fiscal policy is very important, our monetary policy perhaps even more important. My concern is that, if in fact we have any kind of a recession, that you will not have the inflow into the Treasury of dollars that you might otherwise have anticipated and that that $30 billion deficit could grow to $50 billion. Indicators are currently not good.

We are only going to get that capital investment that will level out the recession if the Government doesn't crowd out credit or if the high

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cost of money isn't such a great disincentive to private investors that they decide that they don't want to borrow at these rates.

The real interest is quite low—the nominal rates are boosted by inflation—and I am concerned you will not get a boom in the economy next year if we have a heavy fiscal deficit and a tightening of the money supply by the Federal Reserve System.

Now, would you reassure me that you are going to hold that deficit to $30 billion and that the Federal Reserve System is really going to tighten up on the money supply?

Secretary BLUMENTHAL. Well, Representative Brown, obviously on the latter point——

Representative BROWN of Ohio. There are a lot of increased taxes to pay, too, social security taxes and others.

Secretary BLUMENTHAL. I understand. Obviously on the latter point I believe you are going to have Chairman Miller here, and I think you would probably be best advised to address that latter question to him because that is squarely in his responsibility.

As to the $30 billion deficit in the budget, it is the President's full intention to submit a realistic budget that has a deficit no larger and possibly, if at all possible, below $30 billion.

Now, clearly that is based on certain assumptions as to what will happen with economic activity in the United States.

I wouldn't be concerned about crowding out. With a budget deficit of the kind that we have indicated, which is around 1 percent of GNP, as compared to what we had in the last several years when we were at 2, 3, 4 percent, or more, of GNP, we are in really good shape.

Second, the borrowing abroad that we are doing—because of the way in which we are handling the operation—actually relieves pressure on the U.S. capital markets. There is a further positive factor because we borrow in deutschemarks and have an arrangement between the Federal Reserve and the Bundesbank which will allow us to reduce the dollar borrowing we do in this country.

Now, the basic assumption under which we operate is that the economy will not go into recession. We do not see, and I think I tried to indicate that clearly in my prepared statement, at this point any of the signs that lead to two or more successive quarters of negative growth which is the generally accepted definition of a recession.

We don't see a boost in the economy as you see it; we see a slowing down of the rate of growth next year somewhere between 2 and 3 percent in real terms, and we think that that is appropriate to the circumstances.

Under those conditions and with a rate of inflation that begins to slow as the year progresses, the impact of tight monetary and fiscal policy and of the voluntary wage and price guidelines, we will have this kind of deficit.

Now, if you say, "Well, this is not what is going to happen, you are going to have a recession, you are going to have a different inflation situation, you are going to have a different import situation," then obviously the administration and the Federal Reserve will have to act and react in the light of these changing circumstances.

We don't expect those to happen. That is all we can tell you.

Representative REUSS. Thank you.

Representative Hamilton.

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Representative HAMILTON. Mr. Secretary, the President on a number of occasions has indicated his opposition to mandatory wage and price controls. I think you probably have, too.

Does the administration have under consideration at the present time submitting to the Congress a bill to permit the President to impose mandatory price and wage controls?

Secretary BLUMENTHAL. Absolutely not.

Representative HAMILTON. You say in your prepared statement, Mr. Secretary, that with regard to the fight against inflation there will be no waffling or wavering.

The paper this morning reports that the wage and price guidelines are going to be altered again. Apparently one of the reasons those wage guidelines are going to be altered is to relax the pay standards with regard to fringe benefits.

There has been a lot of speculation that maybe one of the reasons that that's being done is because of some of the negotiations that are coming up, specifically negotiations relating to the Teamsters.

I appreciate your statement that there will be no waffling or wavering. But doesn't it appear that you are wavering or waffling when you announce a further guideline and within a few weeks thereafter you begin to make changes in that guideline because of specific circumstances?

Secretary BLUMENTHAL. Mr. Hamilton, let me put it this way: In the first place, the fight against inflation is being conducted by the President, and this administration, through an integrated interrelated program. The fiscal policies and monetary policies that we have discussed earlier this morning are a key part of that, just as key a part as are the wage and price guidelines and the dollar policies that the President announced on November 1 are a key part of that.

So we have a total program. Now, as to the one part that you have raised a question about, we made it very clear that what we announced originally were suggested guidelines out for comment.

What is the purpose of comment if not to receive it and to evaluate it and to use that information intelligently.

We are not omniscient. I certainly, as a businessman, found sitting on the other side that Government bureaucrats were anything but all-knowing in these matters and, with the best of intentions, do not always find it possible initially to anticipate all of the technical complications that can arise.

Representative HAMILTON. Would that suggest, Mr. Secretary, then, that we will see a series of changes in the presently announced wage and price guidelines? Are we going to see changes every couple of weeks or couple of months?

Secretary BLUMENTHAL. No; definitely not.

Representative HAMILTON. Do we now have a firm set of guidelines that you would not expect to be altered?

Secretary BLUMENTHAL. We have a firm set of guidelines. It may be that over time as we gain experience with them and actually implement them in the course of the next year that there might be conditions and circumstances that change, which require some further amendment to them, but these guidelines that are now announced are the final ones; they reflect the results of the consultations that have been conducted. And let me make one final point.

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It is not a loosening; they do not represent a loosening. They represent in some instances an introduction of greater flexibility and in other instances a greater tightening.

I suggest if you want to go into the details of that, that Mr. Schultze will be glad to respond because he has been spending more time on details of it than I have and can speak well to it.

But basically I don't see this as a weakening of the standards, and I am not at all apologetic that we put them out for consultation and then made the adjustment before we put the final ones in.

Representative HAMILTON. OK. I want to get clear then, you now view these as final as they are presently constituted and that the 7-percent guideline as originally announced was a proposal; is that correct? And not a final guideline? Is that your interpretation?

Secretary BLUMENTHAL. That still has not changed. Those numbers have not changed. It is the interpretation—the definitions that——

Representative HAMILTON. I just want to get clear what your frame of mind is. You now view the guidelines as final and we will not see in the coming immediate weeks any way alterations in those guidelines?

Secretary BLUMENTHAL. That is correct.

That is my expectation.

Representative HAMILTON. Where did the 7 percent come from?

How did you arrive at that figure, just as a matter of my own curiosity? I don't know the basis of it.

Secretary BLUMENTHAL. Mr. Schultze is here, and he has been working with the details of it. I think I can do it, but he can do it better.

Representative HAMILTON. It doesn't matter who responds.

Mr. SCHULTZE. Essentially the 7-percent guideline on wages represents a moderate deceleration from the rate of wage increase, wage and fringe increase, which the economy is experiencing this year, and which—taking wages and private fringes—is something on the order of magnitude of 8 to 8.5 percent, depending on exactly how you measure. It is a number chosen on the one hand not to be unrealistic.

We have had 10 years of inflation and this is now a question of unwinding it gradually. At the same time the standard must be large enough to represent significant progress.

Now, why 7 percent instead of 6.75 or 7.25? There is no magic to that. But it does represent a balance between wanting to make pay increases significantly lower, but not adopting a numerical standard so low as to make it impossible to have any chances of success.

Second, as the Secretary points out to me, it is carefully related to the price guideline where in the price area our basic core standard is deceleration of 0.5 percent below the rate of price increase in 1976 and 1977. If you compare the two, they are consistent. That is, the rate of decrease in wages and fringes and the rate of decrease in prices on the average—not for firm, but on the average—are quite compatible.

Representative HAMILTON. Now the Secretary said he did not view the announcement yesterday as any kind of relaxation of the guidelines, I think he said. But you do permit, do you not, an extra allowance in there for the cost of health care benefits in these contracts and pensions under the new guidelines, the altered guidelines as announced yesterday, and is that not a relaxation?

Mr. SCHULTZE. In that particular part of it it is. Let me put that in context.

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While there are a number of detailed changes, the three large ones, two of them relate to pay and one to price, in the case of the pay standards what we are allowing is any excess over 7 percent in simply maintaining the cost of existing health benefits. That is, any improvement in benefits has to be charged against the standards. It is only the excess of the cost of maintaining current benefits because of medical costs, inflation over 7.

Representative HAMILTON. What does that do to your 7 percent? Doesn't it jack it up a little bit?

Mr. SCHULTZE. That, plus what is also done in the case of actuarially required changes in pensions. We estimate that the two together would add about one-tenth to two-tenths of 1 percent to the pay package nationwide. Conversely, we have tightened up the price standard and while you can't figure exactly what that is going to mean, the changes should be roughly offsetting. So these changes, in essence, provide additional flexibility. They improve the standards, but on balance in effect don't really add to the pay and price increases.

Representative HAMILTON. Thank you, Mr. Schultze.

Let me return to the Secretary while he is here.

You mentioned in your prepared statement that it is too early to see any impact on the inflation rate as a result of the measures that have been taken. When would you expect to see any impact on the inflation rate?

Secretary BLUMENTHAL. It is very difficult to say. I also indicated that the art of economic prognostication is imprecise. I would certainly expect that sometime by the spring or summer of next year, as we move into the second part of next year, that we should begin to see the results in the inflation figure.

Representative HAMILTON. If I may switch to this change that has occurred in the European monetary system now, I would like to get your comments on that. Is that going to help the dollar or hurt it; and if it helps, how is is going to help?

The immediate impact was another siege—temporary, I presume—on the dollar.

Secretary BLUMENTHAL. Well——

Representative HAMILTON. Would you care to comment?

Secretary BLUMENTHAL. Mr. Hamilton, I wouldn't really call it a "siege."

Representative HAMILTON. Well, I don't care what you want to call it. It dropped.

Secretary BLUMENTHAL. Well, then it went up again, you know. It moves around. It has been moving around so much. There have been a number of important developments. There are problems in Iran with oil production, which is substantially reduced at the present time, of course. There was the announcement of the EMS, there was then the announcement of Norway that that country was leaving the "snake."

Representative HAMILTON. Right, I understand.

Secretary BLUMENTHAL. So there are a lot of things that happened.

Representative HAMILTON. But what I want to get at, Mr. Secretary, is how you viewed that development.

Secretary BLUMENTHAL. The EMS as such——

Representative HAMILTON. Will that strengthen the dollar in the long run, as such?

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Secretary BLUMENTHAL. We expect the EMS to be a positive factor based on the way in which we understand it will be operated.

It will be a positive factor to the extent to which it is able to bring about greater stability in Europe, to the extent to which intervention in the European currency markets will be conducted less in dollars and more in other currencies and since we have been assured and fully expect that the system will be operated in full conformity with the obligations that these countries have together with us and the IMF, we really think it will be a positive factor.

Representative HAMILTON. Does the move in Europe suggest in itself a lack of confidence in the dollar?

Secretary BLUMENTHAL. We don't see it that way.

Representative HAMILTON. Thank you, Mr. Reuss.

Representative REUSS. We are honored to have with us our respected colleague, Millicent Fenwick. Do you have questions?

Representative FENWICK. I do have a question that concerns me, the EMS.

I would like, Mr. Secretary, to ask if you have any suggestions or if you are contemplating any tax changes that might help to increase our export situation. I gather we are now importing some $147 billion a year of manufactured goods and I understand that governments abroad have made or have tax arrangements that encourage the export of their goods to other countries. I wondered if you had any suggestions or contemplated tax changes that might increase the position of our exporting companies.

Secretary BLUMENTHAL. The fundamental way in which to increase exports, encourage exports from the United States is, of course, to make us as competitive as possible. I think the kind of measures that we are taking in the economy as a whole, getting inflation down, et cetera, will do that to some extent.

Second, we do have some tax incentives now in effect, particularly through the DISC (Domestic International Sales Corporation).

Representative FENWICK. Do you think that is valuable, that DISC does improve our exporting position?

Secretary BLUMENTHAL. Well, I think it may have some marginal benefit. It is at very high cost to the Treasury, so we don't like it much and it is very difficult to see any real relationship between the volume of exports and that particular device. You may recall that we actually recommended the elimination of it because we felt that the money could be used more effectively to help the economy overall than to spend it on that.

Representative FENWICK. What is the loss?

Secretary BLUMENTHAL. If I remember correctly, it is about $2 billion a year.

We are—to answer your question specifically—doing all sorts of things. The President announced a program of promoting exports, but we are not contemplating as a part of that, recommending any additional tax incentives to people who export.

Representative FENWICK. There is no way balancing it something like the value added tax, which I understand helps?

Secretary BLUMENTHAL. I don't believe the value added tax would have any——

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Representative FENWICK. I am not in favor of it myself, but I wonder if there would be something that we might have that would counterbalance that.

Secretary BLUMENTHAL. We, of, course, have a variety of taxes, but we tend to rely more on direct taxes and the Europeans more on indirect taxes. In theory at least, that should not be a factor. That should neutralize.

Representative FENWICK. But we know what is happening, don't we?

Secretary BLUMENTHAL. It has probably some impact, but that again, I would say, is not the reason why we have a trade problem. Our trade problem is due to a whole range of reasons, many of them historical. They have to do with the fact that in many parts of this country, perhaps not in New Jersey, but perhaps more in the Middle West, medium-sized and smaller manufacturers have the whole big U.S. market and when they move out from their State or their tri-State area, for them the next part is the big, wide world of the United States.

You can't do that in Belgium. You are at the border very quickly, so you export. It becomes second nature even for a small company. For small companies in the United States that is not the case. It is that psychology of not going and reaching beyond the borders that——

Representative FENWICK. It is also, Mr. Secretary, if one can believe the experience of people that there is nothing to compare to close cooperation of Government in promoting exports from other countries. I mean, everything is arranged to facilitate their operation and I wondered if we shouldn't begin to think somewhat along those lines.

Secretary BLUMENTHAL. I think you are absolutely right. That kind of collaboration is much closer. It has historically been. We have a lot to learn there. We have more to do there. The President's program is intended to be a step in that direction. I personally think it is not the last step that needs to be taken. I certainly agree that more needs to be done.

We have increased as a percentage of our GNP our trade from 4 percent to 8 percent over the course of the last couple years.

Representative FENWICK. I understand, but I think we can use much more.

Secretary BLUMENTHAL. We are moving in that direction.

Representative FENWICK. Thank you, Mr. Reuss.

Representative REUSS. Thank you, Mr. Secretary. You have been very helpful. We want to wish you a Merry Christmas, and good luck.

Mr. Schultze, you are already at the pulpit, so consider yourself welcome.

We have your prepared statement. Without objection, it will be received in the record. Would you now proceed in your own way and then respond to our inquiries?

STATEMENT OF HON. CHARLES L. SCHULTZE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SCHULTZE. Thank you, Mr. Reuss.

In the interest of brevity I will go through my prepared statement selectively.

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Representative REUSS. It is my understanding that you have to be at the White House by noon.

Mr. SCHULTZE. I have to be at the White House by noon, yes, sir.

Representative REUSS. We will make it possible for you to be at the White House at noon.

Mr. SCHULTZE. As I say, in the interest of brevity, I will go through my prepared statement selectively, and request it be put in the record with the understanding that the mere fact of skipping any part doesn't mean that I downgrade its importance.

Let me begin my remarks by reviewing the economic developments of 1978 that underlie the necessity for the economic policies that this administration is pursuing. As you know, the rate of inflation remained relatively stable, but uncomfortably high, during the first 2½ years of the current economic recovery. Movements of food prices sometimes moderated the overall rate of inflation, as in 1976, and at other times aggravated it, as in 1977. But outside of food commodities, prices of consumer goods and services rose at around 6 to 6.5 percent a year from the middle of 1975 through the end of 1977.

Increases in pay were also relatively stable during this period, averaging about 8 to 8.5 percent per year. During the first year of the recovery, productivity growth improved substantially, as it typically does at that stage of the business cycle, and the rise in unit labor costs moderated. By mid-1976, however, cyclical improvements in productivity were largely over, and unit labor costs—along with prices—were advancing at a 6 to 6.5 percent annual rate.

In short, until late in 1977, the underlying rate of inflation hovered around 6 to 6.5 percent, and there were few signs that the rate of inflation outside of the volatile food sector was accelerating.

Early in 1978 signs began to emerge that an acceleration of inflation was underway. During the most recent 12 months, producers' prices for finished goods have risen more than 8.5 percent, and consumer prices almost 9 percent. While sharp increases in the cost of food, housing, and medical care have led the surge in prices, an acceleration in inflation can be detected across a wide range of items at both the wholesale and retail levels.

The acceleration of inflation that we have gone through this year can be traced to three distinct problem areas: The very poor performance of productivity, strong inflationary pressures in food, and the depreciation of the dollar in foreign currency markets. I will deal briefly with each of these areas in turn.

PRODUCTIVITY GROWTH

Growth in productivity has been slowing in the American economy for approximately a decade. We were aware of that slowdown a year ago, and had taken it into account in our calculations of possible price and cost developments in 1978. But compared with the 1.5- to 2-percent rate we expected on the basis of recent trends, output per hour over the past four quarters has risen only one-quarter of 1 percent.

The weakening of productivity growth added directly to inflation through its impact on unit costs of production. It added indirectly as well by contributing to an exceptionally sharp rise in the demand for

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labor. In the past four quarters, the gross national product has increased by a little under 4 percent, only moderately greater than the longer run trend, but employment rose at an extraordinary rate.

About 3.3 million new jobs have been created in our economy, and the rate of unemployment has fallen almost a full percentage point in that short period of time. Employment has grown so rapidly, and unemployment has declined so fast, that upward pressure on wages has developed as a consequence. For example, the employment cost index, which rose 7 percent during 1977, increased 8 percent during the 12 months that ended in September. In part, that acceleration is due to the effects of the increase in the minimum wage last January. However, a significant part came from the sheer speed at which demands for new workers increased.

Altogether, the direct and indirect consequences of poor productivity growth this year probably have added well over a percentage point to the rate of inflation during 1978.

The second factor underlying the recent acceleration of inflation has been very sharp increases in prices of food products. Average food prices at the grocery store have risen more than 11 percent during the past 12 months, with the sharpest increases in meat products. Beef supplies have been very limited because of the reduction in cattle herds over the past 4 years. Moreover, pork production has been unexpectedly low, due in part to the impact of harsh winter weather that also caused short supplies of vegetables and citrus crops again this year. Altogether, these developments in the farm economy probably added about three-quarters of 1 percent to the rate of inflation in 1978.

Finally, the depreciation of the dollar in world markets is the final element contributing to the acceleration of inflation in 1978. Even after its recent increase, the value of the dollar measured against a weighted average of the currencies of our major trading partners, is currently about 14 percent below its September 1977 level; after adjusting for inflation differentials, the decline is still about 12 percent. Analysis suggests that such a change in the exchange rate above and beyond what is implied by inflation differentials would raise the domestic price level, directly and indirectly, by about 1 percent in 1978 and continue to put pressure on domestic price levels, though with diminishing force for another year or so.

Let me turn with this background to the structure and rationale of the President's anti-inflation program to deal with the problem.

The actions which were announced on October 24 indicated clearly that the Government would take the lead in fighting inflation. That step was essential. Private cooperation with the pay and price standards proposed by the President could hardly be expected if the Federal Government itself were unwilling to set its own house in order if budgetary policies we are pursuing are designed to create an overall economic climate in which the pay and price standards will not be undermined in the marketplace by excess demands.

The steps we are taking in the regulatory area will help control an important source of cost increases. The key element in the Government's own actions to curb inflation is to pursue the stringent budgetary policies. Aside from signs that employment growth in the early months of 1978 was faster than the economy could digest, as I pointed

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out earlier, the inflation problem of the past several years has not been traceable to classic conditions of excessive demands. But excessive demand would become a problem in the period ahead unless we took action to restrain the growth of economic activity.

As a consequence, a prudent and cautious and stringent budget policy is essential. This is precisely the kind of policy we are pursuing and will pursue. The Secretary has spelled out what that budgetary policy is. I need not repeat it.

The goals we have set for ourselves in this area will not be achieved without very difficult choices among competing demands on Federal resources. But a strict budgetary stance is essential to success in our fight against inflation. We have to demonstrate to both business and labor that their own moderation in private wage and price decisions will not be frustrated by the measure of excess demands.

These steps in the area of overall economic policy will not alone be sufficient to stem the momentum of inflation. For that reason the President also set forth on October 24, standards for wage and price increases in the private sector that are designed to break the price-wage spiral and gradually reduce the momentum of inflation.

The standards have been widely publicized and I need not reiterate them for you this morning.

I will note that we are increasingly encouraged by the response to the standards that we have received from the public. We have every indication from frequent consultations and from visits to cities across the country that businesses are taking the President's standards very seriously and intend to comply with them.

Although the response from the leaders of labor organizations have been measured and occasionally critical, we remain convinced that these standards are sufficiently fair and flexible to warrant the cooperation of America's working men and women. The combination of firm but measured demand restraint and voluntary wage-price standards gives us the balance we need to deal with the inflation problem we face.

Demand restraint will provide an overall economic environment in which excess demand pressures are absent and market forces are conducive to reduction in inflation. The wage and price standards will help break the inertia and momentum in wage and price decisions inherited from the years of inflationary experience. Attempt to rely exclusively on either wage-price guidelines or overall demand restraint would be doomed to failure. Wage and price standards would simply not stand up under the pressure of market forces in the absence of demand restraint.

In the application of very severe monetary and fiscal restraints, in order to cure inflation by deliberate creation of a recession wouldn't work either. Experience during the recessions of 1970, 1974, and 1975 indicate that wage and price increases moderate very little in response to increasing unemployment until that increase becomes very extensive. A recession would not cure your inflation problem. It would, however, cause the existing political consequences on the need to do something about inflation to evaporate.

We do not need another episode of stop-and-go economic policies that address neither inflation nor unemployment successfully.

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Curing inflation is going to take patience, persistence and firmness for a number of years. Extreme solutions, excessively severe demand restraints on the one side or mandatory wage and price controls on the other carry within themselves the seeds of their own destruction. They cannot stay the course.

Because of the economic efficiencies and social costs they impose they are inevitably abandoned in short order, leaving us with large costs and few inflation-reducing benefits. The President's anti-inflation program is a measured and balanced approach that can last the course.

Let me turn, if I may, to the oversea implications of this program.

At the time that the President's anti-inflation measures were announced, a favorable response in the foreign exchange markets was generally anticipated. As events unfolded, however, foreign confidence in the program was less than we had hoped. Financiers and others abroad may have misinterpreted the firmness of our commitment to reduce inflation, but whatever the reason, the value of the dollar in exchange markets slid dramatically in the days following the October 24 announcement. Had the slide been permitted to persist, the resulting inflationary pressure would have underlined the anti-inflation.

The stock market fell from mid-October to the end of October by more than 100 points and thus caused the weakening of the dollar. Throughout the economy business and consumer confidence was rocked by the development of foreign currency markets.

By the fall of this year the devaluation of the dollar had proceeded far beyond anything justified by fundamental economic forces. For example, the magnitude of the decline was not warranted by relative inflation rates between the United States and our major trading partners. Moreover, during the course of 1978, differentials among the growth rates of the industrial economies had narrowed considerably, and that trend could be expected to continue in 1979.

Reflecting the sharp decline in the dollar's value earlier in 1978, and the relative change in growth rates, trade flows increasingly have been moving in our favor. Forecasts of the U.S. current account balance by various international institutions all showed a substantial improvement in prospect.

For these reasons, the President announced the steps taken on November 1 to reaffirm the U.S. Government's commitment to fight inflation and to counter disorder in the foreign exchange markets through active intervention to support the value of the dollar.

The response to the November 1 announcement has been very heartening. The value of the dollar rose by 8 to 9 percent in the month following the announcement. Moreover, there appears to be a genuine recognition abroad that this administration intends to deal forthrightly with the problems facing our economy. I believe that such a development can only augur well for future developments affecting the dollar.

Let me turn, in conclusion, to the economic outlook for 1979 with these policies in place.

The actions taken by the administration on November 1 have led some observers to forecast a recession in 1979. I can understand their concerns, but I do not share their forecasts.

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The American economy still is fundamentally healthy and is growing with considerable momentum. For example, employment gains in recent months have been extremely large, and personal income has been moving up strongly. The annual rate of gain in retail sales between the third quarter of this year and the October–November average was 16 percent. Orders for durable goods, which are an indicator of business attitudes as well as a sign of future production levels, also have been strong. These orders have risen by 8 percent in just the past 2 months. Moreover, orders for capital goods have risen even faster than the total and are now almost 30 percent above levels a year earlier.

Recent surveys of business plans for investment have indeed raised questions about the strength of plant and equipment early next year. These advance surveys, however, have sometimes underestimated the strength of actual investment. There is no slowdown yet evident in recent orders and contracts for plant and equipment.

Most importantly, the economy today shows few signs of the sorts of imbalances that can tip it into recession. Inventories are in good balance with sales; there are few signs of shortages or bottlenecks; there has been little or no overbuilding of shopping centers, office buildings or apartments; and liquidity positions of lenders and large nonfinancial corporations are relatively good.

An added source of optimism that this expansion will continue is the fact that financial restraints are not affecting the economy in the same way that they have in the past. Earlier periods of credit restraint saw the supply of funds dry up first in mortgage financing. As a result, the pinch of credit rationing hit the housing sector abruptly and with devastating consequences.

Earlier this year, however, financial authorities provided banks and thrift institutions with the right to issue "money market certificates," relatively short-term certificates of deposit that pay a maximum interest rate somewhat above the rate on 6-month Treasury bills. As a result, deposit flows into mortgage lenders have remained strong. And housing starts are as high now as they were a year ago, when interest rates were lower.

In general, rising nominal rates of interest are proving less discuraging to borrowers in the current inflationary environment than in the past. Interest rates do make a difference, and it is indeed likely that investment in housing and in other forms will be restrained next year by the rise in interest rates that has already occurred. But there is no reason to expect that credit tightening will have the sort of disastrous consequences for the housing industry that in the past have nosed the economy down into recession.

Economic growth will, and should, moderate in 1979 to something under 3 percent. The impact of slower growth on the rate of unemployment is going to hinge importantly on whether productivity growth improves substantially, reducing the demand for labor, or continues at the sluggish pace of 1978. The outlook for unemployment is uncertain, but the unemployment rate is likely to remain in the vicinity of 6 percent or perhaps edge up slightly in 1979.

Mr. Reuss, I think I summarized the essence of my prepared statement and I would be glad to answer questions.

[The prepared statement of Mr. Schultze follows:]

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Prepared Statement of Hon. Charles L. Schultze

I am pleased to appear before this Committee today to discuss the President's recent initiatives to support the value of the dollar abroad and to reduce the rate of inflation here at home. Your hearings this week focus on the implications of the President's actions on November 1 to correct the clearly excessive decline in the value of the U.S. dollar that had occurred in earlier months. Those actions are most appropriately viewed as one part of a larger effort to moderate inflation. Therefore, I will begin my remarks this morning by reviewing the economic developments of 1978 that underlie the necessity for the overall economic policies the Administration is pursuing.

THE ACCELERATION OF INFLATION IN 1978

The rate of inflation remained relatively stable—but uncomfortably high during the first two and one-half years of the current economic recovery. Movements of food prices sometimes moderated the overall rate of inflation, as in 1976, and at other times aggravated it, as in 1977. Outside of food commodities, prices of consumer goods and services rose at around 6 to 6½ percent from the middle of 1975 through the end of 1977.

Increases in compensation for hours worked were also relatively stable during this period, averaging about 8 to 8½ percent per year. During the first year of the recovery, productivity growth improved substantially, as it typically does at that stage of the business cycle, and the rise in unit labor costs moderated. By mid-1976, however, cyclical improvements in productivity were largely over, and unit labor costs—along with prices—were advancing at a 6 to 6½ percent annual rate.

In short, until late in 1977, the underlying rate of inflation hovered around 6 to 6½ percent, and there were few signs that the rate of inflation outside of the volatile food sector was accelerating.

Early in 1978 signs began to emerge that an acceleration of inflation was underway. During the most recent 12 months, producers' prices for finished goods have risen more than 8½ percent, and consumer prices have increased almost 9 percent. While sharp increases in the cost of food, housing, and medical care have led the surge in prices, an acceleration in inflation can be detected across a wide range of items at both the wholesale and retail levels.

The acceleration of inflation in 1978 can be traced to three distinct problem areas: The very poor performance of productivity, strong inflationary pressures in food, and the depreciation of the dollar in foreign currency markets. I will deal with each of these areas in turn.

Productivity Growth. Growth in productivity has been slowing in the American economy for approximately a decade. We were aware of that slowdown a year ago, and had taken it into account in our calculations of possible price and cost developments in 1978. But compared with the 1½ to 2 percent rate we expected on the basis of recent trends, output per hour over the past 4 quarters has risen only one-quarter of one percent.

The weakening of productivity growth since late 1977 added directly to inflation through its impact on unit costs of production; it added indirectly as well by contributing to an exceptionally sharp rise in the demand for labor. In the past four quarters, the gross national product has increased by a little under 4 percent, only moderately greater than the longer run trend. But employment rose at an extraordinary rate. About 3.3 million new jobs have been created in our economy, and the rate of unemployment has fallen almost a full percentage point. Employment has grown so rapidly, and unemployment has declined so fast, that upward pressures on wages have developed as a consequence. For example, the employment cost index, which rose 7 percent during 1977, increased 8 percent during the 12 months that ended in September. In part, that acceleration is due to the effects of the 15 percent increase in the minimum wage last January. However, a significant part came from the sheer speed at which demands for new workers increased. In a sense, the economy exceeded the "speed limit" for the growth of jobs and put added pressure under wages. This speed-limit effect may be transitory—there already is evidence that wage increases are slowing—but it contributed powerfully to inflation in 1978. Altogether, the direct and indirect consequences of poor productivity growth this year probably have added well over a percentage point to the rate of inflation during 1978.

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The second factor underlying the recent acceleration of inflation has been very sharp increases in prices of food products. Average food prices at the grocery store have risen more than 11 percent during the past 12 months, with the sharpest increases in meat products. Beef supplies have been very limited because of the reduction in cattle herds over the past four years. Moreover, pork production has been unexpectedly low, due in part to the impact of harsh winter weather that also caused short supplies of vegetables and citrus crops again this year. Altogether, these developments in the farm economy probably added about three-quarters of one percent to the rate of inflation in 1978.

The depreciation of the dollar in world markets is the final element contributing to the acceleration of inflation in 1978. Even after its recent increase, the value of the dollar measured against the currencies of our major trading partners is about 11 percent below its year-earlier level. Econometric analysis suggests that such a change in the exchange rate would increase domestic prices—directly and indirectly—by about one percentage point. Most of that rise has probably already occurred, but some effects of past depreciation may continue to influence prices early next year.

It is important to note, of course, that the causal relationship between dollar depreciation and inflation runs in both directions. The acceleration of inflation in our country has helped to drive the dollar down and this, in turn, has made the inflation worse. It has been, and remains, the policy of the United States government to permit exchange rates to be determined by the basic forces of demand and supply—so long as markets do not become disorderly or clearly out of touch with the fundamental considerations that determine competitive conditions and trade and capital flows among countries. In the long run, a system of floating exchange rates benefits the United States economy and the rest of the world economy substantially. At the same time, exaggerated movements in the foreign exchange markets can constitute an independent source of inflationary pressure. As I will discuss later, that was one of the basic reasons for the President's decision to take action to support the dollar on November 1.

ANTI-INFLATION ACTIONS IN 1978

During the course of this year, as the worsening inflation situation became apparent, the Administration took a series of actions to reduce inflationary pressures in the economy· The President's original January 1978 budget recommendations reflected his decision to support the economic recovery through tax reductions while maintaining strict control over the growth of Federal outlays. As the year progressed, and as the surprising growth of employment and reduction in unemployment became evident, the President concluded that the economy required less stimulus than he had previously recommended. For that reason, the Administration, in cooperation with the Congressional budget committees, recommended in May that the tax reduction enacted last year be reduced to about $20 billion and postponed for three months. That recommendation ultimately was concurred in by the Congress as a whole. In addition, growth of Federal expenditures during the year fell short of levels originally anticipated in the President's budget. In light of the Administration's increasing concern over inflation, no effort was made to restore outlays to the levels originally forecast in the President's budget. In combination, these developments in expenditures and taxes constituted a significant shift toward fiscal restraint during the course of 1978.

At the same time, the Federal Reserve was acting to hold down the growth of the monetary aggregates. Since economic growth, combined with rising prices, had increased the demand for money and credit in our economy, the Federal Reserve's actions to restrain the increase of money and credit translated into very sharp increases in interest rates. The current interest rate on 6-month Treasury bills—9¼ prcent—is almost 3 percentage points above the level in December 1977. Long-term interest rates have not risen as rapidly, but they, too, are significantly above year-ago levels. The Federal Reserve's credit tightening actions have complemented the Administration's movement toward fiscal restraint, so that money and fiscal policies are working together in the fight against inflation.

During the late summer and fall of this year, however, it became apparent that the inflation problem required more direct and dramatic action. Accelerating rates of inflation in non-food commodities, combined with less relief from

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food prices than we had hoped for, suggested that the inflation problem had worsened seriously. Moreover, the acceleration of inflation was becoming a serious concern to our trading partners and was undermining the value of the dollar. After deliberating on a range of possible policy approaches, the President on October 24 announced a major new anti-inflation program. This program involves actions both by the Federal Government and the private sector.

THE PRESIDENT'S ANTI-INFLATION PROGRAM: OVERALL ECONOMIC POLICY

The actions announced on October 24 indicated clearly that the government would take the lead in fighting inflation. That step was essential. Private cooperation with the pay and price standards proposed by the President could hardly be expected if the Federal Government were unwilling to set its own house in order. The budgetary policy we are pursuing is designed to create an overall economic climate in which the pay and price standards will not be undermined in the marketplace by excess demand. And the steps we are taking in the regulatory area will help to control an important source of cost and price increases.

The key element in the government's own actions to curb inflation is the pursuit of stringent budgetary policies. Aside from signs that employment growth in the early months of 1978 was faster than the economy could digest, the inflation problem of the past several years has not been traceable to classic conditions of excess demand that stem from Federal deficits that are too large, or growth in money and credit that is too rapid. But excess demand would become a problem in the period ahead unless we took action to restrain the growth of economic activity. Therefore, a prudent and cautious budgetary policy is essential. That is precisely the kind of policy we are pursuing.

In fiscal 1976, Federal expenditures represented 22½ percent of the nation's GNP and the deficit was $66 billion, an all-time record. Next January, the Administration will submit its budget for fiscal 1980—the year beginning October 1, 1979. In the context of an overall economy growing at a modernate rate, the President has set planning targets under which:

The share of total spending in GNP will be reduced to about 21 percent, a goal originally scheduled to be reached one year later; and

The 1980 Federal budget deficit will be reduced to $30 billion or less.

In addition, the President has stated that he will oppose further reductions in Federal income taxes until we have convincing evidence of progress against inflation.

These goals will not be achieved without very difficult choices among competing demands on Federal resources. But a strict budgetary stance is utterly essential to success in the fight against inflation. We must demonstrate to both business and labor that their own moderation in private wage and price decisions will not be frustrated by the pressure of excess demand.

REGULATORY POLICY

During the past decade, we have expanded dramatically our efforts to protect the environment and the health and safety of workers and consumers. Clean air and water, a safe and healthy workplace, and protection for consumers against unhealthy and hazardous products are important national goals. But we must recognize that their achievement has added appreciably to costs and hence to consumer prices. We must not abandon our goals, but we must attain them at a reasonable pace and without imposing unnecessary costs. With this principle in mind, the President has stated his intention personally to exercise his authority if necessary to ensure that the regulatory process is balanced and well managed, and he has directed important steps within the government to improve the regulatory process.

Among those new steps is the establishment of a Regulatory Council consisting of the regulatory agencies in the Executive Branch. The new Council will be charged with coordinating the regulatory process in ways that avoid duplicative or overlapping regulations and with preparing semi-annually a unified calendar of major regulations. We will, for the first time, have a comprehensive list of regulations that the Federal government is proposing—together with information on their costs and objectives. The President also has announced his intention to work with the Congress to reduce regulation in the railroad and trucking industries. During the past year, the Civil Aeronautics Board has taken constructive steps to free the airline industry of outmoded regulatory burdens, and the

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Congress has passed and the President has signed an airline deregulation bill. We must now extend these gains to surface transportation and the Administration will be presenting proposals to the next session of Congress.

These steps, although significant, will not alone be sufficient to stem the momentum of inflation. For that reason the President also set forth on October 24 standards for wage and price increases in the private sector that are designed to break the price-wage spiral and gradually reduce the momentum of inflation. These standards have been widely publicized, and I need not reiterate them for you this morning. I would note, however, that the Administration is increasingly encouraged by the response to the standards that we have received from the public. We have every indication from frequent consultations and from visits to cities across the country that businesses are taking the President's standards very seriously and intend to comply with them. Although the response from the leaders of labor organizations has been measured and occasionally critical, we remain convinced that these standards are sufficiently fair and flexible to warrant the cooperation of America's working men and women.

The combination of firm but measured demand restraint and voluntary wage-price standards gives us the balance we need to deal with the inflation problem we face. Demand restraint will provide an overall economic environment in which excess demand pressures are absent and market forces are conducive to a reduction in inflation. The wage and price standards will help break the inertia and momentum in wage and price decisions inherited from the years of inflationary experience. An attempt to rely exclusively on either wage-price guidelines or overall demand restraint would be doomed to failure.

The wage and price standards would simply not stand up under the pressure of market forces in the absence of demand restraint. And the application of very severe monetary and fiscal restraints—in order to cure inflation by deliberate creation of a recession—wouldn't work either. Experience during the recessions of 1970 and 1974–75 indicates that wage and price increases moderate very little in response to increasing unemployment until it becomes very extensive. A recession would not cure our inflation problem. It would, however, cause the existing political consensus on the need to do something about inflation to evaporate. We do not need another episode of stop-go economic policies that address neither inflation nor unemployment successfully. High rates of inflation have been with us for ten years.

Curing inflation is going to take patience, persistence, and firmness for a number of years. Extreme solutions—excessively severe demand restraints on the one side or mandatory wage and price controls on the other—carry within themselves the seeds of their own destruction. They cannot stay the course. Because of the economic inefficiencies and social costs they impose, they are inevitably abandoned in short order, leaving us with large costs and few inflation-reducing benefits. The President's anti-inflation program is a measured and balanced approach that can last the course.

RESPONSE TO THE PRESIDENT'S PROGRAM ABROAD

At the time that the President's anti-inflation measures were announced, a favorable response in the foreign exchange markets was generally anticipated. As events unfolded, foreign confidence in the program was less than we had hoped. Financiers and others abroad may have misinterpreted the firmness of our commitment to reduce inflation. Whatever the reason, the value of the dollar in exchange markets slid dramatically in the days following the October 24 announcement. Had the slide been permitted to persist, the resulting inflationary pressures would have undermined the anti-inflation program. The stock market fell from mid-October to the end of October by more than 100 points in response to the weakening of the dollar. Throughout the economy, business and consumer confidence was rocked by the developments in foreign currency markets.

By the fall of this year the devaluation of the dollar had proceeded far beyond anything justified by fundamental economic forces. For example, the magnitude of the decline was not warranted by relative inflation rates between the United States and our major trading partners. Moreover, during the course of 1978, differentials among the growth rates of the industrial economies had narrowed considerably, and that trend could be expected to continue in 1979. Reflecting the sharp decline in the dollar's value earlier in 1978, and the relative change in growth rates, trade flows increasingly have been moving in our favor. Forecasts

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of the U.S. current account balance by various international institutionas all showed a substantial improvement in prospect.

For these reasons, the President announced the steps taken in November 1 to reaffirm the U.S. Government's commitment to fight inflation, and to counter disorder in the foreign exchange markets through active intervention to support the value of the dollar.

The response to the November 1 announcement has been very heartening. The value of the dollar rose by 4 percent in the month following the announcement. Moreover, there appears to be a genuine recognition abroad that this Administration intends to deal forthrightly with the problems facing our economy. I believe that such a development can only augur well for future developments affecting the dollar.

ECONOMIC OUTLOOK FOR 1979

The actions taken by the Administration on November 1 have led some observers to forecast a recession in 1979. I can understand their concerns, but I do not share their forecasts.

The American economy still is fundamentally healthy and is growing with considerable momentum. For example, employment gains in recent months have been extremely large, and personal income has been moving up strongly. The annual rate of gain in retail sales between the third quarter and the October–November average was 16 percent. Orders for durable goods, which are an indicator of business attitudes as well as a sign of future production levels, also have been strong. These orders have risen by 8 percent in just the past two months. Moreover, orders for capital goods have risen even faster than the total and are now almost 30 percent above levels a year earlier. Recent surveys of business plans for investment have indeed raised questions about the strength of plant and equipment early next year. These advance surveys, however, have sometimes underestimated the strength of actual investment. There is no slowdown yet evident in recent orders and contracts for plant and equipment.

Most importantly, the economy today shows few signs of the sorts of imbalances that can tip the economy into recession. Inventories are in good balance with sales; there are few signs of shortages or bottlenecks; there has been little or no overbuilding of shopping centers, office buildings, or apartments; and liquidity positions of lenders and large nonfinancial corporations are relatively good.

An added source of optimism that this expansion will continue is the fact that financial restraints are not affecting the economy in the way that they have in the past. Earlier periods of credit restraint saw the supply of funds dry up first in mortgage financing. As a result, the pinch of credit rationing hit the housing sector abruptly and with devastating consequences. Earlier this year, however, financial authorities provided banks and thrift institutions with the right to issue "money market certificates," relatively short-term certificates of deposit that pay a maximum interest rate somewhat above the rate on 6-month Treasury bills. As a result, deposit flows into mortgage lenders have remained strong. And housing starts are as high now as they were a year ago, when interest rates were much lower.

In general, rising nominal rates of interest are proving less discouraging to borrowers in the current inflationary environment than in the past. Interest rates do make a difference, and it is likely that investment in housing and in other forms will be restrained next year by the rise in interest rates that has already occurred. But there is no reason to expect that credit tightening will have the sort of disastrous consequences for the housing industry that in the past have nosed the economy down into recession.

Economic growth will—and should—moderate in 1979, to something under 3 percent. The impact of slower growth on the rate of unemployment hinges importantly on whether productivity growth improves substantially, reducing the demand for labor, or continues at the sluggish pace of 1978. The outlook for unemployment is uncertain, but the unemployment rate is likely to remain in the vicinity of 6 percent or perhaps edge up slightly in 1979.

We must recognize, also, that when the rate of economic growh slows at this stage in a recovery, the risks are greater that growth will be slower than expected than that it will accelerate. The policy path we must walk, therefore, is narrow and difficult, but the magnitude of our inflation problem requires us to walk it.

If we make significant progress in 1979 on the inflation front, as I believe we will, the dangers we now face of an economy weakened by unbridled inflation

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will lessen. Confidence will improve; pressures on financial markets will lessen; the dollar will strengthen in exchange markets; and the prospects for continued recovery will be enhanced. But it will take time before visible results show through in the price indexes. Food price increases and the pass-through of past depreciation of the dollar into consumer prices may keep the monthly inflation statistics uncomfortably high for several months. As businesses and workers begin to cooperate with the President's pay and price standards, however, we expect to see signs of a significant deceleration in the rate of cost and price increase during the course of 1979.

CONCLUDING REMARKS

In summary, the sharp acceleration of inflation during 1978 has required the Administration to alter markedly the course of economic policy. We have not altered our long-range objectives for the economy, but we have recognized that we cannot reach our ultimate goals for output, employment, and unemployment without significant progress against inflation.

Such progress can be attained through a combination of prudent economic policies to support modest growth and standards to reduce the rate of wage and price increase in the private sector. Such a strategy does carry the risk of some rise in the rate of unemployment, and we recognize that our policies will not cure inflation overnight. But the course we have laid out can work, and I believe it will work. And it is far better than the agony of recession or the nightmare of mandatory controls.

Success over the next year in this program will shift the momentum of inflation in our favor. As ships of cooperation with the President's program appear, businesses and consumers will begin to plan on declining, not accelerating, inflation. And financial markets will also respond. Together, these events will bolster confidence in our long-term economic prospects and we will be able to look forward to a strengthening of economic activity in 1980 and beyond.

Representative REUSS. Thank you very much, Chairman Schultze.

In last July 24th's U.S. News & World Report there is an interview with you in which the question was asked, "What do you mean when you say that you are assuming there will be no significant tightening of credit from here on? What is the significance?" Answer: "I don't have any specific number and obviously the Federal Reserve cannot simply peg interest rates to some preannounced level. At the other extreme, if interest rates continue to rise at the same clip they have been rising, that is going to cause trouble."

When you made that statement last July 24, interest rates on 6-month Treasury bills were 7.27 percent. Yesterday they were 9.20. Interest rates on Federal funds, as of July 24, were 7.89 percent; today they are 9.94 percent.

In your prepared statement today you point out that "Recent surveys of business plans for investment have indeed raised questions about the strength of plant and equipment early next year."

You also have indicated—and I thoroughly agree with you—that one of the best ways of getting a long-term handle on inflation is to increase productivity through investment in new plant and equipment. Therefore, my question, "Wasn't Charlie Schultze right on target on July 24 when he said that if interest rates continue to rise, that is going to cause trouble?"

Mr. SCHULTZE. Yes.

Representative REUSS. They sure have risen. They had not risen much before that. They had been quite stable. Now we have had a 20 or 25 percent increase—a significant rise—in interest rates on Treasury bills; on Federal funds; in the prime rate; and so on.

Isn't this a serious problem? Are you indicating "yes"?

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Mr. SCHULTZE. Mr. Reuss, before I respond, let me note an important typo in my paper in which I noted that the dollar had risen in the month after the action taken in November by 4 percent. That is not in a month, that is in 1 day. It has risen actually about 10 percent in the month.

I just wanted to be sure that was recognized.

Representative REUSS. That correction is very well received.

Mr. SCHULTZE. With respect to the interview, aside from demonstrating the occasion "unwisdom" of on-the-record interviews, it seems to me the basic thing that has happened, of course, is that the rate of inflation has significantly accelerated. We were still thinking in April, May, June, in that area, of an underlying rate of inflation of perhaps 6.5 percent, but with the food price bulge, it turns out that the actual rate of inflation has accelerated significantly so that the increase in nominal interest rates has indeed occurred, but the increase in real interest rates has been substantially less.

Obviously in terms of measuring the impact—I don't want to subscribe to the doctrine that nominal interest rates are not important, that real interest rates are the only ones that are important. I think it is important to deal in context with the rate of inflation having accelerated substantially.

Representative REUSS. It is also true, however, that real interest rates have increased.

Mr. SCHULTZE. Real interest rates.

Representative REUSS. Since July.

Mr. SCHULTZE. It depends again where you look. If you look at long-term interest rates——

Representative REUSS. Let's not look at them——

Mr. SCHULTZE. As a matter of fact, it is the other way. In the case of short rates that is true, but in terms of moving to provide an appropriate level of demand restraint in the face of accelerating inflation, what has happened has been appropriate. In the case of the situation in which inflation has not been acccelerating, that is a different kettle of fish. But, unfortunately, we are not living in that world.

It is undoubtedly true, it is clear that a combination of the budgetary restraint and monetary restraints which have occurred are going to provide, as they are intended, a dampener on the growth of demand and slow the rate of economic activity growth, but, we think, slowing it in a balanced way and not overdoing it.

Representative REUSS. Let me try to put in sharp focus what I think is the difference between me and the administration on this interest rate point. I am all for you and the Federal Reserve tightening money and raising interest rates to the extent necessary to combat domestic inflation. No complaints at all. Right on.

But I gather that on November 1, a new element was added; namely—and higher interest rates were a portion of the November 1 program—that for international reasons, we should tighten money and raise interest rates more than we would otherwise do for anti-inflationary reasons. To that extent I think we are going astray. For one thing, I can't find any real evidence that capital movements charge around after the kind of mild extra differential in the interest rates that we are talking about.

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I can see great danger where interest rates are higher than those necessary to combat domestic inflation. We get sluggish productivities, inflation and lack of growth all at the same time. As a result of such stagflation, capital actually leaves this country; it gets out of the sinking stock market, gets out of the unhappy bond market and withholds foreign direct investment in other ways not contemplated.

So I think we are on a very risky course here without—so far as I can see—any factual evidence that this old central bankers' whimsy about high interest rates solving our capital problems.

Mr. SCHULTZE. Mr. Reuss, let me note that I think it is very important to realize that this is not and was not an action taken simply to try to deal with the dollar by changing—simply by changing the interest rates and attract capital inflow to handle the problem. In other words, if that is all it were, you might have a point. But it wasn't.

You have to remember that the 10 percentage point additional devaluation or depreciation of the dollar that we have recovered is worth on the domestic inflation rate when it works its way through the system—worth a number that is very hard to calculate, but taking into account all the repercussions something significantly over 1 percentage point on the inflation rate.

And here is a measure of providing in the face of accelerating domestic inflation and of the independent impact of excessive depreciation of the dollar on domestic productivity where you take demand restraint measures to deal with that problem, which at the same time do have some—I can't pretend to measure it—on the attractiveness of capital flows. But I wouldn't suggest that was the major part of it.

Representative REUSS. But to the extent that it is a minor part of it, otherwise the November 1 pronouncements wouldn't have ballyhooed the international effects so much.

Mr. SCHULTZE. But the international effects, Mr. Reuss——

Representative REUSS. To the extent that the minor part of its was in excess of what was needed to heroically and rigorously attack domestic inflation, I think it was a mistake.

Mr. SCHULTZE. I am not so sure we are so far apart in terms of the basic philosophy, but it is in terms of interpretation that attacking domestic inflation includes not merely what one does to domestic demands, but in this particular case what one did in terms of its impact on demand and changing attitudes and expectations about the dollar and therefore attacking domestic inflation.

You cannot put it just in terms of creating an interest rate differential itself. That is part of it, but you can't untangle it to what part is and what part isn't. I think one might say that making a move all at once like that rather than doing it in a couple of steps probably did help with the dollar substantially and did and will have an important ameliorating impact on inflation.

So that is all part of the package. It isn't just creating the differential exchange rates. I can't put weights on it, Mr. Reuss.

Representative REUSS. Well, I will not belabor the point, but whatever had to be done from the standpoint of domestic inflation rates—and not enough was done before November 1—had to be done, but on November 1, there was something extra, and that something extra as far as I am concerned should be leeched out of our monetary

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policy as quickly as possible lest the prediction you made on July 24—which I find to be extremely thoughtful—comes true.

Specifically, don't you think that in the mix of economic policy we can well afford to be quite rigorous overall in our fiscal policy to decrease the deficit, and be a little less rigorous in monetary policy? We could then get our kicks out of monetary policy because that is what helps capital investment, and it doesn't create a deficit. That is what is so nice about it.

So without getting down to specific numbers, when you are planning the total mix, shouldn't you be a little more rigorous in your fiscal policy, and a little less rigorous in your monetary policy?
fiscal policy, and a little more rigorous in your

Mr. Schultze. Obviously I think we both agree we need some elements of both. That is No. 1.

We are now dealing at the margin with the proper mix.

Representative Reuss. Right.

Mr. Schultze. It is a very difficult set of calls to make. I would only suggest that as you see the 1980 budget as it comes up, you and your colleagues will find that there has been, indeed, a major effort by way of "rigoring" the budget and that the tradeoff between further rigor there and monetary policy is not quite as easy as it might sound in the abstract.

Representative Reuss. Well, I hope so, very deeply. And in that context, another place to apply a good mix is on the budget taxing and spending side; there I should think a mighty broad sword ought be wielded against those elements in the budget which actually cause inflation. For example—so that I may be clear—Congress, obsessed by I know not what last fall in its consideration of the tax bill, in the process of reducing the capital gains tax on common stocks, which was an excellent thing—more of it should be done, I think—grossly and drastically reduced the capital gains tax on land, the most inflationary element in the economy, the price of which has gone up exponentially, which is deeply responsible for the terrible inflation in food and housing.

Why do we not repeal that portion of that which we did and put that $1 or $2 billion saving where it will do the most good?

Mr. Schultze. I think, Mr. Reuss, as you undoubtedly gathered during the course of the tax debate last year, the administration's position on capital gains was not precisely the same as that of the Congress.

Representative Reuss. Right.

Mr. Schultze. That was a very long and difficult battle, and it came out the way it did in terms again of a commonsense approach to try to get cooperation in a tight budget, and to reopen that problem—however you or I might feel on capital gains taxes on land—I am not sure would be productive. In fact, I am quite sure it would be unproductive.

Representative Reuss. The President did have good luck with his veto of the Defense bill to get rid of the B-1 bomber which I think he rightly thought was a problem.

Mr. Schultze. I understand.

Representative Reuss. I commend that action and I will bring up another one. We are merrily going ahead paying the States $2 bil-

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lion plus for State revenue sharing at a time when the States, half of them at least, are getting ready to put potentially inflationary spending power in the hands of our people by distributing some of the surpluses they had kicking around.

That is the current preoccupation within Congress. Why do we supply them with the tickets to do that? They ought to be giving us revenue sharing, not the other way around. [Laughter.]

So I really think that more microeconomics, and less macroeconomics, in the budget would be saving grace that could bring us all together. If that involves vetoes by the President, well, that is what makes the President look good.

Mr. SCHULTZE. As you are aware, the President is prepared to use his veto power appropriately with reason and as is necessary. Let me note that I expect we could spend a lot of time talking about the particular composition, microcosm composition of the budget as it will come up, although we don't quite know what it is going to be so it is a little hard to do.

One sidepoint with respect to the States, just an economic point, is that to the extent the States are reducing property and sales taxes, this does have a direct impact on CPI.

Representative REUSS. Right. To the extent that they are dishing out income taxes in which——

Mr. SCHULTZE. It doesn't. That is correct.

Representative REUSS. In which the people who add to the demand which is hovering over the economy get their pockets filled——

Mr. SCHULTZE. I understand——

Representative REUSS [continuing]. And spend it. You can't tell me that is a good thing.

Mr. SCHULTZE. That's right.

Representative REUSS. And is it really a Wizard of Oz-like economy in which you can sit around claiming we can't do anything about it?

Mr. SCHULTZE. I am not suggesting we can't do anything about it. I was suggesting that there are all sorts of difficult calls that are going to have to be made and I hope we can get general consensuses on it, but I am sure that there will be a lot of microquestions that will arise as that budget comes up.

Representative REUSS. Thank you.

Mr. Hamilton.

Representative HAMILTON. Thank you very much, Mr. Reuss.

Mr. Schultze, a moment ago you were talking about the veto. I asked Secretary Blumenthal about the mandatory wage and price controls. You have probably seen the public opinion polls that show an increasing number of people support mandatory wage and price controls. If the Congress were to pass such a bill, would the President veto it?

Mr. SCHULTZE. Mr. Hamilton, I have learned from long experience that it probably isn't good policy for an administration official before anything ever happens to say what the President will or will not veto. But in this particular case, in this particular case I am convinced he would get a unanimous recommendation from his economic advisers to veto it and I am convinced he will veto it.

Literally, it is so out of the can of what we want to do we have not even talked about the possibility of a veto. I can't imagine given what I have heard from the chairman and the members of the two commit-

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tees who would be involved, I can't conceive of it ever getting out of committee. Let me make one other point on mandatory wage and price controls.

I have seen the polls which indicate people in general seem to want wage and price controls. I think I would be willing to bet more than a single good dinner, several good dinners, that that would last somewhere between 6 months and a year. I don't know the number, but I suspect there are probably 5 million commodities of different kinds in this country.

While for 6 months you can find ways of putting lids on them in some mandatory across-the-board sense, it will gradually deteriorate. Quite apart from the economics of it, the social and political pressures, et cetera formally to get rid of them or to do the same thing by issuing interpretation, would be so great that we maybe would by ourselves in 6 months, maybe 9, and would end up putting the economy in a straitjacket and get nothing out of it.

So that popularly would be very evanescent as we found in 1971.

Representative HAMILTON. You have a lot of business people who expect mandatory wage and price controls to come about. You have a lot of people that want them. Would it, therefore, make sense for the President just to say now he will veto it if it comes up?

Mr. SCHULTZE. I think—although I don't actually remember him saying it in that way—he has sure indicated his strong hostility and opposition to it. I don't even want to say it that way, because it does kind of imply that maybe he will be faced with it and literally I can't imagine it even getting out of committee.

I could be wrong. I have been in the past.

Representative HAMILTON. I appreciate your very clear statement on it, Mr. Schultze.

Let me ask you a question or two about this real wage insurance. I may not be up to date on that. You have not actually submitted that to us yet; have you?

Mr. SCHULTZE. We have not. We are in the process of drafting the detailed specifications. We are discussing it with the staffs and the members of the tax-writing committees, but we have not sent it up yet.

Representative HAMILTON. Can you make any comment to us about who will be covered under it and who will not be covered? For example, another big factor discussed is the cost of it. Could you comment a little about it to the extent that you feel that you can?

Mr. SCHULTZE. It is very difficult to be specific until we have, you know—to speak out ahead of that which we are now working on.

Let me note several things that, in effect, all employees would be eligible in the sense if they, as a group, comply with the basic 7-percent standard.

Representative HAMILTON. But that would not include self-employed people?

Mr. SCHULTZE. No, there is no way of doing that.

With respect to the cost, it again depends on precisely how you write it. There is some self-limiting aspect to it. It is not complete. That is, if you have very widespread participation and observance of the standards, the likelihood of getting a price increase significantly over 7 percent is pretty low. On the other hand, if not, many people observe

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the standards, the likelihood of having to pay out is fairly high, but the number you have to pay it to is fairly low. I don't want to suggest there is no risk of payout. There might well be, but it does have some very important self-limiting features.

Representative HAMILTON. The discussion in the press was that this idea, the real wage insurance proposal, really did not get very much discussion and debate within the administration prior to its announcement.

The fact that you are fairly slow in giving us the details of it would add some credence to that. Was it a thoroughly discussed, thought-out matter within the administration?

Mr. SCHULTZE. Yes, sir, it was. I think——

Representative HAMILTON. If so, why haven't we had more details on it right after the statement of it?

Mr. SCHULTZE. Let me put it this way. I think one of the things that puzzled people was that every other part as far as I can tell of that particular program that the President announced on October 24 found its way into the press before the President announced it. This one didn't and therefore there is some view, well, this must have come in at the last minute. I guess I would have to say—it didn't come along late in the game. It came along somewhat later than some other elements. That is, we were discussing the wage-price standards for a long period of time before the real wage insurance, so in that sense it came along later. But it was subjected to a good bit of analysis.

What we did not have and what proves complex is translating it into specific legislative language. That does take some time.

Representative HAMILTON. You mentioned quite a bit in your prepared statement about productivity and you identify that as one of the factors which accelerated inflation. What do you recommend with respect to Government action to increase productivity?

Mr. SCHULTZE. Well, I first have to start by saying there are literally no nice, neat buttons you can push and get productivity going. There are things we can do to influence the climate and a number of other things. I will discuss some of those.

I would pay particular attention, I think, to three. First, the tax bill that the Congress did pass, even though there is some quarrel about the composition of it, nevertheless did provide some $7 to $7.5 billion in reduced taxes on income from capital, which should provide incentives to investors, which in turn is important to productivity.

Second, up until about 1 year ago, I hope I have my dates right—but about 1 year ago for the 10 years prior to that the real value of governmental support for research and development had declined. If you adjust for inflation, Government investing in R. & D. declined. Since there are a number of areas, particularly in the basic area of research and development, where it almost has to be supported by Government, that probably did contribute to the productivity decline. Even in a tight budget the real research and development expenditures should increase.

They did last year and they should increase again. So the presumption——

Representative HAMILTON. In the new budget it does?

Mr. SCHULTZE. I hope I am not going beyond myself because I have not seen final markups, but I think so. I will make that qualification.

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But the basic premise is that we are interested in turning around that real decline in research and development.

The third thing is an ephermeral thing. It is not something you pass a piece of legislation on, but I think productivity is importantly related to being willing to undertake new things, innovation, risk, and quite apart from investment, incentives that depend, I think, on a climate in which business firms have some sense of being able to plan for the future with some kind of stability. And I think a program, a moderate, firm, restrained program which tries to give us promise of sustained and reasonable economic growth with some reduction in inflation, as we proceed to demonstrate that, I think it will instill the confidence needed to take the steps which are very important to raising productivity.

Representative HAMILTON. Would you, therefore, expect productivity to begin to turn up in 1979?

Mr. SCHULTZE. I would certainly hope so. It only grows at about a quarter percent, less than half a percent in the prior 4 quarters.

I would certainly hope and expect it would grow faster. On the other hand, I have to say that the fact of, first, the longer term decline over the past 10 years and then the very specific 1-year decline last year makes one very cautious in predicting that turnaround as a position. But, yes, I would, but I would be cautious in predicting a very large one initially.

Representative HAMILTON. Looking at those three factors that you singled out that accelerated inflation in 1978, the appreciation of the dollar ought to improve?

Mr. SCHULTZE. That is correct.

Representative HAMILTON. You suggested productivity may improve modestly?

Mr. SCHULTZE. Yes; that's right.

Representative HAMILTON. And food, I guess, is much tougher to call. Do you have any call on food for 1979? What is your projection on that?

Mr. SCHULTZE. Well, not a call, I am not prepared to make such a call in a quantitative sense at the moment.

We are in the throes of trying to nail down our formal forecast. This year food prices have been rising something like 12–13 percent annually. I am confident it will be significantly lower than that next year, but I am not yet in a position to throw it up for you.

Representative HAMILTON. Mr. Schultze, if I have the time; let me observe on the part where you talk about being increasingly encouraged by the response to the standards, you indicate that businesses at least have suggested they are going to comply. Then you say that leaders of labor organizations' response has been measured and occasionally critical.

My impression is that labor has been rather vociferous and rather constantly critical. What do you mean "occasionally critical and measured"? I just had the impression that organized labor has not given too much cooperation at all on the standards. Is that a false impression?

Mr. SCHULTZE. It has varied. Mr. Meany, as even a casual reader of the newspapers can note, has been in opposition. You note in his oppo-

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sition he has reiterated the fact that he is not asking his individual union presidents, the leaders, not to cooperate. He is expressing his personal opposition. But of course, the basic bargaining strategy and everything else is determined union by union.

So the statements that have been made by the president of the Communications Workers, the Auto Workers and Teamsters have varied, but basically they have had significant notes of cooperation in them. It is not to suggest there isn't beginning to be, you know, a year in which there will be difficult negotiations and I don't want to be a Pollyanna, but I don't think one can take just Mr. Meany's statements as an indication of how labor will deal with this.

As I say, even Mr. Meany indicated that he is not asking for cooperation by the unions.

Representative HAMILTON. Does the real wage insurance proposal become critical in labor's attitude toward these standards?

Mr. SCHULTZE. I think it is very important, not merely in terms of organized labor, but also in terms of cooperation from management and workers in whatever it is, approximately 70 percent of the labor force that isn't organized.

Representative HAMILTON. Thank you, Mr. Reuss.

Representative REUSS. I share Mr. Hamilton's feeling that it is too bad that the real wage insurance program isn't now before the Congress. Specifically, it seems to me that it would have been useful to have had even a lameduck Ways and Means Committee, or Finance Committee, considering it now so that Congress could act very promptly on January 15.

What I fear is that you are going to have teamsters and oil workers and everybody else negotiating early in 1979 without the benefit of a real wage insurance program. I presume Congress will do a little better than it did on the energy bill, which took 2 years, but——

Mr. SCHULTZE. If it doesn't, then——

Representative REUSS. What does poor Mr. Kahn, or whoever, tell a union that is negotiating that he can't produce a bird in the hand on the real wage insurance program?

Mr. SCHULTZE. Mr. Reuss, we are, as I indicated earlier, now in the process of not merely doing or working on it ourselves and we have done an awful lot, but we are now discussing it with the staff of the relevant tax-writing committees and with the members, and hope to have something up basically as the Congress gets here, if not before. So that you are quite right, it is an urgent matter in terms of speed.

We are aware of that and are working already cooperatively to have something.

Representative REUSS. Well, I wish it could have been faster.

Let me go into one of those boring arithmetical exercises.

I am having difficulty in seeing this $30 billion deficit which you prefigure for fiscal 1980. Tell me where I am going wrong, if you will.

That $30 billion difference between spending of $535 billion, and receipts of $505 billion. Revenues of that order suggest a GNP of about $2.6 trillion, but to get there the economy is going to have to grow in nominal terms at around 12 percent a year.

Since you have a target inflation rate of 6.5 percent, that sounds like a real growth rate of 5.5 percent, and this is much higher than anyone

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is predicting. So what my arithmetic leads me to suggest is not a $30 billion deficit, but one of those awful $50 billion or so deficits.

Wherein am I going astray?

Mr. SCHULTZE. At the moment I can't go through the arithmetic with you. Let me simply note—again without wanting to indicate that those are the specific numbers one would have to have—the kind of increases of revenues you are talking about, and we have done our homework, don't require anything like that nominal GNP.

In terms of specific numbers I am not prepared to go through with it here, but we see a 12-percent growth in nominal GNP is just not required to get there. We don't.

I would have to go back and go through the arithmetic. There are a number of things occuring: On the one hand, you have a tax reduction coming in; on the other hand, you have an increase in the social security taxes coming in, but I would have to go back and do my own homework to see exactly where the arithmetic is off. But I know 12 percent doesn't jibe with what we think is necessary to get there.

Representative REUSS. Well, we are all going to learn a lot in the next 60 days.

Representative Fenwick.

Representative FENWICK. Thank you, Mr. Reuss.

I am really puzzled. We have been told by witnesses coming before this committee that the automatic rises in the social security, minimum wage, are highly inflationary, that we have been cautioned that we should have not taken those steps, we should have done it when it was appropriate by vote rather than linking it to cost of living and other indexes and that is very inflationary.

Now, we are going to add real wage insurance, which I understand is going to affect it. Isn't that another inflationary push? What do you feel about the rise in the minimum wage and social security tax and the social security benefits tied to the cost of living? Are these not all inflation causes?

Mr. SCHULTZE. Let me respond on several points. One, with respect to real wage insurance. It is not, I underline, an escalator-type provision.

Representative FENWICK. What is it?

Mr. SCHULTZE. In fact, it explicitly is directed toward giving some kind of insurance to those who take action to help reduce inflation. It is not a way to limit inflation. It is unlike the other escalators, precisely addressed to those who take action to reduce their real wage increases. Therefore, it is quite different from an escalator.

Representative FENWICK. You say it stays within 7 percent?

Mr. SCHULTZE. That's right.

Representative FENWICK. So, in other words, it would compensate those who stay at 7-percent rise in inflation caused by others who don't; is that it?

Mr. SCHULTZE. That is the basic idea. Again only the rise over 7 percent, it doesn't compensate up and down.

Representative FENWICK. Would that be automatic or do we have to vote on that?

Mr. SCHULTZE. You would have to get there on the law—excuse me?

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Representative FENWICK. Would that become automatic?

Mr. SCHULTZE. No; we would not propose to have this as a long-term thing that becomes automatic. We might want to ask for it for 2 years, maybe 1 year, but clearly it would not be a long-term automatic program.

Representative FENWICK. What do you feel about the rise in the social security tax and the minimum wage as an effect on human production?

Mr. SCHULTZE. Well, let me note that with respect to the rise in social security taxes that in 1977 when this was clearly necessary to do something about the system, the administration had proposed in a modest way a particular way of injecting general revenues into the system to moderate that. It was not a large amount, but it was a good programing.

The Congress couldn't even get it considered, to my recollection.

Representative FENWICK. Would you advise that?

Mr. SCHULTZE. Pardon.

Representative FENWICK. Will you advise that?

Mr. SCHULTZE. Again I submit at this stage it is a bit like the answer to the chairman on capital gains taxes on land. At this stage the Congress has spoken. However, let me note that there are large increases in social security taxes coming up again in 1981 and I don't want to suggest—in fact, I am fairly sure the administration and the Congress will be wanting to take a look at that whole thing. On the other hand, in terms of reversing an immediate action taken by the Congress, that is another matter.

Representative FENWICK. I know what has happened, Mr. Schultze. I am asking you what you would advise?

Mr. SCHULTZE. I am saying that in terms of the upcoming budget and the upcoming year, the deficit considerations are such that to reduce social security taxes to get rid of some of those increases in the year ahead, I don't see how they could be fitted into a reasonable fiscal policy. If you look at several years, that is another matter and there is a chance, but not in 1979.

Representative FENWICK. I see. I want to go to another subject, cost of food.

Some 4 years ago Lewis Engman, I think Chairman of the Federal Trade Commission, said that if we could make food exempt from the ICC regulations, as all fresh produce is now, we would cut the cost of its distribution by some 35 percent. This happened when fresh chickens were declared to be, as you know, fresh produce and the cost of distributing them dropped by that amount.

What would you think in an effort of eliminating inflationary costs for food, if all food, processed and fresh, were exempted and could be carried without regard to the Interstate Commerce Commission?

Mr. SCHULTZE. As you know, the President has indicated he is going to be submitting legislation in the area of regulatory reform in the surface transportation—rail and truck, in other words.

At this stage, since I must confess I have never thought of that particular approach, I don't know whether it would be the most effective way of dealing with it. However, I do want to make the caveat that there may be better ways to get deregulation. There is nothing magic

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in food, per se. If you save the consumer whatever it is, maybe $100 a year, it is important to save the consumer $100 a year, and it may be better to do it in more ways that are general than to pick one commodity.

I am making the caveat on food.

Representative FENWICK. Of all things that is the one thing we would want to work on.

Thank you, Mr. Reuss.

Representative REUSS. Thank you. Taking notice of your important date, we thank you very much, Mr. Schultze. As always, you have been a super witness, and we want to wish you a Merry Christmas and good luck, and remember that word "micro."

Mr. SCHULTZE. Yes; I shall. Thank you.

Representative REUSS. Thank you.

We will reconvene here at 2 o'clock for the continuation of this hearing.

[Whereupon, at 11:54 a.m., the subcommittee recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

Representative REUSS. Good afternoon.

The subcommittee will be in order for its continued hearings on the dollar rescue mission and its domestic implications.

We are honored to have before us a blue-ribbon panel of witnesses: Mr. Hendrik Houthakker of Harvard University; Leon Keyserling, president of the Conferenec on Economic Progress; Robert Solomon, senior fellow at Brookings; and Thomas Willett, professor of economics, Claremont Graduate School.

Thank you for getting to us your very helpful prepared statements which, under the rule and without objection, will be received in full and placed in the record.

I would now like to ask each member of the panel to proceed, trying to restrict, if possible, his summary to 10 minutes or so, and then we will have an opportunity to ask questions.

Mr. Houthakker, would you lead off?

STATEMENT OF HENDRIK S. HOUTHAKKER, HENRY LEE PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. HOUTHAKKER. Thank you, Mr. Reuss.

I am always grateful for the opportunity to appear before you and perhaps I may remind you that unlike most economists, I was never a proponent of free and floating rates and preferred a reform of the Bretton Woods system to make it more flexible.

However, when the necessary reforms were not undertaken and the Bretton Woods system collapsed, my view was that floating rates should be used to best advantage, and that Government intervention in the exchange markets should be kept to a minimum.

The theoretical case for floating rates was based on the notion that countries could combine full employment and price stability with equilibrium in the foreign exchange markets, surely the best of all possible worlds. Actual experience during the last 5 years has hardly

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confirmed these claims; indeed, it would be more correct to say that the opposite happened.

In most industrial countries inflation and unemployment levels have been at higher levels than at any time since World War I. Unemployment has been at its greatest level since the Great Depression. Surpluses and deficits in the balance of payments have been at least as persistent, and often larger, than they were under Bretton Woods. A cynic might well say that floating rates have brought us the worst of all possible worlds.

Not being a cynic, I would not want to draw this conclusion, nor would I attribute all the present ills of the world economy to floating rates. It seems fair to say, however, that the leading countries of the world have simply been unable to adjust their economic policies to the prevailing regime.

The proponents of floating rates will no doubt say that if they have not worked, it is because there has been much government intervention. There is much merit to this view. Too many countries have tried to prevent the appreciation of their currency by massive purchases of dollars, and some of them even have deliberately kept their economies below the full employment level with a view to maintaining exports and holding down imports.

The United States, however, has by and large played the floating rates game by the theoretical rules. Yet at the beginning of last month we were also forced to reverse the nonintervention policy.

The economic theory underlying floating rates assumes that the foreign exchange markets are stable, both in the short run and in the long run. The experience with the last several years has belied this assumption, particularly as regards shortrun stability, although there is as yet little reason to question the longrun stability of the exchange markets. The shortrun instability appears to be so overwhelming that the longrun is largely of academic interest.

The reason for the shortrun instability of the exchange market is threefold:

1. The lags in the adjustments of exports and imports to changes in exchange rates are fairly long, probably of the order of 2 years. In the shortrun, the effect of depreciation or appreciation is often perverse.

2. The capital movements associated with changes in currency values are frequently destabilizing, a factor aggravated by the huge size of private holdings in the world capital market.

3. Most countries are unwilling to leave the size of their imports and exports to be determined by market forces only.

Of these three reasons, the first two are probably decisive.

While I believe that the only permanent solution to these international monetary problems is a return to a suitably modified Bretton Woods–type system, I have no wish to exaggerate the present difficulties. Despite the serious shortrun instability that has become obvious to most observers, there are signs of a return to better balance. The depreciation of the dollar, in particular, has led to an increasing demand for our exports exceeding the growth in our imports. If continued, this development could bring us close to balance in the current account within 1 year.

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This outcome could be made more likely if countries such as West Germany and Japan fulfill their promises of more stimulative domestic policies, and if we ourselves put our energy policies on a more rational basis by permitting domestic oil and gas prices to rise to world market levels. With this relatively optimistic prognosis in mind, I would like to turn now to the recent intervention.

First of all, I commend the administration and the Federal Reserve, not only for taking strong action when it was needed, but also for not doing much of anything until that time. A substantial depreciation of the dollar was necessary to bring our current account into better balance. It would no doubt have been better if other countries, especially Japan, had been more cooperative in increasing their imports, but in the absence of such cooperation, we had little choice.

The administration can be criticized, though, for making occasional statements suggesting intervention when there actually was no serious intention of intervening; the only effect of these tactics was to undermine credibility and to make the private international capital markets more susceptible to instability. In foreign exchange markets it is action, not words, that count.

In October 1978 it became clear that private international capital movements were getting out of hand. The statistical data against which this inference should be tested will not be available for several months, but the behavior of the exchange markets spoke for itself. The Swiss franc, the favorite counterpart for speculation against the dollar, rose by leaps and bounds, rising to a premium of more than 30 percent over the German mark.

The newspapers were full of statements by presumably responsible financiers implying that the dollar had no way to go but down. These prophesies threatened to become self-fulfilling. Moreover, the dollar was falling to a level much lower than needed to restore current account balance, and the depreciation itself was beginning to pose a serious threat to domestic price stability in the United States.

Whether by foresight or by procrastination, the administration had waited until it saw the whites of the enemies' eyes. Not only was its action of November 1 perfectly timed, but it also was sufficiently massive to convince a demoralized market that the United States meant business at last.

Having put on record my strong general approval of the intervention of November 1, I should nevertheless raise a few questions about the components of the intervention package. The increase in the discount rate and in the reserve requirements was entirely appropriate; until that time interest rates had been kept at an unduly low level, at which the real return on assets was negative, given our inflation rate.

We are now at last seeing the positive real rates of return without which domestic price stability is not conceivable. No doubt these monetary actions have increased the risk of a recession, but in my opinion not to an unacceptable extent. In fact, the administration could have done something on the domestic front and also had a more restrictive fiscal policy.

I am less enthusiastic about the various international credit transactions that were an important part of the November 1 measures. While

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there is no great harm in drawing on the International Monetary Fund, the previous experience with Roosa bonds should have suggested considerable caution in borrowing in foreign currencies. The interest rates abroad may be attractive, but there is a considerable currency risk in light of the apparent long-run tendency toward depreciation of the dollar.

Another component of the November 1 package was an increase in Treasury gold sales. This was a wise decision; indeed, I would have gone further and introduced weekly sales at a rate of, say, 1 million ounces per week. The U.S. gold stock stands at about 275 million ounces, worth more than $55 billion at present prices.

I am certainly not suggesting that this is the course we should adopt. It should be recognized, however, that the gold serves no purpose whatever unless it is used at least occasionally. Our international reserves consist almost entirely of gold; if gold is not used, we have no reserves to speak of.

Of course, I am not suggesting that we return to the gold standard, but greater reliance on our gold stock would have considerable advantages over borrowing abroad. Since the gold does not earn any interest, the cost of using it is very low. To the extent that individual investors want to hold gold as a hedge against inflation, it would be in the public interest to make it available to them rather than keep it unproductively in Fort Knox.

Gold no longer has any role in the international monetary system; it has become simply a commodity of which we happen to hold a large stock because of past history. The idea of selling gold by regular auctions is basically sound; if the price of gold were to drop sharply, we could always suspend the auctions. Greater emphasis on Treasury gold sales would also serve to remind the international capital markets of our assets position.

While I am fairly optimistic concerning the immediate prospects for the dollar, I do not think we are out of the woods in the longer run. International monetary reform should remain high on our agenda, but the results are not likely to be visible soon. Moreover, we should strongly resist foreign pressures to run our economy at a lower level of employment merely to preserve the external value of the dollar.

We need effective anti-inflation policies for domestic reasons, but the question of the exchange rate is an entirely separate one. The fall in the dollar is not primarily the result of higher inflation in the United States; even now our inflation rate is not substantially different from the average of other industrial countries. When it comes to the point, the world at large has a greater interest in continued real growth in the United States than it has in the external value of the dollar.

In summary, our international economic policies should continue to be governed primarily by domestic considerations, including both price stability and full employment. Until there is agreement on a new international monetary ssytem, we should not lock ourselves into any particular external value of the dollar, and intervention should be practiced only in cases of short-term instability. It is only by this strategy that we can hope to induce other countries to pursue similar domestic policies, and to protect our own interests if they fail to see things our way. Thank you.

[The prepared statement of Mr. Houthakker follows:]

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Prepared Statement of Hendrik S. Houthakker

U.S. Policy Toward the Dollar

Mr. Chairman, I am as always grateful for the opportunity to appear before your subcommittee, which has done so much over the years for a better understanding of international monetary affairs. Perhaps I may start out by reminding you that, unlike most economists at the time, I was never a proponent of freely floating rates and preferred a reform of the Bretton Woods system to make it more flexible. However, when the necessary reforms were not undertaken and the Bretton Woods system collapsed, my view was that floating rates should be used to best advantage, and that government intervention in the exchange markets should be kept to a minimum. Although floating rates had come into being by default rather than by design, here at least was an opportunity to test the claim of the proponents that they would permit simultaneous attainment of internal and external balance. The theoretical case for floating rates was based on the notion that countries could combine full employment and price stability with equilibrium in the foreign exchange markets, surely the best of all possible worlds.

Actual experience during the last five or six years has hardly confirmed these claims; indeed it would be more correct to say that the opposite happened. In most industrial countries inflation has been at higher levels than at any time since World War I. Unemployment has been at its greatest level since the Great Depression. Surpluses and deficits in the balance of payments have been at least as persistent, and often larger, than they were under Bretton Woods. A cynic might well say that floating rates have brought us the worst of all possible worlds.

Not being a cynic, I would not want to draw this conclusion, nor would I attribute all the present ills of the world economy to floating rates. It seems fair to say, however, that the leading countries of the world have simply been unable to adjust their economic policies to the prevailing regime. In fact, the only countries that have operated floating rates successfully are those in the southern part of Latin America where inflation has become endemic.

The proponents of floating rates will no doubt say that if they have not worked, it is because there has been much government intervention. There is much merit to this view. All too often countries have tried to prevent the appreciation of their currency by massive purchases of dollars, and some of them even have deliberately kept their economies below the full employment level with a view to maintaining exports and holding down imports. The United States, however, has by and large played the floating rates game by the theoretical rules. Until recently we have intervened very little, while working towards full employment and indeed coming close to accomplishing it. Yet at the beginning of last month we were also forced to reverse the non-intervention policy.

The economic theory underlying floating rates assumes that the foreign exchange markets are stable, both in the short run and in the long run. The experience with the last several years has belied this assumption, particularly as regards short-run stability, but there is as yet little reason to question the long-run stability of the exchange markets. The shor-run instability appears to be so overwhelming that the long-run is largely of academic interest. The reason for the short-run instability of the exchange market is three-fold:

1. The lags in the adjustments of exports and imports to changes in exchange rates are fairly long, probably of the order of two years. In the very short run, the effect of depreciation or appreciation is often perverse.
2. The capital movements associated with changes in currency values are frequently destabilizing, a factor aggravated by the huge size of private holdings in the world capital market.
3. Most countries are unwilling to leave the size of their imports and exports to be determined by market forces only.

Of these three reasons, the first two are probably decisive. If there were more stability, countries might also be more willing to let foreign trade take its course. As it is, they intervene because they are not willing to entrust the fate of their economies to a long-run stability that has not been demonstrated. Since the interventions by different central banks tend to be contradictory, they are themselves a further source of short-run instability.

Although I believe that the only permanent solution to these international monetary problems is a return to a suitably modified Bretton Woods-type system,

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I have no wish to exaggerate the present difficulties. Despite the serious short-run instability that has become obvious to most observers, there are signs of a return to better balance. The depreciation of the dollar, in particular, has led to increasing demand for our exports exceeding the growth in our imports. If continued, this development could bring us close to balance in the current account within a year. This outcome could be made more likely if countries such as West Germany and Japan fulfill their promises of more stimulative domestic policies, and if we ourselves put our energy policies on a more rational basis by permitting domestic oil and gas prices to rise to world market levels. With this relatively optimistic prognosis concerning our current account in mind, I would like to turn now to the recent intervention.

First of all, I commend the Administration and the Federal Reserve, not only for taking strong action when it was needed, but also for not doing much of anything until that time. A substantial depreciation of the dollar was necessary to bring our current account into better balance. It would no doubt have been better if other countries, especially Japan, had been more cooperative in increasing their imports, but in the absence of such cooperation we had little choice. The Administration can be criticized though, for making occasional statements suggesting intervention when there actually was no serious intention of intervening; the only effect of these tactics was to undermine credibility ad to make the private international capital markets more susceptible to instability. In for foreign exchange markets it is action, not words, that count.

In October 1978 it became clear that private international capital movements were getting out of hand. The statistical data against which this inference should be tested will not be available for several months, but the behavior of the exchange markets spoke for itself. The Swiss franc, the favorite counterpart for speculation against the dollar, rose by leaps and bounds, rising to a premium of more than 30% over the German mark. The newspapers were full of statements by presumably responsible financiers implying that the dollar had no way to go but down. These prophesies threatened to become self-fulfilling. Moreover, the dollar was falling to a level much lower than needed to restore current account balance, and the depreciation itself was beginning to pose a serious threat to domestic price stability in the United States. Whether by foresight or by procrastination, the Administration had waited until it saw the whites of the enemies' eyes. Not only was its action of November 1 perfectly timed, but it also was sufficiently massive to convince a demoralized market that the United States meant business at last. In the few weeks since November 1, the exchange markets have been remarkably quiet.

Having put on record my strong general approval of the intervention of November 1, I should nevertheless raise some questions about the components of the intervention package. The increase in the discount rate and in the reserve requirements was entirely appropriate; until that time interest rates had been kept at an unduly low level, at which the real return on assets was negative, given our inflation rate. We are now at last seeing the positive real rates of return without which domestic price stability is inconceivable. No doubt these monetary actions have increased the risk of a recession, but in my opinion not to an unacceptable extent. Except for the abnormally low savings rate, our domestic economic performance has been reasonably well balanced, without the build-up of inventories that has usually been the immediate cause of a recession. Indeed, I feel that the Administration could have gone further in this direction and also announced a more restrictive fiscal policy.

I am less enthusiastic about the various international credit transactions that were an important part of the November 1 measures. While there is no great harm in drawing on the International Monetary Fund, the previous experience with Roosa bonds should have suggested considerable caution in borrowing in foreign currencies. The interest rates abroad may be attractive, but there is a considerable currency risk in light of the apparent longrun tendency towards depreciation of the dollar, a tendency that has been apparent from econometric studies for several years.

Another component of the November 1 package was an increase in Treasury gold sales. This was a wise decision: indeed, I would have gone further and introduced weekly sales at a rate of, say, one million ounces per week. The U.S. gold stock stands at about 275 million ounces, worth more than 55 billion dollars at present prices. This amount would be large enough to cover our current account deficit for a number of years, although I am certainly not suggesting

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that this is the course we should adopt. It should be recognized, however, that the gold serves no purpose whatever unless it is used at least occasionally. Our international reserves consist almost entirely of gold; if gold is not used, we have no reserves to speak of.

I am not suggesting that we return to the gold standard, which would in any case be impractical, but greater reliance on our gold stock would have considerable advantages over borrowing abroad. Since the gold does not earn any interest, the cost of using it is very low. Of course, it is conceivable that the price of gold will rise further in the future, but the opposite is also arguable. A large part of the world's gold stock is now in private hands, much of it in anticipation of future price increases. If these increases are not forthcoming, the gold may be unloaded, leaving the United States with a large capital loss. To the extent that individual investors want to hold gold as a hedge against inflation, it would be in the public interest to make it available to them rather than keep it unproductively in Fort Knox.

Gold no longer has any role in the international monetary system; it has become simply a commodity of which we happen to hold a large stock because of past history. The idea of selling gold by regular auctions is basically sound; if the price of gold were to drop sharply, we could always suspend the auctions. Greater emphasis on Treasury gold sales would also serve to remind the international capital markets that the United States is not without reserve assets and does not need to borrow abroad in case of a deficit.

While I am fairly optimistic concerning the immediate prospects for the dollar, I do not think we are out of the woods in the longer run. International monetary reform should remain high on our agenda, but the results are not likely to be visible soon. Moreover, we should strongly resist foreign pressures to run our economy at a lower level of employment merely to preserve the external value of the dollar. We need effective anti-inflation policies for domestic reasons, but the question of the exchange rate is an entirely separate one. The fall in the dollar is not primarily the result of higher inflation in the United States; even now our inflation rate is not substantially different from the average of other industrial countries. When it comes to the point, the world at large has a greater interest in continued real growth in the United States than it has in the external value of the dollar.

In summary, our international economic policies should continue to be governed primarily by domestic considerations, including both price stability and full employment. Until there is agreement on a new international monetary system we should not lock ourselves into any particular external value of the dollar, and intervention should be practiced only in cases of short-term instability. It is only by this strategy that we can hope to induce other countries to pursue similar domestic policies, and to protect our own interests if they fail to see things our way.

Representative Reuss. Thank you, Mr. Houthakker.

Mr. Solomon, would you come up next with your statement?

STATEMENT OF ROBERT SOLOMON, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. Solomon. Thank you, Mr. Reuss.

In this statement I attempt to assess the wisdom of the actions announced on November 1 and designed, in the President's words, "to correct the excessive decline in the dollar which has recently occurred".

The dollar had been declining for more than a year when the November 1 actions were taken. After 2 years of relative stability, the trade-weighted average value of the dollar—otherwise known as the effective exchange rate—against the currencies of the 10 largest industrial countries, fell about 5 percent in the fourth quarter of 1977, 3½ percent in the first quarter of 1978, and one-half percent in the second quarter.

The downward movement accelerated again in the summer, with a decline in the dollar's effective exchange rate of 5½ percent in the

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third quarter. Then in the first 3 weeks of October the dollar's average value fell about 1 percent per week. It feel more than 2 percent in the week from October 18 to October 25, and 2.7 percent from October 25 to October 30.

Of course, the downslide of the dollar corresponded to a similar accelerating upward movement of the currencies of the other industrial countries, most notably Germany, Japan and Switzerland. In the last two weeks of October the dollar value of the D-mark increased almost 3½ percent per week.

It is clear that exchange rates were moving further and more rapidly than could be justified by any economic criterion. At the low point on October 30, the dollar was down 22 percent from September 1977 on a weighted average basis against the currencies of the other industrial countries. And the daily movement was becoming very large indeed. Among the various consequences was the impact of the rising cost of imports, at least from the industrial countries, on the President's wage-price program. It is my judgment therefore that forceful action was called for to arrest the exchange rate movement.

In the circumstances I have just described, intervention was justified. The underlying balance of payments position of the United States was improving. But, the halving—cutting in half—of the current-account deficit between the first and second quarters of 1978 had been completely ignored by the foreign exchange markets. And the prospects for a convergence of rates of economic expansion between the United States and the other industrial countries promised a further improvement in the U.S. balance of payments. These facts, too, were ignored by the foreign exchange markets. So, the intervention was, in my mind, justified.

Having presented this rationale for the foreign exchange intervention part of the November 1 program, I would like to register some concern about the monetary policy component of that program. It is traditional for central banks to raise interest rates or take other tightening action when an effort is being made to stabilize an exchange rate. And conventional wisdom in the minds of participants in the foreign exchange markets no doubt expected some monetary policy action. But the fact is that monetary policy had already been tightened considerably. Over the year from September 1977 to October 1978, the Federal funds rate was raised almost 3 percentage points. Immediately after the November 1 announcement, many economic forecasters raised the probability they were assigning to a recession in 1979.

Yet, a recession is in the interest of neither the United States nor of its trading partners. As we learned in 1969–70, a mild recession would do little to cure inflation, and I don't think anyone wants to have a deep recession. A recession would have adverse impacts on the prosperity of the rest of the world as well as of the United States. And, ironically, it could lead to a further weakening of the dollar. One cannot imagine that interest rates would not fall in a recession, partly because of reduced demand for credit and partly because the Federal Reserve would adopt a more stimulative policy.

The decline in interest rates could induce capital outflows large enough to outweigh the effects of an improved trade balance. The result would be a depreciation of the dollar. Mr. Reuss, I have spelled

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out the case against a recession in a column in a recent issue of The Journal of Commerce. I am attaching a copy of that column to this statement.

Representative REUSS. It will be made a part of the record.

Mr. SOLOMON. If I may, I would like to elaborate a bit on the reasons for the rather sizable movement of exchange rates in the past year.

A good part of the explanation of the large trade deficit, apart from oil imports in 1977, was the sluggish expansion in Europe and Japan.

This sluggish expansion was holding down American exports. In fact, for a while in 1977, industrial production was actually falling in Western Europe and Japan. From the fourth quarter of 1976 to the fourth quarter of 1977, the volume of imports declined in five of the six major industrial countries other than the United States. The single exception was Germany where imports in real terms increased by 3 percent during that period in 1977. Meanwhile, U.S. import volume rose 8½ percent as the U.S. economy expanded vigorously.

I assign great importance to these facts in explaining the development of the enlarged trade deficit of the United States which in turn had an impact on expectations in the foreign exchange market. As in other relatively free markets, expectations tend to become self-fulfilling.

In trying to understand the movement of exchange rates one can focus on the U.S. deficit or on the surpluses of a few other industrial countries. Correspondingly, one can focus on the downward movement of the dollar or on the upward movement of other currencies.

While the trade-weighted average value of the dollar fell about 15 percent from late September 1977 to late September 1978, the corresponding upward movement of other currencies was far from uniform. Thus, the effective exchange rate of the French franc and the pound sterling were absolutely unchanged over the year. The Italian lira fell more than 5 percent, while the Canadian dollar's effective exchange rate decreased about 20 percent. The average value of the German mark increased only 6 percent during that period from September 1977 to September 1978. The really large appreciations in effective rates corresponding to the U.S. dollar's depreciation were in the Swiss franc, which rose more than 33 percent, and the Japanese yen which went up 28 percent.

It is no coincidence that, apart from one or two OPEC countries, Switzerland and Japan are the countries with the largest current-account surpluses relative to their economic size. In the first half of this year, Japan's current account surplus was equal to 18 percent of its exports and Switzerland's current-account surplus was equal to 21 percent of its exports. In the case of Germany, the current-account surplus was less than 6 percent of exports. Thus, it is not surprising that the yen and the Swiss franc rose so much more than the deutsche mark. With these currencies rising in value, other currencies had to fall by arithmetic necessity. One of those that fell was the U.S. dollar.

Thus, Mr. Reuss, there is more than one way to look at the exchange rate movement of the past year. If I may put in one more plug, this is a point that I have elaborated in an article in the New Republic for November 11, a copy of which I should like to submit, if I may.

Representative REUSS. That, too, will be entered into our record.

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Mr. SOLOMON. What one concludes from all this, at least from the way I look at it, is that it takes two to tango. Exchange rates reflect the interactions among economies. Whether or not official intervention in the exchange markets will have an effect depends on the underlying economic relationship among countries. The November 1 action was justified and seems to have been successful because the underlying conditions were improving.

Growth and imports have speeded up in Europe and Japan. Japan's exports are falling and export orders in Switzerland are dropping off. The large surpluses of these countries seem to be on the downswing, just as the U.S. deficit is decreasing.

Thus, I conclude with the view that stabilization operations in foreign exchange markets are futile when underlying conditions are not conducive to a stabilization or reversal of an exchange rate movement. But when underlying conditions are pointing to a change and the market is ignoring these conditions, official intervention can be justified. Thank you.

[The prepared statement of Mr. Solomon, together with the articles referred to, follows:]

PREPARED STATEMENT OF ROBERT SOLOMON [1]

In this statement, I attempt to assess the wisdom of the actions announced on November 1 and designed, in the President's words, "to correct the excessive decline in the dollar which has recently occurred."

The dollar had been declining for more than a year when the November 1 actions were taken. After two years of relative stability, the trade-weighted average value of the dollar (or effective exchange rate) against the currencies of the ten largest industrial countries fell about 5 percent in the fourth quarter of 1977, 3½ percent in the first quarter of 1978, and ½ percent in the second quarter. The downward movement accelerated again in the summer, with a decline in the dollar's effective exchange rate of 5½ percent in the third quarter. Then in the first three weeks of October the dollar's average value fell about 1 percent per week. It fell more than 2 percent in the week from October 18 to October 25, and 27 percent from October 25 to October 30.

Of course the downslide of the dollar corresponded to a similar accelerating upward movement of the currencies of the other industrial countries, most notably Germany, Japan and Switzerland. In the last two weeks of October the dollar value of the D-mark increased almost 3½ percent per week.

It is clear that exchange rates were moving further and more rapidly than could be justified by any economic criterion. At the low point on October 30, the dollar was down 22 percent from September 1977 on a weighted average basis against the currencies of other industrial countries. And the daily movement was becoming very large indeed.

Among the various consequences was the impact of the rising cost of imports, at least from the industrial countries, on the President's wage-price program.

It is my judgment therefore that forceful action was called for to arrest the exchange rate movement.

In the circumstances, intervention was justified. The underlying balance of payments position of the United States was improving. But, the halving of the current-account deficit between the first and second quarters of 1978 had been completely ignored by the foreign exchange markets. And the prospects for a convergence of rates of economic expansion between the United States and the other industrial countries promised a further improvement in the U.S. balance of payments.

Having presented this rationale for the foreign exchange intervention part of the November 1 program, I would like to register some concern about the

[1] The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of The Brookings Institution, its officers, trustees, or other staff members.

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monetary policy component of that program. It is traditional for central banks to raise interest rates or take other tightening action when an effort is being made to stabilize an exchange rate And conventional wisdom in the minds of participants in the foreign exchange markets no doubt expected some monetary policy action. But the fact is that monetary policy had already been tightened considerably. Over the year from September 1977 to October 1978, the federal funds rate was raised almost 3 percentage points. Immediately after the November 1 announcement, many economic forecasters raised the probability they were assigning to a recession in 1979.

Yet a recession is in the interest of neither the United States nor of its trading partners. As we learned in 1969–70, a mild recession would do little to cure inflation. It would have adverse impacts on the prosperity of the rest of the world as well as of the United States. And, ironically, it could lead to a further weakening of the dollar. One cannot imagine that interest rates would not fall in a recession, partly because of reduced demand for credit and partly because the Federal Reserve would adopt a more stimulative policy. The decline in interest rates could induce capital outflows large enough to outweigh the effects of an improved trade balance. The result would be a depreciation of the dollar. Mr. Chairman, I have spelled out the case against a recession in a column in a recent issue of *The Journal of Commerce*. I am attaching a copy of that column to this statement.

BACKGROUND OF EXCHANGE RATE MOVEMENT

If I may, Mr. Chairman, I would like to elaborate a bit on the reasons for the rather sizeable movement of exchange rates in the past year As the year progressed, the consensus view on the causes of the dollar's depreciation shifted. In the autumn of 1977, much tof the blame, if that is the right word, was placed on remarks made by Secretary Blumenthal, who was accused of "talking down the dollar." Then market talk focussed on the voracious American appetite for oil, for in 1977 our oil imports increased in value by $10 billion, accounting for half of the increase in the U.S. trade deficit in that year. More recently, the blame has shifted to the U.S. inflation rate, which has worsened in 1978 while inflation abated in other industrial countries.

There could be some degree of merit in all of these alleged explanations but what was not adequately appreciated was that sluggish expansion in Europe and Japan was holding down U.S. exports. For a while in 1977, industrial production was actually falling in Western Europe and Japan. From the fourth quarter of 1976 to the fourth quarter of 1977, the volume of imports, declined in five of the six major industrial countries, other than the United States. The single exception was Germany, where imports in real terms increased about 3 percent. Meanwhile U.S. import volume rose 8½ percent, as the U.S. economy expanded vigorously.

In the circumstances, the United States trade deficit increased and the trade and current-account positions of other industrial countries moved to smaller deficit or larger surplus.

In trying to understand the movement of exchange rates one can focus on the U.S. deficit or on the surpluses of a few other industrial countries. Correspondingly, one can focus on the downward movement of the dollar or on the upward movement of other currencies.

While the trade-weighted average value of the dollar fell about 15 percent from late September 1977 to late September 1978, the corresponding upward movement of other currencies was far from uniform. Thus the effective exchange rate of the French franc and the pound sterling were unchanged over the year. The Italian lira fell more than 5 percent, while the Canadian dollar's effective exchange rate decreased about 20 percent. The average value of the German mark increased only 6 percent. The really large appreciations in effective rates corresponding to the U.S. dollar's depreciation were in the Swiss franc, which rose more than 33 percent and the Japanese yen, which went up 28 percent.

It is no coincidence that, apart from one or two OPEC countries, Switzerland and Japan are the countries with the largest current-account surpluses, relative to their economic size. In the first half of this year, Japan's current account surplus was equal to 18 percent of its exports and Switzerland's surplus was equal to 21 percent of its exports. In the case of Germany, the current-account surplus was less than 6 percent of exports. Thus it is not surprising that the yen and the Swiss franc rose so much more than the D-mark. And with these currencies rising in value, other currencies had to fall. One of those that fell was the U.S. dollar.

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Thus, Mr. Chairman, there is more than one way to look at the exchange rate movement of the past year. This is a point that I have elaborated in an article in *The New Republic* for November 11, a copy of which I should like to submit, if I may.

The fact is that it takes two to tango. Exchange rates reflect the interactions *among* economies. Whether or not official intervention in the exchange markets will have an effect depends on the underlying economic relationship among countries. The November 1 action was justified and seems to have been successful because the underlying conditions were improving. Growth and imports have speeded up in Europe and Japan. Japan's exports are falling and export orders in Switzerland are dropping off. The large surplus of these countries seem to be on the downswing, just as the U.S. deficit is decreasing.

Thus I conclude with the view that stabilization operations in foreign exchange markets are futile when underlying conditions are not conducive to a stabiliaztion or reversal of an exchange rate movement. But when underlying conditions are pointing to a change and the market is ignoring these conditions, official intervention can be justified.

[From the Journal of Commerce, Dec. 7, 1978]

Should We Welcome a Recession?

(By Robert Solomon)

As the Federal Reserve has moved to tighten monetary policy further, economic forecasters are assigning a higher probability to a recession in 1979. While these forecasts are understandable, what is difficult to comprehend is the growing view that a recession would be desirable.

This opinion has been expressed most strongly in Wall Street and has brought a rebuke from Federal Reserve Chairman Miller, who was quoted in the Washington Post as saying, "Wall Street may want a recession. You know, there is a certain theory that you can wash it out, and then get a new buying base for stocks and make a killing . . . as long as you're one of the insiders and know how to do it. But I don't think that's good national policy."

TO SLOW INFLATION?

Those who would welcome a recession presumably believe that it is the only way to reduce the rate of inflation. It is useful, therefore, to examine what happened in 1969–70, the last time we had a mild recession. (The experience of 1974–75 is not relevant, since it involved a reversal of the explosion in world commodity prices and adjustment to the quadrupling of oil prices. Furthermore, even the most masochistic of those who would welcome a recession are unlikely to want to see one as deep as in 1974–75.)

The U.S. economy turned down in the latter part of 1969. Real GNP declined at an annual rate of about 4 percent from the third quarter of 1969 to the second quarter of 1970, unemployment rose from 3.6 to 5.2 percent, and then climbed to 6 percent, where it remained throughout 1971.

What happened to prices and wages? It is true that consumer prices rose less rapidly in 1970 than in 1969, but this was entirely the result of a slower advance of food prices in 1970. Consumer prices other than food did not decelerate at all during 1970.

Only in 1971, when the economy was expanding again and productivity speeded up, did the price rise abate.

WAGE RATES CLIMB

Meanwhile, wage rates continued to increase through the recession without slowdown. Average hourly earnings, adjusted for overtime and inter-industry shifts of employment, remained stuck at a 6.6 percent increase in 1969–70 and accelerated to 7 percent in 1971.

Thus, from the 1969–70 episode, there is no basis for looking to a mild recession as a means of reducing the rate of inflation.

Furthermore, the other effects of a recession should be considered. A reduction in aggregate demand, if not brought about by a slowdown in business outlays for plant and equipment, would very likely induce such a slowdown.

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Yet there is a widespread belief that the nation needs a higher rate of business investment to increase the capital stock and improve productivity.

The extent to which a recession would bring a reduction in interest rates cannot be predicted with confidence, but every recession in the postwar period has been accompanied by falling interest rates. This has occurred for two reasons: a reduced demand for credit as spending by business and consumers fell and an increased supply of funds as the Federal Reserve acted to stimulate the economy. It is highly unlikely that the Fed would not act in a similar manner in 1979 if a recession began. Indeed the Fed would be subject to severe criticism if it did not combat a recession.

In these circumstances, the effect on exchange rates might turn out to be different from what the recession advocates expect. The conventional wisdom is that a slowdown in the U.S. economy, by improving the trade balance, would strengthen the dollar. But if interest rates are falling here while they rise abroad, capital outflows could outweigh the trade balance improvement and put downward pressure on the dollar again.

Finally, the human effects of recession should not be ignored. Unemployment would increase and, in an accordian-like manner, youth unemployment would rise sharply. Those who have been most vocal about the medicinal effects of recession are not among the ones in danger of losing their jobs.

The conclusion to which these considerations point is that the government's wage-price program is our best hope of reducing the rate of inflation. That program should be supported by a fiscal and monetary stance that keeps aggregate demand expanding in line with the economy's growing potential. If this sounds like fine tuning, it should be realized that those who favor a recession are, perhaps implicitly, counting on fine tuning to keep a mild recession from becoming severe.

Chairman Miller's public statements suggest that he agrees with the above prescription for economic policy. One must hope that he can bring the Federal Open Market Committee along. And, since President Carter has also rejected the idea of a recession, he should face the implications for fiscal policy.

Whether the President's budgetary aims are consistent with preventing a recession cannot be dealt with here, but the question is worth asking.

[From the New Republic, Nov. 11, 1978]

Courting Recession To Spur the Inevitable Dollar Bounce

(By Robert Solomon)

It has been a steady and, to many people, a disconcerting refrain: "The dollar hit record lows on European and Japanese money markets again today . . ." "The price of gold went up again yesterday, as money traders continued selling dollars . . ." "The Japanese yen and the German mark reached new highs against the dollar today . . ." Ordinary citizens no doubt have been troubled by a seeming collapse of their currency, and some of them may be wondering if it portends a collapse of their economy or even of America's leadership role in the world. I would stress that a strong economy does not necessarily have a high valued currency, nor does a strong currency always signify a strong economy. The causes of the dollar's decline are complex; its effects are confusing and it is not entirely clear what should be done about it. Yet dollar fluctuations are not unprecedented: to the contrary, the rule in money trading seems to be that whatever goes down must come up, and vice versa. By every indication of past performance, it is now time for betting in favor of the dollar again, instead of against it. In fact, we may have begun seeing the dollar bounce back before the Carter administration intervened in international money markets last week.

To begin understanding what has been happening in foreign exchange markets, one should recall that since March 1973 the major currencies of the world have been floating in relation to one another. In contrast to the exchange rate system that prevailed from the end of World War II until 1973, governments in the larger countries no longer fix their exchange rates and attempt to maintain them by buying and selling currencies. That earlier arrangement, the so-called Bretton Woods system, came under increasing strain in the late 1960s and early 1970s, giving rise to frequent international monetary crises.

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Following the abandonment of fixed exchange rates, the dollar went through three cycles, each downward movement being followed by an upswing. Then, for the two years from the autumn of 1975 to the autumn of 1977, the dollar was quite stable as measured against an average of the currency values of the other major industrial countries. And this stability was at a level slightly higher than when floating started. Beginning in September 1977, another downswing got under way and, except for a reversal in the spring of this year, it has continued until the past week.

Just as the dollar has not been the victim of one steady, uninterrupted decline, the extent of its drop has not been as great as news reports might indicate. An exchange rate is the price of a currency in terms of other currencies. Since there are as many currencies as there are nations, no clear-cut and unequivocal measure exists of the value of any one currency. Should it be valued against all other currencies, against those of the larger countries, or simply against the dollar? The dollar, we should remember, is not just the currency of the United States of America, but it is also a world money. It is held in reserve by other countries, and used as a standard of value of other currencies. Each day when the newspapers tell us about a shift in the value of the dollar, they are also reporting on shifts in the value of other currencies—the German mark, the Japanese yen, the French franc, etc.—measured in dollars. During the past year, the dollar value of the Swiss franc has gone up about 50 percent, the yen, 45 percent, the mark, 28 percent and the French franc, 17 percent.

This practice is misleading. Valuing the mark, the yen and the other currencies only in relation to the dollar exaggerates their upward movement and the dollar's decline. Germany and Japan do not trade only with the Unitel States, but with many other countries as well. To get a truer picture of the upward movement of other currencies and the downward movement of the dollar, it is necessary to take an average of the value of each currency against the currencies of at least its major trading partners.

By all measures, though, the value of the dollar has fallen in the past year. According to a Federal Reserve weighted average, the dollar depreciated 16 percent from late September 1977 to mid-October 1978 against the currencies of 10 industrial countries. These 10 countries account for about half of world trade, and it's important to note that the dollar's decline against them has been considerably smaller than the 50 percent or 45 percent recorded against the Swiss franc and the yen. If the dollar is measured against all countries and not just these 10, the depreciation over the last year is even smaller.

The causes of the dollar's depreciation are not easy to pin down. In fact, over the past year, public commentary has shifted from one cause to another. A year ago, much stress was placed on American oil imports, which increased $10 billion in 1977 and accounted for about one half of the enlargement of the US trade deficit for that year. US oil imports are no longer increasing, and lately attention has focused on two other explanations for the dollar's decline.

One is the difference in economic performance between the US and the other industrial countries. In 1977, recovery from the recession of 1975 faltered in Europe and Japan, which are important markets for US exports. In fact, for a while in 1977, industrial production was actually declining in these countries. Meanwhile, the American economy continued to expand at a vigorous pace. The result was that the US "sucked in" imports faster than its trading partners took in US exports. Now things are changing. It's expected that economic activity will accelerate in Europe and Japan while it slows down somewhat here. This should lead to faster expansion in US exports and a slower increase in imports. In fact, this is already happening, as US trade statistics for recent months show. But the contraction of the US trade deficit and of the broader measures of US trasnactions, the balance on current account—which includes not only merchandise trade but purchases and sales of services, travel and income on foreign investments—has not yet affected foreign exchange rates as one normally would expect. Puzzingly, the dollar has continued to fall.

Currently, the most popular explanation for the continued decline of the dollar has been the worensing of inflation in the United States. However, it is difficult to believe that the small increase in US inflation could account for the very large movement in the exchange rate between the dollar and the yen or the dollar and the Swiss franc.

What does explain the movement? To understand it, we have to look not only at what is happening in and to the US economy, but at what is happening abroad.

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Largely as a result of its slow economic expansion, Japan has developed an enormous surplus in its trade and current account balances. Its imports have increased slowly because of its sluggish economy. Its producers, facing slack demand at home, have actively sought to sell abroad. As a result, Japan is expected to have a current account surplus of $15 or $20 billion this year. This extraordinarily large surplus is not matched by an outflow of private capital from Japan, and the result is an upward movement of the yen. Much the same thing has happened in Switzerland and, on a smaller scale, in Germany.

We can conclude from this is that the dollar decline is only part of a larger world currency story. In part, the decline is a reflection of upward pressures on other currencies, just as the large trade deficit in the United States is the counterpart of the large trade surpluses of those countries. Some of the underlying causes of the dollar decline, such as US inflation, reflect weaknesses in the American economy, but others, such as lagging growth abroad, reflect comparative US strength. In any event, perceptions of the trade deficit and inflation have created expectations of a weak dollar, and in foreign exchange markets, as in the stock market, expectations become self-fulfilling.

If the causes of the exchange rate movement are mixed, one result is certainly bad for us: import prices have increased and have aggravated our inflation. And not only are imports more expensive (not to mention travel in Japan and Europe), but increases in prices of import commodities lead American producers of similar items to raise their prices, too. There should be a brighter day coming, however. A depreciated dollar, coupled with more rapid economic growth in Europe and Japan, should result in increased US exports, correction of the US balance of payments deficit and stability for the dollar.

Sometimes it is said that the dollar's decline has a depressive influence on other economies by reducing their exports. But in fact, other countries have been relying too heavily on exports and not enough on domestic consumption. This point appears to have been agreed upon at the recent annual meeting of the International Monetary Fund in Washington. The prospect for more expansive policies in Europe and Japan led to optimistic pronouncements at that meeting concerning a reduction of international imbalances and a stabilization of exchange rates.

There is every reason to expect that the dollar's plunge will stop, but what should we do to make sure? Apart from urging other countries to pursue sensible (that is to say, expansionist) policies, we ought to do things we should be doing even if we didn't have a dollar problem. That is, we ought to conserve energy and we ought to deal with inflation. On both fronts, there has been some progress recently. The energy bill passed by Congress probably isn't all that it should be, but it is a start. Even before the bill was passed, US oil consumption had begun to taper off. President Carter's inflation program has opened to better reviews than one might have expected, and one can only hope that it will succeed.

To the extent that world money traders lack confidence in the US energy program and the anti-inflation policy, they will continue betting for a while against the dollar, and it will continue to fall. But this can not and will not continue indefinitely. The underlying realities of the world economy will take hold, and those realities are that US energy consumption is slowing and US inflation is not running out of control. Meanwhile, other economies are moving into higher gear. The result will be a strengthening of the dollar, particularly against those few currencies that have been moving up sharply.

If there is a single lesson in all this, it is that it takes two to tango. The dollar problem is not purely an American problem. It reflects the interaction between the American economy and the economies of other countries. The leaders of other countries may find it politically convenient to blame the United States for some of their domestic problems, but unless they deal with their own problems—by improving the domestic performance of their own economies—the yen problem, the mark problem and the Swiss franc problem will be prolonged. And for as long as it lasts, it will continue to be labelled, incorrectly, as a dollar problem.

On November 1 the Federal Reserve and the Treasury, acting at the request of the President, announced a series of measures designed to strengthen the dollar. The Federal Reserve is increasing the discount rate and is imposing a supplementary reserve requirement of two percent on large time deposits. The latter measure will inhibit banks from issuing certificates of deposits, an important source of funds for lending. Along with further increases in interest rates that will result from the discount rate hike, this will tend to slow expansion of the US economy. It would strengthen the dollar, but it could also cause recession in the United States.

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The other measures include a step-up in the Treasury's monthly gold sales to 1.5 billion ounces (about $4.3 billion per year at the current price) and various means of mobilizing foreign currencies. These steps are designed to persuade money traders that the US government is prepared to intervene heavily, selling gold and currencies, and buying dollars, to increase the value of the dollar.

Two observations may be made about these actions. First, the dollar strengthened significantly on the day before the announcement. It may have come just as the markets were turning around anyway. If that is so, little of the newly-mobilized resources will have to be used. Second, the fundamentals set forth earlier in this article still apply. Unless other countries' economic polices are directed toward reducing their large balance of payments surpluses, no amount of intervention in foreign exchange markets by the United States will have a lasting effect on exchange rates.

Representative Reuss. Thank you, Mr. Solomon.
Mr. Keyserling.

STATEMENT OF LEON H. KEYSERLING, PRESIDENT, CONFERENCE ON ECONOMIC PROGRESS

Mr. Keyserling. Mr. Reuss and members of the subcommittee, first of all, to the extent of propriety, I want to endorse the brilliant statement appearing in the press today and made yesterday by the chairman of this subcommittee expressing at least some doubts about the current program, which vindicates again my belief that among the Members of the Congress he is one of the most perceptive economically and economically wise and one of the most willing to express his views.

I have been knocking around here for 45 years, and I have been knocked around quite a lot, and I would like to exercise restraint with regard to the current program. I cannot do so because of the reckless and unrestrained nature of that program. It strikes havoc with the American economy, not recognizing that the fundamental source of the strength of the dollar is the strength of the economy of which the dollar is but a medium of exchange.

It strikes havoc with our social purposes. It postpones indefinitely some of our most important programs.

Now, to illustrate that in detail, let me give a few facts. I won't resume the President's program, because it is familiar, but I have computed the results of it.

Taking the statements of the President and his advisers at face value, the Secretary of the Treasury has recently stated that the program will result and should result in an economic growth rate, real, or 2 percent or less for a number of years ahead.

The President and other spokesmen have had ranges of between 3 and 3.5 percent.

The head of the Federal Reserve Board has said that it will take 5 to 8 years under this program to get price stability, and this supports a deliberately contrived very low rate of real economic growth for that purpose.

Now, let me estimate just what this costs. In the first place, in 1979 alone it will mean 1.1 million less man-woman-teenager-years of employment and half a million more of unemployment than if we proceeded with policies designed to accomplish the purposes of the Humphrey-Hawkins legislation to reduce unemployment to 4 percent and 3 percent, respectively, in 1983.

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By 1983 it will result in 5 million less employed and 2.5 million more unemployed than the appropriate program, the difference between the employment and unemployment being due to higher growth rates under conditions of high employment of the labor force.

Now, I would like to state that the current program merely repeats almost precisely all of the mistakes which preceded the last five recessions. It learns nothing. It does substantially the same thing again. It will produce substantially the same results.

I would like to call very briefly your attention to my chart No. 3, which illustrates that during 1953–78 we sacrificed $5.9 trillion of total national production and 75 million man-woman-teenage-years of employment opportunity through trying to do substantially what is being tried to do again.

On the next chart, which is No. 4, I compute the estimates for the years ahead, coming to a difference of $818 billion of total national production and almost 17 million man-woman- child-years of employment.

We cannot afford to do it. We should not do it. We cannot withstand the final cost. We cannot afford the effect on the Federal budget. We cannot afford the danger of civil and civic unrest.

Now I come specifically to some of the programs. The first is the anti-inflation, tight money policy. I have a series of charts on that.

Those charts run through Nos. 9, 10, 11, and 12. Chart 9 shows irrefutably, and this is agreed to by most analysts, that there has been a positive correlation between the tightening up of the money supply and the movements toward stagnation, recession, and higher unemployment. I would say that most of the discussion of the inadequacy of the growth in the money supply does not take account of the fact that the growth rate does not allow properly for the general inflation, and even Paul Samuelson has agreed with me and with others that, in order to get an adequate expansion of the money supply, it has to take some account of the general trends in the price level.

My next chart in that series, which is chart 10, details an entirely intolerable situation. What it does, this chart shows that more than a trillion and a half billion dollars have deliberately been transferred by central bank policy from those who borrow to those who lend since 1952.

I do not need to portray either the economic or social significance of that.

It has more than counteracted many efforts in other ways to transfer income to those who need help most, not only for social reasons, but to the general benefit of the performance of the American economy.

This is a demoniac weapon, and I cannot understand now how any reasonable people can condone or accept a further increase in this policy.

In the chart 11, I show that this policy is now costing more than $20 billion in the Federal budget alone in excess interest payments or about 40 percent of the total Federal deficit. This is advocated by the very people who say that the Federal deficit is the main reason for the inflation of the American economy.

And in chart 12 I show that the excess payments in the Federal budget for interest rates in one year come to two or more times the size of most of the vital domestic priority programs which we say we

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cannot afford because the economy is going to slow, and it's going too slow in large measure because of what the Federal monetary policy is doing.

Next I come to a chart which is my chart 13, which shows very briefly that, despite all the talk, most of the deficit in the Federal budget is caused by the deficient performance in the American economy, and there is nothing I can forecast more confidently than that the hammer blows being struck on the American economy by the current program will not only make it impossible to balance the Federal budget, but will also increase the Federal deficit rather than decrease it.

Next I come to the tax policy which is related. I have here a review in two charts numbered 14 and 15 of Federal tax policy for a great number of years, and that consequence is to increase the disposable income of those higher up tremendously more than those lower down, and the 1978 tax program has doubled this in spades. In it also, the increases in taxes are greater than the decreases.

This is bad for the economy as well as being inequitable.

I come finally to the guidelines. When properly examined, the guidelines will result, if effectuated, in wage rate increases 2 or 3 percentage points lower than the price rate increases.

This means that in terms of the hammer blows upon the American economy—a no-growth budget program, a repressive interest rate program, a repressive tax program—is combined with a program directed to two-thirds of all consumers who are two-thirds of the whole economy, which would actually reduce the buying power of their wages and, in fact, this has been the trend for 10 years in our major industries. Charts 16 through 20 relate to this aspect of the problem.

Now, this is a weird witches' brew compound of policies to direct against the American economy.

Now, I have something here about housing. Chart 24 shows the terrific effect of rising interest rates upon the housing program. Chart 23 shows the immense role of housing in the national economy, and chart 25 shows, although it's out of date, the impact of variable interest rates upon the cost of housing and how every few percentage increase in interest rates de-bars millions of families from housing which it can afford and certainly the purchase of new housing. Charts 21 and 22 also relate to housing.

Finally, I come to the effect of the current program upon inflation itself.

Surely it would be a horrible thing, if this program were to accomplish its purposes, to think that we are a one-purpose Nation which must defer indefinitely four or five or six of our greatest national purposes in order to pursue this one alone at the cost of the others. Surely we can find ways to prevent inflation and to protect the dollar which do not do this.

But infinitely more important, this hammer blow struck upon the American economy will wreck the efforts to stabilize the dollar or reduce inflation.

The main reason is shown on my charts 6, 7, 8, and 9, which trace, as I traced many times before for this committee, the interest correlation between the rate of unemployment and the amount of price

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stability. It's upside down. The Congress in the Humphrey-Hawkins bill by overwhelming major repudiated the tradeoff.

Arthur Burns at one time repudiated it. The President at one time repudiated it. Economists no longer acknowledge it. Why do we go in for it again and again and again, when it produces the same result—more inflation, more unemployment, less attention to social needs, less economic growth and unbalanced Federal budget?

Finally, I want to say this. I have a chart here—it's chart 26—which traces the growth rates in the United States and Japan and Germany, and some other countries. As we see, as to Germany and Japan, their economic growth rates for a number of years have far exceeded ours and they are our primary competitors. Can we afford to signal to them that we are going to widen that gap by the deliberate efforts of our Government, and how are we going to bolster confidence in the dollar by signaling to these other countries that we are going to increase unemployment, increase inflation in terms of the real results, keep the Federal budget unbalanced and make a record in all respects tremendously worse than theirs.

Now, I would just like to read a peroration of this problem of the confidence of other nations.

I am sorry to have gotten wound up, but I feel rather strongly about this.

I do want to say, Mr. Reuss, that it's a strange thing, in all due respect to my colleagues and others, that we have become so confounded and dismally near sighted that we talk only about one thing in economics as if we can talk about exchange rates and money rates and the value of the dollar, and not relate these inseparably to the infinitely bigger question of what is happening to the American economy, of which it is a part; or that we can cure these limited but vital problems by neglecting and postponing treatment of all of the others.

So let me just conclude with what I say about the effect upon the dollar.

But the predominant reason why the current policy to reduce the dollar will fail in the long run in my judgment is that they are based upon a narrow and misguided explanation of why the dollar has become so weak.

The overwhelmingly important reason why the dollar has become so weak and our international balances so huge in terms of balances of payments and international trade and services account is because confidence in the American economy has been reduced by the poor performance and poor prospects of the U.S. economy.

What could be more disruptive of confidence in the currency of a country than prolonged evidence that its national policies have learned only how to prevent stagnation and inflation and have succeeded in only coining a word which covers both, while making clear an inability to remedy it, and instead now is sharpening up the weapons that produced both?

It is high time we start listening to any commonsense person who will point out to the economists that the real wealth and strength of nations is what is happening to the growth of production, reduction of unemployment, use of available potentials for real growth, the re-

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duction of shortages, the awareness of critical social and civil dangers arising from not meeting the most basic needs of so large a part of our population.

What other civilized nation has tolerated for so long a rate of unemployment as high as that in the United States?

There is no nation in the world so richly endowed as we are with a potential for economic growth at home and fair competition with other parts of the world, but as to the latter, what is more closely related to the oversea attitude toward the dollar and what has been happening to us as against other countries?

Would anyone have believed 10 or 15 years ago, before economists in the public services seemed to have lost a part of their discernment, that the United States would attempt to strengthen the oversea confidence in its currency enduringly by deliberately and proudly announcing to the rest of the world that it's going to widen the gap between its fundamental economic performance and its prime competitors and court a sixth economic recession since 1953 which the rest of the world fears more than all else?

Let me just say that one of the most corrosive effects upon confidence at home and overseas is the flagrant violation and disregard by the administration as of now of an act, the Humphrey-Hawkins Act, passed by a majority of 100 in the House of Representatives, by a division of 4-to-1 in the Senate, signed by the President with promises to perform it, and now every element, every element in the current program is directly in violation of that act, and more importantly, in violation of the great lessons of experience which we have learned during 25 years in the laboratory of the American economy.

Thank you very much.

[The prepared statement of Mr. Keyserling, together with the charts referred to, follows:]

Prepared Statement of Leon H. Keyserling [1]

Domestic and Other Implications of Dollar Rescue Operations

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to appear before you, and by your request will concentrate upon the domestic effects of the dollar rescue operations, although I shall also have something to say about the impact of these domestic effects upon the dollar rescue operation itself.

Reluctance to criticize President's policies; but these policies need change

It will not take the Committee long to discover that what I shall say is in sharp disagreement with what you have been hearing from representatives of the Administration, and therefore is in sharp disagreement with policies recently announced by the President of the United States. I particularly regret my criticisms of President Carter's recent decisions in the matter of such grave domestic and international significance. These regrets are not because I am a Democrat and served for twenty years in Democratic Administrations, but rather because that very service made me keenly aware of a President's unique responsibilities and unequaled access to relevant information. This awareness warns me against censuring any President's policies lightly. Moreover, having worked very extensively with two of the eight Presidents since I entered the Government in early 1933, helped at times two of the others through direct contacts, and carefully observed the actions of the other four, I have reached the conclusion that President Carter is well above the average of the seven other Presidents in intellec-

[1] Chairman, Council of Economic Advisers under President Truman. President, Conference on Economic Progress.

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tual range, and the equal of any in the firmness of his determination to do what is best for our country and in willingness to change his policies when he becomes convinced that they need change.

I do believe that President Carter's economic policies now need drastic change, and I believe it to be the moral responsibility of those who have worked and studied in this area to the degree I have to speak out fully and frankly. I could not substitute another President for Jimmy Carter now if I wanted to, and as of now I would not want to if I could. But I have learned from much experience that no President can be really expert about all of the complex problems confronting him, and therefore his views and his actions must be shaped greatly by what his advisors tell him. I think that President Carter needs very much to change some of his economic advisers who are not limited to the Council of Economic Advisers. I submit that it would be good both for the President and the public if there are not so many economic advisers at top levels, competing with one another and confusing the public if not the President. And there are some outside the Government whose advice would be useful.

My conclusions in summary

To capsule what I shall say, I am firmly convinced that the dollar rescue operation in the form thus far announced will have very serious adverse effects upon our domestic economy, and maybe even devastating effects. These effects include a severe further decline in the real economic growth rate below levels which have already trended far too low, including what I regard as large prospects of another absolute recession; large increases in unemployment above levels which have been intolerably high for a long time, and still are; intensified rather than decreased pressures upon rates of inflation which have also been intolerably high for a long time, and still are; further costly consequences through further inexcusable neglect of great domestic national priorities, both economic and social; and large adverse impacts upon attempts to move toward a balanced Federal Budget. I further submit, and will endeavor to demonstrate, that these terribly adverse effects upon the domestic economy will work in the long run against improving the position of the dollar overseas, because the strength of the dollar depends ultimately and in the long run upon the fundamental performance of the U.S. economy as I shall shortly define it and the degree of confidence or lack of confidence which this generates overseas.

And I further submit, as a matter of prime interest to the Congress at large and especially to the Joint Economic Committee, that the program in its current form to protect the dollar is clearly and sharply in conflict with the mandates and objectives of the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. This Act was recently approved by both Houses of the Congress by tremendous majorities, and thereafter signed by the President with a declaration of his intent to labor constantly to fulfill its purposes. More on this, later on in my testimony.

The real source of our economic strength and progress is not price stability alone

The towering and almost inexplicable error in the current program to protect the dollar by obsessive preoccupation with reducing price inflation as the allegedly main cause of the weakness of the dollar is abundantly clear. The error fails to recognize a core proposition, the acceptance of which is dictated by all sound reasoning and all empirical evidence. This core proposition is that the reasonably full use of our resources for the increased production of goods and services in accord with our full potentials, reasonable attention to our great domestic priorities, the adequate servicing of human needs, and the doing of social justice are the indispensible and foundational requirements for building and maximizing our economic strength and security and successes on all fronts, both at home and overseas. The egregious losses suffered through huge and constant departures from fulfilment of these purposes incalculably outweigh any other benefits alleged—I believe incorrectly—to result with respect to other purposes, important though these are.

To be sure, the attainment of reasonable price stability as soon as feasible is an essential objective of national economic policy. But efforts recurrently during a quarter century, and especially during the past ten years and now, to reduce inflation by stunting and misdirecting the fundamental performance of the American economy as defined above has resulted only in a chronic increase in the rate of inflation which is still continuing. This has now been recognized by the Humphrey-Hawkins legislation and by powerful statements on the Senate and

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House floors by leading members of both political parties in support of this legislation.

Even more important, and almost entirely overlooked in the current economic discourse at high levels of the Administration and elsewhere, price movements in themselves are not ultimate purposes or ends in our economic system or in our national values. Prices are but one of a number of means of allocating resources and incomes in a balanced manner conducive to achievement of these ultimate purposes or in an imbalanced manner inimical to this achievement. And neither a rising nor a stable nor a falling price level works per se and automatically in favor of or against this balanced allocation of resources and incomes. During 1922–1929, a remarkably stable price level did not prevent growing maladjustments in the economy which brought on the Great Crash. Although prices remained stable, productivity increases and the profits which they yielded were translated excessively into investment which increased production capabilities. But in other major sectors, the wages, farm income, other consumer income and public outlays which support ultimate demand lagged very greatly. During the years of the Great Depression, a sharply falling price level, with wheat falling to 25 cents a bushel, and labor obtainable at 50 cents a day, did not cure anything. The dollar was worth more during the early 1930s than at any time since, but the well-being and productivity of the American economy were becoming less and less in the course of the greatest economic debacle in modern history. From 1933 to 1937 at least, a sharp reflation of prices was an essential element in a very strong economic recovery. Prior to the recessions of 1953 and 1957–1958, the second one being quite serious, there was reasonable price stability. On the other hand, during 1947–1953, and during 1961–1966, very strong economic performances were accompanied by and indeed facilitated reasonable price stability. Since then, in the main, we have experienced on the average an abysmally low fundamental economic performance accompanied by intensification of price inflation. These examples could be multiplied, but they demonstrate more than adequately the lack of end in itself, while failing to evaluate price movements in the larger framework of their impact upon the allocation of resources and incomes and upon economic balance, and thus upon the ultimate economic and social purposes which I have defined. Yet the Administration's obsessionary preoccupation with price trends is now mounting, with increasing neglect of the larger problems of which trends are only one. And the course is really inflationary, not anti-inflationary.

The glaring failure to achieve our fundamental economic and social purposes

Coming now to the empirical and documentary evidence in support of what I have said. It is necessary first of all to depict the almost unbelievably high costs and hardships resulting from the failure of national economic policies to assume their appropriate role in helping to achieve and maintain an acceptable fundamental economic performance as I have defined it, and as it is defined in the Employment Act of 1946 and now in the Humphrey-Hawkins legislation of 1978. And in order to stress the evil of so much attention to the so-called emergencies or crises of the moment while overlooking longer range and systematic difficulties which also have been primary causes of the so-called emergencies including the dollar crisis, we must view the situation in a meaningful long-term perspective. We will never get anything straightened out by acting from month to month or even from year to year, because the American economy, like Rome, was not built in a day.

As my Chart 1 depicts, the roller-coaster performance of the U.S. economy since 1953 to date, with respect to the real rate of economic growth which is fundamental to all else, has been shocking and inexcusable. Compared with an average annual real economic growth rate ranging from 4.6 percent to 6.5 percent during periods when we were doing well, the average annual rate was only 3.3 percent from 1953 through 1978, and only 2.8 percent from 1969 through 1978. The real growth rate was only 3.9 percent from 1977 to 1978. And today, the Administration and the Federal Reserve are contriving economic policies in the name of protecting the dollar which, according to their own estimates, will reduce the rate of real economic growth to somewhere between 2.5 percent and 3.5 percent during the year ahead, will lift the rate of unemployment substantially, will set aside efforts to service better the great domestic priorities, and will run very serious risks of a sixth recession since 1953 which could be more severe than the most recent one if the trends over the past five recessions continue. I share the general thrust of these estimates within official circles, although my own

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appraisal is even more pessimistic. But I reject entirely the current dollar rescue policies which are likely to translate these gloomy estimates into reality.

To take into account the human factor, and as an index of overall costs which go beyond unemployment and cover every sector of the economy, my Chart 2 depicts the levels of officially recorded and full-time unemployment from 1953 through 1978. The chart also depicts the unequal distribution of the unemployment burden among various groups, a situation fraught with horrible social costs and menacing civil dangers.

Is just avoiding a recession good enough?

The Administration is now confessedly contriving a further slowdown in a very low rate of real economic growth and a large rise in unemployment. Meanwhile, the Administration appears to derive satisfaction from its claim that an absolute recession is unlikely. This assurance may well turn out to be unwarranted, for every serious slowdown in real economic growth and rise in unemployment since 1953 have ended up in absolute recession. But even if this assurance were correct, what a pitiful appraisal this is of the real needs and powers of the American economy and its people. It is not within a million miles of good enough for the American economy to achieve an average annual rate of real economic growth of only 2.8 percent during 1969–1978, when somewhere between 4 and 5 percent would have been optimum and practical. As my Chart 3 shows, an average rate of real economic growth of only 3.3 percent during 1953–1978 caused us to forfeit, on a conservatively estimated basis, more than 5.9 trillion 1977 dollars worth of total national production, and to suffer more than 76 million man- woman- and teenager- years of unemployment in excess of the amount of unemployment consistent with reasonably full employment. If these dismal trends continue, as they are more than likely to do in the face of the current complex of national economic policies (and in accord with the current economic growth rate forecasts of some spokesmen for the Administration and of many other economists and analysts), my Chart 4 contains my own projections that, during 1979–1983 inclusive, we would forfeit another 818 billion 1977 dollars worth of total national production, and have about 16.7 million man- woman- and teenager-years of excessive production. In 1969, employment would be 1.1 million lower and unemployment 0.5 million higher under the low economic growth rate than under the high, and in 1983 employment would be 5 million lower and unemployment 2.5 million higher.[2] My low projections involve a 3.2 percent average annual real growth rate; the Treasury Secretary last week suggested as low as 2 percent. My high projection is at the 5.5 percent real growth rate needed to reach the 1983 goals of the Humphrey-Hawkins Act.

These production and employment forfeitures do not tell the full story of their ramifying effects throughout the economic and social structure. Among other things, the total national production forfeitures during the past quarter century have meant forfeiture of about a trillion and a quarter 1977 dollars in Federal and State and local revenues at actual tax rates. Thus, the financial plight of the cities, and the shortchanging of every major human and social purpose which depends largely upon public outlays or upon an admixture of public and private outlays. And thus the current claim that this shortchanging must continue as the only way of reducing inflation and protecting the dollar. What a distortion of values this claim involves. What a lack of understanding of how our American economy really works is involved in unawareness that the neglect to date of these priority purposes has been a major factor in the poor overall economic performance, and if continued will make impossible the movement to full economic recovery which we so much need. And how astigmatic are those who do not see that the selective shortages caused by some of these neglects have caused some of the most extreme instances of price inflation.

Yet Federal Reserve Board Chairman Miller joins the Administration in the "comforting" assumption that we will not have another absolute recession. What an intelligent and heart-warming assurance that would be, even if one could accept it at its face value. These comforters in our midst are like the proud parents who are delighted that their child is not going to be demoted from the sixth grade to the fifth, instead of worrying that the child is getting very bad marks in the sixth grade and is likely to take two years to reach the seventh. Mr. Miller goes even further than that. In a speech on December 6, he estimated that

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[2] The differences in employment and unemployment are not the same because of differences in labor force growth under the two projections.

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it would take five to eight years to restore an acceptable degree of price stability, and that consequently we should plunk for several more years of sharply reduced real economic growth and rises in unemployment. How much unemployment by 1981?

To depict what we should be starting now to achieve, in vivid contrast with where we are now heading, my Chart 5 depicts goals for various sectors of the economy consistent with reducing officially reported unemployment to 5.6 percent for 1979, and to 3 percent for adults and 4 percent overall by mid-1983 in accord with the goals of the Full Employment and Balanced Growth Act of 1978. The contrast between these feasible goals and where current national policies in defense of the dollar are now heading us is truly appalling.

The program to rescue the dollar by repressing a forward economic movement will not restrain inflation

As I have already stated, the obsessionary preoccupation with price trends as the top priority of national economic policy would be wrong even if it worked to trade off less unemployment to get more price stability, because price trends are not an end in themselves, and because marginal differences in the rate of inflation would not justify sacrifices in production and jobs of the magnitudes which I have already depicted. But this consideration may be of relatively slight significance, because by now the empirical evidence has become compelling that abnormally low growth or recessions and higher unemployment bring more inflation. I have been making this evidence available for so long and so many times to this Committee and other Committees of the Congress, as well as elsewhere, that it would seem improper to go extensively into the matter at length again today. But I do call attention to my Chart 6, which summarizes the empirical evidence all the way from 1947 through 1978. And my Chart 7 adds to the empirical evidence by dealing more definitively with the more recent experience. This chart indicates that the highest rate of inflation since the Civil War was accompanied by the most severe economic downturn since the Great Depression; that price inflation decreased by extraordinary amounts when the rate of real economic growth was extraordinarily high from the fourth quarter of 1975 to the first quarter of 1976; and that the great slowdown in the rate of real economic growth from the fourth quarter of 1977 to the fourth quarter of 1978 was marked by a rate of price inflation coming again close to double digit levels with respect to consumer prices.

I will not deal at length with the many reasons why a stunted economy generates more price inflation. These include the scarcities created, the tendence in the administered price areas to raise prices faster when the volume of business is disappointing, and the rising per unit costs of production due to a declining or negative rate of productivity growth when plant underutilization is very high. There is great concern now about how to increase the rate of productivity growth, but most of the talk and measures directed toward this end are misplaced and in some cases damaging because they ignore the empirical evidence. The plain fact, as demonstrated by my Chart 8, is that productivity growth in the private economy is high and tends to accelerate on a secular basis when resources are reasonably well used, and tends to reduce greatly or become negative when the opposite is the case. Moreover, as shown by the period from fourth quarter 1977 to fourth quarter 1978, the impact of excessive underutilization of resources over a very long period of time continues to operate against productivity growth even when in absolute terms the economy is moving upward but much too slowly and is still nowhere near reasonably full resource use. If we made the successful efforts we ought to be making to bring the economy back to reasonably full resource use, we could well afford to forget about most of the spurious efforts to increase productivity while applying economic policies which continue to militate against it.

Detailed analysis of how the dollar-protection program will gravely injure the domestic economy: and tight money and rising interest rates come first

I come now to a more detailed description of the Administration's policies to protect the dollar. The main elements in these policies may be stated quickly. They include Administration acquiescence in and encouragement of a repressive and regressive Federal Reserve policy of tightening up money and driving interest rates up to near record levels which may soon be reached or surpassed; a fiscal policy of no growth in the Federal Budget, accompanied by at least approval of repressive tax legislation on net balance, including regressive tax

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reduction for the wrong recipients at the wrong time; an attempt to balance the Federal Budget at the expense of the national economy and the great national priorities of economic and social needs; and a price-wage guidelines policy which becomes more repugnant the harder one tries to understand it.

The absolutely indefensible policies of the Federal Reserve have been in effect since the Federal Reserve-Treasury accord of 1951–1952, have accelerated with a vengeance during the more recent years, and have become fantastic during the most recent months. These FRB policies have been and still are a main factor in the abnormally low rate of real economic growth with all of the inseparable evils and costs occasioned thereby.

My Chart 9 indicates the general though not entirely uniform positive correlation between the tightening up of the non-Federally held money supply and the advent of the reduced rates of real economic growth and then the recessions. The inadequate expansion of the money supply to support healthy economic expansion is grossly understated because no allowance is made (on my chart or elsewhere) for the rate of general inflation. For example, if the growth rate in the money supply from the fourth quarter of 1977 to the fourth quarter of 1978 took account of the rate of general inflation of 9.2 percent during the same period, it would become clear that the real growth rate in the money supply was negative when it needed to increase greatly to support an appropriate rate of real economic growth. The same chart fortifies the earlier stated conclusion that deficient economic growth and high disutilization of productive resources are highly inflationary. Thus comes a cropper the claims of the Federal Reserve that its monetary policies restrain inflation; they do just the reverse.

There are other reasons, almost completely ignored in examination of the problem, why rapidly rising interest rates are inflationary. Interest rates are a cost like all other costs, and increases in interest rates are transferred and pyramided throughout the whole economic structure. My Chart 10 portrays the rise in computed average interest rates on the total public and private debt during the 17 years 1952–1978 inclusive, and also portrays the increases in interest costs on the private debt, the State and local debt, and the Federal public debt. The bottom half of this chart translates the percentage rate increases in interest costs into dollar figures. Thus, during the period as a whole, more than 1.5 trillion dollars in the form of increased interest costs have been transferred by national monetary policy from borrowers to lenders. This is intolerable in social terms. And, as will be disclosed, it is highly detrimental to balanced economic development and conducive to the abnormally low average annual rate of real economic growth and the recurrent recessions.

The inordinate increase in the interest rates on the private debt has borne down with tragic severity upon private borrowers in the lower half of the income structure. It does much to explain the increase in the total inflationary burden borne by these groups and the dangerous increase in the expansion of the credit burden imposed upon them. The increases in the interest costs imposed upon the Federal Budget explain a major portion of the Federal deficit, even without allowing for the part of the Federal deficit stemming from abnormally low growth and very high unemployment. It appears strange that those who look upon the Federal deficit as a major cause of inflation favor monetary policies which have done so much to increase the Federal deficit.

My Chart 11 compares the excessive interest costs in the Federal Budget with outlays for high priority Federal programs, looking at both the annual averages during 1965–1978 and the figures for 1978 alone. In calendar 1978 alone, the excessive interest costs in the Federal Budget, hurtful in all economic respects as indicated above, came to somewhere in the neighborhood of one-half or more of the total Federal deficit for that period. Again for calendar 1978, the excess costs in the Federal Budget came to immensely more than Federal Budget outlays for education or housing and community development or manpower programs for fiscal 1979. Yet the Administration, which is claiming that we must cut back on these vital programs because we "cannot afford them," is encouraging huge further increases in the interest costs imposed upon the Federal Budget.

And my Chart 12 portrays the impact of the rising interest costs upon American families and individuals, and also portrays how a very small fraction of these increased interest costs could be used to wipe out poverty in the U.S. In short, recent, current and prospective monetary policies are economically destructive and socially infamous.

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The "no growth" Federal budget policy is highly damaging to the domestic economy

The iniquitous Federal Reserve policies are accompanied in the current program to protect the dollar by a "no growth" Budget policy, except for national defense. Coupled with the repressive effects of the monetary policy and the tax and wage-price guideline policies subsequently to be discussed, the "no growth" Budget policy puts the stamp of certainty upon a further decline in real economic growth and increases the probability of another severe recession. More importantly, the "no growth" Federal Budget policy unconscionably assumes that meeting the real human and social needs of the American people is postponable and is of lower priority than protecting the dollar overseas. Actually, there is no real dichtotomy between economic error and social error in the context of the American economy. Proper investment in the human and social programs is an integral aspect of the task of restoring the American economy to full economic health. And quite apart from the obvious fallacy of trying to balance the Federal Budget at the expense of even minimally-adequate human services, the effort to balance the Federal Budget by policies which will hurt the American economic performance is hard to understand when it is so clear that the blood of adequate Federal revenues cannot be squeezed from the turnip of a stunted economy. As my Chart 13 shows, the increases in the Federal deficit from 1947 through 1978 have been almost entirely in consequence of mounting deficiencies in gross national product and in economic activity when measured against our potentials.

It is hard indeed to argue that the repeated tax cuts from 1945 to date compensate for the repressive nature of the other policies described above. For these personal tax cuts, on net balance, have greatly favored those in the higher ranges of the economic structure at the expense of those lower down. This is demonstrated by my Charts 14 and 15 which measure correctly the impact of these tax cuts, not by the differing percentages in tax cuts at various income levels but by the differing percentages of gains in after tax income. It is a matter of common knowledge that the 1978 tax cuts were far worse in this regard than the earlier tax cuts.

Further, the 1978 tax cuts impel a commentary upon the curious inconsistencies, planlessness, and improvisations in the Administration's economic policies. To illustrate, the tax recommendations which the President sent to the Congress were clearly for large tax reductions although of a different nature from those subsequently enacted, and the President did sign the tax bill which the Congress approved. If the tax bill as signed is regarded as a measure to provide large stimulation to the economy, it does not do this because the repressive increases in the social security taxes outweigh the stimulative decreases in other taxes, and doubly so in view of the regressive distribution of the latter. And if the tax bill were in fact well-designed to stimulate the economy greatly, it would be in irreconcilable conflict with dollar protection policies (initiated so shortly after the President signed the tax bill) designed avowedly to restrain the economy.

Public spending versus tax reduction, and private spending versus public spending

Beyond what has just been said, the combination of a veritable orgy of tax reduction over the years with an increasing animadversion to public spending hardly makes any sense at all. If the objective is to stimulate the economy, even the more conservative of responsible studies have found that each dollar of additional public spending adds more to employment and business activity, and is therefore less costly to the Federal Government, than each dollar of tax reduction. If the great priorities of domestic needs in such fields as mass transportation, energy expansion, urban revitalization, and health, housing, and education are to be well served, it must be obvious that each dollar of intelligently programmed public investment, including marginal assistance to private investment, must be immensely more efficient than tax reductions handed down for everybody to spend or not to spend as they please.

The argument is also advanced that tax reduction serves better than increased public spending to honor the principle that private employment is preferable to public employment. This overlooks the fact that well-engineered increases in public outlays add far more to private employment than badly designed or even well-designed tax reductions. More important, the whole trend toward the notion that, despite technological trends, private employment almost alone can solve the unemployment problem, or the notion that any private employment is preferable to any public employment, or the notion now voiced by

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many at very high levels to the effect that public employment is intrinsically undesirable—these are all notions which would bring about the demise of intelligent or humane national economic and social policies if these notions were permitted to grow from disturbing snowballs into blinding snowstorms. A portion of the Administration's program to defend the dollar by cutting back severely on public service jobs is a good illustration of what is now happening. Many other examples include what is happening to proposed welfare reform and health insurance programs.

Unfortunately, the "no growth" Budget aspects of the policies to defend the dollar have forgotten that the primary purpose of the Federal Budget is not to protect private enterprise nor to balance the Budget, nor even to stabilize the economy. These purposes are valid in degree. But the primary purpose of the Federal Budget is to accomplish what Lincoln meant when he said that the function of Government is to do for the people what they need to have done or cannot do so well in their separate or individual capacities.

The wage-price guidelines to protect the dollar, if effectuated, would be highly damaging to the U.S. economy

In some ways, the most important element in the Administration's program to protect the dollar are the wage-price guidelines and, unless they are drastically altered, one can only hope that they will not become effective because their effectrive use would strike hammer blows at the economy and do much injustice besides. The guidelines provide for about a 6.5 percent increase in prices, with details too complex to discuss here today. Suffice it to say that the average actual increase in prices would tend to be at least as high as the guideline figures in the absense of adequate policing. Further, it is unparalleled to set a guideline for price increases of 6.5 percent, piled on top of all the price increases we have had already. Eeffective price controls during World War II were based upon the immediate objective of reasonable price stability, with some exceptions to iron out inequities and lags in the structure. The price controls during the Korean War, after the Chinese entry therein produced double digit inflation, were also aimed at price stability and price increases averaged only one percent in 1952 and 0.8 percent in 1953. Price stability cannot be accomplished by giving Government approval to high price inflation.

Meanwhile, the wage guidelines provide for average wage rate increases of 7.0 percent. But allowing for the fact that a large majority of the employed labor force would not achieve anything approximating these rates of wage increase, and noting also that the 7.0 percent figure includes fringe benefits which do not add to immediate purchases, the net effect if the guidelines were effective would be average spending-orientated wage rate increases of 3-4 percent, contrasted with average price increases of 6.5 percent or higher. Thus, on top of the fact that average weekly earnings in all nonagricultural establishments were lower in real terms in October 1978 than in 1969, such guidelines would mean a progressively larger decline in the real purchasing power of average wage rates. Combining this with the increase in unemployment which the Administration expects, wage purchasing power and consumer purchasing power in general would fall progressively short of the minimum requirements for the rate of economic progress required to restore our economic health. In these connections, my Charts 16, 17, and 18 depict the growing deficiencies in consumer spending, based upon an inadequate income growth, including adverse trends in wages and salaries.

The Administration's price-wage guidelines are therefore grossly unfair. Far more important than any abstract concept of fairness, however, the price-wage guidelines are based upon the indefensible assumption that excessive wage rate gains have been the major cause of inflation, and that holding back wage rate gains is the central weapon against inflation. But it is generally admitted that real wage rate gains should approximate productivity gains in the private economy, and my Chart 19 shows that just the opposite has been the general rule. Since 1960, and especially during 1977-1978 this has been startlingly true in manufacturing, where the greatest hue and cry has arisen with respect to "excessive" wage rate gains.

To be sure, wage rate gains have exceeded productivity gains in the total private non-farm economy (but not in manufacturing) when the rate of real economic growth has averaged seriously low and when unused plant capacity has been extremely high, this being one reason as stated above for inflation during these periods. But any attempt to reduce real wage rate gains to make them comparable

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with a seriously deficient economic performance would manifestly worsen the entire economic performance all along the line, and this criticism is doubly applicable to the Administration's current attempt to encourage large real wage rate losses in the private economy even while profits have been soaring, as will be discussed below. And even if the wage rate gains needed to play their part in satisfactory economic recovery were to cut profits, even that cut should be borne for a while in the longer range interest of business, or the Government should find other ways of supplementing the ability of business to pay the needed wage increases.

That the Administration is considering asking for postponement of minimum wage rate increases scheduled for January next is another indication of upside-down thinking on the whole wage problem.

The real causes of low growth and recessions are enlarged by the current policies to protect the dollar

The Administration's highly repressive approach to wage rates, coupled with the repressive monetary and fiscal policies described above, are virtually impervious to the real troubles of the American economy and the real causes of the five previous recessions. The dominant cause of these five previous recessions has been that investment in the plant and equipment which add to production capabilities has raced ahead very much faster than the ultimate demand represented by private consumer expenditures and public outlays combined, and the regressive tax reductions abetted this racing ahead. When, for these reasons, the so-called "boom" periods moved into stagnation and then recession, investment was cut back very sharply. And the combination of this with the larger and more enduring deficiencies in ultimate demand brought on the manifold troubles which ensued. My Chart 20 depicts this entire process very clearly, and yet those who refuse to learn from experience are doing all of the same things again with the same likely results.

The avoidance of proper treatment of the housing problem

There is only one additional aspect of the gaps and deficiences in national economic policies which I wish to discuss because of its immense importance. This is the complete failure to recognize the role of housing in the national economy, both as to home construction and home occupancy. This chronic Federal dereliction, evidenced again by current and proposed cutbacks in the HUD program and also by the soaring interest rate policy, has been both inflationary and severely damaging to our overall economic performance and attention to social needs.

As shown by my Chart 21, home construction represents a feast and famine situation. At times as in 1972 and to a lesser extent in 1977 and 1978, the construction of homes for those mostly in the upper portions of the income structure has seemed on the surface to represent a satisfactory overall performance. But as these particular markets have become saturated, this plus the sorely deficient production of homes for those lower down in the income structure has brought on the recurrent famines. Indeed, for the period 1969-1978 as a whole the average annual production of homes was more than 200 thousand less than in 1952, despite very large increases in population, extensive population shifts, large increases in substandard or unsatisfactory housing, and recurrent overcrowding in some important locations. The average annual production of homes during 1969–1978 was only 1.749 million, contrasted with estimates made by the Government itself that the average should have been 2.2 million during 1970-1980 inclusive. Allowing for the cumulative deficiencies over the years, I now estimate that we need almost 3 million homes a year on the annual average during 1979–1983 to meet real housing needs and to exert the needed role of home construction in balanced economic growth at the rates needed to reduce unemployment to 4 percent by 1983 in accord with the Humphrey-Hawkins legislation. Correspondingly, my Chart 22 reveals that the rate of unemployment in contract construction usually has run about twice as high as the overall unemployment rate, and even now is running about 50 percent higher.

I have also attempted to estimate (in a study to which I devoted about a year's time) the impacts of the deficits in residential and commercial construction upon the general economy. My Chart 23 sets forth the results of this study, indicating among other things that the combined deficit during 1953-1976 (I have not yet been able to bring this study up to date) directly accounted for G.N.P. forfeitures of almost one-fifth of the total national production forfeitures

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during this period, with correlative losses in employment opportunity, Federal revenues, and State and local property tax collections.

The most important single factor in making satisfactory housing unavailable to scores of millions of families, or available only at costs so inflationary that they have deprived these families of other necessities or caused them to go excessively into debt, have been and still are the perverse policies of the Federal Reserve. As shown on my Chart 24, the average interest rates on new home mortgages rose from about 4.3 percent in 1952 to 9.54 percent in 1978, or far more than a doubling of the rate. The percentage increase in average interest rates on new home mortgages over the same period of time was 122.4 percent. In the comprehensive housing study to which I have already referred, I estimated the impact of various interest rates upon home owners at various income levels, and the extent to which excessively high and rising interest rates worked so adversely. The results are shown on my Chart 25. This exercise is very revealing, even though the results would be enormously worse if the chart was brought up to date by using a 10 percent instead of a 6 percent interest rate and by taking care of changes in the income structure since 1974.

Again I state that a national policy which so grievously omits proper attention to the housing problem cannot be regarded as responsible or mature with respect to education, health, or other great national and economic social priorities set forth in the Humphrey-Hawkins Act.

Discussion of other questions posed by subcommittee chairman

In a letter to me dated November 28, the subcommittee chairman noted that rising interest rates have not thus far caused the usual crunch in the housing market, and asked whether if this continues (unlike earlier periods of credit tightening) the result would be a slowing of expenditures for capital formation more sharply than before.

As my above discussion of the housing problem reveals, excessively high interest rates have been seriously reducing home construction with great damage to the economy for a long number of years, and this is not gainsaid in the slightest by the observation that housing construction has been at a high rate (it ought to have been still higher) in 1978. Second, as interest rates are considerably higher now than during 1978 as a whole, as it takes a while for increases in interest rates to impact upon home construction, and as interest rates may well go still higher than they are now (the Administration and the Federal Reserve appear inclined in this direction), I agree with many other analysts that home construction will be very much lower in 1979 than in 1978. The usual crunch on housing has not been avoided; it is beginning, and is likely to become much more severe.

Third, even if there were to be no significant slowing of housing construction, excessive tightening of the money supply and excessively high interest rates would operate even more seriously against other types of capital formation than if the impact upon housing were more severe. This merely reflects the truism that one cannot pull too short a blanket up over his shoulders without exposing his feet. And fourth, so long as the Federal Reserve believes albeit mistakenly that the overall tightening is necessary, then that agency should put aside its unwarranted objections to some rationing of credit, as was done in earlier times with great success. The way things have been for some time and still are, the blunderbuss tightening of credit has not had much effect upon some who should be curbed, and has made it even harder for others to make a go of it.

As I have just indicated, the changing distributive impacts of monetary policy should be remedied in part by a more selective monetary policy. No attempt should be made to remedy it by still higher interest rates, because that taken alone would further increase the distortions in the distributive impacts. Higher interest rates are not now needed to achieve a given reduction in aggregate spending, first because (as I have analyzed fully above) a deficiency rather than an excess of aggregate spending has been the problem for a long time and certainly is now, even with regard to the true causes of inflation (deficient fundamental economic performance), and second because, if a decrease in aggregate spending were assumed to be needed, that should be on a highly selected basis, while blunderbuss increases in interest rates would impose the decreases in a wrongful pattern on both economic and social grounds.

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As is clearly revealed on some of the charts related to what I have already said, we need for full economic recovery and for reduction of price inflation a sharp increase rather than a slowing down of the rate of capital formation. Including both plant and equipment and housing, this rate of increase should be greater than for other parts of the economy. But so far as investment in plant and equipment and in other durable producer goods other than housing is concerned, neither defects in the monetary-fiscal policy mix, nor levels of interest rates, nor the inadequate real growth in the money supply, have much to do with this problem. The wrongful monetary policy has caused capital shortage problems for small business and farmers and home occupants. But our large mass production industries, in the main, have not suffered from capital shortages, and have not been much affected by rising interest rates because they finance so large a portion of their investment out of retained earnings and through increases in prices to cover increased interest costs.

My Chart 20, earlier referred to, shows that before each economic downturn, and again during the recent period to date, profits and other incentives have induced the growth of investment in plant and equipment at a much more rapid rate than the growth in ultimate demand represented by consumer and public outlays. Thus again today, before an absolute downturn occurs, one basic need is to provide more incentives to investment in plant and equipment by appropriate expansion of ultimate demand. All of the major policies in the save the dollar operation—the rising interest rates, the "no growth" Budget policy, the guidelines, and the upside-down nature of the recent tax legislation, move in the opposite direction. This is just what happened before the five recessions since 1953 to date. Many business leaders may not agree with my analysis as stated. But they do correctly appraise the consequences of the facts which my analysis describes, and that is why the most recent Government reports indicate a sharp downward revision in business investment plans for early 1979. These reports also urge that abandonment of this downward revision depends upon a large upward surge in consumer spending.

Why damaging the U.S. economic performance is profoundly hurtful to attempts to protect the dollar

What I have said thus far completes my analysis of the damaging and maybe devastating effects upon our domestic economy which, in my judgment, would result from the current program to rescue the dollar. For it would soon become apparent to all that the effort to rescue the dollar mainly by reducing inflation was an effort very unlikely to achieve its anti-inflationary results. Under the going effort, inflation during 1979 might well average higher than during 1978, even though unlikely to average as high as the double digit rate of today.

But the predominant reason why the current policies to rescue the dollar would fail in the long run, in my judgment, is that they are based upon a narrow and misconceived explanation of why the dollar has become so weak. The dollar has not become so weak primarily because of inflation in the United States, nor primarily because of differential interest rates in different countries with rates lower in the United States than in some other places. Nor has the dollar become so weak primarily because of highly unfavorable trends in our balance of payments accounts and in our international goods and services accounts. The overwhelmingly important reason why the dollar has become so weak and our international imbalances so huge is because the dollar's value and the degree of overseas confidence in it have been reduced by the poor performance and poor prospects of the U.S. economy. What could be more disruptive of confidence in the currency of a country than prolonged evidence that its national economic policies have learned only how to abet both stagnation and inflation, and have succeeded only in coining a word which covers both, while making clear an inability to remedy either and instead sharpening up the weapons which have produced both? It is high time that our national policy makers stop listening almost exclusively to the views of international and domestic financiers as to what makes an economy weak or strong, and start listening to any common sense person who would point out that the real wealth and strength of nations is what is happening to the growth of production, the reduction of unemployment, the use of available potentials for real growth, the reduction of shortages, and the awareness of critical social and civil dangers arising from not meeting the most basic needs of so large a portion of the

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people. What other civilized nation has tolerated for long the rates of unemployment we have here in the United States? Moreover, the needed policies just mentioned bring higher tax receipts, lower Federal deficits, reduce price inflation, and increase exports.

There is no nation in the world which is so richly endowed as we are with the potentials for economic progress at home and fair competition with other parts of the world. But as to the latter, which is most closely related to the overseas attitude toward the U.S. dollar, what has been happening is shown graphically on my Chart 26. During the past quarter century or the past eight years, the real annual economic growth rate in Japan has made us look like snails. The real economic growth rates in Germany and France and Mexico have made us look like a rabbit with one of its legs tied to its ear. Would anyone have believed ten or fifteen years ago, before economists in the public service seemed to have lost a part of their discernment, that the United States could strengthen the overseas confidence in its currency enduringly by deliberation and proudly announcing to the rest of the world that it is going to widen the gap between its fundamental economic performance and that of its prime competitors, and court a sixth domestic economic recession since 1953, which the rest of the free world fears more than all else.

It is high time, I respectfully submit, that those who would seek to protect the American dollar by deliberately weakening the American economy, and those who believe that inflation can be reduced by jamming on the brakes of a forward economic movement and putting it into reverse, should read the Full Employment and Balanced Growth Act of 1978. They should then muster up the determination to obey the specific mandates of this law because these mandates embody the reflections and decisions of those in the Congress of the United States who have been steeping themselves in problems of economic policy at least since the Employment Act of 1946 was enacted. And if these readers of the Humphrey-Hawkins Act are high in the public service and dealing with national economic policies, they should obey the mandates of that Act because it is their specific duty to do so.

More important still, those high in the public service should learn to live by the spirit as well as letter of that Act so recently approved after such careful consideration. That Act is based upon the proposition that we have the power to develop upon this continent an economy dedicated to the principle of abundance, equitably shared. The Act does not contemplate that, in the year 1979, we take one frightened step backward instead of one confident step forward. It does not contemplate that we dedicate ourselves to financial policies such as higher and higher interest rates and regressive taxation, which feed the fat and starve the lean. It does not contemplate continuation of the tax injustice of making larger and larger numbers of unemployed bear the major burden of the fight against inflation, and a misguided one at that. It does not contemplate that we become so preoccupied with one problem—in this instance, the dollar problem—that we forget all else, as if we were a one purpose nation instead of a nation with many problems and pluralistic purposes. It does not contemplate that we trap ourselves forever in a disjointed series of emergency actions, but instead plan our national policies comprehensively and harmoniously on a long range basis, with the President and the Congress working together.

I have not in this statement dealt extensively with details of remedial action, although many of them are implicit in what I have said. I believe that the appropriate details will emerge when the mandates of the Humphrey-Hawkins legislation are observed instead of being ignored or depreciated. Some of these details I will suggest next year in testimony before or invited comments furnished to the Joint Economic Committee. Far more important, I believe that (hopefully with some assistance from what I have had the opportunity to offer here today) this Committee and the Congress will fully rise to its share of the responsibility and high opportunity to reconstruct national economic policies, so that we will move forward rather than backward, and with legitimate confidence replacing illegitimate fears.

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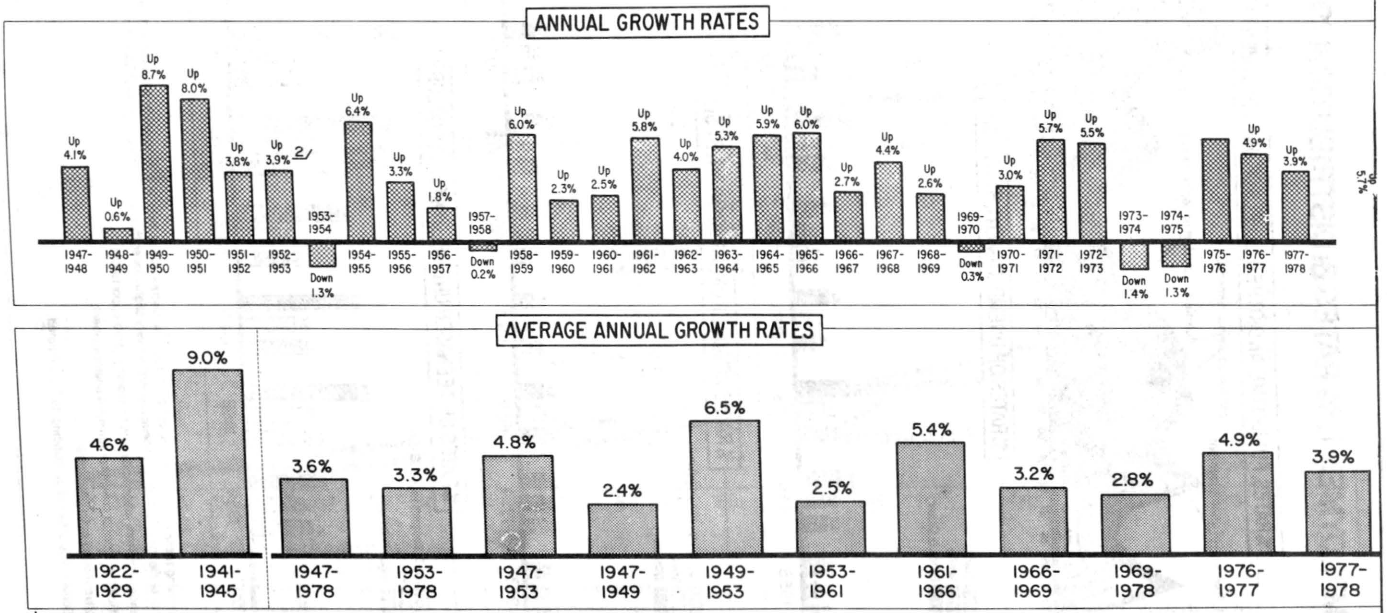
THE "ROLLER-COASTER" ECONOMIC PERFORMANCE: ECONOMIC GROWTH RATES, 1922-1929, 1941-1945, AND 1947-1978[1]

(Uniform Dollars)



1/ 1978 estimated.

2/ Recession during part of period. There were five recessions, 1953-1978, but some were entirely within one year, and began and ended in different years.

Chart 1

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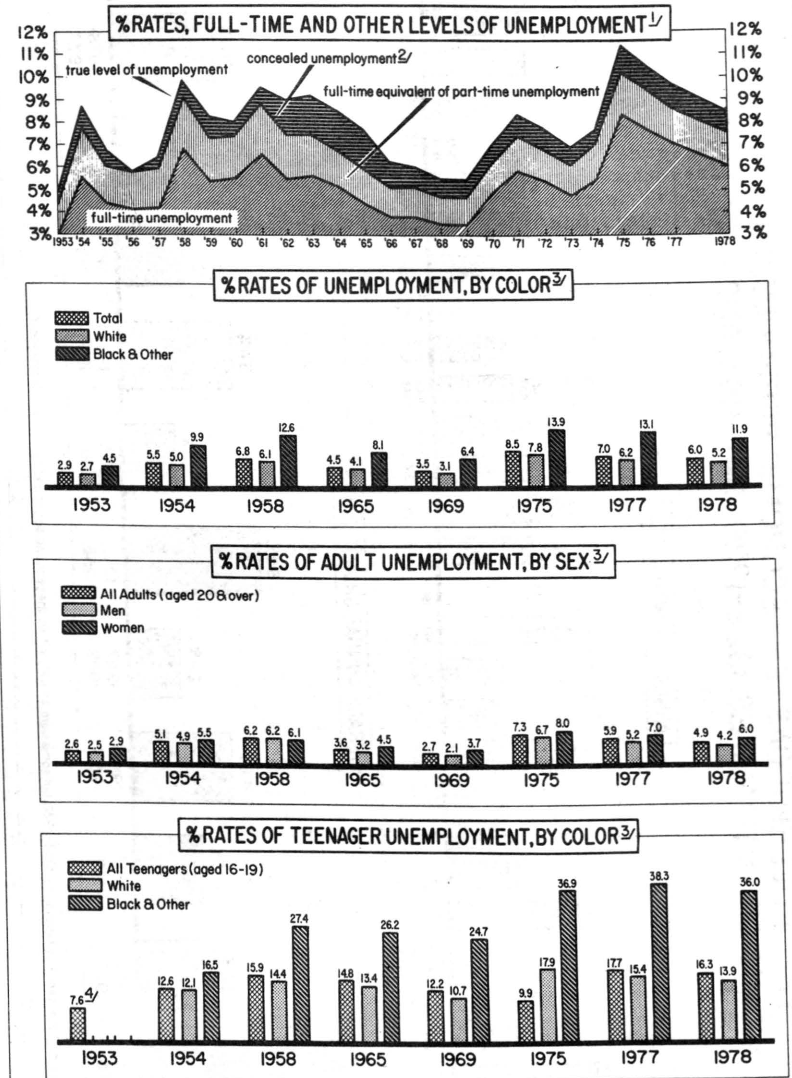
Chart 2

UNEMPLOYMENT, % RATES & DISTRIBUTION, 1953-1978



1/ In deriving these percentages, the officially reported civilian labor force is augmented by concealed unemployment. Thus, some of the rates for full-time unemployment are very slighly lower than in the official reports of full-time unemployment

2/ Withdrawals from labor force, due to scarcity of job opportunity.

3/ Officially reported concept of full-time unemployment.

4/ Distribution by color unvailable.

Note: Some totals affected by rounding. 1978 estimated.

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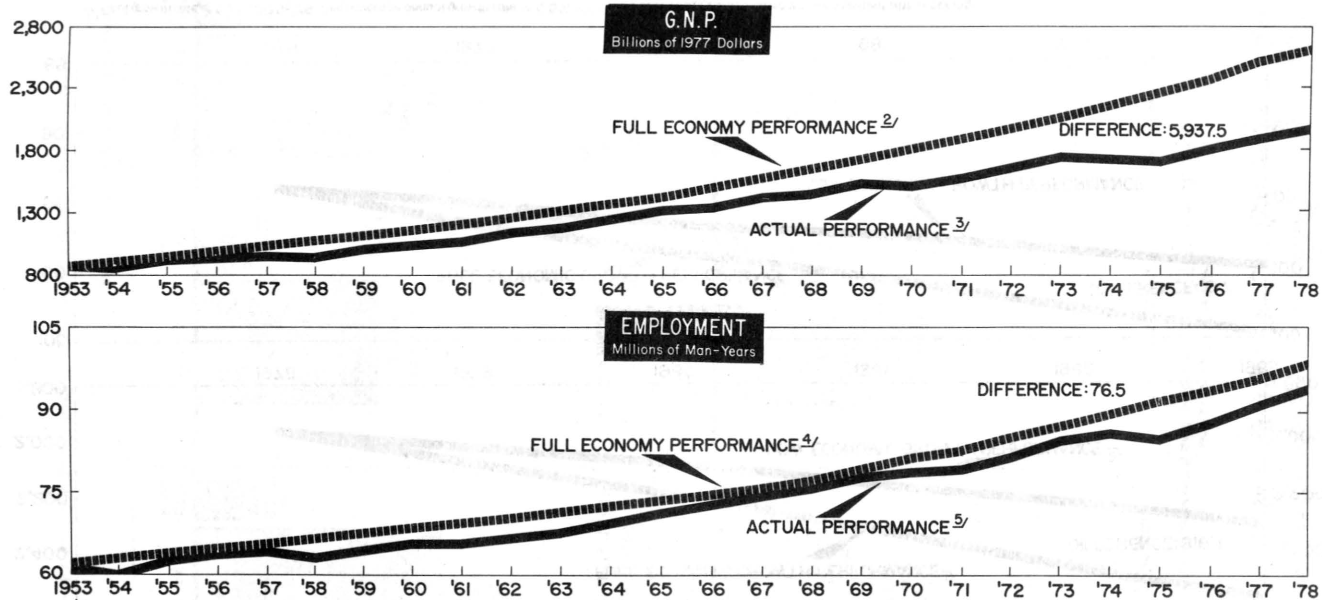
COST OF DEPARTURES FROM FULL ECONOMY, 1953-1978 1/



1/ 1978 estimated.
2/ Real average annual growth rate of 4.4 percent.
3/ Real average annual growth rate of 3.3 percent, the 1953-1978 average.
4/ Average true level of unemployment of 4.1 percent, or 2.9 percent full-time unemployment.
5/ Average true level of unemployment of 7.8 percent, or 5.2 percent full-time unemployment.
Basic Data: Dept. of Commerce; Dept. of Labor

Chart 3

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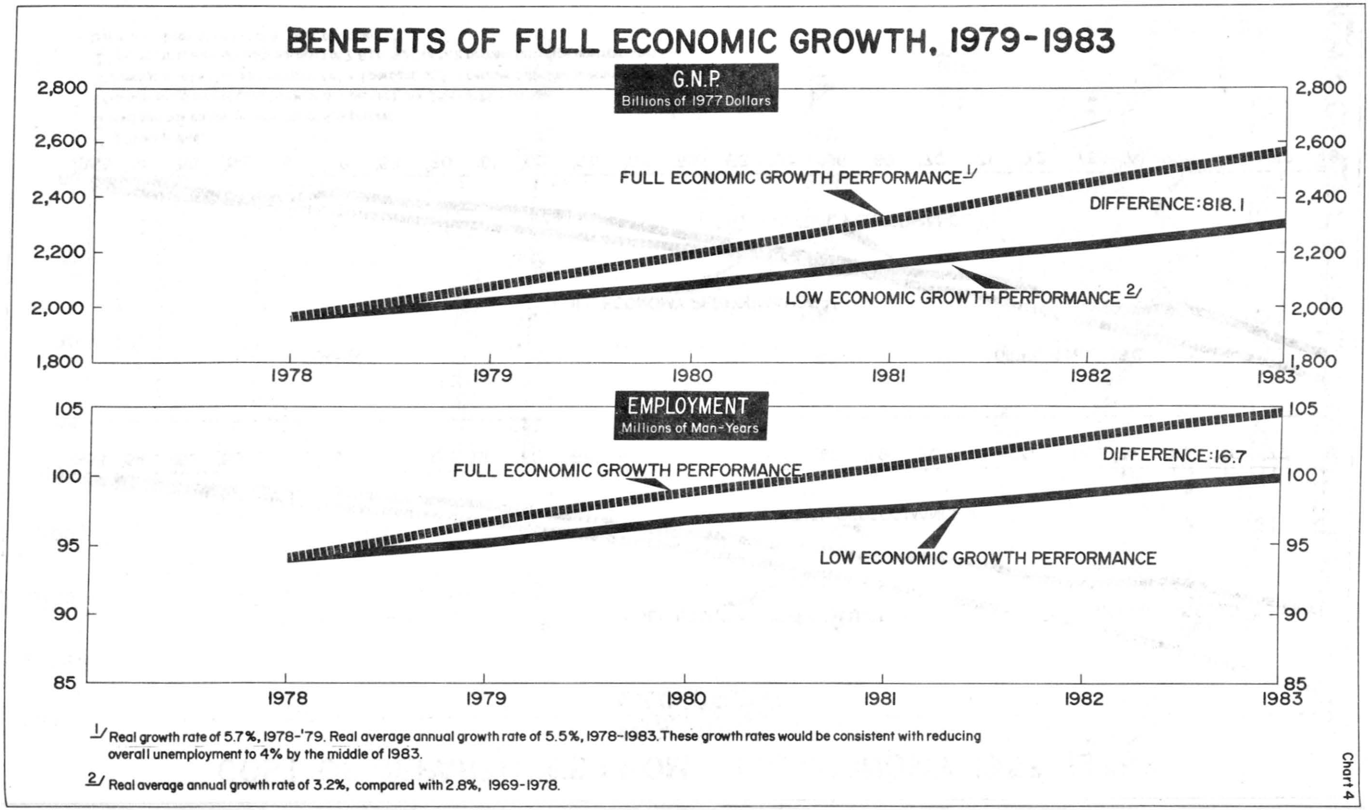

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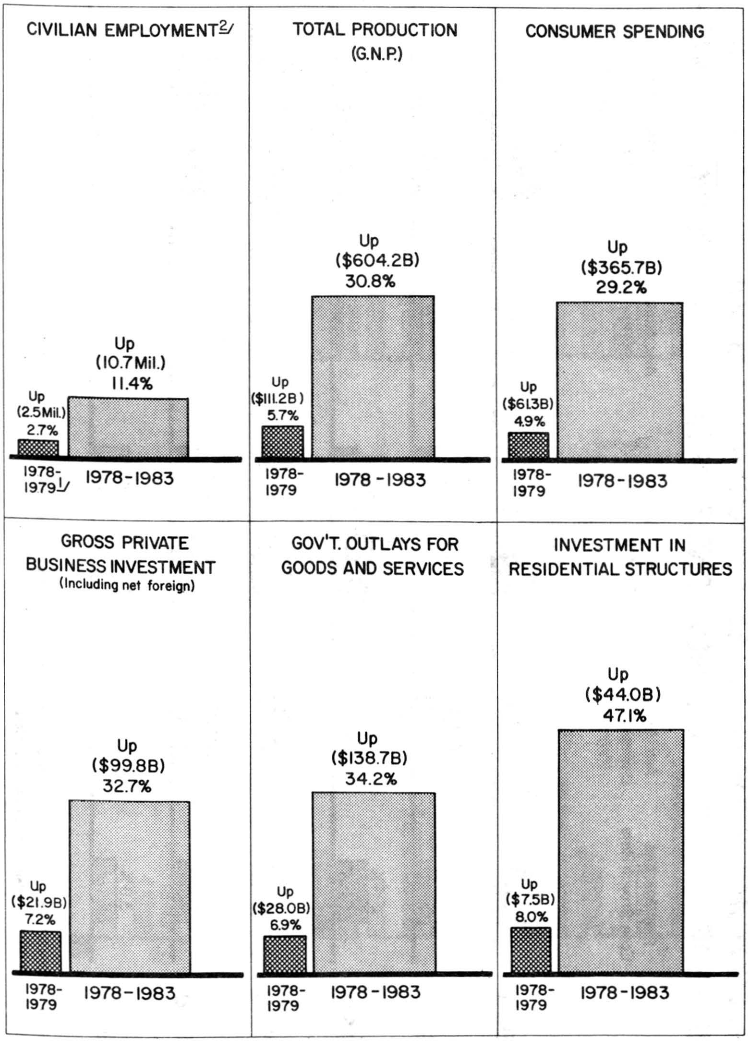
Chart 5

MAJOR GOALS FOR 1983, CONSISTENT WITH 1983 GOAL FOR REDUCTION OF UNEMPLOYMENT

Total Percentage Changes
(Dollar Items in 1977 Dollars, Absolute Data in Parentheses)



[1] Narrower bars for 1978-1979 of no significance.

[2] Full-time unemployment down from 6.0% (6.0 million) in 1978 to 5.6% (5.7 million) in 1979 and 4.0% (4.4 million) in 1983.

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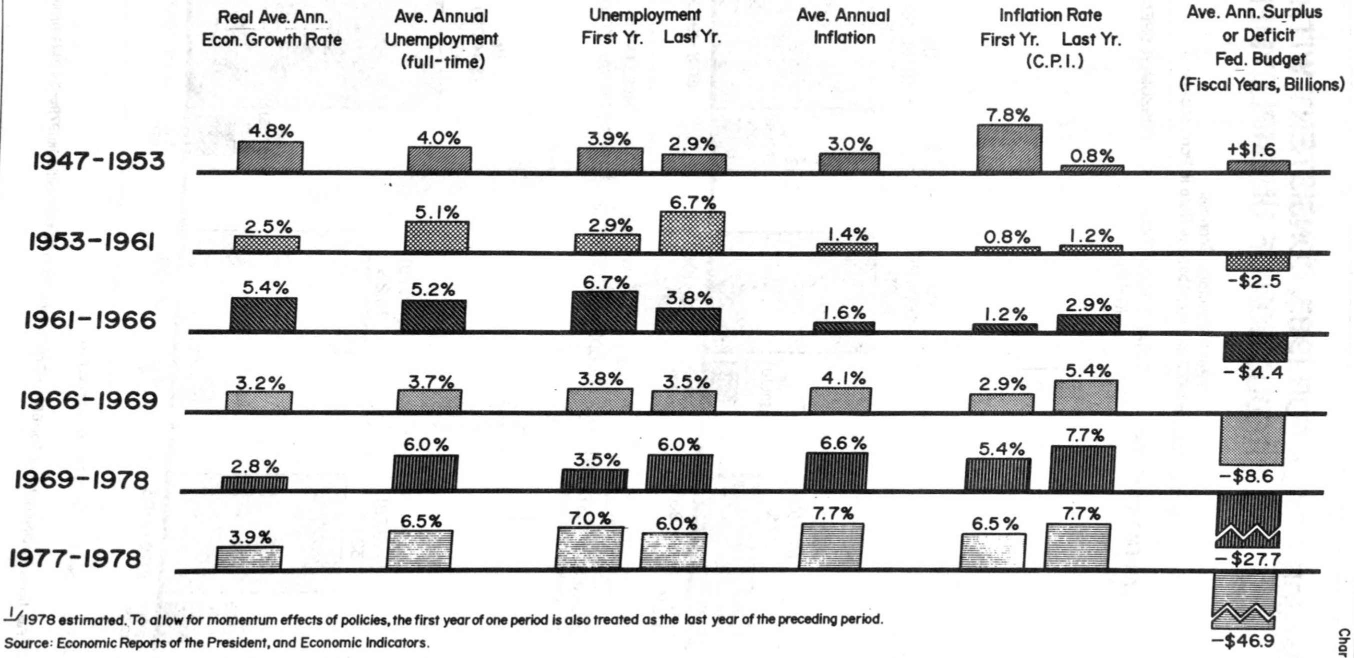
REAL ECONOMIC GROWTH RATES, EMPLOYMENT & UNEMPLOYMENT, INFLATION, AND FEDERAL BUDGET CONDITIONS, DURING VARIOUS PERIODS, 1947-1978[1]



[1] 1978 estimated. To allow for momentum effects of policies, the first year of one period is also treated as the last year of the preceding period.

Source: Economic Reports of the President, and Economic Indicators.

Chart 6

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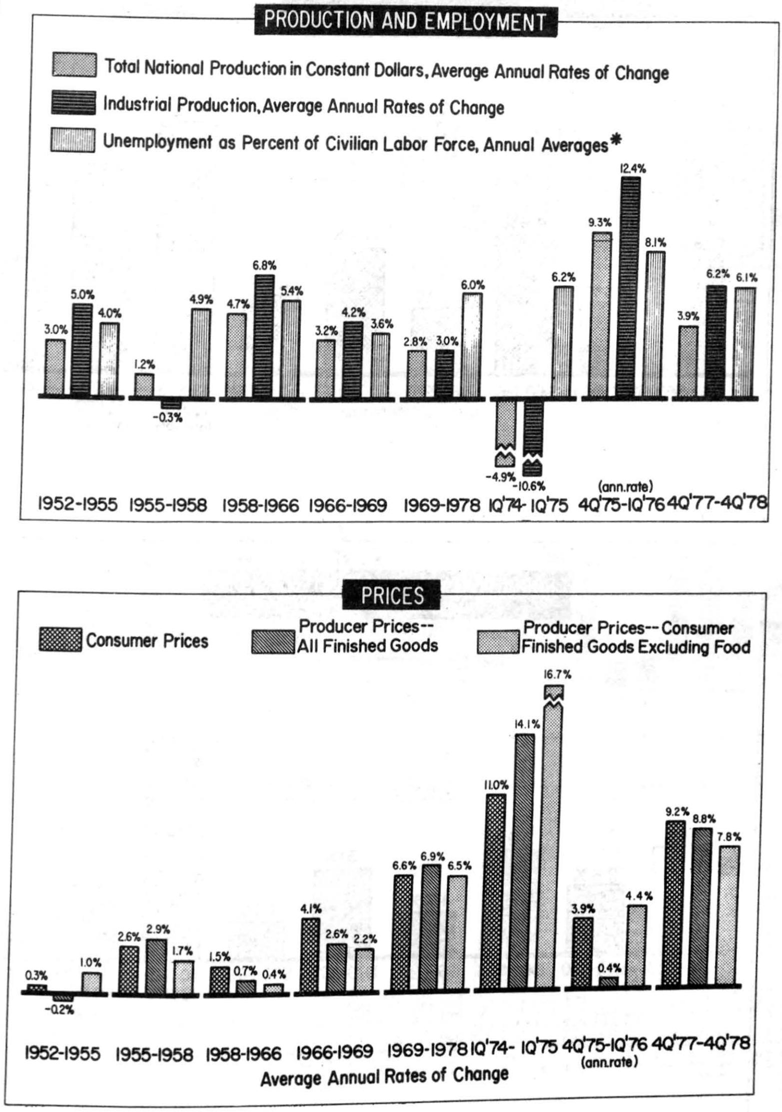
Chart 7

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT, & PRICES, 1952-1978



*/ These annual averages (as differentiated from the annual rates of change) are based on full-time officially reported unemployment measured against the officially reported Civilian Labor Force.

Source: Dept. of Labor, Dept. of Commerce, & Federal Reserve System

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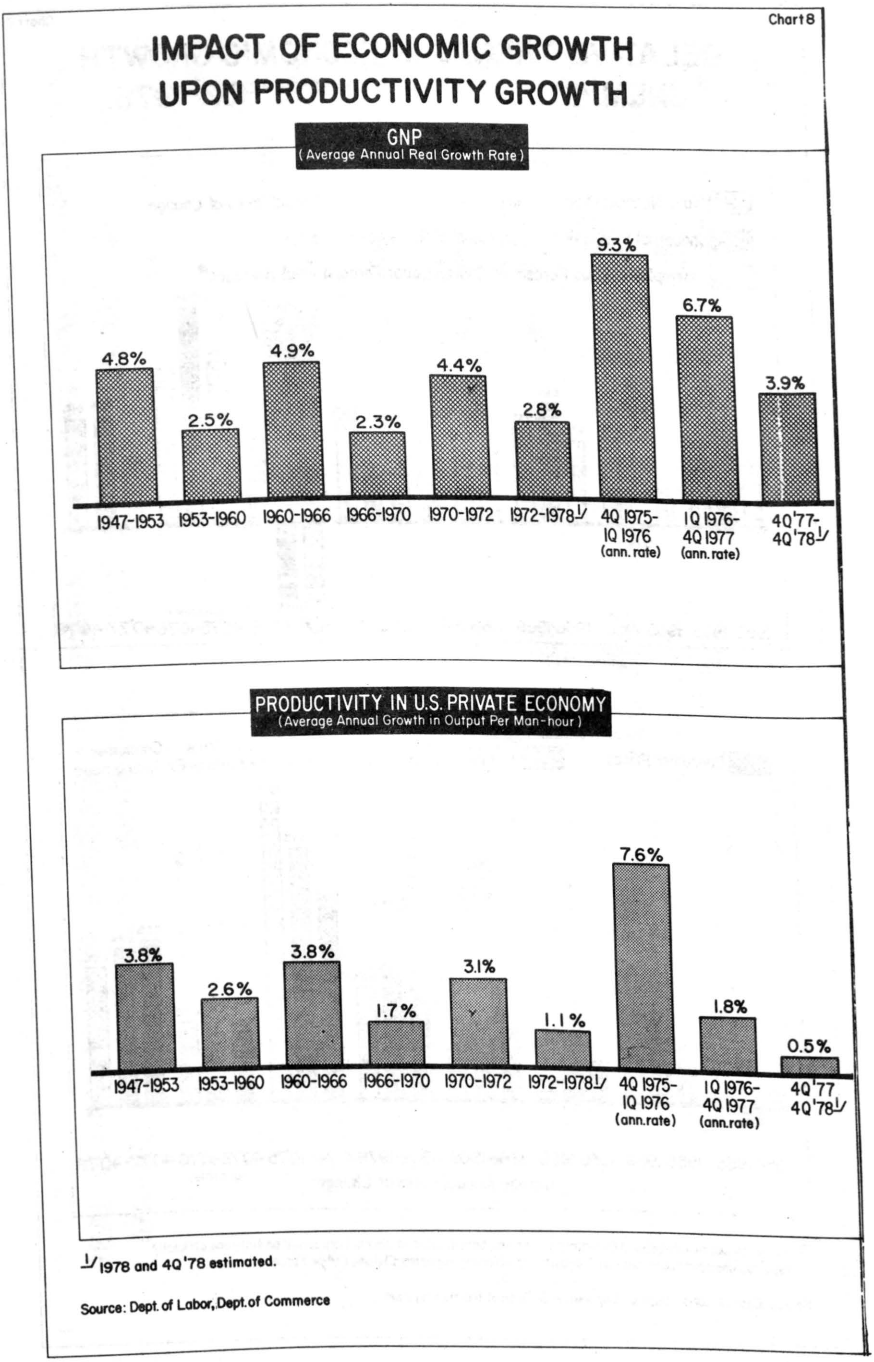
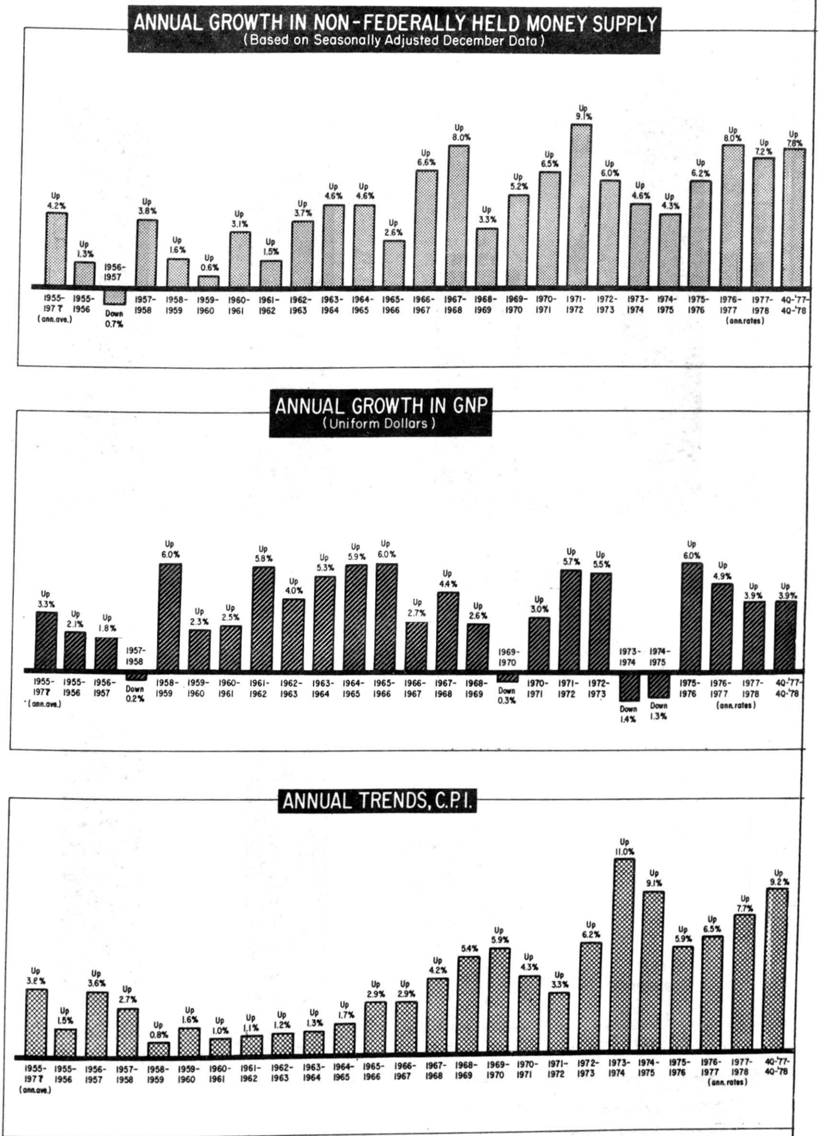


Chart 8
IMPACT OF ECONOMIC GROWTH
UPON PRODUCTIVITY GROWTH
GNP
(Average Annual Real Growth Rate)
4.8%
2.5%
4.9%
2.3%
4.4%
2.8%
9.3%
6.7%
3.9%
1947-1953
1953-1960
1960-1966
1966-1970
1970-1972
1972-1978 1/
4Q 1975-1Q 1976 (ann. rate)
1Q 1976-4Q 1977 (ann. rate)
4Q'77-4Q'78 1/
PRODUCTIVITY IN U.S. PRIVATE ECONOMY
(Average Annual Growth in Output Per Man-hour)
3.8%
2.6%
3.8%
1.7%
3.1%
1.1%
7.6%
1.8%
0.5%
1947-1953
1953-1960
1960-1966
1966-1970
1970-1972
1972-1978 1/
4Q 1975-1Q 1976 (ann.rate)
1Q 1976-4Q 1977 (ann.rate)
4Q'77 4Q'78 1/
1/ 1978 and 4Q'78 estimated.
Source: Dept. of Labor, Dept. of Commerce

Chart 9

COMPARATIVE TRENDS IN NON-FEDERALLY HELD MONEY SUPPLY, G.N.P., AND PRICES, 1955-1978 1/



1/ 1978 estimated.

Data: Dept. of Commerce; Dept. of Labor; Federal Reserve System

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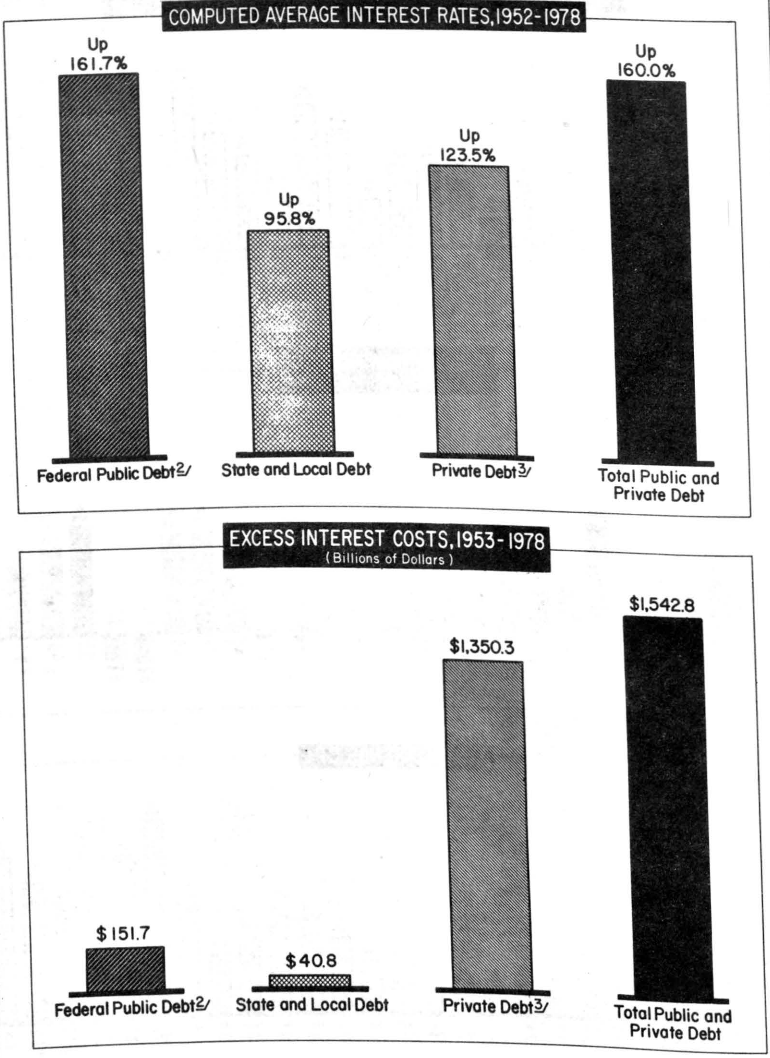
Chart 10

INCREASES IN AVERAGE INTEREST RATES, AND EXCESS INTEREST COSTS DUE TO THESE INCREASES, 1952-1978[1]



1/ 1977 and 1978 estimated.

2/ Includes net foreign interest.

3/ Computed as a residual by subtracting Federal Government and state and local debt from total public and private debt. Includes debt of federally-sponsored credit agencies.

Source: Dept. of Commerce; Economic Report of the President

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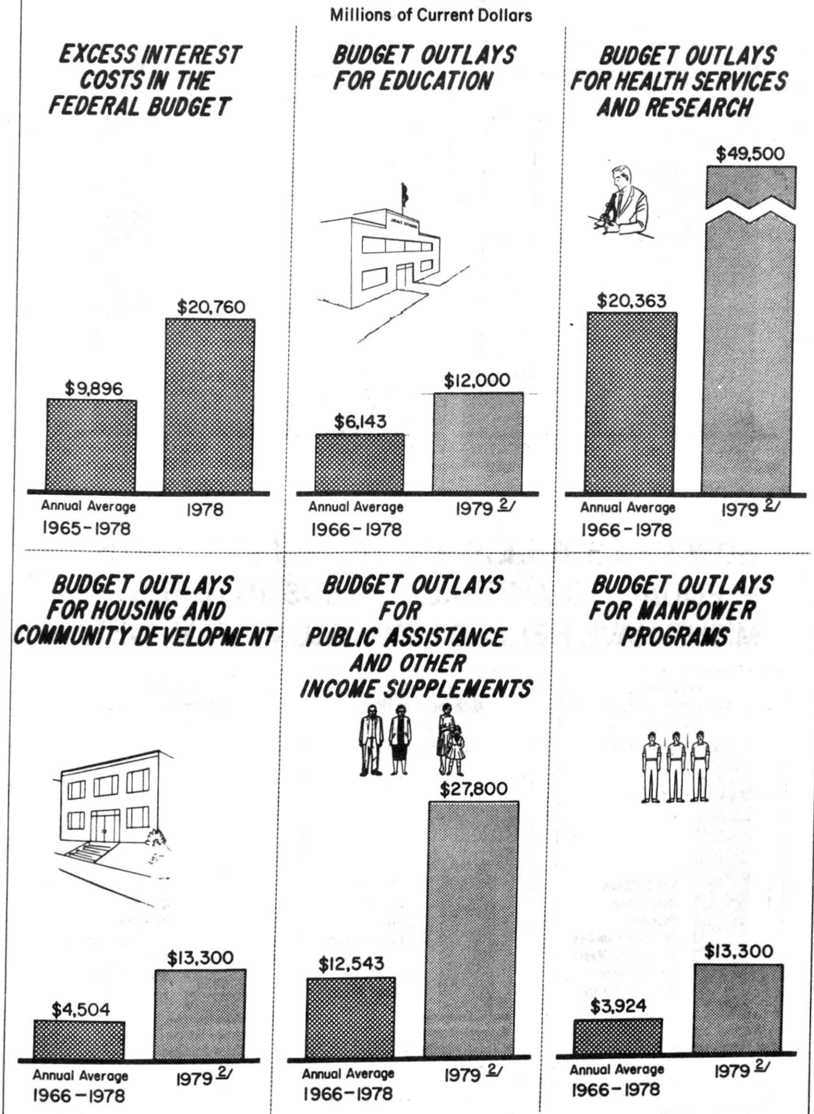
Chart II

EXCESS INTEREST COSTS IN THE FEDERAL BUDGET 1965-1978 CONTRASTED WITH OTHER COSTS FOR SELECTED BUDGET PROGRAMS 1/



1/ Interest costs, calendar years; budget outlays, fiscal years. 1978 interest costs and 1979 budget outlays estimated.

2/ Proposed in fiscal 1979 Budget of President Carter, as revised October 27, 1978.

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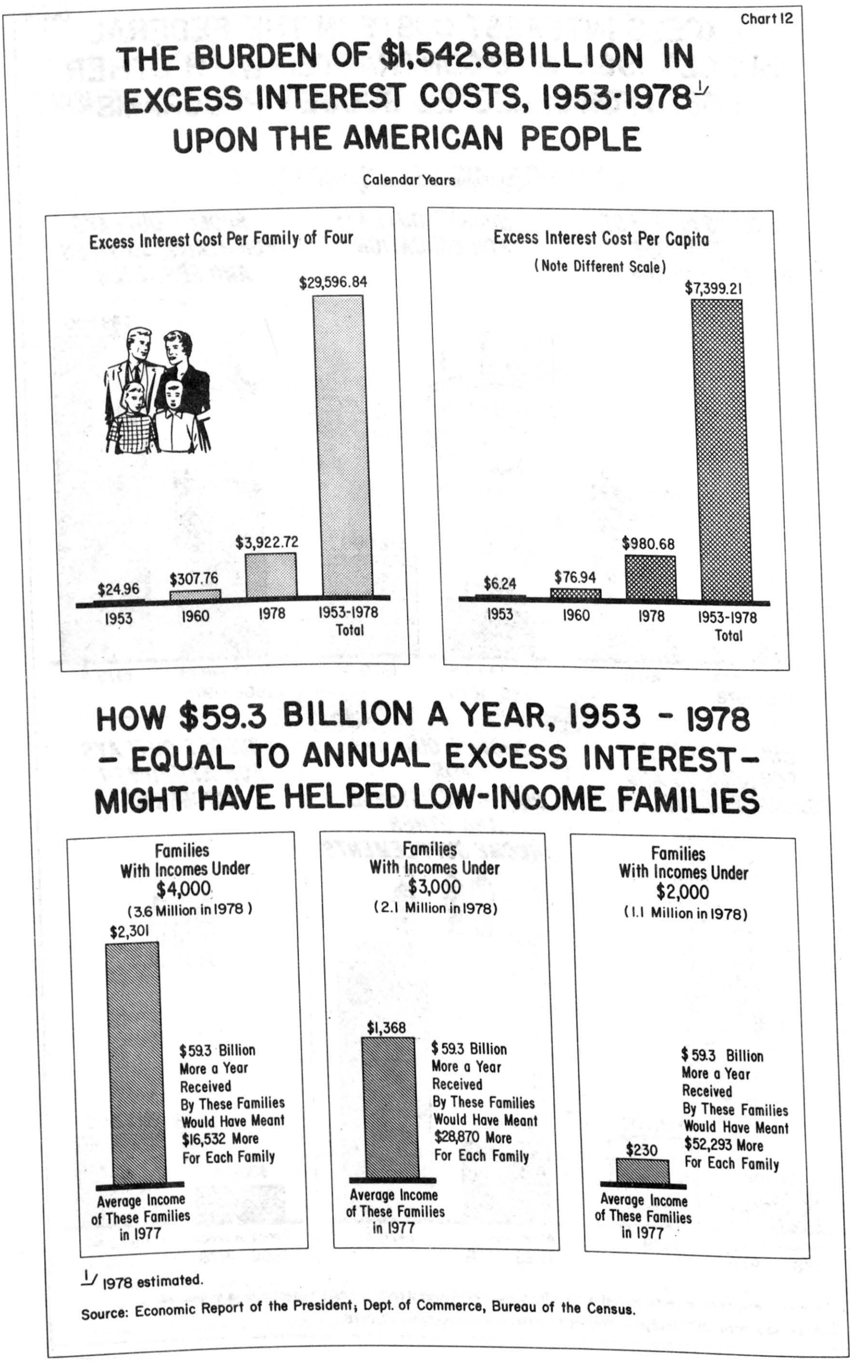

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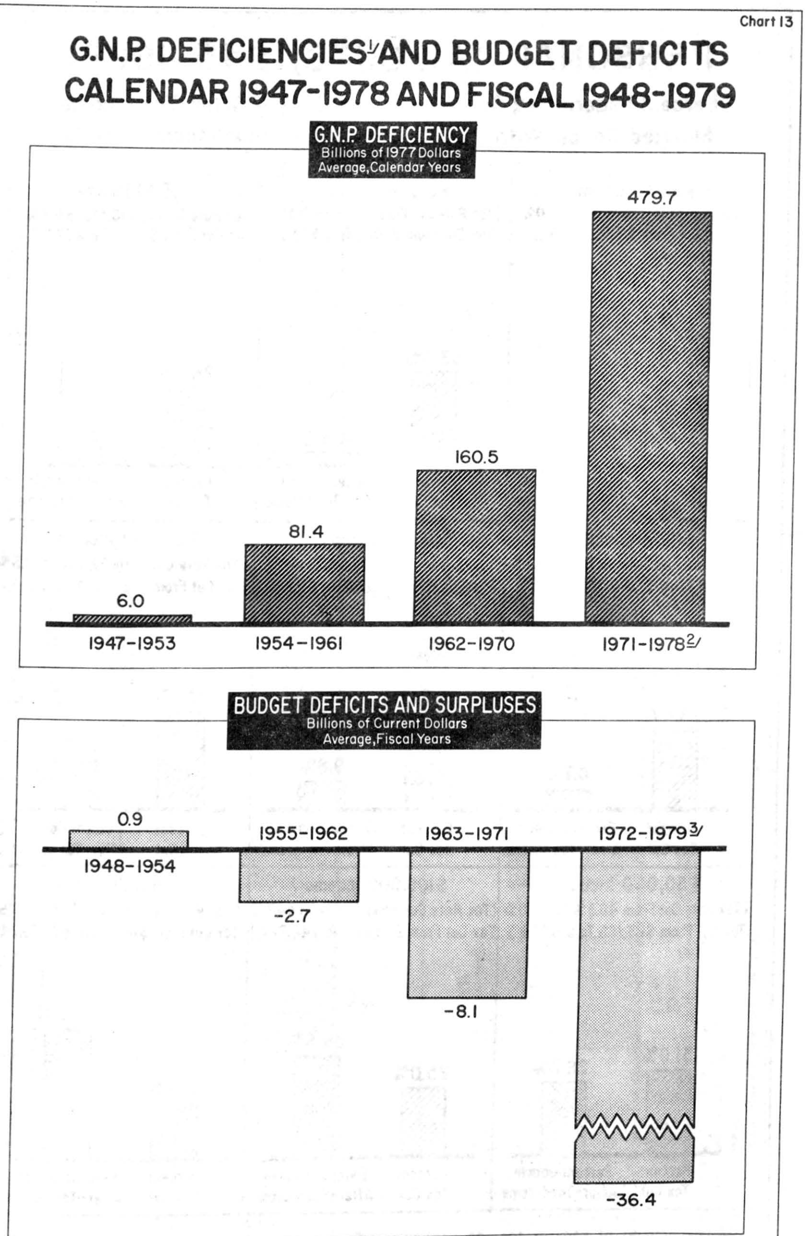

1/ Production deficiencies represent differences between actual production and production at full economy rate of growth. Projections from 1946.

2/ 1978 estimated.

3/ 1979 estimated.

Source: Dept. of Commerce; Office of Management and Budget, for actual figures

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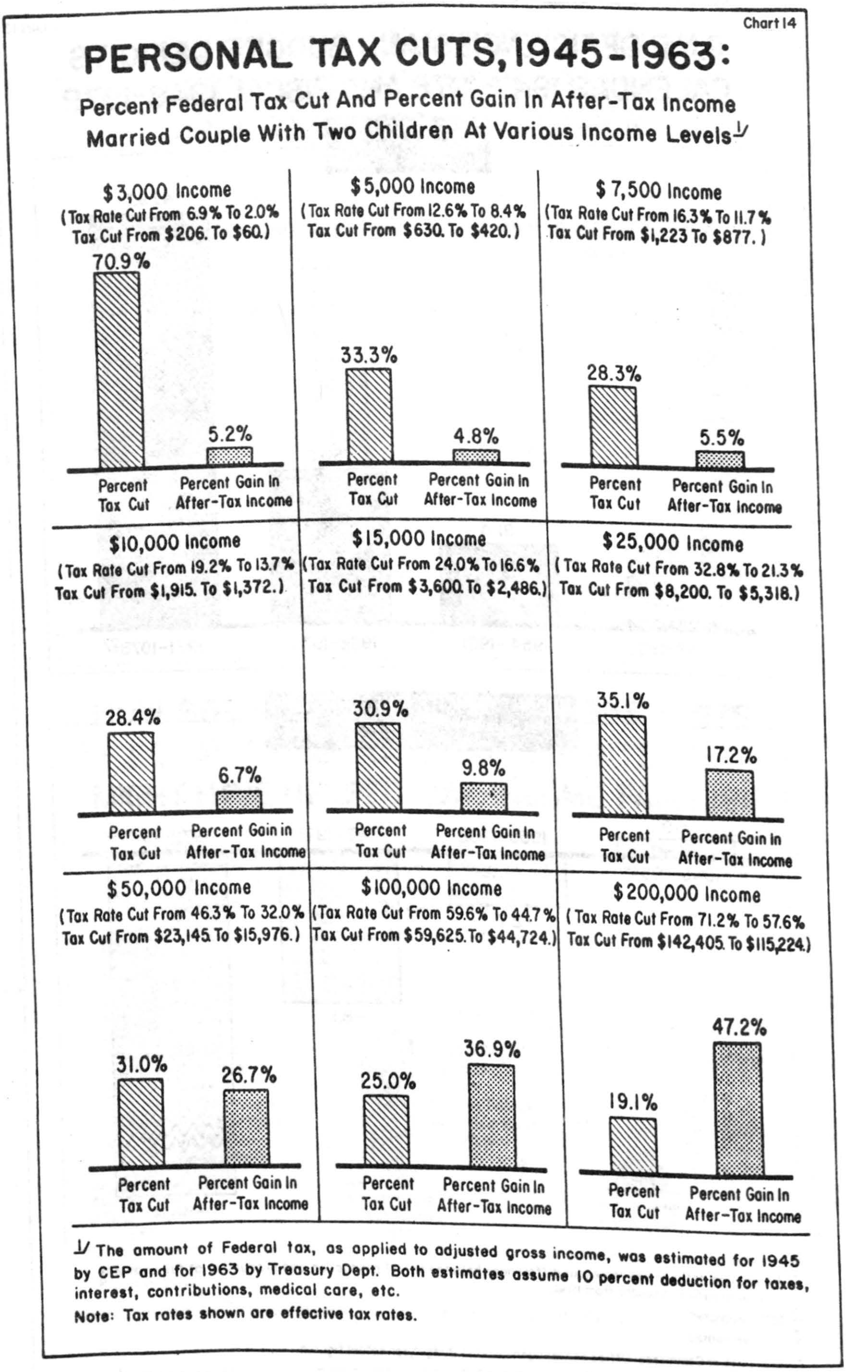

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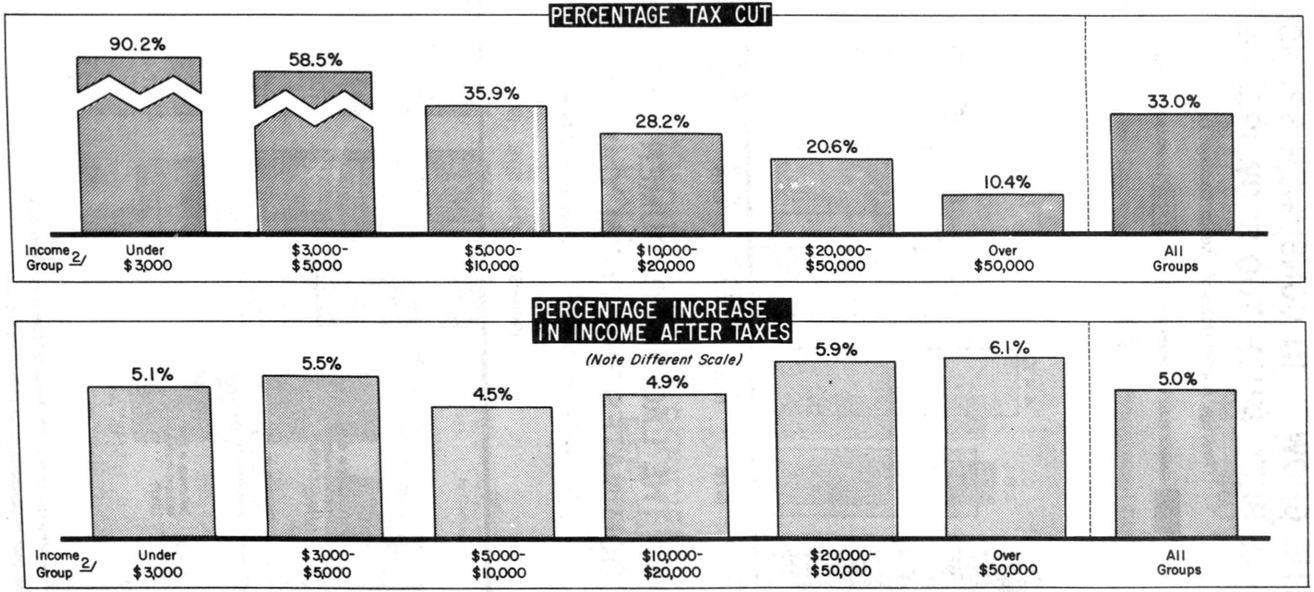
PERCENTAGE TAX CUT AND PERCENTAGE INCREASE IN INCOME AFTER TAX, VARIOUS INCOME GROUPS, 1963-1973 [1]



1/ Effects due to changes in personal tax under Revenue Act of 1964, Tax Reform Act of 1969, and Revenue Act of 1971 (H.R. 10947, as reported by the House-Senate Conference Committee, excluding the effect on personal taxes of removing the first year convention under the Asset Depreciation Range system).

2/ Adjusted gross income class.

Basic Data: House Ways and Means Committee and Senate Finance Committee Reports, and Congressional Record

Chart 15

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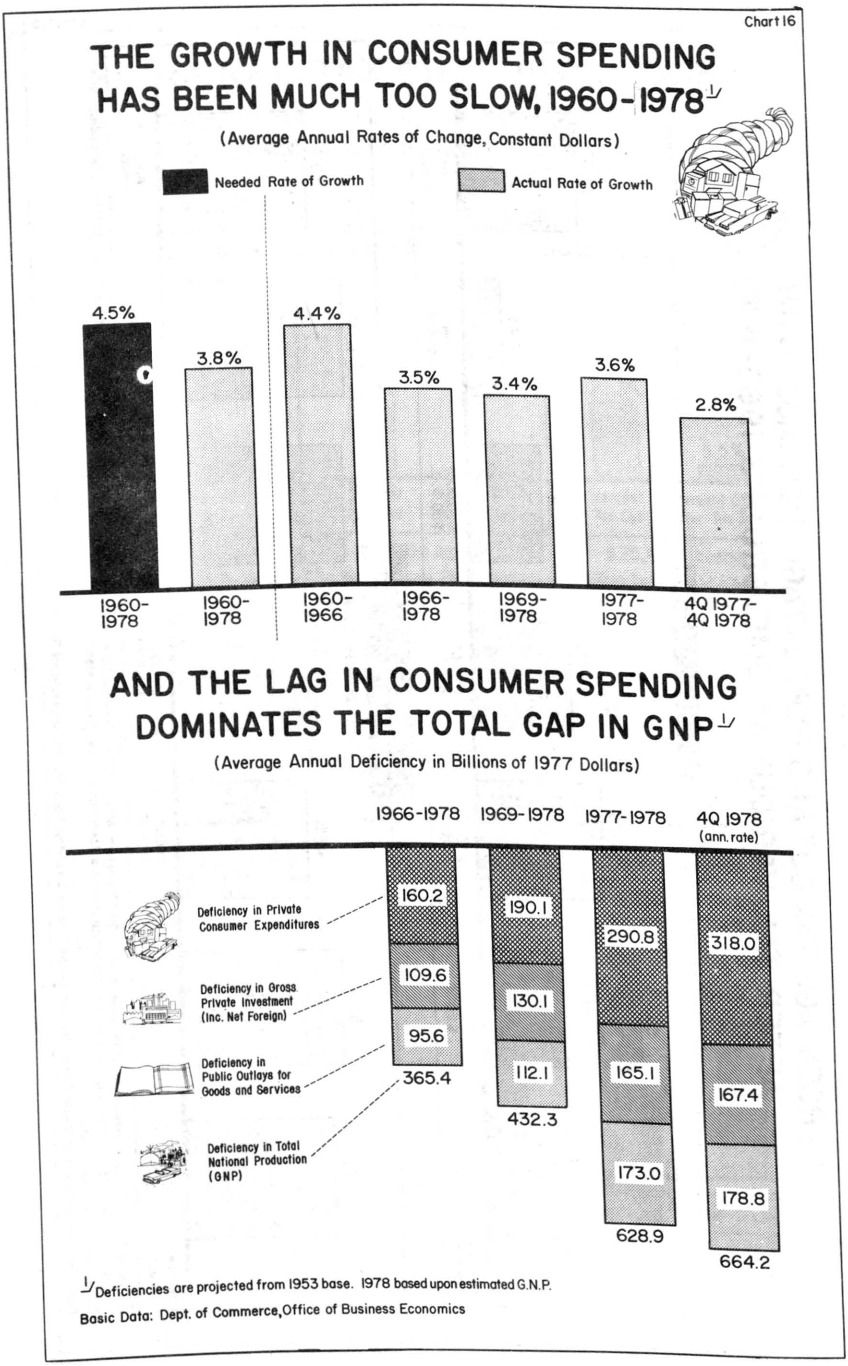

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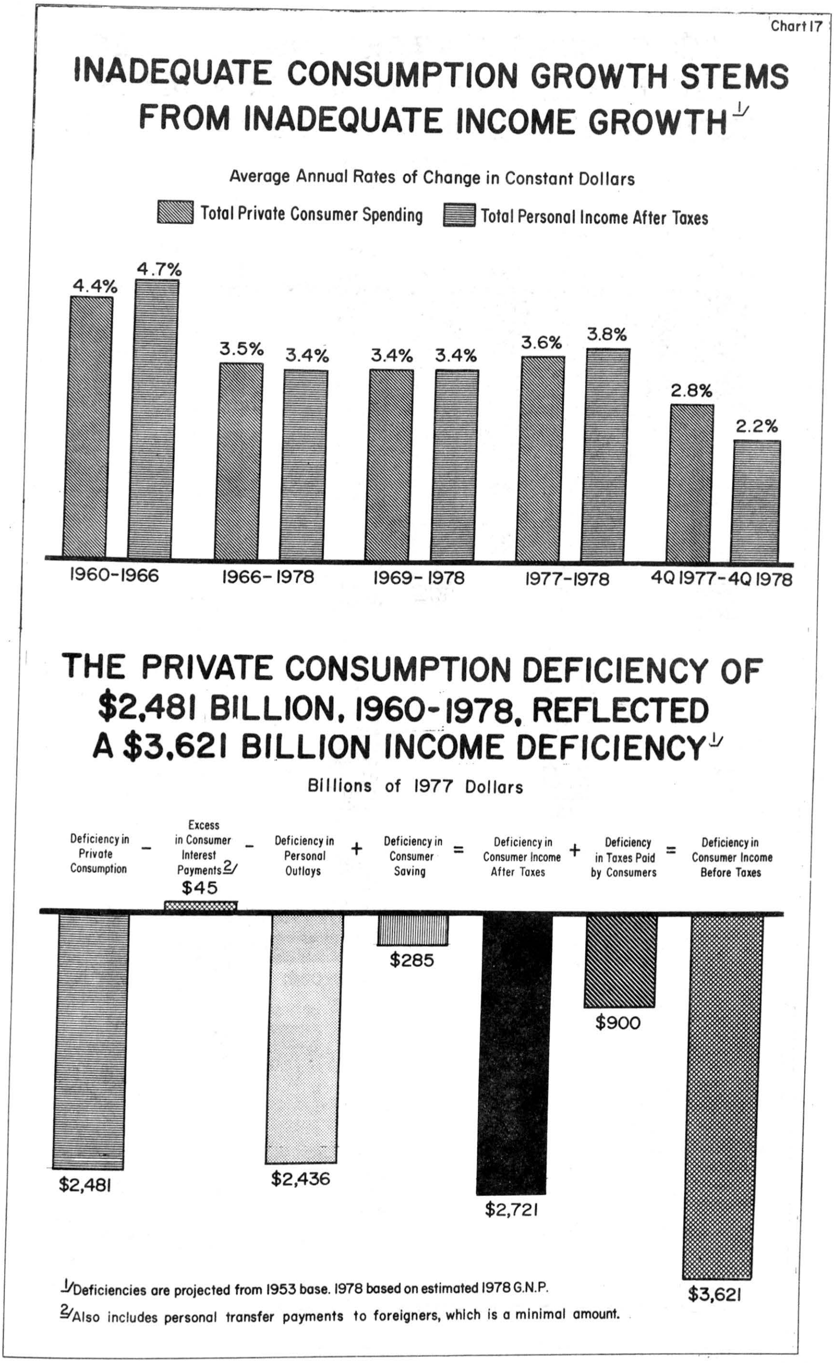

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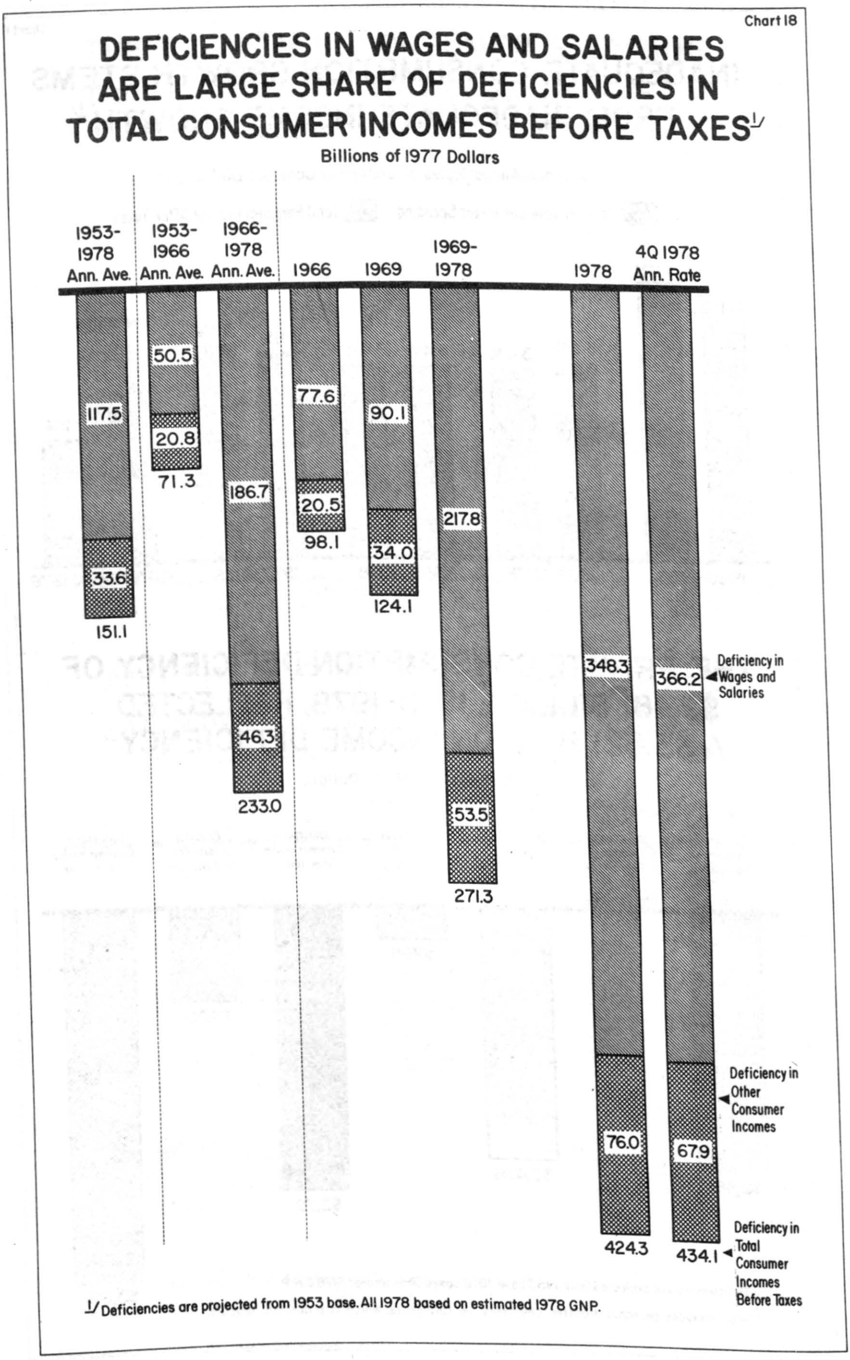

[1] Deficiencies are projected from 1953 base. All 1978 based on estimated 1978 GNP.

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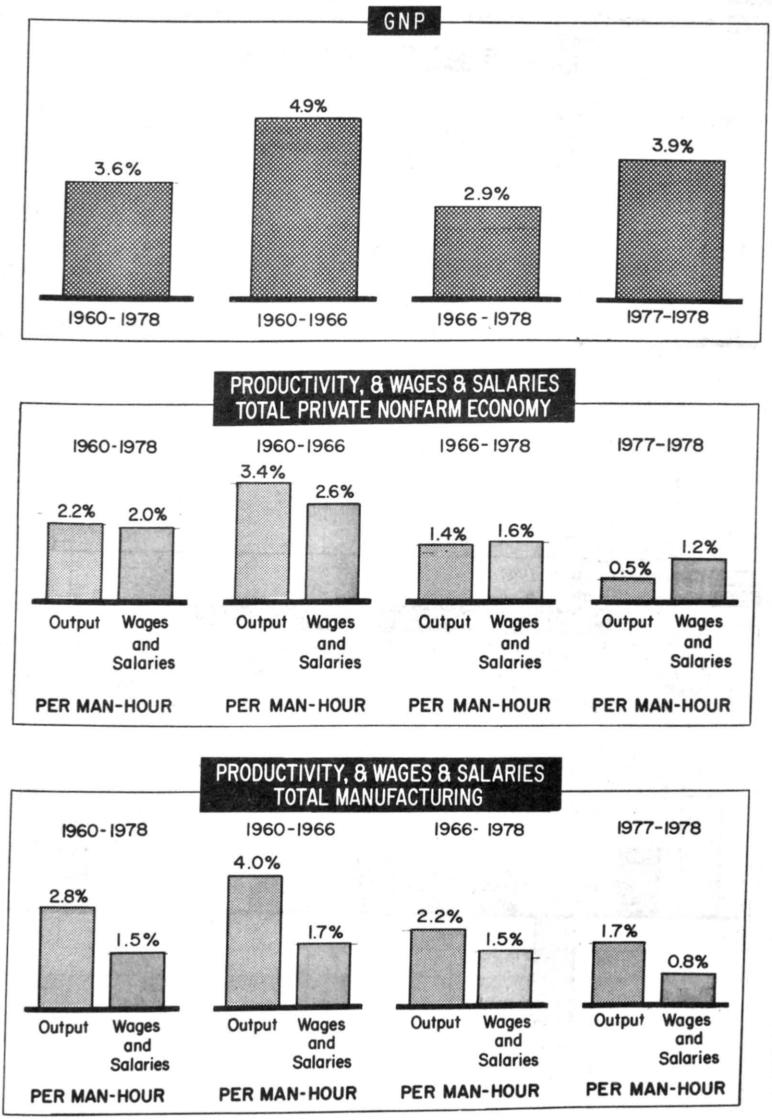
Chart 19

THE LAG IN WAGES AND SALARIES BEHIND PRODUCTIVITY GAINS, 1960-1978[1]

(Average Annual Increases, Constant Dollars)



[1] 1978 estimated.

Basic Data: Dept. of Commerce; Dept. of Labor

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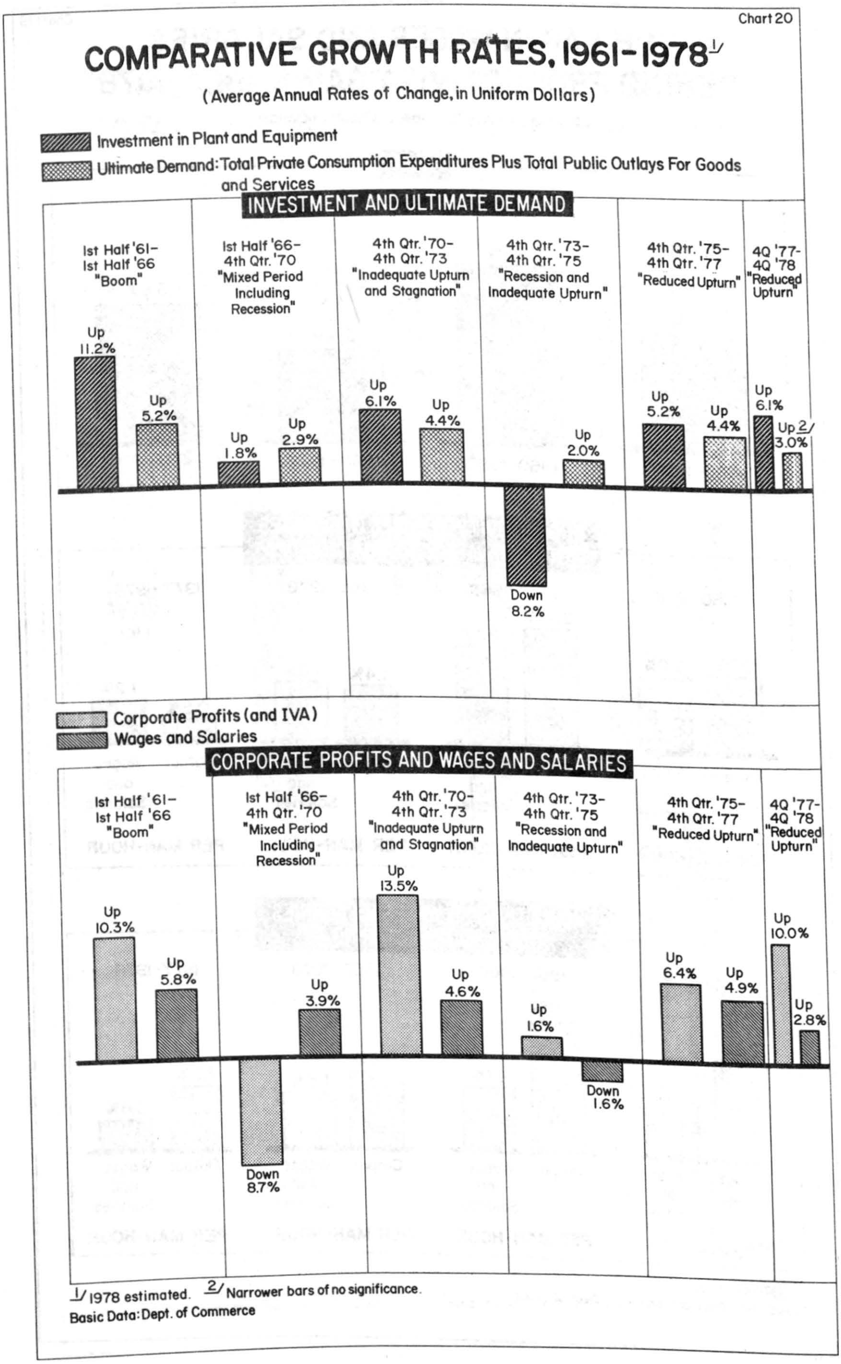

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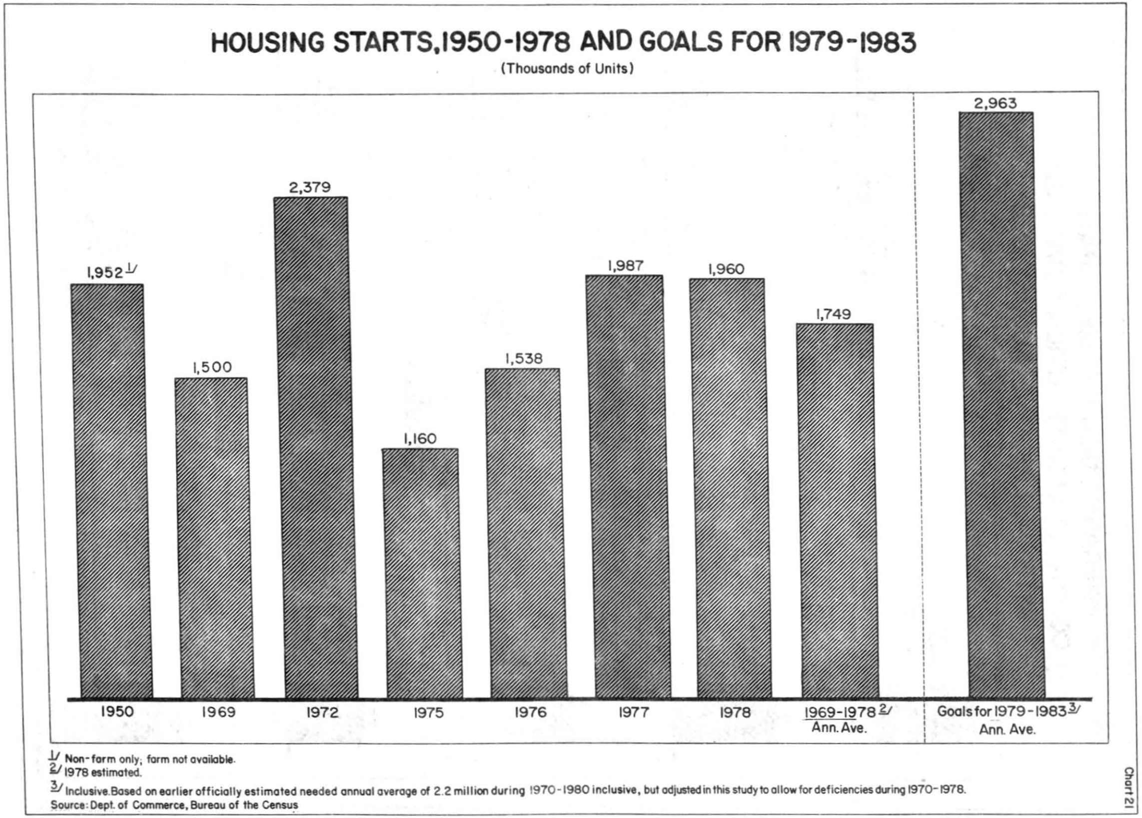

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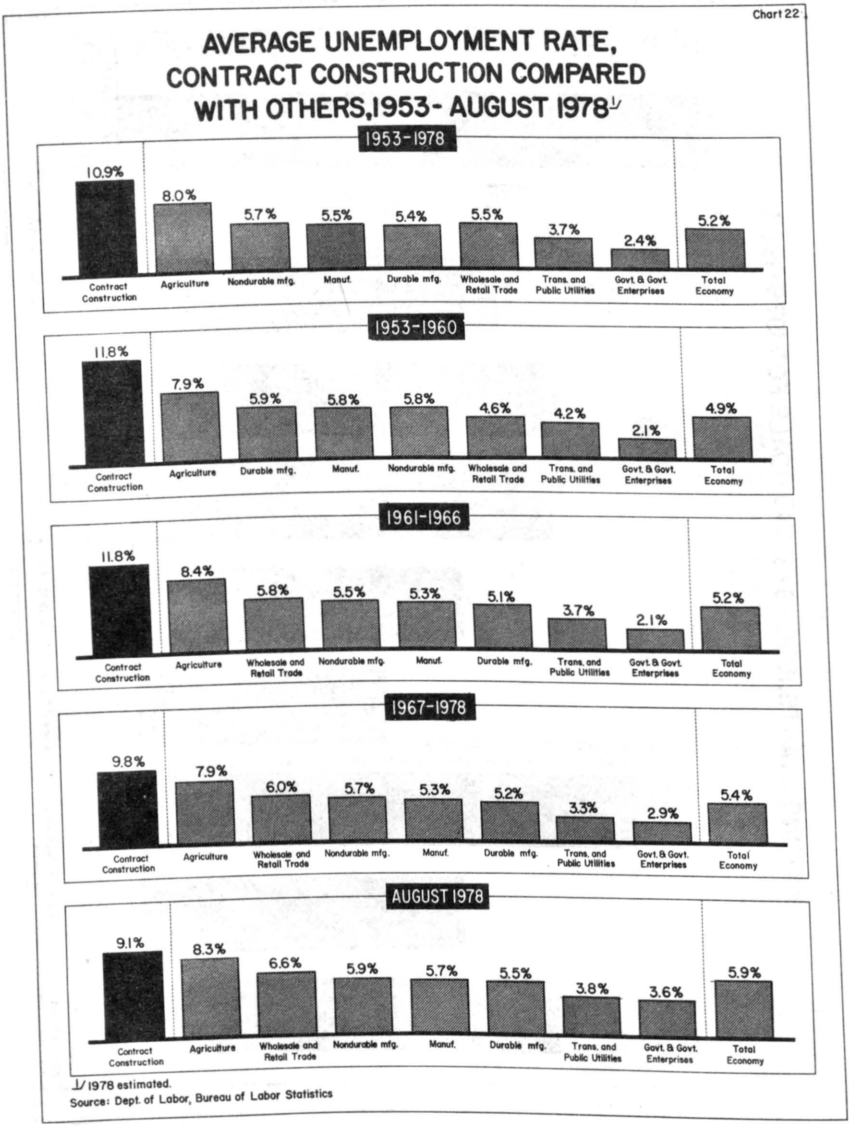

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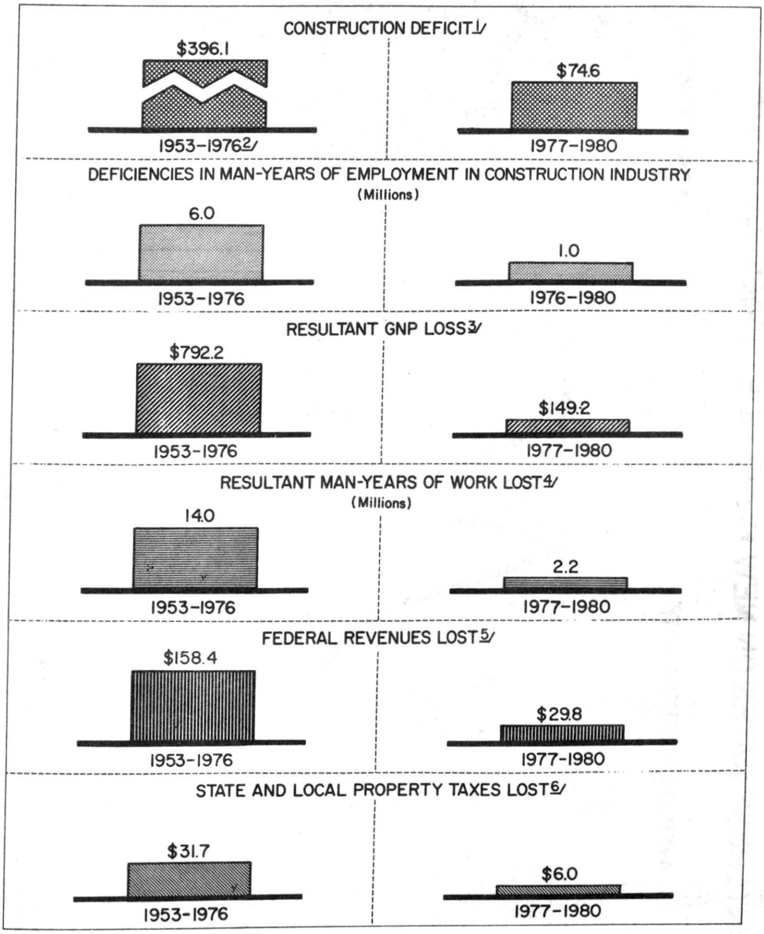
Chart 23

IMPACTS OF DEFICITS IN RESIDENTIAL & COMMERCIAL CONST. 1953-1976, AND PROJECTED 1977-1980

(All Dollar Figures in Billions of 1976 Dollars)

(Note Different Scale in Each Box)



1/ Deficits measure actual (estimated for 1977-1980) performance against estimated needed performance in terms of model for total economy.

2/ Actual average annual growth 2%; needed, 5%, or higher than needed growth rate of 4.4% for total economy.

3/ Based on multiplier of 2.0.

4/ Based on G.N.P. loss, after allowing for that part of the G.N.P. loss due to repressed productivity growth among those employed even in slowly growing economy.

5/ Equals 20% of G.N.P. loss.

6/ Assumes property tax loss is 2% of private construction deficit, cumulated.

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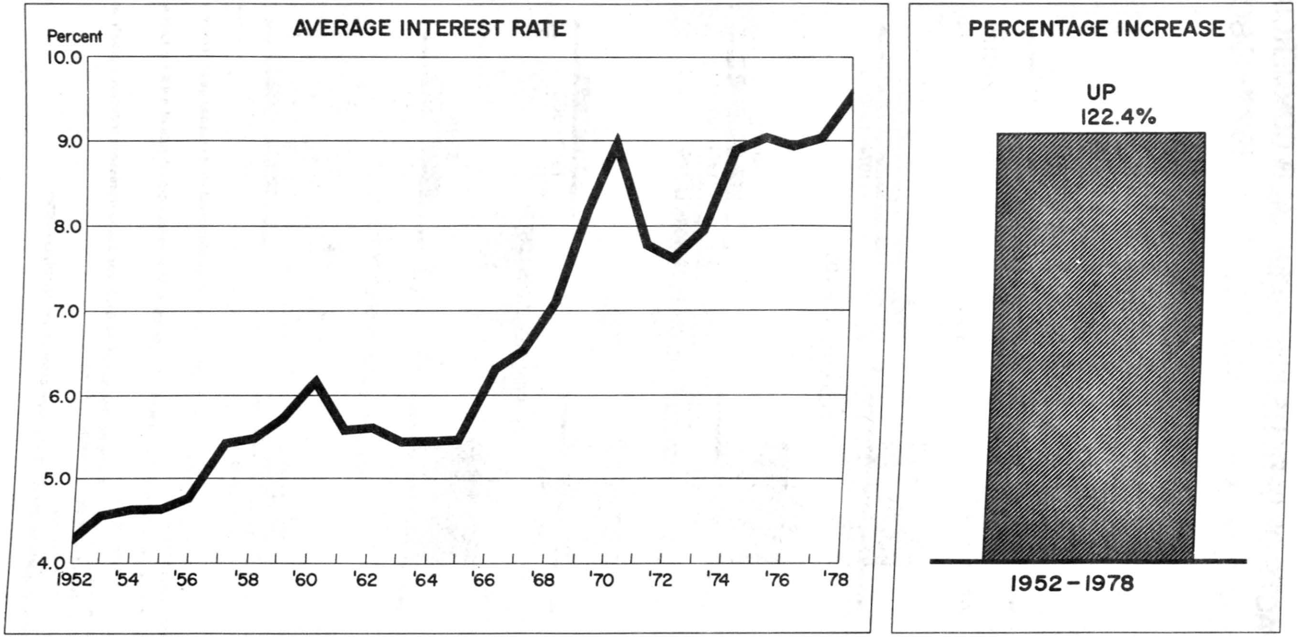
INTEREST RATES ON NEW HOME MORTGAGES, 1952-1978[1]



[1] 1978 estimated. FHA mortgages through 1976. Federal Home Loan Bank Board conventional mortgages, 1977-1978.
Data: Economic Report of the President, Economic Indicators

Chart 24

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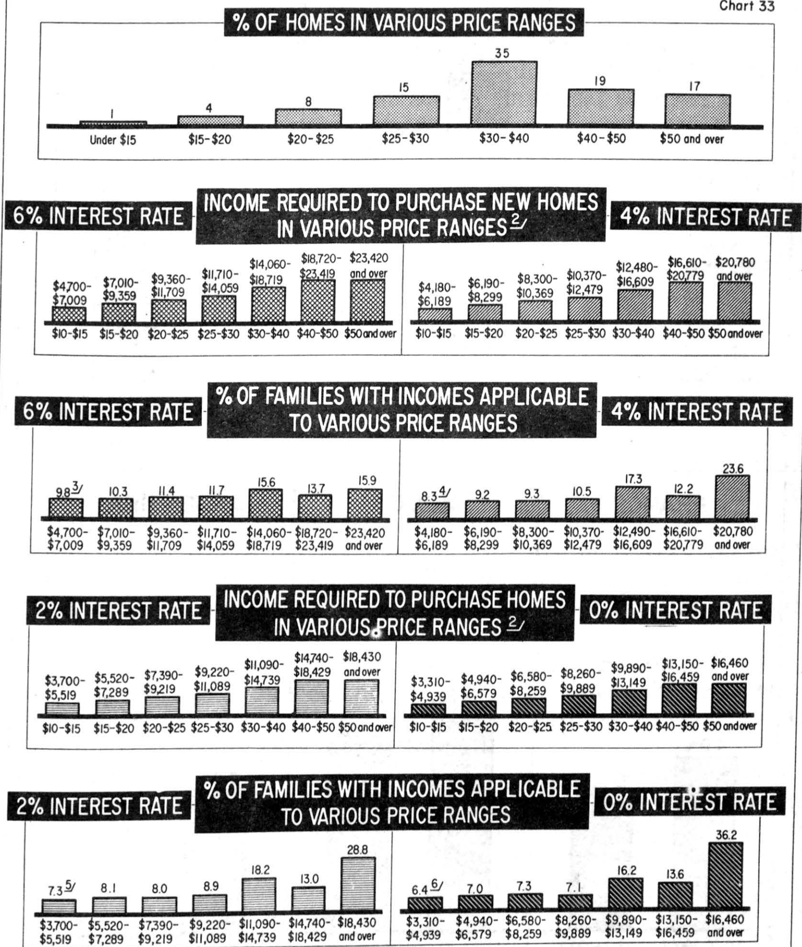
Chart 25

% OF NEW SINGLE FAMILY HOMES AT VARIOUS PRICE RANGES,[1] MINIMUM ANNUAL INCOME REQUIRED TO PURCHASE HOMES IN THESE RANGES, ASSUMING INTEREST RATES OF 6, 4, 2, & 0% FOR THIRTY YEARS, & % OF FAMILIES WITH INCOMES APPLICABLE TO THESE RANGES, 1974

Chart 33



1/ Price ranges in thousands of dollars.
2/ Money income. Includes allowance for taxes, insurance, maintenance, repairs, and utilities.
3/ Under $4,700, 11.6%. 4/ Under $4,180, 9.6%.
5/ Under $3,700, 7.7%. 6/ Under $3,310, 6.2%.

Source: Bureau of the Census; Dept. of Housing and Urban Development; Federal Home Loan Bank Board; Library of Congress

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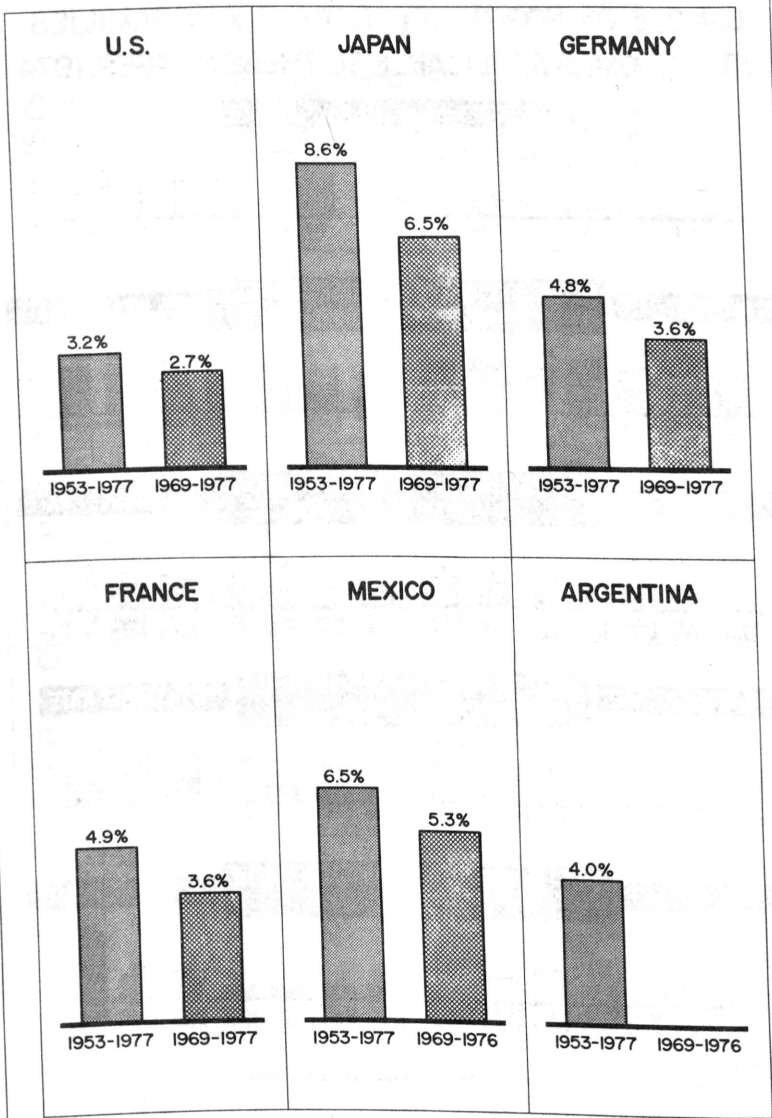
Chart 26

COMPARATIVE REAL ECONOMIC GROWTH RATES VARIOUS COUNTRIES, 1953-1977 AND 1969-1977[1]

Average Annual Rates of Growth



[1] G.N.P. for U.S., Japan, & Germany. Gross domestic product for all other countries.

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Representative REUSS. Thank you very much, Mr. Keyserling. Mr. Willett.

STATEMENT OF THOMAS D. WILLETT, HORTON PROFESSOR OF ECONOMICS, CLAREMONT GRADUATE SCHOOL AND CLAREMONT MEN'S COLLEGE, CLAREMONT, CALIF.

Mr. WILLETT. Thank you. I am very glad to be here.

Perhaps I should start with the background from which I approach these issues. I am not an enthusiast for heavy, formal management of exchange rates.

I think there is no question that exchange rates have been extremely volatile during our period of floating exchange rates. But in my judgment, based on a fairly large set of empirical studies, I do not believe this has been due primarily to failures of the private market.

Indeed, while private speculation has not been perfectly stabilizing by any means, neither have attempts at official intervention, as was very nicely pointed out in the announcement for these hearings. On average, I would judge that the private market has done somewhat better than official speculators in attempting to set equilibrium exchange rates.

The vast majority of the fluctuation in exchange rates that we have observed, I believe, has been caused by reasonable market responses to the highly variable and uncertain economic environment, economic developments, and economic policies.

Having said this as general background, I do strongly support the President's rescue operations of November 1. I think that this was one of the fairly rare occasions in which there was an opportunity for exchange market intervention to have a favorable impact.

By and large, where market expectations are held very strongly, there is very little chance that official intervention is going to have a long-run impact on the market, whether correctly or wrongly perceived.

There are just too many dollars out there. International liquidity is too high. But large movements in exchange rates are not always caused by actively destabilizing speculative capital movements. In fact, I think that is only very rarely the case.

The situation with respect to the dollar during these circumstances, I think, was that a large decline in the dollar which was economically justified, partially on inflation grounds but in much larger part for various real economic reasons which I outline in more detail in my prepared statement. There was the large increaase in oil imports and the slower growth rates abroad relative to the United States. All of these gave rise to the large trade deficit which had to be corrected.

For this to be corrected the dollar exchange rate had to depreciate far below relative rates of inflation to allow these real adjustments to take place.

Now, did the dollar depreciate too far? I think that is hard to say. We don't have a really good idea of how responsive trade is, exactly, in a quantitative sense, to exchange rate changes. Putting different sets of elasticities into different models, you can get answers that the dollar

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depreciated too far or, perhaps, that it didn't depreciate quite far enough.

I would be hesitant to argue that the dollar had fallen completely outside of a reasonable range. But it was at least toward the bottom of that range. There is also a lot of suggestive evidence, from talking with foreign exchange market dealers and forecasters that a number of these experts thought the dollar had depreciated too far, that the economic fundamentals that Bob Solomon was talking about were coming into play, and the dollar would be improving over time.

But the same exchange market participants were not sufficiently confident of their expectations that they were willing to put up enough money to fully back up those expectations. Otherwise the dollar would have started to rise immediately.

In these kinds of circumstances the intervention program of the administration could be seen as aiding the operation of market forces rather than conflicting with them. This is one of the fairly rare types of circumstances in which I think exchange market intervention can have a significant and favorable impact on the exchange market.

I do, however, believe that the tightening of monetary policy was an integral part of the rescue operations, because superimposed upon these underlying favorable economic trends in terms of trade balances was a situation of worsening inflation, so that you were having two conflicting economic factors operating on the market.

It is very hard to say to what extent the market did not take into account sufficiently the underlying improvement in the trade balance, which was already underway, and how much it was rationally discounting increased inflationary fears.

I am very glad we did not see a test of these two conflicting strengths. It made a lot of sense for the package to be combined.

It is important that we not become too overjoyed with the success of the program so as to draw the implications either that we can control the dollar precisely with heavy official intervention, or that because the dollar has now appreciated substantially, we can substantially ease off on monetary policy and keep the dollar from depreciating again.

My fear, of course, is that if we did have a failure to follow through on a tightening of monetary policy, we would further reduce the credibility of Government policies in this area. The impact on expectations in both the domestic economy and the foreign exchange market would be quite devastating.

I think the dollar would plummet again in the foreign exchange markets and in those circumstances the $30 billion, or what is left of it, would buy only very little time. Thus, in my judgment, the somewhat tightened monetary policy was a crucial ingredient of the rescue operation.

In the present, I do not think there is a basic conflict between monetary policy objectives for the domestic economy and those for the international economy or for the exchange rate of the dollar.

Having said that I want to emphasize that where there is a conflict, I think that the domestic economy should receive substantial priority. There has been a lot of increased attention in the last few years to the inflationary impact which an exchange rate decline can have. This is

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very real and considerable one that can have a sizable inflationary impact.

But work they have done recently suggests that the pendulum may have swung too far and that many of the current estimates of inflationary impacts of exchange rate declines may be as much too high as some of the earlier estimates were too low.

The domestic inflationary impact of the declining dollar is something which clearly should be taken into account in setting monetary policy. But it is not so powerful that it should be an overriding determinant of monetary policy.

Today we have a basic conflict among many people as to what our domestic priorities for monetary policy should be. Orthodox monetarists argue strongly that we need to be reducing the rate of monetary expansion to fight inflation. Orthodox Keynesians are much less convinced of this and are much more concerned about the short- or medium-term effect on economic output.

This is an onerous situation in which we have knowledgeable people having quite differing views of what the domestic impact of these policies will be. Whether you have a conflict between domestic and international policies right now depends very crucially on these considerations. There is a vast area of uncertainty about what the domestic impacts of monetary policy would be.

I personally come out somewhat closer to the monetarists' side of this question, but we should admit that we do not know nearly enough to answer with precision. We have not had the economy operating long enough in this period of stagflation, with both high inflation and high unemployment, to have a good understanding of what the precise relationships are in this kind of environment. Therefore, it is not surprising that you have many people having quite different views today about what these relationships are.

In my own judgment, however, a somewhat tightened monetary policy and a very gradual policy of slowing down the growth of monetary aggregates over time probably is desirable for domestic reasons.

Such a strategy will have desirable effects on the exchange rate of the dollar. I do not believe, however, that setting the exchange rate of the dollar should be the overwhelming goal of our domestic monetary policy.

Having mentioned the parts of the President's program which I strongly support, I should say that I am somewhat less enthusiastic about some of the international financing arrangements. I am a little skeptical of the proposals and therefore the implementation of the issuing of the foreign currency denominated Treasury securities.

I don't think it is a great mistake, by any means. However, I probably would not have advocated it. I don't think we will have great benefits from it.

One point I would like to speak to briefly is that in many of the discussions the issuing of the securities abroad is connected up with the general problem of the dollar overhang. I would like to say in this regard that I do not believe that issuing of Treasury securities will have a fundamental effect on the problem of the dollar overhang.

In fact, in my interpretation, the dollar overhang is not a problem as such; it does not make a great deal of difference to the United States

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whether we count up that there are $100 billion held aboard or that there are $600 billion abroad.

There are lots of interesting debates which I have engaged in on just how much we should measure these aggregates, what procedures should we use, and how much is double counting. But I think all of this is fairly irrelevant from a policy standpoint. I think the major point is that international capital mobility is very high. It is going to be very high whether the numbers we come up with for the dollar overhang are 200 billion or whether they are 400 billion. It will stay high whether we marginally increase or decrease the Reserve currency role of the dollar. I think it is a fact of life which we have to adjust to.

High capital mobility means that expectations about developments in the U.S. economy are going to have a major impact on international capital flows and may have a major impact on the dollar.

In my own judgment, there are some things which we may be doing that will make it a little less of a problem, but I don't think that this could be fundamentally eliminated as a problem short of massive capital controls, if then. The basic problem again is one of international capital mobility in general, not one of a dollar overhang. In this regard, I think we should again give consideration to the creation in the International Monetary Fund of a substitution facility that could handle some of the potentially unwarranted dollars held by foreign central banks. I do not think, however, that this would be a major solution to the problems. I think it is something we should give serious consideration to and which may well be desirable, but the benefits from this, I think, would tend to be fairly marginal rather than fundamental.

To conclude, my basic analysis suggests that a lot of the attention on the dollar overhang per se is not well focused. There is not a dollar overhang that we can do something about by issuing $20 billion in foreign securities or creating a new substitution account that will take a few billion dollars of this off the market. The latter may be desirable, but it would not get around the basic problem, which is that we do have a highly interdependent world economy. What goes on in the U.S. economy is going to have a big impact on our exchange rates and on effects in our country. I am afraid the best we can do is just learn to live with that situation. Thank you.

[The prepared statement of Mr. Willett follows:]

PREPARED STATEMENT OF THOMAS D. WILLETT

The Fall and Rise of the Dollar

I. Introduction and summary

I believe that the measures announced by the President on November 1 to help stabilize the domestic and international values of the dollar were desirable, on balance and that the initial implementation of these policies was handled well. I do have reservations about some particular aspects of the rescue package, however, and there are important questions about how we should interpret the recent behavior of the foreign exchange markets and what implications this has for future intervention polices.

While I am an advocate of flexible exchange rates, there are particular sets of circumstances in which I believe that official intervention in the foreign exchange markets can be useful. It appears that the dollar may well have been in just such a situation. There is a danger, however, that the initial success of the recent rescue moves in generating a substantial appreciation of the dollar may

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inappropriately contribute to views that the private market had been dominated by irrationality and destabilizing speculation, that heavy official management of the dollar should be the general rule for the future, and that the need to follow through on anti-inflationary macroeconomic policies has diminished.

Such views would be greatly mistaken, I believe. The fall of the dollar was due primarily to underlying economic factors. To the extent that the dollar may have fallen too far, I believe that this has been due to insufficiencies of the amount of stabilizing private speculation, not to actively destabilizing speculation and widespread irrationalities in the foreign exchange markets. A considerable portion of the appreciation of the dollar was due to the success of the President's message in changing expectations about the future course of macroeconomic policies in the U.S. If these expectations are disappointed, the credibility of government announcements will take another major blow, domestic inflation will accelerate, and the dollar will plunge again.

I do not believe that the domestic inflationary effects of dollar depreciation are so great that attempts to stabilize the international value of the dollar should be an overriding objective of domestic economic policies. At the present time, however, if we are to bring inflation under control, our domestic and international objectives coincide rather than conflict.

Attempts to stabilize the international value of the dollar through intervention policies alone would be bound to fail. This is well recognized by our monetary and financial officials and they appear to have little intention to follow the mistakes of others by attempting to define and defend a narrow range of exchange for the dollar. I am concerned, however, that the availability of large quantities of funds for potential intervention, combined with widespread interpretation that the dollar had previously depreciated much too far, could lead to a tendency to attempt to manage the exchange rate of the dollar too closely. I believe that more attention should be given to monitoring how successful our authorities are in their intervention.

I am less enthusiastic about the issuing of foreign currency denominated U.S securities than I am about the other parts of the rescue package. I am not fully convinced that these measures are necessary or desirable, but neither am I greatly troubled by them.

Some have welcomed the announcement of the intention to issue such securities as evidence of recognition that something must be done about the key currency roles of the dollar. I am doubtful, however, that there is a great deal which can or should be done about the international roles of the dollar. While a case can be made for reconsidering the creation of some kind of substitution facility in the I.M.F. to help reduce the reserve currency role of the dollar, I think it unlikely that we could expect great benefits from such a plan. Stories of the demise of the dollar as an international currency have been greatly overstated. The fact is that international financial interdependence has reached a point where the international roles of the dollar could be substantially reduced only through massive controls over the freedom of international financial transactions or through domestic economic instability.

Basically, international financial interdependence increases the already strong case for promoting domestic economic stability. I believe that the President's November 1 announcement represents an important step in this direction and my major concern is that its initial success not be abused.

II. Was the decline of the dollar caused by irrational destabilizing speculation?

Many commentators have argued that over the past year irrational market phychology, rather than underlying economic fundamentals, has been the major cause of the decline of the dollar on the foreign exchange markets. The inference usually drawn from such views is that heavy official management is needed to offset the deficiencies of the private market.

I do not believe that this interpretation of the fall of the dollar is correct, however. Furthermore, even if it were correct, I am doubtful that official intervention on a feasible scale would be able to substantially alter the course of the dollar.

As many observers have commented, the amount of internationally mobile funds is huge. It is doubtful that official intervention could long maintain an exchange rate that differed substantially from strongly felt market views. As was mentioned in the announcement for these hearings, we have had numerous instances in which official attempts to maintain exchange rates in the face of heavy market

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pressures have failed. But what I think is particularly notable about such episodes is that in the substantial majority of such cases, it was the private market, rather than the official managers, who turned out to be correct.

I certainly do not want to argue that the private market is always magically correct in its composite judgments, and that the foreign exchange markets always operate with ideal efficiency. There is little evidence, however, to support the views that massive destabilizing speculation has commonly dominated the foreign exchange markets and has been a major cause of observed exchange rate volatility.[1]

Market psychology certainly has an impact on exchange rates, and such attitudes are not always rationally formed. In general, however, I would argue that private market expectations about exchange rates have been formed on a fairly reasonable basis. The arguments that the market is behaving irrationally are usually based on differing views and hopes about the future course of economic developments and/or highly oversimplified views about what should determine exchange rates.

In recent years there has been increased general recognition that exchange rates neither can nor should remain unchanged in the face of substantially different rates of inflation among countries. There has been an unfortunate tendency, however, to replace the old popular fallacy of assuming that equilibrium seldom change, with a new fallacy that only changes in national price levels should influence exchange rates.

Behind many of the statements made over the past year that the dollar was demonstrably undervalued was simply the observation that the dollar had fallen considerably more than was required to offset differences in rates of inflation. But on the basis of consideration of a fuller range of economic fundamentals a substantial drop in the dollar is just what should have occurred. Inflation rates are not the only factors which influence equilibrium exchange rates.

Nor do foreign exchange markets act merely as a mechanical mechanism to balance the transactions generated by past economic developments. Just as other financial markets, they react also to the anticipations of future developments. And we are lucky that they do so. Otherwise the dollar would have fallen much further than it did.

Many factors besides prices affect the balance of payments and exchange rates. Most of the huge rise in the U.S. trade and current accounts deficits over the last several years has been due to factors unrelated to general price competitiveness, particularly the effects of more rapid real income growth in the U.S. relative to our trading partners, and the second substantial increase in our oil imports.[2] The value of U.S. oil import payments grew by almost as much over 1976 and 1977, as they did in 1974 following the huge oil price increases of that year. This second surge in oil imports was caused primarily by the combination of the rapid real economic growth noted above, and the failure to implement an effective energy policy which included a substantial rise in energy costs toward market levels. Since there was no comparable shift in the basic desires of OPEC and other countries to invest in the U.S., the restoration of equilibrium would require a decline of the dollar sufficient, not just to offset inflation differentials, but also to stimulate enough additional exports and reductions in imports to offset these noninflation related developments.

As is well known, the responsiveness of exports and imports to changed price incentives is much greater in the long run than in the short run. The size of the exchange-rate decline required to restore better balance in the trade accounts over the short run would have been enormous, if indeed it would have been possible at all. However in such circumstances private speculation will have profit incentives to help buoy up a currency until stronger trade responses come

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[1] Discussions of a number of studies on speculation and exchange rate behavior during the current float may be found in Richard Levich, "Further Results on the Efficiency of Markets for Foreign Exchange," Federal Reserve Bank of Boston, International Monetary Conference, October 1978; Dennis Logue, Richard Sweeney and Thomas D. Willett, "The Speculative Behavoir of Foreign Exchange Rates During the Current Float," *Journal of Business Research*, No. 2, 1978; Susan Schadler, "Sources of Exchange-Rate Variability," *I.M.F. Staff Papers*, July 1977; and Thomas D. Willett, *Floating Exchange Rates and International Monetary Reform* (Washington: American Enterprise Institute, 1977), Chapter 2.

[2] For further discussion on this see Thomas D. Willett, "Economic Fundamentals, Purchasing Power Parity, and the Decline of the Dollar," Claremont Economic Discussion Papers, 1978.

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into play, thus tending to limit the decline in the exchange rate to that required to restore equilibrium over a longer period of time. There are similar profit incentives to speculate out the price or exchange rate effects of developments which are expected to be soon reversed. The dollar did not fall mechanically as the trade deficit worsened. Initially it was widely expected that the major non-price factors causing the deterioration of the trade balance would be reversed within not too long a time period. Growth rates in Europe and Japan were expected to accelerate, reducing a substantial part of the increased trade deficit. It was only when it became increasingly clear that the initially expected rates of growth in Europe and Japan were not going to be met and that the outlook for substantial energy regulation in the U.S. was poor, that the dollar began its significant decline in 1977.

The rise of inflationary expectations in the U.S. at the same time further contributed to the fall of the dollar. It has been argued that the dramatic plunge of the dollar cannot be explained fully in terms of the direct effects of plausible increases in expected national inflation rate differentials. I quite agree, but would not accept the corollary sometimes drawn, that this shows that the dollar dropped much to far and became substantially undervalued. To repeat, past and expected future inflation differentials have an important impact on exchange rates, but they are not the only economic fundamentals which influence exchange rates. Exchange rate movements which differ substantially from inflation differentials do not necessarily mean that the foreign exchange markets are out of touch with economic reality.

Furthermore as was emphasized by my colleague, Richard Sweeney, at a recent monetary conference held by the Federal Reserve Bank of San Francisco,[3] a worsening of inflationary expectations may have a substantially larger impact on exchange markets than just the shift in the mean of expected inflation differentials. As has become increasingly recognized, higher inflation rates tend to produce greater uncertainty.[4] In addition to the substantial domestic costs which this imposes, it makes the U.S. a less attractive place to invest for foreigners as well as for U.S. firms and citizens. This becomes particularly important at a time when the United States needs to attract capital inflows over the medium term to allow the large trade and current account deficits time to adjust gradually to lower levels which would be sustainable.

The fall of the dollar was caused not by destabilizing speculation, but by insufficient autonomous private capital inflows to finance our large trade and current account deficits. Private speculation vis-a-vis the dollar has been predominantly stabilizing, rather than destabilizing, in the sense that it has tended to move market rates toward, rather than away from, medium terms equilibrium rates.

In the absence of private speculation, the decline of the dollar would have been much greater. The real question is whether there has been sufficient private stabilizing speculation.

III. Has there been insufficient stabilizing speculation in favor of the dollar?

There is not a clear cut answer to this question. We do not have any single unambiguous concept of sufficiency, nor do we have the necessary facts to judge conclusively whether particular concepts of sufficiency have been met. I cannot hope to resolve this question today, but a few comments can be made.

Clearly speculation hasn't been sufficient to keep the exchange value of the dollar from falling substantially over the past year. But this is not a reasonable criteria. As has been argued above, there are many economic reasons for a substantial decline of the dollar. The question is whether the decline went too far in the sense that it could be reasonably confidentialy judged that the dollar had overshot its medium term equilibrium value and would therefore be expected to appreciate again in the future.

There is room for considerable disagreement over this question, even if we can succeed in ruling out views based on highly oversimplified analysis. There

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[3] Richard James Sweeney, "Risk, Inflation, and Exchange Rates," Claremont Economic Discussion Papers, 1978.

[4] For early arguments and empirical evidence on this point see Arthur Okun, "The Mirage of Steady Inflation," Brookings Papers on Economic Activity, No. 3, 1971 and Dennis E. Logue and Thomas D. Willett, "A Note on the Relation Between the Rate and Variability of Inflation," *Economica*, May 1976. For an excellent recent discussion and references to the expanding literature on this subject see Gardner Ackley, "The Costs of Inflation," *American Economic Review*, May 1978.

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is wide scope for differing opinions about the future outlook for inflation in the U.S. and abroad, about the relative weight of various price indices, e.g. consumer prices, wholesale prices, and export prices, in influencing exchange rates, about the outlook for nonprice developments such as rates of real economic growth in the U.S. and abroad, and about the size of exchange rate adjustments necessary to offset the effects of nonprice factors.

In my judgment the dollar, despite its very substantial fall, had not dropped below a reasonable range of estimates of equilibrium values over the medium term. This is not to say that I am confident that the dollar had not fallen "too far," but rather that there is sufficient uncertainty about the economic and financial outlook and structural relationships that strong judgments should be not made about the correctness of exchange rates except within a fairly wide range.

There would probably be fairly wide agreement, however, that if the dollar had not fallen below a reasonable range, it was at least well towards the pessimistic end of that range. The administration has reiterated its view that equilibrium exchange rates cannot be determined with a high degree of accuracy, and that it would not be appropriate for the U.S. to defend a particular value of the dollar. It has been argued, however, that prior to the November 1 rescue measures, the dollar had fallen too far—that the market was being too pessimistic about the outlook for the dollar.

There are two major issues involved here. The first is whether the market was being unreasonably pessimistic in its outlook for economic developments which would influence the dollar. The second is whether the current value of the dollar was fairly accurately reflecting the composite outlook of foreign exchange market participants.

(*a*) *Was the market too pessimistic?*

With respect to the first question, it should be recognized that the administration has strong reasons for desiring the market to adopt optimistic expectations about the future course of government policies and the economy. It is understandable that the failure of the President's anti-inflation speech in October to significantly strengthen the dollar was quite disappointing to the administration. It is not really clear, however, whether the administration was being too optimistic or the market was being too pessimistic.

(*b*) *Had the dollar fallen below the market's composite expectations?*

The second issue is also murky. Exchange rates usually reflect the composite of the expectations of exchange market participants. If a substantial majority of participants believed that the dollar had fallen too far and should appreciate in the future, then they would have economic incentives to buy dollars now and profit from the expected future appreciation. In the process this buying would usually bid up the dollar to a value roughly in line with the average of the expectations of market participants. Conversely if a substantial fall in the dollar were anticipated in the future, the dollar would tend to be bid down immediately.[5]

Where there are large underlying payments imbalances and the situation is quite uncertain, this mechanism for bringing market rates into line with composite market expectations may not always work well. While a market participant may believe the odds are relatively high that the dollar should appreciate he may also foresee a wide range of uncertainty. In such circumstances he, quite rationally, might be hesitant to put up large amounts of funds to back up his expectations. With the large U.S. payments deficit on current and autonomous private capital accounts, it is entirely possible that the market could on average believe that the dollar should appreciate, but be unwilling or unable to back such views with sufficient funds for the dollar to appreciate substantially before the anticipated improvements in the balance of payments position clearly began to come about.

[5] A qualification should be noted. Exchange markets may display trends based on different rates of inflation, etc. In such cases, interest-rate differentials are likely to roughly mirror these differential trends and neutralize the incentive for speculation. For example, in the absence of other developments, a country with a higher rate of inflation would be expected to have a currency which depreciated over time, but it would also tend to have higher nominal interest rates which would offset the effects of the expected depreciation of the currency on the incentives to move funds internationally. Thus by and large it is expectations of exchange-rate changes which differ from inflation differentials which would motivate the type of speculative behavior discussed in the text. While there may also be some direct speculation in currency which would be unaffected by interest rates, the magnitude of such speculation is likely to be relatively small.

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In other words, while I believe that the supply of stabilizing speculative funds has usually been reasonably adequate, where there are extremely large temporary payments imbalances this may not always be the case, especially where a great deal of uncertainty is present.

In such circumstances the dollar could depreciate "too far," but this would not be the result of destabilizing speculation and irrationalities in the foreign exchange market. Furthermore this would be a case in which official intervention would be aiding rather than attempting to thwart the operation of market forces. Consequently it is in such circumstances, along with situations of short term disorderly market conditions, in which official intervention in the exchange market can be effective, even though it is only a tiny fraction of total potential international financial flows.

Of course, pointing out the theoretical possibilities of such cases does not ensure that they have actually occurred, or that they are diagnosed correctly by officials when they do occur. Likewise there can easily be a tendency toward wishful thinking in interpreting why one's currency has fallen. However, while it is difficult to offer conclusive evidence, it does appear quite plausible that there was insufficient stabilizing speculation in the period just prior to the November 1 rescue operations. The very rapid and substantial appreciation of the dollar in the wake of the President's announcement is quite consistent with such an interpretation.

IV. Macroeconomic policy and the dollar

A qualification and a warning are in order, however. A major aspect of the President's announcement was a strong signal toward tightening monetary policy. I would suspect that it is this part of the rescue package which has had the greatest impact on the exchange markets.

The sharp appreciation of the dollar following the rescue announcements should not be taken as proof that the market had been behaving irrationally.

Nor should this appreciation lead officials to believe that there is therefore no need to maintain a credible policy of gradually slowing the rate of growth of U.S. monetary aggregates and reducing the size of the federal deficit. Such a course is not without considerable short term domestic costs, and the short term in this case may be a number of years. But I am convinced that such a course is the lesser of two evils. The consequences of not slowing the rate of monetary expansion would be even more pernicious over the longer run.

Where there is a conflict between domestic and international objectives for U.S. macroeconomic policy, I beliece hat much greater weight should be given to domestic objectives. While direct domestic consequences of exchange-rate depreciation neet to be taken into account in designing wise macroeconomic policies, many popular discussions of the hypothesized vicious circle relationships between depreciation and inflation, trend to greatly exaggerate the influence of exchange rate changes on inflation.

It is quite true that the effects of exchange rate changes range well beyond the impact on prices of internationally traded goods alone. An increase in import prices is likely to influence the prices of many domestic producers as well. A few estimate the inflationary impact of exchange rate changes. Today, however, the years ago there probably was a tendency for most analysts in the U.S. to underestimate the inflationary impact of exchange rate changes. Today, however, the balance may well have swung too far in the opposite direction.

Typical econometric estimates have suggested that a one per cent depreciation of the dollar is likely to increase domestic prices over a period of time by between 0.2 and 0.3 per cent. This contrasts with the less than 0.1 per cent direct impact from increased import prices alone. Recent research by Charles Pigott, John Rutledge and myself suggests, however, that because they have typically failed to delineate the causes of exchange-rate changes, current econometric estimates may well be as biased upwards as the earlier import ratio calculations were biased downwards.[6]

The interrelationships between domestic inflation and exchange rates are complex. There is no simple mechanism of domestic inflation exclusively causing exchange-rate changes, nor of exchange rate changes exclusively causing domestic inflation. Often, but not always, price level and exchange rate changes are both responses to the same underlying economic and financial developments. This makes it difficult to tell in what circumstances an exchange rate depreciation is

[6] Charles Pigott, John Rutledge, and Thomas D. Willett, "Some Difficulties in Estimating the Inflationary Effects of Exchange-Rate Changes," presented at the annual meetings of the Western Economic Association, June, 1978.

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an independent cause of additional inflationary pressures, as opposed to merely reflecting domestic inflationary pressures. It also makes it difficult to estimate accurately the domestic effects of the portions of exchange-rate changes which should be considered independent influences on domestic inflation.

A stable international value of the dollar would certainly be desirable, but I do not believe that the consequences of depreciation of the dollar are so damaging to the U.S. economy that its avoidance should be made an overriding policy objective.

I am not a full fledged monetarist, but I do believe that at present there is not a basic conflict between present domestic macroeconomic policies and the objective of avoiding a rapidly depreciating dollar in international markets. Should monetary policy soon turn more expansionary again, the dollar will drop and the remainder of the $30 billion rescue package would not be sufficient to stoy this for an extended period of time. However, the greatest costs of such a policy reversal would be those imposed directly on the U.S. economy through worsening domestic inflation, rather than those which operate through the foreign exchange market.

V. Monitoring exchange market intervention

A second word of warning concerns the danger that beliefs that the private exchange markets have behaved badly combined with the availability of large quantities of funds for intervention could unduly increase the basic propensity of our money manager to attempt to manage the foreign exchange market.

To date U.S. monetary and financial authorities appear to have exercised considerable wisdom in their exchange market interventions. The litany of illustrious failures of government intervention attempts during the current float does not include examples from the U.S.

As argued above, there appear to be sound arguments for the current rescue operation, but we need to be on guard that the funds raised do not end up being misused for excessive intervention. It is, of course, too much to expect that our financial authorities never make a mistake, and there is no feasible alternative to giving such authorities considerable discretion in implementing the inevitably vague policy guideline of avoiding disorderly market conditions. I believe that it would be desirable, however, for the track record of such intervention to be made more easily available to committees such as this, and indeed to the general public.

The Treasury and Federal Reserve are probably the most forthcoming of financial authorities of any of the major countries in reporting (with a lag) their exchange market interventions. It is not possible, however, from the information currently published to tell to what extent official intervention has been successful. For example, to what extent has it tended on average to move the dollar toward or away from trend, as observed ex post.

Some light can be shed on such questions from analysis of profits and losses on exchange market operations. Such statements must be interpreted with considerable care however. The data traditionally published is not usable for such analysis. Recently there has been movement in the direction of presenting more pertinent information, however. Profits and losses on current exchange market operations had typically been buried in general profit and loss statements which were dominated by liabilities acquired before generalized floating began. However in the September 1978 report on Treasury and Federal Reserve Foreign Exchange Operations, the aggregate losses from current operations were reported separately. This is a desirable practice and should be continued.

More attention should also be given, however, to presenting and analyzing information in a way which would give still better clues to how wise our exchange market interventions have turned out to be. For example, where there are trends in exchange rates official intervention which was stabilizing around a downward trend could still make losses. Likewise with an upward trend, profitable intervention would not necessarily be stabilizing. Furthermore trends are not constant, nor is it always clear from an economic standpoint what purchases should be compared with what sales in determining profit and loss calculations. This can become quite important when some interventions are quickly reversed while others are not.

There are many difficulties involved in monitoring the successes and failures of official intervention in the foreign exchange markets, but I believe that this is an area which should receive a good deal more attention, especially if generally higher levels of intervention are continued.

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VI. Foreign currency securities, speculation, and the key currency roles of the dollar

A final set of issues which I would like to discuss briefly concerns the key currency roles of the dollar and the decision to issue Treasury securities abroad denominated in foreign currencies. I am considerably less enthusiastic about this latter decision than I am about the rest of the rescue operations.

For the last several years a number of people in the U.S. and abroad have been advocating the issuance of such securities, and I suspect that it may have been primarily because of this, that the Administration decided to include such measures in its rescue package. Some of the advocates of issuing such securities have been quite naive about what they could hope to accomplish, however. It has sometimes been argued that issuing such securities would soak up speculative funds abroad and in this way substantially reduce the pressures on the dollar. "Skim off the speculation froth" was an expression used. While issuing such securities for dollars could strengthen the dollar a little on balance in the short run, many of the purchases would be likely to come from people who were not getting ready to dump dollars. Thus I do not believe that there was really much mileage in trying to use such security issues to soak up dollars abroad.

The strategy being followed by the Administration is a different one. Payment for the new securities will be in foreign currencies which will be used to accumulate owned currency reserves, available for use for U.S. intervention in the foreign exchange market. At present foreign currencies to be used for intervention are obtained almost entirely from our swap lines. These require repayment within fairly short periods of time unless they are rolled over. Holding owned foreign currency reserves gives our financial authorities greaater freedom to engage in open-ended intervention. This may have had some direct psychological effect in bolstering confidence in the dollar, but I am inclined to think that such an effect by itself would not have been large.

From a longer-run standpoint, whether one believes that the accumulation of substantial owned reserves by the U.S. would be desirable or undesirable, is likely to depend heavily on whether one feels that U.S. authorities would otherwise be likely to intervene "too little" or "too much." I personally do not think that the traditional use of borrowed currency through the swap lines has unduly constrained U.S. intervention, and thus am doubtful that the accumulation of foreign currency reserves is necessary.

It should also be noted that unlike issuing securities abroad for dollars, the direct initial effects of issuing U.S. government securities for foreign currencies will be to increase the demand for foreign currencies relative to dollars. This will in turn tend to cause the dollar to depreciate rather than appreciate, unless some of the acquired currencies are immediately used for intervention to support the dollar.

I am doubtful that the resulting downward pressures on the dollar would be very great, but they should be recognized. Issuing U.S. securities in foreign capital markets would tend to bid up interest rates. This would tend to attract capital inflows, including ones from the U.S., thus tending to bid up the foreign currency relative to the dollar. Likewise the direct demand for foreign currency to be used to purchase the U.S. securities would be increased. There would be some tendency for dollar holders to exchange dollars for foreign currency in order to purchase the new securities. Again downward pressure would be placed on the dollar. Prohibiting purchases by Americans would reduce, but not eliminate, this tendency, and is a policy of discrimination against American citizens which I find objectionable in principle.

The costs of such borrowing will of course not be known until we know the future course of the dollar vis-a-vis the currencies in which the securities are denominated. If the dollar appreciates or depreciates less than buyers anticipated, the financing will have been cheap. On the other hand, if the dollar depreciates substantially, the final cost of paying back the securities in foreign currencies may be much greater than the savings of the lower interest rates which the securities should carry.

Another type of argument that has been made abroad in support of the new securities is that they signal recognition that the U.S. must do something about the key currency role of the dollar. It is not at all clear to me whether anything very significant can or should be done about the key currency roles of the dollar, however.

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This is a complex area, with the dollar playing a number of different roles in the operation of our international monetary system. With respect to the private uses of the dollar I do not see major policy actions which we should take. Concern is often expressed about the huge amounts of dollars in foreign hands. Such discussions often incorrectly include figures for Eurodollars, as if they were full-fledged dollars, and give a hugely misleading picture of the alleged inability of the Federal Reserve Board to control U.S. monetary conditions. Such developments can influence what desirable monetary policy should be, but they cannot in fact undermine the ultimate ability of the Federal Reserve to determine U.S. monetary policy.

The important point is that international capital mobility is relatively high, and that this can have significant effects on the exchange value of the dollar. This would be true, however, whether foreign held dollars, the so-called private dollar over-hang, were $100 billion or $600 billion. We must adjust to living in a world of significant capital mobility. This cannot be avoided by attempting to regulate the Eurodollar market or discouraging the international use of the dollar. What it does do is increase even further the importance of establishing and maintaining a stable economy.

A second set of issues concerns the official use of the dollar as a reserve currency. Again there has been much concern expressed about the official dollar overhang, and many have argued that central bank desires to diversify out of dollars have had, or are likely to have, a major effect on exchange rates.

There has been a tendency for some central banks to diversify out of dollars, but in aggregate this tendency has been quite small. Indeed it is often not recognized that according to the I.M.F.'s statistics, the portion of dollars in foreign official currency holdings was almost exactly the same at the end of 1977 as it was in 1970 (roughly 81 percent).[7]

With the initiation of floating in 1971 and again in 1973, central banks did take the opportunity to reduce their dollar holdings. In 1971 the proportions held by the I.M.F. sample of 53 countries (which account for the vast majority of total reserves) dropped significantly from 81.3 to 77.6 percent. The proportion rose again to 81.0 in 1972, however, before dropping slightly to 79.7 percent in 1973. Since then the ratio has remained remarkably stable, varying only between 80.4 and 81.2 percent. The demise of the dollar thus appears to have been greatly overstated in many discussions.

It may again be desirable to consider whether the I.M.F. should create some kind of substitution account so that central banks who wished to, could reduce their proportions of dollar holdings without immediate effects on exchange markets. Countries could convert their dollars into newly created SDR's, with the U.S. perhaps being expected to earn back the I.M.F.'s new dollar holdings over a period of years. However, as became quite clear in the previous negotiations on monetary reform, there are a great many complications in designing such a facility, and I suspect that the prospective benefits would not be great.

Perhaps the best step in this regard was the decision to begin to allocate new SDR's again, thus allowing countries to have reserve increases without necessitating increased holdings of dollars or other currencies.

There is not time to dicuss all of the other aspects of the key currency roles of the dollar, but my basic conclusion is the following: we do not have any strong national interest in attempting to force an increased key currency role of the dollar on the world economy, but the international uses of the dollar have evolved to a point where there is also relatively little that we can do to substantially diminish these roles of the dollar, without taking drastic actions which would interfere with the freedom of international capital flows.

In short, we should learn to live with continued substantial international use of the dollar. The costs and benefits which this has for the U.S. largely those of international capital mobility in general, and should be interfered with only with great hesitancy. We should not attempt to deflate the economy just to obtain some particular international value of the dollar, but international financial interdependence does strengthen the already strong case for pursuing domestic economic stability.

Representative Reuss. Thank you.

The idea of a "substitution account" in the International Monetary Fund is one that currently appeals to a number of people including

[7] See I.M.F. *Survey*, May 22, 1978.

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Senator Javits and myself. What we have in mind is something designed to answer the criticism of some foreign monetary authorities that, since there are some $700 billion of Eurodollars floating around plus the United States' money supply plus frequent additions caused by our deficits, foreign central banks are almost forced to accept dollars with an unreliable store of value. This, at least at the margin, may add to the instability of the dollar and, as a result, a number of us have taken the view that the United States would do well to make it clear that we have no objection whatever—in fact we favor—an exploration by the leading countries into the possibility of using some rechristened "special drawing rights," not for the purpose of adding to world reserves, since there is already abundant liquidity around the world, but as a partial substitute for the reserves now held. We are talking about $5 or $10 billion or so. We have heard from Mr. Willett on this subject.

How about you, Mr. Houthakker. You have spoken of the need for further international monetary reform.

What did you have in mind and what do you think of the substitution account proposal?

Mr. HOUTHAKKER. In general what I have in mind by new attempts at international monetary reform is an attempt to reestablish rules of international behavior which to my mind have gone by the board in the last 5 or 6 years. Countries do exactly what they please without regard to international obligations.

This, I think, is by itself a source of instability in the world economy.

I would be glad to spell this out in more detail, but I am afraid I would not be answering your main question concerning the substitution account.

It is not clear to me what interest there is in that for the United States. I can see why foreign central banks, after they have acquired dollars for the purpose of preventing their own currencies from depreciating would like to get something else instead, but this is not something to which the United States should be very responsive.

On the whole, during the floating rate period, we have followed a policy of not intervening, of not trying to influence the value of the dollar. Other countries have not followed such a policy. Japan, in particular, has amassed huge amounts of dollars in vain attempts to stabilize the yen. Now, at this point, for us to agree to a means by which they can unload some of these dollars is to sanctify the policy which they have followed earlier in defiance of sound international practice.

So, unless there is a better agreement on exchange rate adjustment, I would not like to see the United States agree to a substitution account for any similar scheme.

Representative REUSS. You say that you do not see any advantage to the United States in a "substitution account." Let me suggest to you one reason that I should think would be a consideration. Many foreign monetary authorities, like good soldiers, have been holding dollar reserves, against undue depreciation. As a good member of the world community we ought to give some thought to their needs.

Let me finish and then you can react to it as you will because I think this is important.

Second, it would seem to me that, at the margin, a method of dissuading foreign central banks from dumping dollars and driving down

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the price, if the dollar is already on the low side, would be well worth doing.

Third, from our own standpoint, it seems to me, at least, that our unique ability to finance our deficits with dollars as a means of enabling us to live higher on the hog than we otherwise would, and to invest more abroad than we otherwise would, is not really in the interests of the United States.

At any rate, if I had to respond to your "What's in it for us" argument, I would say something like that. Maybe you would like to whittle away at my views.

Mr. Houthakker. Yes, I would like to, Mr. Reuss, because the diplomatic point that other countries would like this to happen does, of course, have some merit. In a negotiation, you have to give away something, and if we were going to get something really worthwhile, then maybe we would throw this in as a concession. But I don't see any danger of dumping of dollars by foreign central banks. That is exactly the contrary of what has happened, not only during the last 5 or 6 years but also in earlier periods.

The evidence is that foreign central banks are always trying to prevent their currencies from appreciating. The Germans are perhaps an exception. They have at times consented to appreciation of their currency over short periods, but most countries are not of that mind.

Therefore, by giving them an opportunity to get rid of dollars they acquire in the course of holding up the dollar value in terms of their own currencies, we are just encouraging more of the kind of behavior that to my mind has been destabilizing.

The Japanese Central Bank, as I said earlier, has done so most of all and has a lot of dollars as a result. This was not our wish—far from it. Before 1971 we pointed out that the Japanese yen was too high. We have said so more recently although perhaps in a different way. The fact is that the Japanese Government has tried to keep the yen at unrealistic levels, and this is where the dollars come from. They do not come from any service rendered to the United States. They have not held dollars to be nice to us. We would just as soon they did not hold these dollars and did not have them in the first place. The dollars were the results of intervention, and the intervention on the whole was destabilizing, contrary to our interests and probably also contrary to their interests.

That is the kind of behavior which I would not like to encourage by making it easier through a substitution account.

Representative Reuss. Mr. Solomon.

Mr. Solomon. Thank you, Mr. Reuss.

I would like to say a word or two about this isssue, if I may.

You raised the question of the substitution account in the context of trying to keep the international monetary system more stable.

Representative Reuss. Yes; and if I can interrupt, I completely agree with Mr. Houthakker that we need international rules of conduct. The surveillance role of the IMF seems to have been forgotten about. At least I have not heard anything about it, not since Jamaica, and that kind of international monetary reform is surely needed. However, I directed my question to this little part of the package; namely, the "substitution account."

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Mr. SOLOMON. I just wanted to say a word on that. I happen to agree. In principle, I have no objections to a substitution account. In fact, I have said so in writing. I happen to have been involved with the Committee of 20 where this idea first, I think, was developed. But I think it is correct to say that the effects would be marginal.

No. 1, just to my friend, Hendrik Houthakker, much of what he says is correct. Japan and Germany did acquire dollars by intervening. It is also true that these countries and many others acquired a very large portion of the dollars they hold long before the floating system came into effect. They acquired them in the sixties and fifties.

More importantly, I believe it is correct that the downward movement of the dollar in the past year, which is presumably what we are focusing on, was not in anyway influenced by the selling of dollars by Germany or Japan or other large central banks. I am reasonably sure that the central banks of the industrial countries, the group of 10 countries, have not been dumping dollars. Therefore, the proposal that Congressman Reuss and Senator Javits are talking about would have to be aimed primarily at the central banks of the smaller countries, primarily the developing countries.

I suspect if there has been any diversification out of dollars into other currencies by central banks in the past year—and we do not have adequate facts on that—but if it has been true, and I think your proposal assumes it has been true, Congressman Reuss, if it has been true, this has been done by the smaller central banks, and you would have to make this substitution account attractive to them in order to achieve your purposes.

I just wanted to put that perspective on the proposal, therefore, emphasizing while there is no objection in principle to it, I don't think one should expect enormous results in the way of greater stability of exchange rates out of it either.

Representative REUSS. Before I end this colloquy with you, it occurs to me that you have had quite an historic role in this, you were on the Committee of 20 in 1974, I believe.

Mr. SOLOMON. 1972–74—2 years of my life, Congressman.

Representative REUSS. And you were around in January 1976, at Jamaica, and shortly thereafter you retired.

Mr. SOLOMON. Yes. If I may correct you, I changed my occupation.

Representative REUSS. You retired from the Federal Reserve, of course. So, you were around at the high tide of "substitution accounts." What happened? Jamaica came, they all assembled, and somehow the substitution account got swept under the steel drum.

Mr. SOLOMON. Well, without going into any lengthy history, I think primarily what happened was that the idea of a thorough-going reform of the international monetary system was dropped. It was not dropped at Jamaica. It was dropped in January 1974, right after OPEC quadrupled the price of oil. That is what did in the aspiration, widely held aspiration, to reform the international monetary system. It was simply forgotten after the price of oil went up, because that introduced, as you remember, enormous short-term worries and concerns and confusion.

The idea of a substitution account was intimately connected with the notion of a reformed international monetary system with par values,

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not a floating system. It was intimately connected with the idea of a dollar that would be convertible into some other reserve asset—SDR's if not gold. In such a system with dollar convertibility and par values, you had to have a substitution account, or it would not work.

Since those ideas of a par value and convertibility were dropped with the idea of reform, perhaps wisely—I am not making a judgment now; I am just trying to give you the history—since those ideas were dropped, the idea of a substitution account went with them.

Representative REUSS. That is very interesting.

During the 1974–76 period, because of the OPEC price increase, the general word was "Head for the hills, boys, the dam has busted." Floating exchange rates seemed to be working pretty well; the zest went out of it. Isn't there now, though, a situation where it makes sense to talk about "substitution accounts" once again, because while we certainly have not moved back to fixed exchange rates——

Mr. SOLOMON. I hope not.

Representative REUSS. There is now somewhat of a disillusionment with the operation in practice of floating rates. I think Professor Houthakker gave an account of the system's progress pretty well.

So, since we now have the European monetary system moving toward an ECU, and since we are intervening in other than what used to be called disorderly conditions, we have not quite abandoned floating but have something less than full flexible exchange rates. Thus, isn't there reason now to reopen the discussion of the substitution account?

Mr. SOLOMON. Well, I simply repeat that there may be reason to reopen it, but I don't think one should expect too much from it. You just mentioned the disenchantment with the floating system. That is a disenchantment which I don't share very strongly. Nevertheless, I recognize that it exists, perhaps for the wrong reasons—for all the reasons that you stated either implicitly or explicitly.

Yes; there is good reason to reopen the question of a substitution account, but I just want to repeat, it is not going to get at or give us stable exchange rates for the rest of the time. It is going to make a very, very marginal contribution at most.

Representative REUSS. Well, thank you for your observations on that. I would not quarrel with the marginal evaluation you have made, but even marginal is better than nothing.

Mr. Keyserling, in your prepared statement, you come out in favor of credit rationing. You say, and I quote, "So long as the Federal Reserve believes, albeit mistakenly, that overall tightening is necessary, then that agency should put aside its unwarranted objections to some rationing of credit as was done in earlier times with great success."

I would like to have you spell that out a little more in terms of the immediate problem. Obviously, because of other demands, it is a poor thing that capital investment and R. & D. are languishing at a time when a great deal of American credit has been going into very dubious overseas ventures, when a great deal has been going to finance Atlantic City's gambling adventures, and when a great deal has been going into conglomerate takeovers, and a lot going to bid up the prices of existing assets like land, jewelry and antiques.

However, if you were at the levers of power, what would you do about that? What kind of allocatory powers should the Fed use? I

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think they probably have some legal powers now to do a good many things. But what should they do?

Mr. KEYSERLING. Mr. Reuss, first of all, I want to apologize for not having dealt with this from my prepared statement which is directly responsive to questions that were posed in a letter that I got from you. It was simply a shortage of time. Coming to the matter of credit allocation, the problem is not with the techniques. The problem is that if the Federal Reserve Board now determined to allocate credit it would have no basis or not much basis on which to decide where to allocate it.

Now, this illustrates the larger problem of what makes the President's current program all wrong, and what makes most of what has been tried to be done in the past 10 or 15 years all wrong. We pass tax bills, we change money policy, we enact other programs and similarly resort to credit but unless we have a basic—what for lack of a better term I call "model"—model of what the dislocations in the economy are, what the relative priorities are, what the essential components are in fulfilling the three great purposes of the Nation, which are full use of its resources, meeting of priorities, and doing a modicum of social justice, until we have that first we really have no basis for allocating credit or anything else.

That is why everything is breaking down.

I don't say that as a dodge. That is the fact of the case.

Furthermore, the reason that we could allocate credit successfully, not only during World War II, but during the period when I served with Truman, was that we did have these other things, and I might say this is one of the great contributions of Humphrey-Hawkins if the President would pay attention to it. That is, it calls for a composite, integrated picture of the American economy as to where we are going as a guide to specific policies.

Now, during the Truman administration, particularly during the Korean war, we—the Federal Reserve—used allocation of credit. There were regulations X and Y related to automobiles, housing, related to other things; and, that could be done again. I think that should be done again.

I don't think it should be left to banks. I think it is a natural and proper function of the central bank in our modern economy, but I want to emphasize most of all that unless we move to a quantitative portrayal of where we want the income to flow and where we want the credit to flow in accord with a balanced picture for the development of the American economy, we don't have any guidelines by which to allocate credit. We will simply have myriads of claimants just as we now have myriads of claimants for Government spending, for tax reduction, all of them serving their own interests and some of them being right in terms of the national interest and some being wrong.

But the Government has no evaluation of what it wants to do first, or where to do it. With that contention, I go to this length, because it's such an important question. This is really dealt with on chart 20 in my prepared statement. That illustrates what has been happening in the American economy and what it shows basically is what we are continuing through tax reduction, through no-growth budget, and through the reckless preference for tax reduction as against public investment on which I think the chairman has said something on on occasion.

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We are doing all of that, and we are doing that because we have no real tableau affecting the Government policy and what it does. Now, what this chart 20 shows is that before every recession, as we moved into a period of stagnation—and more profoundly now than in any previous time—what was really happening was that the addition to plant and equipment, which is fed by investment, was growing several times as rapidly as the growth of ultimate demand represented by consumer expenditures and public outlays.

Now, near the bottom, as you can for the period 1977 to 1978, you will see that investment in plant and equipment—despite the claims of capital shortage—was growing more than twice as fast in real terms as ultimate demand.

At the bottom—despite the talk about profit shortages—you see, and I am for profits, the profit rate was growing more than three times as fast as the incomes that enter into ultimate demand.

And, yet, every one of these current policies—and more so in the current program of the President than anything else, and, therefore, I say it will produce a disastrous recession—is allocating in the same wrong direction.

The same applies to credit. You have a form of allocation by banks. Somebody is allocating credit. Somebody is deciding where the loans go.

Now, the loans mostly are going in an improper direction related to the need, and starving what is needed most, serving what is not needed, not serving what is needed most; and serving what is needed least. I would certainly recommend action by the Congress to require the Federal Reserve Board to allocate credit and the techniques are clearly written in the successful use made of that power in the past. I would advocate it be legislatively done, but I would also advocate that the Congress and particularly this committee, equally push for the foundational basis on which the credit can be allocated more successfully than it is being allocated by the banks.

Thank you.

Representative Reuss. On behalf of the subcommittee, I want to thank each member of the panel. You have given us a memorable afternoon, and much help in our attempt to understand the dollar rescue operation and their domestic implications.

So with our gratitude we will now recess until 10 o'clock tomorrow morning in this room.

[Whereupon, at 3:20 p.m., the subcommittee recessed, to reconvene at 10 a.m., Friday, December 15, 1978.]

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THE DOLLAR RESCUE OPERATIONS AND THEIR DOMESTIC IMPLICATIONS

FRIDAY, DECEMBER 15, 1978

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL ECONOMICS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (cochairman of the subcommittee) presiding.

Present: Representatives Reuss, Hamilton, Brown of Ohio, and Heckler; and Senators Proxmire and Javits.

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director; John M. Albertine, Lloyd C. Atkinson, Thomas F. Dernburg, L. Douglas Lee, Katie MacArthur, and Paul B. Manchester, professional staff members; Mark Borchelt, administrative assistant; and Robert H. Aten, Charles H. Bradford, Stephen J. Entin, and Mark R. Policinski, minority professional staff members.

Representative REUSS. Good morning.

The subcommittee will be in order.

I am delighted that Lee Hamilton is here again and my colleague, Senator Proxmire. We thank you, Chairman Miller, for being here. We have your prepared statement and under the rules, and without objection, it will be placed in full in the record.

Would you now proceed with your statement in whatever way you wish.

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

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

I want to stress my good wishes on your recovery from bronchitis. I am not used to appearing before this particular subcommittee when the chairman is not able to keep up with me in decibels.

With your permission, I think it would be appropriate to submit my prepared statement for the record, and perhaps it would be helpful if I could just take a couple of minutes to make some remarks based upon the accompanying charts, which I believe have been placed before the subcommittee and made available for those in attendance at this hearing.

I won't take a great deal of time on these particular charts, but I think they highlight some issues that are of concern to this subcommittee.

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On chart 1, looking at the top panel, we see the trend in GNP prices—the inflation rate, if you will. It shows the decline in the years 1974 through 1976, and the resurgence of inflation to become the No. 1 problem in our economy. If you look at the middle panel, it is apparent that even without food, which has been a main contributor to some of the inflation this year, the inflation rate is running far too high.

On the other hand, the bottom panel shows that the unemployment rate has been declining steadily and that in the last few months we have a rather stabilized condition.

On chart 2, the upper panel indicates the growth in utilization of industrial capacity and economic capacity from the trough of 1975 to the present point in the current expansion. The lesson to be learned from this chart is that we are approaching once again, a level of capacity utilization similar to the level at the peak of 1973, when we had enormous inflationary pressures.

The bottom panel of chart 2 here gives a little more detail on the unemployment rate, separating out the overall rate into that for blue-collar skilled workers and that for heads of households. Unlike the overall rate, these two particular rates show a rapid decline in unemployment. They represent a particular kind of capacity limitation in our economy. The unemployment rate for heads of households in November was 3.4 percent, substantially below the overall national average of 5.8 percent.

I would, of course, recognize—as you have often pointed out, Mr. Chairman—that this does mean there are segments in our population who are unduly burdened by unemployment. This is largely structural and requires intensive, targeted programs that set a national objective. But in terms of current capacity to produce goods and services among those who are skilled and those who are heads of households, the unemployment rate for these groups has been substantially reduced.

In the international sector, chart 3, you are all aware of the shift from the balanced condition of 1975 and part of 1976 to a deficit position in trade and in current account balances. This situation has been improving as 1978 has progressed and the projection is for continued improvement in these balances through 1979.

Chart 4 illustrates one of the problems that we have in our national economic policies and that is to deal with what has been a divergence between the inflation rate experienced by the United States and the rates experienced by the foreign industrial nations. The dotted line shows the inflation rate of G–10 countries plus Switzerland and the solid line shows the U.S. inflation rate. In 1977, the U.S. rate of inflation was equal to or less than the rate of these other countries, but, of course in 1978 this rapid divergence occurred so that U.S. inflation rates are substantially higher than rates in other parts of the world, and this has put considerable pressure on exchange rates and on economic conditions in these nations.

The most recent international figures were released in September, and at that time the inflation rate in the United States was 4.8 percent higher than the average rate of inflation in these 10 other countries.

Chart 5 shows one of the effects of this divergence; that is, that while short-term interest rates in the United States started off in 1977 con-

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siderably below the rates in the other industrialized countries, as our inflation rate increased and theirs declined, short-term interest rates in the United States have increased to the point where the rate for short-term money in the United States is about 4 percent higher than the average rate in the other G–10 countries plus Switzerland.

Short-term interest rates are shown in chart 6 and they do track very closely with the inflation rate. As the Consumer Price Index—the dotted line—goes up and down, there is a tendency for short-term rates to follow along with it. Interest rates are made up of two components: One part takes account of maintaining the purchasing power of invested funds; the other, of realizing a real return on invested funds.

Short-term rates track the inflation rate very closely. The significance of the components of interest rates shows up when we begin to look at home mortgages, in chart 7.

From 1955 through 1965, the average home mortgage interest rate was 5.5 percent. The unshaded section of the right bar is the Consumer Price Index. During the 10 years from 1955–65 the CPI increases 1.6 percent per year on average, so that the real interest rate, which is shown in the upper part of the right bar, was about 3.9 percent.

In the next period, 1966–72, mortgage interest rates went up to 7.4 percent, but inflation went up to 4.2 percent, so there was actually a decline to 3.2 percent in the real rate on mortgages.

But look at what has happened this year, the bars on the right side of the chart. The mortgage rate has crept up to an average of 9.6 percent in 1978, but inflation has been 9.5 percent, so in real terms there has been practically no interest paid on mortgages. This is one of the reasons it has been so hard to restrain the demand for housing and, of course, this consideration also applies in the public's preference for other durable goods: Inflation rates have caused households to purchase homes and durables rather than to store their resources in money which has been depreciating.

Chart 8 deals with the exchange rate of the dollar. As we all know, the dollar has been under considerable downward pressure for the past year. If we look back to the period from September 1977 until the end of October 1978, a period of just over a year, the dollar declined on a weighted average basis by about 20 percent. The bottom panel, incidentally, shows the daily average exchange rate, and it demonstrates the disorders in the markets and the rapid decline of the dollar in October and also the sudden improvement in the dollar with the intervention and monetary actions taken on November 1, as part of the campaign forcefully to support the dollar and correct the imbalances.

Turning to chart 9, it is interesting to note that given the effects that inflation has had on short-term rates and given the effects of the decline of the dollar on inflation and therefore interest rates, the recent impact on long-term rates has been quite moderate.

The top left panel shows interest rates over several years for new utility bonds and for municipal bonds; the right part of the panel shows the weekly averages for October, November, December. So when action—including strong monetary action—was taken at the 1st of

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November, although short-term interest rates were affected, long-term interest rates have been more or less stable, which would indicate an assessment of the action as being positive in its anti-inflation aspects.

Likewise, the bottom panels show that the stock market which had been declining consistent with international market disorders, has been generally trending upward since November 1—not each day, but the general tone of the market has improved.

Part of the economic pattern that affects our current planning relates to the question of Federal deficit, as shown in chart 10. On a unified budget basis—that is the top panel, the solid line—as we all know, during the recession years and following the recession we have had heavy Federal deficits. If we add in the offbudget Federal agencies and their borrowing, we increase the deficits as represented by the dotted line.

Now the anti-inflation actions that have been taken recently by the administration, including the November 1 action, have contemplated a considerable reduction in the Federal deficit; the President has announced that his budget proposal for fiscal year 1980 will involve a Federal deficit of $30 billion or less. But the deficits that have been accumulated over the last few years have added tremendously to the outstanding debt of the Treasury.

The bars in the bottom panel show cumulative increase in Treasury debt. The Treasury debt in 1971 stood at about $400 billion; by the end of 1978, $370-plus billion will be added to that debt; and by 1979, the debt will have doubled from 1971.

Now, this kind of requirement by the Federal Government for financing, as we see on chart 11, means that the Federal Government has had high demands in the credit markets. While the private sector—as shown by the bar without any shading—had relatively higher demands in the years of higher economic activity—1972, 1973, and 1974—you can see that beginning in 1975 there was a substantial increase in demand for Federal financing, thereby putting pressures on credit markets. As we have recovered from the recession and private demand has increased to help finance the expansion and reflation of the economy, the continued high level of Federal spending has put considerable pressure on markets and has contributed to the upward pressure on interest rates.

Chart 12, the last chart, shows the pattern of growth in the expansion, when real GNP recovered from the deep recession of 1974 and steadily expanded through 1977. Recently, there has been a moderation in economic activity, as represented by the slower rate of real growth in the first half and the third quarter of 1978. One of the factors that has contributed to this general moderation has been the moderation in personal consumption expenditures. The housing market has been maintained at a relatively high level because of the availability of funds due to the new money market instruments, but generally real personal consumption has been lower than in the prior year, and this has contributed to a moderation.

Mr. Chairman, I would say that over this year the monetary policy has had several objectives, seeking to achieve the high priority of restraining inflationary forces while maintaining conditions for moderate growth. One objective of monetary policy has been to apply

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restraint, to apply some dampening to the growth of the economy during the maturity of its expansion cycle in order to cool the forces of inflation. But a second objective has been to apply this restraint smoothly so that we would not have dislocations or disruptions in the economy that could be destabilizing.

A third objective has been to maintain balance in the economy so that no sector is unduly burdened by the degree of moderation. It is for this reason, for example, that the new money market certificates were authorized for the thrift and banking institutions. This has permitted competition for funds and a flow of funds that has sustained the housing industry, thus avoiding the kind of depression in housing which was experienced in 1973–74.

A fourth objective of monetary policy has been to accomplish as smooth and as balanced a restraint as possible without tipping the economy into a recession. It would be far preferable, as a matter of economic policy, to adopt a posture of slower, more moderate, balanced growth, rather than to have the ups and downs of excessive expansion and recession which themselves contribute both to inflationary pressures and to distress in the economy. So these have been our objectives.

The economy is now well-balanced, and there are no particular overextensions or underutilizations in the economy which would indicate conditions for recession in the near term.

Now, the action taken on November 1, as you well know involved a combination of policies: it was directed to correcting the fundamental problems of our economy—domestically and internationally—but it also included some bridging actions to insure an orderly process in the dollar and foreign exchange markets until the recovery of our economy and our dollar is confirmed by correction of the fundamental problems. The action included strong monetary action as well as the marshaling of $30 billion in foreign currency resources to use in the bridging activities.

So far the action has generally been favorably received and has been effective in stabilizing the dollar and creating improved conditions for the domestic economy. If the unsettled markets that existed in October had continued the feedback into our domestic economy would have been serious and, I believe, would have put downward pressure on economic activity and increased the risk of recession.

But, by taking those forceful actions and demonstrating to the world and to the domestic analysts our determination to show discipline in fiscal and monetary matters, it appears that conditions have improved for maintaining moderate growth and avoiding the distress of a recession.

Thank you very much for your attention. I hope this has been helpful as a supplement to the prepared statement.

[The prepared statement of Mr. Miller, together with the charts referred to, follows:]

Prepared Statement of Hon. G. William Miller

Mr. Chairman, members of this subcommittee, thank you for the opportunity to participate in this important dialogue. At present, the economy is at a critical juncture. Economic growth has continued at a moderate pace, but the rate of inflation is unacceptably high and poses an ever-growing threat to our social and economic structure. While the challenge for public policy is clearly for-

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midable, these problems are not insurmountable. The Federal Reserve, for its part, is continuing to pursue a monetary policy that aims at a reduction of inflationary pressures while encouraging continued economic growth and high levels of employment.

The rise in economic activity has been both vigorous and generally well balanced since the present expansion began in early 1975. The sharp swings in inventories and production that have ended previous cyclical upswings have been avoided. Growth in the latter part of this year—well into the fourth year of expansion—has moderated, but this represents a desirable adjustment in the pace of activity, given the intensification of inflationary pressures, the rise in capacity use, and the decline in unemployment that has occurred over the expansion period.

The persistence and recent intensification of high inflation has been the most serious problem in the present expansion. Consumer price increases generally remained in the 6½ per cent range over the 1975–77 period, but these prices have risen at a 9½ per cent pace thus far this year. Some of this acceleration can be attributed to weather-related disturbances and to unexpected developments in the farm sector. Labor cost pressures also have played an important role as wage gains have moved up to about 8½ per cent during a period when productivity growth has slowed to a virtual standstill. At the same time, Government-mandated increases in the minimum wage and in payments for social security and unemployment insurance have added a further premium to labor compensation. Finally, the cumulative depreciation of the dollar's foreign exchange value has had an adverse impact on domestic prices that has yet the run its course.

Looking ahead, there is a threat that wage demands could be further escalated, especially with a heavy collective bargaining calendar for 1979 in an environment where inflationary expections are intense. Cost pressures are also likely to be further exacerbated by another round of legislated increases in payroll taxes and the minimum wage. However, the Government's over-all anti-inflation program holds out the real hope that inflationary pressures can be contained, and that the groundwork can be laid for gradual attainment of price stability. The success of the program requires cooperation, perseverance, and patience from all groups of our society. An important new ingredient of the program is the quantitative standards. If adhered to, these standards could very well help unwind the intractable spiral of wages and prices. But it is particularly important that the program recognizes that Government actions can, in themselves, be important sources of inflation; consequently, fiscal restraint and regulatory reform are essential components of this comprehensive set of proposals.

Inflation in the United States not only has eroded the value of the dollar domestically, but has also been associated with a decline in its international value. As the exchange value of the dollar dropped, this in turn adversely affected the domestic price level. It raised the cost of imported goods, and also resulted in a further ratcheting up of domestic prices for those goods competing with imports. While the dramatic drop of late October underscored the problem of deteriorating international confidence in the value of the dollar, the period of decline in this current episode dates back to late September of 1977.

From that date to its low in late October of this year, the dollar's exchange value declined by 21 per cent on a weighted average basis against the currencies of the G–10 countries and Switzerland. Against some individual currencies, of course, the decline was even greater, amounting to 26 per cent against the German mark, 34 per cent against the Japanese yen, and 38 per cent against the Swiss franc. Since important external imbalances between the United States and major foreign countries have existed for several years—most notably differential growth and, more recently, disparate inflation trends—some depreciation of the dollar could be viewed as a necessary correction. However, by mid-summer it was clear that the dollar's decline was continuing in trading that was increasingly disorderly. Consequently, in August the Federal Reserve announced a half point increase in the discount rate and an elimination of reserve requirements on Euro-dollar borrowings. At the same time, the Treasury indicated that it would increase and extend its regular monthly gold auctions.

These measures, which produced a brief rally and then a few weeks of stability for the dollar, were followed by another three-quarter percentage point rise in the discount rate between mid-September and mid-October. But the dollar's slide soon resumed, and it dropped alarmingly to a level well below that warranted by

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basic economic considerations. As a result, the severity of this latest decline threatened to undercut the anti-inflation program at home and lead to an even greater erosion of confidence abroad.

Under these circumstances, more forceful action was clearly necessary. Accordingly, on November 1 the Federal Reserve increased the discount rate by 1 percentage point and imposed a 2 per cent supplementary reserve requirement on large time deposits. In addition, the Federal Open Market Committee voted to take further actions to tighten conditions in the money market and thereby resist excessive expansion of money and credit. Furthermore, in order to provide a substantial increase in foreign exchange available to finance exchange market intervention, swap lines were increased with the central banks of Germany, Japan, and Switzerland by a total of $7.6 billion. The U.S. Treasury simultaneously announced its intention to draw a portion of the U.S. reserve position in the IMF, to sell SDR's, and to issue foreign currency denominated securities. Over-all, $30 billion in key foreign currencies was mobilized by the United States for forceful, coordinated intervention to support the dollar in foreign exchange markets. In addition, the Treasury announced a further step-up in its rate of gold sales.

The objective of this coordinated set of measures was to correct the excessive depreciation of the dollar as part of the governmental effort to reduce upward pressures on domestic prices and to restore confidence at home and abroad. When viewed in its entirety, the policy initiatives of the Administration and the Federal Reserve provide a clear message that U.S. economic policy is one that recognizes fully the need for an integrated approach in dealing with foreign and domestic economic problems.

The measures taken on November 1 produced a dramatic jump in the dollar's exchange value. On that day alone the dollar advanced by 5 per cent on a weighted average basis, and by about the same amount against the mark, yen, and Swiss franc. Substantial cooperative central bank intervention over the following few weeks provided support for the dollar as market participants tested the authorities' resolve. The strength of the dollar generally has been sustained as the market appears to have adjusted to a more favorable outlook generated by the recent policy measures.

To date, the observable repercussions in domestic capital markets also have been generally favorable. In the stock market, most composite share price measures are up from the November 1 announcement date following relatively sharp declines in the preceding two weeks. Short-term interest rates have moved as much as 1 percentage point higher since the announcement; however, over this same period interest rates for longer-term maturities have been essentially unchanged. The comparative stability of most long-term bond rates, as well as the improvement in the dollar's exchange value, is most encouraging and suggests that we may be beginning to reduce inflationary expectations.

A downward adjustment of price expectations is an essential condition to slow the treadmill of inflation, and monetary policy has an important role to play in this regard. However, at the same time, the Federal Reserve will continue to encourage a moderate expansion of over-all activity, thus also facilitating the achievement of the Nation's longer-run goals of growth and full employment. Moreover, as I have emphasized before, monetary policy should not be expected to shoulder the burden alone, and to be effective, it must also be accompanied by prudent restraint of fiscal policy.

Since April, credit conditions have become progressively tauter as Federal Reserve policies have allowed market rates to rise appreciably in order to help restrain expansion in money and credit. Yields on most short-term market instruments, such as Federal funds and commercial paper, have risen more than 3 percentage points during this period, while interest rates at the longer end of the maturity spectrum generally have risen by less than a percentage point.

Experience over recent years has taught us, however, that in an inflationary environment, expectational considerations tend to buffer the impact of high interest rates on spending. Expectations of rising prices of real assets may induce borrowers to incur high interest costs, as is illustrated by the sustained pace of activity in the housing market thus far this year. Indeed, real interest rates—or observed rates adjusted to take account of inflation—appear to be generally lower than in prior periods, especially if taxes are taken into consideration.

Not only have expectations of borrowers and lenders changed in the course of the current expansion, but also monetary institutions have been given addi-

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tional flexibility to compete for funds. This has helped smooth adjustments of credit markets to developing tightness and, as a result, has helped avoid the repetition of "credit crunch" episodes such as in 1969 and 1973–74. The new 6-month money market certificates, introduced half a year ago, have buttressed deposit growth at mortgage lending institutions when prevailing market interest rates might otherwise have produced disintermediation. Consequently, total housing starts have remained at a very high rate—2 million units—during the first three quarters of this year. Building activity may soon begin to decline, but the drop-off next year should be relatively moderate, making it unlikely that the economy will be thrown into a recession by a sharp housing cycle.

Furthermore, signs generally remain on the positive side for consumer spending, as real consumption outlays currently are rising at about the pace of overall demands. Nonetheless, this represents a marked slowdown from the rate of expansion earlier in the current upswing. Near-term growth in consumer spending probably will be somewhat restrained by high debt repayment burdens as well as by efforts to boost personal savings rates back to more normal levels.

In the business sector, capital spending activity continues to be characterized by substantial momentum as equipment orders have moved up briskly in recent months and construction contracts have been maintained at a high level. However, the early surveys of 1979 investment plans suggest that businessmen maintain a lingering caution about embarking on major expansion programs. These surveys—largely taken before the November 1 measures—undoubtedly reflected the uncertainty associated with an economy plagued by high inflation.

On balance, private demands appear healthy at present, but a further moderation of growth is likely over the year ahead. In this environment the Federal Reserve will continue to strive for a gradual deceleration of monetary and credit expansion in an effort to facilitate an easing of inflationary pressures. We believe that the actions taken in late October and early November will prove to be instrumental in the restoration of both domestic price stability and orderly conditions in foreign exchange markets. At the same time, you can be assured that recent measures in the international area were designed to reinforce and not to sacrifice the achievement of longer-term domestic aims.

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Chart 1

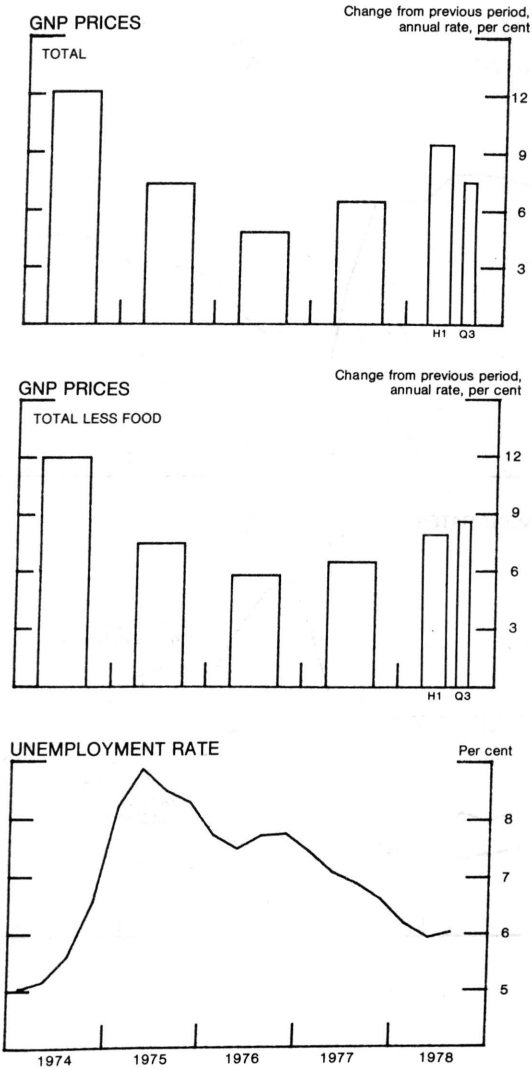

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Chart 2

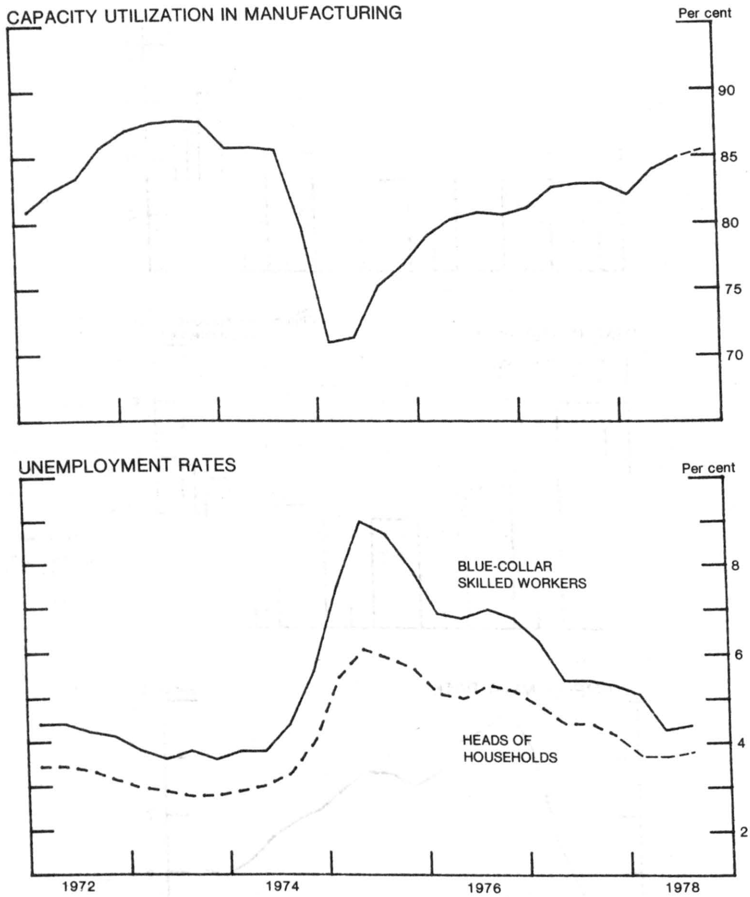

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Chart 3

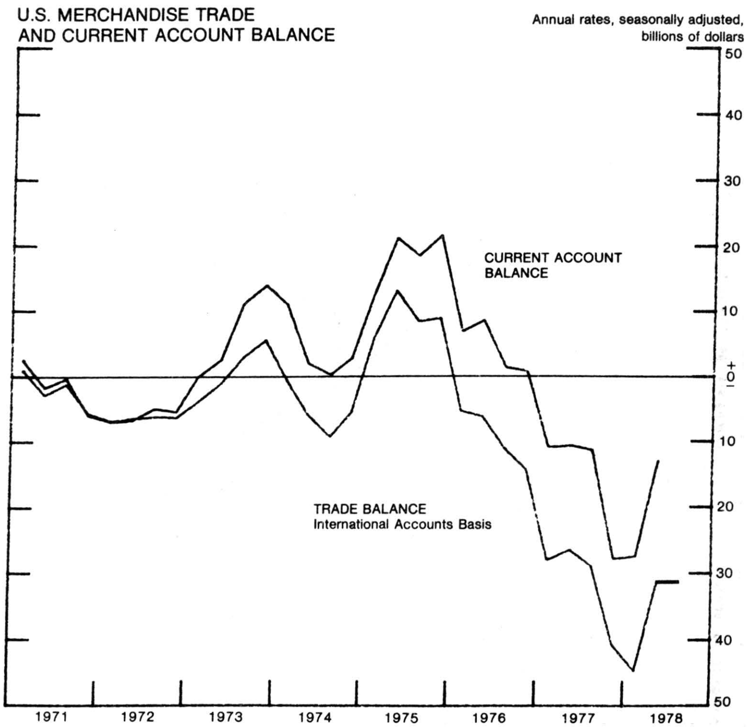

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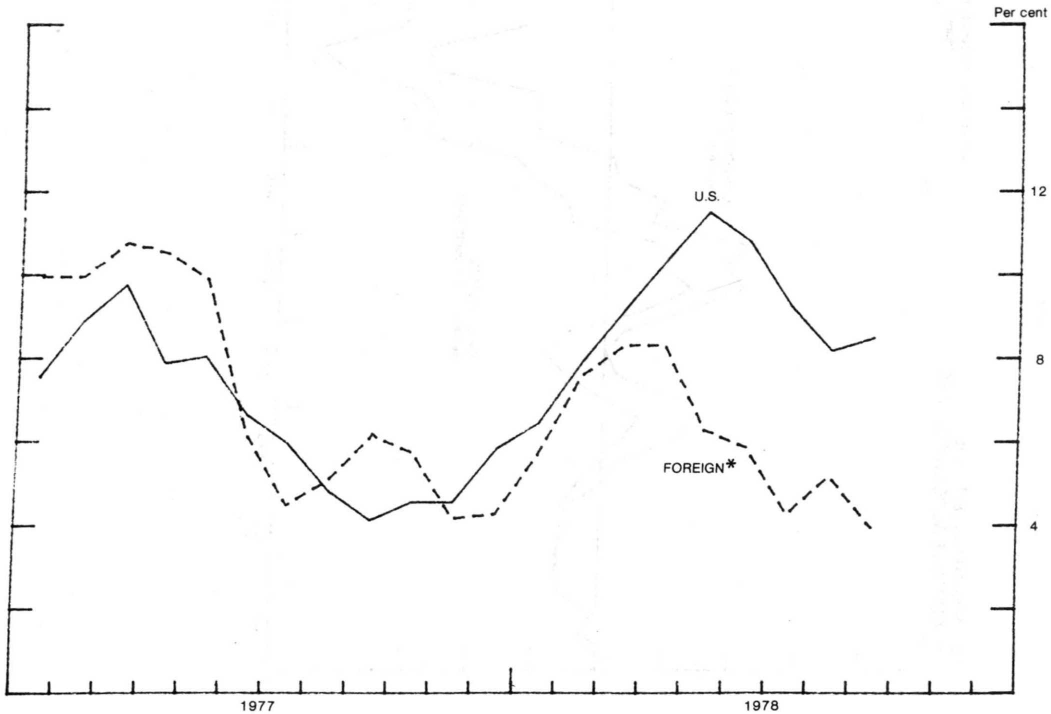
Chart 4

U.S. and Foreign Consumer Price Inflation

Percentage change at annual rates, 3-month moving average centered on month shown



* Weighted average of G-10 countries plus Switzerland.
Weights are 1972-76 global trade of each of the countries.

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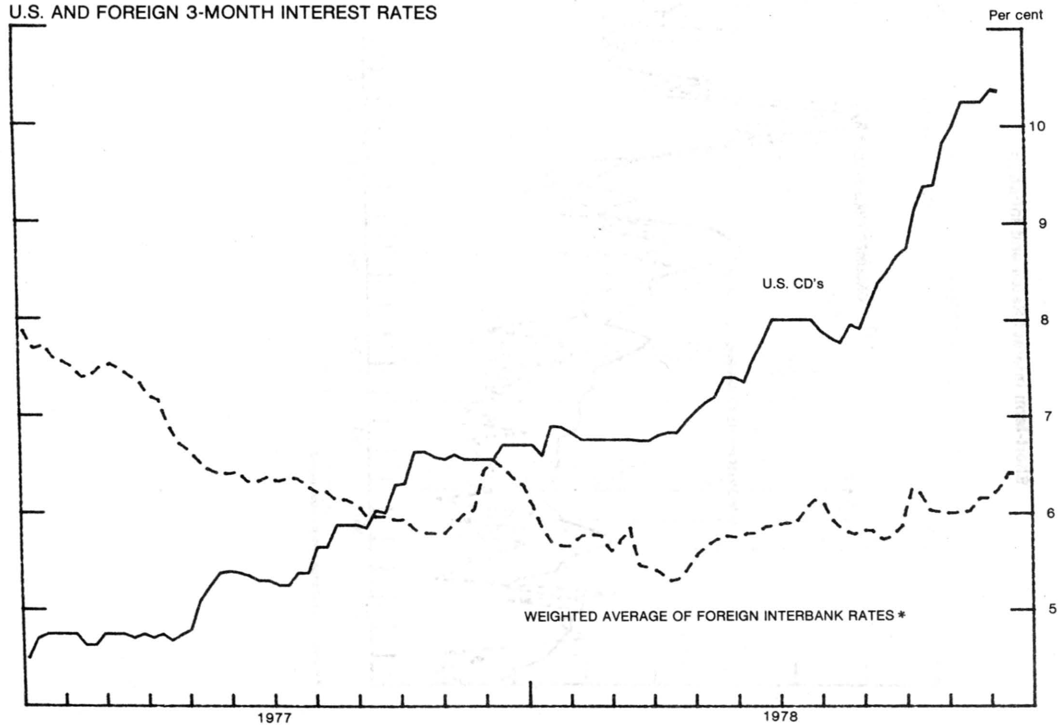
Chart 5



* Weighted average of G-10 countries plus Switzerland.
Weights are 1972-76 global trade of each of the countries.

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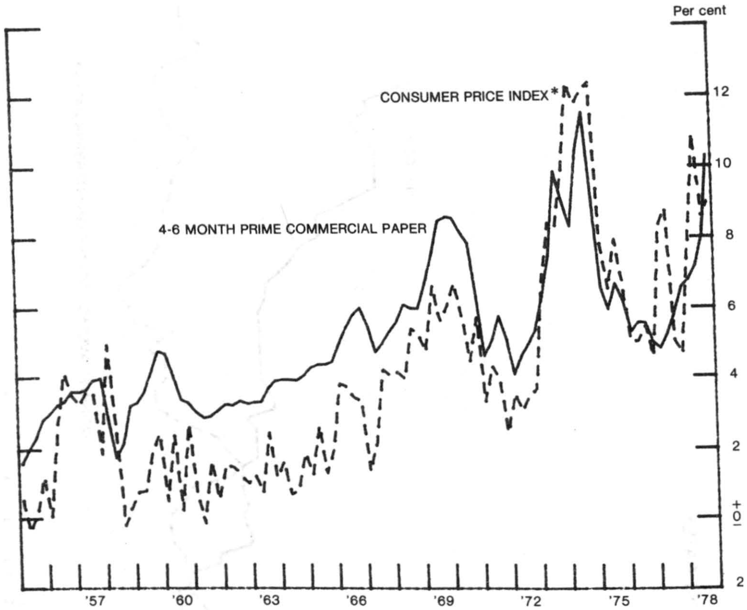
Chart 6

Short-term Interest Rates and Inflation



*Annual rate of change from previous period.

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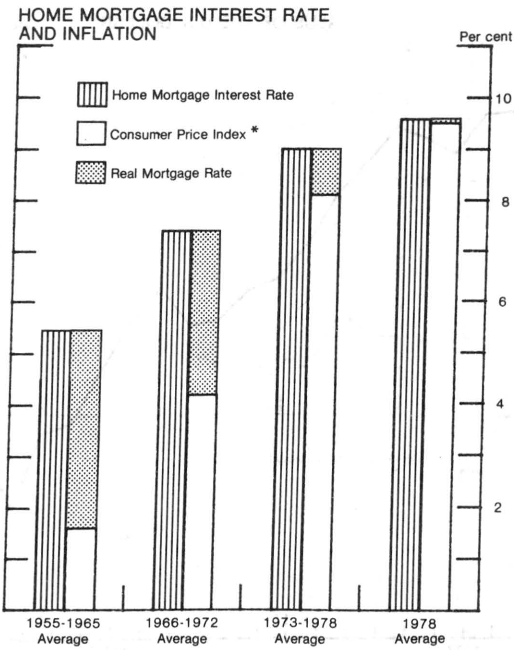
Chart 7



* Annual rate of change.

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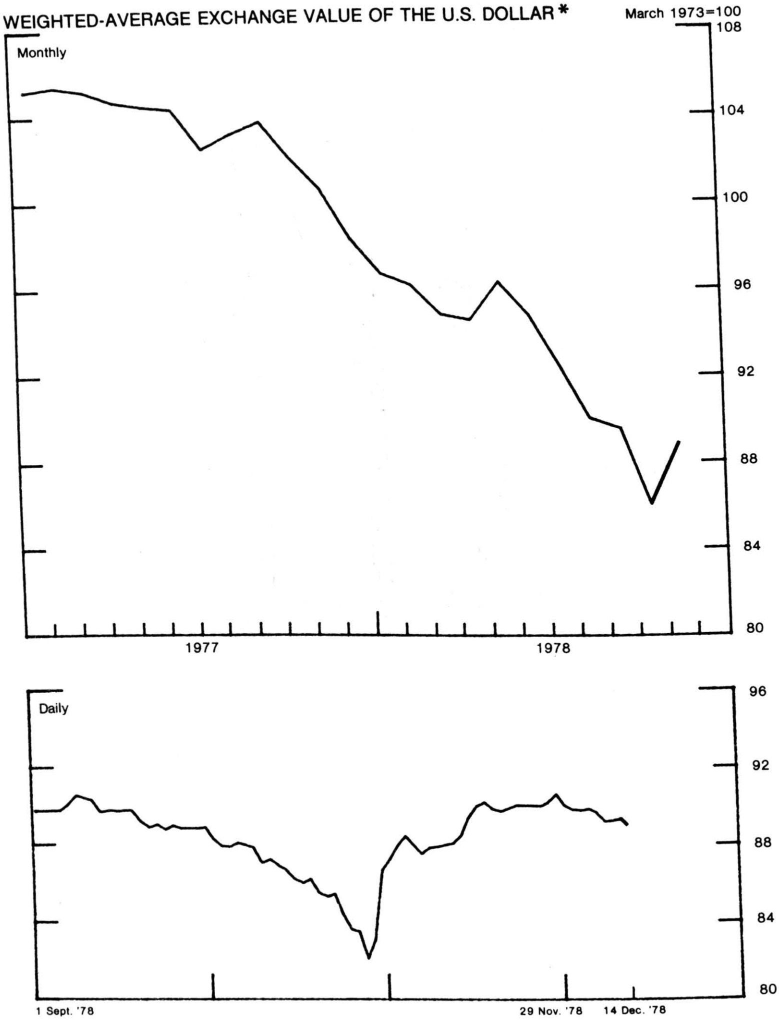
Chart 8



* Index of weighted average of G-10 countries plus Switzerland.
Weights are 1972-1976 global trade of each of the 10 countries.

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Chart 9

Long-term Interest Rates and Stock Prices

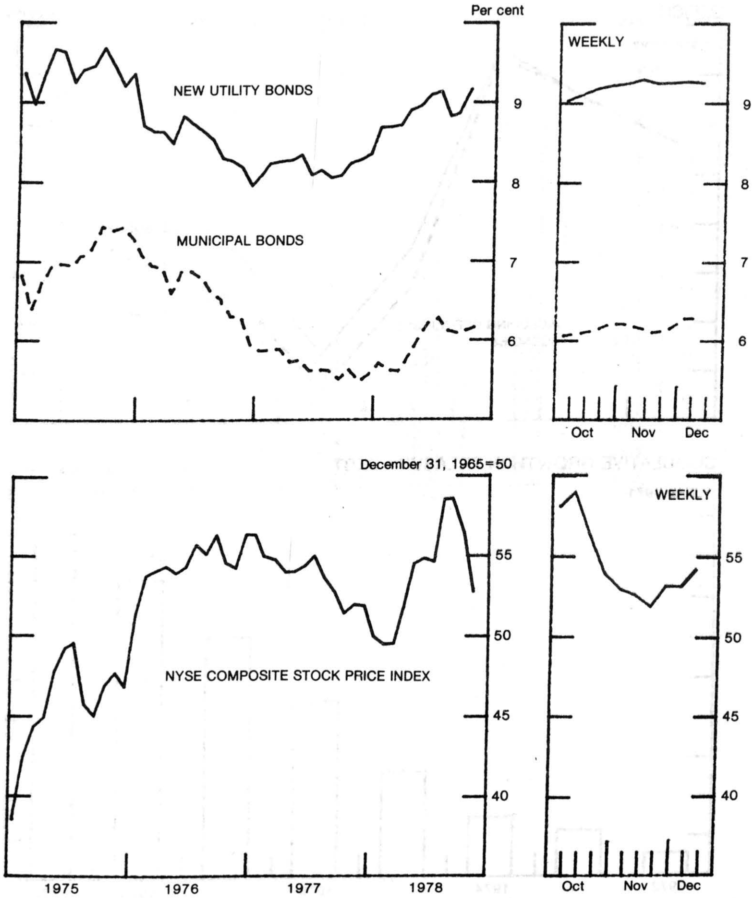

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Chart 10

Federal Budget

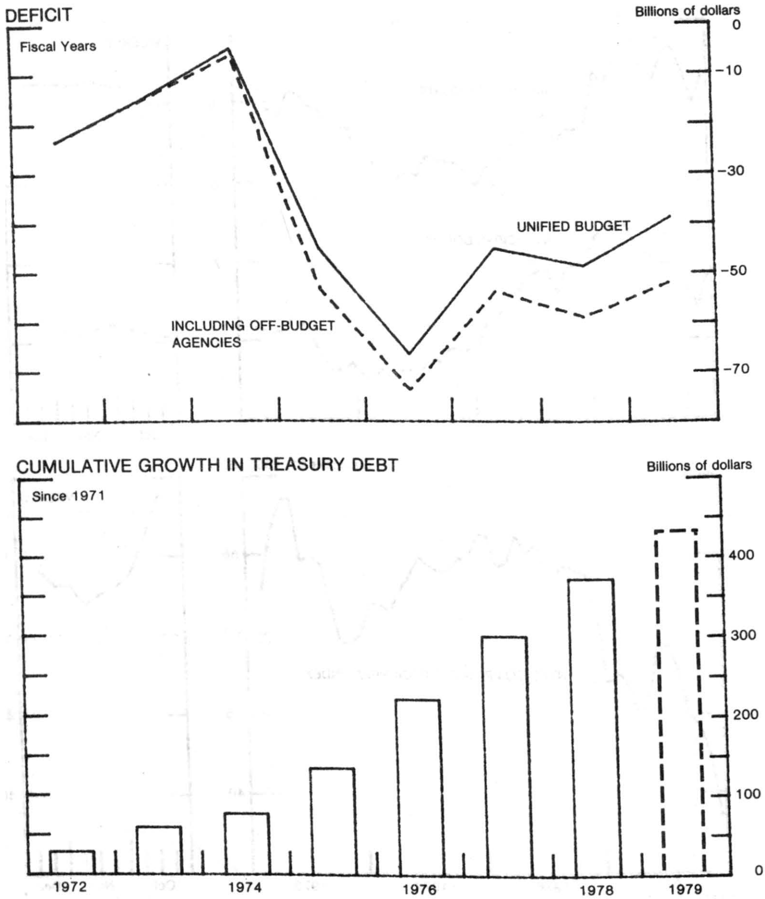

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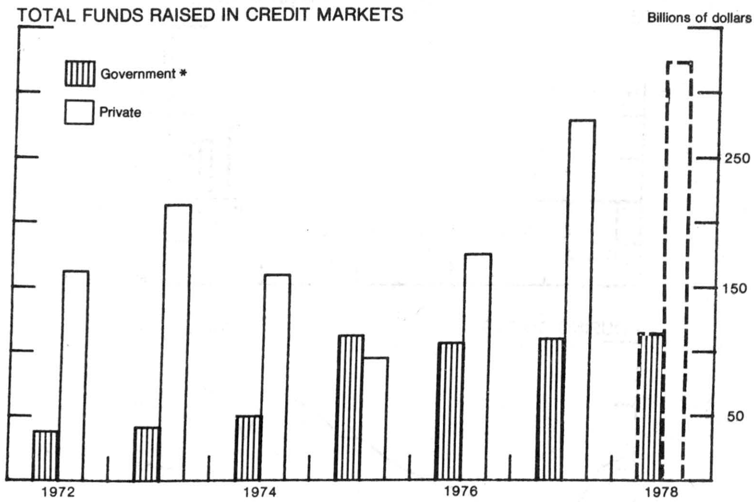
Chart 11



* Includes debt issued by U. S. Treasury and Government sponsored agencies.

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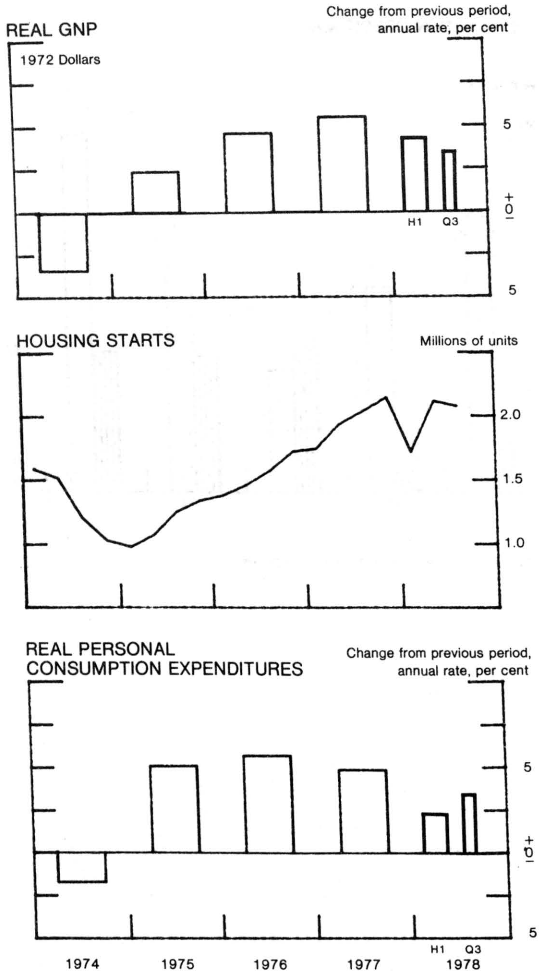
Chart 12



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Representative REUSS. Thank you for a very clear statement.

I am heartened by the comment in your prepared statement in which you say, and I quote, "The Government's overall anti-inflation program holds out the real hope that inflationary pressures can be contained and that the groundwork can be laid for gradual attainment of price stability."

By that I take it you mean that you believe the program, if implemented, will work, and that prices should come down from their present level.

Mr. MILLER. Mr. Reuss, that is correct. This prediction of course, addresses itself not to just any individual action in the anti-inflation effort, but to the broad range of actions. It seems to me that we have seen a rather dramatic marshaling of resources to combat recession in the last few months. We have seen, thanks to the commendable action by the Congress and by the administration, a change in the pattern of fiscal policy toward more restraint and toward reducing the Federal deficits. This kind of approach, this restraint, is continuing.

So one weapon in the anti-inflation arsenal has been fiscal policy. Another, of course, has been the incomes policy that the President introduced on October 24—now being perfected—that seeks the cooperation of management and labor in programs for moderation and includes a series of incentives for compliance.

A third area of effort has been the initiative by the Congress and the administration to adopt a more comprehensive energy program and policies that would reduce our dependence on imported oil. Some progress was made on that in this Congress, but it will undoubtedly require further attention.

We have also begun to focus on promotion of increased exports which is important in achieving a better balance of trade and improvement in our current account deficit.

We have begun policies directed at improving productivity, which is essential if we are to break the spiral of wages chasing prices and prices chasing wages.

And we have seen forceful action to correct the disequilibrium in the foreign exchange markets, to stabilize the dollar, which will prevent inflation from leaking back into our economy through a weak dollar. And we have seen disciplined monetary policy in coordination with these actions.

When you put all of these efforts together, there is hope that we are beginning to get inflation under control.

Representative REUSS. Now turning to interest rates, the prime rate is already a very unsatisfactory 11½ percent. Many knowledgeable observers, including Time magazine's stable of economic experts, are predicting that the rate is going to go up to something like 13 percent this next year. Say it ain't so. [Laughter.]

Mr. MILLER. I have been a slow learner in Washington sometimes, but I have learned that the best way to deal with interest rates is to point to what they are and to what they have been, and to omit the predicting. I don't think any of us can, with confidence, predict what

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interest rates will be, because that depends on how our present policies are affecting inflation and inflationary expectations; it depends upon external factors.

Our objective, of course, is to apply the Nation's full resources; including a prudent monetary policy, to dampen inflation. As that happens, then, of course, the normal expectation is that nominal interest rates can adjust accordingly. It is the real rate of return that seems to govern the expectations of those who lend their funds.

Representative REUSS. Well, you have earlier said that it is your hope and expectation that inflation starting right now, will come down, not go up. If your hope and expectation comes to pass, and in view of the fact that the Federal Reserve has been tightening the money and seeking a higher target for the Federal funds rate which quickly transmits itself to the prime rate in this country, it would seem to me that your goal is to have interest rates not go up.

Mr. MILLER. Mr. Reuss, our goal is to wring inflation out of the economy and to do so on a steady basis so that we make the permanent changes that are essential. I think we have, perhaps, had periods in the past where there was a tendency to treat the symptoms rather than to treat the disease; we need now to treat the disease.

This objective has always seemed to me to involve a considerable need for patience and time. It has been my feeling that we are facing many years of necessary disciplines in order to wring out inflation in our economy. Inflation has been built up over 12 years, and it has become deeply embedded. I have often said that I can see 5, 6, or 7 years of discipline ahead in order to accomplish our objective.

You are absolutely correct that when we have reduced inflation, nominal interest rates will come down in relation to that accomplishment. For this period of turning around inflation and inflationary expectations, something like a sine curve is in operation: As you come up, the curve is very steep; when you come near the top, there is not much change for a while, and it sometimes takes quite a bit of time before you go down the other side.

Once we turn down, then I would think that the probability is that we can continue that trend. Less pressure on money markets and less pressure on interest rates would be with us. When that turn will take place, none of us can tell at the moment.

Representative REUSS. I thought I understood you to say that it is your hope and expectation that the inflation rate would turn downward very soon, in 1979.

Mr. MILLER. I would think that the inflation rate would be about three-quarters to 1 percent less in 1979 than it is this year if our plan continues to have the effect we expect.

Whether or not that means that interest rates will change quickly, I am not sure. As I pointed out in these charts, at the moment it would appear that we have a very unusual situation with the nominal interest rate very close to the inflation rate; Historically this means that the real interest rate is inadequate. How long the adjustment will take, I am not sure.

Representative REUSS. Well, I should think if your hopes and expectations are satisfied, and inflation starts going down, that you cer-

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tainly don't need to further tighten money and raise interest rates through your control of the Federal funds rate. Therefore, the prime rate ought not to go up from 11½ percent; where it is now, to 13 percent.

Mr. MILLER. We have some reason to be encouraged slightly, recently. I think, Mr. Reuss that you probably have noted that the growths of monetary aggregates have recently slowed considerably. This is a matter that we have, of course, discussed in our other hearings on monetary policy. It has been rather discouraging at times during the year to see the stubbornness with which these aggregates have continued to grow given the particular pattern of the economy, the difficulty of inflation, and the effect of inflation upon demands and expectations. But the growth of the aggregates has begun to slow recently, consistent with earlier testimony I have given on the lag effect; I thought they would.

This is an encouraging sign. If that can continue, then I would certainly agree with you that the pressures are lessened on monetary policy because we will have returned growth to ranges consistent with our objectives of moderate economic growth—ranges which we have sought with your guidance to achieve.

Our M_1 figures, even taking account of the new automatic transfers, are showing a much more moderate growth rate. M_1 has been growing, as you know, at about an 8 percent rate for about a year and three quarters, and it has been quite difficult to get it turned down. It is encouraging to see this happening now. The other aggregate measures are also turning downwards.

But I would not want to mislead you by a prediction because the economy has proved so difficult to judge recently. Its behavior is so influenced by how individuals and businesses make their own predictions as to inflation. Because of that, it's been very hard to gage the underlying economy, and therefore I don't want to give you a misleading forecast. But I certainly agree with you that, if we can continue to see the aggregates trending this way, then the pressures will be less.

Representative REUSS. I have one more question. Most people agree that a prominent element in fighting inflation is a greater rate of capital investment in plant and equipment; this helps productivity, which, in turn, helps fight inflation; Congress, of course, has been extremely interested in stimulating capital investment: it has enacted and added to our investment tax credit; it has cut markedly the capital gains tax on common stocks so as to make the financing of plant and equipment more feasible.

You point out that one of the usual early victims of a tight money policy, housing, has been somewhat insulated by the invention, and a good one, of 6-month money market certificates which the thrifts and others can put out in order to lay their hands on lending money.

If, therefore, housing is to a degree spared from the brunt of a tighter money policy, won't most of the burden fall upon the very capital investment in plant and equipment, which everybody, including the Congress, agrees is the royal road toward greater productivity and less inflation?

Mr. MILLER. Mr. Reuss, you have raised an issue that I think is particularly critical in our strategy, and I would like to elaborate for just a moment.

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It seems to me that in the past for undoubtedly justifiable reasons, we have had circumstances in our economy that have resulted in a lack of application of the principles of the marketplace to housing. Housing has been more like a controlled area.

Until this decade, of course, this country had not experienced high rates of inflation except in wartime. So, as we came into this period when we have experienced high rates of inflation that were built up over time, we didn't have a good mechanism to deal with housing. Because of the Reg Q ceiling on savings interest rates, we had limited what the traditional financers of homes—the thrift institutions—could pay to compete for funds for housing.

As inflation drove up other interest rates, we had massive disintermediation. People did not want to limit the yield on their savings to the rates that could be paid by thrifts.

At the beginning of 1973, housing starts were running at an annual rate of about 2½ million. This was too high, actually; it was an overstimulated situation. But in any case, because of that massive disintermediation, housing dropped to a rate of 900,000 annual starts within 2 years. This was not a recession; it was a depression.

Of course, when housing collapsed like that, it dismantled many homebuilders. The demand for home furnishings and the durables that go into housing collapsed, and this helped lead us into the great recession of 1974–75.

In this particular cycle we have tried to avoid that, believing—at least I have been believing, the Federal Reserve has been believing, and the other bank regulatory agencies have been believing—that this is not good economic policy; that housing should be given a more equitable chance to compete in the marketplace for funds on its own, that the marketplace should decide whether people's preference is for the purchase of homes or other investments.

The result has been a much more stable situation, a much more balanced situation. It does have some costs associated with it. Undoubtedly, allowing housing to compete for funds while trying to restrain the total amount of credit available may have had a slight upward effect on interest rates. We may have a little bit higher interest rates than we would have had if we had let housing go into a recession.

But the Nation has benefited, because I think it costs the Nation more to have a depression in housing than it does to allow housing to compete more fairly.

That is the first part of my answer to your very penetrating question. The next part of the question is, doesn't that make it more difficult to finance the business fixed investment we need to get productivity?

My answer to that is—to the extent that we have been able to demonstrate our commitment and determination to fight inflation, to the extent that we have been able to take forceful action, we have actually created conditions for lower long-term interest rates. That is why long-term interest rates have really been rather stable; they are no higher now than they were in July.

That being so, it seems to me that we have maintained conditions for the financing of long-term investments. To the extent that we can continue to succeed in dampening inflationary pressures, I think long-term markets will show further capacity for financing these business fixed investments.

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This process does involve distress in the form of higher short-term interest rates, but it does have the advantage of relieving the pressure on longer term commitments because of the belief that inflation will come down and funds can be committed for the future.

Representative REUSS. Thank you. My time is up.

Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Reuss.

Mr. Miller, just to get on the record here, I want to get your projections for 1979. You commented on this briefly in response to one of the chairman's questions, but what is your projection on the inflation rate for 1979? You said something about three-quarters of a percent below the present rate.

Mr. MILLER. Mr. Hamilton, I might give you the personal estimates that I gave to the Senate Banking Committee, chaired by Senator Proxmire, just a few weeks ago.

My outlook for 1979 is for a rate of real growth in the economy between 2.5 and 3 percent. This is a low rate of growth, but it does indicate a recession. My outlook for unemployment is in the 5¾'s to 6¼ percent range.

My outlook for inflation, measured by the GNP deflator, is in the 6¾ to 7½ percent range, compared with a probable rate of about 8 percent this year. I am sorry that I didn't give those estimates earlier.

Representative HAMILTON. No; that's helpful; I appreciate that very much.

One of the things that strikes me in listening to your testimony and the testimony of Mr. Schultze and Mr. Blumenthal yesterday, and comparing that to a number of statements you read in the press, particularly from business leaders, is that the Government sector is confident of being able to avoid a recession next year. You certainly indicate that in your statement this morning. The witnesses yesterday did.

Yet, when you talk to businessmen and other economists, I have the feeling that most of them really anticipate a recession.

How do you explain this gap, and do you think it's changing in recent weeks?

Mr. MILLER. Perhaps I should not do so, but I might say, somewhat in jest, that to the extent there is a wide consensus on recession, you reduce the prospects for it, because economists quite often seem to be wrong in their forecasts. That is one reassuring thing.

But, to look at it more substantively——

Representative HAMILTON. Mr. Miller, the President said just the reverse yesterday. He said that if people think there will be a recession, it becomes a self-fulfilling prophecy.

Mr. MILLER. I have also said that is true. I believe we can talk ourselves into one. I believe we should not do so because we can change people's expectations and discourage them from investment on the expectation of recession.

But to be serious about it, I think there is a natural human element, an emotional and subjective element that creeps in. The actions on November 1 were powerful actions, and they led to the belief that the amount of restraint involved to bring our international accounts into better perspective—which was so essential—that that restraint was apt to show up in lower economic activity and recession.

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I think several things were overlooked in that time period. One thing that was missed was that the destabilizing conditions in the foreign exchange markets were far more threatening to the domestic economy than the stabilization effort. Actually, creating the conditions for a continuation of enhanced international activity and flow of goods and services would improve prospects. It would improve the prospects, for example, that the growth rates in Germany and Japan will be higher than they have been and therefore have some effect on demand for our goods and help our economy; a weak dollar or an uncertain dollar would have dried up a lot of that activity.

The other thing that's missed, it seems to me, is a careful look at the balance in the economy. It's very hard, when you study the economy sector by sector, to make a case for why there should be a recession. For a recession you need to have something going down.

Let's take personal consumption. I think everyone's lot has been improved by the tremendous increase in employment, by people at work in America whose earnings create the capacity to add to personal consumption. Now, in November, we have seen one of the most remarkable increases in employment we have seen in a long time. Looking over the past 2 years, we have just seen an amazing capacity of this country to absorb the growth in our labor force. We now have, for the first time in history, more than 59 percent of our adult population employed.

That means that we do have capacity for continued personal consumption. It will moderate, as we see in some of the current figures on retail and other activities. Although there have been some strong figures in the earlier part of this quarter, it looks like there is moderation now.

So when we look at that sector, personal consumption, it is not in a recessionary mode. We are not seeing a lack of capacity to consume.

The housing sector is the one area—because of the restraints and levels of interest rates—where we can expect about a 15 percent decline to around 1.7 million starts from 2 million. But that is nothing compared to the 50 percent declines we have seen in the past, and it is really kind of healthy.

Let's look at business fixed investment. A recent survey showed expectations of only moderate real increases next year. But orders placed recently, apparently out of confidence that is building about the anti-inflation program, would indicate that that survey is on the low side. Businesses are actually making commitments now that show a little more strength than the survey would have indicated a month ago.

When we look at inventories, we look at a well balanced condition. When we went into the last recession, we had inventories that had been over-accumulated; the ratios were not healthy. In the first part of 1974 there was a dramatic $80 billion adjustment, at an annual rate, from inventory accumulation to liquidation in one quarter, which meant that lots of factories were shut down. We don't have that now. We have low inventory-to-sales ratios and a very healthy condition.

When we look at the international sector, the higher growth rates in other countries, combined with our lower growth rate, is showing an effect that should improve our exports next year over this year, while our imports are relatively reduced.

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So I don't see, when you add this up, conditions that would bring about a recession.

Representative HAMILTON. Has there been a shift in business opinion in recent weeks, then, toward the view that there will not be a recession?

Mr. MILLER. In fact, we were at the business council dinner Wednesday night at which the President spoke, and just from talking to people there, I felt there was somewhat of a changing attitude, an attitude that there is a better prospect for avoiding a recession. That was my impression. A number of the business people, reporting on their own companies, seemed to have a better outlook than would have been reflected in early November.

Representative HAMILTON. What is your recommendation for steps that we can take in Government to increase productivity?

Mr. MILLER. The most important thing that needs to be done—as soon as it can be done, in my opinion —is to liberalize substantially the depreciation allowance for new investments.

I believe that the way business decisions about new investments are made relates not only to assessment of markets and costs and prices —which tell what kind of yield might be achieved from an investment —but also to the time period during which the investment will be exposed. The longer the time period and the more uncertainty in the economy, the more difficult the decision is. The shorter the time period —or, if you will, the more quickly there is a recapture of the investment—the more business is willing to take the risk. Higher rates of depreciation increase the discounted cash flow and, therefore, have a powerful influence on business investment decisions.

From the point of view of the Government, higher depreciation allowances do not reduce taxes, they only defer them, so they are more effective from the Government's point of view than investment tax credits which are a forever forgiveness. If you take a depreciation allowance this year instead of next; then next year you have to pay taxes on more income because you don't have the deduction.

So, from both points of view, I think you get more bang for your buck.

If we can more progressively toward a 5-year writeoff for production equipment and machinery, and a 10-year writeoff for production structures, then I think that we would really create the conditions which are essential to step our business fixed investment up to the 12-percent range. In that way, we can become more competitive, we can reduce our costs per unit of production, we can become more energy efficient in production, and we can reestablish our technology, which usually goes along with fixed investment.

Representative HAMILTON. Just one other question, if I may, Mr. Miller.

You have already referred to these money market certificates in response to Mr. Reuss' question. Am I correct there is a minimum purchase on those of $10,000?

Mr. MILLER. Yes, sir, that is correct.

Representative HAMILTON. Now, that always bothers me because of the problem with the small saver. What kind of a hedge does the small investor have with regard to inflation?

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He can't buy those certificates. He puts his money in savings and loans, and he doesn't even keep up with inflation.

What can we do to help him out?

Mr. MILLER. It has bothered me that we have this structure. Unfortunately, it's one that I have inherited, and an area in which there have been widely differing opinions. I would like to take a moment on this because I think it is important. As long as we have had regulation Q ceilings that have limited what can be paid on small savings accounts, and as long as inflation has been low, that was all right.

But, as inflation has gone higher—and consequently as interest rates have gone higher to maintain the purchasing power of invested funds—we have left the small saver behind, and we have created a number of effects which are unfortunate. One of these is that, since saving is not attractive there is more pressure to spend, and that's exactly the opposite of what we want to accomplish. So we are doing a disservice.

On the other hand, to have changed that structure this year would have cerated such a massive increase in the cost of funds for thrift institutions as to make it impossible for them to maintain their profits and, I believe, their services. We were in a dilemma, so we did the best thing we could. We created an instrument similar to a Treasury bill as what I hope will be an interim step. I hope Congress will look with favor, as we get inflation down to more normal conditions, on working with us to phase out those kinds of limitations on small savers, which I think are unfair and work against us in times of stress.

The trouble is, when times are good, we don't take the ceilings off; when they get tough, it's too late. It's like the old story about the Arkansas traveler—never fixed his roof when it was sunny because he didn't need it, and, when it was rainy, he couldn't. We have done that with regulation Q, I think.

Representative HAMILTON. Thank you very much.

Representative REUSS. Congressman Brown.

Representative BROWN of Ohio. Thank you, Mr. Reuss.

Mr. Miller, it's nice to see you.

I would like to throw in a suggestion for you and Mr. Hamilton, concerning the small investor. I have a bill which would give the investor in a savings account or bank account a tax credit if his rate of savings is beyond what is the normal or the average rate, and that would not necessarily come out of the savings institutions in higher interest rates; it would come out of the Federal Government, in effect, in lower taxes collected for the Government. I will send that around to you and direct your attention to it.

I want to compliment you, Mr. Miller, on this chart, which I think does effective explaining of what has happened to interest rates. It isn't the bankers and the people with the money who are making the money on that money. It's the Federal Government that is making the money, if you will, on inflation.

I also want to commend you for coming very much closer to meeting the money growth targets that you have set than had been the case previously, or, rather, I should say for setting lower money growth targets and achieving them.

I also want to commend you for convincing the President that real steps should have been taken, as they were on November 1, to bolster

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the dollar, rather than just the cosmetic steps that he took in his October 24, speech. That resulted in the dollar dropping at a record rate during that week until the steps were taken to increase the reserve requirements by $3 billion, which I think was an implicit pledge to bring the money supply in this country under control. Already the gnomes in Zurich, London, and other places have taken into account and stiffened their position a little on the dollar.

You stressed that real interest rates are low, and, as I said, the chart indicates that. I don't think it's the interest rates themselves, that is, the return on the money, that is choking off investment; as a matter of fact, there seems to be a sale on money in that regard right now. But, rather, it is the inflation within that interest rate that is doing it.

I would like to go back to something that you talked to Mr. Hamilton about. Both you and I have run businesses; yours was a little larger than mine. [Laughter.]

Mine was a weekly newspaper in western Ohio, but I want to cite to you a situation here that I think makes sense and why I would say that the President's early steps were cosmetic.

You know, he asked business to limit its profit to 5¾ percent, but, when your cost is going up at the rate of 10 percent, unless you've got a lot of money in the bank—and my guess is your company has more in the bank than ours does, and it's a public company and you can go out and sell stock; I can't—it's a family held business—so I have to rely on the friendly banker. Unless you can do that, or have a big enough reserve, when your costs go up at the rate of 10 percent and your prices can only go up 5¾, you can target specifically when you go broke. That also applies to the individual, because, when he is asked to limit his wage increase to 7 percent and the cost of living is going up 10, he can pick out—for some it will be next week, for some it will be 2 or 3 years off—when he goes broke. So those things don't work.

Let me give you an example of my problem, and you addressed it, but I want to make it specific.

Ten years ago I bought a new offset press for my little weekly newspaper business; it cost me $100,000. I got a good deal on it. Now, I recaptured that $100,000 at the rate of about 10 percent a year in depreciation, and this year I've got my $100,000 accumulated.

The depreciation, of course, reduced my income tax accordingly, because it's a cost to the business. The problem is that I go out and price those new presses and, you know, they are over $300,000 now. My question is, where do I get the other $200,000?

Because the Government—that's you—[laughter] has taken the money from me, half of all I made, in higher taxes because I couldn't depreciate the $300,000, only $100,000, and so I don't have the profits; I have had to pay some of that out in dividends, and I have had to make improvements in the plant and keep it painted. The interest rates are so high—even though it's not the real interest rate, it's inflation—that that discourages me.

And, frankly, if I go out and borrow that $200,000 at those high interest rates, the return on that investment doesn't quite meet my need for the money to pay the interest on the $200,000.

Now, true, I will get somewhat higher depreciation because I am going to spend $300,000 rather than $100,000. I understand that that

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overtaxing that the Government has done, because of those low depreciation alowances amounts to $20 billion that the Federal Government has taken out of prospective investment.

Now, what can you do to help me? [Laughter.]

Mr. MILLER. Here we have got the fundamentals of one of our critical problems. The depreciation allowances now in place are insufficient to fund replacement of plant and equipment, not to mention either expansion of capacity or modernization with new technology.

Now, therefore, we have a serious problem. The fact that these factors have contributed to lower investment levels in the United States for a long period of time is of deep concern to me, and I know to many of you here, because we have discussed it in some of our other hearings.

Representative BROWN of Ohio. We have overstated profits. The total profit rate in the economy has been low in recent years. Not the last 2 or 3, but over the longer period, it has been much lower than it was previously; isn't that correct?

Mr. MILLER. That's correct. You know, I am in the Government and not in the private sector, but let me give you a couple of worries we have to have.

Ideally one could make a case that depreciation should be allowed on the replacement value of an asset, which would help. The trouble with that——

Representative BROWN of Ohio. I would be happy if you indexed it on the basis of inflation.

Mr. MILLER. Yes.

Representative BROWN of Ohio. And it wouldn't always be the same.

Mr. MILLER. One of the problems with that, of course, is that it may work against our objective. If old assets continue to be depreciated, then there is a disincentive to add new assets which may be needed to maintain productivity in the future and to deter inflation.

What I am saying is that that is one way to go, but to suddenly shift to replacement value for depreciation would have a large impact.

Therefore, I tend to be——

Representative BROWN of Ohio. Excuse me just a moment. If you do it on new assets only, not on the——

Mr. MILLER. That's what I was coming to.

So, therefore, I would favor this approach to new assets: what I would be in favor of is a very rapid writeoff on new assets; you get your money back so fast that you have less problem that it's locked up, as yours was, for 10 years and——

Representative BROWN of Ohio. The Government wouldn't tax it away from me either.

Mr. MILLER. That's right.

Representative BROWN of Ohio. Because I could take that off my income tax.

Mr. MILLER. That's correct. The whole theory behind the recapture of your investment is that with a 5-year writeoff and accelerated depreciation in a double-digit system, you would have your investment, and you could capture back that $300,000 that you would have to pay for an offset press today in less than 5 years; your risk because of the inflation would be reduced.

If you index that in addition, then I do think you have a problem. When do you cut it off? You should be only able to recapture it once.

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Representative BROWN of Ohio. Certainly. I only want to recapture it once, but I want to recapture all of it.

Now you have given me hope for the future, if I can find the friendly banker and get those interest rates down.

If I could just work with the bottom part of the chart, not the white part that is inflation, I would borrow the money tomorrow. But I wonder if you could give me any other hope for a tax reduction of some significance so that I could at least say in the future that my return on that investment, my profit, is going to be a little higher. Then I could tell the banker that I am going to be making more money and I can pay the interest out of that additional profit.

Would you be good enough to do that for me?

You encouraged me to expand.

Mr. MILLER. Your friendly Federal Reserve is very much in favor of this.

I hope the administration can come up with a solution.

May I say that you have given here a very practical, specific kind of illustration that helps everybody understand the dangers, the threat, the inequities of inflation and how it could destroy our society.

Your example is just right; 10 years ago you bought a press for $100,000; today it would cost $300,000. That $200,000 difference represents inflation.

In addition, you have to pay a higher interest rate to buy the $300,000 press, which represents inflation; so you have a double whammy.

No matter what we say or do in terms of temporary solutions to the problem, the truth is that if we don't wipe inflation out there is just not enough capacity in the system to avoid disaster.

We need a system that will accommodate and encourage and incentivize the business investment we need to contribute to reducing inflation. But we also need all the other policies—including the willingness to be austere in our aspirations for Government services, and the willingness to be austere even in monetary policy—in order to choke this inflation disease out of the system and get back to where you can buy a press for $100,000 today and you can buy it for $100,000 5 years from now.

Representative BROWN of Ohio. If I can hold out, Mr. Miller, I am going to be all right; but let me just tell you that up at the Washington Hilton today they are in the second day of a conference with the Federal Trade Commission on the concentration of control of the media and newspaper business, and I am not sure whether I can hold out.

The only answer then for me perhaps is to sell out at an inflated price to Gannett or Thompson—and, you know, he is hardly a local—to sell my little string of weekly country newspapers, and I don't want to do that even. Frankly, I don't want to go to work for somebody else. I would like to be able to stand up and write my nasty editorials that way I want to. But the problem I have is one of immediate desperation, and I really do hope that you can find a way to do more than just talk about this; maybe get the Congress convinced, and the President encouraged; so I will pray for you, and you can pray for him.

I do have some other questions that I want to ask, but my time is up, and I will come back.

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Representative REUSS. Thank you.
Senator Proxmire.

Senator PROXMIRE. Chairman Miller, although you may doubt this sometimes, I have great faith in your intelligence. You are an extraordinarily articulate and able man. However, I wonder if any Chairman of the Federal Reserve Board or Chairmen or Secretary of the Treasury or Chairman of the Council of Economic Advisers could come up here in public and predict a recession or predict that inflation won't get better or predict that the economic factors that affect all of us are not going to improve.

The difficulty with this kind of a hearing is that there is a problem of credibility regardless of the faith we may have in the integrity and honesty and ability of the person who is testifying.

Can you help us with that at all? You told us you think inflation is going to get better. You say we are not going to get a recession, but I cannot imagine you or any other chairman coming up here and saying the reverse no matter how strongly you felt it.

Mr. MILLER. I have a character witness to call on. Mr. Reuss, you will recall that I was sworn in on March 8th and I testified before your committee on March 9.

My statement then was that "Inflation is going to get worse." So I have at least one statement on the record that I came here and said, "Problems are going to get worse; let's do something."

Senator PROXMIRE. "Unless." You always say "unless."

Mr. MILLER. No, I said inflation was going to get worse and it did.

Senator PROXMIRE. You said that no matter what we did, if we moderated our budget, our fiscal policy, and so forth?

Mr. MILLER. I said at that time, "Inflation is our biggest problem. It has not yet been perceived to be the problem, but it is going to accelerate on us. Therefore, we should start doing things to win the battle." But, you know, I think your point is well taken. I think that the natural responsibility of those in the Government in making public presentations is not to create a lack of confidence in the economic progress. But I do believe there has been a change, and that there has been more willingness this year to admit the shortcomings——

Senator PROXMIRE. You may be right about that. For 20 years—21 years I have been on the Banking Committee or this committee hearing these predictions and they are always optimistic. They project things are going to be good. Sometimes they are right because, of course, sometimes things do get better and sometimes they are wrong and they are almost always wrong when the situation does then worsen.

Let me put it this way. Let me ask you about this notion that really disturbs many people in the country, particularly in the business community, but also here, too, that if you are going to blink when we come to a situation where you have to choose between stepping in and following a more easy policy in order to stem the possibility of a deep recession, or stopping inflation, that you will take the course of easing the recession. Maybe you should, but it seems to me you are pretty clear that you are likely to do it, but let me put it to you:

Suppose there is a 1973–74 price rise and unemployment rises more sharply. We have a 10-percent inflation as we did then, unemployment rose sharply at the same time as it did then, the dollar weakens

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as it might if inflation continues to be in bad shape. Would you then recognize your responsibility under the Humphrey-Hawkins bill, which we just passed last year and give precedence to unemployment with monetary policy that will help our unemployment situation; or under those circumstances, would you feel that you had to persist in overcoming inflation?

Mr. MILLER. Senator Proxmire, it is hard to answer hypothetical questions premised on the experience of the past because those experiences are so fraught with mistakes that I assume we would not want to make. For example, one reaction to the upturn of inflation earlier in this decade, in the 1971–73 period, was to put on mandatory wage and price controls, and that created the circumstances where, incorrectly, the economy was stimulated and the desire for rapid economic growth was accommodated by holding a lid on. Of course, the lid couldn't prevent the building up of excesses and bottlenecks, and since the United States does not have an isolated economy, it did not prevent the driving up of the world price of all commodities which contributed to the period you just described in 1974. If you will recall, there was literal chaos in the economy, with duplicate ordering, excessive accumulation of materials for fear they would never be available again, hoarding of labor; everything was done wrong. The result was a big collapse.

Those conditions don't exist, and I hope they never exist again, but to the extent that there could be a slackening in the economy at some future date, I think we have a commitment in monetary policy to maintain a position consistent with the real economy. You know, it was just as bad to have an overexpansion of money in 1971–73, while there were controls on, as it was to have an overrestraint on capacity in 1974, after we had already turned the corner. You know, we had already headed down and we were still restraining the economy.

So I think the real way to run monetary policy is to be more prompt to adust to the realities of the economy, up or down, and not drive it into an unnecessarily severe recession nor allow it to bubble up into excessive demands.

Senator PROXMIRE. But we still persist in assuming there is necessarily a tradeoff, that if we move into a period of slower growth or into a period of recession, that prices will moderate. That is not necessarily the case.

Mr. MILLER. No, sir.

Senator PROXMIRE. As you know——

Mr. MILLER. No.

Senator PROXMIRE [continuing]. There are many, many elements in inflation. Energy prices may change regardless of what happens to the economy.

Mr. MILLER. We may have a famine.

Senator PROXMIRE. The crop situation may change so that food prices go up sharply. We don't know what will happen on the labor front, we have high hopes but we don't know. We can't predict. So the question I ask you and I persist in asking is, will the Federal Reserve give the recession priority or will it give inflation priority in those circumstances?

It is a tough question, but it is the big question, that it seems to me we need an answer from you on.

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Mr. MILLER. I am not sure I can answer you or that I have the capacity to answer you because, as you point out, there is not just one kind of recession, there are two kinds of recessions, there are three kinds of recessions. If you have a recession which is deflationary and is itself going to create *x* consequences, you would react a certain way. I am not trying to duck your question, but I think to try to answer in advance what the policymakers will do, without knowing all of the circumstances, creates some dissatisfaction because it may lock us into commitments we can't fulfill.

My view is that a recession at this time is not only not likely, but not good policy, because I do not see a recession as contributing to eradicating inflation.

I see inflation as imbedded deeply and structurally in our system. I see a number of years being necessary to wring it out. And I see the best pattern for wringing it out is to adopt a posture of moderate growth, which will allow us to consolidate and digest our problems and work them off, rather than a recession, which would immediately lead to very high Federal deficits, very high demands for borrowing money and which would get us back on the treadmill of more inflation.

Senator PROXMIRE. As I understand that answer then, you are saying that in the event we move toward a recession, the Fed would ease monetary policy regardless of the effect on the dollar, regardless of the effect on inflation, because recession would have a perverse effect both on the dollar and on inflation in the long run. Is that right?

Mr. MILLER. No, I am saying that today I don't see the conditions for a recession, nor do I see that we should deliberately exercise policy as though there were a threat.

Now if a recession is coming for other reasons—reasons that we cannot now predict—I would want to look at whether or not it is accompanied by conditions that will contribute to a reduction of inflation or whether it isn't. At the present time, I don't see a recession as contributing to a reduction of inflationary forces.

Again, I am not trying to avoid your question, but I don't think one can judge in advance. Is a recession caused because of some upset in the world? Is it caused simply because there is a——

Senator PROXMIRE. Supposing it is caused in part by higher interest rates, and we have already seen some slowdown in housing and it is likely to get more severe, many people feel so anyway. We might get more of a slowdown in business investment capital and equipment. Under those circumstances we might move into a—not what you say, a 2 percent growth, but after all, these predictions are extraordinarily difficult, as you know.

Mr. MILLER. Very.

Senator PROXMIRE. There might be a 2 percent decline and we have a recession. Under those circumstances would you moderate your monetary policy so that interest rates would tend to come down even though inflation had not been, or the corner had not been turned on inflation?

Mr. MILLER. Senator, I just really don't know. I think we have an obligation to continue restraint on our economy until we wring this inflation out. I don't think we can show weakness and give up on that. I think we have to be constant in our purpose. But, on the other hand,

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I don't think we intend to cause a recession that doesn't contribute anything to the solution.

Senator PROXMIRE. I agree with that, but I would call your attention once again to the law, the fact that we passed the Humphrey-Hawkins bill just last year, and I have an amendment in the Humphrey-Hawkins bill that provides we shall adopt policies to stem the inflation that will not aggravate unemployment.

Now, we construe that to mean that as to the conditions of a recession under those circumstances, fighting recession would take precedence and since the Fed is a creature of the Congress, I would follow the law.

Mr. MILLER. I would assume that if the conditions were as you described, the best policy would be one of dampening the decline, as it were. As I say, the present conditions are such that a serious recession would actually add to long-term inflationary pressures and we have to take that into account. The whole objective, it seems to me, is to keep ourselves in a channel that allows much narrower economic divergence than we have had in the past.

As you know, in the decade of the 1970's, we have seen rather high amplitude swings in the business cycle. Those, to my view, are destabilizing and contribute to our problem rather than to our solution.

What I am suggesting to you now are policies that begin to put on restraint to avoid the peaks, and begin to adjust the economy to prevent the slides—policies to keep, the economy on track.

Senator PROXMIRE. Thank you, Mr. Reuss.

Representative REUSS. Thank you.

Mrs. Heckler.

Representative HECKLER. Thank you, Mr. Reuss.

Good morning, Mr. Chairman. Have you, Mr. Miller, discussed what positive signs that you have seen that the dollar rescue operation has been successful? I am referring to the response immediately following your November 1 announcement. Have you had any further indication of the success or what hard date do you have to show that the operation was a wise move by the Government?

Mr. MILLER. The immediate effects, of course, are measured by the changed attitudes of those people who hold dollars as to how they assess our policies. There has been weakness in the dollar because of the fundamental problems of differential inflation rates between the United States and other countries and our current account deficit, which must be financed. Some adjustment would have been expected but as you know, in August and again in October the action on the dollar could not be explained by any normal adjustment process relating to those factors.

It was obvious that the holders of dollars were diversifying out of dollars because of their lack of confidence in our aggregate policies to curb inflation and correct that situation. Since November 1 markets have behaved, which means that people who make the decisions as to whether to sell dollars or not have been more willing to hold dollars. This improvement in the exchange rate of the dollar is itself proof of a change of attitude.

I have just come back from Europe, discussing this program with officials of the major central banks of the world and with leading

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bankers in Europe. They confirm a very positive attitude about these steps and a conviction that we not only dealt with market conditions by marshaling resources, but that we also showed—in our monetary action, and in the President's continuing action to bring discipline to fiscal policy—that we were determined to deal with the fundamentals. This is what has been effective.

Now, measured in terms of how we have had to use our resources, I am somewhat concerned that there have been discussions that we have had to apply considerable amounts of our $30 billion resources in intervention. Maybe, the concern behind your question is, have we just been pouring money in to prop up the dollar?

The answer to that is "No." We have used far less resources than has been rumored. The figures will not be reported for the 3 months, including November, December, and January, until early March. The resources employed have been far less than rumored, which is again confirmation that there has been some real change of attitude rather than just a propping up of the market.

Representative Heckler. You spoke of your persuasive powers in terms of convincing the central bankers of Europe that we in the United States were going to deal with the fundamental question of inflation, not the symptomatic issues that are the current monetary policy agenda. In terms of the fundamental questions on flation, what exactly were the ingredients of your commitment? What do you see as the necessary ingredients of that fundamental change and how do you see this as a commitment of the Government? Is it the President's commitment or the Congress?

Mr. Miller. Congresswoman Heckler, the commitment and the changes in policy that have already taken place involve the President, the Congress, and the monetary authority.

Let me go back for a moment. Major policy changes do come slowly in a democracy because they involve interaction among branches of Government. Even when those policy changes are being made, they are perceived slowly because there is always the view of those outside the process that perhaps the change is only superficial and does not represent a true redirection.

The evidence is now overwhelming that Congress and the administration and the other governmental authorities have made a few major changes of policy that greatly improve the perception of the outside world of our capacity to curb inflation.

One major piece of evidence of the shift in fiscal policy is the fact that the President proposed, last January, a plan for the fiscal year 1979 that started October 1 that would have involved a Federal deficit of $60 billion. Through the course of the year, the Congress and the President consciously and deliberately reduced that by $22 billion, and that is a forceful change and speaks very loud. It is not superficial; it is $22 billion less stimulus in the current fiscal year than was planned last January.

Followed up by a commitment to reduce the deficit even further in fiscal year 1980, it is becoming accepted as convincing evidence of fiscal responsibility, quite different from what was perceived at the beginning of this year.

A second change in policy is that the perception of the world—rightly or wrongly—that we were not particularly concerned about

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the value of the dollar has now been reversed completely. This Government has demonstrated in every way it can—and the President has become personally involved in this—a commitment to a stable dollar. That is a shift of policy that is now accepted.

Now, add to that the incomes policy that began relatively mildly in April and built up to the October 24 proposal. You must remember that an income policy is itself only a bridging action to help until the fundamental fiscal and monetary policies take effect. But with inputs from labor and business, and with adjustment of the regulations and the final publication of the standards, and given the fact that many major corporations are now pledging to comply and that many labor unions have involved themselves in discussing the techniques of compliance rather than refusing to even look at the program, we see an indication that some progress and some contributions can be made on this front.

Add to that the fact that there is, I believe, a serious effort underway to look at how we can improve our exports. I believe there is also a serious effort underway to see how we can reduce the regulatory burden. I believe there is a new shift in our policy of dealing with the dollar—I should have mentioned this earlier—that involves the willingness of this government to sell foreign currency denominated securities. This major shift in policy was demonstrated with a very successful issue this week. For the first time in history the United States was selling foreign currency denominated securities. That is the way a nation should behave if it is taking seriously its current account deficits. That speaks louder than all the speeches in the world. It was a decision; it was carried out.

I must say that add to that the monetary policy which the Fed has been pursuing—and which now, I am gratified to report, has much more support from the Congress and from the Executive than tight monetary policy has had in the past—and I think we have built up a sense of confidence and a belief that these are fundamental changes.

Representative HECKLER. I am delighted that you see the Congress as being a partner in promoting some of these changes at least in the terms of the reduction of the deficit.

Mr. MILLER. Very importantly, yes.

Representative HECKLER. I am concerned about conversations in the business community on the question of the President's wage and price standards and whether or not this approach is going to be successful.

I understand that you have said that you expect inflation to run at about 6.5 percent in 1979 and private forecasters seem to see a much higher inflationary rate. That perhaps suggests that they do not believe that the current approach taken by Mr. Carter would be an effective one in terms of controlling the rate of inflation.

Is your estimate of the rate of inflation related to your sense of credibility of this new wage and price standard proposal?

Mr. MILLER. Mrs. Heckler, may I just correct for the record the information that was perhaps misinterpreted. My estimate of inflation next year is in the range of 6.75 to 7.5 percent.

Representative HECKLER. Thank you.

Mr. MILLER. This would be down from 8 percent.

Representative HECKLER. That is still below the private forecasters' estimates, isn't it?

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Mr. MILLER. No. I think some of them are in the 7.5 percent range. Some of them feel we will stay—about the 8 percent range, that is true.

I don't believe that my view of inflation indicates a breakthrough. I suppose I have tried to be as realistic as I can, and I hope I shall continue to be so in pointing out to Congress and to Americans generally that this whole process of wringing out inflation, which is critical to our well-being as a society, is going to take time. It is going to test our will, our patience, our perserverence, our commitment.

We are going to have to stick with policies that give this priority for the next 5, 6, 7 years. Americans are used to instant solutions. They like quick fixes because, frankly, this Nation has quite often had so much strength that it could come to an issue and solve it rather quickly. It is hard to believe that within a relatively short time, a couple of years after Pearl Harbor, a world war was under control. But we can't get rid of inflation in even as short a period of time as it took to win the toughest war that the world has ever been involved in.

The truth is that inflation is different, deeply embedded. We have built it up over 12 years, and we have to give ourselves enough time to wring it out—or else take action that will so distress our society as to shake it to its roots, which will not solve the problem either. So we must be committed to this task.

My projections on inflation is based on the analysis of the restraints being put on and the trends that are taking place. I admit that there is room for error; if something should happen in the world that would, for example, affect oil prices, we will have to look at the analysis again.

We are assuming that oil prices will be within the range that was indicated by the OPEC countries prior to the Iranian situation. We are assuming there is not going to be a crop failure, because we have stores on hand that should tide us over.

But these are fragile forecasts. I know over 5 years we will wring inflation out, but at what rate we reduce it each year is hard to say.

Representative HECKLER. One final question, Mr. Miller, and that relates to the problem of adjusting our international trade relationships. Now, you and I come from a section of the country where we see the textile and apparel industry, particularly in Rhode Island and Massachusetts, but also in other sections of the country as well, where foreign imports are threatening really to a very, very substantial measure jobs at home.

I think that most of us would never want to return to either the psychology or the reality of Fortress America, a protectionist policy that does not have a fair trade balance. We realize that that would be suicidal. But at the same time how do we address this problem of very, very heavy foreign competition threatening American jobs at the same time that we have a major deficit? How do we deal with our domestic problems while treating the international dimension of our monetary problem at the same time?

How are we going to adjust the equities and what proposals would you favor?

Mr. MILLER. You certainly are correct, the national well-being requires that we have a concept of fair trade among nations. The concept includes an appropriate division of labor and the importance of prosperity in other countries in order to create stable conditions in-

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stead of conditions of tension. But the emphasis must be on the word "fair." Where we have had a problem in trade is not so much from the adjustments in the world that depend on the availability of raw materials which are processed before they come to us, or that depend on the existence of labor resources, but—in the transition periods of recent years—from nations who, faced with higher unemployment themselves, quite often subsidize exports to the very large and very attractive American market.

I believe the way to correct this is on a case-by-case basis by assuring that there is fair competition, that there is not predatory pricing. I think American industry by and large should be and can be and will be able to compete, particularly if we can create conditions that favor the business investment that we were discussing with Congressman Brown. If we can do that, then we can return our Nation to what it traditionally has been—to what it was for 25 years after World War II—and that is the most efficient goods-producing nation in the world based upon its input of capital, its intelligent and well-trained labor force, and a scale of activity that allows it to compete fairly.

In the meantime I do think that we are and will be adjusting to make sure that, as other nations try to solve their problems, we don't become the dumping ground for unfair distribution of goods. That is beginning to come into a little better focus and it is a little bit encouraging.

We can understand the pressures on other nations because we have had them, but we must avoid them. We must persuade everyone that we need an economic order and an international monetary stability that will allow us to build a bigger pie and to be sure that we are using the productive capacities of the world to increase standards of living, rather than let idle capacity result in trade wars which contribute to destabilization and defeat all of our objectives.

Representative HECKLER. And your emphasis will be on the present mechanisms, perhaps stricter enforcement of the antidumping laws. Do you feel our domestic unemployment in certain areas that are heavily impacted by foreign competition, should that domestic employment rate be a factor in our trade policy?

Mr. MILLER. We need an adjustment process, case by case, and we probably need a better one. In the aggregate it appears that international trade creates more jobs in the United States from exports than we lose from shifting to certain imports. But in particular sectors, the dislocations have been quite painful, and we need to shelter those people and to provide for their transition, there is no question about that.

Representative HECKLER. Thank you, Mr. Reuss.

Representative REUSS. Thank you.

Senator Javits, welcome back.

Senator JAVITS. Thank you, Mr. Reuss. I appreciate it. I appreciate the opportunity to question my good friend who is such an able man, Chairman Miller.

Mr. Reuss, I have an opening statement today which I failed to deliver because of delay in getting here in the morning. I ask unanimous consent that it may be made part of the record.

Representative REUSS. Without objection, it will be entered in the record.

[The opening statement of Senator Javits follows:]

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Opening Statement of Senator Jacob K. Javits

I am pleased to be able to join you in the second day of the JEC hearings on the *Domestic Implications of the Dollar Rescue Operations.* I regret that I could not attend yesterday's session with Secretary Blumenthal and Chairman Schultze but I had only arrived on Wednesday from an extended overseas trip, which, unfortunately, was made longer by my attendance at the funeral of a dear and close friend and great stateswoman, Golda Meir.

I have been seriously concerned about the severe problems facing the United States economy and the international monetary system for sometime, and on numerous occasions have spoken out on the need for a restructuring of the present international monetary system. Last April, together with nine other Senators, I introduced a resolution calling on the President to begin immediate discussions with the other major currency countries to supplement the reserve role of the dollar with that of the other major currencies and the SDR. Most recently, last August 17 in a speech on the floor of the Senate, I called for a tripartite solution to the dollar problem which would involve more vigorous intervention in the daily operations of the foreign exchange markets; resolution of the fundamental problems, especially inflation, facing our economy; and the restructuring of the international monetary system by supplementing the reserve role of the dollar with that of the other major currencies.

Although I am concerned that Chairman Reuss' call for the creation of substitution accounts in the IMF would not effectively deal with the problem of the dollar overhang, I believe that he is on the right track in calling for a long-term solution to the structural imbalance in the international monetary system that total reliance on the dollar as the international reserve asset has created.

Mr. Chairman, the actions taken by the Administration on November 1 to defend the dollar were bold, and I once again highly commend the Administration for that action as I did at the time. These actions, however, came too late and should have been taken when the crisis first became evident earlier in the year. Our foot dragging has compounded the problem and has made the remedy more bitter. For example, in my speech of last August, I called on the Federal Reserve Board to tighten the money supply by raising the Federal Funds Rate from 8 percent to 9 percent as a demonstration of our concern for the international position of the dollar. At the time, I was severely criticized for calling for such a drastic increase; so we let time slip by and on November 1, the rate was permitted to go to almost 10 percent to achieve the same psychological effect. I am afraid it will go even higher.

Stability of the dollar in the foreign exchange markets will depend on our ability to allay the Market's expectation about inflation in the United States. Thus, as a matter of overall economic policy, reducing inflation must be our primary objective. We must be willing to accept the burden of continued tight fiscal and monetary policies. We must, however, be selective in our budget cuts to ensure that the ones who can least afford it are not the only ones who will bear the brunt of our fight against inflation.

Stability in the foreign exchange markets is also essential for the structural reform that we seek. Calm markets provide the proper "environment" for such far-reaching discussions. Without calm, there is a natural concern, that I share, that such talk would further destabilize the market.

Mr. Chairman, I share your view that the President should take advantage of the opportunity afforded to him by the upcoming meeting at the Guadeloupe Summit in January to begin serious discussions on a new monetary plan. Such a plan should seek to gradually replace the present exclusive reliance on the dollar as the key reserve asset by a reliance on a combination of reserve assets, which would include the currencies of the major industrialized countries and the SDR. The world leaders should instruct their finance ministers to look into this question and report back to them by the time of the next summit in Tokyo next summer.

While we will no longer be able to continue to meet our international obligations solely with dollars, this new arrangement would make the monetary system more responsive to international financial reality.

In conclusion, I wish to reiterate that the essential element in getting such a program off the ground will be a continued demonstration—by acts, not words—of the Administration's determination to fight inflation. The Administration's

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actions of November 1 to defend the dollar were laudable. The Administration cannot, however, rest on its laurels. Any slackening in its determination to fight inflation will immediately bring pressure on the dollar. Not only will the U.S. economy suffer, but the international monetary system will be severely tested. We cannot let this happen again.

Senator JAVITS. Let me say I agree with Mr. Reuss' call for a substitution account in the IMF to deal with the dollar overhang, but I point out that that relates to central banks which have a minority—not a majority—of the money. Most dollars abroad are in private hands. Therefore, we need a much broader reform structure in the International Monetary System in order to deal with what is now estimated at a $500 billion overhang—which is very, very critical in absolute terms, but infinitesimal when compared with a soon to be $3 trillion U.S. annual economy.

Now, Chairman Miller, what I would like to ask you is this: You mentioned the real guts of this matter, which is "the most efficient goods-producing nation in the world." Now we can affect interest rates, make and carry out international monetary agreements and assist the development of an EMS and everything else, but government does make, government takes; and the questions are: What are we producing? What is the cost of producing it? Where are we going to sell it?

Now, I don't want you to get embarrassed with the administration, but don't you think there hasn't been nearly enough initiative, enough emphasis, enough thought on those three propositions, what we produce, what the cost is of producing it, and where we sell it, in relation to the current impasse in which we, our economy and the world's economy find ourselves?

Mr. MILLER. Yes; I think we have been short in addressing those issues. We have underinvested. We have not created either the attitude or the support for market development around the world. By underinventing, which we have done rather continuously, our productivity has fallen so low we have not been to get unit costs to where we can be competitive. It would be far better to increase our markets through investment and efficiency than through weak dollars. A weak dollar has so many terrible results that it is a poor way to make our goods less expensive for foreigners. We should make them less expensively instead of selling them cheaper.

Senator JAVITS. Exactly right. That leads to my next question, for the real trick is productivity improvements no matter what your situation is, and we found that out before World War II. We were in bad shape, we had 12 million unemployed, our credit was low, and we had just come through the greatest depression without a revolution that this country had even seen. Nonetheless we entered World War II and we raised $100 billion a year for war—which at present rates would be $300 billion a year, or $1.2 trillion in 4 years.

Now, you are the Chairman of the Federal Reserve Board, which is the central agency for insuring the availability of additional credit. I want you to think about this, and tell me now or later. I am not a newspaper, so you don't have to give me a quick answer, but I hope you and your colleagues would think about it—what can we do in a peacetime economy to create a pool of credit which will enable us to be as enterprising in peace as we are in war?

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Now let me be specific. The LDC's are now in hock for about $170 billion up to probably $200 billion by the end of this year, of which the U.S. banks have loaned them probably about $80 billion. Now that pretty much soaks up the capital surplus. Nothing wrong with the fundamental status of banks because of those outstanding debts, but their stockholders may not get anything back if there is a real crunch.

Now, the LDC's are planning to obtain a bigger market share, especially in the industrial field. As yet, there is not too much question of import substitution. Many LDC's are importing food, for example, which is unbelievable.

These activities all need financing so that three-quarters of the world's customers deal in markets which are transformed, instead of being as they are today: so that they become largely makers, instead of takers. One major problem results from the fact that they too must pay oil price increases. Don't you think, sir, therefore, that it is a real challenge to break out of this laundry in which we find ourselves in which we are taking in each other's washing without doing anything to break through and really determine what our country is capable of doing?

What can we do at the Tokyo Summit in June 1979 in order to break this matrix in which we seem to be caught, a matrix in which all of us are arguing about relatively little things instead of what can really crack the world open for a major advance, even accepting this unbelievable tax for nuclear and other arms which we and the Russians have put upon our backs and therefore upon the backs of the rest of the world?

Mr. MILLER. You raise a very fundamental question, Senator Javits. The financing of economic growth in the world under present conditions is a very difficult subject. We do not have, strangely enough, even a good balance sheet of capital "ins" and "outs," so we don't even know where to start. With the central banks of the G-10 group we have been discussing the prospect of assembling information so we could at best look at the sources of capital and where it is required. We have this information for our own country, but we don't have it for the world. We ought to see if we cannot find some new mechanism, as you suggest, or some new institutional way for accommodating these needs in a manner that is stable and also noninflationary.

So I have to agree with you. I am not sure I can give you an immediate answer because these are institutional changes that involve concepts of sovereignty and issues of a high order of magnitude. But you have put the issue in the right form; it belongs with heads of state and heads of government.

Senator JAVITS. Mr. Chairman, may I make a request of you if my colleagues do not object? We are the Joint Economic Committee, we are a think committee. Let us give the Fed a month to submit to us their ideas on this subject. Let's give them until, say, the end of January, in which to submit to us their ideas on how enough credit can be released in the world to do the job which we agree needs to be done, to wit, an adequate acquisition of markets for the world, to really service not only what the world already owns but also the degree to which the world is entitled to advance.

Representative BROWN of Ohio. Well, Mr. Chairman——

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Representative REUSS. I would say that Senator Javits is on a good inquiry. However, since we are asking the Federal Reserve to respond to a very difficult and central question, I think we ought to phrase our request very precisely, not that the Senator didn't, but maybe they need a letter. Why doesn't the Senator prepare such a letter? I am sure I would endorse it. Let's submit it to the cochairmen. However, I think 30 days may be a little abrupt.

Senator JAVITS. Fine.

Representative REUSS. Let's simply ask for a reply as soon as possible.

Mr. MILLER. I think it may take a little more time. May I just elaborate on this a little more?

In my 9 months of experience at the Federal Reserve, we have had the enormous priority of inflation, which certainly implies and requires that we become involved in the international arena, because it is so closely linked with our own problems of inflation and growth.

But we also have a very large agenda of subjects beyond inflation. The condition of Euromarkets is one such subject; the question of a more stable international monetary order is another and the EMS is a part of that question as, perhaps, the zone of stability for some countries in Europe. Beyond that, we have the whole question of financing and flows of capital in the world, and I know these questions are going to be with us for a good many years.

In getting to you a paper as soon as we can, exploring these questions would be helpful, and I think we should endeavor to do so. I hope you appreciate that it may have to be less than perfect at this point because we are looking for inputs and ideas and concepts that haven't been invented yet.

Senator JAVITS. May I say, Mr. Chairman, this is not a challenge or oppositional suggestion?

Mr. MILLER. No.

Senator JAVITS. It is something I hope to work out with Mr. Reuss and with all the members. We have some extremely able members here. We hope to phrase the question and then begin to develop an answer. That is all I shall hope to try to accomplish.

[The following letter was subsequently supplied for the record by Representative Reuss:]

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., January 9, 1979.

Hon. G. WILLIAM MILLER,
Chairman, Board of Governors,
Federal Reserve System, Washington, D.C.

DEAR BILL: During your appearance before the Joint Economic Committee on December 15, 1978, it was agreed that we would communicate to you in writing our request for your views on how the development of broader markets could be financed.

In response to an earlier question that was posed to you, you indicated that, "We have underinvested. We have not created either the attitude or the support for market development around the world . . ." Your answer succinctly but forcefully describes what we believe to be one of the main structural problems facing the international economy, to wit, the inability of the nations of the world to develop adequate markets for their increasing output of goods and services.

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This is a concern not only to the industrial countries but also to the more advanced developing countries whose manufacturing facilities are beginning to compete with those of the industrialized countries. Whether or not the mounting pressures of protectionism will culminate in serious international and economic instability depends on how we meet the challenge in this central question.

The development of markets both in the poorer developing countries and the Eastern Bloc, including the Peoples Republic of China, is dependent on adequate economic growth in those countries. An essential factor in fostering that growth will be the provision of sufficient credits, assuming a receptive investment climate, to permit the investment of large amounts of capital in a variety of sectors of economic activity ranging from basic human needs, such as housing, education, and health, to extensive agricultural, agribusiness, and manufacturing projects. We believe that incentives must be undertaken to ensure that the huge capital surpluses that both the OPEC and the surplus industrialized countries have accumulated are used for these purposes—which is not the case now.

With the free world beset by high inflation and low productivity, it is essential that serious thought be given to how these surplus funds that are available can be best channeled and what mechanism could best accomplish this global recycling of capital. We would appreciate having your views not only on the nature of the problem but also on possible approaches to financing world economic growth under present conditions.

At this time, it is vital to consider the more long-term conceptual issues. As we indicated during your appearance, we are looking for a considered response. Thus, while we would like to have your response within thirty days, we would certainly understand it should you need more time to provide a more considered response.

As always, we found our exchange of views on the fifteenth last to be highly informative and look forward to your response.

With warm regards,

Sincerely,

HENRY S. REUSS,
Member of Congress.
JACOB K. JAVITS,
U.S. Senator.

Senator JAVITS. My time is about up, and I would like to ask a question about the multilateral trade negotiations (MTN), and about the European monetary system (EMS).

First, about the EMS. Do you understand it to be the official policy of the United States now, or is it the policy of the Fed, to favor and encourage the EMS, as it is not inimical to the interests of the United States, either monetarily or in terms of our general economy?

Mr. MILLER. Senator Javits, that would be the policy of the Federal Reserve and I believe it is the policy of the Government as I understand it.

The U.S. Government and, I believe, the American people have favored economic integration in Europe for the past 30 years. It is absolutely consistent, in order to have economic integration to a higher degree, that there be monetary integration. If we believe that a sound economy in Europe, one that can take advantage of its large population and potential scale of production, contributes to stability in the world and creates a new order in the free world—that such an economy avoids the tension of nationalism that has impended Europe's progress in the past—if we believe that, then we must be in favor of such explorations as the EMS.

The EMS is an innovative and courageous proposal. It involves risk because it does mean coordinating economic policies among nations that have divergent inflation rates. It does mean committing

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existing reserve resources of one nation to help the common cause, which may use up the resources of that nation. I think we should encourage and support and wish the Europeans complete success in that effort.

Senator Javits. Thank you. I thoroughly agree with that.

Lastly, on the MTN, do you consider its successful negotiation and approval to be essential to the fight on inflation? And do you consider it desirable for the Congress to facilitate the consummation of the negotiations by the early enactment of authority to waive countervailing duties?

Mr. Miller. There is nothing that could help the MTN negotiations more than if the new Congress were by acclamation immediately in the first session to reinstate the President's authority to waive the countervailing duties. That would set the stage for a more fruitful MTN, which we need in order to make accommodations in world trade and commerce to our mutual benefit and avoid the trends toward protectionism, which inevitably will hurt us all.

Senator Javits. Thank you very much, Mr. Miller.

Representative Reuss. Just briefly, I have been a little concerned that the whole discussion of these hearings has been too much under the aura of the Phillips curve; that is to say, one side says we have to tighten money and restrict the budget, to fight inflation and help the international dollar; and the other side says we have to fight recession by stimulating the economy. In fact, isn't the social problem in this country largely a problem of structural unemployment, with its chief exemplars being young people in our central cities, and isn't the solution to that a set of specific ad hoc policies which come to grips with that problem, rather than an overall pumping up of the economy?

And if that is so, shouldn't you be using your good offices within the administration to say, in effect, "Look, there is a need for a tight fiscal policy and for a policy of monetary restriction. But those things are macroeconomic, and, therefore, in heaven's name, don't cut programs designed to deal with the problems of central city youth unemployment, but find within the $500 billion spending budget the $2 or $3 billion necessary to reduce youth unemployment."

Based on everything I know about you, you ought to be willing to exert that kind of influence in administration circles, and it would be every bit as beneficent as that which you did earlier this year when you pointed out the dangers of a $60 billion budget deficit and of an almost unlimited tax cut.

Mr. Miller. Mr. Reuss, I think you have stated it very well. The most humanistic viewpoint of our economic policies we can take is to realize the permanent damage we can do to all Americans if we allow inflation to remain unfettered. Your analysis is correct; we need the restraint in macropolicies to curb inflation, but we also need to look at where the distress is in the employment area. There is no doubt that it exists principally among the young, among the black, and among urban people.

I am absolutely committed, as you know, to enhancing targeted programs to deal with that problem rather than trying to affect the whole society with macropolicies that could react against us.

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One of the most encouraging things this year, which I hope will gain continued support in the Congress, is the development of local productivity councils, which goes to the issue of how you deal with these problems in their own locale and with the people who can identify the individuals who need help and can work with them. These councils deal with specifics and not general theories.

I can also say that I shall be pleased to add whatever voice I have in the administration in favor of what you have suggested. I believe the President is striving very hard to come forward with a budget entailing a $30 billion or less than $30 billion deficit, but one that retains these programs. I believe he is trying to be sure that they are strong in terms of dealing with human problems and assisting the demographic elements and the urban elements that need to be given their opportunity.

Representative REUSS. Good.

Senator Proxmire.

Senator PROXMIRE. No, Congressman Brown was first, I think.

Representative REUSS. Excuse me. Congressman Brown.

Representative BROWN of Ohio. Thank you, Mr. Reuss.

Mr. Miller, I stated I wanted to change the subject a little bit after talking about the accelerated depreciation rates last time around. I have a couple of different articles here about you and M_1. There is one from the Continental Bank indicating that they think you are doing a reasonable job—well I don't know that they conclude that, they just observe that M_1 seems to have gotten under control in September, October, and November of this year, although it seems that there is always a rather sharp reduction in M_1 in November, at least over 1976, 1977, 1978. That has been true.

But there is another article, entitled "Bill Miller is a Faint-Hearted Inflation Fighter," in Fortune magazine, which is not quite so nice, and it suggests that the monetary base, and I am quoting now, "has been growing at breakneck pace under Chairman Miller, from an already excessive rate during the second half of 1977. It appeared to be slowing by early this spring, but in May the growth rate picked up again and has remained high since then."

I am curious, first, whether you have read the article; second, whether it reflects accurately what has happened to the money supply; and, third, whether the targets are apt to be lower.

Let me paraphrase just one other comment from the article if you have not read it. Maybe it is too soon to get a clear fix on the Fed's post-November 1 policy, but the tentative conclusion has to be that its actions were largely cosmetic. Despite the full percentage increase in the discount rate to 9.5, the Federal funds rate rose only half a point to 9.87 in the 5 weeks following Blumenthal's announcement.

So even when the tightening is measured by the Fed's yardstick, it appears to be minor. Moreover, the Fed offsets its mandated $3 billion increase in the bank reserve requirements with open market purchases of Treasury securities.

Would you want to comment on that, Mr. Miller?

Mr. MILLER. Congressman Brown, I have not had a chance to see that article. I am not sure I know its content. I would say that we perceive the world slightly differently. The decisions on November 1 were

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part of a continuing process and involving the four elements of monetary policy that I have outlined:

First, that we would apply constraint progressively to slow the rate of growth in the economy in order to bank the fires of inflation.

Second, that we would apply the brakes smoothly to avoid the disruptions and dislocations that come with abrupt shocks.

Third, that we would do so in a way that maintains balance in the economy.

And four, that we would bring down the growth rate as low as appropriate without having a recession.

We have pursued that strategy. The actions on November 1 were strong actions and supported that strategy. What is often missed is that, by coincidence, November was a month in which many other activities happened that influenced bank reserves. First, was the beginning of the shift of Treasury tax and loan accounts out of the Federal Reserve into private banks; we had a need to offset that kind of activity. Second, was the authorization made 6 or 7 months earlier for the automatic transfer accounts to go into effect, which created some shifts in the aggregates and, of course, in reserve requirements.

The truth is that the Fed was taking steps to drain what otherwise would have been a rather rapid growth in the reserves. Any one who reads into the $3 billion increase in bank reserve requirements reserve the idea that we put reserves right back in is just misreading the realities. The realities are that the Fed has continued to exercise tough and tight policies to draw down the growth of money and credit, and we intend to maintain our posture consistent with the overall goal that we have discussed this morning, believing that it is not in the national interest to precipitate a recession nor to allow growth which strains our resources and augments inflation.

We have to walk through a fairly narrow channel. I know the channel is narrow because, as you know, we hear cannon to the right of us and cannon to the left of us. There are those who say, on the one hand, "My goodness, stop that, it is hurting," and, on the other hand, those who say, "You haven't even touched us." So when we get cannon to the right side and cannon to the left, we must be right on target.

Representative Brown of Ohio. I would want to congratulate you on this, but you sure have to apply them. Can you tell us what the current targets for M_1 and M_2 are?

Mr. Miller. Yes, Senator Proxmire will probably jump out of his chair on hearing these numbers.

Representative Brown of Ohio. Well, he'll have to do it on his own time though. [Laughter.]

Mr. Miller. The targets ahead of us at the moment are a growth rate of 2 to 6 percent to M_1. That is reduced from the 4 to 6.5 percent that previously existed.

Recently we have reduced the growth of M_1 to get within our old ranges, and we will be within our new ranges most likely.

Now the reason we have such a wide range when Senator Proxmire encourages us to have a narrow range is that we frankly cannot predict at this point what effect the new automatic transfers will have on funds being shifted from demand deposits into savings accounts. We are going to address that issue.

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The growth rate ranges for M_2 are 6.5 to 9.0 percent; and for M_3 9.5 to 10 percent. We have been more or less within those ranges.

We have also set out a 5.0 to 7.5 percent target range for what is known as "M_1-plus," which is an initial stab at setting more helpful monetary measures.

Let me just say that, along with the very important legislative initiative that Representative Reuss and Senator Proxmire will be taking in connection with reserve requirements in the new Congress, we are planning to share information and to seek inputs from everyone on better definitions of money.

The staff will be publishing in January an analysis of the measures of money and seeking inputs with the thought that by next summer we will have some new, more useful measures. M_1 was supposed to measure the basic money supply—that is, spendable money that can have high impact on the economy—by counting currency in circulation and demand deposits. And some years ago that definition worked because when people put money in their savings accounts they were truly putting it away for a rainy day. It required an emergency or unusual expenditure for them to take it out.

That has changed. Today, people put money in savings accounts for 3 days or 6 weeks and they intend to spend it like M_1 money. Now we——

Representative Brown of Ohio. That is because they make a little more and put it in the checking account, but they still fall behind.

Mr. Miller. So I think that M_1 is changing and we want to find again that which is immediately spendable money and that which is being set aside for the future. We want everybody's input in the search.

I am happy to inform Senator Proxmire that the Deutsche Bundesbank has just announced that they are joining the Americans in using a range rather than a single target for the money supply. Senator Proxmire has always told me I should have an exact target like the Germans.

Representative Brown of Ohio. Mr. Miller, I feel like I am——

Mr. Miller. The Germans have now——

Representative Brown of Ohio. I feel like I am only the shuttlecock in this ballgame. [Laughter.]

I would like to have you address yourself to me—and not worry about Senator Proxmire, although I knew that you do worry about him——

Senator Proxmire. Keep it up, Mr. Miller. [Laughter.]

Representative Brown of Ohio. Let me ask how rapid has the growth been in previous recoveries, particularly 1971 to 1973? And how rapidly did inflation build up then?

What occurs to me is that we seem to be having much more rapid buildup of inflation in this period than we have had in previous periods.

Mr. Miller. I think the most rapid expansion of inflation we have ever experienced in our country since the twenties was in 1972 through 1974; the inflation rate was about 4 percent in 1972, and it went to about 12 percent by late 1974.

Representative Brown of Ohio. However, that was a period in which we had wages and price controls lifted. But let's go back to

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1971 to 1973. Perhaps all that is skewed by the wage and price controls and therefore the system doesn't really work when we have those automatic or forced restraints.

Mr. MILLER. Yes, especially by the way we behaved, we pushed inflation into that period.

Representative BROWN of Ohio. And the same could happen again with wage and price controls, would it not?

Mr. MILLER. Yes. But despite these controls and the double-digit rates in their aftermath we have had an underlying rate of inflation of 6 to 6.5 percent pretty much through this decade.

Currently we are running at about 8 percent. We were at a 6-percent rate last year, so that the runup has been a very serious matter. I am talking of the GNP figures, not the CPI; the CPI has performed a little worse. The figures are dreadful, and we have got to bring them down, but I don't think they represent the kind of dramatic shift that took place when we removed controls after a period that combined mandatory controls and a stimulus to the economy.

Representative BROWN of Ohio. I have two other questions.

Do you still favor or do you favor, I should say, a delay in the minimum wage increase scheduled for January 1?

Mr. MILLER. Yes, I think that would have been a wise action—either a delay or the creation of a youth differential. But I appreciate that that can no longer be done because the Congress is not in session. The increase will become effective, and once it is effective I don't see how you can unwind it.

It would be very reasonable for Congress to look at the increase scheduled for next year and see if it couldn't be delayed or a youth differentiation established.

Representative BROWN of Ohio. And the social security tax?

Mr. MILLER. The social security tax doesn't involve quite the same problem. There will be a slight increase in rate on January 1. But the increase in the social security tax base that also goes into effect on January 1 will not have any impact until later in the year——

Representative BROWN of Ohio. It does have impact on small businesses though when that question of replacing equipment and a few things like that, does it not, comes along?

Mr. MILLER. Yes. As you know, I would be in favor of postponing those changes, but only on condition that Congress undertakes to reduce the long-term costs of the system. There are a number of ways to do so which would not detract from the purpose of social security which is to provide a basic pension upon retirement.

I would still like to see that done.

Representative BROWN of Ohio. Finally, the other day we had Mr. Greenspan and Michael Evans of Chase Econometrics with us and they suggested that if there is a slowdown in the economy, that the deficit that the President is targeting now at $30 billion, or at least this is the story that is in the financial press, may, in fact, exceed that, because there would be reduction in receipts to the Federal Treasury because of the business slowdown. The result might be that we would have a deficit as high as $50 billion again, which is what President Carter recommended—well, actually he recommended more than that—in both the previous 2 fiscal years.

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What impact does that have when it occurs, and how can we avoid that? Is it possible, going back to my depreciation question earlier, to stimulate capital expansion and some other things by some tax reductions that would balance out the dampening impact of high interest rates and reduce the possibility of a slowdown that would create a deficit?

Mr. MILLER. That is an observation of the possible impact on the Federal deficit of an unknown kind of recession. You first have to measure the kind of recession you are talking about before you can project a deficit. But your question does illustrate the point I have been trying to make for some time, and that is that a recession which, because of existing programs that would have shortfalls of revenue—with less people employed and more transfer payments—results in higher Federal deficits, puts us back on the treadmill of inflation being stimulated by excessive Government borrowing.

If anything, this is reinforcement for what I think should be our policy objective, and that is not to have a recession, but to have low rates of growth. And ——

Representative BROWN of Ohio. Couldn't that be encouraged by tax reduction on the capital expansion kind of growth which would build strength for another expansion in the country?

Mr. MILLER. If there is any stimulus needed in the economy to avoid falling into a recession, the most helpful stimulus would be to business investment and not to consumption, because we need continued investment over a number of years to improve productivity. You are absolutely right; if we had to stimulate somewhere, that would be the place.

Representative BROWN of Ohio. I will now concede that my time is up.

Thank you, Mr. Miller.

Senator PROXMIRE [presiding]. Mr. Miller, you referred to that appearance that you had before the Banking Committee shortly or just a few days after you were sworn in and there are three references to inflation in that hearing. I don't mean to harp on it except I think it is very important for us to put in context the statement of the top economic officials of our Government. You said:

> There is, however, less reason to be sanguine about progress in curbing the rate of inflation. Food and material prices have risen substantially in recent months and labor costs continue to rise at a relatively rapid rate.

That is hardly a prediction of inflation. That was the only statement on inflation in your prepared statement.

Then in response to Chairman Reuss, you said:

> Macroeconomic policies will not be able to produce the reduced level of unemployment that all of us seek as a national goal without unleashing a greater degree of inflation that would be self-defeating. In fact, we would unleash inflationary forces that would bring us right back to high unemployment.

Again that is certainly not a prediction of inflation.

The final statement I presume to be closest to it, where you say, "I am more concerned about inflation today than I was before. I think we are going to have to begin to focus stronger and harder on the remedies and see if we can find the will, not only in the private sector, but in the Government sector, to begin to take some steps to

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show that we are serious. If we don't take those steps, I am afraid the consequences will be ones that none of us will like. The sooner we realize that inflation is a very serious matter, the sooner we can begin to control it."

Now, I submit that none of this constitutes a prediction that inflation is going to get worse. There are no figures given, there was an indication that you were very concerned about inflation and you urged, very effectively, anti-inflationary policies on the committee.

Now the other point I would make is that it was your first appearance and you had only been in office 2 days, so obviously you couldn't be held responsible. Second, you were like Alfred "Top Banana" Kahn, who is new, and hadn't been around very much; and, therefore, you were like Mr. Kahn willing to make blunt and clear statements without as much concern about their consequences.

Mr. MILLER. And now? [Laughter.]

Now my answers are very obscure and cautious ones?

Senator PROXMIRE. No, no, no, they are very clear, but you are predicting that things are going to get better, which you have said so consistently. You said interest rates are peaking out. You said inflation is likely to improve. You are saying there is no recession.

I say that we have to discount that.

Mr. MILLER. Your point is well taken in that I hope I am not guilty of wearing rose-colored glasses. I hope I am learning the technique of how to report as best I can to this committee. Someday, I hope to be able to predict good news and have it come true; then I would have a chance to predict bad news and have it come true just to improve my credibility—but not now.

Senator PROXMIRE. The second point is this: Last night on a televised interview, President Carter said he would consider signing legislation that would give him standby authority to impose mandatory wage-price controls. Now he did hedge that very carefully. He said such a proposal would have to insure that economic controls would only be used in case of a threat to our Nation's security; and he did not desire that kind of approach. Nevertheless, that does seem to be a backdown from the President's previous position of adamantly opposing standby or any kind of mandatory wage-price controls.

Obviously once we got into a military emergency the Congress would act very promptly, but what is your view on this? Do you think standby controls for the President with any kind of a provision in it would be appropriate?

Mr. MILLER. They would be undesirable. Through the process of considering standby controls, Congress would create the expectation of controls and thereby a rash of anticipatory pricing and wage demands that would be very damaging.

I am sorry, but the way the country behaves is that every time mandatory controls are mentioned—every time there is a prediction that they are eventually going to be put into effect—there is a rash of pressures for getting ahead of the potential controls. The best thing to do would be to put to rest the idea that mandatory wage and price controls have any role to play at this particular time.

I don't think they have any role to play given what we have to do in the next few years. Whether they have a role in some potential war or

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national emergency—or in some future generation—I don't know, but I think even their consideration would be damaging.

Senator PROXMIRE. I appreciate that very, very much. I can tell you that our committee as far as I know, the Banking Committee in the Senate, is unanimously opposed and, of course, it would have to come before our committee. Everybody is adamantly opposed, even for standby controls.

Now, some economists are beginning to raise concerns that the Federal deficit will rise next year rather than decline, because with the best will in the world we cannot, of course, determine what the economy is going to do. So that with a weak economy, transfer payments would rise, receipts would fall.

Can you tell me what is the Federal Reserve's current estimate of the deficit under current policy assumptions for both 1979 and 1980?

Mr. MILLER. For fiscal year 1979 our current estimate is $39 billion, as I recall. For fiscal year 1980, in our recent projections we are using the $30 billion that the President has indicated.

Senator PROXMIRE. That assumes no tax cut; right?

Mr. MILLER. That assumes no tax cut.

Senator PROXMIRE. That assumes that we have a 3-percent increase in real spending on defense?

Mr. MILLER. No; it does not. It assumes a $30 billion deficit without trying to decide whether cuts will come in Defense or from other areas. That debate is beyond the realm of the Federal Reserve.

But it is important that we all determine to stand firm on our commitment to fiscal discipline. It is very important that we don't begin to anticipate with hypothetical guesses what the condition of the economy may be 12 months from now, which would determine what the deficit would be in the fiscal year 1980; this is what we are talking about.

Senator PROXMIRE. Chairman Miller, when you testified before the Banking Committee, you indicated we should expect a $20 billion rather than $30 billion deficit?

Mr. MILLER. Yes.

Senator PROXMIRE. I take it you maintain that position although the expectation is that given policy assumptions we probably would have a $30 billion deficit; is that correct?

Mr. MILLER. I agree with that.

I said at the time that I thought it would be better if we took the deficit of roughly $39 or $40 billion forecast for this year, cut it in half in fiscal year 1980, and balanced the budget in 1981. That would be the ideal situation.

Senator PROXMIRE. Now, part of the President's inflation program is the real wage insurance that was given a lot of attention for a while. There has been some criticism by many people lately. They think it isn't practical, that is, for workers that abide by the wage guidelines.

Given the outlook for inflation, what is your opinion on the real wage insurance proposals?

Mr. MILLER. It would be applied, as I understand it——

Senator PROXMIRE. Do you favor it?

Mr. MILLER [continuing]. To the difference between 7 percent and the inflation rate in 1979, with a tax refund or a credit.

Senator PROXMIRE. It could be a rather massive tax cut, couldn't it?

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Mr. MILLER. It would have to include some ceiling on the credit per individual to avoid an unlimited Federal Government commitment, it seems to me. The financial risk would have to be constrained both by the numbers who comply—which would limit the number who qualify—and by some ceiling on the amount of credit per individual.

Otherwise, I am afraid what you would have is a rather unpredictable situation which, from a financial point of view, would be a bit undesirable.

Senator PROXMIRE. Do you favor it?

Mr. MILLER. I have not yet seen plans for how it is going to work. The idea, to my mind, is innovative and creative, and if it contributes to lessening inflation, it also lessens the amount of real wage insurance to be applied. I look favorably upon it, but before I take a precise position I would like to see how it is going to work; I have not yet seen that.

Senator PROXMIRE. Now are the banks going to have to abide by the wage guidelines and on the price side abide by the profit margin test? Has the Federal Reserve made any effort to determine whether the banks are going to do that or are doing it; and what plans do you have to monitor that situation to see that the banks are abiding by the profit margin?

Mr. MILLER. At the moment the solicitation of bank compliance is being done by the administration.

I have felt——

Senator PROXMIRE. By the Comptroller?

Mr. MILLER. I believe it is being done by the director of the Council on Wage and Price Stability with perhaps the involvement of the Secretary of Treasury who has written to banks on this subject before. But I have felt that as an independent monetary authority it was not appropriate for us to enter into that particular solicitation at this point.

Our role, if we are asked—and I think it would be an issue only if we are asked to—would be to monitor for the Government. But——

Senator PROXMIRE. You are in so much stronger position to monitor, you have a larger staff, you are expert in the field, and you can handle it better.

Mr. MILLER. Between the Comptroller and the Federal Reserve we can do very well. The Comptroller has examination authority over the national banks, of course, and we have it only over the State member banks, about 1,100. But I think you are right, three of us together—the Comptroller, the Fed, and the FDIC—could monitor better, given existing resources.

Senator PROXMIRE. Now you have already spoken about the housing market being cushioned, and shows some reaction to high interest rates in spite of that. Six-month certificates have been very helpful to cushion those effects, but there are some signs that some thrifts will not renew maturing certificates. Also we hear that the thrifts are taking the funds raised with the 6-month certificates and not putting them into mortgages, but rather, investing them in bank CD's.

Now if that is happening in large amounts, the certificates are not doing the job they are intended to do. Do you have any evidence of this diversion of funds and do you think it appropriate or do you think we can act on it?

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Mr. MILLER. Senator Proxmire, the evidence we have at the moment is that the only significant parking of these kinds of funds in CD's is where the funds are being held in liquid form for mortgage commitments. We have not seen any significant evidence that funds are merely being acquired and invested and not working to be more effective.

The reverse has been true, they seem to work more effectively. Offerings of these certificates are being made continuously and funds flow is based in on the choice of savers rather than on the thrifts. As they are accumulated, they allow the thrifts to make mortgage commitments. Mortgage commitments have held up remarkably well, and they have been funded by these resources.

So the mechanism has been working. It could be that we will come to a point where there will be more hoarding of money to see what happens in the market, but that has not happened significantly yet.

Senator PROXMIRE. Now the Board of Governors has two vacancies right now of the Federal Reserve Board, that is. You have been quoted as indicating you think the Board has enough economists now. I feel very strongly that it is very important to have people who can technically do the job and really understand monetary policy, and I just wonder if you would recommend against having more trained economists on the Board.

Mr. MILLER. No; I would not recommend against it. Perhaps I feel lonely as the only noneconomist on the Board at the moment. It seems to me that you are right, you need people who are qualified. But on the other hand, monetary policy, which is the critical role of the Federal Reserve, must relate to the whole world of money and credit. It would be sensible to consider people who have been experienced in commercial banking, for example, and we have no one on the——

Senator PROXMIRE. How about experts in housing? I notice in the Wall Street Journal they talk about Nate Rogg and Mike Sumichrast as possibilities.

Mr. MILLER. Governor Jackson was experienced in mortgage banking and he brought that kind of skill.

Senator PROXMIRE. Yes; he was.

Mr. MILLER. Of course, there are people who have good backgrounds in agriculture or in labor who should be legitimate considerations for a balance. It seems to me that when you have seven members of a Board, it would be well to select a balance of skills.

We now have on the Federal Reserve Board an economist who has spent a very substantial part of his career with the system and therefore understands the technical aspects of monetary policy from the ground up. We have another Governor who has been involved in academia and who has had international experience, and he brings another series of skills. We have another Governor who has been involved heavily in the congressional side and understands budgets and Government, which is very helpful. And there is another Governor who is knowledgeable in Federal Reserve Bank operations.

So I think it would be useful to balance these skills with some other skills.

Senator PROXMIRE. I just have one more question and it relates to the same kind of thing. It is an interesting problem for the Banking Committee—I apologize for asking in this committee, but when you were appointed to the Board, you were appointed from California, as I

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understand it, that was the area that you were appointed from, although you have been a resident of Rhode Island for some time and you have been living for many years away from California.

Now we have one of the leading candidates from North Carolina; we have a man on the Board who comes from Richmond. Supposing we should consider changing that law, that law seems to me—in the national economy we have, that you have to have members of the Board who at one time or another in their lives come from particular sections of the country—to be outdated. It prevents us from getting the best qualified people.

Do you feel we ought to consider modifying, changing, or repealing that law?

Mr. MILLER. I think it is an outdated requirement. I can understand why it was originally enacted because in 1913 the methods of traveling and communication were much slower and the general interaction among the regions was less immediate. At that time, the idea of regional representation was important and wise.

But now I would think you would be well advised to consider eliminating that provision, but if you do you should have some oversight to make sure that the Board is made up with due regard to a balance of skills and experience and geography. You could do that through general oversight rather than specific statutory limitations.

Senator PROXMIRE. Would you suggest we might modify the law to provide that simple language with due regard for geography, but without requiring that they come from various places?

Mr. MILLER. I think so, similar to what you require for the Directors of Federal Reserve Banks: they have to come from a broad range of backgrounds. As you recall, there is a provision looking to representation from industry, from agriculture, from labor, and so on.

Senator PROXMIRE. Yes; it is my understanding that other members have no more questions. Is that correct?

Representative Reuss indicated that he unfortunately had a commitment he had to keep so he therefore had to leave. We want to thank you very, very much, Chairman Miller, for a fine presentation as always and for your responsiveness to our questions.

Mr. MILLER. Thank you very much, Senator.

Senator PROXMIRE. The subcommittee will stand in recess until 2 o'clock this afternoon.

[Whereupon, at 12:30 p.m., the subcommittee recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

Representative REUSS. Good afternoon. The subcommittee will be in order for the final session of its inquiry into the dollar rescue program and its domestic implications.

This afternoon we are privileged to hear from a blue ribbon panel consisting of Prof. Saul Hymans of the University of Michigan, Prof. James Pierce of the University of California at Berkeley, and Ed Yeo, an old friend and former Under Secretary of the Treasury, who is now chairman of the Asset and Liability Management Committee of the First National Bank of Chicago. Professor Modigliani will join us momentarily.

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Under the rule and without objection your respective prepared statements will be—and we appreciate your getting them to us—received in full into the record. We would like to ask each of you to proceed, trying to summarize your position in 10 minutes or so. Would you start out, Mr. Hymans.

STATEMENT OF SAUL H. HYMANS, PROFESSOR OF ECONOMICS AND STATISTICS, AND CODIRECTOR, RESEARCH SEMINAR IN QUANTITATIVE ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. HYMANS. Thank you very much, Mr. Reuss. I am delighted to have the opportunity to discuss my views about the economic outlook before this committee. This is a particlarly crucial time in the evolution of the U.S. economy and the near-term outlook is being heavily influenced by fiscal policies which have recently been enacted by the Congress and by monetary policies which have recently been announced jointly by the administration and the Federal Reserve. Let me outline those policies in terms of their features which are of central importance to the macroeconomy.

In the area of fiscal policy, one of the crucial elements is the Revenue Act of 1978, which is estimated to reduce taxes by about $18.5 billion in calendar 1979, or about twice the amount by which payroll taxes are scheduled to rise in 1979 as a result of previously legislated increases in the rate and base for social security taxes. On the expenditure side of the budget, I am projecting a Federal expenditure increase of about $40 billion for fiscal year 1979 (NIPA basis)—virtually the same as the dollar increase in fiscal year 1978 and thus a good deal less in either percentage or real terms. For fiscal year 1980 I expect an expenditure increase of $44 billion. In my view, expenditure increases of this size would represent a considerable, though not unlikely, amount of success in the stated goals of the President and Congress to hold down Federal spending. In conjunction with the Federal revenues derived from our control forecast, these expenditure levels imply Federal deficits, national income and product basis, of about $28.5 billion in each of fiscal year 1979 and fiscal year 1980.

Regarding monetary policy, the monetary base, as measured by the Federal Reserve Bank of St. Louis, is projected to grow at an annual rate of about 8.5 percent through the first half of 1979. This represents a substantial decline in the growth rate of the monetary base as compared to the 9.5-percent rate over the past year or the nearly 10-percent rate over the past two quarters. The discount rate is expected to remain at its current level of 9.5 percent through the first half of 1979.

Our forecast projects an easing of monetary restraint beginning in the third quarter of 1979. The projected easing of policy is assumed to include a reduction in the discount rate in two steps to 8.5 percent in 1979.3 and then to 7.5 percent in 1979.4 and slight rise in the growth of the monetary base to a 9-percent rate after midyear. I hope to make clear the reasons for the projected change in monetary policy later in my testimony.

I turn now to the outlook itself. Compared with the 3.8-percent rate of growth of real GNP now being estimated for 1978, our forecast contains a sharp decline to a 2-percent growth rate for the year 1979.

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Corresponding to an increase in aggregate production of only 2 percent for the year as a whole is a substantial increase in the unemployment rate to an average of 6.7 percent for the year 1979 and 7.2 percent for the fourth quarter of next year.

The aggregate price level, as measured by the GNP deflator, is expected to be up by 7.9 percent for 1979, compared with a 7.4-percent increase for 1978. The Treasury bill rate is forecast to average 7.8 percent next year compared with 7.2 percent this year; and the rate of growth of the money stock, as measured by M_2, is forecast to decline from 8.9 percent this year to 8.4 percent next year. However, characterizing 1979 as a 2-percent growth per year is really doing violence to the underlying forecast.

The forecast implies virtually no growth at all in the second and third quarters of 1979. My point forecast manages to avoid any negative growth quarters, but I am forecasting annual growth rates of 0.5 and 0.2 percent in the two midyear quarters, and that simply has to mean that the chances of a true recession developing after the early months of 1979 should be regarded as almost "50–50." In other words, I would say the chances of avoiding a recession in 1979 seem to be only slightly better than the chances of experiencing a true recession in which aggregate output actually declines for a time.

Monetary restraint can be expected to produce a substantial decline in residential building activity. The major quartely declines are forecast to occur during the first three quarters of 1979, after which the assumed easing of monetary restraint plays a major role in reversing this drop in housing activity.

Business capital formation is forecast to be on a downward trend, in real terms, throughout the forecast horizon—the result both of high interest rates and the induced effects of the economic slowdown. Consumer purchases of durable goods are forecast to be declining throughout most of next year, followed by a substantial pickup in the closing quarter of 1979. Much of this recovery in durable goods activity, especially the strength of the recovery in late 1979 and early 1980, is heavily dependent on the change of policy toward an easing of monetary restraint which I have assumed will be underway in the summer quarter of next year.

As I said, I will return to that.

The reason why I believe a change in the stance of monetary policy will be necessary in mid-1979 is shown in charts 1 and 2. Chart 1 shows two alternative growth paths for real GNP, one for the control forecast and one for what I have called the continued tight money program. The continued tight money alternative eliminates the easing of monetary policy contained in the control inputs. In other words, it maintains what we now call current monetary policy. The result is a marked retardation of the GNP growth path compared with that in the control forecast.

To be specific, in our forecast when monetary policy begins to ease next year, growth of real GNP accelerates and gets to 4 percent by the third quarter of 1980. Alternatively, the discount rate remaining at 9.5 percent level and the monetary base growing at about an 8.5 percent rate would continue to produce a very lethargic real growth rate where, for example, even by mid-1980 the growth rate fails to

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reach 2 percent and by third quarter 1980 just manages to exceed 2 percent.

So there is a considerable difference in the rate of growth of the economy according to whether or not monetary restraint eases off after mid-year.

These alternative forecasts have very widely differing implications for the unemployment rate as well. In the control forecast in which monetary restraint is relaxed in midyear, the unemployment rate tops out at 7.5 percent in mid-1980; with the continuation of monetary restraint the unemployment rates goes through 8 percent by the third quarter of 1980. In the short run the economic cost of this alternative to the control forecast, the continued tight money forecast, is a substantially higher rate of unemployment, but with a sufficient underutilization of resources that the resulting losses in the growth of productivity negate any of the reduction in inflationary pressures which might otherwise be thought to derive from greater economic slack. In effect, the prolonging of a growth recession has its greatest immediate impact on employment and productivity, not on the rate of inflation.

The real question is whether the situation in the first half of 1979 will produce enough signals to induce the policymakers to begin to ease off along the lines assumed and suggested in the control forecast. In the Michigan model the initial sharp hike in interest rates and the dramatic economic slowdown produce a marked reduction in the rate of growth of M_2—sufficient reduction in the growth of M_2, in fact, to bring short-term interest rates down even before the assumed easing of monetary policy begins.

At the same time price and wage inflation—except for the payroll tax effects on compensation—are forecast to be moderating throughout this forecast horizon. The trouble is that the moderation of inflation in the first half of 1979 is apt to be distinctly modest. An assumed OPEC price increase, the likelihood of fairly large increases in import prices excluding oil, and the substantial hike in payroll taxes, pile a good deal of upward price pressure into the first half of 1979.

Aside from money and prices, another critical factor in the policy decision will be the extent to which the trade balance improves. I am forecasting that current dollar net exports will have shown a substantial improvement in the first quarter of 1979, and may even be quite close to a zero balance in the spring months of next year. Thus, a possible—and in my view likely—scenario as the summer of 1979 approaches is the following: Six months of distinctly moderate growth of the money stocks; nonaccelerating inflation, and perhaps even evidence of some deceleration in a number of key domestic price measures; a substantially improved trade balance; and all this with the economy dangerously close to a recession.

If this conjunction of events materializes, one might reasonably expect that the dollar would already have stabilized, if not appreciated, in the world money markets. That is a basketful of "ifs," but if so, I would expect, and regard as highly desirable, some easing of monetary restraint by next summer.

Thank you, Mr. Reuss.

[The prepared statement of Mr. Hymans follows:]

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Prepared Statement of Saul H. Hymans [1]

Macroeconomic Policy and the Economic Outlook for 1979–80

Let me begin by thanking you for this opportunity to discuss my views about the economic outlook before this Committee. This is a particularly crucial time in the evolution of the U. S. economy and the near-term outlook is being heavily influenced by fiscal policies which have recently been enacted by the Congress and by monetary policies which have recently been announced jointly by the Administration and the Federal Reserve. Let me outline those policies in terms of their features which are of central importance to the macroeconomy.

In the area of fiscal policy, one of the crucial elements is the Revenue Act of 1978 which is estimated to reduce taxes by about $18 1/2 billion in calendar 1979 -- or about twice the amount by which payroll taxes are scheduled to rise in 1979 as a result of previously legislated increases in the rate and base for social security taxes. On the expenditure side of the budget, I am projecting a Federal expenditure increase of about $40 billion for FY'79 (NIPA basis) -- virtually the same as the dollar increase in FY'78 and thus a good deal less in either percentage or real terms. For

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[1] I am grateful to my colleague in the Research Seminar in Quantitative Economics, Ms. Joan M. Porter, for her help and advice in the preparation of this testimony.

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FY'80 I expect an expenditure increase of $44 billion. In my view, expenditure increases of this size would represent a considerable — though not unlikely — amount of success in the stated goals of the President and Congress to hold down Federal spending. In conjunction with the Federal revenues derived from our Control forecast, these expenditure levels imply Federal deficits (NIPA basis) of about $28.5 billion in each of FY'79 and FY'80.

Regarding monetary policy, the monetary base, as measured by the Federal Reserve Bank of St. Louis, is projected to grow at an annual rate of about 8 1/2 percent through the first half of 1979. This represents a substantial decline in the growth rate of the monetary base as compared to the 9 1/2 percent rate over the past year or the nearly 10 percent rate over the past 2 quarters. The discount rate is expected to remain at 9 1/2 percent through the first half of 1979.

Our forecast projects an easing of monetary restraint beginning in the third quarter of 1979. The projected easing of policy is assumed to include a reduction in the discount rate to 8 1/2 percent in 1979.3 and then to 7 1/2 percent in 1979.4 and growth of the monetary base at a 9 percent rate after mid-year. I hope to make clear the reasons for the projected change in monetary policy later in my testimony.

I turn now to the outlook itself. Compared with the 3.8 percent rate of growth of real GNP now being estimated for 1978, I am forecasting a sharp decline to a 2 percent growth rate for the year 1979. Corresponding to an increase in aggregate production of only 2 percent for the year as a whole is a substantial increase in the unemployment rate to an average of 6.7 percent for the year and 7.2 percent for the fourth quarter of next year. The aggregate price level, as measured by the GNP deflator, is expected to be up by 7.9 percent for 1979, compared with a 7.4 percent increase for 1978. The Treasury Bill Rate is forecast to average 7.8 percent next year, compared with 7.2 percent this year; and the rate of growth of the money stock, as measured by M2, is forecast to decline from 8.9 percent this year to 8.4 percent next year.

The quarterly detail contained in the attached table makes it clear that characterizing 1979 as a 2 percent growth year is hiding a good deal of important information. The forecast implies virtually no growth at all in the second and third quarters of 1979. My point forecast manages to avoid any negative growth quarters, but I am forecasting annual growth rates of 0.5 and 0.2 percent in the two mid-year quarters, and that has to mean that the chances of a true recession developing after the early months of 1979 should be regarded as almost "fifty-fifty." In other words, the chances of avoiding a recession in 1979 seem to be only slightly better than the

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Summary of RSQE Control Forecast: December 1978

	1978	1979				1980				
	IV	I	II	III	IV	I	II	III	1978	1979
A. Percent Changes at Annual Rate										
Real GNP and Components ('72 $'s)										
Gross National Product	2.6	1.3	0.5	0.2	1.6	3.1	3.8	4.3	3.8	2.0
Personal Consumption Expenditures	2.3	1.9	1.1	1.8	2.6	3.3	3.2	3.6	3.7	2.4
Durable Goods	-1.3	-5.4	-3.8	-2.2	3.1	7.1	6.5	5.8	3.9	-1.4
Business Fixed Investment	4.4	1.0	-1.2	-2.7	-3.8	-2.9	-1.0	0.5	7.8	1.9
Residential Construction	-6.1	-17.2	-25.9	-22.9	-7.1	16.3	28.4	25.2	3.2	-14.0
Government Purchases	3.6	-0.4	1.4	0.5	1.8	2.7	3.0	3.2	2.1	1.9
Prices (1972 = 100)										
Gross National Product Deflator	8.2	7.7	7.4	7.9	8.2	7.1	6.8	6.5	7.4	7.9
Personal Consumption Expenditures Deflator	7.3	7.4	7.2	7.5	6.9	6.6	6.2	6.0	6.9	7.3
Money Stock (M2)	8.8	7.1	6.9	9.4	10.2	9.5	10.4	10.4	8.9	8.4
B. Levels										
Net Exports (billions of $'s)	-8.6	-2.9	3.1	7.3	12.3	16.2	19.2	22.0	-11.2	4.9
Net Exports (billions of '72 $'s)	11.5	14.3	18.0	19.5	21.3	22.6	23.4	24.2	9.3	18.3
Federal Budget Surplus (billions of $'s)	-24.8	-27.6	-27.6	-33.6	-34.9	-30.3	-24.8	-23.8	-39.3*	-28.4*
Total Private Housing Starts (millions of units)	2.0	1.9	1.8	1.7	1.7	1.7	1.8	1.8	2.0	1.8
Unemployment Rate (%)	6.0	6.2	6.5	6.9	7.2	7.5	7.6	7.6	6.0	6.7
Personal Saving Rate (%)	5.0	5.4	5.4	5.6	5.5	5.2	5.0	5.1	5.3	5.5
90 Day Treasury Bill Rate (%)	8.8	9.2	8.4	7.2	6.2	6.6	6.3	6.6	7.2	7.8
Aaa Corporate Bond Rate (%)	9.0	9.2	9.3	9.2	9.2	9.3	9.2	9.3	8.7	9.2

*Fiscal 1978 and fiscal 1979.

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chances of experiencing a true recession in which aggregate output actually declines for a time.

As shown in the table, monetary restraint can be expected to produce a substantial decline in residential building activity. The major quarterly declines are forecast to occur during the first three quarters of 1979, after which the assumed easing of monetary restraint plays a major role in reversing the drop in housing activity.

Business capital formation is forecast to be on a downward trend, in real terms, throughout the forecast horizon — the result both of high interest rates and the induced effects of the economic slowdown. Consumer purchases of durable goods are forecast to be declining throughout most of next year, followed by a substantial pick-up in the closing quarter of 1979. Much of the recovery in durable goods activity — especially the strength of the recovery in late 1979 and early 1980 — is heavily dependent on the change of policy to an easing of monetary constraint which I have assumed will be underway in the summer quarter of next year.

Charts 1 and 2 indicate why I believe a change in the stance of monetary policy will be necessary in mid-1979. Chart 1 shows two alternative growth paths for real GNP, one for the Control forecast and one for what I've called the "continued tight money" program. The continued tight money alternative eliminates the easing of monetary policy contained in the control inputs. The result is a marked retardation of the GNP growth path compared with that in the Control forecast.

The components of aggregate demand which suffer the most in the alternative forecast are, of course, residential building and purchases of consumer durables. A good part of the story is contained in the fact that the continued tight money alternative produces a Treasury Bill Rate of 8.2 percent in 1980.3, a full 160 basis points above the comparable value shown for the Control forecast in the attached table.

Chart 2 shows the alternative unemployment rates for the two forecasts. In the Control forecast the unemployment rate tops out at 7.6 percent in mid-1980; with the continuation of monetary restraint the unemployment rate goes through 8.0 percent by the third quarter of 1980. In the short run the economic cost of this alternative to the Control forecast is a substantially higher rate of unemployment but with a sufficient underutilization of resources that the resulting losses in the growth of productivity negate any of the reduction in inflationary pressures which might otherwise be thought to derive from greater economic slack. In effect, the prolonging of a growth recession has its greatest immediate impact on employment and productivity, not on the rate of inflation.

The real question is whether the situation in the first half of 1979 will produce enough signals to induce the policy-makers to begin to ease off along the lines

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Chart 1

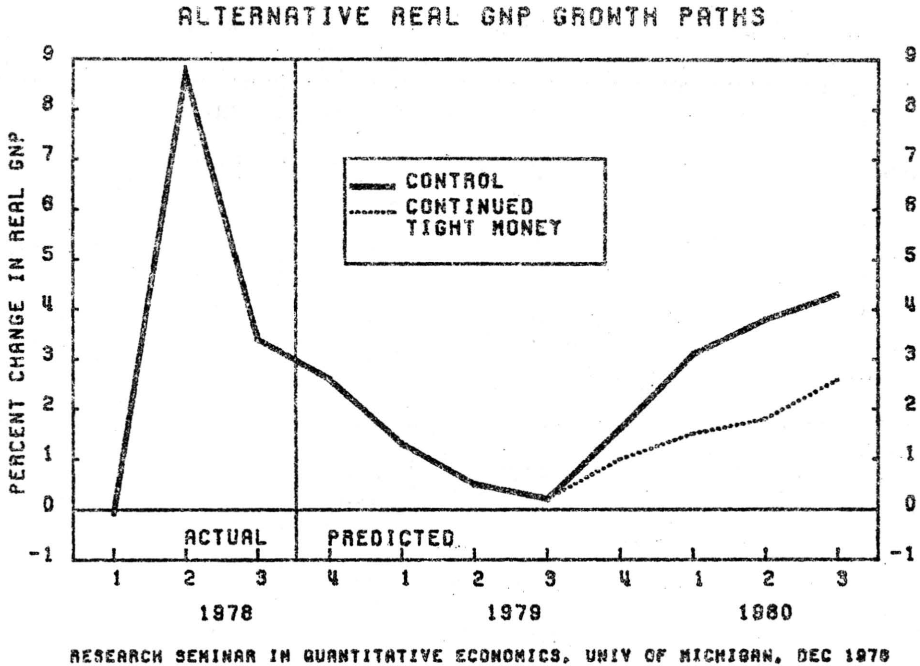

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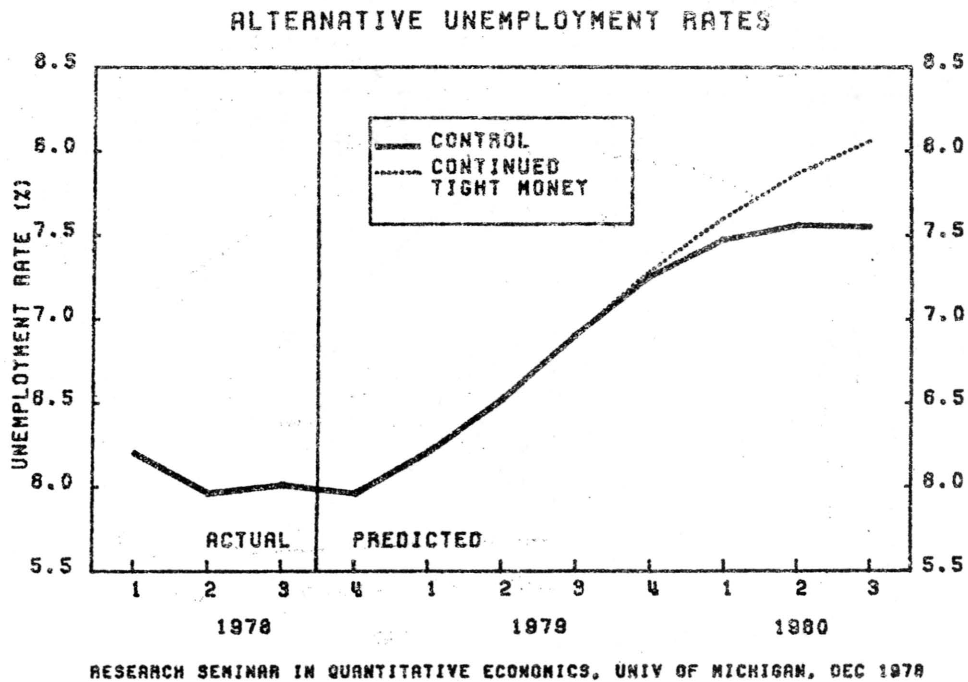
Chart 2



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suggested in the Control forecast. In the Michigan model the initial sharp hike in interest rates and the dramatic economic slowdown produce a marked reduction in the rate of growth of M2 — sufficient, in fact, to bring short-term interest rates down even before the assumed easing of monetary policy begins. At the same time price and wage inflation — except for the payroll tax effects on compensation — are forecast to be moderating. The trouble is that the moderation of inflation in the first half of the year is apt to be distinctly modest. An assumed OPEC price increase, the likelihood of fairly large increases in import prices excluding oil, and the substantial hike in payroll taxes, pile a good deal of upward price pressure into the first half of 1979.

Aside from money and prices, another critical factor in the policy decision will be the extent to which the trade balance improves. I am forecasting that current dollar net exports will have shown a substantial improvement in the first quarter of 1979, and may even be quite close to a zero balance in the spring months of next year. Thus, a possible — and in my view likely — scenario as the summer of 1979 approaches is the following:

- six months of distinctly moderate growth of the money stock,
- non-accelerating inflation, and perhaps even evidence of some deceleration in a number of domestic price measures,
- a substantially improved trade balance,

and • the economy dangerously close to a recession.

If this conjunction of events materializes one might reasonably expect that the dollar would already have stabilized, if not appreciated, in the world money markets. That's a basketful of "ifs", but if so, I would expect — and regard as highly desirable — some easing of monetary restraint by next summer.

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Representative REUSS. Thank you very much, Mr. Hymans.
Mr. Pierce.

STATEMENT OF JAMES L. PIERCE,[1] PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. PIERCE. Thank you, Mr. Reuss.

My prepared statement is so short, let me just try to read it rather than figure out how to summarize it.

I am happy to provide one more voice to the confusing array of policy analyses and advice that you have heard in recent days. I doubt that my statement will eliminate the confusion, but perhaps I can succeed in isolating some potential dangers for the domestic economy of the administration's current economic program.

It seems fair to characterize the policy moves announced by the administration in recent weeks as being a consequence of a feeling of frustration. Economic events were not proceeding according to plan. While employment and production experienced impressive gains from the 1974–75 collapse, inflation was accelerating and the international value of the dollar was plummeting.

In response to the worsening inflation and international situation, the administration apparently decided that it had to "do something," and to do it fast. As a result, a massive dollar-support program was announced; the Federal Reserve signaled a sharp increase in interest rates through a large increase in the discount rate; wage-price guidelines and general enforcement procedures were announced; and an austere Federal budget was proposed.

Since the program was announced, interest rates have shot up and the dollar has rallied in international markets. It is too early to tell whether the dollar will continue to appreciate, and it is too early to see many domestic consequences of the program, except heightened uncertainty about the future. The important questions have to do with the future.

There appears to be little disagreement among economists and other observers that the economy will experience a pronounced slowdown next year and probably slip into recession. The administration, however, continues to announce that it expects no recession at all.

I have reviewed several private forecasts and have even attempted to do a little forecasting myself. Based on these exercises, I conclude that it is very likely that the economy will experience a recession next year. The recession is apt to be relatively mild, with recovery commencing early in 1980. Assuming that a classic inventory recession does materialize, the decline in real output should be modest and unemployment might not rise much above 7 percent.

With these developments, inflationary pressures should weaken somewhat and the rate of inflation may fall to about a 7 percent annual rate. Thus, economic slowdown and recession can be expected to take the economy part way toward the administration's wage-price goals. It is unlikely, I believe, that the wage-price guidelines themselves will make a significant contribution.

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[1] Former Associate Director of the Division of Research and Statistics, Board of Governors of the Federal Reserve, 1965–75.

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In assessing the implications of policy actions, it is sometimes helpful to examine the nature of the uncertainties that face the economy. In the case at hand, it is useful to consider optimistic and pessimistic views of the administration's program. In the optimistic version, the austere monetary and fiscal actions will produce only a slowdown in economic activity. This slowdown will itself help to reduce the rate of inflation. The wage-price guidelines will then be easier to apply.

By public censure and selected enforcement activities, the administration could then achieve its goal of reducing inflation to under 6 percent. This would be achieved in large part by reducing inflationary expectations that would hold down wage settlements and lessen price hikes. In this optimistic world, American society realizes that slow economic growth and Government wage-price guidance are necessary measures for solving the Nation's inflation and balance of payments problems. Society falls into line and supports the administration's program. This optimistic views seems to be the one held by the administration.

The pessimistic view can be summarized by a single phrase: "Here we go again." The economic mistakes of the Nixon-Ford years are going to be repeated. During those years, a recession was generated in 1969–70 by monetary and fiscal policies. The recession was expected to slow inflation and aid the dollar overseas. The recession accomplished little on these scores, and it was followed by wage-price controls.

With the controls, monetary and fiscal policies turned highly expansionary in 1972. Inflationary pressures built up and the controls had to be abandoned. With the dropping of controls and the actions of OPEC, the United States experienced tremendous inflation. The Government responded by pursuing extremely restrictive policies. As a result the economy experienced its worst collapse since the 1930's.

The pessimist would view the administration's recent policy moves as the first step along the path to the stop-go policies of earlier years. Unfortunately inflation and international problems are far worse today than they were when Nixon began the series of policy blunders that followed. If the same policies are followed this time, the consequences could be even worse.

I believe that the recently anounced policies have created a great deal of uncertainty in the private sector of the economy. One can neither accept nor reject either the optimistic or the pessimistic view. If the popular forecasts are correct, the outlook for the economy is fairly favorable. Unemployment will rise somewhat, but not a great deal and there will be some progress in reducing inflation because of slackening demand.

But what if the forecast does not materialize? There are two distinct dangers that face the economy and make many participants in the private sector very uneasy. First, the recession might be worse than most observers expect. This would occur if monetary and fiscal policies continue to tighten or if consumers and business becomes more cautious than expected in their spending, or if some unexpected external development occurs such as crop failures. If the recession is worse than anticipated, it is necessary to try to guess how the Government will respond.

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One possibility is that with the falling receipts and rising nondiscretionary expenditures induced by the deeper recession, the administration would attempt to adhere to its target for the deficit by further restricting discretionary spending. Such an act would serve to worsen, further, the recession. Alternatively, the administration could respond to the recession by calling for mandatory wage-price controls. With controls it could then pursue expansionary policies, relying on the controls to limit inflation.

The second danger is that inflation could be worse than anticipated. Here again there are two possible responses by the Government. It could pursue more restrictive general policies to bring down the inflation rate through classic aggregate demand management. Alternatively it could seek to impose mandatory wage-price controls.

It is informative that in assessing the implication of either a worse recession or a worse inflation, or both, it is not possible to guess even the direction the Government might move. It might pursue restrictive policies to combat the budgetary effects of recession, it might pursue a stimulative policy in the face of accelerating inflation because it plans to use mandatory wage-price controls to combat the inflation.

It is a disturbing commentary that one of the greatest uncertainties about the future of the economy involves the direction and character of governmental policies. There currently is great uncertainty about future expenditure and tax policies, about future monetary policy and about future wage-price policy. Business and private citizens have every right to be upset with the uncertainty that the Federal Government adds to an already uncertain environment.

I think that the Federal Government could do a great service to the economy by announcing how it would respond to such dangers as a sharp recession or accelerating inflation. It serves no useful purpose for the Government to paint a more rosey picture than events justify, and it does no good for the Government to keep its contingency plans to itself. The public will have to make its own contingency plans whether it hears from policymakers or not. If the public guesses the wrong policy because none has been announced, expectational effects can swamp the Government's efforts to respond to different contingencies.

I would like to end my testimony with some comments on the current mix between monetary and fiscal policy. With the recently announced 6-month money market certificates issued by thrift institutions and banks, and with massive Federal mortgage support programs, the mortgage market has managed to withstand the current upsurge in interest rates quite well. Housing has become more protected from swings in monetary policy. The insulation of housing implies that if monetary policy is to have an effect on reducing aggregate demand, it must affect markets other than the mortgage market. This can be achieved with sufficiently high interest rates.

If interest rates rise more rapidly than expected inflation, and if they rise high enough, borrowing to finance capital expenditures will be reduced; investment will be retarded. Such retardation seems unfortunate in light of the need to improve the Nation's productivity and modernize its productive capacity.

It seems appropriate in the current context to seek a shift of emphasis away from restrictive monetary policy to more restrictive fiscal

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measures. With such a shift could come lower interest rates and more capital formation.

In conclusion, however, I think that the greatest contribution that this administration and this Congress could make to controlling inflation and maintaining real output growth lies in a commitment to a gradual and predictable policy designed to slowly reduce the inflation rate.

Drastic measures and crash programs rarely work. What is needed is a willingness to be moderate, but persistent in reducing inflation. With moderation and persistence will come a public awareness that the Government can pursue sensible policies and that the Government will cease being a source of uncertainty and instability. If this awareness is justified by Government action, it will materialize. When it materializes, the Government's own job will become much easier.

Thank you.

Representative REUSS. Thank you, Mr. Pierce.

Mr. Yeo, your entire prepared statement, as well as those of the other witnesses, will be received in full into the record. You may proceed in whatever way you like.

STATEMENT OF EDWIN H. YEO III,[1] CHAIRMAN, ASSET AND LIABILITY MANAGEMENT COMMITTEE, FIRST NATIONAL BANK OF CHICAGO

Mr. YEO. Well, Mr. Reuss, it is a pleasure to be here before you again. I don't think that I will read my prepared statement instead, with your permission, I will summarize it and proceed from there.

I think I ought to begin by saying that I am personally quite concerned about the circumstances in which we find ourselves. My concern stems largely from a substantially different analysis of where we are and where we are going in terms of the domestic economy. I think the key point was made by one of my colleagues at this hearing just a moment or two ago in the phrase "Here we go again."

Americans have been conditioned by the past. They are extremely intelligent, well informed people, and they have noticed a pattern that has led them to say their expectations have changed. The key element in the American economy in 1978—as far as I am concerned—has been tangible evidence that people expect inflation to continue and to worsen, and that they have started to conduct their affairs in a different manner as a result of those expectations.

First, there is the evidence—summarized in my prepared statement—that individuals have conditioned their expenditure decisions on the expectation of higher prices—anticipatory buying. Advertisements in the "New Yorker" and other magazines, for silver medallions—in my opinion, ghastly looking, though the advertising says that they are attractive, are an example. The interesting thing, however, is that they are claimed to be stores of value. The demand for these medallions or bars or various other artifacts reflects a shift in asset preference, away from financial assets and in the direction of holding real assets.

[1] Former Under Secretary of the Treasury for Monetary Affairs.

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This is a very rational, logical development based on our experience of past inflation. As an intelligent people, we are drawing on this experience and extrapolating it to the future. You could say that this is consumer inventory accumulation. It has required enormous financing and is the reason why we have witnessed, month after month, reports by the Board of Governors of large increases in consumer credit. As you know, various relationships, such as measurements of consumer debt burdens relative to income, or relative to assets, have shown an appreciable erosion in consumer liquidity—a logical result of the kinds of attitudinal shifts that we think we discern.

Businessmen also have charged their attitude, based on their experience in 1974–75 and the horrible inventory excesses that were revealed by that recession. To date, they have run quite lean inventories as a whole. They have operated with a set of expectations that, in effect, involved a fear of recession in the future, and a memory of recession in the past.

We think that is beginning to change. Month after month of pricing increases, particularly in the crude materials area, and developing shortages, lead us to believe that *ex ante* inventory preferences by some sectors in business are changing—and changing very rapidly.

These two areas—consumer behavior and the change in inventory preferences—are likely to propel the economy in money terms quite rapidly into 1979. Frankly, the economy has been moving a little bit more swiftly than we had expected, particularly in the fourth quarter. We expect that this strength will continue into the first half of the year.

However, these are the symptoms of a warped expansion, an expansion characterized by a consumer boom which has been fueled by expectations of continuing inflation and financed by enormous amounts of credit.

Federal Reserve policy has largely facilitated this process—at least until recently. We do not interpret the increases in interest rates up to November 1 as attributable to the Federal Reserve. If anything, the rise in interest rates up to that point did not fully reflect expectations.

We are near full employment both in terms of real resources, and in terms of people, at current price levels, and, we think, at full employment in financial terms.

Another manifestation of the kind of economy we are living in is the depreciation of the exchange rate. Our current account deficit is another understandable and lamentable consequence of this situation.

The question is, What can we do about it at this stage? The administration's program, as I understand it, contained, first, a financing package, a very large financing package. That is what it amounted to. They said $30 billion—well, we will call it $30 billion. But it also involved a change in the nature of the financing—including, they said, and they have done so in their DM issue, some longer term financing. Second, it involved a change in monetary policy, the substantive part represented by an increase in reserve requirements on large denomination CD's. And the third part was the promise to the American people; namely, that there was going to be continued change in policy so that, "Well, fellas, we didn't get it right, but we are going to get it right."

I think that our discussions about appropriate policy initiatives should involve much more restriction in terms of Federal Government

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expenditures. For example, I think that we ought to freeze expenditures at 1978 levels. And I think that we ought to legislate a prohibition against wage and price controls because, frankly, this is another area where Americans have very, very, active memories. Their attitudes and actions today are conditioned by their memories and interpretations of the past. Voluntary wage and price efforts simply titillate the memories of the past and might prompt action—no matter how well intended everybody is—that really is countervailing in terms of overall policy.

In terms of our external situation, we have experienced some improvement in the foreign exchange markets. As you know, Mr. Reuss, the test is not how the dollar is behaving in the short run, but rather, how much intervention or lack thereof was required to make it behave in a certain way.

I personally wish that interest rates were lower. The easy way to reduce interest rates is more policy, more conditionality. The process is like a pair of scissors, one blade is interest rates and monetary policy, the other blade is Federal expenditures and fiscal policy; both must move.

What we have to do, both internally and externally, is to change expectations regarding future price performance in this country. As soon as those expectations are changed, interest rates will appear to be high, at whatever level. That, in turn, will elicit capital inflow, stabilize the dollar, and will obviate the need for large-scale intervention.

In summary, Mr. Reuss, we don't see any difference between external considerations and interests and our domestic considerations and interests. We think they are one and the same.

We are hopeful about the administration's package, its program. We interpret it as a beginning, not the end, and we feel that we are going to have to do more if we are to safely stabilize the American economy.

[The prepared statement of Mr. Yeo follows:]

Prepared Statement of Edwin H. Yeo III

INTRODUCTION

Mr. Chairman, it is a pleasure and an honor to appear once again before this distinguished committee. I confess, in looking back over the times that I have appeared before you, that the learning process has always been inverted—I have acquired more knowledge than I have given. I expect that it will be the same today.

In its broadest outlines, the committee's inquiry is based upon the policies that have come to be called the "November 1st Package", viewed in the context of the policy announcements that preceded it and further refinements that have followed. A frequently heard description of this "package" would be:

A $3 billion increase in reserve requirements on large certificates of deposit and a rise in the discount rate by a full 1 percent;

An increase in Treasury's monthly sales of gold to at least 1½ million ounces per month, starting with this month's auction;

A decision to join with Germany, Switzerland and Japan in closely coordinated exchange market intervention;

The mobilization of $30 billion in DM, Swiss francs and yen to finance US intervention including $15 billion in swaps with Japan, Germany and Switzerland; IMF drawings of $3 billion; sale of about $2 billion of Special Drawing Rights; and issuance of foreign currency denominated securities in amounts up to $10 billion.

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The word package, so often used in everyday conversation, arouses apprehension. "Package" connotes something finite and something placed upon the table in completed form. My interpretation of November 1st is different. It appears to me that the announcements on that date could be divided into three parts:

A change in monetary policy (the substantive component being the increase in reserve requirements);

An enlargement of and a shift in official financing facilities;

And a promise.

On the basis of the above interpretation, I congratulate the Administration and support these initiatives. Of the three parts, the promise is the most important. It was, as I interpret it, a promise to the American People that economic policy in this country would change. A change based on the delayed recognition that an overheated US economy poses a threat to our livelihoods and those of our friends throughout the world. The promise implied a process of informing the American people as to the nature of our circumstances and our alternatives. Such a process is inconsistent with the term "package".

I would like to think that these hearings are an integral part of this process. In this spirit let me begin with a discussion of current economic conditions—facts that should not be a source of disagreement. Do the measures taken since October 29 contribute to the achievement of our basic policy objectives—the maintenance of a steadily expanding economy and increasing standards of living in the environment of stable prices?

THE ECONOMY IN 1978

The facts, as I know them, are the following:

Income and Employment Gains Continue Strong

Since January civilian employment has increased by three million; since the trough of the last recession the economy has added eleven million jobs. At the same time overall unemployment has fallen. In November the unemployment rate for married men stood at only 2.5 percent and the most sensitive indicator of labor market conditions—wages—has indicated progressive tightening. Compensation per manhour for the non-farm business sector has steadily risen from a 7.7 percent year-to-year increase in the fourth quarter of last year to 9.4 percent in the third quarter of 1978.

Consumers Expect Further Gains in Income and Employment

Retail sales grew very rapidly in October and November. Savings rates have sunk to historically low levels. We estimate that the savings rate in the fourth quarter declined further from the 5.1 percent rate of the third quarter.

Industrial Activity Is Strong

Industrial production gains have not slackened, contracts and orders for capital goods, in real terms, show year-to-year gains near 20 percent. Some might point, Mr. Chairman, to the relatively modest gains in inventory as evidence that the recovery remains well-balanced. But, this balance is a very fragile, and perhaps illusory.

We Are At Full Employment Of Capital and Labor

Inflation is unlikely to decline in the foreseeable future. We have entered the phase of the expansion where marginal additions to output can be realized only at progressively higher costs. Capacity strains have been evident for some time. The upward pressures on prices from increases in aggregate demand are continuing.

One evidence of capacity strains has been the rapid rise of raw material prices and backlogs. Backlogs rose at a 16 percent annual rate in the six months ending October—and there has been a comparable rise in prices. The rapid accelerations in raw material prices and backlogs may be the first concrete signs of a change in businesses' previously cautious attitudes toward inventory, both on hand and on order.

Such a shift would help propel the economy into next year but would also further strain productive capacity. As measured by the Federal Reserve's index of capacity utilization, the economy was operating at 85.3 percent of capacity in October and will likely reach 86 percent by the end of the year. This would be the highest level in recent years. In the second quarter of 1974, when measured

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utilization reached 85.8 percent, severe capacity constraints had begun to emerge, particularly in raw materials industries. The only reason that we have not faced similar problems up to this point is that capacity rates have been more balanced across sectors and, as a result, we have not yet seen more evidence of speculative inventory behavior.

We Are Approaching the Limits of Our Financial Capacity

Federal government credit demands remain unusually high for an economy in its fourth year of expansion. The Federal deficit is currently running at an annual rate in excess of $40 billion, while the aggregate operating surplus of state governments is likely to have been virtually eliminated in the course of 1978. Investment and inventory expenditures have made the business sector which was a net provider of funds to the economy between 1975 and the first half of 1977, a heavy demander of funds. Loans through the domestic banking system and commercial paper markets to non-financial corporations increased 16 percent between November 1977 and November 1978 and may expand at an even more rapid rate during the coming months. Businesses' response to rising prices has been to add liabilities at the expense of liquidity. The domestic liquidity ratios of non-financial corporations have fallen back to the very low levels reached in early 1975, in one of the sharpest such declines during post-war period.

The strains on our financial capacity have led to higher interest rates. We have failed to recognize the strains, Mr. Chairman; we have attempted to offset these pressures on interest rates by pursuing more accommodating monetary policies. It is not correct to say that our monetary policies have been directed towards raising interest rates. Our monetary policies—with money growth, year-to-year, at roughly 7 percent have had the effect of initially preventing interest rates from reflecting financial realities and then only with a lag increasing upward pressures on rates.

Let me explain.

INFLATION AND INTEREST RATES

When individuals expect rising inflation, it requires that interest rates rise well above the anticipated inflation rate to dampen the demand for credit and slow inflation. A 10-percent mortgage rate doesn't deter home buying if home prices are expected to keep rising at 15 percent a year, and a 12-percent rate doesn't dampen a businessman's urge to accumulate crude materials if these prices are expected to keep rising at a 20 percent or more rate.

Expectations of higher prices, unless interest rates fully reflect them, undermine our ability to attract the pool of savings—foregone consumption—necessary if we are to add to our productive capacity. What attraction has a savings account to a small saver if he expects that prices will rise by 10 percent in the next 12 months?

Consumers have learned to look at interest rates in real terms. Credit card purchases willingly financed at an 18 percent interest rate when expected inflation was 6 percent are even better bargains today when inflation is expected to be 10 percent.

By refusing until recently to allow interest rates to mirror the increase in expected inflation, the Federal Reserve has encouraged consumers to borrow heavily. Their response has been predictable. Encouraged by apparent rising equity values in housing and other assets, the consumer in the first ten months of this year has added roughly 27 cents to his installment debt burden for every dollar increase in personal income.

Accelerating expectations of inflation generate massive demands for credit in order to beat price increases, to hedge against or to speculate on inflation.

This new recognition of inflation helps to explain how the share of consumption, including consumption outlays by the government sector, has risen from less than 75 percent of output in 1970–73 to roughly 77.5 percent in the past three years.

The effect of the declining consumer savings rate on the economy has been complicated by below average returns to the business sector. New investments by non-financial corporations are inhibited by two difficulties—inadequate return on existing investment and the weight of government borrowing in the credit market.

In 1977, non-financial corporations reported pretax earnings of $143.5 billion, 10 percent above 1976. When these profits are adjusted for inadequate depreciation (including double-declining balance depreciation) and to reflect inventory costs at replacement value, these corporations had just $3.5 billion (after taxes,

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dividends, and mandated EPA/OSHA requirements), to meet the need for new additions to the capital stock. Over the past five years, retained economic profits by this measure total a negative $22 billion, providing no incentive to add new capacity longer-term; in 1978, retained economic profits are again likely to come in negative.

This might not be an insurmountable obstacle to new investment, but it is made more difficult by the ubiquitous presence of government borrowing in the credit markets. Even with the proposed reduction in the Federal deficit, the overall level of government borrowing will rise in 1979 because of higher borrowing of states and localities—now moving into deficit on their overall current accounts—and off-budget agencies of the Federal government.

In the past, large government deficits would have given the economy a temporary boost. People were slow to translate more rapid monetary growth into expectations of higher inflation. We face an entirely different game today, and one with different rules. What is particularly unique about the current situation is that people not only full anticipate inflation, but may even have exaggerated expectations of future inflation.

This process runs the risk of the "greater fool" syndrome. Consumers are bent headlong on taking on more monetary debt relative to monetary assets in order to acquire a variety of illiquid real assets—a process that leaves them vulnerable if anticipated income gains fail to materialize. Furthermore, the prices of supposed hedges against inflation (including houses) already incorporate the expectation of considerable future inflation. And many hedges (such as gold) share the volatility of commodity prices in general. Even if such prices continue to keep ahead of inflation over long periods, they might lose value in hard times when people most need to acquire cash. Buying things to hedge or speculate against continued inflation can only continue so long as others are both willing and able to bid up the affected prices. When financial constraints put a lid on the process, as sooner or later they must if inflation is to be tamed, the notorious search for a "greater fool" must come to an end.

The behavior of the foreign exchange markets closely parallels this new "rationality" on the part of the consumer and business. The dollar's precipitous decline against the yen, the mark, and the swiss franc in international capital markets reflected the markets' expectations of accelerating inflation in the U.S.

It is important to realize that the marked weakness of our balance of payments during 1977 and 1978 was only partly caused by relatively faster growth in the U.S. than abroad. The dollar fell as we accumulated a massive trade and current account deficit to meet growing demands for imported goods and services. Relatively slower growth in our major trading partners meant that foreign demand for our exports remained depressed.

Countries import and export capital as well as goods. The effect of trade and current account imbalances on a currency can be reinforced or offset by capital flows. If we run a deficit on current account and also experience a capital outflow, then the dollar is likely to come under sustained pressure. Foreign central banks and the Federal Reserve can offset only some of this pressure through exchange market intervention; inevitably the exchange value of the dollar will fall.

During much of the last two years, with the U.S. current account strongly in deficit, there has also been a large net outflow of capital, especially private capital. International capital flows are conditioned by relative financial rewards and risks between assets denominated in different currencies. At the margin, investors were unwilling to hold dollars despite higher nominal short-term interest rates in the U.S. than in other major countries. Although interest rate differentials have progressively widened in favor of the United States, capital flows have not responded. Clearly the differential has not been great enough to compensate for increases in expected U.S. inflation, which is another way of saying, expected dollar depreciation.

In this situation, other countries have two alternatives:

First, to adopt policies intended to rapidly increase domestic output, at the potential cost of higher domestic inflations rates, in order to accommodate higher aggregate demand from the United States without reducing their own expenditures, or

Second, to maintain cautious economic policies, continue to reduce inflationary pressures, and divert output from domestic consumption to exports.

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The response to the huge expansion of dollars internationally in 1977 and 1978 was mixed. Initially, most major industrial countries intervened to slow their currencies' appreciation while others intervened only to smooth the dollar's decline, to avoid the potential inflationary pressures caused by the expansion of their monetary bases. Countries like Italy and Spain depreciated along wth the dollar, improving their own competitive positions against strong currency countries. As the fall of the dollar accelerated, European countries generally abandoned the support operations, in effect trying to insulate themselves from the inflationary pressures being generated in the U.S. economy.

The developing countries, on the other hand, have mainly depreciated against the dollar, seeking continued high nominal growth rates at the cost of accelerating inflation. Many developing countries including several Asian countries, have taken the opportunity afforded by capital outflows from the U.S. to increase their long-term borrowing. An excess supply of dollars has allowed countries to borrow on better terms regardless of their domestic situations.

These countries are acting with somewhat the same motivations as nonfinancial corporations and households in our domestic markets. Like domestic borrowers, foreign borrowers of dollars base their decision on the expectation that continued inflation in the U.S. will progressively reduce the real burden of the debt repayment.

Higher long-term borrowing by these countries carries with it an increase in their debt service requirements which is not necessarily offset by higher export revenues. It is one of the ironies of the current situation that our country, which professes great concern about debt service problems in developing countries has pursued policies that have had the direct result of encouraging higher rates of debt formation.

This should be a point of fundamental concern. Our domestic instability—inflation—has contributed to external instability in the form of capital outflows and payments imbalance. There are not separate domestic and foreign dollar markets. There is only one dollar market, and we should not be surprised to find that excesses that are developing domestically are simultaneously emerging in the international arena.

THE DOLLAR "RESCUE" AND ANTI-INFLATION POLICIES

Expectations of double-digit inflation domestically were matched by the precipitous fall of the dollar on foreign exchange markets. As October progressed, external financial instability spilled over into domestic financial markets. The bond market weakened, and the stock market sagged. This was the uncertain environment which the Administration attempted to address with the October and November fiscal and monetary measures.

There are five dimensions to the Administration's program.

Moderate reductions in the budget deficit during the current fiscal year and the next,

Wage and price guidelines intended to dampen price expectations,

A commitment to deregulation and increased competition,

Higher interest rates, and

More aggressive U.S. intervention in the foreign exchange markets.

The fiscal policy proposals—to reduce the deficit to $39 billion in FY 1979 and to $30 billion in FY 1980—are simply inadequate. They do not stem the rise in government spending. They will not reduce the total of government pressures on the credit markets. The reduction in the deficit at the Federal level will be dwarfed by the swing towards deficit in the aggregate operating accounts of the state and local levels.

What is not recognized in these moderate reductions is the importance of changing expectations. Until a major shift in government expenditure policies is broadly perceived, there is little likelihood that minor reductions in the deficit will play any role in restoring confidence in government or in our ability to pursue policies directed towards price stability.

This is equally true of guidelines. Whether voluntary or mandatory, they do not enjoy a distinguished track record either here or abroad. Controls attempt to alter market behavior. They do not slow the rate of increase in spending or of money incomes, which ultimately parallel the growth of the money supply. If money is still pouring into the economy, somebody is going to spend it and somebody is going to receive it. Guidelines only affect the distribution of the new

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money—that is, they are a device for shifting the burden of inflation. Economic controls tend to demand irrational individual behavior—to forsake real or financial protection from inflation—in the interest of trying to lower the overall rate of price increases.

Regulation is strangling our markets and eroding our effective capacity. Over-regulation breeds more regulation to regulate the regulators. But I am concerned that Administration sentiments for deregulation are not being translated into actions, and evidence that for every well publicized deregulation victory there seem to be three new regulations. I propose a simple test: will there be a meaningful reduction in the number of new pages being added to the Federal Register.

INTEREST RATES

The government's dollar support program included a percentage point increase in the discount rate and some tightening of the federal funds rate. I have already suggested in effect that high interest rates are not necessarily synonymous with tight money. Since both demand and supply curves determine the price of money, high nominal interest rates can be caused by demand outpacing steadily expanding supply. The increase in the discount rate at least validated market pressures and allowed interest rates to align more closely with inflationary expectations.

The new monetary targets for M1 (2 percent to 6 percent) for the hybrid aggregate M1+ (5 percent to 7½ percent) lower the upper bound on M1 growth by one half percentage point. But the new approximation to "transactions" balances, M1+, now has a growth target even higher than the range formerly used for M1 (4 percent to 6.5 percent).

As you are well aware, Mr. Chairman, the credit markets now scan every nuance of our monetary policies. They have developed an extraordinary sensitivity, as manifested in the attention paid to weekly money data. This attention would be frivolous except that in the past we too often have made policy on the basis of short-term crises. A part of the November 1 promise to the American people and to the world at large must be evidence of the long-term sincerity of our commitment to moderate monetary growth. It is far too early to say that we have made progress in this commitment, and we must realize that we will be evaluted relative to our past excesses. Our word alone does not carry the weight it once did.

INTERVENTION

The U.S. has committed itself to more active intervention in foreign exchange markets. Such operations address symptoms rather than causes and by increasing liquidity in foreign financial systems run the risk of increasing inflation abroad. Moreover, intervention must be viewed in a global context. The policy of buying dollars in Frankfurt and then selling them in New York through domestic open market operations is inconsistent. Such policies can achieve only temporary exchange rate stability. The location of dollars—the distinction between domestic and Eurodollars—has little meaning in a world of integrated and increasingly efficient capital markets.

Exchange rate management cannot substitute for market determination of exchange rates except at great risk. Exchange rates must reflect fundamental economic conditions.

Financial bridging operations basically assume that the exchange markets are irrational. Massive intervention presumes that markets do not understand present or anticipate future economic conditions. However, to my mind the evidence on this score favors the markets and not the intervenors.

The danger that the November dollar "rescue" operation may become primarily an international financing operation should not be discounted. Without the support of appropriate domestic policies, such an operation cannot provide a lasting basis for dollar strength and the "$30 billion" could be quickly exhausted. Foreign willingness to import U.S. inflation by supporting the dollar would disappear at the same pace.

DOMESTIC RISKS

A policy of moderation is not without risks. A much greater risk, however, is that if policies have not been changed and that inflationary expectations continue, while actual inflation rises. A cure which appears risky and, potentially painful, may prove excruciating if delayed.

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We must realize that a modest recession—the "soft landing" conceived by many forecasters—is not only increasingly unlikely, but also will not succeed in modifying inflationary pressures. In 1974–75 it proved quite difficult to get inflation down from more than 12 percent to less than 5 percent; that alone should serve as a warning of the peril of delay or dilation. It should have proved easier to reduce price increases from that point to our postwar low of less than 2 percent. But we were seduced by an economic fallacy. We associated high levels of unemployment with low pressures on prices. We believed that the economy was characterized by an underutilized capital stock, and were lulled into a false sense of security even as excesses developed.

The key question remains: Is the US economy headed toward a recession next year because of the measures adopted in October and November? And the answer has to be exactly the opposite. If the U.S. economy is headed for recession, it is because measures were not adopted *before Novemmber*. The importance of the November decisions is that they began a process of policy adjustment—the bridge and the promise.

U.K. REVISITED?

Some analysts have compared the current economic and financial situation in the United States to the situation which existed in the United Kingdom in 1976—and there are similarities. Both the pound and the dollar were under significant exchange market pressures, suffered from weak external payments positions, sought international financing arrangements to bridge the economic adjustment process, and adopted measures to both reduce the public sector deficits and raise nominal interest rates.

There are other similarities. During 1976 credit demand in the U.K. was rapidly increasing: private sector demand for sterling liabilities increased at the same time that the government's borrowing requirement remained large. Simultaneously, Britain's price performance began to deteriorate. Inflationary expectations began to re-accelerate.

The analogy between the U.K. and U.S. situations has several glaring weaknesses. The British economy in 1976 was at the beginning of a cyclical recovery from its deepest post-war recession. Productive capacity was significantly underutilized. Industrial production remained below levels attained three years earlier; unemployment was rising even while wage pressures increased.

As the British crisis unfolded, both private and official sterling holders sought to diversify into "stronger" currencies, reinforcing sterling weakness. Major central banks helped UK authorities resist these pressures through an increasing level of official intervention.

The government's reaction to the developing instabilities is also interesting. In June 1976, with sterling under strong pressure—the pound had fallen some 15 percent during the previous three months—the British arranged a six month bridging loan from the Treasury, and U.S. and European central banks agreed to finance intervention operations. In July a mini-budget was announced which included 2 billion pounds in expediture cuts and tax increases (in particular. an increased surcharge on industry) and in September the minimum lending rate was raised to 13 percent.

These measures had little effect on the economy and after an August lull sterling came under intense pressure. Even after the MLR was raised to a record 15 percent in October, the pound remained under pressure arising from capital outflows and speculative movements in payments leads and lags. Interest rates, high in nominal terms, were not perceived to be high relative to the prospects for inflation. Neither the exchange markets nor the British people believed that the underlying direction of economic policy had changed.

But by the end of 1976 British authorities announced measures to complement the earlier interest rate increases. Strict limits were placed on the level of public spending for both 1977 and 1978, and plans were announced to reduce the rate of domestic credit expansion.

These policies were viewed as being draconian. They would not have been ncessary had meaningful moderation been accepted earlier. But they succeeded in altering expectations of future policies as a solid political consensus in support of these policies developed. It was not an overnight development, but as confidence returned, interest rates which under earlier expectations seemed low, now seemed high. Credit demands moderated, the financial markets stabilized and capital flowed into the country.

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ALTERNATIVES

I began by suggesting the basic goal of economic policy ought to be sustained economic expansion. The obvious preconditions are domestic and international price stability. The test of the Administration's policies is whether they contribute to this goal.

Our economy needs lower, not higher, interest rates. But lower interest rates require stable monetary policies and controlled government spending. Through lower spending, the Federal deficit could be eliminated: if the public sector became a net supplier of funds to the economy, then credit pressures on business and households would ease.

This could be accomplished by an immediate across-the-board freeze of Federal expenditures. Such a freeze could be implemented in a variety of ways. If outlays were maintained at FY 1978 levels through the current fiscal year, the Federal Government would be approaching balance, compared to a presently projected $40 billion deficit. On the other hand, if expenditures were held at the level reached at the end of the fiscal year, then the FY 1979 deficit would be on the order of $26 billion. These funds would be effectively returned to the economy, providing substantial relief to the credit markets. Most importantly, an expenditure freeze would best be accomplished by sharply reducing the federal government deficit. heretofore accurate assumption that there will be no significnt budget restraint.

A second legislative priority should be to remove the threat of economic controls. The Congress should move quickly to prohibit the imposition of wage and price controls and to insist on prior consultations before so-called voluntary guidelines are announced. This is the only way that expectations of "controls" can be quieted and the damage caused by such expectations limited.

When these policies are implemented, the conduct of monetary policy will be made somewhat easier. Reducing the government's heavy presence in the credit markets would facilitate moderate expansion of the monetary aggregates. A dramatic spending freeze would demonstrate to a skeptical public the sincerity of government's commitment to reducing inflation. This would certainly mean greater structural economic stability and reduce perceived risks of doing business in the United States. Capital inflows, attracted not by higher interest rates but by the prospect of lower inflation, would strengthen the balance of payments and the capital base of the economy.

In short, our domestic policy goals require that the United States avoid a recession. To accomplish that at the present time primarily requires a significant change in inflationary expectations. Economic policy must induce people to believe that price increases can be reversed, that interest rates are already high. Secondly, avoiding a recession requires a reduction in credit demands which would best be accomplished by sharply reducting the federal government deficit.

The alternatives—lost real output, structurally higher inflation and less capacity over the long term—should make the policy choice extremely easy.

CONCLUSION

My analysis of the basic condition of the U.S. economy, of the international credit markets, and the example—not a guide, but rather the example—of the U.K. situation, convinces me that:

Markets are behaving entirely rationally. Nothing that we can say will convince the domestic borrower or the seller of dollars that they have been wrong to react as they have. They require a clear signal, such as a freeze on Federal spending—a clear and unequivocal sign of new policy guidelines.

Wage and price guidelines cannot play this role. Rather than being a signal of a change in policy, they are perceived as an attempt to maintain the status quo.

Domestic capacity, physical and financial, such much more strained than many realize.

To break inflationary expectations in an inflation prone economy will require a significant departure from past policies.

Representative REUSS. Thank you very much, Mr. Yeo.

Professor Modigliani, welcome.

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STATEMENT OF FRANCO MODIGLIANI, PROFESSOR OF ECONOMICS AND FINANCE, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. Modigliani. I regret that my commitments have made it impossible to turn in a prepared statement.

The purpose of the hearings, as you have announced, Mr. Reuss, is that of examining the domestic implications of operations to rescue the dollar.

I have pondered over these words of yours. I thought there was something that didn't sound right to me, and finally I understood why I disagreed with the formulation. Of course, you know I have great respect for your thoughts, but I found in it something that needed reformulation.

The reason is that there are two meanings to the words "rescuing the dollar." One is rescuing the external value of the dollar and the other is rescuing the internal value of the dollar, that is, its purchasing power. Now the way you presented the question was as though we were going to discuss how a set of gimmicks, which were designed to salvage the external value, were going to offset the domestic situation.

It seems to me that these two problems cannot be separated, since the external value impinges on the internal value and the internal value impinges on the external value. It is in fact quite clear that a major determinant of the external value of this dollar is its internal value, through the so-called purchasing power parity principle.

But it is also clear that the external value impinges on domestic inflation. As a matter of fact, I understand that Mr. Schultze in his testimony yesterday morning stated that over the last year the effect of the 10-percent devaluation of the dollar might be assessed at something like a 1-percent contribution to the domestic inflation.

Now, 1 percent, Mr. Reuss, as you know, is a gigantic number when we realize that in terms of what we know about fighting inflation, the only tool we know that works—not well, but it works nonetheless—is unemployment. And it has been estimated that it might take as much as a 2-percent unemployment for 1 year to offset 1-percent rise in inflation. And 2-percent unemployment is roughly a 5-percent loss of output, which at today's $2 trillion economy is $20 billion. These estimates, though crude, serve to give an idea of the serious domestic costs of external depreciation.

Clearly then we must be concerned with it for its reflections on the internal economy. I would suggest, therefore, that what we really ought to discuss here is how the operation the administration has launched recently is going to affect both the external and internal value of the dollar and the relation between these two.

There is a good reason why one might want to undertake operations to preserve the external value when there are grounds for thinking that the external value might deviate appreciably from what is economically warranted. We do know, at least most of us agree, that the market isn't always right. The market may at times overshoot the mark, and the trouble is that in a system of floating exchanges, the overshooting may, within limits, be self-fulfilling.

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That is absolutely clear in countries in which wages respond promptly to prices, through indexation or otherwise, such as Italy, Spain or some of the other European countries like England. It is easy to show there that if, by mistake, the exchange rate falls 5 percent below the initially warranted level, the result would tend to be a rise in wages and prices which would tend to validate the lower exchange rate. This possibility justifies being concerned with the external value per se.

When we look at the problem this way, I think we must agree that what the administration was trying to do was primarily to rescue the domestic value of the dollar, because I think there can be no question in anybody's mind that today that is the real problem facing the American economy.

We have had, unfortunately, a serious deterioration in the behavior of inflation, in the course of 1978. This deterioration, which is in the order of moving from a trend of 6–6.5 percent to something like 8–8.5 percent, unfortunately can be blamed on the administration to only a moderate extent. I think that the administration is not blameless. I think many people would agree that there are at least three things for which the administration can be criticized. First, the minimum wage legislation, which has been rather expensive in terms of inflation; second, an agricultural policy; and third, the social security policy, that is, raising social security taxes in the face of a situation where such a raise unavoidably contributes to the rate of inflation. And I must add that it isn't just the administration one should blame, but also Congress, because all these measures were passed with approval of Congress.

Another contributing factor has been, as noted earlier, the external depreciation of the dollar, which perhaps might have been avoided by more active market intervention, though that is a much more debatable question.

However, though these various factors have contributed some, they are certainly not the whole story. So one must look at some other exogenous forces such as the behavior of food prices and the behavior of productivity, which have been mentioned by Mr. Schultze.

Perhaps there are other forces which are not fully understood. Perhaps there has been, as Mr. Yeo suggested, some rekindling of the inflationary attitude or frame of mind. Certainly we are aware of some speculating excesses. One can easily point to the housing market as a place where in many regions clearly prices have been inflated by what must be described as a speculative bubble.

In the face of these circumstances, whether they are our own doing or an act of God, there seems to be no question but that we must take care of bringing down that inflation.

We do not need to discuss here again the question of why inflation is socially and economically costly. It may well be that in the mind of the public, inflation appears worse than it really is. On the other hand, inflation is a lot worse than most economists think or used to think. So there is little question that we must act vigorously to bring it down.

To accomplish this task, one can think of many finesses; but, as mentioned earlier, the one blunt tool that seems in the long run to work more or less well, is clearly a slack in the economy.

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I think that the administration's operation should be seen as a conscious attempt to respond to the rising inflation, of which the deteriorating exchange rate was a symptom and perhaps contributing cause as well by cooling off the economy in order to reduce inflation.

So I would see the increase in interest rates primarily as having a domestic goal, and not just that of attracting foreign capital. But then there is no point in asking "Are these measures undesirable because they are going to cool off the economy?"

The answer is that we should hope they do, because if they don't, then they have been a failure. They were intended to do exactly the kind of painful thing that you, Mr. Reuss, do not like, and I do not like, but which we have to accept as unavoidable at this juncture.

The question still remains however: How much is the right amount of cooling? That is a delicate question that we couldn't discuss in just a few minutes here. But let me say that I do object to the fact that the administration, or some of its spokesmen, are engaging in a certain amount of doubletalk. The theme one hears is, "We want to cool the economy, but also we want to avoid a recession, and you can be sure there will not be a recession."

Mr. Blumenthal said yesterday, as I understand, that there will be no recession. There will be a growth of 2 to 3 percent.

Now there are two possibilities: First, his growth figure may refer to the change for the whole of 1970 over 1978. If he is talking about this, as most other people are, then he comes under serious suspicion of double talk. For a 2 percent year-over-year growth means almost unavoidably a couple of quarters at minor contraction, or at least stagnation, and that is what in essence we mean by recession.

On the other hand, if he talks about 2 to 3 percent from this quarter to fourth quarter of 1979, then we are in bad trouble because that means we are not cooling the economy. Indeed, that might mean 3.5 to 4.5 percent growth in terms of year over year, which would be excessive in my view in terms of what we are trying to achieve.

I wish the administration would be more precise and I wish Congress would insist on more specific targets. Of course we can't expect a target to be hit precisely.

But it would be important to know what the administration is aiming for and why, so that we can discuss it and see whether it is a sensible number.

There are, of course, other possibilities. There are temptations perhaps to rely on other tools and the usual other tool one talks about is income policies. I think there is a broad agreement among economists and thoughtful people that there is no hope in wage and price controls, and I can only say that I am very proud that in 1971, a few months before they were instituted, I testified before this committee recommending and pleading not to try that experiment. Unfortunately, I was preceded by Ken Galbraith who made the opposite point and he clearly carried the day.

The trouble with Galbraith is that he speaks too eloquently. It doesn't mean that he is right, but he speaks well. [Laughter.]

The administration has been trying to take a different approach, the approach of voluntary, more or less voluntary, programs. This is not the approach of prohibition, "Thou shalt not," but the approach

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of the carrot and the stick, the stick being the penalty of procurement cancellation; and the carrot being the so-called inflation insurance.

I think that it is right for the administration to try these ways out. They represent a tangible expression of concern and as long as they are voluntary. I think they cannot do very much harm, and may do a little good.

Unfortunately, I have real questions as to whether you can succeed with the so-called inflation insurance because it seems to me the technical problems involved are formidable. I read recently an article of Mr. Ullman explaining those difficulties and they are exactly the same that I have myself pointed to in some writings of mine. I think there are formidable difficulties, but it is certainly worth trying the best. But these measures will not do very much.

They will only help if there is slack in the economy. The more the slack, the more they are likely to help.

The other thing that perhaps I would like to suggest to the Congress is that they keep after another angle. Let's recognize that inflation is with us and we do not know of any way that will get rid of it fast. Hopefully with some luck we will be able to decelerate a couple of points not too long from now—but it is a long process.

I suggest therefore, that Congress should still give attention to various measures that will make inflation less painful. One has to distinguish between two effects of inflation. One is in terms of what it does to past contracts; the other is what it does to newly entered contracts.

Now, there is nothing one can do in practice about past contracts. Inflation, even though perfectly foreseen from now on will be very damaging to those who have, let's say, a pension written in the past in nominal terms. But for those contracts that are newly written there are things that can be done. As a matter of fact, the recent decision of the administration to allow the thrift institutions to issue special certificates which carry a market rate is exactly in the direction of reducing the cost of inflation.

One of the great problems has been in the past that poor people confronted with 7- or 8-percent inflation were only allowed to earn 5 percent on the kinds of instruments that were available to them. They did not have the means or the sophistication to invest in instruments whose return more adequately reflected the varying course of inflation.

I still think that stopping at what has been done so far is grossly unfair because now we are saying if you have $10,000, you can escape one cost of inflation, but if you are really a small holder, you are still under the 5- or 5.5-percent ceiling. I think Congress should give attention by now to the elimination of ceilings. I think now it can be done with little danger because the S. & L.'s have accumulated surpluses and are earning enormous profits on the spread between the mortgage and the ceiling rate.

There are a few other measures which I could mention in discussion which go in the direction of making inflation less painful: For instance, mortgage design, encouraging mortgage design appropriate to an inflationary environment. I am not suggesting that we should, or could, make inflation pleasant—it will never be—because there are many past contracts and many costs that cannot be eliminated.

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But we should work toward making inflation less costly wherever we can.

I come finally to a couple of questions which you have raised in your letter. First, the question of the policy mix.

Assuming that the size of the restriction is right, are we achieving it with the right mix?

It is clear that the mix chosen so far has been leaning heavily on the monetary policy component. We have basically gone about it by raising interest rates and reducing the money supply. You can see in the short run some reason for that. Such a policy does two things, kills two birds with one stone.

On the one hand, higher interest rates improve the dollar situation. Making interest higher does tend to attract foreign capital and therefore helps the support of the dollar.

Now, I would agree that in the short run, if you are trying to treat an acute case, that policy might have justification. But in the long run, as you have hinted, Mr. Reuss, in your statement, this is fundamentally an objectionable policy. In fact, I have been spending a lot of effort recently complaining about the fact that over the last few years, since 1974–75, in this country and in the world we are pursuing consistently the wrong policy mix. That is, we have been restricting demand by essentially tighter monetary policy and then offsetting that by easier fiscal policy.

Perhaps the underlying notion is that monetary policy controls prices and fiscal policy controls output, so you have a restrictive policy to kill inflation and you turn around and by fiscal policy try to prevent it from reducing real output. That is nonsense. You cannot reduce inflation by monetary policy as such. It is only insofar as monetary policy produces slack that you create that effect.

The result of that policy mix has been that we have ended up by reducing investment, and encouraging consumption because that is exactly what that policy mix does. We end up with a policy which, on the one hand, reduces investment and then to compensate taxes and expands consumption. And then, we complain that investment has not recovered.

Of course it hasn't, and though this reflects in part another pervasion, it has paradoxical effects of inflation; namely, that it has seriously depressed equity values. And a depressed stock market in which firms sell typically way below their reproduction costs discourages investment both by raising required yields and by shutting off one possible source of financing.

The issue of why the stock market is affected by inflation is the subject of a study of mine which will be published soon, and which will show that the fundamental reason why this happens—against what everybody thought should happen—is that investors are not able to value firms correctly in a world of inflation.

The same difficulty may lead firms to raise yields required of new investments. To conclude, I quite agree with you that we ought to redirect our policy toward tighter fiscal policy and looser monetary policy and that in addition inside the fiscal policy we should emphasize the income taxes and reduce the social security taxes, that being a step which for a given amount of collection does tend to reduce inflation.

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I think I have exceeded my time and therefore I will not try to go into the one of intervention, but I am sure there will be occasion in the course of your questioning.

Thank you.

Representative REUSS. Thank you, Mr. Modigliani.

Starting with the point you raised last, you indicated that the country would do better with a somewhat easier monetary policy and a somewhat tighter fiscal policy because that mix would induce toward greater capital investment, which would be a healing deterrent of inflation. That view, it seems to me, is probably shared by other members of the panel.

Mr. Pierce, you almost said the same thing. Would you agree?

Mr. PIERCE. Yes, I do with one caveat since we are discussing the real world of policy; provided we are assured that with easing of monetary policy we get a tightening in fiscal policies. I think there is a tendency to put more emphasis on loosening the monetary side and then forgetting to tighten the fiscal. One of the reasons I think so is that much of the burden of policy falls on the Fed. It is much easier for the Fed to get away with a tighening of policy than it is for Congress and the administration.

It is politically easier. So there is a danger, I think, that in trying to change the mix, you don't just change the mix, you change the level of policy. But given that qualification, yes.

Representative REUSS. For this discussion at least, changing the mix means changing the mix.

Mr. PIERCE. That is correct, if in fact we are assured we will change the mix. From an academic point of view, yes, if you change the mix, it should be in favor of more tightening of fiscal policy and discouraging consuming, as Professor Modigliani said, I agree.

Representative REUSS. Do you agree with this general proposition, Mr. Hymans?

Mr. HYMANS. Yes, sir, I would.

Representative REUSS. And Mr. Yeo?

Mr. YEO. I agree with the proposition. I would not characterize monetary policy as tight at any time in the last 18 months—and I am not really certain that it is tight now. Interest rates are high because it has not been tight.

Representative REUSS. Let me now ask what should be done about it? Is the mix that emerges from the November 1 package plus the subsequent leaks on budget policy for fiscal 1980—should that be changed? Specifically, on the basis of what we now know, the administration is projecting a budget deficit of $30 billion or less for fiscal year 1980. Should that deficit be lowered to $25 billion or something less? And if that goal is achieved, should it be an occasion for a modest untightening of money?

Mr. HYMANS. A few comments, Mr. Reuss.

One can't, as you well know, legislate the size of the deficit. One affects tax rates and one affects the level of Government expenditures and then through that intervention in the economy the deficit changes.

So if we were in a situation where we were quite certain that the economy was overheated, we might say that we would cut Government spending. That would, of course, slow the economy down. There would

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be a partial loss of revenue. The deficit would, of course, decrease not by as much as the reduction in Government spending, and that would be an appropriate measure to undertake if the purpose were to slow the economy down.

I think, myself, that the mix of policies we have now in terms of the tax rate structure, the level of Government spending, and monetary policy, is for long run purposes too tight on the monetary side; though I think that the tightness on the monetary side, as I indicated in my testimony, is probably appropriate for a time.

But as I urged in my prepared statement, I think that by the middle of next year we ought to be concerned about that tightness of monetary policy if, in fact, it is really there. There is, as you well know, a set of strange events going on which makes it very difficult to disentangle what is happening. There seems now to be inconsistent movements between the money stock and the monetary base. Assumig that that is a matter of short-term perturbations, all of which are a part of the underlying tightness of monetary policy as announced in early November, then I think we are going to find that monetary policy is a little too tight when we start to approach the middle of next year.

That is when I would urge that monetary policy become easier. I think that would be the correct policy mix, as opposed to keeping monetary policy where it is and loosening fiscal policy. I think it is the loosening of monetary policy that should be used as we get to the middle of next year.

Representative REUSS. In the event that we run into a recession or such a slowdown in growth as to——

Mr. HYMANS. Yes; there would be a number of goals, all of which push us in the same direction. If we run into a situation similar to what I projected and what Jim Pierce projected, that we really do have a couple of quarters or virtually no growth or almost no growth, essentially something indistinguishable from a mild recession. Then our goals on the international side will also be well served by that set of events so that we would want to stop the economy from winding up in a situation of further substantial increases in unemployment, and at the same time we would have had a major impact in the right direction on the international value of the dollar, we would be on track toward domestic improvement of the dollar and that would be the time to ease up on monetary policy.

Representative REUSS. But that time is not now as far as you are concerned?

Mr. HYMANS. No; I think that time is not now. I think a little cooling off is important at this point.

Representative REUSS. What do you have to say, Professor Modigliani?

Mr. MODIGLIANI. I quite agree with this proposition. I didn't give any measure, but I think that in the present circumstances aiming for an increasing unemployment, which might get us somewhere not far from 7 percent, does not strike me as exaggerated. In other words, it might be on the high side, but we ought to go in that direction. With this policy I think we might get there, and so I would say, on the whole, that the administration program, which means a maintenance of current posture for a while, is justified.

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When the time comes to turn around in a sense that we try to prevent further slow down, then would be the time to make the decision not to cut taxes, but to ease monetary policy.

You see, on every previous occasion at the trough when we had higher unemployment, we turned around and cut taxes. Some cut of taxes is appropriate just to keep them constant in real terms, but only a limited amount. But fundamentally at that point a decision should be made that expansion should come from easing monetary policy.

Representative REUSS. Mr. Pierce, would you address yourself to the policy mix question and to the situation as we now know it in which the administration appears to be aiming for a budget deficit of $30 billion or less, and in which monetary policy is at the stage where short-term interest rates have gone up about 2 percentage points this last summer; where M_1 and, I guess, M_2 have been flat for a month or so? If I am misstating the way things are, correct me.

Anyway, is that all right for the moment or do you think that one needle valve or the other should be changed?

Mr. PIERCE. It is a little hard to answer those questions. Given what has happened to date, I think the policy—the short-term policy moves that the administration and the Fed took were probably appropriate.

The Federal Reserve did announce tightening of policy and then accomplished it. If you measure tightening of policy either in terms of growth of monetary aggregate, which slowed markedly even though inflation is quite high, or measured by short-term interest rates, by either measure, I think most people would agree there has been a tightening of policy.

Maybe it is not as tight as some people would like to see, but I think the direction is clear.

I think the fiscal measures that the administration has announced in terms of spending are again appropriate, but it is always hard to translate deficits into anything that is real. But if one tries to translate that deficit projection into what the growth in Government spending would be in real terms, it would have to be really quite low, about 2 percent or less for the year. That is not rapid Government spending at all.

So I think there has been a tightening on the fiscal side and on the monetary side at the same time.

Now, my answer was in terms of where we are now. If I had my druthers, I would have preferred to see a more gradual expansion in the economy over the last year to year and a half. I think that there was not enough concern about inflation for quite a while. There seemed to be the belief that somehow we got the gain in production and employment for free; that it didn't cost any more inflation.

Well, we have been through that argument before. It takes a while for inflation to accelerate again after the economy gets close to capacity. There have been some bad events, but we ought to be use to bad events by now. We seem to get them all the time. We might as well assume that food prices are going to rise, oil prices are going to rise and so on, rather than say it is not any of our fault, "it is the dirty food prices."

So I think that the policy now is probably appropriate given that is it was not as restrictive as I would have liked to have seen in earlier months. But since it was not tight, I think appropriate action was taken.

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In terms of where we go from here, I agree with Professor Modigliani than an ideal time to change the policy mix would be one where it isn't necessary to raise taxes, and cut expenditures, but rather, not to cut taxes. That is politically must easier to do; to reduce interest rates and keep taxes higher than they would otherwise have been. That will in and of itself change the mix. But I want to just conclude by saying the policy mix question is a longer run matter.

For any 6-month period I don't think policy mix in terms of productive capacity change makes any difference. Over the longer term it surely does and I think the Congress and the administration have to worry about that mix, and forego the temptation that if the economy does go into recession, of trying to be stimulative from fiscal policy, and also avoid the temptation of being too stimulative with either policy.

It is unpleasant, but I think that the one way we know that works fairly well of reducing inflation is to have excess capacity in the economy, unemployed resources, including people. That is unpleasant, but the other measures don't seem to work at all.

I think we just have to live with that, and not try to get back to full employment very rapidly. I think if monetary policy is highly expansionary in 1979, inflation expectations will go very high indeed.

I will stop with that.

Representative REUSS. So far—before we get to Mr. Yeo—the consensus of those who have spoken is that if the employment production situation worsens, get your kicks out of easier money rather than out of reducing taxes or increasing expenditures?

Mr. MODIGLIANI. Yes.

Mr. PIERCE. Yes.

Representative REUSS. Is that it?

Mr. MODIGLIANI. That is exactly the message.

Mr. PIERCE. Yes.

Representative REUSS. Mr. Yeo, I want to ask you separately about why you think that money isn't tight now. But, address yourself, first, to the mix question. Do you agree or disagree with the proposition as it comes to you?

Mr. YEO. I would like to formulate it a little bit differently, Mr. Reuss. I think that in a longer run sense it would be desirable to operate with a much different budget configuration. We ought to be in surplus now. We ought to be running a surplus, an actual surplus. Not the full employment surplus, because I don't know who can calculate full employment.

Representative REUSS. If we ran a surplus, which would mean reducing the projected deficit by another $30 billion, could we then use easier money than is now the case? You say it is——

Mr. YEO. Well, Mr. Reuss——

Representative REUSS. You say it is not tight now?

Mr. YEO. If we ran a surplus, as a matter of fact, if we even were able to legislate actions that would appreciably reduce the deficit—not by $3 billion—and I know from the standpoint of Congress and the executive, $3 billion is an enormous amount, I have been on that side, we would change inflationary expectations.

The key thing about the administration's program to date is that it isn't working in that respect. All of the evidence that we can see in

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financial markets or in real markets suggests that inflationary expectations have not abated. Rather, they continue; and according to some evidence, have even heightened. An appreciable reduction in the deficit now—not in fiscal 1980, but in 1979, would lessen the price pressures in the economy, including interest rate pressures. So that my answer is, first, I have some question about whether the program is working. I am concerned—there is plenty of time left—but I am concerned.

Second, longer run, I would certainly support a change in policy mix. And now I am at your mercy, Mr. Reuss, you want to know why I think monetary policy is not tight.

Representative Reuss. Yes. Is it because the monetary aggregates—except during November—are still pretty frisky?

Mr. Yeo. I think it——

Representative Reuss. I don't quarrel with the observation. I just wonder what you based it on.

Mr. Yeo. The monetary base, is one key component, but since reserve requirements lag 2 weeks, it has to be used very carefully. Four weeks is not a long enough period of time for me to say monetary policy has become tight or has not become tight. All I know is that it has not been tight.

We have had a very frisky economy in November, quite spritely. And if our interpretation of what is going on, what is producing this rather animated character is correct, we would be very surprised if the result aggregrates, M_1, M_1—plus, M_2, over the longer course show a marked deceleration.

Representative Reuss. What do you and your associates—whoever the "we" is—who is the "we," by the way?

Mr. Yeo. Well, I have Alan Stoga and David Woolford here, some of the people in our economics department.

Representative Reuss. All right, fine.

What are these elements in the economy which you discerned during November?

Mr. Yeo. First of all, consumer expenditures have turned out to be a little firmer than we had anticipated—quite firm, as a matter of fact, You have seen the retail sales numbers for the month. It is an estimate, as we know. The automobile market has been a little firmer than we had anticipated.

If you are starting ot change expectations, the automobile market is the place you look for the first signs. Our anecdotal evidence as bankers from retailers suggests that things really haven't changed as much as some had imagined they would when these initiatives were announced.

New order data suggest that business ordering continues at a very rapid clip, so that if you take all of these little pieces of information, and look at them as we do, we come to the conclusion that the economy really was moving quite nicely, in a very narrow sense, in November and into December.

Representative Reuss. Along those lines, you said earlier this afternoon that you discerned tendencies toward consumer—you didn't use the word "hoarding"—but consumer purchasing, which looked like a hedge against inflation.

Now, heaven knows—at least everybody knows—that there has been big inflation hedging in the purchase of land and homes and

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antiques and jewelry. Do you discern something similar in the case of neckties, Kleenex, handkerchiefs and stereo tapes? You may. I am just asking.

Mr. YEO. I think I do.

Representative REUSS. What is going on?

Mr. YEO. As you suggest, Mr. Reuss, it is much easier to make the case for items that are finite in supply or at least are presumed to be. But I think that there has been some acceleration elsewhere. You know, the difficulty is that the really meaningful thing isn't whether there actually has been, but whether there is a desire to have accelerated expenditures ex ante; whether people have ex ante shifted their savings pattern. I think that they have.

Mr. HYMANS. Mr. Reuss, could I comment on the recent state of the economy as indicated by recent evidence? Let me, if you wouldn't mind, begin with a story told by my college professor, Tom Juster, director of Institute of Social Research at the University of Michigan. This involves his listening into one of the latest telephone surveys being made to try and tap into the consumer mood.

The interviewer was asking a woman respondent over the phone whether this is a good time to buy, and he asked first about homes, and he said, "Tell me, is this a good time to buy a home?" And the woman said, "A home? Prices of homes are outrageous now. They have gone up so far so fast nobody can understand it."

And the interviewer said, "But is this a good time to buy a home?" She said, "It is a wonderful time to buy a home. Prices will be even higher next year."

He said, "What about cars?" She said, "You realize my husband looked all over town and we can't find a car for under $9,000. The prices of cars are out of sight." He says, "Is this a good time to buy a car?" She said, "It is a terrible time. Look how high the prices are."

Well, I think that indicates a good deal about what is happening. Many consumers are totally confused about how to behave in the face of inflation, surprises about inflation, and variations in the rate of inflation from time to time.

So we see some buying that surely is buying ahead of anticipated price increases and we see some evidence of resistance to high prices and behavior reflecting the possibility that one can simply make do without in the face of these high prices.

Regarding automobiles, for example, the issue as to whether all sales are running strong now, I contend they are not running strong. Sales rates have come down in the recent 10-day period and what would one expect if the car market is about to soften, as I believe it has? One would expect that, first, the fringe buyers decide, no, this is not the time to buy a car.

Not the regular buyers, not the every-other-year-almost-like-clockwork buyers, but the fringe buyers. One does notice American Motors doing even worse than it has recently been doing, Chrysler doing worse than it has been recently been doing, Ford doing a little worse than it has recently been doing and General Motors hanging in there. That is the kind of preliminary buying pattern one typically sees, not if car sales plummet to a 9 million car rate, nobody predicts that. But if you say car sales will drop off from an 11.2 to 11.5 rate to something in the 10.5 million range, that is the kind of preliminary pattern you would see.

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Further, nobody was expecting that the fourth quarter, the one we are in now, is going to show a half percent growth rate or 1 percent growth rate, and we are getting data which seem to be consistent with a 2.5 to 3 percent growth rate in the fourth quarter. That is pretty much in the standard forecasts which contain within them the further results that the growth rate should go down in the first quarter and down further in the second quarter.

So far as I am concerned, I see the kinds of straws in the wind that I would expect to see. I guess that is true of all of us. Given what we expect to see, we can easily interpret what is happening on the current scene in a manner pretty much consistent with what we expect to see as we go further out.

Mr. Yeo. Speak for yourself.

Mr. Hymans. I just did.

Representative Reuss. These straws in the wind—if I understand you correctly—are straws which indicate greater consumer resistance to buying than has been true in the past? While consumers are still buying homes because they think they are going to rise, they are more marginal——

Mr. Hymans. On some other things.

Representative Reuss [continuing]. On things that have a shorter life than a home.

Mr. Hymans. On some things, yes.

Representative Reuss. Is there any correlation between the shortness of the life of goods and the consumer's desire to buy?

Mr. Hymans. I am afraid I am not prepared to be that scientific about it. The evidence is very difficult to handle.

Mr. Yeo. Mr. Reuss.

Representative Reuss. Yes.

Mr. Yeo. In the first 10 days through December, domestic automobile sales were at an 11 million unit annual rate. I think that was the highest rate since May.

Another straw in the wind was November's retail sales and the revision of retail sales in October. October's retail sales were revised upward and November came in at a very strong, very substantial increase. Those are the "straws in the wind" that we see, and I think it really is not too germane, because in responding to your question I also said financial attitudes and expectations had not changed and clearly in the long-range bonds market—and I think in some other financial markets—inflationary attitudes have not changed appreciably since the announcement of the package.

Representative Reuss. Well, I resort to the attitude of one who doesn't intend to do anything about it. It is a very fluid situation. I don't see any reason for big policy changes based on these straws in the wind because they certainly are straws at this point, though I have learned a lot from hearing about them.

I want to thank you all for your very helpful contributions to our hearing. They will be considered extensively by this committee and we are grateful to the outstanding nature of your discussions.

Thank you.

[Whereupon, at 3:29 p.m., the subcommittee adjourned, subject to the call of the Chair.]

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