

932

**THE 1979 ECONOMIC REPORT OF
THE PRESIDENT**

HEARINGS
BEFORE THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
NINETY-SIXTH CONGRESS
FIRST SESSION

PART 2

JANUARY 31 AND FEBRUARY 5, 6, AND 7, 1979

Printed for the use of the Joint Economic Committee



U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1979

47-108 O

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402
Stock No. 052-070-05082-9

257

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

LLOYD BENTSEN, Texas, *Chairman*
RICHARD BOLLING, Missouri, *Vice Chairman*

SENATE

WILLIAM PROXMIRE, Wisconsin
ABRAHAM RIBICOFF, Connecticut
EDWARD M. KENNEDY, Massachusetts
GEORGE McGOVERN, South Dakota

JACOB K. JAVITS, New York
WILLIAM V. ROTH, Jr., Delaware
JAMES A. McCLURE, Idaho
ROGER W. JEPSEN, Iowa

HOUSE OF REPRESENTATIVES

HENRY S. REUSS, Wisconsin
WILLIAM S. MOORHEAD, Pennsylvania
LEE H. HAMILTON, Indiana
GILLIS W. LONG, Louisiana
PARREN J. MITCHELL, Maryland
CLARENCE J. BROWN, Ohio
MARGARET M. HECKLER, Massachusetts
JOHN H. ROUSSELOT, California
CHALMERS P. WYLIE, Ohio

JOHN R. STARK, *Executive Director*
LOUIS C. KRAUTHOFF II, *Assistant Director-Director, SSEC*
RICHARD F. KAUFMAN, *Assistant Director-General Counsel*
CHARLES H. BRADFORD, *Minority Counsel*

CONTENTS

WITNESSES AND STATEMENTS

WEDNESDAY, JANUARY 31, 1979

| | Page |
|--|------|
| Bentsen, Hon. Lloyd, chairman of the Joint Economic Committee: Opening statement | 1 |
| Blumenthal, Hon. W. Michael, Secretary of the Treasury | 2 |

MONDAY, FEBRUARY 5, 1979

| | |
|--|-----|
| Bentsen, Hon. Lloyd, chairman of the Joint Economic Committee: Opening statement | 41 |
| Grayson, C. Jackson, Jr., chairman, American Productivity Center, Houston, Tex | 42 |
| Carlson, Jack, vice president and chief economist of the Chamber of Commerce of the United States, accompanied by Harry McKittrick, deputy director, Productivity Center | 132 |
| McIntyre, Hon. James T., Jr., Director, Office of Management and Budget, accompanied by Van Doorn Ooms, Assistant Director for Economic Policy ... | 158 |

TUESDAY, FEBRUARY 6, 1979

| | |
|---|-----|
| Proxmire, Hon. William, member of the Joint Economic Committee, presiding: Opening statement..... | 183 |
| Greenspan, Alan, president, Townsend-Greenspan & Co., Inc., New York, N.Y., and former Chairman, Council of Economic Advisers | 184 |
| Fair, Ray C., professor of economics, Yale University | 187 |
| Christ, Carl F., Abram G. Hutzler Professor of Economics, the Johns Hopkins University, Baltimore, Md | 189 |
| Barrett, Nancy S., director, program of research on women and family policy, the Urban Institute, Washington, D.C., and former Deputy Assistant Director, Fiscal Analysis Division, Congressional Budget Office | 205 |

WEDNESDAY, FEBRUARY 7, 1979

| | |
|---|-----|
| Bentsen, Hon. Lloyd, chairman of the Joint Economic Committee: Opening statement | 239 |
| Bernstein, Edward M., president, E.M.B., Ltd., research economists | 240 |
| Perry, George L., senior fellow, the Brookings Institution | 248 |
| Stein, Herbert, A. Willis Robertson Professor of Economics, University of Virginia; senior fellow, the American Enterprise Institute; and former Chairman, Council of Economic Advisers | 274 |

SUBMISSIONS FOR THE RECORD

WEDNESDAY, JANUARY 31, 1979

| | |
|--|----|
| Blumenthal, Hon. W. Michael: Prepared statement | 11 |
|--|----|

IV

MONDAY, FEBRUARY 5, 1979

| | Page |
|--|------|
| Carlson, Jack, et al.: | |
| Prepared statement | 137 |
| Grayson, C. Jackson, Jr.: | |
| Prepared statement, together with exhibits | 45 |
| McIntyre, Hon. James T., Jr., et al.: | |
| Prepared statement | 162 |
| Response to Representative Brown's request to supply anticipated dollar figures for individual income tax receipts for calendar years 1980 and 1981 due to inflation | 169 |
| Table reflecting individual income and employee social security tax liabilities as a percentage of personal income for the period from 1960 through 1979 | 170 |
| Response to Representative Brown's query regarding the effect on the U.S. economy if Congress passed legislation setting U.S. farm prices at 100 percent of parity | 172 |
| Response to Representative Brown's request to supply anticipated outlays and budget authority for off-budget Federal entities for fiscal years 1978-84 | 174 |
| Response to Representative Brown's request to supply more detail of uncontrollable programs than was previously published in the President's budget | 176 |
| Response to Representative Brown's request to estimate the effects on the budget of higher unemployment and a drop in real growth output | 180 |

TUESDAY, FEBRUARY 6, 1979

| | |
|--|-----|
| Barrett, Nancy S.: | |
| Table reflecting funds raised in credit markets by households and non-financial, nonfarm business, 1970-78 | 210 |
| Christ, Carl F.: | |
| Tables: | |
| 1. Inflation and the growth of money stocks | 193 |
| 2. Monetary growth rates before and after October 18, 1978 | 194 |
| Prepared statement | 194 |
| Rousselot, Hon. John H.: | |
| Chart reflecting Federal and federally assisted borrowing | 234 |

WEDNESDAY, FEBRUARY 7, 1979

| | |
|--|-----|
| Bentsen, Hon. Lloyd: | |
| Prepared statement of Otto Eckstein, president, Data Resources, Inc., and Paul M. Warburg Professor of Economics, Harvard University | 291 |
| Bernstein, Edward M.: | |
| Prepared statement | 243 |
| Article entitled "The Balance of Payments, the Exchange Market, and Interest Rates" | 259 |
| Stein, Herbert: | |
| Articles from the AEI Economist: | |
| "The New Economic Policy: What Is It? Will It Work? What Next?" December 1978 | 277 |
| "The Next 'Recession,'" January 1979 | 285 |

THE 1979 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, JANUARY 31, 1979

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, Proxmire, McGovern, Javits, McClure, and Jepsen; and Representative Reuss.

Also present: Louis C. Krauthoff II, assistant director-director, SSEC; Richard F. Kaufman, assistant director-general counsel; John M. Albertine, Lloyd C. Atkinson, William R. Buechner, Thomas F. Dernburg, Paul B. Manchester, and M. Catherine Miller, professional staff members; Mark Borchelt, administrative assistant; Katie MacArthur, press assistant; and Stephen J. Entin and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

Mr. Secretary, I am sure we will have a strong membership representation in a few minutes, but we have a reputation of starting on time here, and we know you have limitations on your schedule, so we will get underway.

I do want to welcome you here this morning. This is the fifth in a series of hearings discussing the state of the economy. There are few witnesses I can think of, Mr. Secretary, who are in a better position or who are better qualified than yourself to comment on our economic problems, at home and abroad.

Let me first begin by congratulating you on the impressive success you have had in your recent program to stabilize the dollar. It is rare, indeed, Mr. Secretary, to see our government react so quickly and decisively and effectively in a crisis situation.

Relative stability for the dollar on international currency markets is obviously a prerequisite for economic progress in this country, and you are to be commended in this regard.

I would be interested, Mr. Secretary, in your longer term prognosis of international economic trends. What happens when we exhaust the \$30 billion pool we have devoted to exchange stabilization? Will 1979 be a year of relative stability in foreign exchange markets? To what extent is the international monetary system in need of further reform?

I certainly don't have to tell you that one factor contributing to the weakness of the dollar has been our balance of trade problem. Part of that balance of trade problem is from unfair trade practices.

From recent reports, Mr. Secretary, it would appear that the Treasury is less than enthusiastic about its obligations to protect the domestic industry from unfair trade practices, dumping in particular. Mr. Secretary, I am not just speaking of your tenure in the Treasury. I am talking about a history in Treasury where, for quite a number of years, we jumped at the opportunity to waive countervailing duties when it had been demonstrated that a foreign competitor had altered his practices. We have seen the situation where countervailing duties have been imposed, and we have seen, from what I have been told by a number of industries, that Treasury moves rather quickly to lower them when they find the situation has been corrected—but they drag their feet when it comes to the point of putting it on. Treasury has been quick to waive the duties, but slow to impose them.

The International Trade Commission in many, many instances has found that (countervailing duties) should be imposed, but the Treasury in a very small percentage of those cases has acted.

Now, Senator Danforth and I introduced legislation last week designed to improve our ability to enforce unfair trade practice statutes, and I believe that kind of legislation is called for.

I would like to see what you have to say about Treasury's ability or inclination to deal with important trade problems like dumping and subsidies and, closer to home, I would like to hear your comments on the problems of productivity. I have some figures which suggest that if the average annual productivity growth rate which our economy experienced from 1947 to 1968, if they had been maintained last year, the Gross National Product would have been \$300 billion greater than it is today. I think the dropoff in productivity is one of the most significant factors in our current economy.

The Joint Economic Committee is going to be devoting a lot of attention to it in trying to develop some long-term solutions to our productivity problem.

Finally, Mr. Secretary, when we are talking about the administration's budget and where we can cut, I think a very compelling case can be made to end revenue sharing for the States, and I am going to introduce legislation today to try to achieve that objective. Ending revenue sharing would cut the Federal budget by over \$2¼ billion, and I think it would end the absurd practice that we have today where we have a huge deficit in the Federal budget, and the States run surpluses. Not one single State, to my knowledge, is predicting a deficit in their budget in 1979. I am not talking about the cities, nor about the municipalities, but about the States themselves, and I would like to hear your comments on that, too.

Mr. Secretary, we are pleased to have you.

Proceed with your testimony.

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

Secretary BLUMENTHAL. Thank you, Mr. Chairman.

I am grateful for the opportunity to appear before this committee, the Joint Economic Committee, which looks at questions of the overall economy, both domestic and international. It is a vitally important forum, Mr. Chairman, for our government's work on problems that clearly are at the top of the agenda, and must be, for this nation. The very careful consideration of these issues by you and your colleagues will make a great contribution, and we are all delighted to share our thoughts with you.

I think, Mr. Chairman, that the testimony that you have already had from my colleagues here in the last 2 or 3 days will have indicated that this administration and President Carter have a clear economic policy, a clear sense of priorities, a clear viewpoint of where we must go over the period ahead, and that that program, that agenda, is geared entirely to our firm recognition that the No. 1 problem before this country is to deal successfully with the problem of inflation, and that whatever we do, whether it be in the international area on the dollar, whether it be domestically on the budget, on monetary policy, on all of the matters that you have raised and about which you have posed questions, all of this must be dealt with in terms of the absolute requirement of coming to terms with, and successfully overcoming, the problem of inflation in this country. For, if we do not do that, then none of the issues that you have touched on can be satisfactorily resolved; and the U. S. economy and the world economy will suffer greatly.

Budget decisions that the President has made and proposed to Congress have all been made with that viewpoint in mind. I have a prepared statement which I would like to submit for the record. I will not read it, Mr. Chairman, with your permission.

Senator BENTSEN. Without objection, your prepared statement will be placed in the hearing record.

Secretary BLUMENTHAL. I will summarize some of the critical points. I think I will be dealing with some of the questions you have raised. I will be glad to deal with the others not covered in the summary of my remarks.

As I have said at the outset, Mr. Chairman, the budget decisions for 1980 are designed to move us along toward the solution of the inflation problem. The challenge that the Congress has is to do its part to help us achieve this goal.

In dealing with the inflation problem, it is important, always, to recognize at the outset that what we are facing is not a weak, an uncertain, or tired economy. On the contrary, the economy is strong, remarkably strong. We are in one of the longest periods of recovery and growth this nation has enjoyed, and we have nothing to fear as regards the resiliency and strength of our economy, except the problem of inflation.

We have created in the last 2 years 7 million new jobs, the greatest gain in U.S. history. We have a higher employment-to-working-age population ratio than we have ever had. Our real GNP is up over 10 percent in 2 years; real disposable after-tax income is up almost 9 percent over the last 2 years.

So the basic strengths of the economy are clear for all to see. The problem of inflation threatens this progress for the future, and it is that that we must deal with.

In the seventies, inflation averaged 6¾ percent annually, which is totally unacceptable, but what is more unacceptable, Mr. Chairman, is that last year that the rate of increase in consumer prices accelerated to 9 percent, and it is not surprising, therefore, that the dollar over the last year, beginning even in 1977, has come under strong attack.

Putting the anti-inflation effort at the top of our economic priorities in my judgment is not a 1-year requirement. We must continue it for an extended period of time, and it is clear that we must do so because no solution, no single or multiple set of solutions, is going to allow us, or enable us, to bring inflation down to the more acceptable levels, which clearly have to be below the 6¾ percent that we had in the rest of the 1970's, and it is clear that we have to set as our target a much lower inflation rate such as we enjoyed and experienced in the early part of the 1960's.

That will require political courage and patience. It will require long-term economic discipline, and I would say that our economic system and our system of government has not yet shown that we have the kind of economic discipline that we can bring to bear over an extended period of time to get that under control.

There are some who say the problem is not solvable, Mr. Chairman. To those I would say that we have ample evidence that other countries have managed to deal with this problem without putting their economies into serious economic difficulty, and it seems to me, therefore, that we ought to be able to, likewise.

Japan reduced its inflation rate from 22½ percent to 4 percent over the last 5 years. Germany reduced its inflation rate from 7 percent to 2½ percent over the last 4 years. If they can do it, I think we can do it. It is our job to do it, and in talking with responsible officials of those governments, I have become convinced that we can, but I have also become convinced, Mr. Chairman, that this is a multiple-year effort, and that they also did not do it in 1 single year.

There are many causes of inflation. I wish there were a single one. We would then be able to design a cure. There are many complex causes. I am sure that we would not, and our economists do not, fully understand all of them, for some of them really are the result of new situations in the national and world economy.

We, therefore, must devise multiple cures and approaches to deal with these multiple causes.

This morning I do not have time, of course, to deal with all of them, or engage in an exhaustive analysis of the interaction of these, but I do want to deal, as I did in my prepared statement briefly, with four dimensions of those problems that I think are key and critical in the overall scheme of the inflation situation that we face.

These four are, first, excess aggregate demand; second, the point you have touched on, sluggish productivity growth; third, the problem of the momentum of the wage-price spiral, once inflation starts; and, finally, the other point that you have quite properly pointed to, namely, the dollar's value in the foreign exchange markets.

Let me first turn to aggregate demand. The administration feels strongly, Mr. Chairman, that the key to an anti-inflation program

is firm and persistent restraint on aggregate demand through fiscal and monetary policy.

There are two reasons why this is needed. First, because there are signs now that there is excess demand pressure in our economy. One reason we had an acceleration of inflation by more than 2 percentage points in the course of the last year is clearly the movement toward an economy that is increasingly tight, and where there are some pressures of aggregate demand on the resources available to us. The fact that in the last calendar quarter of 1978 the economy grew by a substantial amount, by some 6 percent, in real terms, clearly indicates that these kinds of pressures do exist.

The 1 million new jobs created in the fourth quarter of 1978 alone clearly also had narrowed the margin of idle resources and had put some strains on labor markets.

This is not a critical or serious situation, but it is obvious that the kind of budget that the President has presented, which envisages a reduction of the growth rate in 1979, is absolutely essential if we are not going to get further inflationary pressures from this continued growth in aggregate demand which is in excess of the long-run growth that this economy can sustain.

The President's budget, which has been drawn with that in mind, clearly meets that need. The annual rise of Federal expenditures in real terms is less than 1 percent, versus some 3.2 percent on the average over the last 8 years.

Outlays are down to 21 percent of GNP for fiscal year 1980, versus 22.6 percent as recently as 1976.

The deficit in the Federal budget has been targeted at below \$30 billion, and at a little more than 1 percent of our GNP for the first time in 5 years.

Federal employment is actually to be cut by 58,000 persons, as compared to January of 1977.

Let me note here that in participating over the last 2 years in the difficult task of fashioning a budget for presentation to the Congress, I have become impressed by the difficulty of the job. The President faces a most difficult job because three-fourths of the outlays are practically uncontrollable in the short run. Of \$531 billion in this 1980 budget, over \$400 billion are in fact mandated by continuing statutes or obligations. Some \$250 billion out of the \$531 billion relate to transfer payments of various types, which are usually indexed to the rate of inflation.

You see here the great problem which indexing already poses for our economy. This is one of the reasons why we oppose any further extension of indexing, for it makes the problem of dealing with inflation all the more difficult and really builds it into the economy.

The President, therefore, has to work with a very narrow segment of the overall budget that he presents. When people talk about the need to cut the budget, about strong action by the President and by the Congress, they must understand that under our system, under the way that the budget confronts us, we have in fact only a relatively small portion, less than a quarter, that we can deal with; at least in the short run, in order to bring about the kind of cuts that we need.

The President, I think, has allocated the cutbacks from current services fairly among the various competing needs, recognizing the need to maintain a strong defense and our obligations to our allies on the one hand, and recognizing the therapy which, overall, must be extended for a period of time, but, nevertheless, must not be done in such a way as to harm the poor, those with low incomes and those that are particularly vulnerable to the ravages of inflation.

It is clear that inflation, if allowed to go on, inflicts great harm on our society, and a budget leading to less inflation will, in turn, be of greatest benefit to those sectors of our economy.

Similarly, monetary policy has to be restrained and consonant with the fiscal approach that the President has reflected in the budget he has presented to the Congress.

The Federal Reserve, I understand, has a long-term commitment to keeping the monetary aggregates under control. There is a complete understanding between us on the need for coordination and for concerted action on this matter, and I have no doubt that that kind of coordination and consistency of basic approach will continue as long as this problem exists into the future.

It is also vital that we do not let the Federal credit demands rise unduly, and this budget also reflects that understanding, one, obviously, that is of particular concern to us at the Treasury.

Next year, Federal borrowing from the public will actually decline, and the decline will be even greater relative to total credit availability. Federal borrowing will be a little over one-tenth of credit demands in 1979, and less than that in 1980. That compares to one-fifth in 1976.

The concern that has to be always before us, namely, a crowding out by the Federal Government of private borrowers in the credit markets, therefore, is one that need not concern us greatly. We are bringing down Federal borrowing substantially, and, therefore, the pressures on the private credit market to an equal extent.

Productivity growth is another key area that I briefly want to touch on. The growth in real output per worker is the key to real growth in our economy. If we do not increase productivity, the pie will not grow, and if the pie does not grow, we cannot do better in real terms. It is in fact the fulcrum between wage inflation and price inflation.

To the extent that we cannot increase productivity, we are likely to have both.

Productivity growth in the private nonfarm business sector was 2.5 percent in the 1948 to 1968 period, and has fallen to 1.5 percent in the last 10 years and fell to an abysmal eight-tenths of 1 percent in 1978.

Price and wage inflation were nearly identical in 1979; 9¼ percent in one case versus 9 percent in the other. It is a clear indication that we must bring productivity up.

We need more investment and fewer costly regulatory constraints.

I think the tax bill that the Congress passed last year, which contains \$7 billion of tax cuts for business, including a reduction in the taxation on capital gains, is a step in the right direction. That

is just being implemented. I certainly expect that that will have a salutary effect on productivity in the economy.

The President's efforts to review all new regulations for their economic costs and benefits will be of considerable help, and we are going to need the help of the Congress in that area. We are doing a lot of thinking and a lot of work. This is really one of the important areas.

If you will allow me for a second, it reminds me of a story I heard just the other day, which is both funny and sad. It is about the general counsel who was called before his board of directors, who are of a company that are in some difficulty, and the general counsel addresses the chairman of the board and says, "Mr. Chairman, I have some good news and some bad news for you."

And the chairman says: "Well, that is kind of worrisome."

And the general counsel says: "What would you like to hear first, Mr. Chairman."

He said: "Well, tell me the bad news first."

He said: "The bad news is that we are broke, Mr. Chairman, the company is bankrupt, finished, kaput."

"Well, that is awful. What is the good news?"

"The good news, Mr. Chairman, is that you are in compliance with all Federal regulations." [Laughter.]

Senator BENTSEN. I have a Texas story that I should tell.

Secretary BLUMENTHAL. Clearly, the burden that regulation places on business is heavy and has economic costs, fully recognizing that many of these rules and regulations are very important, that they deal with goals that are very necessary. We need to get a better handle on the economics of those kinds of regulations, the costs and benefits that are involved, and we need to budget those in terms of what we can afford.

It is obvious that to the extent to which business is forced to allocate an increasing share of total available investment resources to meeting regulations, rather than to the kinds of investment that raise productivity and output per worker, to that extent, the overall productivity level in the economy will be reduced, and that, I think to some extent, is what we have perceived.

Let me then turn to the third element, Mr. Chairman, that of the momentum of the wage-price spiral. It is a tail-chasing process. It involves inflationary expectations in which labor anticipates further inflation and seeks to make gains on the wage front which puts it ahead of the game, its members ahead of the game.

It entails business recognizing and expecting further inflation and engaging in preemptive price increases in order to protect it against the ravages of inflation.

The result is the fact that once a certain chain of events has occurred which pushes inflation up, it is very, very difficult to get inflation back out of the economy.

The numbers indicate that clearly. Even in the 1974-75 recession, when certainly there was slack in the economy in overall aggregate demand, we were only able to bring down during that period the rate of inflation to 6 percent, which, in itself, was too high.

There is no doubt that one of the reasons was simply the momentum and the fact that these kinds of expectations get built into the economy and, once built in, are very difficult to root out.

The speed of the response of wages and prices to demand restraint is not fast enough and it is for this reason that the President promulgated his program of voluntary wage and price standards. These standards are an important part of the overall attack on inflation.

They are not the key or the only element. They make sense only in the context of the fiscal and monetary restraints to which I have already referred, and the attack on cost-ineffective regulations and all the other things we are doing to deal with the inflation program.

The stress is on voluntary, Mr. Chairman and members of the committee. It is voluntary, because experience shows mandatory controls do not do the job. They sound easy, "Just pass the law and everybody will abide by it and the economy will behave well."

Unfortunately, experience shows that is not the case. We burden the economy with distortion of resources and incredible paperwork. Once we give up on this, as we must, the burst of inflation in the economy is greater than would otherwise have been the case. This administration is firmly opposed to all kind of mandatory controls.

That, however, means that the voluntary program must work. I will not go into the details by describing it. I think it is well known to you, Mr. Chairman, and to the members of this committee.

I do want to mention in passing, and I will be glad to talk about it more in the question period, that the real wage insurance which the President has proposed, and on which I began the testimony on Monday before the House Ways and Means Committee, is an important tool to enable us to make the voluntary wage-price program work more effectively. It is a tool that the President needs. I do hope that the Congress will give him that tool.

There was a lot of concern, even before this legislation was introduced, whether it was a workable, or sensible program. I sense that as a result of the explanations that have already been given, as a result of the close study which is now being given by the Ways and Means Committee that there is an increasing recognition that we do, indeed, have a program here that is worthy of a try. It will make it much easier for labor to accept the kind of wage standard we have in mind, limiting wage increases to 7 percent. It will make it much easier for all American workers to abide, and employers, by that standard, because they will know that if for reasons that occur, despite their willingness to take that chance, inflation in the economy should be greater, that workers will be compensated for it up to the level of 10 percent, and certainly we don't expect inflation to be higher than that.

It is a way of breaking the vicious cycle with wages and prices chasing each other. It answers the question that labor has posed:

Why should we be the first? How can we be sure that if we in fact take the risk, that we will not still be confronted by rapidly escalating prices which will substantially reduce real income for our people?

It answers the problem with:

Look, if you are first, others will follow suit, the increase will abate, and we provide you with insurance that if for some external reason that should not be the

case, your members and workers and employees throughout the land will not be unduly harmed and the only ones making that kind of sacrifice.

Let me turn now to the question of the dollar's value abroad. Clearly, we have learned in 1978 that we cannot contain domestic inflation unless we also insure the dollar's strength. We think that until the November 1 action, the substantial dollar decline, quite apart from the temporary developments on the world monetary scene and in the exchange markets, contributed as much as 1 percent to the rate of inflation in this economy. The actions of November 1 put an end to that vicious spiral of inflation feeding dollar depreciation and, in turn, feeding inflation. And the results, as you have indicated, are certainly encouraging.

The dollar has rallied more than 9 percent since October 31. That was the low point. Markets reflect new confidence in our determination to contain inflation and reduce the trade deficit, and in the joint commitment, not only of the United States, but the United States together with Germany, Japan, Switzerland, and others, to use their full resources to keep the dollar strong and stable.

The United States, Mr. Chairman, is determined to prevent any resurgence of the kind of conditions in the foreign exchange markets which led to the action of November 1. Our resources are very substantial, and we will not hesitate to use them as necessary to achieve our objectives. The other participants have committed their own substantial resources to those joint operations.

There is, in fact, no quantitative ceiling on the resources which the four countries could use. Other members of IMF are also dedicated to assuring exchange market stability.

We are prepared to consider with an open mind ideas for evolutionary change in the monetary system. What is important is that any change be an improvement and that the transition be accomplished smoothly and in ways which strengthen open international trade.

Let me digress here, Mr. Chairman, and deal with one question you raised, which is mainly with regard to the dollar. What is there that can be done, will the \$30 billion run out, and is the system in need of further reform?

As I have already indicated, there are ample resources available to us. We have been selling Treasury bonds denominated in the currencies of other countries. We are committed to a program to continue that. The other countries are equally committed to help support the dollar. There are no limits on their resources.

In addition to that, of course, it is clear that the program, in itself, will not do the job. The program will only work if in fact the kind of budgetary restraint that the budget shows and monetary restraint, are continued and if the trade deficit is reduced and if inflation comes down.

I will be dealing with the trade deficit in a minute.

Meanwhile, there are discussions underway to see how the international monetary system can be strengthened further. This is a gradual process. I would like briefly to read from my prepared statement on that point, because it is critical.

First, while we do not believe the reserve role of the dollar is a major source of current exchange market difficulties, we are pre-

pared to consider proposals for evolution of the international reserve system. We have no interest in preserving an artificial role for the dollar, and we are quite prepared to contemplate a reduction in its relative role in the international monetary system.

Second, substitution proposals are under discussion in the International Monetary Fund, and we are participating in those discussions. Our objective will not be to resist change, but to insure that any change be an improvement from our own point of view and that of an open and stable system.

Third, while the substitution idea may look simple, appearances can deceive. There are serious questions about the costs of such a scheme and their distribution among countries; about the implications of a substitution account for the exchange rate system; about the contribution such an account could make to a better sharing of responsibilities for operation of the system; and about whether such an account would in fact contribute significantly to greater monetary stability.

In sum, the substitution approach involves questions that deserve careful evaluation—and certainly closer examination than they are frequently given. We intend to give the idea full consideration, weighing both its potential contribution and its potential costs. While it may be that some form of substitution proposal will ultimately be found practical, useful, and agreeable to the international community, I would prefer that the United States suspend judgment on that matter pending careful study.

To conclude this discussion of the international dimensions of our economic situation, let me stress that to keep the dollar firm, the United States must continue reducing its trade and current account deficits. The portents are hopeful on this front. Containing inflation at home will make our goods more competitive both at home and abroad. Foreign economies, and thus markets, will grow faster than our own economy in 1979 for the first time in 5 years, and this will provide better export opportunities.

Our trade balance showed marked improvement during 1978, and we expect this to continue. In the second and third quarters of 1978, the trade deficit narrowed to a \$31½ billion annual rate (balance of payments basis), some \$14 billion below the rate of the preceding 6 months. In the fourth quarter of the year, the trade deficit averaged about \$2½ billion, a \$30 million annual rate. Export volumes have risen strongly since March 1978; growth in nonoil import volume has slowed down substantially. We expect continued strong export growth and a very small increase in import volume in 1979. Although the oil price rise will add about \$4 billion to oil imports, the trade deficit should decline to about \$25 to \$28 billion for the year as a whole and, owing to our growing net invisibles surplus, the current account deficit could drop by about 50 percent from the \$17 billion estimated for 1978.

All this, Mr. Chairman, leads us to the expectation of a moderating real growth in the domestic economy from 4¼ percent down to the 2 to 2½ percent range and the inflation from 9 percent down to about 7½ percent for this year.

I think the recession forecasts are wrong. Of course, no one can be completely sure, but we feel confident that our forecasts are accurate.

First of all, the momentum in the fourth quarter of 1976 showed strong real growth. Second, inventory remains low and well balanced. Third, housing starts are good, but will level off. Fourth, exports should continue to be a source of growth, and that will be helpful, and also consumer spending, while leveling off, will continue at an acceptable rate. We don't see any sign of collapse in that area.

Finally, the investment picture is more mixed than we would like, but we expect at least moderate growth in that sector.

In conclusion, therefore, Mr. Chairman, we think that since November 1 there are hopeful movements in the economy.

Let me conclude by citing some of these.

The dollar has rallied by more than 9 percent against OECD currencies, the stock market gained substantially after the President's action. Financial leaders here and abroad now recognize that the Government is determined to see the inflation fight through to its successful conclusion.

It is no longer the smart bet to wager against the American economy. The recovery remains resilient. The American people have ignored the cynics and have shown a receptivity to a common voluntary effort to restrain wages and prices.

All this adds up to evidence that our economy can be steered to a less inflationary pattern without dislocation. These hopeful signs do not, of course, mean we have won the fight, but they give us a genuine chance to win it if we can maintain the momentum.

What we need to maintain our momentum is a sign that Congress too is committed to maintaining our prosperity for the decade ahead. I look forward to working with you and your colleagues on this important enterprise.

Thank you, very much.

[The prepared statement of Secretary Blumenthal follows:]

PREPARED STATEMENT OF HON. W. MICHAEL BLUMENTHAL

Mr. Chairman and Members of this distinguished Committee, I appreciate this opportunity to discuss with you the President's economic and budgetary plans for 1979 and 1980.

The American economy is at a critical juncture. Since the deep recession of 1974-75, we have enjoyed an unprecedented recovery of employment and production, but we have had less success in maintaining the value of our currency at home and abroad. This imbalance in our achievements cannot persist. Either we shall right the balance ourselves by bringing inflation under orderly control, or events will reassert equilibrium for us, by bringing the economic recovery itself to a disorderly close. There is no doubt which alternative best serves the public interest. The only question is whether we in Washington, subject as we all are to the usual political cross-currents, can find the will to choose and hold to the correct path. The stakes are high. In deciding upon this budget, the new Congress will largely determine whether or not we enter the 1980's with a firm foundation for long term prosperity.

We reach this decision point after several years of truly exceptional economic performance. Since President Carter assumed office, the gains in employment and output have outpaced even optimistic expectations:

Over 7 million new jobs have been created. This is the largest gain in employment during any two year period in our history, and the ratio of employed persons to the working-age population is at an all-time high.

The number of unemployed has been cut by more than 1 million persons, and the rate of unemployment has been reduced to below 6 percent. By way of reference, the rate peaked at 9 percent in 1975 and was still close to 8 percent at the end of 1976.

Real output has expanded by 10 percent, and industrial production has risen by 13 percent.

Real disposable personal income—income after taxes and corrected for inflation—has risen by almost 9 percent. Corporate profits have also increased—by more than a third—even after adjusting for the rise in replacement costs.

But all of these achievements now stand threatened by inflation. Unless we assure the integrity of our currency, both at home and abroad, the economy's forward progress will reach the familiar dead-end of recession and financial dislocation. We can avoid these evils, but only if we are prepared now, and for an extended period, to move the fight against inflation to the top of our list of economic priorities.

That is the message of the President's budget. I believe the American people are prepared to respond to that message—to join earnestly in a common effort to re-secure the fundamentals of economic progress for the next decade. I do not sense that the people share the superficial view that this budget lacks interest because it is short on new ideas for spending their tax dollars. They realize that in its very sparseness the budget constitutes a new initiative of major importance: an initiative to assert responsible control over our economic destiny.

I. THE INFLATION PROBLEM

Over the 1970's, inflation has posed a critical threat to economic progress throughout North America, Europe, and Japan. It has made all of our other problems much worse. In some countries, inflation has compromised political stability and democratic procedures. More than once, it has seriously shaken the international monetary system. Everywhere it has retarded economic growth and social progress. Inflation has proved to be far more destructive of prosperity, and far more intractable, than any of us would have imagined possible ten years ago.

As the decade comes to a close, however, we have learned that inflation is not like death and taxes: we can rid ourselves of it. In 1974, Japan suffered a 22½ percent rate of inflation; the Japanese inflation rate is currently running at 4 percent. Similarly, Germany has reduced its inflation rate from 7 percent to 2½ percent over the past 4 years, and the British brought their inflation rate down from 24 percent to 8½ percent between 1975 and 1978.

That is cause for hope. But it is also reason for impatience about our own experience. The inflation record of the United States has been less than admirable. The dollar's buying power has been cut in half since 1967. In the 1970's, inflation here has rarely gone into the double digits—but it has averaged 6¾ percent. Last year, the inflation rate experienced a disturbing acceleration. At the end of 1978 the CPI was 9 percent higher than at the end of 1977. This constituted an increase of more than 2 percentage points over the previous year's inflation rate.

The roots of our inflation problem are numerous and deep. There is no one cause for the problem, and we cannot expect to solve it either quickly or with any single panacea.

In the spring of last year, the President moved the fight against inflation ahead of all other objectives and began to mobilize the full arsenal of weapons necessary to win the fight.

During the spring and summer of 1978, the President worked with the Congress to reduce the 1979 budget deficit to less than \$38 billion. In late October and November, the President added important new weapons to the arsenal. He set a target of \$30 billion or less for the 1980 budget deficit; he announced that the Federal Reserve Board would take strong steps to contain credit expansion; he arranged with Germany, Japan, and Switzerland a far-reaching program to stabilize and strengthen the dollar in the foreign exchange markets; he set in place an unprecedented program for reviewing the economic impact of federal regulations; he promulgated a full program of voluntary wage-price standards, supported by an innovative plan for real wage insurance to encourage compliance with the wage standard.

The emerging anti-inflation strategy addresses virtually every major dimension of the problem, but I would like today to lay stress upon the four aspects of inflation that require governmental responses of a particularly determined, sustained, and concerted character: excess aggregate demand, sluggish productivity growth, the sheer momentum of the wage-price spiral, and the dollar's value on the foreign exchanges.

II. AGGREGATE DEMAND: THE NEED FOR SUSTAINED FISCAL AND MONETARY RESTRAINT

The centerpiece of the President's anti-inflation strategy is sustained and concerted restraint on aggregate demand, effected through both fiscal and monetary policies. There are two reasons for this emphasis on prudence in the making of budgets and the creation of dollars.

First, there have been clear warning signals of demand excess in recent months. The economic recovery has been sufficiently powerful and prolonged to absorb most excesses and indeed to generate inflationary strains in some labor and product markets. Our real economic growth has averaged 5.1 percent over the last 45 months; in the last quarter of 1978, real growth proceeded at a 6.1 percent annual clip. We are clearly reaching a point where the margin of idle resources is very thin in many sectors of the economy. Unless we now apply fiscal and monetary restraint in a controlled but firm and definite way, we risk hitting unmoveable barriers. This would throw us into a wholly unnecessary recession, with a great deal of unnecessary hardship.

There is a second reason for demand restraint: both here and abroad, experience has demonstrated that no anti-inflation effort—no array of policies—can succeed without the long-term, unwavering support of fiscal and monetary discipline. This long-term discipline is essential to reduce inflationary expectations and reverse the wage-price spiral. The President has not joined this battle against inflation to win temporary victories. Our goal is not a momentary pause in the wage-price spiral, but an economy securely settled on a path of long-term price stability and sustainable progress in growth and employment. This will require a long-term commitment to hold down the government's claims on the economy's real and financial resources, and a long-term commitment to keep the supply of dollars from validating excessive demands.

The President's fiscal year 1980 budget sets an example of restraint for the economy:

Federal spending will be nearly frozen in real terms. After adjusting for inflation, Federal outlays in 1979 will grow by only 0.3 percent and those of 1980 will be only 0.7 percent higher than in 1979. These are the smallest increases in five years and far below the 3.2 percent average increase for the previous 8 years of this decade.

Federal spending will be held to levels that absorb a smaller share of total output. Outlays in 1980 will be down to 21 percent of GNP, compared with the recent high of 22.6 percent in 1976.

The Federal deficit will be below \$30 billion for the first time in five years and will be barely more than 1 percent of GNP.

Federal employment will actually be reduced. Civilian employment in the government will be about 58,000 less by the end of 1980 than it was when President Carter took office. This will bring the ratio of federal workers to the total population to about 1.24 percent, the lowest point since 1950.

To achieve this degree of budgetary restraint is a major feat. Our long-term defense needs are substantially dictated by foreign dangers beyond our control. About three-quarters of federal budget outlays—over \$400 billion of the \$531.6 billion—are mandated by continuing statutes or obligations which are nearly impossible to alter in the short term. About one-half of budget outlays—over \$250 billion—represent transfer payments for individuals, which are usually indexed to the rate of inflation, so that total spending has a nearly inexorable tendency to rise in times of inflation. This leaves only a relatively small portion of the budget susceptible to practical control on a year-to-year basis by the President and the Congress.

In his budget the President has taken great pains to allocate the needed cutbacks fairly and sensibly among the many competing public demands, showing particular regard for those groups most in need of federal help and support. But make no mistake: The budget makes a major contribution to the poor and the disadvantaged in its very restraint, its very emphasis on fighting inflation. For it is society's most vulnerable members that suffer most grievously from inflation.

Fiscal austerity must be complemented by monetary restraint until the inflation problem is brought firmly under control. As Chairman Miller stated last week: "The Administration's wage-price standards and other anti-inflation initiatives can be successful only if they are backed up by macro-economic policies of restraint . . . We must find the courage to adhere for a sustained period to the course of policy we have charted."

Innovations in our financial system are keeping monetary restraint from concentrating its impact predominantly on the housing industry, which in previous cycles was the earliest victim of increased credit stringency. The impact of monetary restraint is now less discriminatory, but it remains a powerful and necessary component of our anti-inflation arsenal. And it is being used.

Our tight budgetary policies are easing the task of the monetary authorities. With a reduced deficit, and with off-budget financing activities being monitored more closely, Federal demands on financial markets will be substantially reduced. Federal borrowing from the public this year and next will be declining both absolutely and relative to the total amount of credit raised in financial markets. In 1976, the

federal government accounted for over a fifth of total credit demands. This year, federal borrowing will be around a tenth of the total, and the share of credit absorbed by the government will decline further in 1980. This means that monetary aggregates can be restrained without choking off essential flows of credit to the private sector.

III. SLUGGISH PRODUCTIVITY GROWTH

Another major source of our inflation problem is sluggish productivity growth—a low rate of increase in real output per hour of work. On this criterion, we have been finishing dead last among industrial nations throughout most of the 1970's.

Productivity growth is the fulcrum between wage inflation and price inflation. Over the long term, one can usually approximate the figure for price inflation by subtracting productivity growth from the rate of wage inflation. From 1948 to 1968, productivity in the private non-farm business sector rose about 2½ percent a year; labor compensation rose at 5 percent; and price inflation averaged below 3 percent. Over the last ten years however, productivity growth in the private non-farm business sector has averaged only 1½ percent, and last year it fell to an abysmal 0.8 percent. This means that average wage increases and price inflation now run at nearly the same rate: last year, for instance, compensation per hour (wages plus fringes) rose by about 9¼ percent; with productivity growth depressed, price inflation tracked right along at about 9 percent.

To improve productivity growth requires a long term effort to increase our investment in productive resources and to refrain from imposing excessive regulatory burdens upon the private sector. Last year's tax bill, involving substantial incentives for investment, will help. The President's new program for reviewing regulatory costs and benefits will help.

But it will take persistent policy attention over a number of years to return productivity growth to the high rates that made life so cheerful for economic advisers in the 1960's. Until then, price inflation will parallel average wage inflation: to bring down price inflation, we must bring down wage inflation, and vice versa.

IV. THE MOMENTUM OF THE WAGE-PRICE SPIRAL

Central to our long-term inflation problem is the sheer, self-reinforcing momentum of the wage-price spiral.

Inflation persists because everyone expects it to persist. Expecting high inflation, business sets high prices, labor demands high wages—and we thereby generate precisely the high inflation that was expected.

The wage-price spiral is enormously stubborn. Demand restraint can have some effect on it, and is clearly a necessary part of any cure; but, acting alone, demand restraint works its cure quite slowly and harshly. The U.S. inflation rate in the 1970's has declined with painful slowness even during periods of great slack in labor and product markets. Even when aggregate demand is sharply cut back, business and labor continue for a substantial period to act upon deeply ingrained expectations of high inflation. The inflationary momentum persists and, while it does, the decline in demand delivers its impact on the only remaining targets: employment and real growth. It is only after a considerable period of demand restraint that inflationary expectations finally begin adjusting to the changed economic conditions.

To succeed in reducing inflation, we must learn patience, but we must also seek to speed up the response of wages and prices to conditions of demand restraint. Every advanced nation has recognized this. Each has established its own particular procedures and institutions for braking wage-price momentum—for overriding unrealistic inflationary expectations—so that demand restraint can reduce inflation without socially wasteful delays.

It is for this purpose that the President promulgated voluntary wage-price standards last October. These standards describe a path for wages and prices consistent with the general moderation of economic activity that is assured by our application of fiscal and monetary discipline. If these standards are followed, the inflation rate will adjust downward to the slowing pace of the economy. We will avoid an unnecessary, sharp fall-off in real growth rates and an unnecessary, large increase in unemployment.

The wage-price standards are voluntary. The President strongly opposes mandatory controls. The U.S. experience with controls, and that of virtually every other nation, is that they saddle the economy with enormous bureaucracy, miles of red tape, and crippling inefficiencies. Very quickly, mandatory controls collapse under their own weight. Controls are an attempt to usurp the roles of the marketplace and the collective bargaining table in setting every price and wage throughout the

economy. That's an absurd and unnecessary project. Our purpose is merely to brake the momentum of wages and prices that is unresponsive to basic macro-economic conditions. That vital, but limited, purpose can be accomplished without excessive government interference in allocating resources and incomes throughout the economy.

But voluntarism raises a basic issue. It requires that everyone forego apparent short-term economic gains in exchange for long-term economic improvements of a much more substantial, general, and lasting character. Every working person has the legitimate concern that his or her compliance with the program will not be matched by others and will accordingly result in reduced real income as inflation continues beyond a 7 percent level. Wages are set for extended periods—6 months, a year, sometimes several years. Compliance on the wage side constitutes a relatively long-term commitment, and thus triggers a particularly acute concern about real income loss. This is the concern that drives the wage side of the wage-price spiral.

The President has proposed an innovative program for real wage insurance to meet directly this central concern of working people. The proposal would materially reduce the financial risks of compliance; it would lead to more widespread compliance, and thus to a more rapid and pronounced impact on the inflation rate.

The proposal in effect sets up an insurance contract. In this contract, we ask wage restraint from each employee group, so as to reduce inflation for the benefit of all; in return we offer to share the risk that inflation will in fact exceed the wage increase ceiling. This is a novel, but natural, response to a dilemma that has evaded solution for many years. In the overall structure of our anti-inflation policies, real wage insurance plays an important role for which there are no readily imagined substitutes.

V. THE NEED FOR A STRONG AND STABLE DOLLAR

The dollar's value cannot be protected at home if it is weak abroad, and we cannot maintain its integrity abroad if it is shrinking at home. Last year, that maxim received a sharp and painful illustration. The acceleration in domestic inflation served to weaken the dollar on the foreign exchange markets, and this in turn raised the domestic price level even further—as the cost of imported goods rose and provided an umbrella for domestic price increases. We estimate that the dollar's depreciation last year may have added as much as one full percentage point to our inflation rate.

The President moved forcefully on November 1st to put an end to this vicious cycle. He endorsed the imposition of greater monetary restraint domestically and arranged with Germany, Switzerland and Japan a program of closely coordinated intervention in the foreign exchange markets.

The U.S. has mobilized most of the \$30 billion in foreign exchange resources being used to finance our share of this effort. These funds have been obtained partly through use of U.S. reserves and partly by borrowing, including the issuance of foreign currency denominated securities.

The increase to \$15 billion in the central bank swap lines with those three countries took effect immediately on announcement. Drawings on the IMF in Deutschmarks and Japanese yen, amounting to the equivalent of \$2 billion and \$1 billion, were made in early November. Later that month we sold about \$1.4 billion equivalent in SDR's for Deutschmarks and yen. To date we have undertaken two issues of foreign currency bonds totaling the equivalent of \$2.8 billion—a DM issue of about \$1.6 billion in January, and a Swiss franc issue of about \$1.2 billion in January. We expect to borrow additional amounts during the fiscal year but have not yet decided upon the details of further issues.

The shift in intervention practices announced on November 1 was designed to restore order in exchange markets and a climate in which rates can respond to the improved outlook for the economic fundamentals that underpin the dollar's value. We are not attempting to peg exchange rates, nor to establish target zones, nor to impose exchange rates inconsistent with the fundamental economic and financial realities.

The initial response in the foreign exchange markets to the November 1 actions was good. From its low point on October 31 the dollar recovered on a trade-weighted basis by 12 percent by November 20. Against the DM and the yen the recovery was also 12 percent; against the Swiss franc, 18 percent. Subsequent pressures from political developments in Iran and the OPEC decision to increase oil prices substantially were met by forceful action from monetary authorities and by the resiliency of two-way trading. The dollar has stabilized and, today, on a trade-weighted basis, the dollar is over 9 percent above the October low.

We are beginning to see a change in tone and expectations in the foreign exchange and domestic money markets. Markets have been much more orderly and better balanced, although there is still some nervousness and uncertainty. I believe we will see increased stability as our determination to persevere becomes more evident.

The United States is determined to prevent any resurgence of the kind of conditions in the foreign exchange markets which led to the actions on November 1. Our resources are very substantial, and we will not hesitate to use them as necessary to achieve our objectives. The other participants have committed their own substantial resources to those joint operations. There is, in fact, no quantitative ceiling on the total resources which the four countries are ready to use.

Other members of the IMF are also dedicated to assuring exchange market stability. The recently amended IMF Articles of Agreement provide for strengthened surveillance of members' economic policies to insure achievement of this objective.

We are prepared to consider with an open mind ideas for evolutionary change in the monetary system. What is important is that any change be an improvement and that the transitions be accomplished smoothly and in a manner which strengthens our open international trade and payments system.

Mr. Chairman, at this point I would like to comment briefly on proposals to substitute special drawing rights for a portion of official dollar reserves, proposals that have been endorsed by some members of your Committee. I have three observations.

First, while we do not believe the reserve role of the dollar is a major source of current exchange market difficulties, we are prepared to consider proposals for evolution of the international reserve system. We have no interest in preserving an artificial role for the dollar, and we are quite prepared to contemplate a reduction in its relative role in the international monetary system.

Second, substitution proposals are under discussion in the International Monetary Fund, and we are participating in those discussions. Our objective will not be to resist change, but to ensure that any change be an improvement from our own point of view and that of an open and stable system.

Third, while the substitution idea may look simple, appearances can deceive. There are serious questions about the costs of such a scheme and their distribution among countries; about the implications of a substitution account for the exchange rate system; about the contribution such an account could make to a better sharing of responsibilities for operation of the system; and about whether such an account would in fact contribute significantly to greater monetary stability.

In sum, the substitution approach involves questions that deserve careful evaluation—and certainly closer examination than they are frequently given. We intend to give the idea full consideration, weighing both its potential contribution and its potential costs. While it may be that some form of substitution proposal will ultimately be found practical, useful, and agreeable to the international community, I would prefer that the U.S. suspend judgment on that matter pending careful study.

To conclude this discussion of the international dimensions of our economic situation, let me stress that to keep the dollar firm, the United States must continue reducing its trade and current account deficits. The prospects are hopeful on this front. Containing inflation at home will make our goods more competitive both at home and abroad. Foreign economies, and thus markets, will grow faster than our own economy in 1979 for the first time in five years, and this will provide better export opportunities.

Our trade balance showed marked improvement during 1978, and we expect this to continue. In the second and third quarter of 1978, the trade deficit narrowed to a \$31½ billion annual rate (balance of payments basis), some \$14 billion below the rate of the preceding six months. In the fourth quarter of the year, the trade deficit averaged about \$2½ billion, a \$30 billion annual rate. Export volumes have risen strongly since March 1978; growth in non-oil import volume has slowed down substantially. We expect continued strong export growth and a very small increase in import volume in 1979. Although the oil price rise will add about \$4 billion to oil imports, the trade deficit should decline to about \$25 to 28 billion for the year as a whole and, owing to our growing net invisibles surplus, the current account deficit could drop by about 50 percent from the \$17 billion estimated for 1978.

VI. THE ROAD AHEAD

We are mobilizing every element of economic policy behind the fight against inflation—fiscal policy, monetary policy, international financial policy, regulatory policy, wage-price policy, and more. None of this will work instantly; for success, we

will need a long-term commitment by the entire federal government, supported by a determined nation, to keep the anti-inflation effort at the top of our list of priorities for a number of years.

This does not mean that we face a bleak future. Quite the contrary. It is only by turning firmly against the forces of inflation, and then holding our course, that we can save our economy from economic turmoil in the short run and the trap of stagflation in the long run. If we show the requisite discipline, this economy can be successfully steered, without a recession, on to a path of price stability and steadily enlarging prosperity.

I am well aware that some are forecasting a recession for 1979 or 1980. In passing, I would note three points: First, we have been hearing such forecasts for better than a year now; as the economy shows continued resiliency, the predicted recessions keep getting a rain check. Second, the recession scenarios all involve much milder and much shorter downturns than we experienced in 1974; no one sees us on the road to a serious bust. Third, with very rare exceptions, the forecasters are not suggesting that we should seek to avert a downturn by now liberalizing our fiscal or monetary policies; this could only lead to a much more severe and prolonged recession.

My major point, however, is that the path we are now pursuing need not involve a recession. We do foresee a definite slowing in the pace of real growth—from 4½ percent last year to the 2 to 2½ percent range this year—and a concomitant moderation in the pace of inflation—from 9 percent last year to about 7½ percent this year. Our projected growth rate is just about where we ought to be—for the economy to cool itself off in a measured fashion, for inflation to turn resolutely away from the double digit range, for the trade deficit to narrow significantly, and for the dollar to firm up substantially.

Our projected moderation in inflation will come from a number of sources: the slowdown in growth itself, a fall off from last year's abnormally high rate of food price increases, the renewed stability of the dollar, a slower pace of advance for housing costs, and the discipline of the wage-price standards.

The respectable, though clearly diminished, rate of real growth in 1979 will follow from the continued resiliency and balance of the recovery. On this point, I believe, the private forecasters have been too bearish. Let me draw your attention to a number of hopeful signs.

Momentum: Contrary to most forecasts, the economy was growing at the end of 1978 at a very strong annual rate of over 6 percent. One million new jobs were added in the last quarter of the year, three million for the year as a whole, and we entered the new year with the ratio of civilian employees to the population at a record high.

Inventory balance: We have avoided excessive inventory accumulation throughout this recovery. Businessmen have been alert in keeping their stock-building close relative to sales. Even after adjusting for the inflationary bias in inventory/sales ratios (sales are recorded at current prices, but inventories may be carried at earlier and lower prices), these measures show reasonably good balance in most industries.

Housing: While housing activity can be expected to taper down some next year, partly in response to the high prices of new housing and partly because of the high level of financing costs, there is no reason to expect the sharp drop in housing activity that has been characteristic of past cyclical swings in the economy. Usually an early victim of credit stringencies, housing starts have been at over a 2 million unit rate since last winter. This strength reflects in part the strong support of the mortgage market by government housing agencies, but more importantly, the changes in financial structure that have enabled the housing sector to compete for funds in the financial markets despite sharp increases in interest rates. At the same time, social and demographic changes in family structure should continue to support strong housing demand.

Consumer spending: The ratio of consumer debt to personal income is high by historical standards and bears very careful watching. But the reasons may be due more to demography than to a serious abuse of consumer credit. There are now an unusually large number of consumers in the 25- to 44-year age group. People in this age category are typically the heaviest users of credit—they are forming households and buying homes and durable goods with the reasonable expectation of rising incomes in the future. The increasing trend toward two wage-earner households is another factor encouraging durable goods purchases often financed on credit. In view of these demographic factors, and of the fact that delinquency rates have been relatively stable over the past three years, the rise in consumer debt appears somewhat less alarming. It remains in need of careful monitoring, but a consumer

debt appears somewhat less alarming. It remains in need of careful monitoring, but a consumer-led recession does not at this point appear likely.

Exports: Exports are finally becoming a potent source of growth, as domestic demand abates and recent exchange rate changes work to increase the foreign demand for U.S. goods. Signs of accelerated export growth are already clear—nonagricultural exports in the latest three months, September–November, increased by more than 20 percent from levels of six months earlier.

Investments: Signs here are more mixed. The recent surveys indicate somewhat slower real growth for 1979 in business fixed investment, compared to the past two years. However, other advance signs of capital spending, such as new orders for capital goods and construction contract awards, indicate continued strength in this vital area. Our attack on inflation requires that we accelerate the extremely slow pace of productivity advance, and this means we need increased capital formation, to upgrade and modernize our capital stock. This was a primary emphasis in last year's tax bill, and I expect its enactment will help this sector toward at least moderate, continued advance in the coming year.

Taken in sum, this evidence points to a pronounced but orderly easing of the economy's advance; it does not point to an actual reversal. Obviously, all economic forecasts leave a great deal to be desired, but the available evidence does not justify a gloomy view of our prospects.

VII. CONCLUSION

I began by noting that the American economy is at a critical juncture. Let me close with a word of guarded optimism.

It has been just three months since the President took a series of bold and coordinated steps in fiscal, monetary, exchange rate, and wage-price policy. These steps have set in motion broad and hopeful trends throughout the economy.

The dollar has rallied by more than 9 percent against OECD currencies, and the stock market has gained substantially, since the President acted. Financial leaders, both here and abroad, now recognize that this government is determined to see the inflation fight through to a successful conclusion. It is no longer the smart bet to wager against the prospects of the American economy. The recovery remains balanced and resilient. The American people have ignored the cynics and have shown a genuine receptivity to a common, voluntary effort to restrain wages and prices.

All this adds up to strong evidence that our economy can indeed be steered to a deflationary path without dislocation, turmoil, and recession.

These hopeful signs do not of course mean we have won this fight, but they give us a genuine chance to win it—if we can retain the momentum.

What is needed now, to maintain our momentum, is a clear sign that the Congress too is committed to securing the foundations of our prosperity for the decade ahead. I look forward to working with you on this important enterprise.

Senator BENTSEN. Mr. Secretary, I will limit the questions to 10 minutes per member. And if time permits, we will make a second round, as long as we get the Secretary out by 12 o'clock, and no later.

Mr. Secretary, I have already commented on the dollar rescue that you introduced in November and I congratulate you on being able to sell the administration on that with very positive and affirmative results.

I certainly agree with you on the regulation phase. I introduced four bills this year, and passed three of them last year through the Senate, aimed at cost-effectiveness, and the problems of conflicts in regulations, and the regulatory budget, and extending these to the independent agencies to try to accomplish more in this area. I would appreciate your looking at some of these proposals, and having your staff look at them to see where you can be supportive of my efforts).

Now, concerning the problem of inflation, one of the ways that Germany and Japan cut their inflation down to 4 percent was through the strengthening of their currencies, and, frankly, I think, through the use of trade restrictions, particularly by Japan.

We had a \$28½ billion deficit last year, according to the Washington Post, and we are predicting something like a \$25 billion deficit next year. That is some improvement, but it is pretty modest.

Yesterday, we asked Chairman Miller the following question: Suppose the dollar weakens once again in the months ahead. Would you prefer to attack that problem by increasing interest rates, or would you prefer to see an import surcharge imposed like the one that was put on back in 1971?

At that time, I think, we put on a temporary 10-percent surcharge and one of the reasons, as I recall, was to get some support for a floating rate.

Now, you are long experienced in some of these trade problems, and I recall one story in which, in the middle of the negotiations, you walked out on them, and virtually started to walk up the gangplank to the plane, looking back over your shoulder, I guess. At that point, as I understand it, they stopped you. But you had to do that to get some of these things accomplished.

I think we have to do some of those same kinds of things now. I am not criticizing Ambassador Strauss, who I think has done a very fine job, but we started off the Tokyo Round with such imbalances. For a long time, we thought we had so many claims that we could lose some of them and still come out all right. We argued that it was trade, not aid. But we carried it to such a degree that imbalances were created. Now, when we try to get some kind of consideration, they want it on a quid pro quo basis, and we start from a position where we have very little to give, unlike some of our counterparts. It is a very serious problem for us.

Chairman Miller said if he were faced with the choice of higher interest rates and a surcharge, he would favor a surcharge. I know that a surcharge is a very dramatic approach, which will have a profound effect, but most of the decisions we have made on trade since World War II have been based on their political consequences and not their economic consequences. But if we lose the economy of this country, the political consequences will be nothing. We are down the tube.

I think we have to give serious consideration to a surcharge as one of the possibilities. I guess one of the options is to just tough it out, but that can be a long-term situation, with a very debilitating effect on the dollar.

I would like to have your comment on this, Mr. Secretary.

Secretary BLUMENTHAL. I will be glad to comment, Mr. Chairman.

Let me say that it is always difficult, and I try to avoid it, to give comments or opinions or answers on hypothetical situations.

Senator BENTSEN. That \$25 billion deficit doesn't sound too hypothetical.

Secretary BLUMENTHAL. The choice between a surcharge and escalating interest rates at this point, however, is hypothetical, and it is difficult for me to comment in those terms. I would say we have to be aware of the fact that a surcharge on our imports would in the first instance be inflationary.

Senator BENTSEN. That is right, but at the same time it strengthens the dollar, which works to slow inflation. The decline of the dollar last year added about 1 percent to our inflation.

Secretary BLUMENTHAL. I think the dollar is affected by two basic considerations, Mr. Chairman, our ability to get inflation under control and the prospects for a permanent, sustainable reduction in our deficit in trade and current accounts.

Let me deal with the problem of unfairness in trade.

As you indicated, I do know a certain amount about that, and I fully share your concern. I think that there are some markets, and I think the market of Japan is one of them, where we do not have sufficient access, and where, clearly, it is necessary and essential, and I know that Ambassador Strauss and all of us have made that very, very clear, that we cannot conclude a multilateral trade negotiation, we cannot maintain the kind of situation that presently exists if there is not substantially greater and better access to the Japanese market, and to other markets, in which products of the United States are dealt with discriminatorily.

There are a whole range of these practices that have to be removed. We have in the area of subsidies, for example, all kinds of hidden and open subsidies all over the world which discriminate against American products, and the subsidy code which is being negotiated in the MTN, would make an important contribution in that regard.

I think there is another factor, however, that we have to bear in mind, and that is that we have to instill in our own people a greater export consciousness. Big companies do export, but that whole vast segment of medium sized business in the United States looks first at the American market and not at the overseas market.

It looks at it quite differently than European or Japanese businessmen do. That requires a lot of work on our part, on the part of the Government. There is the whole problem of productivity. If we can accelerate productivity and get inflation under control, we will be able to compete better in international markets.

More R. & D., promoting our technology, more investment in productive plants, all of that allows me finally to deal with the question of the Treasury's administration of the statute on anti-dumping, which you raised earlier.

We do our very best to administer that statute fairly and efficiently. We do not seek to administer it in a protectionist way. We do not see the Congress mandate as being one in which we are asked to use the antidumping statute to move the U.S. economy to a protectionist stand.

We do use that statute as it was written to protect the U.S. domestic manufacturer from sales into this market at less than fair value.

Senator BENTSEN. Mr. Secretary, my concern is that Treasury carry out the intent of the law as passed by this Congress, not that it be done in a protectionist way, but that we do it for equity in trade and that we see we are not discriminated against. I have had many, many statements made to me by representatives of domestic industry who say that it is not evenhanded; that if a situation is found where the subsidy problem has been corrected, the Treasury—and I am not just talking about your tenure, but about a long

history at Treasury—is very quick to maneuver to handle that, but if discrimination is found to exist, Treasury officials drag their feet. They bend it, and we have had this kind of action taken by some of the people in the Treasury.

Secretary BLUMENTHAL. Mr. Chairman, I will personally want to look into any instance in which it is felt that we are not carrying out the intent of the statute. My instructions to the Department, as long as I am there, are to comply fully with the intent of the statute.

There are frequently, of course, as you realize, technical decisions that have to be made. We want to be fair to the importers and to the American consumer, as well as to the domestic competitors, but the instructions are clear.

If you know of an instance, or any of your colleagues, where we are dragging our feet, I wish you would let me know, and I will look into it personally.

Senator BENTSEN. We will go back to these people for specific instances so that we can submit them to you.

I think Japan is particularly flagrant in this regard. I think they are one of the most protectionist of the modern nations.

With respect to their concession on beef, they can afford to be magnanimous. They, at the present time, allow the importation of one thin hamburger patty per Japanese resident per year; now they have agreed to a quarter pounder.

They made \$250 million in concessions, but they had an \$8 billion trade surplus in 1977. They said, "Give us a little time, and we will take care of that." They took care of it all right. Their surplus went to \$12 billion. You have a concession which is one forty-eighth the size of the problem.

I am sorry. My 10 minutes have expired.

Senator McClure.

Senator McCLURE. Thank you, Mr. Chairman.

I notice with some interest your statement with respect to the reforming of the IMF, in which you indicate that we are not blindly opposed to the creation of a new reserve system, but if I read in context all of the statements that were made in your prepared statement, it seems to me that you are taking a cautious view of the possibility of substitution of something else for the dollar as a reserve currency.

Am I correct in that assumption?

Secretary BLUMENTHAL. We are taking a cautious view, and I have tried to indicate why that is. It is not because we are opposed to a relative reduction in the use of the dollar as a reserve asset in the future. It is for two reasons, or maybe three.

It is, first, that we are conscious of the fact that the dollar's reserve role evolved gradually, and that any evolution toward greater use of other currencies as reserves will have to be gradual if it is not to cause a lot of difficulty.

Second, there are difficult technical and to us very important questions that have to be resolved, and I gingerly referred to some of them in my prepared statement. They require very careful negotiation, or the results could be harmful.

The third point is that we are in discussion of this problem, of course, within the IMF. Those discussions are going on, and we

wish not to prejudice them or harm the probable outcome. But the overall thrust of what I attempted to say, sir, is that we certainly recognize this evolutionary development, and it is not one that we want to resist.

Senator McCLURE. There seems to me to be a shift in policy as far as the trade vehicle is concerned, or the enunciation of a new policy, because 2 or 3 years ago, the Treasury was eagerly promoting the idea of substitution of something else for the dollar as a reserve currency, and as I read the statements and listened to the testimony of Treasury and others before this committee and before the Budget Committee, they were pushing the idea that we had to abandon the dollar as reserve currency, that the dollar as a matter of fact should not be a store of value, but only a medium of exchange, and that was its only appropriate role.

I take it that you don't agree, or you don't agree as I stated it.

Secretary BLUMENTHAL. Well, I don't, Senator.

I would say I would be surprised—certainly not as long as I have been in the Treasury.

Senator McCLURE. This was before you were Secretary.

Secretary BLUMENTHAL. Now, if you are referring to the SDR's, the special drawing rights, we have continued to be strongly supportive of strengthening the role of the special drawing rights.

That policy has not changed at all. It is really the terms and conditions under which this happens, including the idea of substitution accounts and all those things, that I was referring to. But we are still in the lead in promoting the SDR's role and strengthening that role, and, again, it is a gradual process. We cannot do it in 1 year.

Senator McCLURE. I was hoping there was a more pronounced change of direction than that statement would indicate. I have never been enthusiastic about it, but the idea that substitution of paper accounts for real mediums of exchange was a substitution in the long run.

I think that is how we got into this problem in our country. It was too easy to juggle paper accounts and turn on the printing presses and print money.

Now, there are \$500 billion in Eurodollars. I don't see how we can meet that problem when we continue to run a deficit in our balance of payments which is chronic, and it continues to be chronic.

You know, we are always measuring progress against the worst it has been, even though by any other test, the current statistics would be horrendous, whether it is inflation rates, or interest rates, or unemployment rates, or deficits in balance of payments.

They only look good by comparison to the alternative of what they have been and might be.

Secretary BLUMENTHAL. Senator, I certainly agree with the fact that while you can show some recent progress compared to the nadir of the situation, it is hardly a satisfactory situation at all. I would agree with you.

Second, I think that we have to be realistic about what is possible. There are some countries that have some reticence about the international use of their currencies, and which have limited capability of promoting their currencies' reserve status.

Some of them are concerned about the impact of reserve currency use on their domestic money supplies. Some of them do not have the well developed capital markets that would be required for this. But we have seen over the past an increase, some expansion, in use of the German mark and the Japanese yen, for example, in both absolute and relative terms as reserve currencies. And we would be quite prepared to see a further expansion of this, in addition to considering the other kinds of reforms in the IMF to which I referred a little bit earlier.

Let me make one final point about the overhang you have referred to, the \$500 billion—nobody knows exactly what it is. It would be erroneous to leave the impression that that amount of dollars is out there because we have been running, for a number of years, an adverse current account balance.

Certainly, in recent times that has contributed to it. But, a good portion of those foreign dollar holdings represents borrowing by foreigners in the United States for productive purposes. As a matter of fact, I am not totally sure what would have happened to the international economic system if we had had controls on this market, or even whether such controls would have been possible.

Now, a problem has been created as a result of it, and I don't want to underrate the significance of that, but it would be wrong to say it is all due to the profligacy of the United States—that there are many hundreds of billions of dollars out there, and that they represent only our deficits.

Our deficits represent a relatively small portion of that total. Much of the rest of it is borrowing by foreigners in this market which is very helpful to them.

Senator McCLURE. Assuming for a moment that foreign governments operate as ours does—which they don't—they have frequently taken our advice and sometimes they have been right.

They could have created the capital necessary for expansion in the same way we have: Simply print more money. They didn't choose to do that. They came to borrow from us. We accommodated them by creating more money which they could borrow from us.

I assume that that money flowed out because the return on the dollar was better in foreign countries than it was here. Otherwise, they would not have come over here to borrow, where it is cheaper, and would have invested there where the opportunities are greater, except for the fact that their own countries are more restrictive on monetary policies than we.

Thirty years ago, the French were here to complain about the effects of the chronic deficits which supported our currency surplus to France, and caused their economy to suffer the inflation caused by that increased capital, while we escaped some of the inflation in this country because we had exported some of our excess capital.

I know the West Germans have absorbed nearly \$50 billion in their dollar support operations up to now. I know, too, that they have expressed their concern that they have had to create deutsche marks in response. In that process, and when they have done that, they inflate the German money supply which produces a major inflation in their own country. I would think they would be clearly unhappy, in view of their past history of management of their economy and the monetary system, if we were to throw more of the

burden of the support for the dollar onto their shoulders by increasing the rate at which we create dollars.

Are you in support of the Federal Reserve's current practice—current posture, I should say—with regard to the rate of money growth?

Secretary BLUMENTHAL. I am. That is a responsibility that the Federal Reserve has, of course. I have been encouraged by the way in which the aggregates have been moving, at least over the last several months.

As Chairman Miller has testified, they are moving in the right direction. I think, really, it comes back to—and I could not at all disagree with you, Senator—our budgetary policies and the kind of restraint that the President has been urging.

I think if we do that, if we bring the budget deficit down and bring it down further in 1981 than in 1980, and move it toward balance, as the President wants and has committed himself to do, I think the problem will take care of itself.

I have been encouraged by talking with my colleagues in Germany and elsewhere in Europe, and also to the bankers and other private groups. They are now seeing daylight. They do see our policies as being correct and, with your help, I think we will succeed.

Senator McCLURE. Thank you, Mr. Chairman.

Senator BENTSEN. Congressman Reuss.

Representative REUSS. Mr. Secretary, I am delighted to hear in your statement what you have to say about a possible substitution account in the International Monetary Fund. My happiness relates somewhat to what Senator McClure was just saying. Without the express willingness of the United States to discuss a substitution account in an international forum, we don't really have any answer for the complaints of some of our friends abroad, who talk about the exorbitant privilege which the United States has, as the possessor of a key currency, and about being able to pay for its debts in its own money.

I quite agree with what you have to say. You have to inspect proposals very closely; in your words, "Weighing both its potential contribution and its potential costs." But with that very necessary caveat, I think we are in a much better position internationally.

I commend you for the willingness you are displaying. To any foreigner who makes the suggestion, from here on out, that the United States is simply printing money to pay its debts, I think we can now respond by saying that we are as cognizant as anyone else of the odd situation where the key currency country also runs a deficit, and that we are ready to cooperate with those who think that their exchange risk should be cushioned.

I think it can be done in a way that minimizes costs to the United States, but that remains to be determined by negotiation. That is your job, not our job.

Secretary BLUMENTHAL. Congressman Reuss, may I make some comments on that, because that is a very important issue. You are right. We are willing, and that willingness is clearly on the record.

Second, may I say—and I will phrase myself carefully—the point to which you mention and which we hear from some of our friendly partners in other countries from time to time, about the exorbitant

privilege of the United States, at times strikes me as somewhat disingenuous.

Perhaps that is the right diplomatic way of putting it, for with the exorbitant privilege also goes an obligation. Others are well aware of the fact that we bear that obligation, and they are quite happy to have us bear that obligation, in fact, that is part of the negotiating problem, Congressman Reuss. There are certain obligations that they have to take on. They would like us not to have any privileges but to have all the obligations. What we are negotiating about is sharing the privileges and the obligations.

For example, it is clear that we cannot succeed in the world unless there is cooperation on both sides. That is implicit in what I have said. For each deficit there is a surplus someplace. The chairman quite properly referred to the large and increasing surplus on the part of the Japanese. It has been a tenet—unfortunately, one observed more in theory than in practice—in international discussions that surplus countries have an obligation to adjust their positions. I must say those discussions go back to the last time I was in the Government, almost 20 years ago. We used to say almost ritualistically that the surplus countries have as much obligation to get rid of their surpluses as the deficit countries do to get rid of their deficits. While there is still a ritualistic bowing in that direction, we don't see as much effort at reducing surpluses as they would like us to pursue in the reducing of our deficits.

As for substitution accounts, without elaborating further, I would say there are very important questions here that require careful negotiations. The exchange rate is a very important issue. The interest rate to be paid on the account and by the account to the depositors is important, as is the medium in which it is to be paid. There is a whole range of not just technical questions, but questions that have a financial impact. If we agreed on them in the wrong way, I know I would be before this committee and many others very, very quickly, and be subject to a great deal of critical scrutiny with reference to what it is we had agreed to. There is a road to travel toward a willingness to work these things out, and it is really that key issue—an appropriate balance of privileges and obligations—that I have in mind when I note a certain amount of caution in this exercise.

Representative REUSS. As I said, I am pleased with both the position and the caveat, and I note what you said about getting rid of surpluses. I think we Americans can point with some pride to the fact that in the last 25 years we have done a more stupendous job than any nation in the history of the world in getting rid of surpluses—if that is cause for congratulations. [Laughter.]

I liked what you said in your prepared statement, "To keep the dollar firm, the United States must continue reducing its trade and current account deficits."

Our thinking is on target with what the West German finance minister has to say, and although I don't always think foreign advice is on target, I think he is right there. We note a \$28 billion deficit last year in our trade account—

Secretary BLUMENTHAL. \$20 billion.

Representative REUSS. \$28 billion.

Secretary BLUMENTHAL. In balance of payments terms, last year it was almost \$35 billion—\$34½ billion.

Representative REUSS. Oh, yes.

Secretary BLUMENTHAL. We are a little concerned that there be no confusion about that number you saw in the prepared statement. The number you saw in the prepared statement—\$26 billion or something—is on a census basis. We use the balance of payments basis of \$34½ billion, and we expect that to decline by something like \$10 billion.

Representative REUSS. Then you say you are hopeful that we will get a decline in our deficit. You point out reasons for hopefulness. One is that containing inflation will make our goods more competitive at home and abroad. We must continue to hope for that.

Second, you point out that in 1979 our economy is not going to grow as fast as others in 1979, and that ought to help us. Perversely, that is true, but you and I, and everybody else, hope that this will be a 1979 phenomenon by itself, and that we will start growing again, just as soon as we get inflation under control.

What I am getting at is this: We now import some \$40 billion worth of oil. It is down a couple of billion, I suppose, from the year before, but the price of oil is going up again this year. What real way is there of getting our trade and current account deficits under such control that the international dollar, without market rigging, will be strong, other than some combination of taxes and rationing, for cutting down on the pleasure use of gasoline in this country?

It is pointed out that if we could restrict unessential driving, that alone could enable us to bring our oil imports under control, and thus our trade and current account deficit.

I know that there are problems, but it does seem to me that by a combination of taxation and rationing, having in mind the necessity of protecting American workers and others who need gasoline for essential getting to and from work and for other purposes, we could accomplish a diminution of the record dimensions of our pleasurable and joyous, but economically disastrous, use of this fossil fuel.

Secretary BLUMENTHAL. There are a number of points, sir.

The first one is that we expect our current account deficit this year to decline by about 50 percent from some \$17 billion to about half that.

Representative REUSS. Our deficit?

Secretary BLUMENTHAL. Yes, our current account deficit to decline. Our trade deficit, if our projections are correct, will be in the area of \$25 billion. Our current account deficit will be significantly smaller because we have historically had—and continue to have—a large and growing surplus on invisible items. I make that point to underscore the fact that it is not necessary, nor perhaps even desirable, for an economy like that of the United States to have a balance in the trade account. We don't object to it, but that does not need to be our goal.

What the foreign markets and international observers watch is not only the trend, both as to trade and current accounts, but also whether or not the current accounts get in reasonably stable bal-

ance for the longer term. We must improve our trade balance. I want to come to that point now.

Our trade deficit must be reduced, but it need not be totally eliminated for us to have a balance or, indeed, a surplus in the current account.

Now, the problem of energy to which you refer is clearly a very, very critical matter. We estimate that the cost of energy imports in this coming year, in the one that has just begun, will be some \$4 billion more than it was last year due to higher prices, and that is a burden. I think there are a variety of ways to improve our trade balance generally, and our deficit on energy accounts.

I would have to say to you—and it may not surprise you greatly—that before I would urge that we move to rationing of gasoline for other than essential use, I would want to seriously explore and try all kinds of other things, because when I inveigh against controls, I include those kinds of controls as well.

In my judgment, the black market for gasoline coupons and the distortion—the determination of what is or is not essential driving is difficult—you know, one would have to be in a pretty extreme situation to want to resort to that.

Increasing production in the United States, increasing research on alternate sources of energy clearly are other ways, and perhaps more effective ways, in which we can reduce our independence on foreign energy.

The President has previously said that the domestic price of oil will have to rise. Now, that has some short-term inflationary effects. I don't think they will be there over the long term. I think that would be helpful. So we have to use various ways to bring oil imports down and get our exports up. I would hope—and the tax system can be used in a variety of ways—that we don't have to go to rationing. I would be very dubious about that.

Representative REUSS. My time is up, but I would give part of a rejoinder.

All of the difficulties you see with controls I would agree with, but I still think it would be very helpful if the President went on television, and outlined precisely the kinds of things like driving habits, family budgeting, carpooling, cutting down on pleasure driving, coordinating trips, smaller horsepower—the whole business—that are needed, and educate the American public so that the average citizen could see, as he now cannot, the real need for this kind of conservation.

I think that the American people—on a voluntary basis—would be willing, as they have been in other fields, to surprise some of their governors on how much voluntary conservation they are capable of.

So, I would hope, that among the things that we do, would be some sort of a real, understandable, commonsense, voluntary program of gasoline conservation to try to cut down on nonessential driving.

Senator BENTSEN. Thank you very much, Congressman Reuss.
Senator McGovern.

Senator MCGOVERN. Mr. Secretary, as long as we are on the trade question, I would like to raise one additional question.

In the Sunday New York Times, there was a piece by Mr. Nevin, president of the Zenith Corp., in which he was giving his analysis of why we have this large trade deficit, especially with the Japanese. He made the comment that it is commonly thought that it is related to productivity, but actually the American worker is 50 percent more productive, at least in the television and electronics fields, than his counterpart in Japan, and that the real problem is the taxing differential, which has the effect of making American products more costly than the Japanese exported products.

To what extent do you share that analysis?

That may not be the full picture. He was talking about the whole problem of dual pricing of goods that are produced in Japan as compared to American goods. They are priced in a discriminatory way.

Secretary BLUMENTHAL. Senator, I think there is something to what Mr. Nevin says. The American worker is quite productive. He has a lot of capital available to him. Our technology is as good or better than that of any other country, so that point is well taken.

I must say that the growth in productivity, the relative development we have here, is, as we said earlier, very worrisome. The fact is that it has not been growing.

Senator MCGOVERN. When we use that phrase, is it the total productivity or the individual per worker productivity?

Secretary BLUMENTHAL. We are using it in macro terms. We are using it for the economy as a whole, but we are relating the total output of the economy to the total efforts of all workers, and when you add it all together; that is, you add the television industry, which Mr. Nevin knows something about, and the service industries and everything else, we come up with the results that you get very little additional output per unit of labor input last year than you did the year before.

That is worrisome, that it does not continue to grow. It should grow by 2 or 3 percent at least.

Senator MCGOVERN. I was startled by his contention that the individual American worker's productivity is 50 percent higher than the Japanese worker.

Secretary BLUMENTHAL. Well, I don't know that exact figure, but let me give you the figures for the growth in manufacturing output per hour.

Senator MCGOVERN. Yes.

Secretary BLUMENTHAL. During the period 1960 to 1977—a fairly long period—the United States, being a more mature economy, grew by 2.6 percent output per hour.

The Japanese grew by 8.8 percent. They, I think, led the parade. Germans grew by 5.5 percent; twice as much as the United States.

In the period 1970 to 1977, just taking this decade, we dropped from 2.6 to 2.3 percent. The Japanese were still about double ours at 4.2 percent. They also slowed down, and the Germans really went up a little more, to 5.7 percent. That, again, is more than twice as fast as we.

I have given you our productivity figures for the last year in my prepared statement. I think the key point that you make is correct in that the whole structure of costs, which is not just output per

worker and pricing, is quite different in Japan than it is here, and that at times tends to be discriminatory toward the U.S. markets.

I did not read the article, but knowing the problems of the color television industry, that is one that Mr. Nevin has great concern about, and he is right to be concerned.

It has to do with a number of things. The first is that we use direct taxes, income taxes. Germans, other Europeans, the Japanese and others use a much higher proportion of indirect taxes, value-added taxes.

Under the international trade rules, indirect taxes are rebatable at the border. Direct taxes are not. There has been some suggestion, and I think Senator Long has raised that issue, and I believe Congressman Ullman has raised that issue, as to whether or not the United States should not consider changing its tax system more in the direction of that kind of a value-added tax.

Senator MCGOVERN. Either that, or change the trade rules.

Secretary BLUMENTHAL. That would be another way. But if you are referring to the tax system, the differences in the tax system, that is the issue that has to be addressed. My answer would be that we shouldn't do it just for trade purposes. The primary purpose of taxation is to have a fair and equitable system of raising revenues for national needs. However, that would be one important consideration if we do make a change, that it would probably help on the trade front.

I personally welcome a careful and clear study of that issue, which I hope will get underway, so that we may move in that direction.

Now, apart from that, it is true that in that industry, the Japanese have at times been selling at what we considered to be less than fair value under the definition which the Congress has laid down in the antidumping statute, and we have acted.

Now, again, people could quarrel as to whether we acted sufficiently, or fast enough. It is very difficult to establish what fair value is, under the terms that we have to use, but that has been done, and we have brought about some correction of that.

Senator MCGOVERN. Turning to another matter now, Mr. Secretary, the administration has repeatedly stated that the present inflation has not been caused by excessive demand, and last year's report of the Council of Economic Advisers, in there there was a rather lengthy explanation of why demand restriction is a costly and inefficient way to deal with inflation.

Just to bring the language back to mind, I am quoting from last year's report:

An attempt to purge inflation from the system by a sharp restriction of demand would require a long period of very high unemployment and low utilization of capacity.

That same view is echoed by a number of former members of the Council. Mr. Okun said that trying to balance between reduced inflation and reduced growth can cause severe consequences—suggests that a 5-percent slowdown in GNP under present circumstances would cut the inflation rate by less than a percentage point, and cut the growth of real output by more than 4 percent. In short, it would eliminate real growth and barely put a dent in the inflation rate.

My question is: Have conditions changed so drastically that what was considered sound doctrine a few months ago is no longer sound?

Secretary BLUMENTHAL. No, they have not, Senator. I think if you were to draw one distinction, one principal—and there are many—but one principal distinction between the approach to economic policy of this administration as compared to that of the previous administration, it is that we do not believe that there is one single cause for inflation, and that we can cure inflation in 1 year or in several simply by tightening the economy, by restricting overall demand, letting unemployment rise, and wringing inflation out of the economy in that way.

That is not only, in our judgment, ineffective, it is unjust, and would not do the job.

It is for that reason that the President has proposed a whole series of measures which would impose restraint, certainly a moderate restraint, under which we assume the rate of unemployment would rise only very slightly from the present levels in overall terms. Obviously we face a somewhat different situation now than we did in the period for which this report was written, because at that point the total percentage of productive capacity being utilized in the economy was lower than today. We do have today a pressure on resources, and, therefore, we clearly have to slow things down. We cannot grow as we did in the last quarter, calendar quarter, of last year, at a 6-percent annual rate in real terms, or we would have demand-induced inflation added to all the other factors.

We want to slow it down somewhat, not to put this economy into a recession, not to raise the rate of unemployment substantially, but to moderate the rate of expansion. That kind of moderate program means a lower budget deficit but not trying to do too much in any one year. We need to take action on all these other fronts: stimulating productivity and strengthening the dollar. We need to do all these things to bring about a continually expanding economy and not one that we put into a tailspin in order to deal with inflation.

Senator MCGOVERN. Thank you, Mr. Chairman. My time is up.

Senator BENTSEN. Senator Javits.

Senator JAVITS. Mr. Chairman, I join my colleagues in welcoming the Secretary. I have noted with great satisfaction your response to suggestions of Congressman Reuss and myself respecting the substitution approach to dealing with the huge overhang in the world markets. While this approach has problems attached to it, it also may have enough attractions to justify it. This will depend on whether we can get the necessary agreement and cooperation from other major nations whose currencies would be involved.

I appreciate your views very much, and I feel that Congressman Reuss and I will be patient. We understand the problem, but you also understood very clearly our concern with this overhang where the dollar is always in jeopardy. There is a great note of uncertainty, especially in view of the volume of the overhang, despite the enormous resources that we now have to deal with raids on the dollar. In the face of such a vast amount outstanding, our reserves would hardly be adequate.

So I hope, Mr. Secretary, that this represents an important priority, and that it will be pursued and that we will hear from you on it.

Secretary BLUMENTHAL. It certainly is, Senator Javits.

I commented on this not only in my prepared statement, but in my exchange with Congressman Reuss, rather fully. I will not repeat it here. We are working on this problem, and as I indicated, we are not resisting it. We are trying to promote progress in the light of a lot of technical problems that have to be worked out which have great financial and policy implications for us.

Senator JAVITS. Also, I gather from your interchange with Senator McClure, that you indicated our willingness to see the very strong currencies—the deutsche mark, the yen, and the Swiss franc—as contrasted with our own, some added reserve role.

Secretary BLUMENTHAL. Yes, indeed.

Senator JAVITS. Now, one question I would like to ask you about Japan. Their balance of trade with us, of course, grew, rather than receded. Nonetheless, you anticipate a material drop in the U.S. trade deficit this year.

I would like to, therefore, ask you for your appraisal of the effect of continued growth in the United States. You just testified to that to some extent. I want to ask whether that would have a negative effect on the trade deficit, as forecast by the President.

Could we have a little better idea as to the plans of the administration in that regard?

Secretary BLUMENTHAL. As to trade, Senator, we believe the improvement is there for us to see. Looking at the numbers that they have developed for a variety of reasons, we see that, overall, first, nonagricultural exports are up for the United States. These nonagricultural exports, seasonally adjusted, are up over 40 percent at an annual rate since the first quarter of 1978, as against a decrease of about 7 percent in the prior 6-month period. So that is a marked improvement.

While nonpetroleum imports are up about 15 percent over that same period since the first quarter of 1978, I think we made headway there, as against a 40-percent rate of growth in nonpetroleum imports in the prior period. So the situation has shifted overall.

We think that the reduction in the growth rate in the United States which we anticipate for this year will help, and the program for further domestic demand expansion in Japan as well as in Germany, which was discussed and agreed to, and is being carried through in Germany and in Japan, will be important factors that will further move us in that direction.

Now, what has happened in the case of the Japanese is that they have had some real problems, which I think they honestly did not anticipate. I think they are genuinely embarrassed about it, in bringing about a reduction in their surpluses.

The first thing that happened, of course, as the dollar went down is that their raw materials became cheaper in terms of their own currency while the value in dollars of exports at constant yen selling prices rose, because of the cheaper value of the dollar in terms of yen. Thus, they, in the beginning, tended to increase their surplus, expressed in dollar terms.

The slowdown in exports by Japan in industrial products, which is what they mainly sell, is already noticeable. It has been noticeable for some time in yen terms, or in volume terms, physical volume terms, and we have seen that it is becoming noticeable, also, in dollar terms.

Now, does all of that, that effort to encourage domestic demand expansion in Japan and elsewhere, and to bring about a slowdown in the rate of growth in the United States economy represent fine tuning?

I don't really think so. You have to have some targets of direct tuning to which you want to go, and while we have to give you, as we do, precise numbers in the economic report and have to use rather precise numbers for estimating the budget and the impact of the economy on the budget, we all know that obviously we cannot tune the economy down to one-tenth, two-tenths, or three-tenths of a percent. That is why a lot of the discussion about whether there is going to be or not going to be a recession in 1979 sometimes strikes me as unreal. Because the important thing, it seems to me, is that both we and virtually all of the private observers, including the Congressional Budget Office incidentally, are pretty much agreed on the force of the economy. The differences, some of the slight differences, which would involve, I think, real fine tuning to hit one instead of the other, lead some to say that technically there is going to be a recession and others to say that we will barely escape it. That is because there is an arbitrary dividing line.

We are not trying to fine tune the economy, but to slow it down to a moderate extent so that during the four quarters of this year we expect to have growth in real terms of 2 percent or a little more, and an average for the year of perhaps a little more than 3 percent. We want that instead of negative growth, and we think we can do that without fine tuning.

Senator JAVITS. I have two other questions.

Is it fair to characterize the view of the administration that we will not have a recession in 1979, but we will have a diminution in growth which will give us the elbowroom that we require to correct the imbalance in our trade?

Secretary BLUMENTHAL. That is clearly our objective, Senator. It is our clear view.

We felt confident of that when we established those numbers. Subsequently, as the result of what we have seen in the fourth calendar quarter of 1978—very substantial growth—we are even more confident that we will not have a recession in 1979.

Senator JAVITS. Now, Mr. Secretary, I have a question on New York City. Would you mind answering that?

The paper this morning indicated that you told Ed Koch, our mayor, that your good news was that the administration had cranked the \$100 million into the budget that he counted on to make up his serious deficit, but the bad news was that Congress "was unlikely to approve it."

Now, can we have some idea as to whether that is a fact and why you came to that conclusion?

Secretary BLUMENTHAL. Yes, sir.

Let me put it a little differently with regard to good news and bad news.

I told him the good news was that we could, under the terms of the statute, approve his financial plan for 1980. That financial plan contained budget cuts that the city would have to make, what they call level-1 cuts and level-2 cuts.

Level-one cuts were necessary, in any case, in the view of the city to help bridge the budget gap. The level-two cuts would only be necessary if there was a shortfall in their projection of increases in Federal and State aid. The Federal share was about \$100 million, composed of essentially a few legislative proposals as well as certain administrative actions.

One was countercyclical revenue sharing and the others included changes in public assistance programs. The administrative issues included a range of actions the Government could take.

I told him the bad news was that they would have to make the level-2 cuts, because we had attempted to get an extension of countercyclical revenue sharing last year in the last session of the Congress, that we had failed, that we were reintroducing it on a much more limited basis, and that, if passed by the Congress it would, in fact, under certain assumptions make available to the city \$50 million.

My sounding of the Congress indicated that the chances of passage of that proposal were not overly great, and, therefore, they were not a great deal greater during the new session.

I hoped it would be passed and we want it to be passed and we will argue for it, but prudence dictated that they not count on it, because the Congress did not pass it last year and may not pass it again.

The other legislative proposals by the city were increases in categorical aid—I was going to say balance of payments—and not unrestricted revenue made available for other purposes, and accordingly that that really should not be counted on.

The Financial Control Board has also told the mayor that they would institute both the level-1 and level-2 cuts, and based on implementation of those actions, we would be in a position, under the statute, to approve the fiscal year 1980 financial plan.

Senator JAVITS. Thank you, very much.

Senator BENTSEN. Senator Jepsen.

Senator JEPSEN. Thank you, Mr. Chairman.

Yesterday, I asked Mr. Miller if he thought it was time to index the tax code for inflation. I understand from the remarks you made earlier this morning that you indicated opposition to indexing.

As you know, inflation puts individuals up into higher tax brackets, creates illusory capital gains and results in a steady increase in the real tax burden on the American people.

Mr. Miller replied that indexing was wrong because it would shelter us from the effects of inflation, lead to larger budget deficits and exacerbate the budget deficit.

Since then, I have received from the CBO the budget projections for the next 5 years. On page 63 of this report, the CBO indicates that even with indexing, the real tax burden will still increase in the coming years.

Without indexing, the magnitude of coming tax increases is enormous, on the order of \$200 billion over the next 5 years. This, I might add, just figures in the income tax increase.

The CBO even says that tax reductions like those in the Roth-Kemp bill might be possible even with indexing. If you could, I would like you to comment on this situation and see if you can come up with additional justification, better ones, for opposing indexing, than Mr. Miller made.

Secretary BLUMENTHAL. Yes, sir, I would be happy to.

You are correct. I strongly oppose indexing. The administration strongly opposes indexing, for the very important reason that indexing would make it all that much more difficult to get rid of the problem of inflation in the American economy. It would bake inflation into the structure of the economy rather than to purge it out.

Let me deal separately with the two problems of taxation; namely, income taxes and payroll taxes.

The fact is that in 1979, the income taxes as a percentage of personal income remained at roughly 10.6 percent, which is about the rate at which personal income has been taxed for as far back as my statistics go here, which is 1960.

The range has been roughly between 10 percent and 11 percent.

In the early 1960's, it was 10.2 to 10.4 percent. In 1969, it went as high as 11.6. In 1974, and I picked these numbers at random, sir, it was 10.7. In 1978, 10.7; and 10.6 as a result of the tax reduction that has just been voted.

In other words, income taxes, contrary to what some people think, have not increased as a percentage of personal income.

It is clear, as the Congressional Budget Office points out, if you project forward without any further tax decreases, the result of inflation on this, you will get an increasing percentage.

For example, my numbers indicate, and I am sure the Congressional Budget Office would confirm this, that if we just went forward on the present basis, including the effects of legislation proposed in the 1980 budget, we would be at almost 14 percent by 1984, which would be a historical high. I pick that year at random, too. There is no significance to 1984. But the Congress periodically votes tax reduction in the light of overall circumstances, and in the light of its desire further to improve the justice and effectiveness of the tax system.

That kind of tax reduction provides flexibility to the Congress to take over all economic circumstances into account. To do it on an automatic basis would put it into a straitjacket and would reward those in the economy who are least cooperative with bringing inflation under control.

The more you raise your prices and your wages, the more you are going to get back in the way of tax reductions. What we would rather have is the kind of program of fighting inflation, which would reduce the rate of inflation. This includes and real wage insurance, which rewards only those who are willing to play their part in reducing their increases in prices and wages. That is a short answer.

Now, on the income tax side, what is increasing are social security taxes and payroll taxes, and those are around 3 percent of personal income in 1979.

That hasn't changed much in the last 5 years, but it is up from, say, 2.2 percent in 1970, and 1.3 or 1.4 percent in 1961.

That is due to the fact, sir, that the Congress, for a lot of good reasons which we understand, has voted to increase benefits and has indexed some of those benefits. It seems to me that the solution to dealing with the increasing burden of payroll taxes lies not in indexing the rest of the system and creating further inflation, but rather dealing with the social security problem—benefits as well as taxes—so that we keep the payroll taxes under control.

If we don't want to spend more of the taxpayer's money, then we need to ask ourselves what is going to happen to those benefits. You cannot have it both ways, I guess, is what I am saying.

I would hope that the Congress would carefully look at the social security tax situation not for fiscal 1980, because we cannot afford it that year, but by 1981. I believe that inflation will have eased at that point, and the solution will not be to index, but the solution will be to look at the overall problem of what to do about the burgeoning costs of social security.

Senator JEPSEN. Thank you.

I understand you are saying that the spending programs, some of them are indexed, so we cannot afford to index the taxes.

Spending programs rise about 10 percent for a 10 percent rise in prices. Taxes rise 16 percent for a 10 percent rise in prices.

Now, using indexing, that only lops off about 6 percent, so that leaves taxes rising by about 10 percent.

Keep in mind that it is the Government that creates inflation, and the more inflation, the more revenue the Government gets.

Secretary BLUMENTHAL. Right.

Senator JEPSEN. It is the Government which is rewarded by inflation under current law.

Secretary BLUMENTHAL. Senator, first of all, there is an interaction between inflation on the one hand and the growth of the economy on the other, and we have accelerated inflation, and we have a number of devastating consequences.

One of those is that the economy soon goes into a tailspin. We have had that experience many times before. That reduces the growth, and therefore, the taxes which we can collect.

You are right. There is a large share of government spending which is due to what is already indexed on the spending side.

I would rather see us deal with that than to index the system. I would point out, however, that Congress does take care of reducing taxes every couple of years, and it seems to me that that kind of balanced consideration by the Finance Committee and the Ways and Means Committee and by both Houses, provides a greater flexibility to reduce the tax burdens on the average American than the straitjacket approach which allows no leeway whatsoever.

It is also true that the President is already in a large straitjacket, because of spending that is beyond his immediate control.

I would not want to extend that and make it even tighter.

Senator JEPSEN. Thank you, Mr. Secretary.

I may have, if we have an opportunity, to ask some other oral questions.

Senator BENTSEN. Thank you.

Senator Proxmire.

Senator PROXMIRE. Mr. Secretary, I am glad to see you. I have read your prepared statement, and I concur in the stimulating discussion you have had here.

You say we have to move the fight against inflation toward the top of our economic list of priorities, and that the budget constitutes a matter of importance.

Yet this is a budget that goes up 7.75 percent. It doesn't even comply with the President's guidelines.

The President is asking business not to increase their prices over 6 percent and yet the President is asking for an increase well above that. This is not an austere budget, Mr. Secretary.

After all, you have a very big increase for defense. You have the big increases all along the line.

Sure, many expenses are uncontrollable, but why can't you come up here and ask us to rescind revenue sharing, for example?

The Governors are saying that we are spending too much, that we are an engine of inflation. They are getting the revenue sharing.

The educational programs aren't working. The cities are in worse shape than before we started the programs. Why can't we cut some of those?

Secretary BLUMENTHAL. Well, Senator, the budget is increasing by less than 1 percent in real terms.

Revenue sharing, a program that you mentioned, is due to expire in, I believe, 1981, which means that we have to consider what to do about that program.

Senator PROXMIRE. Why can't we rescind it now? Just because it expires in 1981 doesn't mean that we can't take action to knock it out in 1980 and 1981.

Secretary BLUMENTHAL. It is our judgment that there are a great many areas and localities which are very much dependent on it.

We don't want to create undue unemployment. The question has been raised, I believe by the chairman earlier, as to whether or not the States, as against the cities and localities, should continue to get it.

President Carter himself, as a candidate, raised that question. It is clearly something that we ought to look at.

I would say that we have to do things in an orderly manner. I think to bring down the budget in such a way—and we have already cut \$18 billion out of the current services budget—that is, I would say, a considerable feat, especially if you consider that three-fourths of the budget was really beyond the President's control.

The judgment was made by him that he could not and should not go further.

I would say that if the conference finds ways that you can agree on for further cutting in spending, further cutting the budget in a fair and effective way, maintaining the strength of our defenses and maintaining the kind of justice and help that some people and particularly poor people require, the President could—

Senator PROXMIRE. I welcome that statement very much.

I want to follow up on what Senator Javits asked about New York City.

This is a responsibility of our committee to some extent, and we are very concerned about it.

You said that you told the mayor that it is not likely that Congress would act on the recommendations to assist the cities, including New York.

Then you indicated that he should make the level-2 cuts that you described. What was the mayor's response?

Did he say he would make them?

Secretary BLUMENTHAL. I was very encouraged, Senator. The mayor takes a very responsible attitude. He says, "Look, we have to do what we have to do. We have obligations, and we will carry them out. This is a painful process, but we will do what is required of us."

Senator PROXMIRE. If the mayor does not make the cuts, do you feel you could make the guarantee on February 15?

Secretary BLUMENTHAL. I made it clear to him that our approval of his program and the guarantees are dependent on his balancing his fiscal year 1980 budget.

He would not be in compliance without balancing the budget.

Senator PROXMIRE. Did he make a specific commitment on level-2 cuts?

Secretary BLUMENTHAL. He said they would make whatever cuts are necessary, taking into account what they did not get in unrestricted aid from the State and Federal governments to balance their budget.

Senator PROXMIRE. Regulation limits interest rates to 5 percent and 5.25 by the thrifts, and is outpaced by the prime rate, which is twice as high, and other sources of income to the banks and S. & L.'s.

This creates a very serious inequity. He indicated he would consider consideration by Congress of legislation that would gradually increase the ceiling in regulation Q.

In view of the fact that we can't expect to have inflation conquered, as you say, in 1 or 2 years—we are going to have it for some time—would you or would you not support legislation that would permit us to raise regulation Q and allow small savers to get a better break than they get now?

Secretary BLUMENTHAL. I can't give you a definitive answer. We would want to see a consideration of that. I would want a little more time before I give you a definitive answer as to interest rates.

Senator PROXMIRE. I think the President's program will work if you stick to it and the Congress will support you, and I hope they will.

I intend to do all I can.

Many people don't agree with that. They think inflation is going to get worse, and a very large number of very wise people think so.

As you know, we can't predict inflation. Last year, the prediction was 6 percent. It ended up at 9 percent.

I would like to know what you propose if the President's current program fails and inflation accelerates.

What do you do?

Secretary BLUMENTHAL. That is one of those hypothetical questions that I try to avoid.

Senator PROXMIRE. It is a distinct possibility.

Secretary BLUMENTHAL. I really believe that it is only a question of time before this program will work, and I think it will work in the time frame that we have laid out.

Senator PROXMIRE. You mean you have no contingency plans?

Secretary BLUMENTHAL. We are always planning, Senator, what we would do, and we are always asking "what if," but we don't like to talk about that to the public too much, because it would create the wrong impression.

What I would suggest is that we continue for as long as necessary the kind of tightening in the deficit, maintain monetary policy consonant with that kind of approach and make an even more vigorous effort to increase productivity and cut regulations that are cost ineffective.

I think that approach—

Senator PROXMIRE. Would you have a tougher incomes policy?

Would you go for a penalty, penalizing by taxes, when wage and price increases exceeded the guidelines?

Secretary BLUMENTHAL. I think the range of TIP programs should be studied further, those rewarding as well as punishing.

We have presented to the Congress a simple program of real wage insurance. I think we ought to give that a chance to work for a year.

We will know over the next year or so whether it is effective or not. I think it will be effective in inducing people to meet the wage guidelines.

If not, I would go to using the tax system in other ways.

Senator PROXMIRE. What about more drastic cuts in spending?

Secretary BLUMENTHAL. I think that would have to be considered, too.

Senator PROXMIRE. In your prepared statement, you stated, "Our tight budgetary policies are easing the task of the monetary authorities.

"With a reduced deficit, and with off-budget financing activities being monitored more closely, Federal demands on financial markets will be substantially reduced." But according to the budget figures in the special analysis of the budget, total borrowing would be \$40 billion in fiscal 1979 with a deficit of \$37.5 billion, and borrowing for fiscal 1980 is \$39 billion with a deficit of \$29 billion.

I am wondering how that will help the economy at all.

Secretary BLUMENTHAL. Let me see if I can find the numbers here.

Credit market conditions are going to be changing substantially, so that the share of resources that the Federal Government has to use in borrowing will be substantially reduced.

Here are the numbers: On a calendar year basis, borrowing from the public by the Federal Government in 1979 will represent about 12 percent of the total demand in the credit market, and in 1977 it was 14.2 percent, and in 1976, 21.9 percent; in 1980, we estimate it will go down to about 9 percent.

So, it is representing an increasingly smaller portion of the total requirements.

Senator PROXMIRE. Now, the table on page 106 of the Special Analysis does show a sharp reduction from 1978 to 1979.

It goes from \$59 billion down to \$40 billion, but it shows, again, the 1979 estimate is \$40 billion total borrowing requirement from the public, and in 1980, \$39 billion.

So, there is no change.

Secretary BLUMENTHAL. That is, in part, because we anticipate some changes in cash balance, to get drawn up or down. So, even though we are reducing the deficit, we anticipate a much smaller reduction in total borrowing, since the economy and total credit flows are expected to grow between 1979 and 1980, the \$39 billion would translate into a smaller percentage as compared to the \$40 billion.

It is more than \$1 billion worth, because the whole economy is growing. If our cash balances are somewhat better, and we estimate that conservatively, then, of course, there would be a further improvement.

Senator PROXMIRE. Thank you, Mr. Chairman.

Senator BENTSEN. Thank you.

I promised to get you out of here by 12 noon.

Let me make a closing remark. You said when the deficit in trade with the Japanese was \$8 billion, and it went to \$12 billion, you felt they were embarrassed.

I don't think they embarrass very easily. They took affirmative action to moderate the change between the yen and the dollar, and they took it for 2 years, and they took it to help moderate large-sized and small-sized companies.

In addition to that, on their own government procurement program, they issued directions and they very carefully held off the purchase of American goods.

The telephone company is a prime example of that kind of situation.

Now, with respect to revenue sharing, the Center for Policy Research for the Governors' Conference is projecting that the States are going to have a substantial surplus, an overall surplus in their budget, and that not one State is going to have a deficit in 1979.

Now, it just doesn't make any sense to me that we should send them another \$2.25 billion to add to their surpluses while the U.S. Government has gone all the way from a \$29 to a \$37 billion deficit, whichever one of the estimates you want to take. It seems to me that there is one place where we can have an affirmative cut. I understand that we are going to have a confrontation with some of the Governors, but I think we have to face up to some of these responsibilities.

Secretary BLUMENTHAL. I think it is worth looking at.

Senator BENTSEN. It is worth doing.

Thank you very much, Mr. Secretary. The committee stands recessed.

[Whereupon, at 12:07 p.m., the committee recessed, to reconvene at 10 a.m., Monday, February 5, 1979.]

THE 1979 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 5, 1979

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senator Bentsen and Representative Brown.

Also present: Richard F. Kaufman, assistant director-general counsel; L. Douglas Lee, John M. Albertine, Paul B. Manchester, and Thomas F. Dernburg, professional staff members; Mark Borchelt, administrative assistant; Katie MacArthur, press assistant; Charles H. Bradford, minority counsel; and Robert H. Aten, minority professional staff member.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

We would probably have better attendance if we held it down on Memorial or Chain Bridge.

Mr. Grayson, why don't you come up to the witness table. We will get started even though, obviously, a number of people have not been able to surmount the traffic problems.

Today, we begin the third week of the Joint Economic Committee's annual hearings on the Economic Report of the President. The committee will hold 3 days of hearings this week, and will receive additional testimony following the February 12 recess. We shall announce the remainder of our schedule during the next few days.

President Carter has stated that reducing inflation must be our No. 1 economic priority this year. I agree entirely with this proposition.

In his economic report, the President points out the clear relationship between inflation and lagging productivity in our economy. He suggests that unless we can come to grips with our productivity problems, we stand little chance of overcoming inflation.

If anything, I would go even farther than the President in stressing the key role of productivity in that complex equation that has given us inflation for so long. The simple fact of the matter is that, in the absence of dramatic gains in productivity, our efforts to stem inflation cannot succeed.

That is not a very cheery prognosis, but it is also difficult to refute. I personally do not see how it will be possible for the

President to meet his objective of a 7.4 rate of inflation this year unless we exceed his target for productivity growth.

Last year, productivity grew at less than 1 percent; one-tenth of what it is in Japan.

The President's productivity goal for 1979 is 0.4 percent—a really modest objective by any standard; a rate of growth that is one-half of last year's disaster.

But the President also forecasts an 8.5 percent rise in total compensation per hour. Now, if you perform a little simple economic arithmetic and deduct expected productivity growth from growth in total compensation, you end up with an 8.1 percent increase in unit labor costs for 1979. And that figure is especially alarming because unit labor costs normally rise less than the rate of inflation.

The problem is clear: How do we get inflation down to 7.4 percent if unit labor costs rise by 8.1 percent? What happens to the rest of the administration's forecast if inflation is higher than the target? What should be done to increase productivity in our economy?

These are difficult questions and we are pleased to have with us today two distinguished experts who we hope will try to help find answers to them. Jack Carlson, vice president and chief economist of the U.S. Chamber of Commerce, who will be here shortly, and C. Jackson Grayson, chairman of the American Productivity Center, have already rendered valuable service to their nation from the private sector viewpoint and the academic viewpoint, and is really zeroing in on these questions.

They have been in the forefront of the effort to call attention to the important problem of productivity.

At 11 a.m., if he is able to wind his way through the tractors, we will hear from James T. McIntyre, Director of the Office of Management and Budget.

You may proceed with your oral presentations and then we will ask our questions.

Please proceed, Mr. Grayson.

**STATEMENT OF C. JACKSON GRAYSON, JR., CHAIRMAN,
AMERICAN PRODUCTIVITY CENTER, HOUSTON, TEX.**

Mr. GRAYSON. I have submitted a prepared statement to your staff and ask that it be printed in the record with the exhibits.

Senator BENTSEN. That will be done.

Mr. GRAYSON. I will confine my oral remarks to a few succinct remarks in the interest of productivity and in the interest of my voice which I hope will hold out.

I would like to home in on the centrality of productivity in economic policy. As you stressed, Senator, the President's Economic report pulled productivity up to the level of attention that it deserves.

He said, and I quote one section: "The primary concern in economic policy is inflation;" and, then, in another section of his report, and I quote: "A large part of the worsening of inflation last year stemmed from poor productivity."

Then, he goes on to state that the productivity slowdown is one of the most complex and misunderstood questions, which lacks understanding.

If you take those statements together, it says in effect that productivity must be the cornerstone of our economic policy. That in itself finally is getting the attention it deserves.

I left the Price Commission with the firm conviction that this is one of the areas that the country had not paid enough attention to in recent years. All of the attention has been focused on fiscal and monetary matters and, certainly, they are important, but one of the root causes of inflation is poor productivity.

It is not a recent phenomenon that it has been slowing down. It has been slowing down for a decade. If we pay attention to only the branches on the tree of high inflation, high unemployment, high interest rates, balance of payments and don't attack the fundamental causes, we will forever be spinning our wheels.

We have to get to the root causes which are fiscal and monetary policies and productivity.

The position today is that not enough is being done by the Government and the private sector; what we need is a "National Productivity Program." That is what I am recommending to you today with my testimony.

Efforts that are underway in the executive branch by the National Productivity Council, in my view, are not going to get the job done. I think that the efforts are underfunded, not staffed, not given enough attention, and not given a seat on the economic policy matters of the country.

We must correct that or we will continue to drift in this very important sector.

Wage and price controls, with which I have had some experience, are counterproductive and tend to lower productivity instead of going the other way.

What I have outlined in my prepared statement is the blueprint for what would be a national productivity effort or program. I am calling upon all sectors to launch such a program. I spelled out in my testimony things that I would recommend for the Federal Government to do, things for industries to do, things for individual firms to do and the international dimensions connected with that program.

Primary in my recommendations to government would be, first of all, to select two focal points for attention to productivity, one focal point in the Congress and one focal point in the executive branch.

I would further recommend that the focal point in the Congress be the Joint Economic Committee. The JEC would be the best focal point for directing the efforts from the congressional side, paying constant attention to the subject of productivity.

I will make a further recommendation that when the productivity figures are released quarterly, that the JEC hold hearings just as you now do monthly on unemployment figures, for productivity also ranks as one of the top concerns of the economy of the Nation.

I would recommend the same focus for the executive branch—that there be one single focal point for paying attention to productivity, not diffused, not scattered among a number of agencies, but

one focal point in the administration looking at productivity in its broadest aspects throughout the Government.

Unless we do that, I think we are going to continue giving productivity lipservice and rhetoric, writing memos, forming committees, giving lots of articles and speeches and not getting action.

I have described in my testimony some tests I would recommend for anyone to use in order to see that that focal point is created.

It should be funded and staffed. There should be power, timetables, accountability, and there should be followup.

Unless they exist, which I do not now find in the "National Productivity Council," then I don't think there will be the action that is needed.

I have also recommended in my prepared statement what such a focal point would do, including such things as creating a productivity impact analysis of all of the regulations that are existing and all new regulations.

This would be in line with the regulatory and budgetary analysis of regulations now being proposed in various bills, but we still need one group to have sustained, long-run accountability for following those.

I further recommend we assist the State and local governments, that we look at productivity in the Federal Government, and expand the efforts now underway in the Office of Personnel Management and the GAO.

In other words, what we need to do is organize the efforts, not centralize them, but centralize the focal responsibility for an overview of what is being done.

In the private sector, I have recommended several things that need to be done at the level of the individual firms and industries of the Nation. If we continue to look only at macro-economic policies and don't get down to the micro level down to individual industries and individual firms, we may continue to remain mystified about this slowdown without understanding it.

I am recommending that we have industry productivity studies, with inter-firm productivity comparisons and industry measurement systems, combined into industry productivity programs. We should do this not only for the industries where we know we have problems with productivity but eventually with *all* of our industries and firms.

Unless we get down to the firm level, where most of the action is in this country, we won't get the results we need in productivity across the Nation.

So, I am recommending both a macro approach and a micro approach.

Last, I recommend a very strengthened program in research. We simply do not understand some of the productivity slowdown that has occurred. In particular, we need to have a strengthening of productivity measures. I know measures by themselves don't improve productivity. But if you don't have good measures you don't understand where you have been and you don't understand where you are going.

We need to know the causes of the slowdown and that not enough research is being done on the subject. I have looked at the measurement program in the Bureau of Labor Statistics and it is

good. But they simply don't have enough funds and resources to do the job that is required. They need to strengthen and expand their program together with the private sector also expanding its own programs in productivity measurement.

In summary, if we were to have a collective effort by the Government, by industries, and by individual firms, I think we could make some progress in productivity improvement.

I think that is absolutely essential if we are going to solve the problems of inflation, unemployment, balance of payments. All else will be rhetoric and talk and we will end up a year from now still talking about productivity problems without progress.

Thank you.

[The prepared statement of Mr. Grayson, together with the exhibits, follows:]

PREPARED STATEMENT OF
C. JACKSON GRAYSON, JR., CHAIRMAN,
AMERICAN PRODUCTIVITY CENTER

Before the Joint Economic Committee of the
Congress of the United States
February 5, 1979

Mr. Chairman and Members of the Committee, I am C. Jackson Grayson, Jr. Chairman of the American Productivity Center (APC) in Houston, a privately funded organization now in its second year.¹

I was formerly Dean of the Graduate Business School of Southern Methodist University and, as some of you remember, I served as chairman of the Price Commission from 1971 to 1973, this country's previous serious attempt to control wages and prices in a peacetime economy.

I deeply appreciate the opportunity to appear before you today on the subject of productivity--and to urge upon you, as a matter of high national priority, the creation of a comprehensive national program to address this nation's very serious productivity crisis in both the government and private industry.

It might be of interest to the members of this committee that it was my experience in the Price Commission--not as a business school dean--that first convinced me that

1. A description of the APC is contained in Exhibit A.

our economy had a real and growing productivity problem. In my opinion then, this was at the root of our problems of inflation, unemployment, and balance of payments, and this is even more true today.

In the interim, we have had seven years of deteriorating productivity and increasing inflation--and throughout this time, the problem has been largely ignored by the leaders of government, industry and labor. It has been equally ignored by our economists, our business schools, and to a large extent by our national, business and academic press.

Little wonder, then, that today we are faced with the situation in which a major national productivity crisis is upon us.

The alarm bells are finally beginning to ring. Speeches are being made. Memos and articles written.² More committees are being formed. But we all know that alarm bells do not put out fires. And articles do not solve problems.

We need action. Strong, decisive coordinated action. And we need it immediately. This is what I have come to urge upon you today.

I have some very specific proposals which require such decisive action by the Congress and by the Administration. These are spelled out in some detail in my written comments

2. Two illustrative productivity articles are reproduced in Exhibit B.

which have been distributed to members of your staff. I would like to review them for you briefly.

I believe this nation needs a National Productivity Program involving government, management, and labor.

There should be programs created that operate at four levels:

- Government--federal, state, and local
- Industry
- Individual firms
- International

At each of these levels, programs must be created that are specific and action oriented, and they must include attention to such fundamental variables as: (1) power, (2) funds, (3) incentives, (4) timetables, (5) accountability, (6) leadership, and (7) long term commitments.

These are the variables that have been missing from some of the earlier attempts to improve productivity, and they are the principal reasons that many of these efforts fell far short of the mark.

Government

Government should have an organized productivity program at all levels--federal, state, and local, but the leadership for a government program has to come from the federal government and the Congress, through the following steps:

- (1) Creation in the executive branch of a single focal point with responsibility for a national productivity program. Not an oversight or coordinating group. But a focal point with the power and the responsibility and the funding to make the program work.

- (2) Creation in the Congress of a productivity focal point with responsibility for overseeing productivity legislation and conducting investigations.

I feel these two institutional steps are absolutely essential if a government productivity improvement program is to have any significant impact.

Why?

Because unless productivity improvement is institutionalized into the power mechanisms of government, little more will happen than is already happening today. Future work will consist of "coordination, meetings, studies, recommendations, reports," and we will go on recording stagnant productivity growth in 1979, 1980, 1981 and so on.

It is not that the government is doing nothing. There is work underway and there are people in the federal government vitally interested and concerned about productivity. In particular, there is some work in the Departments of Labor and Commerce, the General Accounting Office, the Office of Personnel Management, and the Office of Management and Budget.

But their work is underfunded, understaffed, outside of the power circles that influence policy, and little noticed. The activities are scattered with no central direction or focus to maximize their impact, or to enhance learning from one agency to another.³ Most of their activities

3. An inventory of productivity related activities in the Executive Branch was given by Mr. Wayne C. Granquist, Associate Director of OBM, before the House Sub-Committee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, Ninety-Fifth Congress, Second Session, September 14, 1978, pp. 113-115.

are buried in their respective agencies, and their views are seldom heard in any of the economic policy power groups in the Congress or in the White House.

And yet, this is the problem that was labeled in the 1978 Economic Report of the President as "one of the most significant economic problems of recent years" and highlighted again in the 1979 Economic Message, with the statement that "If we ignore the realities of slower productivity growth...our inflationary problems will worsen."

Until September of last year, the belief existed in the minds of some that the Federal Government had an organized and active productivity program in the form of the National Center for Productivity and Quality of Working Life (NCOPQWL). But that belief was wrong. The Center was flawed from the beginning in its charter, funding, and location; and it never really succeeded in its mission. It died on September 30, 1978 because of a lack of support from either the Congress or the White House.

There was some hope that productivity work would be undertaken by the Council on Wage and Price Stability (COWPS) because its authority states, in part, that COWPS shall "focus attention on the need to increase productivity in both the public and private sectors of the economy."⁴

But that has not happened.

In fact, the opposite has occurred. COWPS has

4. Section 3 (A) (5) of the Council on Wage and Price Stability Act, 12 U.S.C.S. 1904.

been handed the responsibility for implementing the wage-price standards program which, in and of itself, lowers productivity. The application of wage standards and price ceilings, regardless of productivity differentials, ignores the adjustment process essential to a dynamic economy with widely varying productivity levels among firms and industries.

Furthermore, some specific standards in the COWPS regulations will seriously curtail some of the most effective productivity improvement programs existing in the nation. We and others have to date been unsuccessful in our efforts to have these anti-productivity elements corrected.⁵ In fact, we have been given a very clear message that the Council on Wage and Price Stability is aware of the productivity problem, but intends to do nothing.

One way, incidentally, to force a change in this particular feature would be for Congress to enact legislation similar to its amendment to the Economic Stabilization Act of 1971 which removed some of the anti-productivity effects of that Act. (See Exhibit D.)

In a recent meeting of the National Productivity Council (NPC), Chairman Kahn referred to the difficulty of developing wage and price standards which would encourage productivity. On the question of how and what COWPS could do, Chairman Kahn said--I quote--"more research might be a possibility."

There is, of course, no question that more research is

5. Comments by the APC on COWPS proposed standards are contained in Exhibit C.

needed. But, if I may say so, this is a clear example of what is wrong with governmental efforts to improve productivity when they are given to any department, office, council, or agency with a crowded agenda that has higher priorities or even conflicting goals with productivity.

It is for these same reasons that I am very skeptical about the present plan to allocate to various groups some of the late National Center for Productivity and Quality of Working Life (NCOPQWL) efforts, meager as they were. The operating functions were sent to the Departments of Labor and Commerce and to the Office of Personnel Management. Overall policy formulation and coordination were given to the newly created National Productivity Council (NPC), chaired by the Director of the Office of Management and Budget (OMB).

I fear that these efforts will also continue to be meager, undirected, low in priority, underfunded, and outside of the real power circles that create policy and change.

OMB is an extremely competent and influential Office. But it has higher priorities, an already overcrowded work agenda, and it has never assumed responsibility to date for an operating program. Furthermore, it is subject to short term crises and, unless separately structured, productivity would likely become a stepchild.

I suppose the focal point could be located in OMB.

There is no reason that this could not be done, provided that the program was openly supported by the

President, significantly funded, given adequate power, set up as a discrete operating unit and provided that a Committee of Congress had oversight and investigative powers over the unit. Anything short of that is likely to produce no significant action.

I also do not think that an agency, co-chaired by the Secretaries of Commerce and Labor, is likely to produce results. All of my experience says that any responsibility that is co-chaired is not likely to be accepted by either party with real accountability.

I could cite other instances of how the productivity issue is being Balkanized in government and how it is likely to continue that way unless institutional change is undertaken.

My own preferences for the "single focal point" would be either (1) a properly authorized and funded responsibility as a unit of OMB, or (2) the creation of a new "National Productivity Office," with adequate funding, power, staffing, etc., as part of the Office of the President with a seat on the Economic Policy Committee.

What would this "focal point" or "Federal office" do?

- (1) Hold all Cabinet officers and agency heads responsible for setting and achieving explicit, measurable productivity goals, and installing productivity programs.
- (2) Bring together managers of like functions in government to share productivity ideas, programs, facilities, etc.
- (3) Assist State and local governments to improve their productivity through (1) the Federal

grants system, and (2) management improvement assistance.⁶

- (4) Require a "productivity impact statement" of all significant new Federal Regulations and for selected existing regulations.
- (5) Examine the method by which each regulatory agency acts to achieve its objectives, and make productivity studies of various alternative methods that could improve productivity.
- (6) Make recommendations to Congress of possible changes in anti-trust laws to allow for appropriate private sector cooperative efforts to improve productivity.
- (7) Initiate studies of changes in various fiscal policies to encourage productivity-improving capital and research and development investments with assistance from other policy and operating organizations of government involved in fiscal policy
- (8) Perform a special analysis of the federal budget to document where federal support of private sector improvement is being spent, and how it can be made more efficient and effective.
- (9) Instruct all government agencies to work with private sector organizations by providing them with information, literature and direct assistance. It would be particularly helpful for the Departments of Labor, Commerce, and the Small Business Administration to provide such help.
- (10) Examine other ways in which the government can provide incentives for higher productivity in the private sector.

In addition to the work of this new Federal office, I believe that two other important units of government should be encouraged to play a more active role in improving productivity.

- The Council of Economic Advisers (CEA) shall perform a continuing overall economic analysis of the short and long term impact on productivity

6. Details of such a system are outlined in a GAO publication entitled: State and Local Government Productivity Improvement: What is the Federal Role? 660-78-104, December, 1978

of various structural blocks to productivity improvements in the economic system and periodically report to the President and Congress.

- The Bureau of Labor Statistics shall be given additional funds to enlarge and improve its productivity measurement work. The present level of work by BLS is extremely useful and performed by competent people. But BLS is underfunded, and their charter of work is limited. Both should be enlarged. The forthcoming productivity measurement recommendations of the National Research Council Panel on Productivity Statistics and the GAO should be given top priority for funding, and implementation. A later part of my testimony also addresses the measurement needs in more detail.

The Role of Industry

As a part of this National Productivity Program, entire industries should create explicit productivity improvement programs, and the Federal office should provide some assistance.

The prime locus of the work, however, would rest with industry trade associations, professional societies, and other organizations involved in industry-wide endeavors.

The reason for the Industry part of the National Program is that productivity improving actions must get below the national macro-economic level, down to the level of entire industries, and eventually to individual firms.

Individual industries vary widely from extremely low to very high productivity growth. For the period 1972-77, output per employee-hour rose in the hosiery industry by 10.2% per year, whereas coal mining and iron mining dropped by 3.5% per year.

For the industries measured by the BLS in 1977, in about three-fourths of the industries, productivity growth

was lower in 1977 than in 1976. Twenty-five of the 66 measured industries showed productivity declines in 1977 compared to only 10 in 1976. Coal mines declined for the ninth consecutive year.

Clearly, we need to know more about what is happening to individual industries--why their productivity is declining or growing, what the sources and obstacles are to change, and how labor-management-government can work together to improve productivity. This is particularly true of those industries where growth has stopped, slowed, or declined. The nation must handle the social and economic problems of phasing workers and capital out of these industries into higher productivity areas. We need early warnings of such slowing industries so that the decline trend can possibly be reversed in time, or the proper preparations made for change.

Such studies and action programs are rarely done, or they are only initiated after an industry is in trouble. This is not only costly in the form of government support, but also leads to embittered labor-management fights over declining jobs and profits. The vital question is how to prevent the stagnation of such industries, or if the decline seems inevitable, how best to prepare for it. Such changes may now come more rapidly and frequently as the higher cost of energy changes the economics of industries, and as foreign competition increases from the developing nations with cheaper labor costs.

Specific programs should include:

- (1) The creation of "Industry Productivity Task Forces" in selected industries, with representation from labor, management, and government. These Task Forces would identify sources and obstacles to productivity improvement, and would work over a period of several years to seek improved solutions. (See Exhibit E.)
- (2) The creation of industry wide productivity improvement programs in all dimensions-- measurement, incentives, quality of working life, technology, etc.
- (3) The creation of inter-firm productivity measurement systems, by which individual firm productivity data are gathered, analyzed, compared, and reported back to firms on an anonymous, coded basis. Other nations are already doing this.
- (4) The collection and dissemination of "best practices" of individual firms in industries for the spreading of productivity ideas.

It is estimated that at the present, there is a seven year time lag before "best practices" are disseminated throughout an industry.

Individual Firms

Government, at all levels, has an essential and positive role to play in improving national productivity. But it should be stressed that we must rely primarily on the private sector, the profit motive, and market competition to achieve productivity improvement.

And, in the private sector, the individual firm is where the action is. There is where the main thrust of the private sector productivity program must come from.

That message was loud and clear when GAO sent questionnaires to 1,200 firms throughout the nation in 1977 to ask about the role of the government in productivity improvement. A vast majority did not want Federal assistance and were adamantly opposed to further governmental intrusion

into their businesses. Given a choice between (1) receiving help from the Federal government or (2) from private sector institutions, 85% opted for the private sector.

The individual firm is also the only context in which we can ever hope to understand what is really happening to productivity in this nation. The economist's theory of the firm may be good for describing overall market behavior, but not for describing real firms.

If we are to escape from the "productivity slow-down puzzle," we must go to the individual firm level. The analysis of what is happening and why must come from micro-economic data to see what the consequences are as a result of changes in tax laws, government regulations, new technology, interest rates, wage price standards, higher energy costs, patents, etc.

We must be able to link the basic productivity variables: output, materials volume, capacity, fixed investment, and utilization, with some of the macroeconomic variables. We must be able to tie together at the individual firm level: labor costs, energy costs, materials costs, and capital costs and understand the interaction and trade-off variables.

Such a system is being planned by the American Productivity Center, called the "Productivity Analysis and Strategic System" (PASS). An outline of PASS is given in Exhibit F.

Any individual firm program must include cooperation on the part of management and labor. Management clearly has

an interest, but in the end it is labor that has the most at stake.

Specific individual firm efforts should include:

- (1) Every firm should be urged to adopt a formal, sustained productivity program, organized by management with the assistance of labor, organized and unorganized.
- (2) Labor/management productivity teams should be created in every organization.
- (3) Productivity incentives and gainsharing programs should be organized in individual firms.
- (4) Employee adjustment programs should be created to assist those employees dislocated by productivity improvement.
- (5) Quality of working life programs should be created to operate jointly with productivity improvement programs. The two are interdependent.

International

The international element of a national productivity program should not be overlooked.

The world economy is becoming increasingly interdependent. Our balance of payments problem is at an all time high. Developing nations are seeking USA markets.

Furthermore, our principal foreign competitors, Japan and West Germany, have consistently had higher productivity growth rates in recent years. At presently projected growth rates, both Japan and West Germany will exceed the USA productivity level in the 1980's.⁷

7. If the USA grows at a rate of 1.5% for future years, and Japan grows at its projected growth rate of 6% per year, Japan will exceed the overall USA productivity level by 1988--just 10 years away. If West Germany were to grow at its recent rate of 5.4% annually, they will pass us by 1984.

Our national productivity program should include:

- (1) Measurement of international productivity levels and trends by nations and by industries.
- (2) Organization of international productivity tours.
- (3) Study and dissemination of information about international technology to American firms. Other nations learned productivity ideas from us. We can learn from them in many areas, such as automaking, videotape recorders, steel making, machine tools, and others.
- (4) Assistance to developing nations in the establishment of their own productivity centers. It is better to have trading partners than warring opponents.

Research and Measurement

There are two additional items that should be part of the National Productivity Program that do not fit neatly under either government, industry, individual firms, or international. They either run across all categories, or need special consideration.

One is research. The other is measurement.

Fundamental and applied research is desperately needed in the area of productivity.

It is a sad and shocking commentary that so little is known about one of the most fundamental economic variables in the American economy. There are legions of economists who have worked thousands of man-years on other macroeconomic variables, in the area of fiscal and monetary policy. We have elaborate macroeconomic models that encompass almost every form of variable, but only simplistic notions of how productivity fluctuates.

Respected academic productivity researchers have

reached similar conclusions regarding the slowdown: "We simply do not understand it."

This should not be allowed to continue.

Part of the National Productivity Program should be a greatly expanded program of productivity research-- reasons for productivity change, interactions and tradeoffs among input-output factors, projections, impacts of alternative macroeconomic policies, total factor productivity, and so on. This research should be undertaken by both the private and public sectors, both macroeconomic and microeconomic research. The disciplines should not be only economics, but also accounting, industrial engineering, industrial relations, behavioral science, management, international trade and law.

A suggested agenda for research is included in the Exhibit G, as well as my own views about the causes of the productivity crisis (Exhibit H).

Measurement

Though many people understand what productivity means at a conceptual level, precision in understanding or action is not likely to occur until some measures are established.

Our chief measuring organization in the USA today is the Bureau of Labor Statistics (BLS) in the Department of Labor. BLS is an extremely competent organization, with a long career in productivity measurement. They are probably the best in the world.

But what they are doing is not adequate to the task,

simply because they have not been given the charter, nor the funds, nor the staff, nor the leadership to ask them to do more. I understand that their annual budget is approximately \$~~1.7~~^{3.1} million, a pitifully small amount relative to the demands of the situation.

There are many areas needing attention, but to mention two general areas would help illustrate the problem:

- BLS productivity indexes should be expanded and improved. At present, they do not explicitly include input factors of capital, energy, and materials. They measure hours paid for, but not hours actually worked. They do not measure plant level productivity. BLS publishes officially only about 75 industries out of over 400 identifiable segments.
- Federal, state, and local government productivity figures need strengthening. A good start has been made at the Federal level, but the program needs strengthening and expansion. Output measures need refinement. Data collection needs to be expanded and made more consistent. Only a very few state and local government units have good productivity measures

These and other improvement areas are addressed by the National Research Council's Panel on Productivity Statistics and the GAO, and their recommendations should be considered strongly by the appropriate executive and legislative bodies for immediate funding and implementation.

Summary

In summary, this country is facing a productivity crisis. The implications are just beginning to be understood. They range from continuing high levels of inflation to a gradual stagnation of American economy and the end of its world economic leadership. The American Challenge of the 1950's and 60's, could easily become the American

Tragedy of the 70's and 80's.

On behalf of the American Productivity Center, which was founded two years ago to help focus on this problem and help the nation to find solutions to it, I reiterate that we need a firm commitment at the highest levels of government and industry to a National Productivity Program.

To initiate such a program will require Congressional action, support by the President, and cooperation of labor and management.

It will also require funds. I do not know what funds will be required, but a guess is that it is likely to add up to an additional \$50 million if the total program were adopted. In a "lean and austere" budget, that may be looked upon with concern.

Let me point out two things.

One, the budget for the Japan Productivity Center was \$22 million last year. Japan's GNP is about 1/3 of ours, so a comparable expenditure to just match their present level would be about \$66 million. And we need to do some catching up.

Two, if the USA had maintained its 1947-67 growth rate of 3.2% per year from 1967 onward, our real GNP would be \$268 billion higher in the year 1978.

That's \$268 billion, not million. Not a bad return for a \$50 million investment.

The GNP increase would show up as more jobs, more capital and R&D investments, reductions in unemployment

assistance, less inflation, less unemployment, higher tax revenues, and lower costs of performing the same governmental services, etc.--all across the board.

You in this Committee are to be commended for holding the subject of productivity up to such a high level of visibility and concern. I urge you to take whatever action you feel appropriate to help make a commitment to a National Productivity Program a reality.

Let's make it happen.

EXHIBIT A

AMERICAN PRODUCTIVITY CENTER DESCRIPTION

The American Productivity Center (APC) was founded in 1977, for many of the same reasons that have been discussed in this testimony.

I saw during my experience with price controls during the 1971-73 Phase II of the Economic Stabilization Program that (1) price controls did not work and (2) that productivity was a relatively neglected, but extremely important area.

I saw the persistent inflationary tendencies of the economy and the slowing of our productivity growth. It was my prediction then that the public sector center, The National Center for Productivity, had little chance for success for the same reasons that eventually killed it.

As I looked around the world, I also saw our strongest competitors--Japan and West Germany--had strong productivity growth and each had a productivity center. I believed that this nation would also benefit from such a center, and a recommitment to productivity improvement.

With this belief, I began a fund raising effort in 1976 to secure funds from private sector organizations to establish a private, non-profit productivity center. That effort was successful, and the Center is in operation today in Houston, Texas. It is non-partisan, not a lobbying organization, and involves labor, management and the academic community.

There are 48 staff members in Houston today, with 22 of them contributed by their corporations to spend a year or two at the Center working on productivity problems. These contributed executives, called "Associates", will return to their organizations with improved information and experience in productivity improvement.

The purposes of the Center are threefold:

- . Develop a broad awareness of the need for gains productivity and the quality of working life.
- . Develop specific techniques for productivity improvement.
- . Assist public and private sector organizations in achieving improvements in productivity.

It is financed primarily by contributions and grants from 156 corporations, foundations and individuals, and is governed by a Board of Directors, composed of prominent leaders from business, labor and academia.

The APC plans to accomplish its purposes through five strategic objectives:

- (1) Awareness: Programs, seminars, conferences, publications that make audiences (micro and macro) aware of the productivity problem,
- (2) Research: Applied research to organize existing knowledge and to discover new knowledge about productivity and quality of working life, in all aspects.
- (3) Standard Programs: A variety of seminars and learning packages offered on a wide and repetitive basis to large numbers of audiences on all aspects of productivity and quality of working life improvement--measurement, appraisal, incentives, techniques, government regulation, etc.
- (4) Custom Programs: A customized set of programs

to help specific organizations and groups so that they can learn from the APC, and the APC can learn from the applications experience.

- (5) Institutional Relations: Programs to relate to a wide variety of institutions: corporations, unions, media, academia, government, non-profit organizations, associations, foundations, individuals, and international groups.

To give some specific examples, the APC offered in 1978 25 programs in nine cities around the nation: New York, Chicago, Philadelphia, Minneapolis, Cleveland, Atlanta, Houston, San Francisco, and Los Angeles.

These programs were attended by about 1,100 participants, all of whom are interested in some aspects of improving productivity in their organizations. The participants came mostly from business, but also from the federal government, state and local government, hospitals, unions, and schools.

The programs are concrete and practical. Some sample program titles are:

- How to Plan and Manage a Successful Productivity Program
- How to Measure Productivity at the Firm Level
- Productivity Appraisal: An Executive Overview

In addition, the APC held a national conference in New York in October, 1978 on how productivity helps to reduce inflation and unemployment. It was attended by over 300 people and had prominent speakers from government, business, labor, academia, and international organizations.

National Productivity Program

The American Productivity Center was created

specifically for some of the same goals envisioned by the National Productivity Program recommended in my testimony today.

Whether or not my recommendations are adopted, the APC will continue its work as indicated. However, if a National Productivity Program is created, in whole or in part, the APC stands ready to assist in the execution of any or all parts of it.

**“...dedicated to
strengthening the
free enterprise system
by developing programs
to improve productivity...”**

Productivity: A growing national problem

Our country currently faces one of its most challenging economic problems—lagging productivity growth. The rate of productivity growth in the United States during the last decade has slowed alarmingly. According to the Council of Economic Advisors, it is much more than just a periodic slowdown—it is a subject for major national concern.

From 1947-66, manufacturing output per man-hour grew by 3.2% per year, but from 1967-77, it slowed to only 1.5%. This compares poorly to other nations such as Japan, West Germany and Great Britain who have achieved yearly productivity gains ranging from 4% to as high as 9%.

If this slowdown isn't reversed, our country faces continued problems with high inflation, high unemployment, a declining dollar, reduced profits and uncompetitive American products. In short, the declining U.S. productivity growth rate is a serious national problem which must be addressed immediately.

The American Productivity Center

The American Productivity Center (APC) was created as a privately funded, non-profit organization dedicated to strengthening the free enterprise system by developing practical programs to improve productivity and the quality of working life in the United States. The APC is:

- Dedicated to developing practical, company-level methods for improving productivity
- Neither pro-management nor pro-labor, but brings both together to find ways to solve productivity problems
- Free from bureaucratic constraints and political influences
- Non-duplicative of productivity improvement efforts of other groups and organizations

The idea for an American Productivity Center was first conceived by Dr. C. Jackson Grayson, Jr., former business school dean and Chairman of the Price Commission from 1971-73. Grayson realized that while most American firms agree that productivity is important, the majority of them do not have coordinated, ongoing productivity improvement programs; only a very few of them understand the value of productivity measurement as a key management tool; and that many obstacles, such as management inattention and increased government regulation, have slowed productivity growth.

With pledged financial and personnel support of \$10 million from 75 national corporations and foundations who shared his concern, Grayson launched the American Productivity Center in January, 1977. Since then, support has grown to \$13 million from more than 100 organizations.

Objectives

The APC is committed to operate in a practical, business-like manner. In fulfilling this commitment, the APC has developed a sound management system and detailed plans for accomplishing written objectives which have been grouped into the following seven categories:

Awareness

American business, labor and government must be made aware of the importance of productivity, its trends and what it means to our economic future. Productivity is often mistaken as a code word for speed-up, layoffs and stop watches. Some feel it is only applicable to heavy industry, blue collar workers or industrial engineers. These mistaken impressions are holding us back in improving our productivity levels.

The APC is developing materials and methods to increase awareness of productivity, its importance and its benefits—ranging from major media exposure to company awareness programs.

Information

Decision-makers in business, labor and government are rapidly discovering the need for formal information systems to help them solve critical productivity problems. Until now, they have not had a single, centralized source for the specialized productivity data they require—it has been buried, scattered and, for practical purposes, inaccessible.

APC Information Services acts as a central clearinghouse reference source for productivity information, providing a wide range of productivity data from more than 70 computerized data bases, preparing bibliographies and reading lists and maintaining a library of books, periodicals, films and other published materials dealing with productivity and the quality of working life.

Appraisal

Individual plants, firms and industries require a comprehensive productivity audit to determine (1) their levels of productivity, (2) their productivity problems and (3) opportunities for improvement. They can benefit greatly from a thorough internal and external evaluation of their productivity measurement systems, communications systems, incentive systems, productivity program organization, accounting systems, capacity utilization and labor/management cooperation.

The American Productivity Center is developing special briefings and seminars on how to conduct productivity appraisals to identify opportunities for improvement.

Programs

While many firms agree that productivity is important, most of them do not have an explicit, ongoing program for productivity improvement. Some give periodic pep speeches, or initiate cost-cutting drives, but few have created sustained, formal programs.

To help organizations develop programs to improve their productivity, the APC has developed a series of one-day briefings on "How to Plan and Manage a Successful Productivity Improvement Program," that are presented in several cities throughout the nation. Managers who attend these sessions take with them a greater awareness of what productivity is and why it is important; specific guidelines for developing their own integrated productivity improvement programs; and the first-hand experiences of managers who have tackled productivity improvement head-on, dealt with the associated problems and pitfalls, and have started effective, integrated programs within their companies.

Measurement Productivity measurement tells an organization how well it manages its labor, capital, material and energy resources. The less resources used for a given output, the more productive they are. However, most firms rely on dollar accounting data to analyze their operations, even though these data include the effects of such things as inflation, tax depreciation and arbitrary fixed cost allocations—information often unrelated to the productive process under study.

The APC is focusing its efforts on total productivity measures, which take into consideration all resources. The measurement information developed by APC will be presented in the form of special educational courses. Some of these courses will include full explanation of the newly developed APC Performance Measurement System which emphasizes total productivity measures.

Major features of the APC system are:

- It measures the productivity of each resource element in relation to total output
- It provides a total productivity measure
- Elements are weighted to recognize quality differences
- It can analyze performance at several organizational levels
- It measures the effect of productivity on profits
- It isolates the effects of inflation on profits

Human Resources Both the individual and the organization benefit from productivity improvement. Labor and management can work together on programs for improved productivity and quality of working life. Joint productivity or labor-management teams at the level of individual firms or for a whole industry are strong evidence of this fact.

The APC is playing an important role in bringing individuals and organizations together to work toward lasting cooperative relationships.

Techniques There are literally thousands of ways to improve productivity and new ones are created almost daily. The problem is that many of these techniques are not widely disseminated. Sometimes they are not transferred among members of the same industry and sometimes not even from department to department within a single firm.

The goal of the APC is to compile a body of information about the various productivity improvement techniques and make them available wherever and whenever they are needed by business and industry.

Products

The APC is currently developing and marketing a series of special "products," which take the form of briefings, seminars, workshops, conferences, advisory services, books, manuals, case studies, pamphlets and audio-visual materials.

Products planned for the immediate future include:

- Productivity Awareness Programs—publications, films, slides, tapes, speech materials and posters
- Productivity Information Services—books, periodicals, reference services, data bases, research sources and case studies
- Productivity Appraisal Methods—briefings and seminars on how to determine the most productive areas to direct improvement efforts.
- Company Productivity Programs—special briefings on how to plan, implement and manage productivity improvement programs
- Cross-industry Productivity Measurement Seminars—courses on how to measure productivity at the company level
- Multi-firm Comparisons of Productivity Data—confidential collection and analysis of productivity data in conjunction with industry trade associations
- "Inflation and Unemployment: The Productivity Solution"—a special conference emphasizing labor and management cooperation to reduce inflation and unemployment through productivity improvement

Location

The American Productivity Center is currently located at 1700 West Loop South, Suite 210, Houston, Texas 77027.

The APC was moved to Houston from Dallas in June, 1977, when a group of Houston business leaders expressed interest in having the APC based in their city. These business leaders formed a special foundation to raise \$5 million for the construction of permanent facilities, planned for completion in late 1979. The new facility will be adjacent to The Houstonian, an 18-acre conference center complex which includes living quarters, executive meeting rooms, a medical center and physical fitness facilities.

Finances

The APC receives the majority of its operating financial support through contributions from major corporations and foundations. More than a hundred firms are now listed as APC Founders as a result of their contributions.

Most of these contributions are in the form of five-year pledges of cash and/or personnel. Within five years, the APC intends to generate a major portion of its operating funds from the nationwide marketing of its own products.

Management

Although the APC is organized as a non-profit group, it is operated as a managed goal-seeking organization. It has adopted a sound management system which establishes priorities and assigns responsibility for completion of various projects.

Dr. C. Jackson Grayson serves as Chairman of the Board and has overall responsibility for the direction and operation of the American Productivity Center.

The President and Chief Operating Officer, like his industry counterpart, is responsible for directing the day-to-day activities of the Center and its staff.

Most of the APC's management team are managers experienced in line operating positions. Their broad experience in a variety of industries provides depth to the Center's operational capabilities and maintains a focus on the development of practical programs.

Associates Program

The APC is unique among other organizations in that a portion of its staff is comprised of key executives from major national firms. These "Associates" are assigned to work at the APC for periods of a year or more and bring with them a wealth of practical business experience. They come to APC from such leading firms as Gulf Oil, Weyerhaeuser, Honeywell, Mead Corporation, Exxon Chemical, International Multifoods, Celanese Corporation and American Can.

The Associates are organized into special project teams—some grouped by industry and others by specific problem area—and are currently engaged in field projects related to the seven APC objective areas.

After working for a period of time on assigned APC projects, the Associates return to their firms with specialized productivity knowledge which helps them in managing their own internal productivity improvement programs.

Summary

The American Productivity Center is fully operational. Since its founding, it has established a workable list of goals, objectives and strategies; it has drawn together a staff of productivity specialists and a body of productivity information; and it has begun to develop practical and marketable products.

The APC realizes it cannot solve our country's productivity problem by itself, but it is a beginning—a private-sector starting place to reduce unemployment, fight inflation, provide capital, increase profits, improve the American standard of living, and preserve the free enterprise system.

Founders

Operating Funds

Allen-Bradley Company
 The Allen Group Inc.
 Amax Inc.
 American Can Company
 American Standard Incorporated
 Amsted Industries, Inc.
 Anheuser-Busch, Inc.
 Arcata National
 Armstrong Cork Company
 Arthur Andersen & Company
 Atlantic Richfield Foundation
 The Babcock & Wilcox Co.
 Boise Cascade Corporation
 Burroughs Corporation
 Butler Manufacturing Company
 Cabot Corporation
 Castle & Cooke, Inc.
 Caterpillar Tractor Company
 Celanese Corporation
 Chicago Bridge & Iron Company
 Cities Service Company
 Coca-Cola Bottling Co. of New York, Inc.
 Continental Illinois National Bank & Trust Company
 Continental Oil Company
 Conwed Corporation
 The Cross Company
 Crown Zellerbach
 Cyclops Corporation
 Dekalb AgResearch, Inc.
 The Dexter Corporation
 R. R. Donnelley & Sons Company
 Eli Lilly and Company
 Emerson Electric Co.
 Field Enterprises, Inc.
 First National Bank of Chicago
 General Foods Corporation
 General Motors Corporation
 Gifford-Hill & Co., Inc.
 Goldman, Sachs & Co.
 Gulf Oil Foundation
 Handy & Harman Foundation
 Harsco Corporation
 H. J. Heinz Company
 Honeywell, Inc.
 International Business Machines Corp.
 IC Industries, Inc.
 Inland Steel Company
 Institute for Continuing Studies, Inc.
 International Multifoods
 International Paper Company
 Kraft, Inc.
 Kuhlman Corp.
 Lilly Endowment, Inc.
 Lucky Stores, Inc.
 Lykes Corporation
 McCord Corporation
 Mead Corporation
 Medtronic, Inc.
 Melville Shoe Corporation
 Memorex Corporation
 Meredith Corporation

Herman Miller Inc.
 David Milton Trust
 Morrison-Knudsen Co., Inc.
 Motorola Inc.
 Murphy Oil Corporation
 NL Industries, Inc.
 Northrop Corporation
 Overhead Door Corporation
 J. C. Penney Company, Inc.
 Pennwalt Corporation
 J. Howard Pew Freedom Trust
 Phillips Petroleum Company
 Potlatch Corporation
 Price Waterhouse & Co.
 The Quaker Oats Company
 Ralston Purina Company
 Reading & Bates Offshore Drilling Company
 J. B. Reynolds Foundation
 The Riley Company
 Rockwell International
 The St. Paul Companies, Inc.
 Simpson Timber Company
 Southern Pacific Transportation Company
 Standard Oil Company Ohio Corp.
 Sun Company
 Texas Gas Transmission Corporation
 Texas Instruments, Incorporated
 Touche Ross & Co.
 TransUnion Corporation
 United States Gypsum Company
 United States Steel Corporation
 Universal Leaf Tobacco Co.
 Varian Associates
 Wells Fargo Bank
 Weyerhaeuser Company

Capital Funds

The J. S. Abercrombie Foundation
 Albert Alkek
 American General
 M. D. Anderson Foundation
 Bratten Construction Inc.
 Cameron Iron Works, Inc.
 Dresser Foundation, Inc.
 Entex, Inc.
 Ernst & Ernst
 The Fondren Foundation
 Gulf Consolidated Services, Inc.
 Halbouty, Michel T.
 Halliburton Company
 Haskins & Sells
 Houston Clearing House Association
 Houston Natural Gas Corporation
 Hughes Tool Company
 Lincoln Financial, Inc.
 Oppenheimer & Co., Inc.
 Perry Homes, Inc.
 The Prudential Insurance Company of America
 Shell Oil Company
 Weldon Weekley
 Wilson/Crain/Anderson/Reynolds

**Board of
Directors**

Robert Abboud, Chairman, First National Bank of Chicago
I. W. Abel, Labor Consultant, Past President, United Steel Workers
John Biegler, Managing Partner, Price Waterhouse & Co.
Don C. Burnham, Officer, Director, Westinghouse Electric
Frank Cary, Chairman, International Business Machines
George A. Chandler, President, American Productivity Center
James L. Ferguson, Chairman, General Foods
C. Jackson Grayson, Chairman, American Productivity Center
John Kendrick, Professor, George Washington University
Donald S. MacNaughton, Chairman, Prudential Insurance Co.
Charles H. Pillard, President, International Brotherhood
of Electrical Workers
W. F. Rockwell, Jr., Chairman, Rockwell International
W. J. Usery, Jr., Labor Consultant, Past Secretary of Labor
Glenn E. Watts, President, Communications Workers of America
John Whitehead, Senior Partner, Goldman Sachs & Co.

PRODUCTIVITY: Whipping Inflation Through Increased Output

An Interview with Dr. C. Jackson Grayson



PRODUCTIVITY: Whipping Inflation Through Increased Output

An Interview with Dr. C. Jackson Grayson

AS INFLATION HEATS UP, intensifying the threat of federal wage-price guidelines or outright controls, there's one word that is getting increasing attention among business executives, government officials, labor-management consultants, and economic experts. That single word is productivity—the measure of how much output of goods or services is achieved in relation to input of labor, materials, and money.

The best answer to steadily rising labor costs, economic authorities agree, is to improve productive efficiency and boost output per hour. Unfortunately, the growth trend in the U.S. in recent years has been in the opposite direction. Productivity growth has been going down, not up. According to the Council of Economic Advisers, it is not just a periodic slowdown, but a significant decline that must be reversed if the nation is to attack inflation, provide more jobs, improve profits, and pave the way for solid business growth.

What can be done to bring a turn-about? Can worker efficiency be improved in retail stores, service industries, corporate and association offices, as well as on the factory production line?

For answers, ASSOCIATION MANAGEMENT turned to Dr. C. Jackson Grayson, Jr., chairman of the American Productivity Center with headquarters in Houston. Dr. Grayson is former dean of the School of Business at Southern Methodist University and was chairman of the Federal Price Commission from 1971 to 1973. While in the latter post, he saw that price controls were not the answer to reducing inflation, and he concluded that increased productivity was the only effective way to deal with spiraling costs and prices.

In the interview that follows, Dr. Grayson explains in understandable terms what the productivity problem is all about, how it can be attacked, and how trade and professional associations can play a special role in helping their members develop techniques for productivity improvement.

Dr. Grayson, just what has happened to productivity in this country in recent years?

Its rate of growth has slowed alarmingly over the past decade. We used to be accustomed in this country to steady, year-by-year strong growth in output per hour as industry kept installing modern machinery and equipment and made the best use of

technical skills and good management methods. Between 1944 and 1966, output per working hour grew by 3.2 percent per year. But from 1967 to 1977, it slowed to only 1.5 percent a year. On average, we've cut our productivity gains in half. The U.S. productivity growth, in fact, is the lowest among all the major industrial nations of the world, including Japan, West Germany, Sweden, France, Canada, and Italy.

What has caused the slippage in the American rate of productivity?

A whole batch of things, including government rules and regulations that hamper industry's efforts to hold down costs; a reduction in total capital investment, in "real" terms, in many industries; an influx of inexperienced people into the labor force; and, finally, lack of attention by management to production and technical skills at a time when foreign competitors have been concentrating on improving efficiency.

Does all this have an effect on business costs and on consumer prices?

Definitely. It's no coincidence that over the past decade, while our rate of

productivity growth has been going down, we have experienced unprecedented inflation and unemployment, declining profits, lowered capital investment, and sluggish gains in the "real" wages paid to workers.

When productivity growth declines, it causes many problems. Inflation and unemployment tend to accelerate. For example, increased productivity helps to pull inflation down, because gains in the rate of output act as an offset to cost increases.

Aren't there some areas, though, where it's very difficult to get much increase in productivity over and above what already has been attained?

Certainly. But in every industry, some gains can be made. If an industry

does not favor mandatory controls, and his advisers and cabinet members say that, too. But I see steps occurring which tend to lead in the direction of controls. People remember that President Nixon said in 1971 that he was against controls, but we ended up with them. If inflation should go up much beyond its present rate, and stay there, then the public will demand, and President Carter and the Congress probably will institute, controls. I can tell you, from my experience as chairman of the Price Commission, that they won't work.

Why not?

Because they don't get to the fundamental causes of inflation. All they do is act as an outside force to suppress by coercion the basic causes of rising

One thing is training. In many cases, by giving employees additional training—or by retraining workers whose skills have been outmoded by new tools or machinery or new ways of doing things.

A second important thing is motivation. That means convincing workers that they have a stake in the success of the enterprise, and that stepping up their output will help them hold onto their jobs and improve their real earnings, part of which are now lost to inflation.

Finally, management must be prepared to give workers a share of productivity gains in the form of increased pay and additional job responsibilities.

Does the boss or supervisor play a key role in spurring productivity gains?

Very much so. I've seen cases where middle-management people and supervisors are blocks to productivity. One of the accusations by some businessmen is that it's the unions that are causing us to lose productivity. I know there are cases where unions impose work restrictions and insist on certain job rules. But I also know that management often imposes restrictions on labor that make the workers inefficient. So I don't think we can assign the bulk of the blame to either side. The important thing now is to stop trying to blame one another and realize that we should be engaged in a joint enterprise of tackling the productivity problem.

Has the federal government been doing anything to try to improve productivity?

Yes, but its role has been pretty much ignored. A National Center for Productivity and Quality of Working Life was created late in 1975 with headquarters in Washington. It has produced some studies of value. But in the main it has not lived up to the expectations and hopes of a great many people, and it is now being allowed to expire this year. Any organization in the public sector inevitably is going to find it difficult to get cooperation from, and productivity data supplied by, the private sector.

What about your own productivity center, Dr. Grayson? How did it get started, and what are your aims?

In my work at the Price Commission, I saw the importance of using productivity gains rather than controls to fight inflation. And I also observed that neither workers nor managers in a vast number of firms in this country know

"Wage and price controls won't work, because they don't get to the fundamental causes of inflation."



cannot make any gains, it will eventually go out of existence—and it should go out of existence. In many cases, such an industry will be picked up by another nation. However, there are many lines of business that can make far larger gains than they are now making. I'm trying to get more firms to realize the potentials they have for improvement.

Do you see improvement in productivity as a way to avoid mandatory wage-price controls?

Definitely. In fact, it's the only way, I think, that the private sector can marshal its resources to offer a better alternative than wage and price controls imposed by the government.

Dr. Grayson, are you worried that the present administration sooner or later may resort to controls?

Yes. President Carter has said that he

prices. That merely postpones a later blow-off. In the meantime, it causes misallocation of capital, which goes in the wrong direction, because you're interfering with prices which in a free economy give signals on supply and demand.

Controls breed more controls. They treat industry as a public utility. They cause people to avoid taking risks. So the whole thing runs counter to what is normal business behavior.

So you come back to productivity as a basic way to fight inflation. . . .

Exactly. If you look at the other alternatives, nearly every one says the government should do something. That's not the answer. The only long-term answer is in the private sector, and productivity is its chief hallmark.

What can management do to encourage higher productivity?

what productivity is; they've heard the word, but they don't really understand it.

I found, too, that few companies have any sort of coordinated, ongoing program for improving output. Only a few have any concept of the value of productivity measurement as a management tool. And Americans generally aren't aware of the link between maximum output and the strength of our free enterprise system.

For all these reasons, I left my Price Commission job with the conviction that productivity needed more attention. And I wanted to work at it in the private sector because that's where the responsibility lies and where there's the greatest opportunity for improvement. I wanted a privately supported center, funded by private organizations, to work with individual firms.

Has anything like this been done in other countries?

Yes, to a limited extent. I looked abroad and found that Japan and West Germany both had productivity centers. In each case they are large centers, working actively with manufacturers and other enterprises. Not insignificantly, those two countries have had some of the highest productivity gains of any nations. The productivity centers didn't create all the gains, but they certainly helped.

So I began calling for a center of a similar nature to be set up in the U.S. I made speeches, wrote articles, traveled around the country trying to drum up

interest. When nobody responded, I decided to do it myself. I spent a year asking corporations if they'd contribute funds to an American Productivity Center.

What happened?

At the end of the year, I added up my support and found that 75 corporations and several foundations had pledged \$8.5 million plus \$1.5 million worth of people's time. That was enough for me to decide to go ahead. In January of 1977, I resigned my position at Southern Methodist University to give full time to this project.

What caused you to pick Houston as a site?

A group of Houston businessmen felt that the center should be there. They said, "If we were to build you facilities, free of charge, to house the center, would you establish it in Houston?" It was an offer that I couldn't turn down. However, the location of the headquarters isn't the important thing. The productivity problem isn't going to be solved at our headquarters. It's going to be done at individual plants and offices all over the nation. We're not a think-tank. We're a nuts-and-bolts, individual-approach, product-level kind of operation.

What exactly do you offer companies that are willing to participate in your program?

The approach we're taking is four-fold. One aspect involves seminars,

conferences, and workshops all across the country. In those, we describe to firms what we think are ways they should consider improving their productivity, how they can organize a company productivity program of their own, how they can involve employees, how to motivate them and share gains with them.

A second area concerns research on productivity. Particularly, we are concentrating on ways to measure output and methods for implementing programs in various types of industries.

The third aspect centers on publications, in which we write up case studies: Here's how the ABC Company, for example, measures the productivity of its employees; here's how the XYZ Company has organized a company-wide improvement program; here's how still another firm has used flexible working hours to boost productivity.

The fourth area includes advisory services—a program where members of our staff will go to a firm and advise them on how to get started.

Have you recruited a competent staff for that purpose?

Yes, an excellent one. We are building a permanent staff of experienced people. In addition, part of our support from industry is in the form of management people on loan to us for a year or more. These associates bring to us their practical business experience. They come from such diverse firms as Gulf Oil, Weyerhaeuser, Honeywell, Mead Corporation, Exxon Chemical, International Multifoods, and American Can. They are organized in project teams, some grouped by industry and some by specific problem area. They go out into the field to tackle projects related to various APC objectives.

Do you charge for your services?

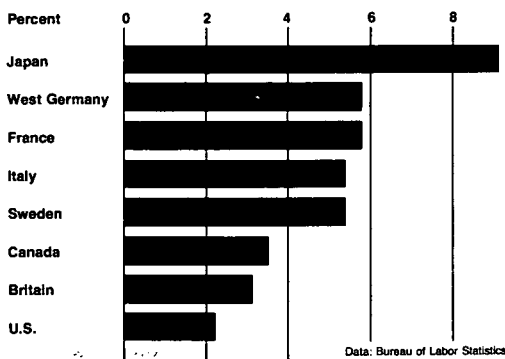
Yes, we have a scale of charges for seminars and publications that will help to meet some expenses, and we plan an active membership program to supplement our contributions.

What sort of cooperation are you getting from organized labor?

In general, labor leaders are supportive of the idea of trying to improve productivity. It's only the minority that still views it as a management trick for speeding up the production line, forcing people to work harder, and destroying the union.

We have four labor leaders on our board of directors. Their view is that

Average Annual Increase in Productivity, 1966-76



"We're talking with several associations about setting up programs that will, first of all, seek to measure productivity in their industries."



improving output is a way to preserve both the union and workers' jobs.

Are you actively seeking help from trade and professional associations?

Yes. We have just set up a proposal for joint programs with associations. We recognize that associations offer a unique resource in the area in which we're working. We can benefit each other. Each association has regular and influential contact with dozens of companies, hundreds of plants, and thousands of decision-makers. Associations can provide many services to their members more economically than can individual members working alone. Finally, as one business consultant has noted, "The fundamental purpose of most associations is to improve the productivity of members—individually and collectively."

What types of cooperative effort do you envision between your center and various associations?

An important activity is working out ways of measuring productivity, taking into account all the resources that go into it — not only labor, but materials, capital, and energy. Until an organization measures its present productivity trends, it can't tell where improvement is needed.

Many companies have told us they'd like to know how the productivity levels and trends in their plants compare with those of their competitors. But up to now, a single, confidential source for productivity measurement knowledge simply hasn't been available.

In February of 1978, we began field work for our data collection and analysis service, working in conjunction with the National Flexible Packaging Association. We are sending out an

APC questionnaire to all of the association's members.

The resulting productivity statistics and evaluation of performance will be available to all the participating firms. We are also talking to several other national trade and professional associations.

We are prepared to set up industry-tailored briefings for association members on how to start productivity improvement programs in their own companies. And we are ready to share with associations our materials and presentations on human resources development techniques, including quality of working life.

We realize the importance of coordinating our APC efforts with those of other private sector organizations, and associations are one of the key aspects of that shared effort.

Do you encounter resistance from association people or company executives to share their methods for improving productivity? Is there a tendency to say, "Well, we've got some secrets that we don't want anyone else to know"?

Not one firm out of several dozen that we've invited to Houston to date has refused on that basis. We've had such companies as IBM, Detroit Edison, Texas Instruments, Xerox, Beech Aircraft, Northrup, and others. We've been most encouraged by the way leading companies in this country are coming in to describe their programs.

You mention Detroit Edison. Many people can understand how it's possible to boost output on an assembly line, where tangible products are turned out. But what do you do when it comes to a service business—an electric utility, a restaurant, a retail store?

Those enterprises need productivity gains just as much as does the manufacturing sector. But many service industries are resistant to the idea that productivity concepts apply to them. I'm trying to get the message across, and it's an area where associations can help spread the word: It's equally important to get more productivity in the service sector—not only for the companies but for the country's economic future, because more and more of our economy is shifting to services.

Admittedly, it's more difficult to apply productivity concepts to service-sector companies because of the problem of defining output. What's the output of a doctor? Or an educator? Or a waitress? Or a lawyer? But that sort of measurement, while difficult, can and must be worked on, or we'll continue to see productivity slide backward rather than moving forward. In regulated industries, especially, it's vital to have productivity gains, because regulatory bodies are not going to allow them to continue to raise prices, particularly at present levels of inflation. So the only way those industries can continue to be profitable is to make productivity gains.

You've been quoted as saying that one of the biggest impediments to productivity gains lies in the corporate boardroom. What do you mean by that?

Simply that management has given scant attention to productivity in recent years. They've neglected it in favor of concentrating on such things as market share, mergers, acquisitions, and so on. They've tried to play the earnings game while ignoring the supply side of their operations; and it's that side, in the long run, that's going to permit their survival. I'm trying to draw more boardroom attention to the need to concentrate on the productivity side of things.

Don't restrictive government regulations tend to hamper productivity improvement? Industry has had to spend billions in recent years on pollution controls, occupational safety measures, and similar programs that, while desirable, don't contribute at all to getting goods and services produced. . . .

Yes. I think we should take every regulation that's now in effect, look at it on a cost-benefit basis, and find out how much it is contributing to inflation. Similarly, we ought to have every

proposed new act of Congress reviewed for its impact on productivity.

Many individual businessmen have spoken out against such productivity-destroyers, but often they speak in abstractions. One role of our center

will be to speak collectively, with a prestigious voice, building a public awareness of the way restrictive regulations—and management mistakes, too—destroy productivity.

The American Productivity Center

won't solve this pervasive national problem by itself—no single thing will—but it is a start, and that is what we need today.

18

What's Needed to Close the Productivity Gap

The American Productivity Center is concentrating on seven key areas in which industry can work to improve output. Here is how the center's chairman, Dr. C. Jackson Grayson, Jr., describes them:

Awareness. Organizations need to make employees and managers aware of productivity's importance and the need for their involvement. "Myths, mistaken impressions, and management inattention are holding us back."

Information. A central clearinghouse for information is essential: case studies, manuals, books, films, tapes. "What little productivity information we have is esoteric and incomprehensible to those who need to act on it."

Appraisal. Individual companies and industries need to find out where they stand in relation to competitors, where their productivity problems are, where they can improve.

Programs. Even the firms that recognize the importance of productivity often have no program for improvement. Sustained, formal efforts are needed, on a long-term basis, not as a one-shot, cost-cutting drive.

Measurement. "This is the weakest link in the whole effort to boost productivity." At the national level, information on measurement is woefully inadequate. At the industry or plant level, measurements—if they exist at all—generally are superficial and misleading. What's needed are measures for "total factor" productivity, counting not only labor, but capital, materials, and energy as well.

Human resources. Joint cooperative efforts by workers and managers are necessary, not an adversary relationship that can be detrimental to each. Employees need to be involved with incentive systems, with retraining programs where necessary, and with motivational efforts. "Productivity gains must be shared with workers."

Techniques. Literally thousands of ways to improve productivity exist, but many firms know little about them. There has been no central forum for exchange of ideas and methods. "We need to have documented data on successes and failures, and to provide a source of contact for information and assistance."

Further information about the American Productivity Center and its programs can be obtained from Dr. Grayson at the center's headquarters, 1700 West Loop South, Suite 210, Houston, TX 77027. Phone: (713) 961-7740.

National Journal

THE WEEKLY ON POLITICS AND GOVERNMENT

Productivity: A Call for Action

"This productivity slowdown is one of the most significant economic problems of recent years."

That stark sentence, almost buried on page 147 of the 1978 Annual Council of Economic Advisers Report, should be ringing alarm bells.

It is more than just a cyclical slowdown. Something fundamental has happened. From 1947 to 1966, output per man hour grew by 3.2 per cent per year, but from 1967-77, it slowed to 1.5 per cent per year (which is even lower than the usually quoted performance of the manufacturing sector, illustrated in the accompanying chart).

It is no coincidence that roughly in this latter period we have also experienced unprecedented inflation and unemployment, falling profits and capital investment, and sluggish real wage gains.

No significant let-up is in sight. Costs are rising faster than prices. Wage escalators are built into labor contracts. Price escalation is built into forward sales. Two successive years of high federal deficits are planned.

Standard Keynesian stimulation of demand has stimulated inflation even more, and without solving the unemployment problem or stimulating capital investment sufficiently. Severe fiscal and monetary restraint has reduced output faster than inflation, and increased unemployment.

Income redistribution programs have focused policies on allocation—on dividing the pie—instead of *expanding* it. And regulation, public spending programs and taxes are increasing, driving prices further upward.

The tempo builds, therefore, for inaugurating "incomes policies."

WAGE AND PRICE CONTROLS

President Carter calls for "voluntary restraint" by business and labor. The Council on Wage and Price Stability is asked to undertake "an analysis of the outlook for market conditions and cost trends in specific industries" and "members of the Administration will participate in informal private discussions with firms or industry groups." Shades of jawboning, arm-twisting and guidelines.

Lurking in the wings are mandatory wage and price controls.

President Carter has said that he does not favor mandatory controls. But people remember that Nixon said the same thing in 1971. If inflation should rise to the 8 per cent mark—and stay there for a period of months—then the American public will demand, and Carter and the Congress will institute, controls. And I can tell you, from my experience as Chairman of the Price Commission, they won't work.

PRODUCTIVITY GROWTH 1966-1976



Source: U.S. Department of Labor, Bureau of Labor Statistics

All the proposed solutions have one thing in common—government intervention and direction of the economy. Notably missing in all of them are (1) any real appreciation of the *private sector's* role in solving national economic problems, and (2) any real understanding of the role of productivity, the historical strength of the private sector.

Yet it is in the private sector, where 80 per cent of our goods and services are produced, that the battle will be won or lost. Productivity is one of our most powerful weapons in the fight against inflation and in the long struggle to reduce unacceptable levels of unemployment. Gains in this sector can bring tremendous benefits to the economy: an improvement of less than 1 per cent in output per employee-hour can mean billions of dollars in gross national product.

MANAGEMENT PRIORITIES

What is most urgently needed now is *not* more government intervention, but an awakening of the private sector to

reassume the role it has gradually abdicated.

For years now, too many of our nation's top business managers have largely ignored productivity and have been playing the game of money and demand management. Key measures have involved return on equity (not return on assets), with emphasis on acquisition, merger and tax manipulation. Laurels, bonuses, and CEO slots have been going to financial, accounting and marketing specialists, with less attention to production and technical skills. Management inefficiencies have crept in, as score-keeping has been not on productivity, but on increasing capacity, market share points, profitability, and price leadership. Even leading business schools preparing management leaders of the future have all but dropped production and productivity courses in favor of behavioral science, accounting and finance courses.

Meanwhile, foreign competitors have been concentrating on efficiency and gaining steadily. In a growing number of industries—shipping, steel, television manufacturing, footwear—we are already in serious trouble. In others—computers, autos, electronics—the warning signals are there. Professors Jorgenson and Nishimizu of Harvard and Princeton recently estimated that "by 1973 technology at the aggregate level in Japan was very slightly ahead of that in the U.S."

THE KEY AREAS

Awareness: Too often, productivity is mistakenly treated as a code word for speed-up, layoffs and stop watches. Others treat it as something applicable only to heavy industry, blue collar workers or industrial engineers. Myths, mistaken impressions and management inattention are holding us back. We need educational programs to increase labor and management awareness of productivity's importance and its benefits—not in abstract, economic theoretical terms, but in terms of where it really counts: jobs, paychecks and profits.

Information: What little productivity information we have is typically esoteric and incomprehensible to those who need to act on it. It is buried, scattered and, for practical purposes, inaccessible. A central clearinghouse reference service of productivity information is needed: case studies, manuals, books, films, tapes—in short, a specialized productivity information center.

Appraisal: Individual plants, firms and industries need to undertake a comprehensive productivity "audit": to determine their level of productivity, their productivity problems and opportunities. They need a thorough inside and outside evaluation of their productivity measurement systems, communication systems, incentive systems, productivity organization, accounting systems, capacity utilization and labor/management cooperation.

Programs and goals: While many firms agree that productivity is important, most have no explicit program for improvement. Some give periodic pep speeches on productivity. Some initiate cost cutting drives. Most programs die as start-stop efforts. Firms need to create sustained, formal efforts toward productivity improvement with detailed goals, objectives, strategies, assignments, data gathering systems, monitoring and follow up.

Measurement: Measurement is the weakest link at both the micro and macro levels. At the national level, the data are woefully inadequate for public policy analysis of causes of the productivity slowdown, or analysis of the impact of proposed public policy alternatives. At the plant, firm or industry level, most firms rely on only financial and profitability figures and have few real productivity measures. And what measures there are, even in leading firms, are typically superficial and even misleading. Virtually none have measures for "total factor" productivity—productivity of labor, capital and materials.

Labor/Management: Both labor and management gain from productivity improvement. Yet recent years have seen a growing adversary relationship detrimental to each. The relationship is often structured so that employees have the incentive *not* to cooperate—threatened job security, no gain sharing, poor management and poor working environment. Labor and management can work together on programs for improved productivity. Restraints can be reduced, and opportunities opened up. Some firms and industries are already doing this with productivity teams, quality of working life programs and gain-sharing agreements.

Techniques: There are literally hundreds of ways to improve productivity, and new ones are created daily, in this country and abroad. The waste is that many firms know little about these techniques. Improvement occurs in another industry, in another country, and many firms have no way to share in the ideas. Ideas are sometimes not even transferred within the same firms. We need to have documented data on successes and failures, and to know who to contact for information and assistance.

The American Productivity Center was brought into being one year ago to help industry and labor focus on these key areas that will make productivity improvement possible. We are all now paying the cost for having ignored productivity for too long.



C. JACKSON GRAYSON JR. CHAIRMAN
AMERICAN PRODUCTIVITY CENTER

AMERICAN PRODUCTIVITY CENTER BOARD OF DIRECTORS: Robert A. Abboud, Chairman of the Board, First National Bank of Chicago; I. W. Abel, labor consultant, former President, United Steelworkers of America; John C. Blesler, Managing Partner, Price Waterhouse & Co.; Donald C. Burnham, Director-Officer, Westinghouse Electric Corp.; Frank T. Cary, Chairman of the Board, IBM; George A. Chandler, President, American Productivity Center; James L. Ferguson, Chairman, General Foods Corporation; C. Jackson Grayson, Jr., Chairman, American Productivity Center; Dr. John W. Kendrick, Professor of Economics, George Washington University; Donald S. MacNaughton, Chairman and Chief Executive Officer, Prudential Insurance Co.; Charles H. Piliard, President, International Brotherhood of Electrical Workers; Willard F. Rockwell, Jr., Chairman of the Board, Rockwell International; William J. Usery, labor consultant, former U.S. Secretary of Labor; Glenn E. Watts, President, Communications Workers of America; John C. Whitehead, Senior Partner, Goldman, Sachs & Co.

THE AMERICAN PRODUCTIVITY CENTER

The American Productivity Center was established in February 1977 to provide American business and industry with a major resource for the achievement of significant gains in productivity.

Services provided to individual companies or industry groups include information, research and development, education and training, and assistance in the design and implementation of appropriate productivity measurement and improvement programs.

The Center is a non-profit organization supported by private contributions, principally from companies and foundations. It is governed by a board of directors of prominent leaders of American business and labor.

Arrangements for briefings and further information on the Center and its programs may be obtained from: The American Productivity Center, 1700 West Loop South, Houston, Texas 77027. Telephone: (713) 961-7740.

Mr. Alfred E. Kahn
 November 28, 1978
 Page Two

and respectfully offers the following findings and modifications. */

FINDINGS

As proposed, the COWPS wage-price standards could seriously curtail some of the most effective productivity improvement programs in America. This would be contrary to the goals of the President's Anti-Inflation Program and to the statutory authority pursuant to which the standards are promulgated.

As authority for promulgating wage-price standards, the COWPS relies primarily on Sections 2(c), 3(a)(4), and 3(a)(5) of the Council on Wage and Price Stability Act, 12 U.S.C. § 1904 note. See 43 Fed. Reg. at 51952 (§ 705.1 Authority). Section 3(a)(5) of the Act states in part that COWPS shall "focus attention on the need to increase productivity in both the public and private sectors of the economy."

The central importance of productivity to a lasting solution to inflation, to an increasing standard of living, and to decreasing unemployment has been recognized many times by government, business, and labor leaders. The President, the Federal Reserve Chairman, the Comptroller General of the United States and the Chairman of COWPS have all stressed the high priority of increasing productivity.

In order to further the statutory policy cited as enabling authority, and to be consistent with established national policy and with the public interest, COWPS wage-price standards should encourage rather than hamper efforts to improve productivity. The following proposed modifications will remove impediments to productivity now contained

*/ Staff with expertise in anti-inflation programs were asked to review all suggested modifications for their consistency with a controls program.

Mr. Alfred E. Kahn
November 28, 1978
Page Three

in the wage-price standards without increasing the regulatory burden, or reducing the effectiveness of the program. The modifications also are designed to be consistent with the objectives of the program, and to fit into the proposed standards with minimum redrafting.

MODIFICATIONS

Proposed Modification of Section 705A-4 Profit Margin Standard

Add: To the extent that an improvement in profit margin can be demonstrated to be directly attributable to an improvement in productivity it will be in compliance with this standard.

Rationale

This standard acts as a disincentive to productivity improvement efforts and as an incentive to increased inefficiency. In some cases it would even prohibit productivity improvement. For example, a bank compelled by the government's monetary policy to increase interest rates would automatically be in violation if it substantially increased its productivity.

As modified, this standard would act as an incentive for increasing productivity and decreasing costs. It would not open any loopholes and would encourage voluntary compliance. It would decrease regulatory burden, regulatory lag and compliance costs by decreasing the number of exception requests.

Section 705A-4 as Modified

705A-4 Profit Margin Standard. A company which does not achieve the price deceleration standards in 705A-1,2, and 3 will be considered to be in compliance if its program-year profit margin does not exceed its profit margin base. If product lines excluded under parts 705A-6 (i) (1) and 705A-6 (i) (3) account for more than 75 percent

Mr. Alfred E. Kahn
 November 28, 1978
 Page Four

of program-year dollar sales volume and there is no reasonable accounting method capable of establishing a separate profit margin for the nonexcluded product lines, the company is excepted from the preceding profit margin criterion for compliance. To the extent that an improvement in profit margin can be demonstrated to be directly attributable to an improvement in productivity it will be in compliance with this standard.

Proposed Modification of § 705A-9
Undue Hardship or Gross Inequities

Add: or negative productivity impact.

Rationale

In its current form, this section does not allow for exceptions where the standards inadvertently and unintentionally act in a manner inconsistent with maintaining or increasing productivity. Without modification, it could destroy productivity in specific instances and embodies a generally negative attitude toward productivity improvement.

The additional language, while not weakening the standards, will provide a necessary safeguard against hampering productivity and will help to create a positive atmosphere for productivity improvement programs. It will also act as a stimulant to these efforts by highlighting the Council's concern that its standards not be detrimental to productivity.

Section 705A-9 as Modified

705A-9 Undue Hardship or Gross Inequities. The Council on Wage and Price Stability may except a company from the application of the price standard, make adjustments to the base rate of price change, or alter application of the profit-margin standard to avoid extreme situations of hardship or gross inequity or negative productivity impact.

Mr. Alfred E. Kahn
 November 28, 1978
 Page Five

Proposed Modifications of Section 705B-6
 Pay-rate Increases Traded for Productivity-
 Improving Work-Rule Changes

Delete: contractual
 Change: alter to improve
 Add: practice

Rationale

In its present form, this section would bring many progressive and necessary productivity efforts to a complete standstill and undo recent progress in this area. Recent programs have tried to dispel the erroneous and detrimental beliefs that productivity only involves the "blue collar" worker, and that productivity only means working harder and faster. In fact, productivity includes all workers, and improvements come from working more effectively. Furthermore, productivity improvement comes not only from improvements in labor productivity, but also from capital, energy, and materials inputs. This "total factor" approach requires that all employees share the responsibility for productivity improvements and should be provided appropriate incentives.

The present standard, by allowing pay above the seven percent limit only for contract labor and only for changes in work rules, inhibits efforts to stress total factor productivity. Rather, it fuels the erroneous assumption that productivity comes only from squeezing more from workers, and would have many undesirable effects: it would prohibit many productivity gainsharing plans, such as Scanlon Plans; */ it would be detrimental to labor-management cooperation; and it would largely prohibit incentives, direct or indirect, to non-contract labor. In short, this section is discriminatory, unfair and unjust to all non-contract labor.

*/ For a more detailed explanation of productivity gain-sharing programs such as the Scanlon Plan, see the attachment entitled Productivity Gainsharing Plans.

Mr. Alfred E. Kahn
 November 28, 1978
 Page Six

This sort of unfairness erodes public support for a program that is entirely dependent upon such support for success.

As modified, Section 705B-6 will exert a positive influence by providing recognition of and incentive for productivity improvement by all employees. It will not weaken the standard but strengthen it. It is non-inflationary in every sense and will improve support of and compliance with the pay standard and with the entire anti-inflation program.

Section 705B-6 as Modified

705B-6 Pay-Rate Increases Traded for Productivity-Improving Work-Rule Changes. In determining compliance, that part of a pay-rate change that is in return for changes in contractual work-rules and practices that improve productivity will be deducted from the pay-rate change. In order to comply in this manner, it must be demonstrated that the cost reductions generated by the work-rule-practice change are equal to or greater than the excess of the pay-rate change over the pay standard.

Proposed Modification of § 705B-7
Undue Hardship or Gross Inequities

Add: or negative productivity impact.

Rationale

Same as given above for § 705A-9.

Section 705B-7 as Modified

705B-7 Undue Hardship or Gross Inequities. The Council on Wage and Price Stability may grant an exception from the application of the pay standard or may make appropriate adjustments in the standard to avoid extreme situations of hardship or gross inequity or negative productivity impact.

Mr. Alfred E. Kahn
November 28, 1978
Page Seven

Proposed Additions to § 705C DEFINITIONS.

Productivity - The Bureau of Labor Statistics productivity definitions, where applicable, should be used.

Work Practices - "Work practices" are the activities and processes associated with the performance of a specific job or group of jobs. Such practices can be identified in contractual agreements, employee manuals, policy manuals, etc., or developed informally over a period of time and accepted by employees and management as "standard" or past practice.

Rationale


In the proposed standards, the terms "productivity" and "work practices" are omitted from the definitions in section 705-C. Since the meaning of these terms will be crucial to determining compliance for many companies, they should be defined.


CONCLUSION

The APC strongly urges COWPS to adopt the above suggestions and is prepared to aid and assist the Council in any appropriate manner.

For further information, or specific requests, please contact Michael S. Lang at 713/961-7740.

Sincerely,


C. Jackson Grayson Jr.
Chairman


Michael S. Lang
General Counsel

Enclosure

cc: APC founder companies, Members of Congress

-7C-

ATTACHMENT: PRODUCTIVITY GAINSHARING PLANS

Productivity gainsharing programs are based on three principles:

1. The philosophy that every employee can make a significant contribution to the effectiveness of the group in which he works by sharing his ideas for improving the way the work gets done.
2. A means for that employee to have his ideas heard and evaluated by other employees and managers who can help refine and implement the new process.
3. A financial agreement in which employees and the company share the results in productivity gains according to a pre-determined formula.

Several hundred companies, ranging from small operations of 25 or 30 people to major corporations employing thousands of people, currently have these plans or are exploring the possibility of implementing one. Successful programs report impressive productivity gains, sometimes as high as 30% to 40%. These gains result from more effective utilization of materials and energy as well as improved product quality and production.

The Scanlon Plan is a well-known variety of this approach. Under a Scanlon plan, the productivity bonus is determined by calculating the ratio of total labor cost to the sales value of production--a figure generally called the base ratio--and then applying this ratio to the calculated sales value of production for a given period. If actual labor cost has been less than the calculated costs, the difference represents a savings shared by workers and owners in a pre-determined ratio.

The bonus calculation is made monthly, and the bonus (if any) is paid in a separate check as soon as possible in the following month. The Scanlon bonus is divided between the company and the employees, typically 25% and 75%, respectively.

Each employee's share is calculated as a percentage of the total payroll of included employees for the month (including overtime), and the percentage is announced. Each employee receives a bonus check representing that percentage of his or her total pay for the month.

These plans have been implemented in both unionized and

non-unionized work places, and usually include not just contractual, but all of the employees in an operation--management, direct labor, indirect labor, engineering, research and development, and office and clerical staff.

Section 705B-6 assumes that any practices and work rule changes that result in productivity improvement must be contractual and negotiated as if they were collective-bargaining issues. In fact, productivity gain-sharing programs may or may not be a part of the collective-bargaining agreement. In unionized organizations, the plan is usually covered by a memorandum of agreement between the union and company rather than being a section of the formally negotiated contract. As written, the guideline does not address changes in non-contractual work rules and practices that improve productivity. This improved labor productivity results from the many cost-saving suggestions introduced by employees covered by the plan.

This guideline must be rewritten as suggested to allow these productivity gain-sharing programs to continue and to encourage other companies and unions to explore this approach to productivity improvement.



Congressional Record

PROCEEDINGS AND DEBATES OF THE 92^d CONGRESS, FIRST SESSION

S 19858

CONGRESSIONAL RECORD—SENATE

November 30, 1971

ECONOMIC STABILIZATION ACT AMENDMENTS OF 1971

Mr. PERCY. Mr. President, I call up my amendment No. 766 on behalf of myself and cosponsors Senators Javits, Proxmire, and Rieckhoff. I ask unanimous consent that the Senator from Delaware (Mr. Roth) be added as a cosponsor.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. PERCY. Mr. President, I ask unanimous consent that an explanation of the amendment which has been given to each Senator be printed in the Record. There being no objection, the explanation was ordered to be printed in the Record, as follows:

Amendment No. 766 to S 2801, on behalf of myself as sponsor and Senators Javits, Proxmire, Ribicoff, and Roth, the Economic Stabilization Act Amendments of 1971. It will:

1. Amend Section 203(a) of the bill by adding a new paragraph (3) to exempt from Wage Board controls pay increases that are tied directly to productivity increases.

2. Amend Section 207(c) to require that the Pay and Price Boards where possible draft their rules and regulations so as to encourage labor-management efforts to increase productivity, and that the Wage and Price Boards when appropriate consult with the National Commission on Productivity.

These changes are needed to build the vitally important objective of increasing national productivity growth into the economic stabilization effort. Senator Javits, Senator Proxmire and Senator Ribicoff are cosponsors of this amendment.

The changes we propose are the result of extensive consultation with experts in the field of productivity. These experts have been deeply concerned that Phase I and II programs have not taken productivity incentive programs adequately into account. They argue correctly that a major objective of Phase II is to increase productivity, yet the pay guidelines of 8.5 percent could actually operate to prevent existing employee productivity incentive programs from operating, or new ones from being created.

This amendment will not create a loophole for wage payments in excess of the pay guideline.

It is drafted so that increased pay under employee incentive programs must directly reflect increased productivity. This wording will allow the Pay Board to reject pay schemes that are not truly linked with productivity growth.

The need to increase American productivity has been nationally recognized. In his LSC Day address the President called increased productivity the key "to a better life for the American workingman and his family."

The National Commission on Productivity, headed by OMB Director George Schultz as Chairman, said in its interim report on September 7, 1970, "a major objective must be to devise new ways of stimulating productivity through incentive pay plans."

Most economists and leading businessmen have stressed the need to increase productivity as the U.S. rate of productivity growth

has in the last several years dropped to one of the lowest among industrialized countries.

Labor has a new understanding of the importance of increasing productivity as the best way to obtain real wage increases that are not immediately eaten up by price increases.

Increased productivity will increase real income and real GNP, and will improve U.S. competitiveness in world markets. By helping to bring inflation under control it will help to bring down price and wage controls. Senator Javits, Senator Proxmire, Senator Ribicoff and I urge your consideration and support of this amendment, which will directly promote these objectives.

Mr. PERCY. Mr. President, I ask for the yeas and nays on my amendment. The yeas and nays were ordered.

Mr. PERCY. Mr. President, this amendment has been cleared by the Pay Board and has also just received the approval of the Treasury Department on behalf of the administration.

I wish to draw particular attention of my colleagues to an interpretation of the amendment, for purposes of legislative history:

The intent of this amendment is that the increased pay that is exempt from pay limitation under this title must be paid pursuant to existing or new employee incentive programs that directly reflect increased productivity. It is understood that the Pay Board may face policy guidelines to limit the applicability of this amendment to bona fide employee compensation programs that are directly related to productivity increases, and that in formulating such policy guidelines the Pay Board will consult with recognized experts in the employee incentive compensation field, and with the National Commission on Productivity or its designees.

Mr. President, I ask unanimous consent to have printed in the Record an excerpt explaining the types of employee compensation plans that would be covered by the amendment.

There being no objection, the excerpt was ordered to be printed in the Record, as follows:

TYPES OF EMPLOYEE COMPENSATION PLANS COVERED BY THE AMENDMENT

The types of employee incentive plans covered by Amendment No. 766 are mainly the type known as "productivity sharing" plans.

Under productivity sharing plans companies can, for example, institute a program of "productivity bonuses" on a plant-wide basis to reward workers for achieving established productivity goals.

Such plans are not an alternative to piece-work pay systems. Productivity sharing plans are plant-wide plans, they do not reward an individual worker for individual output increases.

The productivity bonuses are not like wages. They do not become a fixed part of the compensation of the worker. They are not paid out when plant productivity falls.

Such plans are not designed to "exploit" workers by driving them harder. Productivity

in a plant can often increase because of the introduction of new systems and new machines that actually make work easier.

Amendment No. 766 could also apply to added employee compensation resulting from "suggestion systems", when such employee suggestions actually result in increased productivity.

Though I am a great believer in profit-sharing plans, the amendment would not apply automatically to profit-sharing plans. Profits can increase for many other reasons besides increased productivity. When a profit-sharing plan can be shown to increase productivity directly, however, the Pay Board should consider applying this amendment to such profit-sharing plans.

Mr. PERCY. I hope that, together with the cosponsors of this particular amendment, and together with the Senator from New York (Mr. Javits), we will tomorrow direct the attention of the Senate to what we can do now about stimulating worker productivity. We certainly should not try to freeze wages if, by so doing, we remove the incentive for increasing productivity.

Increased productivity is the key to many of our present problems. Increased rates of productivity growth can permit labor to achieve wage increases without increasing costs and thus without price increases. Wage increases based on productivity gains are by definition non-inflationary. They do permit workers to take home more pay while insuring that that added pay is not immediately eroded by increased prices.

Obtaining increased productivity growth during the phase II economic stabilization effort is particularly important both to business and labor. Profits will improve without price increases

THE PRESIDING OFFICER. All time having expired, the question is an agreeing to the amendment of the Senator from Illinois. On this question the yeas and nays have been ordered, and the clerk will call the roll.

The result was announced—yeas 82, nays 0.

So Mr. Percy's amendment was agreed to.

[§ 3735]

§ 201.59 Productivity incentive programs.

[§ 3735.05]

(a) *Existing productivity incentive programs.* A productivity incentive program (as defined in paragraph (d) of this section) in existence, or proposed for installation and communicated to employees, prior to November 14, 1971, will be allowed to operate according to its terms. Thus, any increases attributable to the operation of such a program may be excluded from adjustment computations pursuant to § 201.57(j). This paragraph shall apply to productivity incentive programs on either a plant-wide or less than plant-wide basis. In the case of a substantial revision of such a program, the provisions of paragraph (b) or (c) of this section (whichever is applicable), shall apply.

[§ 3735.10]

(b) *New or revised productivity incentive programs on a plant-wide basis.* Increases attributable to the operation of a new or substantially revised existing plant-wide productivity incentive program (as defined in paragraph (d) of this section) may be excluded from adjustment computations pursuant to § 201.57(j) if—

(1) Within 30 days of the installation of such a program, or revision thereof, or within 30 days of June 22, 1972, whichever is later, the employer has filed with the Pay Board a certification of such installation or revision which shall include a full description of the program and (if applicable) its revision, and

(2) Increases under such program, or revisions thereof, actually reflect and are directly related to increases in productivity.

[§ 3735.15]

(c) *New or revised productivity incentive programs on less than a plant-wide basis.* If, on less than a plant-wide basis, the installation of a new productivity incentive program (as defined in paragraph (d) of this section) or the installation of changes to an existing productivity incentive program which would substantially revise the terms of such program, would cause the annual aggregate wage and salary increase of an appropriate employee unit to exceed the maximum permissible annual aggregate, increases attributable to the operation of such program may be excluded from adjustment computations pursuant to § 201.57(j); provided, That increases under such program, or revisions thereof, actually reflect and are directly related to increases in productivity. Prior to the installation of such a program or the implementation of revisions thereto, or within 30 days of June 22, 1972, whichever is later, the employer shall provide the Pay Board with a description of such program and shall certify to the Board that the program, or revisions thereto, will substantially meet criteria appropriate for such plans or practices. Among the factors which may be considered are that the plan or practice—

(1) Provides employees the expectation of a level of earnings above base rates which will vary in relationship to changes in productivity, but which will not result in increased unit labor costs for the employer;

(2) Is designed to provide earnings opportunities sufficient to motivate the participants;

(3) Contains standards of performance and provisions for revising such standards to reflect changes in equipment, methods, quality requirements and other factors related to the basis for standards development;

(4) Contains guarantees of wages and earnings for such contingencies as down-time for reasons beyond the control of participants and for nonstandard work; and

(5) Defines the employees included and their relationship to increased productivity.

[§ 3735.20]

(d) *Productivity incentive program defined.* For the purposes of this part, the term "productivity incentive program" means a plan or practice which establishes a formal system whereby, in accordance with predetermined formulas, wage and salary payments to an employee or a group of employees increase as the measured productivity of such employee or group increases; provided, that where a single plan or practice is plant-wide and includes all or substantially all of the employees in a plant or firm, payments may be based on the measured increase in productivity for such plant or firm as a whole.

[§ 3735.25]

(e) *Discontinuance.* If a productivity incentive program is discontinued and such action results in an increase in wages and salaries to the employees affected, the employer shall certify to the Pay Board within 30 days of discontinuance that such action was taken in good faith and not for the purpose of circumventing the intent of the economic stabilization program.

* * * * *

Excerpted by The Eddy-Rucker-Nickels Company, 4 Brattle Street, Cambridge, Massachusetts 02138 --- Specialists in the design and guidance of plant-wide productivity sharing incentives.

POSSIBLE INDUSTRY TASK FORCES

| <u>Industry</u> | <u>Objective</u> |
|-----------------------------|--|
| 1. Banking and Insurance | To discover ways to measure and improve productivity in key industries with high public interest <ul style="list-style-type: none"> *High labor intensity *Increasing competition *Difficulty of defining output |
| 2. Coal Mining | To determine specific barriers to improving industry productivity and how each barrier can best be overcome <ul style="list-style-type: none"> *Major impact from OSHA regulation *Heavy labor factor--labor saving technology major issue *National need for energy sources important |
| 3. Manufacturing (a subset) | To select a subset (or several) in the manufacturing sector to examine several productivity impacting factors: <ul style="list-style-type: none"> *Computerated manufacturing *Capital productivity *Guaranteed job security/income *Alternative work schedules *Incentive systems |
| 4. Footwear | To examine the international competition position of the footwear industry <ul style="list-style-type: none"> *Fragmented industry *Obsolete equipment *Impacted by imports *Resistance to change |
| 5. Machine Tool | To determine whether the international competitive position of our machine tool industry has deteriorated and why, particularly from the standpoint of product innovation and cost competitiveness <ul style="list-style-type: none"> *High importance for productivity in other industries. *Heavily dependent on capital market health, economy *Highly impacted by imports *Significant technology factor |

| <u>Industry</u> | <u>Objective</u> |
|----------------------|---|
| 6. Steel | To examine recent trends in international competitive position of our steel industry. Pinpoint major reasons. |
| 7. Public Utilities | To determine best means to improve capital and labor productivity of utility industry 'Major capital factor 'Technology change important 'Impacted by government regulations 'Capital project management key nationwide issue 'Key to energy sufficiency |
| 8. Medical Equipment | To determine key means to improve industry productivity 'High technology factor 'Fragmented industry 'Important factor in health care delivery improvement 'Impacted by government regulation |
| 9. Construction | To examine key determinants of industry productivity by comparing high-productivity project results vs. low-productivity project results; determine why high productivity is not achieved for all projects. |
| 10. Pharmaceuticals | To examine international competitive position of our pharmaceutical industry from a productivity standpoint to determine cost/benefit of U.S. approaches to product research development, testing, and introduction. |
| 11. Textiles | To determine the key means of improving industry productivity and, in turn, the international competitive position of U.S. textile industry 'Heavy focus on capital recovery 'Labor saving technology and its use are major factors |

INDUSTRY PRODUCTIVITY TASK FORCES

Objectives

- (1) To create a mechanism where the key leaders from business, labor, and government who can affect productivity in an industry are brought together in a constructive atmosphere for discussion, involvement, and cooperative efforts to seek improvement.
- (2) To obtain action from the task forces, not just discussion and reports.
- (3) To focus national (and in some cases, international) attention on some productivity problems in key industries.

A SUMMARY OF THE IDEA

The idea is to organize industry productivity task forces composed of representatives from labor, business, and government to seek improvement in productivity in selected industries in the nation.

The mechanism for accomplishing this is the creation of task forces that will be organized, operated, and followed-up by the American Productivity Center. The goal is to seek improvement of productivity by identification of sources and obstacles to productivity in that particular industry, by seeking understanding of the needs of each of the groups, and by searching for solutions that can be accepted and implemented.

These task forces will be initiated through an initial meeting to bring together the leaders, followed by separate task forces that work on identified problems over a one to two year period with direction, progress reports, and periodic meetings supervised by the American Productivity Center, together with the Task Force Chairman.

The reasons for approaching the productivity problems of industries in this way are:

- (1) Declining productivity growth is a serious problem for many industries, and in some industries, productivity is actually declining.
- (2) Present methods of seeking solutions to productivity improvement are not working well in many of these industries. Labor, management, and government have often drifted into antagonistic, formalized positions from which only miniscule progress can be made.

- (3) A private sector Center has a greater opportunity to bring the parties together, for many private sector organizations will not accept further government intervention and direction.
- (4) A structured approach, organized and followed-up over a long period of time, has more chance of progress than confrontation over a bargaining table or in government administrative proceedings.
- (5) While some "task forces" can degenerate into nothing more than discussion groups, the structure followed here is designed to minimize that possibility.
- (6) The results are never certain. Perhaps no progress can be made. But what is the alternative? Often it is a continued stalemate or a continued decline with parties wanting negotiating mechanisms but having none.

INDUSTRY PRODUCTIVITY TASK FORCES

I. STRUCTURE

- A. American Productivity Center organizes and administers the program
- B. Task Force Chairmen
 - 1. Labor
 - a. One current president of a union
 - b. One retired officer of a union
 - 2. Management
 - a. One current CEO or President
 - b. One retired CEO or President
 - 3. Government - Appropriate officials

II. PARTICIPANTS

- Companies
- Unions
- Government
- Industry Associations
- Academia
- Media

III. FORMAT

- A. Initial meeting (approximately two days)
- B. Creation of task forces, each designated to tackle one or more major issues with representatives from each of the groups on each task force.
- C. Follow up meetings, progress reports, final reports

IV. INDUSTRIES

- Steel
- Coal
- Railroads
- Trucking
- Forest Products
- Apparel
- Construction
- Health
- Retailing
- Footwear
- Food Processing
- Printing
- Education
- Shipping
- Housing

_____ INDUSTRY PRODUCTIVITY TASK FORCE

The _____ Industry Productivity Task Force will have three principal objectives:

- Open discussion on issues relating to productivity enhancement with people who must participate in any change.
- Create an agenda for action and research.
- Encourage innovative demonstration projects or changes which may improve productivity.
- Seek action.

In order to have maximum effectiveness, the task force study must have the following features:

- It must be rigorously organized in advance of outside participation so that the task force effort will not run down of its own momentum.
- Target goals and target products must be clearly designed in advance so that principal efforts can be expended on developing specific substantive issues rather than on process and procedures.
- Time schedules must be set and precisely regarded so that several levels of effort will mesh while enthusiasm is maintained at a high level.
- Principal substantive work efforts will be carried out by small groups of industry, labor and government experts with the assistance of the APC staff and others. The results of these small group efforts will be extensively reviewed by a large number of industry experts, who through their ex post review and comment will indirectly participate in the task force.
- Action must be the end goal.

TASK FORCE ORGANIZATION

The task force effort should be carried on at several different organizational levels. There will be: 1) APC staff, 2) Senior task force, 3) Working task force, 4) Outside consultants. General responsibilities are sketched in this section.

APC Staff

The APC staff will direct the task force effort. The staff will structure all task force efforts in advance so that little possibility will exist for deviation from a short, direct, output-oriented course. Agendas, report outlines, papers dealing with specific empirical issues should be prepared in advance of each work session by the APC. Papers prepared at the working task force level should pass through the APC staff to the Senior Task Force for final approval. The staff should serve in this conduit capacity as an editorial, refining, and polishing agency.

Senior Task Force

The Senior Task Force will consist of senior representatives of labor, industry management, federal officials, industry associations and academics. The Senior Task Force will serve the following functions: 1) Plan and approve the coverage of the Task Force report; 2) Recommend representatives for each of the Working Task Force groups. In some cases, these representatives may be persuaded to volunteer direct staff support; 3) Review and approve the final output of the Working Task Force groups; 4) Make whatever recommendations or certifications the entire Task Force may arrive at.

Working Task Force

Several Working Task Force groups will be established. Each one would be organized around areas which corresponded to the principal topical divisions of the final Task Force

report. Each group will consist of junior representatives of labor unions, industry management and the federal government. The task force members should be able to devote full time during two to three concentrated work periods to the effort.

Each Task Force work session will be organized in advance and participants prepared to arrive at a final written output. Each work session will be given a running start in the form of working papers on specific topics prepared by outside consultants or assembled from the available literature. Working Task Force members should come to sessions prepared to dispute specific points of view, to present empirical information, or to assert specific positions.

The Task Forces will be divided into subgroups of two or three members each which will be assigned a topic for detailed exploration. Each subgroup will have an appointed secretary who will be responsible for drafting a rough position on the assigned topic. These rough working papers will be approved and refined at full meeting of the Task Force. Outside consultants can be called in to extend arguments and to develop empirical evidence for positions taken by the working task force.

Outside Consultants

When appropriate, outside consultants will be called upon to do research, to prepare papers, and to lend facilitating assistance when helpful.

PRODUCTIVITY ANALYSIS AND STRATEGY SYSTEM (PASS)

The American Productivity Center is planning to create a "Productivity Analysis and Strategy System," hereafter referred to as PASS.

PASS will collect productivity data from individual establishments, analyze productivity levels and trends, make diagnostic analyses, indicate possible areas for corrective attention, and also allow managers to explore strategic options themselves.

The output of PASS will be useful to various groups:

- (1) Managers in companies
- (2) Industry associations
- (3) Researchers in universities, research organizations
- (4) Staff of the American Productivity Center

Proper steps will be taken to preserve confidentiality of data for individual firms, to control access to the data, and to observe all anti-trust regulations.

Such a collection of productivity data, together with an analytic and strategic capability, does not now exist. The closest analog is PIMS, but this system does not collect certain data necessary for productivity analysis, nor does the system have some of the same goals as PASS.

PASS OPERATING PLAN

I. OBJECTIVES

1. Assemble a data base reflecting productivity strategy experiences of a group of participating companies.
2. Conduct a research program on that data base to discover variables that govern (a) productivity levels (b) other outcomes of strategic productivity actions, and (c) outcomes of changes in the business environment on productivity.
3. Conduct an applications program to make the findings of the research available to participating companies on a form that they can use.
4. Carry out other activities--publication, education, service to participants, study of productivity methods, impact of governmental regulations.

II. CONFIDENTIALITY

Information entrusted to the Center by the Members is held under strict confidence and a program of data security prevents the possibility of leakage among members, companies or to outsiders.

III. MEMBERS

Any business organization can be a Member, provided it subscribes to the objectives of the Center and the conditions of Membership:

- Contribute data to the data base
- Respect data security measures
- Restrict PASS findings, reports, to internal company use
- Designate a representative (and an alternate) to act in a liaison capacity to the Center
- Pay a pro-rata share of the cost of operating PASS

PASS OPERATING PLAN (cont.)

IV. STAFF

The staff will consist of people with diversified backgrounds: business experience, economic research, business planning, industrial engineering, computer utilization, and productivity expertise.

This staff will be supplemented by selected researchers located at different institutions, and occasionally by service firms on contract from the Center.

V. DISSEMINATION

The resources, findings, and reports of PASS are available only to the companies contributing data. However, there will from time to time be selected publications directed at the well-being of the economy at large in areas where the Center can make a useful contribution.

VI. DATA BASE

The unit of observation in PASS is an establishment.

An establishment can be a division, product line, or occasionally an entire firm. The establishment should sell a distinct set of products or services to an identifiable group of customers, in competition with a defined set of competitors, and where a meaningful separation can be made of revenues, operating costs, investments, and output.

Eventually, the data base will grow to where there are characteristics of market environments, the state of the competition, the strategy pursued, and the operating results obtained for each establishment.

Standardized forms will be used to collect the data. The forms are designed to break the required data into simple elements that can readily be assembled from

PASS OPERATING PLAN (cont.)

financial or physical data records, or that can be estimated if there are not specific identifiable records.

Time and effort required to complete a set of forms will depend on the state of the business records in a firm. Companies with good systems will typically require two to three man days to complete the forms; others will require about four days.

VII. RESEARCH AND DEVELOPMENT

The research portion of PASS consists of a continuing analysis of experience reflected in the data base, to discover the empirical relationships that determine what strategy, under what conditions, produces what results.

These factors are incorporated in a set of productivity predicting and profitability predicting models that assign to each factor its proper weight, judging from experience in the data base. The models also indicate how the impact of each productivity determining factor is conditioned by other inputs.

The models are designed to aid the assessment of strategic moves. An assumed change in one or several productivity influencing factors can be analyzed to determine the productivity and profitability consequences both during the time that the change is being executed, and after it has been completed.

VIII. FEEDBACK TO MEMBERS

Members receive three kinds of feedback from the Center:

1. Reports on the general principles of productivity strategy disclosed by analysis of the data base

PASS OPERATING PLAN (cont.)

2. Specific reports on each establishment the company has contributed to the data base
3. Access to computer models in which the general strategic principles are incorporated in a manner useful for strategy planning and simulation, plus instruction and counsel in the interpretation and use of these resources.

IX. MAJOR REPORTS

1. Productivity Reports

Productivity reports specify the productivity index that is "normal" for the establishment given the characteristics of the market, competition, position, technology, and cost structure.

It reports whether this establishment is the kind that normally achieves 4% productivity, judging by the experiences of other establishments with similar characteristics. It also identifies the major strengths and weaknesses of the establishment that account for the high or low index.

2. Strategy Sensitivity Report

This report is a computational pretest of several possible productivity strategy moves in the establishment. It indicates the normal short and long term consequences of each move, judging by the experiences of other establishments making a similar move, from a similar starting point, in a similar establishment environment. It will specify the productivity impact likely to be achieved by projected changes, along with the associated investment and cash flow.

This report is used by upper level managers and

PASS OPERATING PLAN (cont.)

planners, for evidence of potential effects of broad moves in cost-effectiveness, productivity, and pricing recovery. It is used by middle level managers for evidence of the potential effects of specific action in such areas as programs to improve relative product quality, changes in capital-labor ratios, improvements in capacity utilization, investments in R & D, etc.

3. Optimum Strategy Report

This report suggests a combination of several strategic moves that promises to give optimal results for the establishment. It presents an opinion for any of several different measures, such as productivity indexes, cost-effectiveness indexes, pricing recovery indexes, return on assets, cash flow, etc.

X. USES OF PASS REPORTS

1. To provide a common language for the discussion of productivity strategies.
2. To generate questions that should be asked about an establishment.
3. To nominate promising future establishment strategies for detailed exploration.
4. To estimate the future consequences of specific strategies.
5. To suggest details of strategy execution that usually succeed.
6. To screen specific establishments for possible acquisition, disposition, or reorganization.
7. To estimate the overall productivity and profitability levels that constitute normally expected performance for an establishment with a particular profile.

PASS OPERATING PLAN (cont.)

8. To identify the strengths of an establishment on which future strategy can build, or the weaknesses that future strategy should aim to correct.
9. To propose several optimal input combinations, given certain external factors.

XI. CONFIDENTIALITY

1. All dollar values are rescaled by the establishment contributing it. They multiply the information by an arbitrary disguise factor known only to that establishment, prior to entry into the data base.
2. The business is not identified as to the nature of the products or market represented. The sole identification of an establishment is also coded.
3. The identity of the parent is also coded.
4. Access to the data base is limited to researchers working on approved projects, and to the extent that they have a need to know. Representatives of Members have access to the "sanitized" version of the data base, from which any possible means of indirectly identifying companies and businesses have been removed. They may not retrieve data on individual establishments, other than their own, even in the concealed form.
5. Members may recall their data, in part or in total, at any time on a 30 day notice.
6. All information contributed to the Center is the responsibility of the Chairman of the Center. The Chairman establishes an operating procedure for the secure handling of the data, and delegates selected control with direct accountability to him.

PRODUCTIVITY RESEARCH NEEDS

- I. MEASUREMENT
- II. SOURCES/OBSTACLES TO GROWTH
- III. ADJUSTMENTS TO CHANGE
- IV. PRODUCTIVITY, GROWTH, AND CYCLES

I. MEASUREMENT

1. Industry Data

Better measures and more experimentation are needed for many industries in the private sector: for example, construction, railroads, steel, coal, footwear, health.

2. Quality and Mix Change in Output

Quality and mix changes should be taken more fully into account in measures for manufacturing and services, e.g. health.

3. Measures of Capital and Other Inputs

There is need for further research on conceptual issues: capital stock, output of services, relation between capital consumption depreciation and obsolescence; the use of proxy measures such as energy. Entrepreneurship deserves attention for its role in shifting from one production function to another.

4. Company Measurement

Data collection by individual companies would provide not only information valuable to these firms, but also insights into the dynamics of change, e.g. the influ-

ence of capacity utilization, the length of runs, and technical and managerial innovations.

5. Total Factor Productivity

Measurement techniques need to be created that will examine output in relationship to all input factors-- labor, capital, energy, and materials.

6. Inter-Firm and Inter-Industry Comparison

Data should be collected by products, by firms and by industries so that productivity comparisons can be made inside industries and between industries to study sectoral shifts.

7. International Comparisons

International comparisons of productivity for individual industries should be computed, on a comprehensive or multifactor basis, as well as on a man-hour input basis.

8. Productivity in the Household

With the concept of the family as producers of utilities becoming more widely accepted, research should be addressed to the concept of the stock of educational capital and the role of education in efficiency in consumption.

II. SOURCES OF PRODUCTIVITY GROWTH

1. Innovative Process

Plant and company studies of innovation and R & D are needed to understand mechanisms for translating R & D activity into marketable products.

2. Effect of Incentive Systems

The long term effects of wage and salary incentive systems need to be studied to determine their effectiveness.

3. Motivation and Productivity

More study is needed to measure the relation between productivity, job satisfaction, motivation and hours of work.

4. Productivity Programs in Foreign Countries

There is need to study the efforts made by government and industry in foreign countries to improve productivity.

5. Effects of Investment

Studies should be undertaken in different industries about how new technology is incorporated in new investment.

6. Management Strategies

Data and models are needed so that the effects of various management strategies can be tested and varied.

7. Rate of Technological Innovation

Relationships among productivity, character and rate of technological innovation, and age of industry need to be examined to test whether the rate of innovation suffers a retardation as the industry exploits the technological breakthrough that gave rise to it.

8. Tax System

Information is needed about the implications for productivity of changes in tax incentives such as investment tax credits for physical capital, training and research, accelerated depreciation, and capital gains.

9. Quality of Working Life

Research needs to be done to understand what quality of working life means and what programs are successful. Also, research is needed to study the relationship between quality of working life and productivity improvement.

10. Government Regulations

Studies of the impact on productivity caused by government regulations are needed in all areas of influence.

III. ADJUSTMENTS TO CHANGE

1. Displacement

Longitudinal as well as cross sectional studies are needed of the forces which determine who gets displaced, how displacements take place, and the events that determine reemployment of displaced workers.

2. Management Processes

The decision-making process in managing adjustment to change needs research on such items as the criteria used in the assessment of manpower and community impacts of change, and an evaluation of the effectiveness of various adjustment mechanisms.

3. Early Retirement

Studies are needed on the results of experiences of workers who take early retirement, including patterns of labor market behavior and income needs, subsequent employment and productivity.

4. Cost of Adjustment

There should be studies of the social costs of technological change to estimate the amount chargeable to industry, government, and society.

5. Collective Bargaining

Concrete examples are needed of adjustments to technological change under collective bargaining, in both the blue and white collar field.

6. Training and Retraining

Information is needed on: numbers and variety of private training programs, types of curricula offered, who conducts them, the characteristics of effective programs compared to ineffective programs.

IV. PRODUCTIVITY, ECONOMIC GROWTH, AND CYCLES

1. Cyclical Changes

Studies should extend existing work on the pattern and causes of cyclical fluctuations in output, input, productivity, and rate of capacity utilization, including the reasons why costs rise faster than prices, the influence of international competition, and differences among plants and industries.

2. Counter Cyclical Policies

Research is needed on policies that would induce or promote countercyclical behavior of productivity and costs, especially in slowdowns that develop during expansions.

3. Regulated Industries

More needs to be known about differences in productivity growth between regulated and non-regulated industries and how regulation influences efforts to improve productivity.

CAUSES OF THE PRODUCTIVITY CRISIS

There is little question that the USA productivity growth rate has slowed and that it is a fundamental--not just a cyclical--change.

Between 1948 and 1965, productivity growth in the private nonfarm sector averaged 2.6% per year. In 1965 to 1973, it averaged 2.0%, and from 1977 to 1978 it averaged 0.6%.

These figures, together with other evidence, indicate that the slowdown in productivity is not just a temporary aberration and provides accumulating evidence that the underlying trend is probably considerably less than 2.0% per year.

In fact, the 1979 Economic Report of the President states the CEA's forecast for a productivity growth of only 1.5% annually over the next five years: 1979-1983.

That, combined with labor force trends, is projected to lead to only a 3% annual real growth over the same five year period.

This is not a happy economic forecast for the health of this nation in any of its dimensions--inflation, unemployment, balance of payments, foreign competitiveness, social dividends, and standard of living. It is indeed a gloomy forecast.

Why?

Why has this occurred?

A frightening answer is that no one is really sure why.

Of course, there are suspicions, and some evidence. Everyone has his pet theories. But the leading researchers largely confess that while they have some estimates of various contributions to the slowdown, most are still puzzled.

That fact, in and of itself, should be enough to spur an enlarged productivity effort. It is too important a variable and influence on policy to be left in such a state of relative ignorance.

The list of candidates for causes of the slowdown are: (in no particular order)

- Lagging capital investment
- Lagging R&D and technological change
- Negative influence of government regulations
- Required environmental investments
- Age-sex change mix in the workforce
- An increasing shift from agriculture to other sectors
- Drags from major low productivity areas--construction, mining, and other
- Higher energy prices
- Worker alienation
- Decreased management and labor attention to productivity
- A series of accidental shocks to the economy
- Stop-go economic policies that create uncertainty about the future
- Inflation
- Wage-price controls and standards
- Work rule restrictions

The truth is that it is probably not any one item on the list, but a combination of several. There are also items on the list that interact with one another. For example, governmental regulations slow innovative R&D, thereby slowing

technological change, thereby slowing capital investments, etc.

Among my own candidates for leading causes are:

- Government regulations
- Lagging capital and R&D investments
- Labor & management inattention
- Inflation and stop-go economic and incomes policies

Capital Investment

Has capital investment slowed? How much of the slowdown is attributable to lagging capital investment relative to labor? What policies would be most effective in stimulating capital formation and investment?

First, there is little doubt that capital investment is important to productivity improvement. Most productivity analysts agree that a significant portion of the nation's productivity growth stems directly from technological improvement; and such improvements, in turn, are necessarily based on capital invested for industry. Only by devoting a significant share of current production to replace, modernize, and expand capital can we hope to maintain productivity growth. Though the emphasis is typically on physical capital, intangible capital formation and investment in people (human capital) are increasingly important in our inevitable shift to an information-knowledge oriented society.

It is unfortunately a fact of life that the rate of capital formation and investment for our industrial plants has dropped off significantly during the past four years. During the decade or so prior to the 1974-75 recession, fixed real nonresidential capital investment had averaged a little

more than 10.3% of real GNP.

During the past four years, however, fixed investment has averaged an anemic 9.8% of real GNP. This difference may not sound very large at first glance, but look at the facts: If the past 10.3% average investment had continued through 1978, an additional \$32.6 billion would have been expended on productivity-improving new and more efficient plants and equipment, together with expanded plant capacity where feasible.

It seems clear that the rate of capital investment has declined in the past few years, that the productivity of capital has also declined, and that the real rates of return to capital have declined. Reasons for reduced capital productivity are numerous--government mandated capital investments in nonproductive areas, less productive technology available, poor management, an aging capital stock, higher energy costs. The same is true for Britain, where the problem is not so much the amount of capital available, as it is the productive use of the capital.

Another indication of the capital problem is the decline in the capital/labor ratio.

The change in this ratio can occur for many reasons, and its exact impact on productivity is not certain. This ratio grew at an average annual rate of nearly 3% between 1948 and 1973, and since then, the growth of this ratio has declined more than one percentage point. It is probably not accidental that this period also coincides with the productivity slowdown.

What policies should be changed to stimulate the productivity of capital?

The most common suggestions are expansion of the investment tax credit to include construction of new plants, accelerated depreciation allowances for tax purposes, more flexibility and slowed timetables for investments in environmental, health, and safety standards, and fewer restrictive government regulations.

It is likely that all of these would have some favorable impact, but perhaps the greatest long term assistance would be reduction in the overall corporate tax rate, reduction in inflation, and stability in economic policies. Capital investments are long term commitments--bets on the future--and corporations will hedge their bets, regardless of the added stimulus, until they are certain about the economic environment of the future.

R&D and Technological Innovation

Another related contributor to the slowdown is lagging R&D expenditures.

It is not R&D per se that results in improved productivity, but its results: technological innovation. The majority of technological innovation results from basic and applied R&D, and it is the changed level and kind of R&D in recent years that is of concern to our future productivity.

Indications of our technological slowing are:

- The overall USA patent balance with other major nations has declined almost 47% from 1966 to 1975.
- The number of USA patents granted to foreign residents has more than doubled in the last

15 years, with the two countries most active being West Germany and Japan.

US technological innovations that can be termed "breakthroughs" declined from 36% in 1953-59 to 16% in 1967-73.

While the USA percentage of GNP devoted to R&D has been declining, the same percentages in Japan and West Germany have been increasing.

Furthermore, while the percent of USA research funds devoted to national defense has been about 51%, Japan has devoted 2%, and West Germany 11%.

The same questions asked about capital are relevant for R&D: What is happening to R&D expenditures? How much of the slowdown is attributable to R&D change? What policies would be most effective to stimulate R&D? For what sectors?

And as with capital, the evidence is not firm as to the exact relationship between R&D and productivity growth, but most research indicates a relationship.

John Kendrick, one of the nation's leading productivity researchers, believes strongly that this has been one of the major contributors to the slowdown, contributing as much as one-fourth of the retardation, embodied in both the human and nonhuman factors of production.

A 1977 Commerce Department report stated that technological innovation was responsible for 45% of the nation's economic growth from 1929 to 1969. Other researchers have shown that companies in high technological growth areas have consistently shown greater productivity gains, had more price reductions, and given more people jobs.

The ratio of R&D to output reached 3.0% in 1964--its peak--but has since dropped to 2.2% in 1978. Much of

the research is in military and space-related research, some of which is transferable to the private sector productivity improvement, but much is not.

Private industry has provided about 1% of GNP for R&D for a long period of time. Though the amount of private R&D has not dropped dramatically, the kind of R&D has changed.

Many firms report that they have been forced by government regulations to shift part of their R&D efforts to compliance with government regulations and away from productivity improving basic research. This will be difficult to turn around rapidly, for firms have had to hire a different set of researchers.

Another cause is that some managers report that they have shifted their R&D (and capital investments) to lower-risk, shorter term projects to reduce uncertainties due to government regulations, inflation, and stop-go economic forecasts.

All of this adds up pretty clearly that our rate of technological innovation is slowing and particularly so relative to our principal competitors.

As with capital, there are recommendations for direct help to R&D through extending coverage of the 10% investment tax credit to include R&D, increased basic research, special R&D subsidies to industries with productivity problems and foreign competitive inroads, and stepped-up government sponsored R&D in the private sector.

These would undoubtedly have some effects, but the greatest help could come from across the board measures--

general corporate tax cut, reduction of double taxation of dividends, reduction of inflation, stability in the economy, and amelioration of governmental regulations negatively impacting productivity-improving R&D. Technological innovation may just as well be served not by "more" R&D, but the right kind of R&D, together with improved diffusion and technology transfer.

Government Regulation

At the top of many people's agenda for the cause of productivity slowdown is the amount, kind, and scope of government regulations.

How much has it slowed productivity? What specific regulations are most detrimental? What can be done?

People are quick to indicate where government has harmed their productivity, but it should be remembered that government also aids productivity through providing a framework for orderly processes of business, maintenance of law and order, and maintaining an infrastructure such as roads, rivers, bridges, etc. If anyone thinks that this contribution is negligible, let him assess the impact on productivity of the turmoil in Iran.

That aside, the evidence is strong that government regulations have slowed down our productivity growth.

Probably the most publicized and authoritative study is that of Denison, who attributed an annual slowdown of 0.4% in our productivity growth from 1973 to 1976 because of governmentally mandated environmental, health, and safety regulations. As he and others have also pointed out, this is

only the cost side, and ignores the benefits that accrue to society through improved air, water, health, and safety.

In analyzing regulatory impact, a division should be made between economic and social regulation. Economic regulation, such as in energy or railroads inhibits efficiency of allocation by restricting resources from flowing to those uses that have a high demand value. There is little question that these economic regulations negatively impact productivity.

Social regulations, such as OSHA and EPA, are more complicated, although they too reduce productivity.

They inhibit productivity growth because of added costs of compliance in the form of management time, added accountants and lawyers, delay in decision making and implementation of projects, added uncertainty in capital commitments, and direct specification of how the standards are to be met, rather than specifying performance levels and leaving it to the private sector to find the most productive means.

We truly do not know whether the costs of social regulation outweigh the benefits, but it is likely to be true, especially because of the hurried timetables of recent years, the ways that the regulations were written, and the absolute neglect of any productivity impact analysis.

More than 72% of the firms responding to a 1977 GAO survey in the private sector said that altering government regulations and restrictions would be a desirable and effective way to contribute to productivity improvement.

What should be done?

One important recommendation is that all new and existing regulations should be required by legislation to have a productivity impact analysis. Regulation is an area fully controlled by government and can only be changed by government.

A federal productivity focal point should promote the identification, development, and adoption of broad acceptable regulatory reform proposals and productivity test criteria, with participation from the regulators themselves, public interest groups, the regulated, and others.

The idea of a regulatory budget, as proposed by some, could also be a part of this process and should be studied for implementation.

As for which regulations impact productivity the most, detailed studies are not available. The Business Roundtable has been conducting a study for about a year to calculate the costs of regulation to a selected sample of firms. That study should be helpful. Their respondents indicated that the agencies that added the most costs were OSHA, EPA, EEOC, IRS, and in some firms, DOE.

However, more work is urgently needed to study productivity impacts at the individual firm level, at the industry level, and across the economy. Such micro studies should have been made earlier but with our productivity problem reaching alarming proportions, these studies are now urgently overdue.

One special sub-sector that should be singled out

for early and special relief from excessive regulation are the small and medium sized businessmen, who do not have the staffs, funds, nor time to comply with the myriad of regulations. Not only does excessive regulation hurt these individual firms, their over-regulation stifles small firm innovation, and aborts potential start-ups that would help the nation.

One small businessman, George Lockwood in California, reported that "meeting the demands of 42 different federal, state, regional, county, and municipal government agencies has taken at least half my time." That's time away from his job, he says, as "chief scientist, chief engineer, chief financial officer, and general manager."¹ His story is repeated all over the nation.

Management and Labor

Another area leading to the productivity slowdown is a lack of relative attention by labor and management to productivity in recent years.

It is not that managers or employees are of poorer caliber. But for various reasons, they have not paid much attention to productivity in recent years. Too many of the business leaders have largely ignored productivity in favor of more attention to money management, acquisitions, government regulation, market share, tax compliance, and manipulation. Labor leaders have been more concerned with added fringes, protection against inflation and division

1. Houston Post, January 28, 1979, p. 2A

of the pie.

Neither management nor labor is "wrong."

Nor is this a broad scale indictment of all management and labor, for there are clearly many who have active productivity programs and work very hard to improve their record, particularly in the manufacturing sector. However, this is not the case for many firms in the nation, particularly in the service and government sectors where many of the organizations have simply neglected productivity for a variety of reasons--social, political, and economic.

They simply have not kept their eye on one of the most important variables of all--improved productivity. The same is true of government, in its fiscal and monetary policies: more concerned with demand management and redistributing the pie, instead of supply, management, incentives, and productivity improvement.

Though this brief review of probable causes is not complete, it constitutes a list of the most likely contributors in recent years. More research is needed in both the private and public sectors to understand the causes more clearly and to create programs that turn the productivity crisis into opportunity.

Senator BENTSEN. Mr. Grayson, that sounds like pretty sage advice and you have certainly hit a responsive chord with me because you know of my concern about productivity.

I started hearings 4 years ago on capital formation and we have been able to get some modest interest and make some modest headway.

This subject is one which will take a while to get in the consciousness of all of the people who should be rightly concerned about it.

Mr. Carlson, we are glad you were able to get your tractor through the rest of the crowd. We are glad to have you here, please proceed.

STATEMENT OF JACK CARLSON, VICE PRESIDENT AND CHIEF ECONOMIST OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY HARRY MCKITTRICK, DEPUTY DIRECTOR, PRODUCTIVITY CENTER

Mr. CARLSON. Thank you, Mr. Chairman.

I was not threatened with being plowed under but the taxicab driver was threatened and we wound up coming on the subway.

I will insert my prepared statement for the record.

Senator BENTSEN. That is fine.

Mr. CARLSON. There is no doubt productivity has slowed, not just in a particular industry, although some have gone down much faster than others and we are much worse off than other countries around the world.

I think it is important as Jackson Grayson referred to the fact it is important to fight inflation but it is important for the well-being of the people of this country overcoming this upward spiral.

The lower average productivity in the last decade has resulted in the average American household receiving \$3,700 less in personal income. If the rate continues to go as people are forecasting like ourselves—

Senator BENTSEN. Let me have those numbers.

Mr. CARLSON. The \$3,700 is referred to in table 4 of my prepared statement.

The fact that productivity is 1.5 percent during the last 10 years versus 3.3 percent means the average household in this country is having available to consume \$3,700 worth of goods and services. That is a personal income measure.

If we make no changes in the figure, the forecasts that most people have for productivity growth is what we have had in the last 10 years unless there is a marked change, and we will lose \$4,800 per household during the next 10 years if we do nothing. That is in addition to what we have already lost. So, it really comes home to roost in every one of our lives.

Clearly, one can see the inflationary impact and we try to show it in some of our agencies as others have. The causes of slower growth have been documented by scholars in the field, such as John Kendrick and Edward Denison.

We have a table which shows the slowdown as they have identified it. The Council of Economic Advisers has come forth with a section on productivity and they, too, identify similar causes.

We have conducted a survey of business leaders, and in my prepared statement I have a summary of it. We asked them for the reasons for the slowdown of industry. They identify the same reasons as identified by scholars and the Council of Economic Advisers.

I would take note that Federal regulations were No. 1 on their list in a given factor as well as take note of another one and that is they identify business attitudes and worker attitudes as rather important.

Inasmuch as attitudes are important because improvements in terms of outcomes can come from management, worker or any other; and because it is an attitudinal factor, it has an opportunity for leadership because leadership can set up a climate one can be concerned about productivity and, therefore, national leadership is important from the Congress, the President, those of us who have responsibilities in particular sectors.

Everyone else agrees with the slow growth in capital formation. We are slow compared to other countries and slow in relationship to needs other than productivity, increasing factors such as our social objectives.

On the capital side, we have had an increase of effective tax rate during the last 10 years from around 41 percent up to about 55 percent last year, our latest estimate. The reason for the effective increase has been the role of inflation upon the valuation of inventory and valuation of capital costs and recovery at last in relationship to replacement costs.

It is interesting to note Congress took a step forward of \$4 billion tax relief for corporate investment but that was total and more than offset by the fact that replacement costs in relationship to depreciation allowances increased by more than \$4 billion and, consequently, at the time the deliberations were going on in Congress, the tax code, because of inflation, wiped out all of the benefits.

It is interesting to note the legislation passed in the last Congress has been the most productivity inhibiting legislation in any congressional or Presidential leadership I know of.

What seems good on other criteria, increases in taxes and farm price support, clear act amendments, et cetera, more than offset the tax relief that was provided with the tax relief legislation that helped to increase productivity and consequently reduce productivity and investment and employment during the last 3 years so business as usual is leaning toward more limitation through policy on the growth of productivity.

We also take note of growth in regulatory agencies has been at the rate of 28 percent this year in terms of their funding and the President proposes 14.42 percent. Those are the two highest priority areas by amount of money that the President is proposing—much higher than defense.

In talking to the administration—I am sure Mr. McIntyre can comment on this—there is no aggregate amount of how much has been proposed in terms of outlays in appropriations or authorizations, I should say, for regulatory authorities.

Yet, this is identified by everybody as one of the reasons for slowing down productivity growth.

The Federal Government's response to slow productivity growth has been recognized in the President's Economic Report, even though this is a good economic report, at least the Council report is a good one, shows considerable scholarship and education.

The President displays benign neglect in his report by following the reasons for the weakening of productivity are complex and not fully understood.

He does not recognize the need for leadership in this area. The President disbanded the National Productivity and Quality of Working Life Center, the only place in Government where declining productivity growth was comprehensively considered.

The token creation of an anemic Federal Council on Productivity, consisting solely of Federal employees with other full-time jobs, hardly responds to the need for leadership and commitment, and I understand they have met only once to consider this rather critical problem which has lost \$3,700 per average family in the past 10 years.

In terms of recommendations, if we are to overcome our largely self-inflicted decline in productivity growth, we must treat the causes of the decline.

HIGH EMPLOYMENT AND NEAR CAPACITY UTILIZATION OF ENERGY

Clearly, maintaining high employment and economic growth without accelerating inflation—demand pull—through appropriate fiscal and monetary policies is necessary. Economies of scale are rather important in increasing productivity growth.

The Federal Government, with business and labor, and consumer leaders, must provide leadership to improve the general climate for productivity growth. Improvements in risk taking innovation, removal of barriers to efficiency, are all necessary functions of public and private officials. Such an approach can produce more goods and services for the benefit of everyone. It is an all-win situation. This is not a trade-off at least over the longer run.

Enactment of tax relief as percentage for business investment was suggested by the Council of Economic Advisers in their report. We have given an example: Lowering the useful life of equipment from 11 to 9 years and increasing the investment tax credit by 2 percentage points beginning in mid-1980 need not affect the Federal deficit significantly in fiscal year 1980 but could by the end of 1982 increase productivity by 1.5 percent and by 3 percent by 1985—or 0.5 percent higher annual productivity growth rate.

We have a table showing our analysis on that.

Also, tax relief should be provided to spur private sector investment in new developments and applied research. Risk-taking and innovation is now discouraged by high taxation. The Federal Government has taken steps to reverse the decline in basic research; now encouragement must be provided to bring the bright idea to a usable technique embodied in new physical technology, such as new and more efficient equipment.

The huge growth of regulations as an important tool of Government policy—the others being spending, taxing, and credit—is accompanied by very little political accountability or responsibility.

The Congress enacts a bill giving the objectives of public policy and turning over the responsibilities for establishing particular policies or regulations to narrow administrative bureaus of the executive branch, with organization heads that remain in the position for about 2 years.

Sometimes the law will be quite specific and rigid about goals or timing; often the agency will have wide discretion. These bureaus have promulgated and are promulgating the largest mass of costly and productivity-limiting public policy in the history of the United States.

This is being done in most cases without any explicit acceptance of these regulatory policies by an elected official of the Federal Government. I am talking about my own experience, Mr. Chairman, in government and not only people running these areas now.

Typically, a bureau chief promulgates these regulations without clearance from the President or from the Congress. The decisions add up to huge resource reallocations, but there is no system for making the decisions in light of the expected effects. This is government without proper representation or accountability.

The problem is so bad that the President does not even know the total sum of additional funds he gives in the form of budgets to regulatory agencies. He readily identifies in his budget message the total for spending, the total for taxing, and even the subtotal for tax expenditure but he has no idea as to the total for regulations.

It is, therefore, not surprising to find out that the growth of regulatory authorities has proceeded at a much faster pace than the growth of Federal taxes and spending. Even the less rapid pace of Federal taxing and spending is bringing forth a taxpayers revolt as illustrated by proposition 13 in California.

For example, the President proposes to increase the regulatory budgets by 44 percent between 1978 and 1980, either indicating his highest priority or greatest ignorance. As identified by scholars such as Professor Murray Weidenbaum, the increase in regulatory capability and resources is magnified twentyfold in terms of additional costs imposed upon industry and State and local governments. Moreover, this high increase in agency capability and in costs ultimately borne by the American consumers and workers is done with the least amount of representative government or accountability.

I would like to draw a parallel, and a contrast, between the decision process on Federal regulatory activities and that on Federal credit activities.

The following points have been advanced by the administration in support of its proposal for control by the President and Congress of Federal credit activities; while these same points are applicable to regulatory activities, no similar control proposal is being offered:

(a) They are a large and growing means of meeting objectives of Federal programs;

(b) There is no established mechanism for regularly and closely reviewing total Federal activity;

(c) Hence, there is no way to consider the resource allocation implied by those plans; and

(d) For the Government to foster efficiency in the allocation of economic resources—in the economy as a whole, it must exercise better and more systematic control.

The same arguments can be made even more forcefully for looking at the regulatory side as a whole.

At a minimum, the President should be required to submit to the Congress each year, total outlays and appropriations he proposes for regulations and regulatory authorities.

Second: He should be required to include, to the extent available, the costs and benefits associated with such expenditures recognizing that such estimates will be subject to considerable improvement as more and more are attempted.

Third: The legislative branch should also be held accountable and responsible by enacting a provision that Congress can veto proposed new regulation.

Fourth: Sunset provisions should be established for all Federal regulations, and legislative reauthorization of programs should only occur after a legislative benefit and cost analysis has been performed on the major regulations.

Fifth: The President and the Congress should establish capability for evaluating the impact of proposed regulations subject to congressional veto and subject to Presidential review.

The beginnings of the capability exist in the Council on Wage and Price Stability and the staff of the Council of Economic Advisers and perhaps in the Congressional Budget Office.

Sixth: Any evaluation of regulations should include a review of ways to achieve the agreed social objectives at the least cost. Productivity inhibiting engineering requirements or specifications of a particular piece of equipment or technology should be replaced with performance requirements allowing for new technology, equipment, techniques, and innovations.

Seventh: We would find it unacceptable for the President (as some now argue and as is argued in some current litigation) to be in a position where officials whom he selects and who serve at his pleasure, may be able to exercise regulatory powers and not be subject to the President's policy control. Presidential policy control is an essential element to achieving political accountability and representative government.

Eighth: The Congress should begin by slowing down the double-digit growth of Federal regulatory agencies now.

The capability for evaluating impacts of regulations should be strengthened and be in a separate Executive Office entity during the initial 5-year period. After the 5-year experience, the need for a change in the organization or structure should be considered.

In the Congress, the beginnings of some capability resides in the Congressional Budget Office and perhaps in some legislative committees. In time the skill mix of the staff should reflect a capability to measure the benefits and costs of proposed regulations.

While public policy must remove the barriers to the growth of productivity, American business can and will do more to improve productivity. In order to carry out this commitment the National Chamber established a Productivity Center last October with the following objectives:

Evaluate trends and policies influencing productivity growth;

Identify public policies that reduce productivity growth and recommend changes to public officials;

Encourage business leaders to review how they can increase productivity in their own companies and in cooperation with workers and consumers.

We plan to achieve these objectives in full cooperation with State and local Chambers of Commerce, trade associations, and productivity centers across the country, including the very best of the productivity centers that Jackson Grayson heads up.

Thank you very much.

Senator BENTSEN. Thank you very much.

[The prepared statement of Mr. Carlson follows:]

PREPARED STATEMENT OF JACK CARLSON

Stimulation of Logging Productivity Growth

I am Jack Carlson, Vice President and Chief Economist of the Chamber of Commerce of the United States. I am accompanied by Harry McKittrick, Deputy Director of the National Chamber's newly created Productivity Center. On behalf of the National Chamber's 80,000 members, we greatly appreciate the opportunity to present our views on the serious problem of slower growth of productivity, to recommend some policies to improve productivity growth, and commit American business to continue working to accelerate the growth of productivity in the future.

SLOWER PRODUCTIVITY GROWTH

There is no doubt that productivity growth within the United States has slowed (Table 1).

TABLE 1.—LABOR PRODUCTIVITY GROWTH, 1948-78

[Percent change per year]

| Sector | 1948 to 1955 | 1955 to 1965 | 1965 to 1973 | 1973 to 1977 | 1977 to 1978 ¹ |
|-------------------------------|--------------|--------------|--------------|--------------|---------------------------|
| Private business economy..... | 3.4 | 3.1 | 2.3 | 1.0 | 0.4 |
| Nonfarm | 2.7 | 2.6 | 2.0 | .9 | .6 |
| Manufacturing | 3.3 | 2.9 | 2.4 | 1.5 | 2.5 |
| Nonmanufacturing | 2.4 | 2.4 | 1.7 | .6 | -.3 |

¹ Preliminary.

Note.—Data relate to output per hour paid for, for all persons.

Source: Department of Labor, Bureau of Labor Statistics, as found in the 1979 Annual Report of the Council of Economic Advisers, p. 68.

The slower productivity growth has occurred in every sector of the U.S. economy (Table 2).

TABLE 2.—PRODUCTIVITY GROWTH BY INDUSTRY, 1950-77

[Percent change per year]

| Industry | 1977 output share (percent) ¹ | 1950 to 1965 | 1965 to 1973 | 1973 to 1977 |
|---------------------|--|--------------|--------------|--------------|
| Agriculture..... | 2.9 | 4.9 | 3.6 | 3.0 |
| Mining..... | 1.5 | 4.3 | 1.9 | -6.1 |
| Construction..... | 4.3 | 3.4 | -2.1 | .3 |
| Manufacturing..... | | | | |
| Nondurable..... | 9.9 | 3.2 | 3.3 | 2.2 |
| Durable..... | 14.4 | 2.5 | 2.2 | 1.2 |
| Transportation..... | 3.9 | 3.0 | 2.9 | 1.0 |
| Communication..... | 3.2 | 5.3 | 4.6 | 6.7 |
| Utilities..... | 2.3 | 6.1 | 3.5 | .2 |

TABLE 2.—PRODUCTIVITY GROWTH BY INDUSTRY, 1950-77—Continued

[Percent change per year]

| Industry | 1977 output share (percent) ^a | 1950 to 1965 | 1965 to 1973 | 1973 to 1977 |
|--|--|--------------|--------------|--------------|
| Trade..... | | | | |
| Wholesale..... | 7.3 | 2.6 | 3.4 | -.8 |
| Retail..... | 10.0 | 2.3 | 2.1 | .8 |
| Finance, insurance, and real estate..... | 15.4 | 1.6 | .2 | 2.3 |
| Services..... | 12.0 | 1.2 | 1.7 | -.3 |
| Government..... | 12.5 | .4 | .5 | .1 |
| All industries..... | | | | |
| Current weights..... | 100.0 | 2.7 | 2.0 | 1.1 |
| Fixed weight (1977 output weights)..... | | 2.6 | 1.9 | 1.1 |

^a Detail may not add to 100 percent because of rounding.

Note.—Growth data relate to output per hour worked for all persons.

Source: Department of Commerce (Bureau of Economic Analysis) and Council of Economic Advisers, as found in the 1979 Annual Report of the Council of Economic Advisers, p. 71.

The decline in productivity growth is most obvious in the United States compared to other Western industrialized countries, particularly in the manufacturing sector (Table 3).

TABLE 3.—PRODUCTIVITY IN MANUFACTURING, 1960-76

[Average annual percent change]

| Country | 1960-76 | 1960-66 | 1966-76 | 1966-76 versus 1960-66 |
|--------------------------------|---------|---------|---------|------------------------|
| United States..... | 2.9 | 4.0 | 2.2 | -45 |
| United Kingdom..... | 3.3 | 3.7 | 3.1 | -16 |
| Canada..... | 3.8 | 4.3 | 3.5 | -19 |
| Switzerland..... | 4.3 | 2.9 | 5.1 | +76 |
| France..... | 5.7 | 5.5 | 5.8 | +5 |
| Sweden..... | 5.7 | 6.5 | 5.2 | -20 |
| Italy..... | 5.8 | 6.7 | 5.3 | -21 |
| Germany..... | 5.9 | 6.0 | 5.8 | -3 |
| Netherlands ¹ | 6.7 | 5.6 | 7.4 | +32 |
| Belgium ¹ | 6.8 | 5.0 | 8.1 | +62 |
| Denmark..... | 7.0 | 5.4 | 8.0 | +48 |
| Japan..... | 8.9 | 8.8 | 8.9 | +1 |

¹ 1960-75.

Note.—Data for 1976 are preliminary estimates.

Source: U.S. Department of Labor, Bureau of Labor Statistics, as found in the New York Stock Exchange, Office of Economic Research, January 1979 publication.

The lower average productivity of the last 10 years compared with the average of the previous 20 years has resulted in a great loss of human physical welfare, higher poverty and less opportunity. The average American household now receives \$3,700 less income (Personal Income) for better housing, food and clothing, savings for the future and tax payments for government services as a consequence of the decline in productivity. If the trend is not reversed, the average American household will lose \$4,800 more income in 1988 (Table 4).

TABLE 4.—*Loss of household income from slower growth during last 10 years and forecast for next 10 years*

| | |
|---|---------|
| Average productivity growth 1948-68 (percent) | 3.3 |
| Average productivity growth 1968-78 and forecast for 1978-88 (percent)..... | 1.5 |
| Loss in productivity growth | 1.8 |
| Resulting loss of household income in 1978 | \$3,700 |
| Additional loss if slow growth continues to 1988 | \$4,800 |

Higher labor costs are closely tied with higher business costs and with consumer prices. This has been true during the recovery from the 1975 recession (Table 5).

TABLE 5.—CHANGES IN WAGES, PRODUCTIVITY, AND UNIT LABOR COSTS IN NONFARM BUSINESS AND CONSUMER PRICES, 1975-78

[Annual percent changes]¹

| | Compensation per hour worked | Output per hour worked (productivity) | Unit labor costs | Inflation | |
|------------|------------------------------------|---|------------------------|--------------------------------------|---|
| | | | | Consumer Price Index inflation | Nonfarm business implicit price deflator |
| 1975 | 9.9 | 1.9 | 7.8 | 9.1 | 10.6 |
| 1976 | 8.4 | 3.5 | 4.7 | 5.8 | 5.4 |
| 1977 | 8.1 | 1.3 | 6.7 | 6.5 | 5.9 |
| 1978 | 9.4 | 0.6 | 8.8 | 7.7 | 7.0 |

¹ Col. 1 minus col. 2 equals col. 3.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

Also, slow growth in productivity undoubtedly led to higher wage demands, labor costs and inflation than workers may have expected from official estimates (Table 6).

TABLE 6.—*Situation during 1978*

| | Percent |
|--|---------|
| Administration estimate of consumer price inflation (January 1978) | 5.9 |
| Growth in real income based on historical experience (1948-68)..... | 3.3 |
| Compensation increase | 9.2 |
| Actual productivity growth (private, business sector)..... | 0.4 |
| Labor costs inflation (unit labor costs)..... | 8.7 |
| Increase in consumer prices..... | 7.8 |

CAUSES OF THE SLOWER GROWTH

The causes of the slower productivity growth have been analyzed by several scholars, including Professors John W. Kendrick and Edward F. Denison (Table 7).

TABLE 7

| Sources of Productivity Growth 1948-1977 (U.S. Domestic Business Economy) | | | | | | |
|--|---|-----------|------------------------|---|------------------------------|--|
| | | | | Change Between Periods | | |
| | 1948-1966 | 1966-1973 | 1973-1977 ^p | 1966-1973 vs 1948-1966 | 1973-1977 vs 1948-1966 | |
| | (a) | (b) | (c) | (a)-(b) | (a)-(c) | |
| | (Percentage Point Contribution to Growth Rate) | | | (Percentage Point Contribution to Change in Growth Rate) | | |
| Technological Progress | 1.4% | 1.1% | 0.8% | -0.3% | -0.5% | |
| + Changes in Labor Quality | 0.6 | 0.4 | 0.7 | -0.2 | +0.1 | |
| + Changes in Quality of Land | 0.0 | -0.1 | -0.2 | -0.1 | -0.2 | |
| + Capital and Labor Mobility | 0.8 | 0.7 | 0.3 | -0.1 | -0.5 | |
| + Changes in Output Growth | 0.4 | 0.2 | -0.3 | -0.2 | -0.7 | |
| + Net Government Impact | 0.0 | -0.1 | -0.3 | -0.1 | -0.3 | |
| + Other N.E.C. | -0.5 | -0.6 | -0.4 | -0.1 | +0.1 | |
| | Average Annual Rate of Growth | | | Change in Average Annual Rate of Growth | | |
| = Total Factor Productivity | 2.7% | 1.6% | 0.7% | -1.1 | -2.0 | |

p = preliminary
N.E.C. = Not Elsewhere Classified.

Source: Professor John W. Kendrick, George Washington University, as found in The New York Stock Exchange, Office of Economic Research, January, 1979 publication.

The President's Council of Economic Advisers devoted several pages in their latest Annual Report describing the causes of the slowdown in productivity growth (pages 67-91):

Slower growth of investment

... analytical studies estimate that (the growth in the capital stock) could well have reduced productivity growth by up to one-half of a percentage point per year from earlier trends.

Increase in social regulations

Increased economic and social regulation has aggravated the productivity slowdown in a number of ways.

In addition, important indirect costs are generated by social regulation. The implementation of new regulatory statutes is often associated with considerable litigation and uncertainty which tends to reduce innovation and investment. Moreover, some regulations specify or suggest the technology to be used to meet new standards, rather than prescribing a level of performance to be attained. As a consequence, innovations that could meet the standards at lower cost are not encouraged.

... the direct costs of compliance with environmental, health, and safety regulations may have reduced by (0.4) percentage point from annual growth of output relative to inputs since 1973.

... from 1950 to 1965 labor productivity in mining grew 4.3 percent per year, but since 1973 it has declined at an annual rate of 6.1 percent. In the late 1960s and early 1970s stringent mine safety laws began to take effect. ... regulation has undoubtedly been very costly in terms of real output per hour worked.

In the utilities sector, growth in output per hour worked fell successively from 6.1 to 3.5 to 0.2 percent per year in 1950-65, 1965-73, and 1973-77. While a number of influences have been at work to reduce productivity growth in this industry, the increase in environmental regulation had an important bearing.

Increase in employment of women and teenagers

Productivity growth has also been reduced by a dramatic shift in the age-sex composition of employment.

Research and development

Some have suggested that a decline in the intensity of research and development in the United States may be a significant cause of the productivity slowdown.

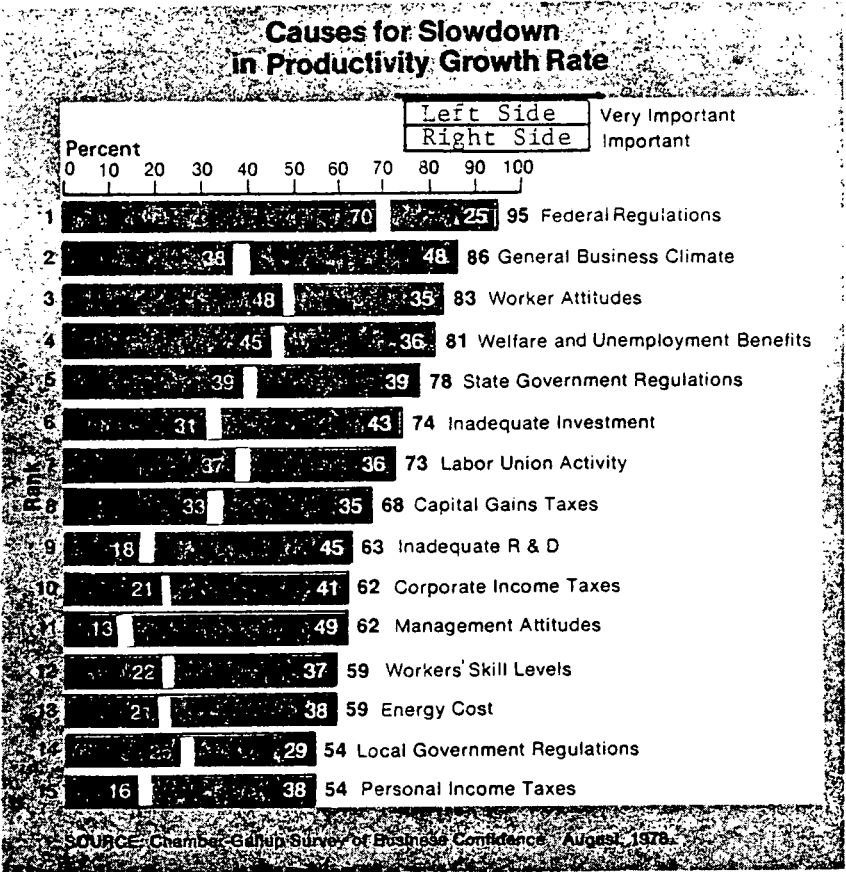
Others

Little of the 1965-73 decline in private nonfarm labor productivity or the further reduction in 1973-78 seems to stem from shifts in the industrial composition of employment.

Some suggest that the oil embargo of 1973-74 and the subsequent quadrupling of oil prices had an adverse impact on productivity growth. However, it is difficult to find a mechanism by which an oil crisis could have such an immediate and severe effect on the economy.

Business leaders have also identified causes for slowdown in productivity growth (Chart 1).

CHART 1



Slow growth of capital

Professors Kendrick and Denison, the Council of Economic Advisers Annual Report, and the survey of business leaders all identify the importance of new capital formation, which embodies the latest in technological progress, cost-reducing techniques, diffusion of techniques across the country, the movement of capital to growth areas, and lowering cost of compliance with Federal regulations.

Unfortunately, fixed capital formation as a percent of the U.S. output is lower than in the past and lower than any major Western industrialized country (Table 8).

TABLE 8

| Japan 33.0 | Fixed Capital Formation * |
|---------------------|---|
| | as a Percentage of Gross Domestic Product |
| | 1961-1976 |
| Australia 25.5 | |
| West Germany 24.3 | |
| Netherlands 24.2 | |
| France 23.2 | |
| Sweden 22.8 | |
| Canada 22.2 | |
| Italy 21.0 | |
| United Kingdom 18.6 | |
| United States 17.8 | |

Source: Cover of National Chamber's Report: "Public Policy and Capital Formation."

This is understandable when it is realized the effective corporate tax rate on the real income of U.S. corporations has been increasing during the last 10 years (Table 9).

TABLE 9.—EFFECTIVE TAX RATE ON THE REAL INCOME¹ OF NONFINANCIAL CORPORATIONS, 1967-78

| Year: | Effective tax rate on real corporate income (percent) | Change in Consumer Price Index (year over year) | Increase in effective tax rate due to inventory profits and understatement of depreciation ² |
|-------------------------|---|---|---|
| 1967 | 41.2 | 2.9 | -1.2 |
| 1968 | 46.6 | 4.2 | -0.1 |
| 1969 | 50.2 | 5.4 | 1.4 |
| 1970 | 52.8 | 5.9 | 3.3 |
| 1971 | 50.9 | 4.3 | 3.6 |
| 1972 | 46.5 | 3.3 | 2.4 |
| 1973 | 52.1 | 6.2 | 9.4 |
| 1974 | 71.8 | 11.0 | 30.3 |
| 1975 | 52.1 | 9.1 | 12.3 |
| 1976 | 52.7 | 5.8 | 11.6 |
| 1977 | 51.8 | 6.5 | 10.7 |
| 1978 ³ | 54.9 | 7.8 | 12.8 |

¹ Real income of non-financial corporations is the profits of non-financial corporations with the U.S. Department of Commerce's inventory valuation and capital consumption adjustments. The effective tax rate on real corporate income is the ratio of the federal, state and local corporate profits tax liability of non-financial corporations to their real income (times 100).

² The ratio of corporate profits tax liability to profits with inventory valuation and capital consumption adjustments minus the ratio of liability to unadjusted profits (times 100).

³ Estimates.

Source: U.S. Department of Commerce, Bureau of Economic Analysis and Chamber of Commerce of the United States, Trends and Perspective Center.

The small \$4 billion tax relief for encouraging corporate investment has been more than fully offset by inflation-induced understatement of capital consumption allowances in comparison with replacement costs during the time the tax bill was debated and enacted.

In fact, all major economic legislation enacted in the last Congress caused less investment for subsequent years. This was true for increases in minimum wage, social security taxes, farm price supports, and clean air amendments. These increases more than offset tax relief to stimulate investment. They also caused loss of employment (Table 10).

TABLE 10
UNITED STATES
ACTUAL AND POTENTIAL IMPACT ON INVESTMENT AND EMPLOYMENT
OF THE CARTER ADMINISTRATION'S PROPOSALS AND
CONGRESSIONAL ENACTMENT OF 1977 AND 1978 LEGISLATION (1)

| | Investment | | | | | Employment | | | | |
|--|--|------|------|------|------|---|--------|--------|--------|--------|
| | Gain(+) or Loss(-) Per Worker (\$1979) | | | | | Gains(+) or Losses(-) (Thousands) | | | | |
| | 78 | 79 | 80 | 81 | 85 | 78 | 79 | 80 | 81 | 85 |
| ENACTED LEGISLATION 1977-78 | | | | | | | | | | |
| (1) Economic Stimulus | 34 | 20 | 8 | 8 | 6 | 502 | 206 | 103 | 101 | 100 |
| (2) Minimum Wage | -4 | -55 | -60 | -61 | -55 | -605 | -1,230 | -1,815 | -1,837 | -1,926 |
| (3) Social Security Taxes | 0 | -5 | -14 | -25 | -64 | 0 | -108 | -305 | -501 | -1,284 |
| (4) Farm Support | -4 | -6 | -5 | -5 | -5 | -108 | -109 | -110 | -110 | -111 |
| (5) Federal Pay (1977) | -1 | -3 | -3 | -2 | -3 | -102 | -110 | -110 | -120 | -209 |
| (6) Clean Air Amendments <2> | -50 | -123 | -167 | -198 | -292 | -68 | -229 | -231 | -389 | -821 |
| (7) Public Works Jobs | 1 | 1 | 2 | 2 | 2 | 130 | 115 | 50 | 20 | 0 |
| (8) Tax Relief | 0 | 7 | 40 | 74 | 89 | 0 | 32 | 201 | 395 | 406 |
| (9) National Energy Policy<3> | 0 | 1 | 6 | 6 | 6 | 0 | 23 | 42 | 50 | 60 |
| (10) Federal Pay (1978) | 0 | -1 | -2 | -2 | -2 | 0 | -75 | -81 | -81 | -153 |
| (11) Total Gross Impact <4> | -24 | -162 | -196 | -203 | -320 | -251 | -1,484 | -2,305 | -2,473 | -3,938 |
| (12) Total Net Impact <5> | -12 | -75 | -123 | -130 | -199 | -163 | -928 | -1,490 | -1,602 | -2,888 |
| LEGISLATION PROPOSED OR SUPPORTED BUT NOT ENACTED | | | | | | | | | | |
| (13) Labor Law Reform | 0 | -3 | -13 | -30 | -84 | 0 | -109 | -202 | -305 | -703 |
| (14) Common Status | 0 | 0 | 0 | -1 | -2 | 0 | 0 | -1 | -5 | -18 |
| (15) Cargo Preference | 0 | 0 | -1 | -1 | -3 | 0 | 0 | -61 | -68 | -91 |
| (16) Alaskan Lands Withdrawal | -13 | -21 | -56 | -47 | -58 | -20 | -150 | -620 | -845 | -1,723 |
| (17) Crude Oil Tax | -2 | -20 | -56 | -62 | -68 | -81 | -143 | -212 | -346 | -863 |
| (18) Potential Gross Impact<6> | -39 | -206 | -322 | -345 | -536 | -352 | -1,887 | -3,402 | -4,042 | -7,337 |
| (19) Potential Net Impact<7> | -20 | -95 | -202 | -220 | -333 | -229 | -1,180 | -2,199 | -2,618 | -5,381 |

<1> Change in levels of economic activity.

<2> Based on initial interpretation prior to plans submitted by state-local governments.

<3> Includes natural gas deregulation.

<4> Sum of rows (1) through (10).

<5> Adjustment of row (11) for overlapping policies.

<6> Sum of rows (1) through (10) and (13) through (17).

<7> Adjustment of row (18) for overlapping policies.

SOURCE: U.S. Chamber of Commerce, Forecast and Survey Center. Assumptions and modeling by Dr. Jack Carlson and George Trensak using econometric models of Data Resources, Inc. and Chase Econometrics Associates.

Similarly, all sources identify that Federal regulations have been a key reason for declining productivity growth. Understandably, this is so because the \$5 billion spent on regulatory agencies is leveraged to cause about 20 times that figure additional costs on private industry and state and local government, which, if passed on to consumers of taxpayers is equivalent to an average decline of about \$1,400 for each American household. Moreover, the President has set the growth of regulatory capability as his number one priority by increasing the regulatory agency budgets faster than any other area (Table 11).

TABLE 11.—FISCAL YEAR 1979 BUDGET AND FISCAL YEAR 1980 PRESIDENTIAL BUDGET PROPOSALS

| | Fiscal year 1979 estimate (percent) | Fiscal year 1980 Presidential proposal (percent) |
|--------------------------|--|--|
| Regulatory agencies..... | | 14.2 |
| Defense | 6.6 | 9.2 |
| Average of areas | 9.4 | 7.7 |

FEDERAL GOVERNMENT RESPONSE TO SLOW PRODUCTIVITY GROWTH

The President and some members of the Congress, including the members of the Joint Economic Committee, recognize the problem of slow productivity growth but the government is doing very little to increase productivity. The President displays benign neglect in his Economic Report: "The reason for the weakening of productivity growth . . . are complex and not fully understood."

Official Federal actions reflect lack of leadership. Both the President and the Congress disbanded the National Productivity and Quality of Working Life Center, the only place in government where declining productivity growth was comprehensively considered. The token creation of an anemic Federal Council on Productivity,

consisting solely of Federal employees with other full time jobs, hardly responds to the need for leadership and commitment. Based upon the importance of changing attitudes of workers, managers, and public officials, leadership is a very important missing ingredient.

RECOMMENDATIONS FOR PRODUCTIVITY GROWTH

If we are to overcome our largely self-inflicted decline in productivity growth, we must treat the causes of the decline.

High employment and near capacity utilization of energy

Clearly, maintaining high employment and economic growth without accelerating inflation (demand pull) through appropriate fiscal and monetary policies is necessary.

Change in attitude

The Federal government, with business and labor and consumer leaders, must provide leadership to improve the general climate for productivity growth. Improvements in risk taking innovation, removal of barriers to efficiency, are all necessary functions of public and private officials. Such an approach can produce more goods and services for the benefit of everyone.

Tax relief to increase productivity-enhancing investment

"Enact tax relief designed to strengthen incentives for business investment," is wisely suggested in the Council of Economic Advisers Annual Report. For example, lowering the useful life of equipment from 11 to 9 years and increasing the investment tax credit by 2 percentage points beginning in mid-1980 need not affect the Federal deficit significantly in fiscal year 1980 but could by the end of 1982 increase productivity by 1.5 percent and by 3 percent by 1985 (or 0.5 percent higher annual productivity growth rate) (Table 12).

TABLE 12.—ECONOMIC IMPACT OF LIBERALIZED DEPRECIATION ALLOWANCES AND INVESTMENT TAX CREDIT

[Mid-1980 to 1985]

| | 1982 | 1985 |
|--|---------|---------|
| Increase in productivity (percent): | | |
| Level | 1.5 | 3.0 |
| Rate | 0.5 | 0.5 |
| Increase in net capital stock: | | |
| Dollars (billion) | \$14.8 | \$35.1 |
| Percent | 1.8 | 3.3 |
| Increase in employment | 182,000 | 150,000 |
| Increase in household disposable income (1979 dollars) | \$126 | \$254 |
| Change in Federal receipts: | | |
| Dollars (billion) | \$7.2 | \$10.5 |
| Percent | 1.1 | 1.2 |

Source: Chamber of Commerce of the United States.

Tax relief to increase research and development

Also, tax relief should be provided to spur private sector investment in new developments and applied research. Risk-taking and innovation is now discouraged by high taxation. The Federal government has taken steps to reverse the decline in basic research; now encouragement must be provided to bring the bright idea to a usable technique embodied in new physical technology, such as new and more efficient equipment.

Regulatory policy to enhance productivity

The huge growth of regulations as an important tool of government policy—the others being spending, taxing and credit—is accompanied by very little political accountability or responsibility. The Congress enacts a bill giving the objectives of public policy and turning over the responsibilities for establishing particular policies or regulations to narrow administrative bureaus of the Executive Branch, with organization heads that remain on the position for about 2 years. Sometimes the law will be quite specific and rigid about goals or timing; often the agency will have

wide discretion. These bureaus have promulgated and are promulgating the largest mass of costly and productivity-limiting public policy in the history of the United States. This is being done in most cases without any explicit acceptance of these regulatory policies by an elected official of the Federal government. Typically, a bureau chief promulgates these regulations without clearance from the President or from the Congress. The decisions add up to huge resource reallocations, but there is no system for making the decisions in light of the expected effects. This is government without proper representation or accountability.

The problem is so bad that the President does not even know the total sum of additional funds he gives in the form of budgets to regulatory agencies. He readily identifies in his budget message the total for spending, the total for taxing, and even the subtotal for tax expenditure but he has no idea as to the total for regulations. It is, therefore, not surprising to find out that the growth of regulatory authorities has proceeded at a much faster pace than the growth of Federal taxes and spending. Even the less rapid pace of Federal taxing and spending is bringing forth a taxpayers revolt as illustrated by Proposition 13 in California.

For example, the President proposes to increase the regulatory budgets by 44 percent between 1978 and 1980, either indicating his highest priority or greatest ignorance. As identified by scholars such as Professor Murray Weidenbaum, the increase in regulatory capability and resources is magnified 20-fold in terms of additional costs imposed upon industry and state and local governments. Moreover, this high increase in agency capability and in costs ultimately borne by the American consumers and workers is done with the least amount of representative government or accountability.

I would like to draw a parallel, and a contrast, between the decision process on Federal regulatory activities and that on Federal credit activities. The following points have been advanced by the Administration in support of its proposal for control by the President and Congress of Federal credit activities; while these same points are applicable to regulatory activities, no similar control proposal is being offered:

(a) They are a large and growing means of meeting objectives of Federal programs,

(b) There is no established mechanism for regularly and closely reviewing total Federal activity,

(c) Hence, there is no way to consider the resource allocation implied by those plans,

(d) For the government to foster efficiency in the allocation of economic resources . . . , in the economy as a whole, it must exercise better and more systematic control.

At a minimum, the President should be required to submit to the Congress each year, total outlays and appropriations he proposes for regulations and regulatory authorities.

Second, he should be required to include, to the extent available, the costs and benefits associated with such expenditures recognizing that such estimates will be subject to considerable improvement as more and more are attempted.

Third, the legislative branch should also be held accountable and responsible by enacting a provision that Congress can veto proposed new regulation.

Fourth, sunset provisions should be established for all Federal regulations, and legislative reauthorization of programs should only occur after a legislative benefit and cost analysis has been performed on the major regulations.

Fifth, the President and the Congress should establish capability for evaluating the impact of proposed regulations subject to Congressional veto and subject to Presidential review. The beginnings of the capability exist in the Council on Wage and Price Stability and the staff of the Council of Economic Advisers and perhaps in the Congressional Budget Office.

Sixth, any evaluation of regulations should include a review of ways to achieve the agreed social objectives at the least cost. Productivity inhibiting engineering requirements or specifications of a particular piece of equipment or technology should be replaced with performance requirements allowing for new technology, equipment, techniques, and innovations.

Seventh, we would find it unacceptable for the President (as some now argue and as is argued in some current litigation) to be in a position where officials whom he selects and who serve at his pleasure, may be able to exercise regulatory powers and not be subject to the President's policy control. Presidential policy control is an essential element to achieving political accountability and representative government.

Eighth, the Congress should begin by slowing down the double-digit growth of Federal regulatory agencies now.

The capability for evaluating impacts of regulations should be strengthened and be in a separate Executive Office entity during the initial 5-year period. After the 5-year experience the need for a change in the organization or structure should be considered.

In the Congress the beginnings of some capability resides in the Congressional Budget Office and perhaps in some legislative committees. In time the skill mix of the staff should reflect a capability to measure the benefits and costs of proposed regulations.

THE NATIONAL CHAMBER AND PRODUCTIVITY

While public policy must remove the barriers to the growth of productivity, American business can and will do more to improve productivity. In order to carry out this commitment the National Chamber established a Productivity Center last October with the following objectives:

Evaluate trends and policies influencing productivity growth;

Identify public policies that reduce productivity growth and recommend changes to public officials;

Encourage business leaders to review how they can increase productivity in their own companies and in cooperation with workers and consumers.

We plan to achieve these objectives in full cooperation with state and local Chambers of Commerce, trade associations, and productivity centers across the country.

Senator BENTSEN. In the last session of the Congress I introduced six regulatory bills and was able to get three of them passed, and I have three along this line on cost effectiveness and the other on a regulatory budget.

That is tough to get a handle on but I think that is one we have to work out. We put a limitation on how much these agencies can spend each year, but I think it is time we put a limitation on how much they can make people spend each year, so we know and understand the economic impact that is being passed on to all of the consumers of this country.

Mr. CARLSON. I think that is the way to go and clearly moving in the direction of operation rather than ignorance being clearly the way to go.

Senator BENTSEN. In view of the comments you have made in your prepared statement, I would like you to take a look at the bills I and Congressman Brown have introduced and see if you fellows don't want to add your support to them.

Mr. CARLSON. We would be pleased to do that. In principle, the direction in which you are going is one we can all applaud. We will look at the specific provisions and provide a letter back to you.

Senator BENTSEN. We want more than rhetoric. We want reality. It is going to require a lot of support from all segments.

I made a point earlier—either of you might comment on it—is it possible to reduce inflation to 7.4 percent as the President has stated if productivity increases by only 0.4 percent and unit labor costs go up by 8.1 percent?

Are those contradictory?

Mr. GRAYSON. I will give my own answer.

Unit labor costs, generally speaking, track very well with price increases unless profit margins are going to suffer around the country.

I think there is no way to hold inflation down to the level forecast unless productivity is better than what is now forecasted.

Senator BENTSEN. We have a contradiction there in the President's forecast.

Mr. GRAYSON. Yes; there is.

Furthermore, let me add when the wage and price standards program was calculated, assumptions were made wages would rise about 7½ percent because of the 7 percent standard, plus one-half percent due to other added costs—social security, et cetera.

Prices were set one-half percent below the base period to yield 5¾ percent price increases. A little arithmetic will show that the assumption built into the wage and price standards is that productivity will rise this year 1¾ percent. That is built into the mechanism. It is not spelled out. That is implied by those two figures.

One and three-fourths rise, therefore, is the implicit productivity forecast and yet, last year, we were only able to eke out four-tenths of 1 percent across the country.

Mr. CARLSON. I would agree with that analysis. Our forecasts show a late forecast. The administration assumes in its guidelines and I would say it is impossible to achieve the objectives even though American business is trying to do its part and where it has discretion in keeping down the growth of prices.

Senator BENTSEN. According to the Economic Report of the President, by the end of 1983, output per hour will be only 7½ percent higher than at the end of 1978. That compares with a 17 percent gain over 5 years which would be obtained at the 3.2 percent annual rate of productivity growth achieved in the two decades after World War II.

This means that some of the hopes and dreams of our people are not going to be fulfilled. It means that a lot of the poor who thought they were going to be able to break out of poverty are not going to be able to break out.

Doesn't that lead to social strife—some serious economic implications for our political system?

Mr. CARLSON. I would certainly agree with you it does dash expectations if they were based on historical growth and output per man-hour. Just the time period you are talking about, if in fact we were going at the historical level that we had for a 20-year period, 1948-68, 1½ percentability into these numbers are somewhat less than that.

The average household by 1983 would be receiving over \$2,000 worth of additional income at the higher productivity level. With \$2,000, you can do an awful lot on an average increase in terms of individual households, in terms of overcoming poverty, in terms of upward mobility, in terms of any group effort such as environmental quality or whatever else we may desire.

Clearly, it cuts down our options by growing less.

Mr. GRAYSON. I would like to supplement that, Mr. Chairman.

I made some calculations looking simply at what would have happened if we had maintained our productivity growth rate of 3.2 percent from 1947 to 1967. Though I don't have it on a per household figure, real GNP would be about \$265 billion higher in the year 1978.

That is a fantastic figure. These are real dollars that could go for social dividends for improving the health and welfare of the Nation, for helping the poor, for higher wages and for fighting

inflation. It is not just rhetoric. It is a real figure that gets right down to the household.

Some people say that productivity improvement can only be a half of a percent or 1 percent. And since we are dealing with inflation of 9 and 10 percent, we would be reducing inflation by only 1 percent if we improve productivity by 1 percent.

That would be true in the first round but as you accumulate that increase over a period of time, you will bring down inflation rapidly. A calculation done by William Freund of the New York Stock Exchange shows the arithmetic of how a slowing of productivity growth can ratchet inflation up rapidly, and how, on the other side, it can bring inflation down rapidly by increased productivity.

Senator BENTSEN. I think this next question is obvious, but I want it in the record.

Is the problem of the lack of increase in productivity a problem that primarily concerns management, or is it an issue that also concerns labor, and are labor leaders concerned that higher productivity could lead to higher unemployment?

Mr. GRAYSON. It must concern management and labor. Labor probably has the most at stake. Three-fourths of our national income is in the form of compensation of employees.

Senator BENTSEN. How do you respond when they say you will replace workers on the production line with a machine and get greater productivity?

Mr. GRAYSON. I have heard that concern many times and the record clearly shows that increased productivity results in more jobs.

In 1977, a Department of Commerce study extensively showed that the highest employment growth areas were in the industries with the highest productivity. It is unquestioned in some cases that where there is immediate productivity improvement there may be some job dislocations.

One of my arguments to business and labor is that we must take care of those employees through improved retraining, new training, job skills, job adjustment assistance, et cetera.

In my view, labor has just as much at stake as management, and we have on the board of directors of the American Productivity Center several labor leaders who agree with this.

Mr. CARLSON. In the prepared statement, we have the example of increasing productivity through increasing investment. You not only increase the investment and output of each worker so that in this case we have household income going up by \$254 by an increase in the depreciation allowance which is more liberal and also the investment tax credit, an increase by 150,000, the number of jobs available in your economy.

So, clearly, except for the fictional problems we are talking about, we could talk about adding jobs, not reducing jobs as we go to a higher productivity level.

Senator BENTSEN. You were talking about a disaggregated approach, to try to get a better definition of where the lack of productivity is taking place so we can attack it better.

Studies we have seen say the slowdown of overall productivity can be accounted for by the collapse of productivity in certain

specific sectors—construction, mining, utilities, and wholesale and retail trade.

According to staff calculations, in the decade 1967 to 1977, productivity in construction and mining declined by nearly 2 percent. Productivity in utilities grew by only 2 percent, while productivity in wholesale and retail trade grew by less than 2 percent.

Do you have any explanation for those figures, and what would be the policy implications?

Mr. CARLSON. Inasmuch as I had responsibility years ago in the Government for the coal industry and also for the health and safety of miners in that industry, I have to admit that the Government regulations were the primary cause for the decline in the productivity in the mining industry.

Senator BENTSEN. We had to do some things there, didn't we?

Mr. CARLSON. Clearly, the health and safety regulations were not adequate but also clearly we have some bad regulations even in that important area that we should clean out and overhaul which we are not doing.

In the utility industry, we have had heavy regulations and that is the primary cause for slower growth coming to this industry which has been noted for high productivity in the past.

So, government regulations, some of it good and some of it bad has had an impact upon productivity growth in those two areas.

Senator BENTSEN. Do these regulations retard the building of new utility plants?

Mr. CARLSON. Also the delays. We are aware of the nuclear delays but there are delays on other new plants and there are new regulations. Some add not one bit to the health and safety of the workers or the communities in which they reside. They turn out to be unnecessary delays and costly delays that lower productivity.

Senator BENTSEN. Last week Chairman Miller of the Federal Reserve Board testified. He stated that accelerated depreciation allowances are the best policy for stimulating investment.

How would you rank accelerated depreciation, the investment tax credit, depreciation allowances based on replacement costs, and cuts in corporate tax rates as measures to modernize the productivity capacity of this country?

Mr. CARLSON. I think the order you read them is a responsible order. Whether the depreciation is accelerated or close to replacement cost, accelerated gives it a little more front-end loading along with the tax credit as having the most stimulative and immediate effect.

Mr. GRAYSON. We need the short-run stimulus in some cases, but I think overall, we have to take a long-run view, for it is a long-run problem.

We have to look at the top and bottom. We have to dig deep if we are going to solve these problems.

Mr. CARLSON. Mr. Chairman, the latest report we have from the Commerce Department shows that the gap between capital cost of recovery allowances and depreciation allowances and recovery costs is now nearly \$20 million, so some modest improvement would close that gap where it is accelerated depreciation or reform of the depreciation system itself would be very, very useful.

I think some people have an understanding that some improvement needs to be made in that area, let alone wise from an economic standpoint.

Senator BENTSEN. I have had some concern about trying to use replacement cost. You may run into a lot of very practical problems in that regard. In fact, I believe that the Secretary of the Treasury, or one of our other witnesses, testified that, with replacement cost depreciation, people might have a tendency to hold on to old assets.

Mr. CARLSON. The practicality is you will not be able to capitalize your capital cost system to have enough to replace your equipment. Consequently, some improvement in the economic life for depreciation purposes is a useful direction to go and thereby you don't need to get into as you have identified some of the indexing problems trying to match up replacement costs with the depreciation allowance.

Senator BENTSEN. Mr. Grayson, you have charged that the President's wage-price guidelines could seriously curtail some of the most effective productivity improvement programs in America, because productivity gains may be counted as offsets to pay increases only for labor under union contracts.

About one-fourth of the labor force is unionized.

Could you elaborate on that criticism? Would it be administratively unfeasible to broaden this?

Mr. GRAYSON. In fact, there was an amendment in 1971 to the economic stabilization program which said productivity had to be taken into consideration in setting pay standards. If we are going to continue today's standards without allowances for productivity improvements, we are going to destroy incentives for productivity programs, some of which are already being hurt by these current standards.

I submitted written comments to COWPS to this effect. If we allow exemptions only in the union area, as it is now written, it hurts the nonunion areas not covered by this particular exemption. Also, it does not permit the formation of new productivity plans.

Some specific examples—there is a Houston welding firm which can't install an improvement program because they don't have a past record.

There is another firm, James Berry Valve Co., making certain control valves for atomic subs. They can't exceed the standard on the wages from their productivity program if they go over their base period.

In other words, what we are doing by these standards is freezing the ability and incentives for firms to improve something that is vital to this Nation. The wage/price guideline is holding them back at this point.

Senator BENTSEN. Do you have a comment on that, Mr. Carlson?

Mr. CARLSON. No, I agree with that. I think that is the drift as we go down into the wage and price areas. Also, we have noted in Great Britain, if in fact they do not take into account productivity, they have this freeze which affects technology.

But it is difficult to administer any program, monetary or voluntary, in calculating product improvements. Consequently, the effect of most of our experience on the wage and price guideline side has

been to encourage productivity when we have had wage and price guidelines or mandatory controls.

Mr. GRAYSON. Some firms have told me, they are not going to slow down their productivity improvement program, and they are going to violate the guidelines because they don't believe it is in the best of interests of their country or their firm.

I hate to see that they feel they are violators of the guidelines.

Senator BENTSEN. Let's discuss a group very much in the news this morning. Productivity in agriculture increased between 1946 and 1977 by approximately 500 percent, an extraordinary increase. Yet, the net income for the farmer today, after inflation adjustments, is less than it was in 1946.

Now, why is that? I want you to help me answer some of the questions I am going to have to answer later this afternoon.

Mr. CARLSON. I still have to make it back downtown. Clearly, one of the great success stories of this country has been an increase in productivity in agriculture. Some of that is attributed to wise public policy. The fusion of technology in the agriculture section and some of the R. & D. stimulus that has come from some of the grant colleges and industries in this area.

Agriculture is still a very competitive part of our economy. Most of the R. & D. in investments and productivity occur outside the industry by the suppliers, certainly those who provided the tractors that the farmers are now using, as we see around the industries, are much more efficient pieces of equipment than 5, 10, 15, 20 years ago. And that has been a major factor. Most of the R. & D. has been done off the farm with the automobile industry providing that input.

Because of the competitiveness, because the R. & D. is being handled elsewhere, because there has been a desire to reduce the excess labor that was thought to be needed on the farm and, therefore, attracted into the city, the incomes on the farms have not been excessive in the past, but quite frankly speaking, given the improvements that occurred this last year, we have over a 25-percent increase in the income of farmers.

There is enough to attract farmers in many areas to continue with their business. There is a tradeoff that has to be looked at. If you have additional farm price supports, that is cost-push inflationary and to what extent is an adequate level of income to farmers producing the food that we need and also what is inflation, and excessive value judgment on you and other Senators?

Senator BENTSEN. Do you want to comment on that, Mr. Grayson?

Mr. GRAYSON. I essentially agree with that. They should know that they are not alone in this problem of real income gains.

If you look at the after-tax real income gains for the average worker in this country, they have not risen. I don't know the exact number of years—but for some 11 or 12 years true earnings have gone up. But take away the effects of inflation and taxes, and what the worker has left to take home leaves him also in a bad lot. So the farmer needs to compare himself with others to realize this is a national problem and not just his problem alone.

Senator BENTSEN. We are talking about the Bureau of Labor Statistics for measuring productivity. What do you think of the

procedures that are used by the Bureau of Labor Statistics for measuring productivity in the private sector?

Mr. GRAYSON. The Bureau of Labor Statistics is probably one of the most competent organizations I have run across in the Government. They have an extremely good group.

My suggestion is that they be given a broader charter, more funds, in order to improve what they are doing. Their budget is now \$3.1 billion, but in several areas they need to expand their work because we need the data.

One, they need to look at total factor productivity instead of just output in man-hours. We need to look at inputs of capital, materials, and energy. We use the output per man-hour as sort of the surrogate for all of those and we don't see the interaction or contribution of all of these other inputs. They ought to start moving toward total productivity.

Two, we need to begin to look at more industries than we now analyze. The Bureau of Labor Statistics only publishes about 60 to 70 industries. We need to expand that to include the 400 industries we have around the Nation. We need to have more data on nonproduction type employees because we are expanding the number of employees in that category.

We need to have more studies on the service sector than we now have data for. That is the growing sector of the economy.

There is a whole series of recommendations from the National Research Council. They have already formed their recommendations which are now in the hands of GAO and will shortly be coming to Congress.

I recommend adopting many of these which would strengthen the statistics we badly need.

Mr. CARLSON. I would agree with that assessment, but I think we should add to the qualifications and the spending of that agency.

Senator BENTSEN. Let's try to break this productivity slowdown into three factors—give me your opinion as to how much is attributable to each.

One of them is insufficient capital formation—you just told me the numbers on it. The second is insufficient research and development. The trend is excessive government regulation.

Mr. GRAYSON. I will give you my views. I have looked at the figures computed by Ed Denison at Brookings and John Kendrick at George Washington University, who, together with a number of other researchers, have been trying to calculate the causes of slowdown for a period of time.

They all have a list of candidates and each one has his own estimates. But I will give my views.

Tangible capital investment contributes approximately 20 percent to productivity growth. We also get improvement from R. & D. and other forms of intangible capital improvement—education and training—which improves the quality of labor and creates intangible human capital. Together, these contribute anywhere from 20 to 50 percent.

The range of our ignorance in this area is enormous.

There is the area of technological advance which includes the quality of management, and the ability to mix the various input factors. These are changes caused by utilization of capacity and by

changes in the economy. Then there is also the measure of ignorance or the residual, which is simply what is left over and unexplained.

In that area would probably go how much government regulations have impeded productivity. It is about time we started to calculate that. It can't be done by one swift calculation. We need to accumulate the data by the budgetary process, by industry studies, and by getting down to where the firms are impacted.

Until we do that, we won't know what policy changes we need in order to change the productivity gains.

Mr. CARLSON. I would just add to that that capital formation, where you buy a piece of equipment, not only provides more equipment with a given technology per worker, but it can also include improved technology. So, it is a more efficient piece of equipment than the one before.

Also, by having more capital formation, the mobility of capital is an area not growing so fast, so depreciation capital moving into somewhere else is also tied up with the capital formation.

So, I would say on the capital side, the largest amount that can improve your productivity from increased R. & D. is part of that R. & D. has to be embodied in terms of human beings and better techniques they have to work with as part of their brainpower or mechanical capability or embodied in physical capital, new equipment.

So, your R. & D., to be effective, sometimes has to come back in the form of human capital.

On the regulation side, I was interested to note the Council of Economic Advisers recognizes 4.4 percentage reduction in the productivity rate has been due to regulations.

That does not include the changes in the use of the public lands which has been identified by other scholars as a reason for productivity going down and Government regulations have affected that.

Also, Government regulations have affected the pace at which technological advances can occur by how much investment can occur, people holding back because they feel they may not be in compliance with the regulation. So, at least you have. Four percentage point drops in about 1½ percentage points, drop in productivity of roughly one-fourth that they identify, and other categories would be higher.

In overcoming that, I would like to stress the capital front is doable as well as the attitudinal. If people are more conscious of the need to increase output per man-hour or manage public officials, that can help considerably too, because the attitude has been in the opposite direction in the last decade.

Mr. GRAYSON. Mr. Denison has calculated just the direct costs in the environmental, safety, and health areas. What we don't calculate are the added costs going on daily in terms of added staffs in the private sector, the uncertainties, and the delays.

There is the tendency of a lot of businessmen to postpone or put investments into low-risk activities. In the end, I suspect the impact Denison calculated is short of what the real number is.

Senator BENTSEN. Has there been a trend in recent years for American business to stress short-term investments and research

activities, rather than long-term studies that can give us more major breakthroughs in technology?

Mr. CARLSON. Yes, I dare say the trend has been in both the public and private sector, and investing in equipment and short-lived equipment has been more pronounced and in major plant expenditures or expansion. And in the public sector, we moved away during the last 5 to 10 years, away from basic research and more in applied and most of it in development even in the areas of the public sector.

There is good reason for that. It is a riskier environment out there and the return for taking that risk is lower than now.

Mr. GRAYSON. A lot of the R. & D. is being put on the defensive measures to be sure firms are complying with the regulations.

Senator BENTSEN. What do you fellows think about the National Productivity Council's role in improving productivity?

Mr. GRAYSON. I made a few statements in my opening remarks that I don't think the current National Productivity Council will get the job done.

Senator BENTSEN. Is the Council doing anything?

Mr. GRAYSON. They had one meeting on December 11, and I understand no further meetings are scheduled at this point. I am sure they will meet again, sometime. But at that meeting, concern was expressed about the problems and the discussion ranged over several topics. But again, no action, no comprehensive program, no funding, no staff—all of the key variables that I view as being important to making something happen.

OMB is certainly an excellent agency. No question about it. One of my recommendations is that the focal point for the administration be in OMB, as a program responsibility.

I know this would be new. OMB does not normally have program responsibility, but there is no reason why they couldn't have as their responsibility a reconstituted National Productivity Council. You can take what is on paper and give it the authority, the funds and the staff and have it become the focal point for the administration.

As now structured, I do not think that will get the job done.

Senator BENTSEN. Mr. Carlson.

Mr. CARLSON. I share the same conclusion and also the same support for the current Director of OMB.

I also think, in addition to what Jackson Grayson just said, we need to have a tie-in to the private sector through advisory committee arrangement or some other tie-in with management. And labor and perhaps some other groups, including State and local governments, if in fact we are going to provide comprehensive leadership for this effort to improve productivity growth and I think we should.

The fact is it is a great disappointment not to take the shell that existed before with the Productivity and Quality of Life Center that existed to go ahead and use that to make it productive, and getting on with the leadership role.

Mr. GRAYSON. As chairman of the American Productivity Center, I would be most happy to work with them. I am meeting with Mr. Granquist later on today to offer my support in whatever areas

they want to work. I think we need both public and private sector cooperation.

Senator BENTSEN. We were talking about R. & D. and Government support through tax incentives to industry, yet some public interest groups strongly oppose this, saying that R. & D. has to be directed; otherwise, industry will come up with spending to develop synthetic potato chips or something else.

How do you answer that one?

Mr. CARLSON. Most of the research activity in this country is a derived demand from objectives that consumers want to pursue, and many of those objectives have been because a particular price of transportation or something else they wanted was particularly high which created an incentive for business to find a lower, less costly form of transportation, or whatever other objectives consumers wanted to pursue.

Once you remove basic and applied research from the wishes of consumers away from the marketplace, in fact, you are going to have research that will not have any application, a supply-push approach only to basic or applied research is inadequate.

Consequently, I would argue, yes, there is room for public purposes and applied R. & D. and development for that purpose, but also there is a crying need for that larger part of the economy that is in the private sector.

Our tax laws tend to discourage investment in private R. & D. because the rate of return is so far—the return is so far down the road that the taxation effect occurs very early on and the discouragement occurs early on and the tax occurs early on. And, consequently, there is not adequate investment in the research area.

Senator BENTSEN. I am on the Finance Committee. I am sympathetic to trying to find a way of encouraging R. & D. But, it is difficult to define R. & D. to avoid serious abuse, and have some things that you and I might not think of as R. & D., and yet might be so charged, to try to take advantage of the tax incentive—do you have any idea how that could be tied down?

Mr. CARLSON. I think the improvements made last year in the capital gains side, when you do recognize the benefits of applied research, developments, new technology, new product and the selling of that product and the returns coming from it are not so heavily taxed was a move in the right direction and tends to help that longer time process that occurs from the applied research being made and the payoff that comes from it.

I think there can be identified other provisions in the tax bill that could be somewhat pinpointed to encourage private sector R. & D. We would be pleased to recommend some to you.

Senator BENTSEN. I would like to see some. I think that with capital gains, there is such a delayed result, that I question how much motivation results from that. I would like to see ways to further define R. & D. so we would not have a lot of abuses in the utilization of an incentive.

Mr. CARLSON. It has been somewhat disappointing because your committee, in the past, and in the House and both bodies have given the Secretary of the Treasury, in some areas, the authority to reduce the depreciation life of certain investments that could be categorized in the R. & D. category. And the Treasury Secretary

has not used that authority, so there is already some discretion in the tax law which is not being used. And I am sure there are some additional provisions that could be used and we would be pleased to make some recommendations.

Senator BENTSEN. It is difficult to distinguish between true innovation and some minor product innovation, for example, going back to tailfins on cars.

Mr. CARLSON. You will always have the problem of something being of value to one person and not another, where a person may be willing to buy a product, where you and I might think it has excessive gadgetry on it. You will always have that difficulty in trying to draw a fine line. It will be difficult, I agree.

Senator BENTSEN. I thank you very much.

Our next witness, Mr. McIntyre, is scheduled for 11 o'clock. He is having a little trouble budgeting his time, apparently.

We have Mr. Van Doorn Ooms, Assistant Director for Economic Policy, Office of Management and Budget.

Would you come forward, please.

We understand the Director is on his way, subject to traffic.

Do I understand you are prepared to present the testimony?

Mr. Ooms. Yes, Senator Bentsen. I would be pleased to give the Director's testimony.

Senator BENTSEN. Why don't you do that in the interest of time. Speak directly into the mike so we can all hear you. State your name and position for the record please.

**STATEMENT OF HON. JAMES T. McINTYRE, JR., DIRECTOR,
OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY
VAN DOORN OOMS, ASSISTANT DIRECTOR FOR ECONOMIC
POLICY**

Mr. Ooms. Mr. Chairman, my name is Van Doorn Ooms, Assistant Director for Economic Policy at OMB. I would like to read the prepared statement of the Director of OMB, which is as follows:

We welcome this opportunity to discuss the President's 1980 budget with you. I understand that my colleagues—Fred Kahn, Mike Blumenthal, and Charlie Schultze—have testified before this committee at other times.

I know that Secretary Blumenthal and Chairman Schultze have discussed the administration's fiscal policy and economic objectives with you in detail. I would like to discuss this subject briefly before turning to other aspects of the budget.

As we began to prepare the 1980 budget last year, we faced the harsh reality of accelerating inflation. Continued reports of good economic news, such as gains in employment and industrial production, seemed to be offset by almost daily reports of higher rates of inflation.

The proposals in this budget reflect the President's belief that our most important domestic priority is to bring inflation under control. We simply cannot be content to live with rates of inflation as high as those we have experienced recently. No other economic problem is so acutely felt by the American people.

Inflation is terribly corrosive of social values. It intensifies the struggle over shares of a slowly growing economic pie. When economic standards are no longer reliable, all of us focus more atten-

tion, too much attention, on maintaining our economic status. The preoccupation with economic security through higher wages and higher prices becomes acute.

We must reduce the rate of inflation. However, the fiscal policies of the administration attempt to avoid an abrupt—and unnecessary—swing to extreme restraint. A recession would bring, at best, slight and temporary relief from high inflation, relief that would come at the expense of the unemployed.

The fiscal policy in the budget, instead, applies moderate additional restraint to the economy, slowing down growth to ensure that shortages and supply bottlenecks do not add to inflation. The best way to prevent a recession, and its high social costs, is to avoid the boom-and-bust cycle of fiscal policies.

In the longer term, this is the only prudent course. In combination with the wage and price standards, and with additional compliance induced by real wage insurance, this fiscal policy will permit a gradual reduction in the rate of inflation. A recession would not only cause great hardship, it would also retard investment activity and reduce productivity growth. A boom-and-bust cycle now would only make fighting inflation more difficult in the years to come.

Senator BENTSEN. Mr. McIntyre, would you like to carry on with your presentation?

Mr. McINTYRE. Thank you, Mr. Chairman.

I had planned to submit my prepared statement for the record and just make some comments on the highlights of it.

Senator BENTSEN. I will take your entire prepared statement into the record and you may proceed as you wish.

Mr. McINTYRE. I would like to apologize to the committee. I had a little trouble getting here this morning.

Senator BENTSEN. One of the previous witnesses said he was now plowed under and I see you have worked your way out of it.

Mr. McINTYRE. Mr. Chairman, inflation is a long-term problem. It requires in my judgment long-term solutions. We must be prepared to apply restraint to the economy for an extended period so that the rate of inflation comes down gradually. This fiscal policy should not be rapidly reversed. The rates of inflation that we have shown in the budget for 1979 and 1980 are far too high to be satisfactory.

The performance of the economy in the final months of 1978 has convinced me that we can continue moderate growth with a policy of restraint. The economy is fundamentally strong, and it will respond favorably to slower inflation.

The budget has been described as "lean" and "austere," and I would like to suggest four ways to demonstrate that restraint:

First, if you look the growth in outlays, you will see that the growth in total outlays has been significantly reduced. This budget provides for outlays of \$531.6 billion in 1980, 7.7 percent more than in 1979. This is a somewhat slower rate of growth than the 9.4-percent increase between 1978 and 1979, and significantly slower than we have experienced over the past 5 years when outlay growth averaged 12 percent per year.

The proposals in this budget reduce the percentage of gross national product and income spent by the Federal Government

from 22.6 percent in 1976 to 21.2 percent in 1980. If continued restraint is exercised, we would expect that share to decline further in future years.

A third way to look at the degree of austerity in the budget is to look at the measure of the relative impact of fiscal policy is provided by the high-employment budget margin. Decreases in the high-employment deficit reflect a fiscal policy that is moving in the direction of restraint. The 1980 budget shows reductions in the high-employment deficit of \$8 billion in 1979 and of \$15 billion in 1980.

The fourth and final way I would like to suggest to this committee is that it look at the budget and compare it with the current services budget estimate for 1980. The administration's current services estimate, including projections of programs under existing law and the changes that would occur as a result of changes in the number of eligible beneficiaries without any changes in law, amounts to \$536.1 billion in 1980. As we put this budget together, \$11.6 billion in proposed program reductions below the current services level were partially offset by \$7 billion in proposed increases.

The net reduction below the current services level amounts to \$4.5 billion in 1980. This is the first budget since the current services concept has been in general use that does not provide—I repeat, “does not provide”—an increase over the current services level.

Let me emphasize that our method of computing the current service figures does not include any inflation increases for discretionary or nonindexed programs. Inclusion of an inflation adjustment for these programs would bring the total spending reduction to about \$12 billion.

By any of these measures, the President's 1980 budget provides the restraint that is appropriate to current economic conditions.

To achieve the required fiscal restraint, while at the same time meeting our most important national needs, the 1980 budget was subjected to a thorough and painstaking review. This budget reflects the President's view, repeated in his state of the Union message, that Government can be both competent and compassionate. That view was expressed in the direction that I received from the President to protect programs that truly help the disadvantaged and to reduce or end programs that are not effective. I believe that this budget complies with that directive.

The discipline imposed by the 1980 budget is not arbitrary. This budget provides better discipline over Federal spending by: (1) Recommending the reduction or elimination of lower priority programs; (2) proposing improvements in existing programs to make them more effective; (3) providing adequate resources for the higher priority programs, such as assistance for the disadvantaged; (4) reorganizing, consolidating, and targeting Federal activities; and (5) reducing and eliminating wasteful practices.

Mr. Chairman, you have asked me to comment on the economic assumptions in the budget and the relationship of the budget policy in relation to them. The short-range assumptions represent a forecast of how the economy will respond over the next 2 years, not

only to budgetary policies proposed by the President for 1979 and 1980, but to the President's anti-inflation program.

The long-range assumptions for 1981 to 1984 are not forecasts. They are projections of the economic performance that would be required to reach the 1983 goals of 4-percent unemployment and 3-percent inflation stipulated by the Humphrey-Hawkins Act, given necessarily uncertain projections of labor force and productivity growth.

The short term unemployment and inflation assumptions for 1979 and 1980 are consistent with the recognition that substantial further reductions in unemployment require that we first bring inflation under control. The likelihood of achieving the sustained economic growth required to reduce unemployment while inflation remains high is very small.

The economic assumptions for 1981-1984 represent very ambitious goals in that they would require simultaneously reducing inflation and unemployment very substantially. As the Humphrey-Hawkins Act indicates, these goals are unlikely to be achieved through aggregate fiscal and monetary policies alone. It will require a substantial reduction in structural unemployment. The administration is pursuing several strategies toward that end.

In the near term, we will continue to spend large amounts on programs that seek to reduce structural unemployment. Some 470,000 training and work experience opportunities are being sought for the economically disadvantaged under CETA title II-A, B, C and title III. Public service employment, with over \$4.9 billion in 1980 outlays for an average of 546,000 jobs, is being targeted more toward the structurally unemployed. Outlays of over \$2.1 billion for special employment programs for youths are requested, including funding of a wide range of carefully devised research and demonstration programs to help us begin to understand this especially serious aspect of the structural unemployment problem.

The administration will soon propose a welfare reform program, to take effect by 1982, that will emphasize incentives for permanent, unsubsidized employment for welfare recipients.

Perhaps most importantly, 1979 marks the implementation of two new efforts that signal the overall turn toward a direct attack on the problems of the disadvantaged. These are (1) the private sector initiative in CETA title VII that will finance a new partnership between government and private business, to enhance placement of the disadvantaged by all CETA and Employment Service activity; and (2) the targeted jobs tax credit which provides a special incentive for the employment of disadvantaged persons, particularly youth between the ages of 18 and 24. Both programs, proposed by this administration, are especially relevant to the concern expressed in the Humphrey-Hawkins Act that primary emphasis be given to the enlargement of employment opportunities in the private sector of the economy.

As you are well aware, the Federal Government has been spending billions on structural programs since the early sixties. We are constantly learning how to spend more wisely in this area, but we clearly still have much more to learn before we can say with confidence that anyone knows precisely how to substantially reduce structural unemployment in a noninflationary way and

accelerate progress toward the goals established in the Humphrey-Hawkins Act.

Mr. Chairman and members of the committee, the President has made proposals that will reduce the rate of inflation and dramatically improve the prospects for the development of the American economy in the coming decade. This is part of building a new economic foundation.

We need the consent of the Congress to begin to build this new foundation. We will be actively working with the authorizing committees to adopt legislative proposals that both increase program effectiveness and reduce the Government's burden on the taxpayer. All the Members of the Congress will be called to judge the President's budget recommendations. I urge that you endorse them.

Mr. Chairman, that concludes the highlights of my prepared statement and I would like the entire statement to be submitted for the record.

Senator BENTSEN. That will be done.

[The prepared statement of Mr. McIntyre follows:]

PREPARED STATEMENT OF HON. JAMES T. MCINTYRE, JR.

Mr. Chairman and Members of the Committee, I welcome this opportunity to discuss the President's 1980 budget with you. I understand that my colleagues—Fred Kahn, Mike Blumenthal and Charlie Schultze—have testified before this Committee at other times.

I know that Secretary Blumenthal and Chairman Schultze have discussed the Administration's fiscal policy and economic objectives with you in detail. I would like to discuss this subject briefly before turning to other aspects of the budget.

As we began to prepare the 1980 budget last year, we faced the harsh reality of accelerating inflation. Continued reports of good economic news, such as gains in employment and industrial production, seemed to be offset by almost daily reports of higher rates of inflation.

The proposals in this budget reflect the President's belief that our most important domestic priority is to bring inflation under control.

We simply cannot be content to live with rates of inflation as high as those we have experienced recently. No other economic problem is so acutely felt by the American people.

Inflation is terribly corrosive of social values. It intensifies the struggle over shares of a slowly growing economic pie. When economic standards are no longer reliable, all of us focus more attention, too much attention, on maintaining our economic status. The preoccupation with economic security through higher wages and higher prices becomes acute.

We must reduce the rate of inflation. However, the fiscal policies of the Administration attempt to avoid an abrupt—and unnecessary—swing to extreme restraint. A recession would bring, at best, slight and temporary relief from high inflation—relief that would come at the expense of the unemployed.

The fiscal policy in the budget, instead, applies moderate additional restraint to the economy, slowing down growth to insure that shortages and supply bottlenecks do not add to inflation. The best way to prevent a recession, and its high social costs, is to avoid the boom-and-bust cycle of fiscal policies.

In the longer term, this is the only prudent course. In combination with the wage and price standards, and with additional compliance induced by real wage insurance, this fiscal policy will permit a gradual reduction in the rate of inflation. A recession would not only cause great hardship, it would also retard investment activity and reduce productivity growth. A boom-and-bust cycle now would only make fighting inflation more difficult in the years to come.

Inflation is a long-term problem. It requires long-term solutions. We must be prepared to apply restraint to the economy for an extended period so that the rate of inflation comes down gradually. This fiscal policy should not be rapidly reversed. The rates of inflation that we have shown in the budget for 1979 and 1980 are far too high to be satisfactory.

The performance of the economy in the final months of 1978 has convinced me that we can continue moderate growth with a policy of restraint. The economy is fundamentally strong, and it will respond favorably to slower inflation.

The fight against inflation will not be waged by fiscal restraint alone. The wage and price standards are essential to the anti-inflation policy. These standards provide a basis for assessing the consistency of wage and price decisions with the national goal of lower inflation.

The public response to the standards so far has been encouraging. However, I believe that the Congress can improve compliance by passing the President's proposal for real wage insurance. This is an innovative proposal that is both fair and simple. It will increase the effectiveness of the wage and price standards and is a major part of the President's anti-inflation program.

The deceleration of inflation indicated by the standards is essential for continued prosperity. Fiscal restraint will thus result largely in lower inflation and only modestly in lower growth. Employment and real income will be higher if businesses and workers abide by the standards than if they do not.

This budget is lean and austere. I suggest four ways to demonstrate that restraint:

The growth in total outlays has been significantly reduced. This budget provides for outlays of \$531.6 billion in 1980, 7.7 percent more than in 1979. This is a somewhat slower rate of growth than the 9.4 percent increase between 1978 and 1979, and significantly slower than we have experienced over the past five years, when outlay growth averaged 12 percent per year.

The proposals in this budget reduce the percentage of gross national product and income spent by the Federal Government from 22.6 percent in 1976 to 21.2 percent in 1980. If continued restraint is exercised, we would expect that share to decline further in future years.

Another measure of the relative impact of fiscal policy is provided by the high-employment budget margin. Decreases in the high-employment deficit reflect a fiscal policy that is moving in the direction of restraint. The 1980 budget shows reductions in the high-employment deficit of \$8 billion in 1979 and of \$15 billion in 1980.

Finally, I would like to compare this budget with the current services budget estimate for 1980. The Administration's current services estimate, including projections of programs under existing law and the changes that would occur as a result of changes in the number of eligible beneficiaries without any changes in law, amounts to \$536.1 billion in 1980. As we put this budget together, \$11.6 billion in proposed program reductions below the current services level were partially offset by \$7.0 billion in proposed increases. The net reduction below the current services level amounts to \$4.5 billion in 1980. This is the first budget since the current services concept has been in general use that does not provide an increase over the current service level. Let me emphasize, that our method of computing the current service figures does not include any inflation increases for discretionary or nonindexed programs. Inclusion of an inflation adjustment for these programs would bring the total spending reduction to about \$12 billion.

By any of these measures, the President's 1980 budget provides the restraint that is appropriate to current economic conditions.

To achieve the required fiscal restraint, while at the same time meeting our most important national needs, the 1980 budget was subjected to a thorough and painstaking review. This budget reflects the President's view, repeated in his State of the Union Message, that government can be both competent and compassionate. That view was expressed in the direction that I received from the President to protect programs that truly help the disadvantaged and to reduce or end programs that are not effective. I believe that this budget complies with that directive.

The discipline imposed by the 1980 budget is not arbitrary. This budget provides better discipline over Federal spending by:

- Recommending the reduction or elimination of lower priority programs;
- Proposing improvements in existing programs to make them more effective;
- Providing adequate resources for the higher priority programs, such as assistance for the disadvantaged;
- Reorganizing, consolidating, and targeting Federal activities; and
- Reducing and eliminating wasteful practices.

The changes proposed for public employment programs provide a good example of the priorities and choices established in the budget. As the economic recovery has progressed, there are more jobs being created in the private sector and less need for countercyclical employment programs to assist those who were unemployed as a result of the 1974-1975 recession. At the same time, structural unemployment among minorities and the disadvantaged remains too high. The program proposals

in this budget redirect the CETA jobs program toward those who are most in need, the structurally unemployed.

Uncontrollable programs have not been exempt from scrutiny. For example, a number of adjustments are being proposed to the social security program that would result in savings of about \$600 million in 1980, \$1.6 billion in 1981, and \$2.9 billion in 1982. The features being proposed for change are largely special benefits that predate such programs as supplemental security income and the basic educational opportunities grants program. These provisions are now generally duplicative, and they can be more carefully targeted under the newer programs. Moreover, the changes move the social security system back in the direction of a retirement program directly related to work experience by eliminating some special benefits that are unrelated to past worker and employee contributions.

Similar scrutiny was given to developing the budgets for other Federal programs:

In national defense, the increases in funding are carefully directed to maintain our security and that of our NATO allies.

Programs for the disadvantaged received special attention, as a result of which there was a retargeting of some programs and an overall increase in the level of funding for these programs taken together.

To provide for the Nation's energy needs, funds were carefully allocated to reduce duplication and to provide us with a long-term reduction of our dependence on foreign energy sources.

Basic scientific research received enhanced support to increase the Nation's productivity and to invest in our technological future.

Preparing this budget has reminded us once more of the vast demands placed on our resources and the limited means we have to satisfy them. Having to face the dilemma of providing for essential national needs while restraining the Government's role in the economy forced us to develop principles for resolving this dilemma. Those that the President developed are:

We have an obligation to manage with excellence and to maintain proper priorities within the budget totals that are consistent with sound economic policy.

The budget must be kept within the bounds of appropriate economic policy. In today's world, economic policy calls for restraint.

The Government has no resources of its own; the only resources it can use are those that it collects from the taxpayer. We have an obligation to use these resources prudently.

Government action must be limited to those areas where its intervention is more likely to solve problems than to compound them.

Mr. Chairman, you have asked me to comment on the economic assumptions in the budget and the relationship of the budget's economic policy to them. The short-range economic assumptions for 1979 and 1980 represent a forecast of how the economy will respond over the next two years, not only to the budgetary policies proposed by the President for 1979 and 1980, but to the President's anti-inflation program. The long-range assumptions for 1981 to 1984 are not forecasts. They are projections of the economic performance that would be required to reach the 1983 goals of 4 percent unemployment and 3 percent inflation stipulated by the Humphrey-Hawkins Act, given necessarily uncertain projections of labor force and productivity growth.

The short-term unemployment and inflation assumptions for 1979 and 1980 are consistent with the recognition that substantial further reductions in unemployment require that we first bring inflation under control. The likelihood of achieving the sustained economic growth required to reduce unemployment while inflation remains high is very small.

The economic assumptions for 1981-1984 represent very ambitious goals, in that they would require simultaneously reducing inflation and unemployment very substantially. As the Humphrey-Hawkins Act indicates, these goals are unlikely to be achieved through aggregate fiscal and monetary policies alone. It will require a substantial reduction in structural unemployment. The Administration is pursuing several strategies toward that end.

In the near term, we will continue to spend large amounts on programs that seek to reduce structural unemployment. Some 470,000 training and work experience opportunities are being sought for the economically disadvantaged under CETA Title II-A,B,C and Title III. Public service employment, with over \$4.9 billion in 1980 outlays for an average of 546,000 jobs, is being targeted more toward the structurally unemployed. Outlays of over \$2.1 billion for special employment programs for youths are requested, including funding of a wide range of carefully devised research and demonstration programs to help us begin to understand this especially serious aspect of the structural unemployment problem.

The Administration will soon propose a welfare reform program, to take effect by 1982, that will emphasize incentives for permanent, unsubsidized employment for welfare recipients.

Perhaps most importantly, 1979 marks the implementation of two new efforts that signal the overall turn towards a direct attack on the problems of the disadvantaged. These are (1) the private sector initiative in CETA Title VII that will finance a new partnership between government and private business, to enhance placement of the disadvantaged by all CETA and Employment Service activity; and (2) the targeted jobs tax credit which provides a special incentive for the employment of disadvantaged persons, particularly youth between the ages of 18 and 24. Both programs, proposed by this Administration are especially relevant to the concern expressed in the Humphrey-Hawkins Act that primary emphasis be given to the enlargement of employment opportunities in the private sector of the economy.

As you are well aware, the Federal Government has been spending billions on structural programs since the early 1960s. We are constantly learning how to spend more wisely in this area, but we clearly still have much more to learn before we can say with confidence that anyone knows precisely how to substantially reduce structural unemployment in a non-inflationary way and accelerate progress towards the goals established in the Humphrey-Hawkins Act.

Mr. Chairman and Members of the Committee, the President has made proposals that will reduce the rate of inflation and dramatically improve the prospects for the development of the American economy in the coming decade. This is part of building a new economic foundation.

We need the consent of the Congress to begin to build this new foundation. We will be actively working with the authorizing committees to adopt legislative proposals that both increase program effectiveness and reduce the Government's burden on the taxpayer. All the Members of the Congress will be called to judge the President's budget recommendations. I urge that you endorse them.

Similarly, I ask that you support the other proposals that the President has made. Real wage insurance will enhance the prospects for winning the fight against inflation. It is an important and innovative new weapon in our anti-inflation arsenal. Those who dismiss it easily should be asked how they would stop inflation.

The President will make proposals for reform of the regulatory system and for substantial deregulation of the surface freight transportation system of the country. These proposals will be important in the fight against inflation and will need your support.

Slowing inflation will require the cooperation of all Americans. The President and his Administration can lead, but they alone cannot reduce inflation. I believe that the American people will cooperate, and I have confidence that the Congress will make restraining inflation paramount in their consideration of these proposals.

Mr. Chairman, this concludes my formal statement. I would be pleased to answer the Committee's questions.

Senator BENTSEN. We have been having full attendance on this committee until today. I assume the membership has had some of the same problems in getting here, not because of any lack of interest, because they are very much concerned about the President's budget and the economic issues facing us.

Let's turn to getting inflation down to 7.4 percent and productivity dropping to 0.4 percent and labor unit costs going up 8.1 percent. Do you have a contradiction in those figures? If so, what are the implications? They don't seem to add up to me.

Mr. MCINTYRE. Let me start off by saying that I am very concerned about the lack of productivity in this country. It has been going down rather rapidly in the past several years and it is the problem that causes us some great concern.

I am not certain that we know the answers to getting productivity turned around in the short term. However, that is not at all intended to mean that we are not seeking ways to get productivity turned around.

Senator BENTSEN. Let me ask about that. Last fall the President called for the formation of a National Productivity Council and you are chairman of it. What have you done about it?

Mr. McINTYRE. First of all, we held a meeting in December. We have established three task forces.

Senator BENTSEN. Do you have a staff?

Mr. McINTYRE. We have a staff we have borrowed from the various agencies.

Senator BENTSEN. Is there a staff allocated to that Council that they have under their control, dedicated to this effort?

Mr. McINTYRE. There is not a separate staff employed by the Council. The Council does have a staff that has been selected from respective agencies and has been asked to work on the Council's activities.

Senator BENTSEN. I don't see how you are going to accomplish much unless you have people there dedicated to that purpose without all of the conflicting requirements that they have. I am deeply concerned about this issue. I just hope we just don't go to rhetoric on it, but we try to work toward final solutions.

Mr. McINTYRE. I have a deep and abiding interest in this. It is not an issue relegated to rhetoric. We have taken some specific actions in the administration. Let me mention a couple of them before this Council was actually created.

First of all, in the Federal sector, which we can't overlook, we have 2 million employees, including the Postal Service.

Senator BENTSEN. I would hope you wouldn't.

Mr. McINTYRE. We have to focus on the Federal sector, which is one on which we have the most control. The previous Congress passed the Civil Service Reform Act which I think can do probably more than any other single action of the Congress and the administration to provide for improvements in Federal employee productivity. We are making a major effort to implement the new law right now.

We have given implementing civil service reform highest priority in the administration.

A second thing that we are trying to do, as we go through the budget process, is to improve technology that will provide for possible improvements in productivity. To that end, we have recommended real growth in the budget in basic research and development. It is not as much as we would have liked to have recommended, but when you consider that this entire budget represents a rather austere approach to funding Federal agencies, and when you consider that fact and the fact that we have actually provided for real growth in basic research, then I think that is another good example of evidence of the administration's commitment to doing things to increase productivity.

Senator BENTSEN. Let me ask you, will changes in productivity at the Federal level show up in the index? Is there an assumption that the increase in productivity at the Federal level is zero?

Mr. McINTYRE. Let me ask Mr. Ooms to address that.

Mr. OOMS. Mr. Chairman, it is certainly true our measures of inputs and outputs in the Federal sector are not such that they will necessarily reflect the types of productivity increase that we might—

Senator BENTSEN. We should be measuring the Federal Government along with the rest of the economy and decide whether we are really making some headway or losing ground.

Mr. OOMS. That's right. Mr. Chairman, it is not as easy to measure service sector output as in the Government as it is to measure the widgets, gadgets, automobiles, and other identifiable items produced in the manufacturing sector of the economy.

So there are some conceptual problems as well as practical problems in attempting to measure these things.

Senator BENTSEN. Mr. Director, I have introduced legislation concerning revenue sharing for the States. That is about \$2.25 billion. How in the world can we justify revenue sharing for the States when the Council of Governors Research Center estimates for 1979 indicate that not one of them is going to have a deficit, and we turn around, hopefully with a \$29 billion deficit, with some predicting \$40 billion? How can we talk about adding to the surplus of the States?

Mr. McINTYRE. Mr. Chairman, that is a very good question. That is a question I examined when we put the budget together.

As you know, the Revenue Sharing Act is authorized through the end of fiscal 1980. We expect to address the issue of general revenue sharing in the coming months and make proposals to the Congress. We are required by law to recommend reauthorization by May of this year, according to provisions of the Congressional Budget Act.

We are looking at that issue in the administration and will have our recommendations to you at the appropriate time. Let me tell you why I did not recommend amending the law and taking out revenue sharing in the 1980 budget. It was an issue that we seriously considered, but since Congress had already acted on that law, and since we would have to come back up this year with our recommendations on whether or not that law should be amended or whether it should be continued in its current form, or whether it should be just let go and not be reauthorized, we felt that was the appropriate time at which to address the issue.

In my judgment, had we come up with an amendment to the general revenue-sharing law, taking out the States' portion or the entire amount, we would have been subjected to some criticism about gimmicks in the budget. I tried to make sure that any proposals that we made with respect to legislation were proposals that we really felt we could get and we felt we could fight hard for and accomplish this.

Senator BENTSEN. Mr. Director, I think that is one we have an excellent chance of getting, and I don't think it has anything to do with accounting practices. I think it is a good point and one which has an excellent chance of passing in the Congress. All the opposition I have heard is from the hired lobbyists for the Governors. I have not yet heard from the Governors and I am not sure that I will, but I think you will see a lot of support from Governors.

Mr. McINTYRE. I think you will find some support from the Governors, but if it came to the administration and we took advantage of that type of savings in this budget, we would be subject to questioning on the Hill about it. At least that was my judgment, particularly since the law itself authorized—

Senator BENTSEN. You talked about cutting back on the social security benefits. You know, I have walked up that hill before and I will tell you it is pretty steep.

Mr. McINTYRE. When speaking of the social security benefits, we are talking about a \$115 billion program. We are talking about changes in the benefits that have a good programmatic basis because there are other programs in the Government that would cover the same individuals who would be affected by these benefit changes. We have proposed benefit changes that would reduce outlays by \$600 million, which is about one-half of 1 percent of a \$115 billion program. These are very minor changes in comparison to the total and, more important, changes that duplicate other Federal Government programs.

Senator BENTSEN. Let's get back to this question of revenue sharing with the States and your concern about having come up with a budget and being charged with gimmickry. Now you have it proposed. You had it proposed by a member of the Senate Finance Committee, by the chairman of the Joint Economic Committee and I don't think you would be charged with gimmickry if you just supported it.

Mr. McINTYRE. We will look at that in the administration and tell you what our position is.

Senator BENTSEN. My 10 minutes have expired.

Congressman Brown.

Representative BROWN. I don't know whether I should be on your side or his side, so I will pick a side of my own and go from there.

I don't notice much in your prepared statement about tax receipts, what you anticipate as receipts. How much have tax receipts increased between the 1978 and 1979 fiscal years? Do you have any estimate of that?

Mr. McINTYRE. We have a place in the budget where we actually give you the percentage increases.

Representative BROWN. I know it is in the budget, but it is not in your prepared statement and you did not address yourself to that in your testimony.

Mr. McINTYRE. The actual level of budget receipts was \$402 billion in 1978. We expect receipts in 1979 to be \$456 billion and \$502.6 billion in 1980. Then in the years of 1981 and 1982 the tax receipts under current law are shown to increase rather significantly to \$576.8 billion in 1981 and \$652.6 billion in 1982.

Representative BROWN. I want to talk about that a little bit, if I may.

How do you anticipate that those receipts will be increasing in 1980, 1981, and 1982?

Mr. McINTYRE. They will be increasing in several ways. Of course, in the individual income tax area, you have people moving to higher brackets by increases in their real personal income as well as by inflation pushing people into higher brackets.

Representative BROWN. What is the dollar figure for the latter?

Mr. McINTYRE. I will have to get that for you.

Representative BROWN. Would you supply that for the years you have just given me?

What occurs to me here is that that is an actual tax increase on individual citizens. I don't need to give any evidence of the fact that when somebody gets a cost-of-living increase of, say, 10 percent, their tax percentage goes up unless they happen to be in the highest brackets, so it is an increase in the income tax for those in

the lower income brackets. The upshot is that we get a sort of secret, hidden tax increase and the Government gets the benefit of it.

[The following information was subsequently supplied for the record:]

According to estimates prepared by the Office of Tax Analysis in the Treasury, inflation will cause individual income tax receipts to increase by \$8.8 billion in calendar year 1980 over calendar year 1979. The corresponding figures for calendar years 1980 and 1981 are \$20.6 billion and \$34.0 billion.

Mr. McINTYRE. That occurred this past year, and if you look at the budget, there are at least six places in the budget where we recognize this problem. We addressed the problem, and we specifically say that the administration will propose further fiscal actions and, in particular, further tax reductions during the period 1981 to 1984.

Representative BROWN. This would indicate a sharply higher increase.

Mr. McINTYRE. That is because the receipts do not take into account any changes in the tax laws, which you and I know happen fairly regularly throughout the process.

Representative BROWN. I would like to make them much more regular by law. I would like to see them indexed so that when the Government is not able to control inflation, the individual citizen does not have to pay for it through the nose, if that is the proper part of the anatomy through which we pay.

Mr. McINTYRE. It is a very hard thing to do. It will be difficult on the Congress as well, because you have to make certain decisions with respect to fiscal policy. If you limit your flexibility in how to deal with those decisions, then it is not only going to be hard on the budgetmakers, but it will be hard on other policymakers as well.

We think that tax burdens should be held down by tax cuts at the appropriate time. The appropriate time has to be determined by looking at the factual situation we are in.

Representative BROWN. The fact of the matter is that we have not done that historically. We have raised the burden on the middle income individual rather precipitously over the past few years. There was a time not too many years ago when people of average income paid no taxes at all. That has all gotten out of hand.

We have a tax rebellion going on now in the Congress and if the administration does not address it, the people are very likely to address it on their own initiative. We may find ourselves with a constitutional amendment which is written, not in Washington, but someplace else. Or we may find ourselves with a constitutional convention.

Mr. McINTYRE. Let me make this comment.

If you look at the tax system as a whole, you are correct. I could get you the breakdowns on the percentages for the record.

Representative BROWN. I would appreciate that.

[The following information was subsequently supplied for the record:]

The attached table shows individual income and employee social security tax liabilities as a percentage of personal income for the period from 1960 through 1979.

There was no significant change in the individual income tax share of personal income during this period; however, the employee social security share more than doubled from 1.4 percent to 3.1 percent.

If there are no changes in tax laws, both of these shares will rise between 1979 and 1984. Without a tax cut the individual income tax share will increase to over 13 percent and the employee social security share will increase to 3.5 percent.

INDIVIDUAL INCOME TAX LIABILITY AND EMPLOYEE SOCIAL SECURITY CONTRIBUTIONS AS A PERCENT OF INCOME

| Calendar year: | Income tax as a percent of personal income | Tax as a percent of personal income plus employee social security | |
|-------------------------|--|---|---|
| | | Employee social security tax only | Income tax and employee social security tax |
| 1960 | 9.9 | 1.4 | 11.1 |
| 1961 | 10.2 | 1.3 | 11.4 |
| 1962 | 10.2 | 1.4 | 11.4 |
| 1963 | 10.4 | 1.6 | 11.8 |
| 1964 | 9.5 | 1.5 | 10.9 |
| 1965 | 9.2 | 1.5 | 10.6 |
| 1966 | 9.6 | 2.0 | 11.4 |
| 1967 | 10.1 | 2.0 | 11.9 |
| 1968 | 11.2 | 2.1 | 13.1 |
| 1969 | 11.6 | 2.3 | 13.6 |
| 1970 | 10.5 | 2.2 | 12.5 |
| 1971 | 9.9 | 2.3 | 12.0 |
| 1972 | 9.9 | 2.4 | 12.1 |
| 1973 | 10.3 | 2.8 | 12.8 |
| 1974 | 10.7 | 2.9 | 13.3 |
| 1975 | 9.9 | 2.8 | 12.4 |
| 1976 | 10.3 | 2.8 | 12.8 |
| 1977 | 10.4 | 2.8 | 13.0 |
| 1978 ^a | 10.7 | 2.9 | 13.3 |
| 1979 ^a | 10.6 | 3.1 | 13.4 |

^a Estimated. Includes effects of legislation proposed in the 1980 budget.

Mr. McINTYRE. The increase has been largely due to social security and I think you are going to have to look at that issue in the Congress. That is exactly why we have tried to look at the long-range problem and make these very minor changes in benefits in social security that the chairman alluded to.

Representative BROWN. With all due respect, Mr. Director, a tax is a tax is a tax. It does not make any difference to the person who pays the tax what it is dedicated to. We pay all kinds of taxes in Ohio. One is supposed to pay for public schools, and yet we have public schools closing. The Federal Government is somewhat more precise in its dedication to social security funds, although I think the social security system has been used to cover some other things on a bookkeeping basis in the Federal Government.

I wouldn't get into that except to say that the tax does have to do with personal incentives, it seems to me, and that addresses the questions the chairman was addressing to you about the issue of productivity incentive. Productivity is related to investment, and the ability of the individual citizen to have money for investment

or to feel the incentive of extra investment of his own effort relates very much to taxes.

Mr. MCINTYRE. May I make the observation, though, that the tax bill which the President has just approved, recommended by this Congress, does provide some incentive for investment. We are just now seeing the effects of that law going into effect. It will take several months, perhaps a year, to judge the beneficial effects of the corporate effects provided in that tax reduction package.

Representative BROWN. If you will pardon my saying so, and I think the average citizen perceives it this way, it is not a generalized tax cut. It is a tax cut in income taxes and tax increase in social security taxes and the net impact for most Americans is a tax increase. And, with all due respect, I think most of them are cynical about government anyway and with the way this has worked out they are made even more cynical.

Mr. MCINTYRE. We think you will have to look at the benefit structures of programs like the social security system, particularly where the benefits duplicate other government programs. You will have to look at those situations and tie them into future tax reductions. That is exactly the route that this budget indicates the administration is looking to.

Representative BROWN. Mr. Director, let me just say, as the chairman said, we come from two different parts of the country and in some respects two different philosophies. Perhaps that is not a politically wise comment because, in the past, there have been efforts to cut impact aid to schools.

I think every President since Eisenhower has suggested that. It has never succeeded and I think its prospect of succeeding are between slim and zero, and I am optimistic about "slim." The President may believe it stands a chance of being accomplished in Congress, but it is not likely to be, so I think you have overestimated your reductions. I think you have overestimated your receipts.

We have had a couple of people come before this committee and suggest that the economic assumptions are not correct. Last week we were told that a number of private forecasters apparently believe the assumptions are too optimistic, and real economic growth next year may be negative. If that is the case, would you outline for us the changes in receipts and outlays so that we have some idea what the real budget situation will be?

You can do that for the record, if you like.

Mr. MCINTYRE. I think we have presented to you what the real problems are. We don't have the same economic forecast as some of the private economic forecasters.

Representative BROWN. Let's assume for the moment that you do face that problem next year. Where will you recommend increases. And what do you see in terms of receipts if you have half a percentage of unemployment increase. Can you give us some figures on that?

Mr. MCINTYRE. It is very difficult at this point without knowing the nature of the economic situation to say what we would recommend. It would depend to a large degree on the nature of the economy at that time and why the economic situation was different.

Representative BROWN. Let me try one other one. You are not really terribly responsive to my question.

Farmers are in town today asking for somewhere between 90 and 100 percent of parity. I have heard both comments from farmers in the group. Leaving your assumptions as they are now, what would happen now if the Congress decided to approve 100 percent parity for farmers?

Mr. McINTYRE. The first thing that would happen would be increased inflation.

Representative BROWN. Why?

Mr. McINTYRE. Higher prices.

Representative BROWN. And higher Federal expenditures, is that correct?

Mr. McINTYRE. I would not want to agree that all higher Federal expenditures would have a direct impact on inflation. It depends on the amount—

Representative BROWN. Say that again. You don't think that higher Federal expenditures would have anything to do with inflation?

Mr. McINTYRE. We are talking about a question of degree. I don't think it would have a significant effect. It becomes a matter of degree.

Representative BROWN. My time is up, but would you please submit for the record the impact on the budget with no other assumptions changed, because apparently you are unwilling to concede the possibility of changes in the economic circumstance from that optimistic base that you have put into this budget. But would you tell me what will happen if Congress should pass a 100-percent parity farm legislation in terms of the expenditures of the Federal Government?

Mr. McINTYRE. I would be glad to submit that for the record.

[The following information was subsequently supplied for the record:]

A year ago the Department of Agriculture analyzed the impact of the American Agriculture Movement's proposal to set all U.S. farm product prices at 100 percent of parity. It was assumed at the outset that this objective could be achieved by effectively controlling the quantities of farm products reaching the market. Therefore, Federal farm program costs would fall sharply rather than increase.

This does not mean, however, that the AAM proposal would have no impact on the budget.

Food prices would rise 20 percent leading to increased outlays in those program areas that are indexed to rise with living costs.

Unemployment would rise by about one-half of a percentage point causing increases in unemployment benefits and welfare outlays.

GNP would grow about one-half of a percentage point less, resulting in decreased revenues.

Mr. McINTYRE. Let me say I am not suggesting, Congressman Brown, that there are no other sets of economic assumptions which are viable. What I am saying is that we think we have a reasonable set of economic assumptions. They are the set that this budget is based on and it would be sheer folly for me to come up here and say we don't have any faith in those assumptions, and I am not going to do that because we do have faith in them. The strong showing of the economy in the fourth quarter of last year indicated that there is strength in the economy. Therefore, fiscal policy is designed to take account of that strength.

Senator BENTSEN. I promised to get you out of here by 12 noon, so I will ask a question or two and see if Congressman Brown would like to close.

What is your reaction to a constitutional amendment requiring a balanced budget, or requiring a limit on Federal spending relative to GNP?

Mr. McINTYRE. Let me say, first, this administration has had balancing the budget as one of its goals and objectives. This must be accomplished over a period of years because of the high deficits that we had when this administration took office. We think we should try to control Federal spending and the current budget proposals are designed to do that. However, it is our judgment that it would be unwise to put something in the Constitution. A constitutional amendment would not give us the flexibility that is needed in government to deal with the economic situation as we find it each time the budget is put together.

We think that we should try to balance the budget and achieve the reductions in Federal spending through careful and deliberate economic planning. Ultimately there is no substitute for making those tough economic decisions on a year-by-year basis as circumstances dictate and as we have been trying to do.

The deficit has been reduced substantially. The percentage that the Federal Government takes from the GNP has been reduced substantially since 1976. We think those are the best policies to use to achieve this balance.

If we were to have such a constitutional amendment, it could not be written flexibly enough and, therefore, it would have the effect of tying the hands of budgetary and fiscal policy. It could cause the Government to add to cyclical instability in the economy. It could prevent us from responding to economic recession, thereby causing massive unemployment and lower income for profits and investments.

Senator BENTSEN. Let me say that while you think about endorsing my proposal for ending revenue sharing to the States, remember there are about 25 such States calling for a constitutional amendment to balance our budget. I just want to help them in that regard and have a balanced budget as soon as we can.

Mr. McINTYRE. They are not only receiving benefits from revenue sharing, but if you count it, there is a total of \$82 billion grants-in-aid.

Senator BENTSEN. I understand that.

When we originally came up with the real wage insurance proposal, I was quite intrigued by it and it sounded pretty good. It is certainly a laudable objective. Then we had Chairman Schultze up here testifying and he said the budgetary impact of real insurance is limiting. He said, "If most workers comply with the wage standards, inflation is most likely not to exceed 7 percent." If it succeeds, we will pay less money. Isn't it possible you would get the worst of all worlds? You have things beyond wages, be it the cost of energy or interest on bank loans or food prices, and then you would have a situation that materially contributes to the deficit in the budget. That disturbs me very much.

I have some serious second thoughts about this insurance.

Mr. McINTYRE. You are absolutely correct, Mr. Chairman. There are things that could happen outside the area of wages that could have an impact on inflation. I have asked Mr. Ooms to look at some of these things and, Van, if you would, would you give the chairman some of our thoughts on that.

Mr. OOMS. Mr. Chairman, it is undoubtedly true that one can think of a set of circumstances such as those we faced in 1973-74, for example, in which there would be a significant effect on the budget. That is to say, you could have food prices rising by an amount well out of anyone's forecast at the moment. You could have massive shortages in—

Senator BENTSEN. You have spot oil contracts at \$20 now because of the Iranian situation.

Mr. OOMS. It is also understood that the energy situation is part of those possibilities. It is, nevertheless, the case that a higher rate of inflation, taken alone, although adding to the budget deficit through real wage insurance, has a larger positive effect on budget receipts through increases in corporate and individual income taxes.

I think the thing one has to be aware of here is if we are faced with a set of circumstances like that, the sort of circumstances that we faced in 1973-74 that are not only outside the range of this administration's forecast, but outside the range of commercial forecasters, we would need to look at fiscal policy in general. We no longer would be looking at a change of a billion dollars in receipts in a slightly different situation, but at a totally different economic environment than when the budget was put together.

You would have to look at the entire spending program and fiscal situation at that time.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Mr. McIntyre, I wonder if you would provide for the record of the committee, because we have to respond to the Council of Economic Advisers' statement on the budget for the Congress, the anticipated outlays and budget authority for off-budget Federal entities for fiscal years 1978-84.

Mr. McINTYRE. Yes, sir.

[The following information was subsequently supplied for the record:]

The attached table reports on the anticipated outlays and budget authority for off-budget Federal entities for fiscal years 1978-84.

Off-Budget Federal Entities
Outlays and Budget Authority, Fiscal Years 1978-1984
(in millions of dollars)

| | 1978 <u>Actual</u> | 1979 <u>Est.</u> | 1980 <u>Est.</u> | 1981 <u>Est.</u> | 1982 <u>Est.</u> | 1983 <u>Est.</u> | 1984 <u>Est.</u> |
|--|-----------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| <u>Outlays</u> | | | | | | | |
| Department of Agriculture: | | | | | | | |
| Rural electrification and telephone revolving fund | 62 | -- | -- | -- | -- | -- | -- |
| Rural telephone bank | 113 | 124 | 143 | 140 | 135 | 131 | 127 |
| Department of Labor: | | | | | | | |
| Pension Benefit Guaranty Corporation | -32 | -24 | -31 | -33 | -36 | -38 | -40 |
| Department of the Treasury: | | | | | | | |
| Federal Financing Bank .. | 10614 | 11477 | 11288 | 11300 | 11300 | 11300 | 11300 |
| Postal Service | -496 | 349 | 529 | 94 | -304 | -820 | -785 |
| U.S. Railway Association . | 66 | 63 | 27 | -- | -- | -- | -- |
| Total | 10327 | 11990 | 11956 | 11501 | 11096 | 10574 | 10602 |
| <u>Budget authority</u> | | | | | | | |
| Department of Agriculture: | | | | | | | |
| Rural electrification and telephone revolving fund | 355 | -- | -- | -- | -- | -- | -- |
| Rural telephone bank | 135 | 156 | 150 | 146 | 144 | 137 | 132 |
| Department of Labor: | | | | | | | |
| Pension Benefit Guaranty Corporation | -- | -- | -- | -- | -- | -- | -- |
| Department of the Treasury: | | | | | | | |
| Federal Financing Bank .. | 12659 | 15134 | 13869 | 14000 | 14000 | 14000 | 14000 |
| Postal Service | -- | -- | -- | -- | -- | -- | -- |
| U.S. Railway Association | 20 | 27 | 30 | 26 | 26 | 26 | 26 |
| Total | 13169 | 15317 | 14049 | 14172 | 14171 | 14164 | 14159 |

Note: Detail may not add to totals because of rounding. Source: Office of Management and Budget January 1979.

Representative BROWN. May we also have a list of those things in the budget that you consider to be uncontrollable, that is, expenditures which are included in the budget as estimates, but which under the law have no limitation if people are entitled to them?

I have in mind such things as USITA programs and social security benefits. If you could supply that, I would appreciate it.

Mr. McINTYRE. Controllability of outlays is on page 560 of the Budget of the U.S. Government, fiscal year 1980, itself. If you would like something more detailed than this, I would be glad to work up the additional detail.

Representative BROWN. If it can be done, I was seeking a list of the programs themselves, such as the food stamp program—not in great detail, but in a little more detail than what you have provided there.

Mr. McINTYRE. We can provide that.

[The following information was subsequently supplied for the record:]

The attached tables provide more detail of uncontrollable programs than was previously published in the budget.

BACKUP TABLE B.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE) PAYMENTS FOR INDIVIDUALS

[In millions of dollars]

| Description | 1978 actual | 1979 estimate | 1980 estimate | Change |
|---|----------------|------------------|------------------|---------------|
| Social security and railroad retirement: | | | | |
| Federal old-age and survivors trust fund (HEW)..... | 81,205 | 89,649 | 101,546 | 11,897 |
| Federal disability insurance trust fund (HEW) | 12,655 | 14,056 | 15,740 | 1,685 |
| Receipts from Federal old-age and survivors trust fund (HEW) | -1,618 | -1,386 | -1,440 | -54 |
| Railroad retirement account (RRB) | 3,983 | 4,267 | 4,581 | 314 |
| Total, social security and railroad retirement..... | <u>96,225</u> | <u>106,585</u> | <u>120,427</u> | <u>13,842</u> |
| Federal retirement and insurance: | | | | |
| Military retired pay | <u>9,171</u> | <u>10,281</u> | <u>11,435</u> | <u>1,154</u> |
| Civilian programs: | | | | |
| Civil service retirement and disability fund..... | 10,908 | 12,371 | 14,035 | 1,664 |
| Special benefits (Department of Labor) | 174 | 228 | 304 | 76 |
| Coast Guard retired pay | 156 | 178 | 198 | 21 |
| Foreign service retirement and disability fund | 94 | 113 | 128 | 15 |
| Retirement pay and medical benefits (PHS) | 52 | 60 | 71 | 10 |
| Employees health benefits fund | -85 | -158 | -131 | 26 |
| Employees life insurance fund..... | -485 | -324 | -341 | -17 |
| Retired employees health benefits fund | 6 | 3 | 2 | 1 |
| Contribution for annuity benefits..... | 5 | 8 | 8 | 0 |
| Agency payments for salaries of reemployed an- nuitants..... | -18 | -20 | -20 | 0 |
| Total, Federal retirement and insurance, civilian programs | <u>10,806</u> | <u>12,459</u> | <u>14,253</u> | <u>1,794</u> |
| Unemployment assistance: | | | | |
| Unemployment trust fund | 11,169 | 11,000 | 13,100 | 2,100 |
| Federal unemployment benefits and allowances..... | 1,165 | 820 | 950 | 130 |

BACKUP TABLE B.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE) PAYMENTS FOR INDIVIDUALS—Continued

(In millions of dollars)

| Description | 1978 actual | 1979 estimate | 1980 estimate | Change |
|---|----------------|------------------|------------------|--------|
| Advances to the unemployment trust fund and other Funds | 1,086 | | | |
| Repayable advances from general fund for Federal unemployment account and for advances for extended benefits..... | -1,045 | -800 | -900 | -100 |
| Total, unemployment assistance..... | 12,376 | 11,020 | 13,150 | 2,130 |
| Veterans benefits: Pensions, compensation, education, and insurance: | | | | |
| Compensation and pensions | 9,573 | 10,637 | 11,183 | 546 |
| Readjustment benefits | 3,362 | 2,741 | 2,294 | -448 |
| National service life insurance fund | 668 | 740 | 771 | 31 |
| Other VA insurance and education funds | -493 | -496 | -503 | -6 |
| Total, veterans benefits | 13,110 | 13,622 | 13,745 | 123 |
| Medicare and medicaid: | | | | |
| Grants to States for medicaid | 10,680 | 11,804 | 12,374 | 570 |
| Federal hospital insurance trust fund..... | 17,862 | 20,728 | 23,670 | 2,942 |
| Federal supplementary medical insurance trust fund.... | 7,350 | 8,771 | 10,153 | 1,382 |
| Total, medicare and medicaid..... | 35,891 | 41,303 | 46,197 | 4,894 |
| Housing payments: | | | | |
| Housing payments (HUD) | 2,920 | 3,588 | 4,404 | 816 |
| Payments for operation of low-income housing projects | 691 | 652 | 720 | 68 |
| Total, housing payments | 3,612 | 4,240 | 5,124 | 884 |
| Public assistance and related programs: | | | | |
| Child nutrition programs (USDA) | 2,527 | 2,669 | 3,022 | 353 |
| Food stamp program (USDA) | 5,499 | 6,321 | 6,877 | 556 |
| Special milk program (USDA) | 139 | 140 | 32 | -108 |
| Assistance payments program (HEW) | 6,639 | 6,702 | 6,961 | 259 |
| Special benefits for disabled coal miners | 982 | 995 | 1,004 | 9 |
| Supplemental security income program | 5,855 | 5,558 | 6,340 | 782 |
| Payment where credit exceeds liability for tax | 881 | 841 | 1,547 | 706 |
| Regional rail transportation protective account | 80 | 100 | | -100 |
| Black lung disability trust fund (DOL) | 27 | 309 | 455 | 146 |
| Special benefits and special workers' compensation expenses (DOL) | 23 | 8 | 9 | 1 |
| Total, public assistance and related programs | 22,651 | 23,642 | 26,247 | 2,605 |
| Total—Payments for individuals..... | 203,843 | 223,153 | 250,578 | 27,425 |

BACKUP TABLE C.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE), NET INTEREST, GENERAL REVENUE SHARING, AND FARM PRICE SUPPORTS

(In millions of dollars)

| Description | 1978 actual | 1979 estimate | 1980 estimate | Change |
|-----------------------------------|----------------|------------------|------------------|--------|
| Net interest: | | | | |
| Interest on the public debt | 49,020 | 60,129 | 66,034 | 5,905 |

BACKUP TABLE C.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE), NET INTEREST, GENERAL REVENUE SHARING, AND FARM PRICE SUPPORTS—Continued

[In millions of dollars]

| Description | 1978 actual | 1979 estimate | 1980 estimate | Change |
|---|----------------|------------------|------------------|---------|
| Interest (offsetting receipts) ¹ | — 13,585 | — 17,137 | — 19,864 | — 2,727 |
| Total, net interest..... | 35,435 | 42,992 | 46,170 | 3,178 |
| General revenue sharing: State and local government fiscal assistance trust fund..... | 6,823 | 6,852 | 6,863 | 10 |
| Farm price supports: Price support and related programs, reimbursement for net realized losses..... | 5,509 | 4,986 | 2,785 | — 2,201 |
| Total..... | 47,767 | 54,830 | 55,818 | 987 |

¹ Proposed legislation in open-ended programs and fixed costs includes \$8 million in 1979 and \$88 million in 1980.

BACKUP TABLE D.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE) AND OTHER OPEN-ENDED PROGRAMS AND FIXED COSTS

[In millions of dollars]

| Description | 1978 actual | 1979 estimate | 1980 estimate | Change |
|---|----------------|------------------|------------------|--------|
| Payment to the Postal Service..... | 1,778 | 1,803 | 1,698 | — 106 |
| Legislative and Judiciary (excluding interest payments to miscellaneous trust funds)..... | 1,484 | 1,738 | 1,925 | 188 |
| All other relatively uncontrollable outlays: | | | | |
| Funds appropriated to the President: | | | | |
| Disaster relief..... | 461 | 276 | 241 | — 34 |
| Advances, foreign military sales (net) | — 341 | — 100 | | 100 |
| International financial institutions..... | 858 | 857 | 1,023 | 165 |
| Agriculture: Forest service permanent appropriations..... | 328 | 347 | 421 | 75 |
| Commerce: Operating differential subsidies..... | 303 | 293 | 307 | 14 |
| HEW: | | | | |
| Grants to states for social services and child welfare services..... | 2,809 | 2,965 | 2,586 | — 379 |
| Human development services (social services) | 1,517 | 1,499 | 1,680 | 181 |
| HUD: | | | | |
| Federal housing administration fund..... | 357 | 111 | 34 | — 77 |
| New Communities fund..... | 97 | 43 | 35 | — 8 |
| Interior: Miscellaneous trust funds and permanent appropriations (special funds)..... | 257 | 229 | 276 | 46 |
| State: Contributions to international organizations..... | 332 | 371 | 439 | 68 |
| Treasury: | | | | |
| Charges for administrative expenses of trust funds (offsetting receipts)..... | — 169 | — 164 | — 173 | — 9 |
| Claims, judgments and relief acts..... | 198 | 238 | 152 | — 86 |
| Miscellaneous permanent appropriations (special funds)..... | 237 | 290 | 86 | — 204 |
| Internal revenue collections for Puerto Rico..... | 188 | 210 | 220 | 10 |
| Veterans Administration: Loan guaranty revolving fund..... | 80 | 157 | 30 | — 186 |
| Other independent agencies: | | | | |
| FDIC fund..... | — 567 | — 1,121 | — 1,192 | — 71 |
| FSLIC fund..... | — 404 | — 391 | — 506 | — 115 |
| Payments to air carriers (CAB) | 77 | 73 | 72 | — 1 |
| Other small accounts and offsetting receipts..... | 118 | 424 | 530 | 106 |
| Total all other..... | 6,736 | 6,607 | 6,201 | — 406 |

BACKUP TABLE D.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE) AND OTHER OPEN-ENDED PROGRAMS AND FIXED COSTS—Continued

[In millions of dollars]

| Description | 1978 actual | 1979 estimate | 1980 estimate | Change |
|---|----------------|------------------|------------------|--------|
| Total, other open-ended programs and fixed costs, relatively uncontrollable | 9,998 | 10,148 | 9,824 | —324 |

SUMMARY—BACKUP TABLE E.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE) AND NATIONAL DEFENSE OUTLAYS FROM PRIOR-YEAR CONTRACTS AND OBLIGATIONS

[In millions of dollars]

| | 1978 actual | 1979 estimate | 1980 estimate | Change |
|--|----------------|------------------|------------------|--------|
| Defense—Military | 27,371 | 31,417 | 35,729 | 4,312 |
| Department of Energy | 777 | 953 | 1,361 | 408 |
| Other agencies | 50 | 63 | 36 | 28 |
| Total, national defense, outlays from prior-year contracts and obligations | 28,198 | 32,433 | 37,126 | 4,692 |

BACKUP TABLE F.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE) AND CIVILIAN PROGRAMS, OUTLAYS FROM PRIOR-YEAR CONTRACTS AND OBLIGATIONS

[In millions of dollars]

| Agency | 1978 actual | 1979 estimate | 1980 estimate | Change |
|--|----------------|------------------|------------------|--------|
| Funds appropriated to the President | 2,420 | 2,506 | 2,750 | 244 |
| Agriculture | 1,354 | 1,594 | 1,461 | —133 |
| Commerce | 3,911 | 2,845 | 1,310 | —1,535 |
| Defense—Civil | 654 | 744 | 975 | 231 |
| Energy | 1,064 | 4,556 | 2,044 | —2,512 |
| HEW | 9,553 | 11,274 | 12,718 | 1,444 |
| HUD | 3,364 | 4,037 | 5,351 | 1,314 |
| Interior | 1,120 | 1,291 | 1,678 | 387 |
| Justice | 762 | 794 | 720 | —74 |
| Labor | 4,664 | 2,772 | 2,857 | 85 |
| State | 131 | 127 | 221 | 94 |
| Transportation | 7,779 | 8,826 | 9,495 | 669 |
| Treasury | 209 | 231 | 190 | —41 |
| Environmental Protection Agency | 3,445 | 3,410 | 3,918 | 508 |
| GSA | 190 | 409 | 381 | —28 |
| NASA | 671 | 635 | 1,024 | 389 |
| VA | 746 | 867 | 929 | 62 |
| Other independent agencies: | | | | |
| ACTION, operating expenses | 56 | 65 | 58 | —7 |
| Community Services Administration, community services program | 310 | 359 | 274 | —85 |
| Export-Import Bank | 106 | 91 | 561 | 470 |
| Federal Emergency Management Agency | 131 | 101 | 68 | —33 |
| Washington Metropolitan Area Transit Authority, Federal contribution | 98 | 72 | 32 | —40 |
| National Foundation for the Arts and Humanities | 127 | 77 | 113 | 36 |
| National Science Foundation | 391 | 442 | 405 | —37 |
| Small Business Administration | 456 | 707 | 417 | —290 |

BACKUP TABLE F.—1980 BUDGET: CONTROLLABILITY OF BUDGET OUTLAYS (RELATIVELY UNCONTROLLABLE) AND CIVILIAN PROGRAMS, OUTLAYS FROM PRIOR-YEAR CONTRACTS AND OBLIGATIONS—Continued

[In millions of dollars]

| Agency | 1978 actual | 1979 estimate | 1980 estimate | Change |
|---|----------------|------------------|------------------|--------|
| Tennessee Valley Authority fund..... | 352 | 433 | 526 | 93 |
| Other..... | 263 | 362 | 280 | -82 |
| Total, civilian programs, outlays from prior-year contracts and obligations..... | 44,115 | 49,627 | 50,756 | 1,129 |

Representative BROWN. You seem to be very firm on what would happen if your assumptions are wrong. Let me ask this: If you are wrong in your predictions of the effects of those policies you are asking Congress to implement; such as reduce social security benefits and some of the educational outlays and so forth, is the President prepared to veto bills that increase budgeted outlays beyond those items, beyond those budget estimates for expenditures and what you have recommended in the budget?

Mr. McINTYRE. I do not know what the President would do under such a general set of circumstances. As a generality, however, I can tell you if an authorizing bill or appropriation bill has the effect of busting the budget, I will not hesitate to recommend to the President that he disapprove that legislation.

Representative BROWN. Good.

Let me ask you now to make two other assumptions and give us some figures. One is an assumption that sees unemployment at the end of the year go up from 6.2, as you have predicted, to 6.7 percent, and another one that sees economic growth drop 2.25 percent, which the Council of Economic Advisers sees for real growth for the coming year, down to A or B percent growth rate.

If you can give me some idea of what will happen to the budget only on that basis, I would appreciate it.

Mr. McINTYRE. Yes, sir.

[The following information was subsequently supplied for the record:]

The President's budget requests are based upon the economic assumptions shown in the budget document. These economic assumptions are needed to make outlay estimates in a large number of programs and receipts estimates for several types of taxes. It is not possible to make these estimates with the same precision for alternative sets of economic assumptions.

However, it is possible to employ some fairly reliable rules of thumb to estimate the effects of alternative economic assumptions upon spending, receipts and the deficit. If the rate of inflation beginning in the first quarter of 1979, is one percentage point higher than assumed, and other factors are unchanged, outlays, receipts and the deficit would be changed as follows:

[In billions of dollars]

| | Fiscal 1979 | Fiscal 1980 |
|--------------------------------------|-------------|-------------|
| Outlays..... | +0.7 | +3.6 |
| Receipts..... | +2.1 | +4.2 |
| Deficit (decrease)..... | -1.4 | -0.6 |
| (Excluding real wage insurance)..... | -1.4 | -5.0 |

A one percentage point reduction in the rate of growth of real output over the same period, with other factors unchanged, would affect outlays, receipts and the deficit approximately as follows:

(In billions of dollars)

| | Fiscal 1979 | Fiscal 1980 |
|-------------------------|-------------|-------------|
| Outlays..... | 0.4 | 1.9 |
| Receipts..... | -2.1 | -8.3 |
| Deficit (increase)..... | 2.5 | 10.2 |

The effects of higher unemployment rates are subsumed in the effects of lower real growth. At present one percentage point less real growth would typically produce about a one-third to one-half of one percentage point increase in the unemployment rate. It is then possible to estimate the effects on the budget of higher unemployment by extrapolating from the table above.

Representative BROWN. I would conclude by saying that two very distinguished economists, the former Chairman of the Council of Economic Advisers, Alan Greenspan, and Chase's economist, estimate deficits closer to \$50 billion than \$30 billion. So I don't think my request is out of line because some of those assumptions go into their figures.

Finally, the Congressional Budget Office estimates the size of the deficit is really going to be closer to \$50 billion rather than the optimistic \$30 billion which you were predicting. I would have to say I hope your optimism is correct. Frankly, I would have preferred to see that budget deficit closer to \$15 billion rather than \$30 billion. I think that is the only way we are going to get inflation under control and if we don't get it under control, the bottom will be dropping out of everything, which is a possibility that has appeared increasingly ominous in the last decade or so as a result of Congress proclivity for spending and its neglect of that part of Keynesian economic theory that would dictate a budget surplus any time we have any kind of recovery.

I think the President is subject to a similar inability to take the proper action in office. I hope he is becoming a fiscal conservative, which I think you are.

Mr. McINTYRE. And have been for some time.

Representative BROWN. That record is perhaps as well established as the President's is, because you are replacing Mr. Lance. I am comforted by your willingness to recommend the vetos. I just want to see you hang in there. I have you on record on that issue.

Mr. McINTYRE. Let me ask you one question, Congressman Brown.

We will need some additional information to provide you the figures you asked for under those two sets of economic changes, one being unemployment and the other in growth. Is it permissible for us to work with your staff and would you tell me with whom we should work?

Representative BROWN. Get in touch with Mr. Bradford, who is the ranking staff man on the minority side. He can provide whatever information you need on the subject.

Mr. McINTYRE. My second point: We have recognized some of the difficulties in characterizing fiscal policy only with a deficit figure because of the automatic stabilizers in the budget. We recognize

that receipts, especially, are sensitive to the economy. Accordingly, in my prepared statement and in my summary of that prepared statement before the committee I tried to emphasize the expenditure side of the budget, the outlays.

If you look at outlays, they do represent a restraint in growth. They do represent a smaller share than the Federal Government is taking out of the gross national product. They do contribute to further decreases in the high-employment deficit. The expenditures that the Federal Government makes are extremely significant and important.

We have tried to increase the awareness of the effects of expenditures, just as some people are exhibiting about the effects of the deficits. Your point about expenditures is well taken and one which I would urge the Congress to keep in mind under any of the economic scenarios you have mentioned.

We have to look at the total amount the Federal Government proposes to spend. We would urge the Congress not to exceed the recommendations the President has made for Federal spending.

Representative BROWN. I join you in that and let me say for your benefit, and for that of the Chairman, that I don't consider myself an identifiable economist. By that, I mean that I do not identify myself as either a "fiscalist" or a "monetarist." I think there is a lot of psychology in economics. I think different things affect different people at different times in different ways.

I think we need to control expenditures and deficits, and we would be served well by a tax cut which would restore some incentives to our society. Those three things have to be achieved with some degree of balance, of course. So, I am more interested in your assumptions at the moment than I am with embarrassing you with any thought of what happens in the event of a half percent increase in unemployment.

I want to know what you think is going to happen in the event something totally separate from your Federal budget affects the growth rate. Perhaps inflation in general is the result of energy policy, which is totally out of your control at the moment, or at least significantly so.

Senator BENTSEN. Let me say I strongly commend the President for breaking that line in budget deficits and bringing out what I think is a lean budget, and I will be very supportive of keeping it that way.

We are very pleased that you could come to testify this morning. The committee is recessed.

[Whereupon, at 12:10 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 6, 1979.]

THE 1979 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 6, 1979

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. William Proxmire (member of the committee) presiding.

Present: Senator Proxmire and Representative Rousselot.

Also present: Louis C. Krauthoff II, assistant director-director, SSEC; Richard F. Kaufman, assistant director-general counsel; John M. Albertine, L. Douglas Lee, and Thomas F. Dernburg, professional staff members; Mark Borchelt, administrative assistant; Katie MacArthur, press assistant; and Stephen J. Entin and Robert H. Aten, minority professional staff members.

OPENING STATEMENT OF SENATOR PROXMIRE, PRESIDING

Senator PROXMIRE. This morning I am pleased to welcome a distinguished panel of experts to discuss current fiscal and monetary policies. Our witnesses are Alan Greenspan, former Chairman of the Council of Economic Advisers; Nancy S. Barrett, director, Program of Research on Women and Family Policy, the Urban Institute, and formerly with the Congressional Budget Office; Carl Christ, professor of economics at the Johns Hopkins University; and Ray C. Fair, professor of economics at Yale University.

Your assistance to the committee at this time could not be more timely. If we knew only that unemployment averaged 6 percent in 1978 and is expected to go higher this year, we would be calling for expansionary policies.

On the other hand, if we knew only that consumer prices accelerated throughout 1978 and that the CPI would be 9 percent higher in December than it was 1 year ago, we would be stepping on the monetary-fiscal brakes.

That is our quandary. How can we stop the inflation without stopping the economy?

A second issue that we are very much concerned about is the mix of monetary and fiscal policy. Some time ago, Professor Franco Modigliani told our Subcommittee on International Economics that one of our problems is that we have attempted to slow inflation by means of tight money.

The result, frequently, has been recession and we have responded to that by tax cuts and other forms of fiscal stimulus. Repetition of that sequence has produced a consumption oriented policy mix that

causes high interest rates and massive budget deficits. It also places a drag on capital spending and home construction and thus, perhaps, accounts for our recent poor productivity and unit labor cost performance.

Welcome to this hearing. I hope you will address yourselves to the issues I have raised in my opening statement.

We are very delighted to have this distinguished panel before us. Mr. Greenspan, go right ahead.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC., NEW YORK, N.Y., AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. GREENSPAN. Thank you, Senator.

While I intend to address all of the issues which you raised in your opening remarks some time this morning, I would like to concentrate on just a few of them in my opening statement.

There can be little doubt that in recent months the President has endeavored to some degree to restrain Federal spending and is sincere in his desire to sharply reduce and, ultimately, balance the budget.

In the context of the current services budget, there is some element of restraint implicit in the document the President presented to the Congress in January. I regret only that this administration did not sense the dangers of inflationary fiscal policy when it first came into office. Had it done so, I believe we would be much farther along the road to restoring a noninflationary economic environment than we are today.

Let us not forget that the then outgoing President Ford proposed outlays for fiscal 1981 of \$527 billion, \$51 billion less than President Carter is currently proposing for that year. Only a small part of the difference reflects cutbacks advocated by President Ford which President Carter has not chosen to follow.

Certainly, little of the gap can be attributed to a change in economic forecasts. The current projections for 1980 and 1981 are not substantially different from those of the outgoing Ford administration. The difference lies largely in new programs advocated by President Carter and/or passed by the Congress.

From the context of someone who has been intimately involved in attempting to curtail a budget with vast political constituencies supporting it, I admire much of what the President and his budget people have endeavored to do in the last several months. Nonetheless, I do not believe they have gone far enough in curtailing the growth in outlays. It is becoming increasingly evident that we must create a far more effective mechanism to restrain outlay expansion.

The basic problem, as we have all observed, is that, while restraint in total outlays is supported by virtually everybody, when it comes to a specific expenditure proposal, the short-term benefits to a specific constituency tend to override the long-term costs to the Nation as a whole.

The current services budget estimates for future years invariably indicate that expenditure growth will slow rather markedly. But this is partly illusory, since there is an implicit assumption that

the Congress will be on vacation 52 weeks a year and will add no new spending to the budget.

We often forget that there is a special type of uncontrollable spending which is built into our political system. It derives from the fact that the Congress meets for extended periods each year and that most bills on which committees hold hearings have a significant price tag on them. It is rare that a congressional committee will meet in extended session on an inconsequential budgetary matter, unless it has wide political or media interest. One cannot tell in advance which particular bills will pass or which particular expenditures will be authorized.

However, we would not be terribly far off if we specified a certain aggregate level of newly authorized outlays per day of congressional session. This, in a certain sense, is as much an uncontrollable add-on as previously mandated outlays.

It appears, therefore, that the only way in which we can curb a rate of growth in Federal outlays which outruns the revenue raising capacity of the economy is to impose some form of constitutional restraint on outlays.

I say this with great reluctance. Constitutional amendments should not have to deal with technical problems such as those which now confront us on the budget.

However, given our institutional structure, I see little hope of achieving the type of restraint that our economy requires other than through the Constitution.

Now, it may be that rather than focus on a particular level of outlay growth, real or relative to GNP, which would be difficult to monitor, we can probably resolve the outlay growth problem by requiring that all budget authority, appropriation, and expenditure bills be passed by two-thirds, rather than a simple majority of both houses and signed by the President.

A Presidential veto, in that case, would merely require that the two-thirds vote be reaffirmed. Such a procedure would avoid many of the problems associated with defining an appropriate constitutional amendment. It would not, however, resolve the problem of defining what in fact constitutes expenditures.

I have no doubt that if we restrain what is covered under the current definition of outlay or expenditure by some legal prohibition, the Congress, in its wisdom, will find alternate means to accomplish what it ordinarily would do on the expenditure side.

However, I nonetheless believe that such means are limited and that, while we can never expect any particular constitutional amendment, either one requiring a two-thirds vote on money bills or one restricting the level of outlays generally, to be fully effective, it clearly will have a major impact on restraining the growth of the Federal sector.

Restraining budget outlays, however, will not be enough in itself. We must focus not only on on-budget outlays and financial requirements, but on all of the direct and indirect preemptions of private savings embodied in Federal policy as well. The inflationary impact of the Federal Government is only partly related to the on-budget deficit financing requirements and I believe we take far too simplistic a view by employing the deficit as our sole measure of fiscal policy.

Off-budget borrowing has risen sharply in recent years. So have mandated capital investment by business—pollution, safety equipment, et cetera—which must be financed; and matching grants, which have induced increased spending and borrowing by State and local governments. These demands have added heavily to capital market pressures, but in total, have been small compared with the extraordinary expansion in mortgage credit.

Prior to the 1970's, an increase in mortgage credit on one- to four-family homes rarely exceeded \$15 billion per year. During the past year, the increase has approached \$100 billion. Changes in institutional structures and subsidy programs sponsored by the Federal Government, from mortgage-backed bonds to the newest 6-month certificates tied to the Treasury bill rate, have been responsible for this explosion in mortgage credit.

As a result, we have arrived at a point where we no longer have the luxury of employing sophisticated mixes of fiscal and monetary policy. Monetary policy has become increasingly hostage to fiscal policy in recent years. Until we reduce the aggregate drains on the credit markets created by Federal policy, direct and indirect, the Federal Reserve will have little leeway to pursue a discretionary monetary policy.

We have largely run out of options which enable us to calibrate various degrees of monetary restraint and budgetary stimulus. Unless we apply strong restraining policies, both on the fiscal and the monetary side, we risk being unable to subdue, and ultimately defuse, the inflationary pressures which undercut the productivity of the American economy.

There is no question that policies of restraint risk the inadvertent triggering of a recession. But we have procrastinated so long in suppressing inflationary pressures, that we have run out of low-risk policies.

I can readily envisage an easier monetary policy carrying economic growth and employment through the end of this year and into 1980. But that could be done only through increasingly more stimulative monetary and fiscal policies. This would accelerate inflation at a prodigious cost to the economy and the Nation in 1980 and beyond. We cannot eliminate a confrontation with the inflationary forces which now grip the economy. We can, perhaps, postpone the inevitable date, but at increasingly negative tradeoffs between inflation and recession.

We no longer have a broad set of options available to us. Policy, in my judgment, must focus on reducing the credit pressures engendered by the Federal Government, thereby enabling the Federal Reserve to reduce the rate of growth of the monetary aggregates without driving interest rates sharply higher. The Federal Reserve's ability to lower interest rates in the context of heavy credit demands from the Treasury and other Federal preemptors of credit is currently extremely limited.

Senator PROXMIRE. Thank you very much, Mr. Greenspan.

Mr. Fair, please proceed.

STATEMENT OF RAY C. FAIR, PROFESSOR OF ECONOMICS,
YALE UNIVERSITY

Mr. FAIR. I have been asked to comment on the appropriateness of the monetary policy—fiscal policy mix for fiscal year 1980 in light of the administration's budget. I have also been asked to comment on Prof. Franco Modigliani's complaint at the recent set of hearings of the Subcommittee on International Economics that the current mix is too heavily weighted toward a tight monetary policy.

The question of whether the mix is appropriate or not is difficult to answer because much more is known about future fiscal policy than about future monetary policy. For the first three quarters of 1979, we know roughly what fiscal policy will be from the fiscal year 1979 budget, and for fiscal year 1980, we have the administration's budget to help us predict what fiscal policy will be. For monetary policy, on the other hand, one has little to go on except to extrapolate past behavior of the Federal Reserve. My answer to the question about the appropriateness of the mix is thus that it depends on what future monetary policy will be, about which we know very little. Since this answer is not very satisfying, I will try to be more specific.

If the Federal Reserve allows short-term rates to fall by 1 or 2 percentage points during the next year and a half, then the administration's budget seems about right to me. I should add that I am only talking about the macroeconomic implications of the budget. Obviously, similar macroeconomic goals can be achieved with, for example, quite different allocations of expenditures among categories. The President's budget is, by his own admission, lean and austere, and in view of this, it seems to me that a somewhat easier monetary policy is needed to avoid such things as a significant rise in the unemployment rate.

Note that if monetary policy does ease relative to fiscal policy, this will help meet Professor Modigliani's complaint. I agree that monetary policy has been too tight relative to fiscal policy in the past year, and I hope the Federal Reserve will ease its policy in light of the proposed budget.

I might add in support of Professor Modigliani's complaint that my econometric work indicates that a tight monetary policy is, other things being equal, inflationary. A rise in interest rates increases costs, and my work indicates that at least some of these higher costs are passed along in the form of higher prices. This increase in prices is in addition to the obvious increase in the consumer price index that results from a rise in the interest rates that are a part of the index itself. So as not to give a misleading impression about the effects of monetary policy on inflation, it should be noted that a tight monetary policy also cuts aggregate demand, which is, other things being equal, deflationary. The net effect of a tight monetary policy on inflation is thus ambiguous. The important point here, however, is not whether the net effect is inflationary or deflationary—my work indicates that it is deflationary—but that a mix of tight money and an easy fiscal policy is likely to be more inflationary or less deflationary than is a mix of easy money and a tight fiscal policy. This is particularly true if the

tight fiscal policy is a result of expenditure cuts rather than tax increases.

Coming back now to the assumption about the behavior of the Federal Reserve. If the Federal Reserve is not going to ease its policy in the next year and a half, then I think the administration's budget is too restrictive. In this case, I would argue for more expenditures or lower tax rates.

In the time left, I would like to make two further points about the present situation that I think it is important to keep in mind as the economic events for the year develop. The first concerns the impact of a tight monetary policy on housing investment and plant and equipment investment. With the recent reforms that have taken place in the financial sector, there is now less credit rationing in the mortgage market than there used to be during periods of tight money. This means, among other things, that the same degree of monetary tightness now corresponds to higher interest rates than before since interest rates are now allowed to play more of a role in clearing markets. It also means that plant and equipment investment is now hurt more relative to housing investment during periods of tight money. This is not to say that I feel that the removing of restrictions in the financial markets is a bad thing, but only that one should be aware that a tight monetary policy is now likely to hurt plant and equipment investment more and housing investment less than it did in the past. This is, of course, a further argument for an easier monetary policy for those who feel that more stimulus for plant and equipment investment is needed.

My second point concerns the emphasis of the administration on the size of the budget deficit in its fight to control inflation. This emphasis is, in my view, misguided. In examining the likely effects of fiscal policy on inflation, one should consider how the policy will affect aggregate demand and supply, rather than what budget deficit will result from the policy. To give an example, say that the administration's forecast of the economy for fiscal year 1980 is too optimistic, in particular that it has overestimated real growth. In this case, tax revenues are likely to be less than anticipated, and so the budget deficit is likely to be greater than anticipated. It would surely not be reasonable, however, to argue that because of the larger deficit, there will be more inflation in this case than in the more expansionary case.

I would finally like to conclude with an argument by way of analogy. If the administration and Congress disagree with the Federal Reserve about the goals for the economy, my argument is that, on average, the Federal Reserve will win out. This seems to me to be undesirable in our democratic society, and so I believe that Congress and the administration should have more power in determining such things as the future monetary policy—fiscal policy mix.

The analogy is as follows: Consider a reservoir with two pipes running into it, one large and one small. Each pipe has a valve that controls whether water flows into or out of the reservoir and at what speed. The valve for the large pipe is controlled by Congress and the administration. The valve for the small pipe is controlled by the Federal Reserve. The valves can be changed monthly, but Congress and the administration must decide a year in

advance what each of the 12 monthly settings will be. The Federal Reserve, on the other hand, can decide its setting each month. The Federal Reserve knows the 12 settings of Congress and the administration at the time they are announced. Now, if the two groups differ as to what the height of the reservoir should be, who do you think will, on average, come closer to achieving its goal? Unless the small pipe is quite small relative to the large pipe, which my work, among others, indicates is not the case, then it is obvious that the Federal Reserve will on average come closer to its target. Note that this is true even though Congress and the administration may control a larger pipe.

I forgot to say, however, that Congress can also throw softballs at the Chairman of the Federal Reserve. These sometimes hurt, especially when thrown by Senator Proxmire—I should add, Senator, that I wrote this before I realized you were going to chair this session. I hope you left your arsenal at home—but generally they do not hurt enough to make the Federal Reserve change its preferred height very much. An important question is whether the present institutional structure should be changed to allow Congress and the administration more say in how the small pipe's valve is set. My view is that this should be done. Softballs are not enough.

Senator PROXMIRE. Thank you, Mr. Fair. We used to call pitchers like you "junk pitchers." Eddie Lopat was a pitcher of junk balls and he was very effective.

Mr. Christ, please proceed.

STATEMENT OF CARL F. CHRIST, ABRAM G. HUTZLER PROFESSOR OF ECONOMICS, THE JOHNS HOPKINS UNIVERSITY, BALTIMORE, MD.

Mr. CHRIST. Thank you, Senator Proxmire.

It is a pleasure to be here to discuss the best mix of monetary and budget policy. These remarks will be a shorter version of the prepared statement that has been distributed. I will refer to one additional sheet, containing two tables.

The program I advocate can be summarized in four main recommendations.

Let me first list the results that can realistically be expected to occur under this program, after a suitable transition period. They are: (a) Zero inflation, permanently maintained. (b) Permanently low interest rates. (c) Absence, or at least extreme rarity, of major depressions. (d) Routine occurrence of mild recessions. (e) An overall unemployment rate averaging about 6 percent, varying between perhaps 5 percent in prosperity and 7 or 8 percent in recessions.

The four main policy recommendations are as follows. The third one is listed first.

Three: Manage stabilization policy with due regard for the analogy between its effects on the economy and the effects of amphetamines on the human body.

One: After a transition period starting immediately, keep the rate of growth of the M_2 money stock: (a) Low on the average, about 3 percent a year, and; (b) Fairly steady, usually between 2 and 4 percent, and always between 1 and 5 percent.

These numbers may need to be revised very slightly, every 5 years or so.

Two: Provide countercyclical variation in the Federal deficit, from about zero in prosperity to perhaps 2 percent of GNP in the normal mild recession, and averaging about 1 percent of GNP.

Four: Use labor-market and human-resources policies to reduce unemployment and/or to assist those who suffer from it.

Part I of my prepared statement deals with long-run effects of inflation and money.

In every country and every era of which I have knowledge, the rate of inflation is inseparably connected with the rate of growth of the stock of money. The United States is no exception.

Table 1, attached to my oral statement, compares the low-inflation period 1948-61 with the high-inflation period 1970-78. Notice how the growth rates of the monetary base and the M_2 money stock accelerated.

Theory and experience make it clear that inflation cannot be stopped until monetary growth rates are reduced to near zero and kept there, whereas inflation will be stopped if that is done.

The Federal Reserve System is the agency that controls these growth rates, but as Mr. Greenspan indicated earlier, the Fed needs some budgetary discipline from the Congress if monetary growth rates are to be brought down and kept down, as we will see in a moment.

The inflation rate depends heavily on the growth of the money stock, but also on the growth of real output and on changes in the velocity of money. For 20 years the velocity of M_2 has been almost constant, fluctuating between 2.2 and 2.4.

Suppose it stays constant in the future. Real output will probably grow about 3 percent a year.¹ Ten, if M_2 grows at 3 percent a year to match real output, the price of output will stay constant—inflation will be zero.

This is the basis of my recommendation 1(a), that the average growth rate of the M_2 money stock should be about 3 percent a year. The reduction should be made gradually, over a period of years, for the reasons to be discussed later.

I will venture the prediction that over the next 5 years, 1979-83, the average annual inflation rate, based on the GNP deflator, will be 1 to 5 percentage points below the average annual growth rate experienced during the 5 years 1978-82 by M_2 , provided that the past relationship is not disturbed by major changes in technology or government regulation, such as price controls, or interest rate regulation.

Interest rates have risen to historic highs since the early 1960's. This is chiefly because of inflation. Market interest rates include a premium to allow for expected future inflation.

The only way to obtain and maintain low interest rates for the future is to stop inflation. Then interest rates will come down, as borrowers and lenders come to realize that the inflation is done with.

In a hearing before a House subcommittee a year ago, I said:

If monetary policy maintains the growth rate of the monetary base at 8 or 9 percent a year in the future, interest rates will rise somewhat more, and will settle somewhat above 8 or 9 percent, in or near the 10 to 14 percent range.

This prediction has come true.

¹ See the "Economic Report of the President," January 1979, p. 74.

A persistent large budget deficit requires the Treasury to issue new securities continuously to finance it. If the Fed did not buy any of them, they would have to be sold to private lenders.

That would push interest rates up, without inflation, and crowd out some of the private investment we need for growth. Hence the Fed is pressed to buy a good share of them. But that means a large increase in the monetary base. And that means more inflation.

The conclusion is that persistent large deficits are bad, because their financing will either cause inflation, or risk crowding out private investment.

If the deficit were to amount to 1 percent of GNP on the average, this would permit about a 3 percent annual average rate of increase in the monetary base and in the privately held Federal debt, since annual GNP, now \$2,100 billion, is equal to about three times the sum of the monetary base, \$140 billion, plus private holdings of Federal debt—\$509 billion.

This is the basis of the part of my recommendation 2 that says the deficit should be small, about 1 percent of GNP on the average.

President Carter's fiscal 1980 budget provides for a deficit of \$29 billion, which is 1.2 percent of predicted GNP. This is a welcome improvement over the large deficits of 1975-77. It is just about right. Bear in mind, however, that if 1979 and 1980 bring the recession that some people expect, then the deficit will go up and GNP will fall short, so the deficit will exceed 1.2 percent of GNP.

In the 30 years from 1900 through 1929, the average overall unemployment rate for the United States was 4.6 percent. For the 31 years, 1948-78, it was 5.1 percent. For 1970-78, it was 6.2 percent.

With present labor-market policies, it appears unlikely that the average unemployment rate over the next several business cycles will be as low as 6 percent. More about this later.

Part II of my prepared statement deals with short-run effects. The first concerns monetary growth.

The experience of many countries shows that, if the rate of growth of the money stock is increased, the first effect is a temporary improvement in output and employment. This wears off after 3 or 4 years, even if the growth rate of the money stock is kept high.

The second effect, if monetary growth is kept high, is a corresponding increase in the inflation rate.

In the last half century we have had only three episodes in which the annual unemployment rate was below 4 percent for 2 consecutive years or more. They were all wartime episodes in which the growth rate of the money stock was increased, followed first by temporary low unemployment for 3 to 6 years, and then followed by the return of unemployment to normal levels, together with increases in the rate of inflation.

The three episodes were in 1943-48, 1951-53, and 1966-69. After the first two, the growth rate of the money stock was decreased and the inflation subsided. After the third, the growth rate of the money stock was increased further, and the inflation accelerated, but the improvement in unemployment was still temporary.

Decreases in the growth rate of the money stock appear to have similar effects, in reverse. First a temporary decline in output and then a reduction in inflation.

The moral is that substantial abrupt variations in the rate of growth of the money stock are bad policy. This is the basis of my recommendation 1(b) calling for a fairly steady growth rate of the money stock. And it explains why my proposed reduction in monetary growth rates should be gradual, not sudden.

The effect of amphetamines on the human body is analogous to the effect of changes in monetary growth rates on the economy. An injection of amphetamines produces a short-lived high.

Some people develop a tolerance to the high. They escalate the size of the injection in order to repeat or continue the high. This results in undesirable side effects, loss of appetite and weight, paranoia, and sometimes violent aggression. In some cases there are withdrawal symptoms.

It is better not to embark on such highs in the first place. Similarly, it is better not to use increases in monetary growth rates to achieve highs in output and employment, because the inflationary side effects become intolerable, and then one must endure the withdrawal symptoms in order to get rid of the inflation.

This is the meaning of my recommendation 3.

Monetary growth rates were kept high, on the average, insuring continued high inflation, for the 8 years from late 1970 to October 1978. Since October, monetary growth rates have decreased considerably, as shown on table 2, attached to my oral statement. The growth rate of the monetary base has declined 2 percentage points. M_1 has not only stopped growing, it has actually declined. But M_1 is no longer a reliable policy indicator, because depositors are now switching from demand deposits to time deposits to take advantage of the new automatic transfer service that became permissible on November 1. There is an estimate of the amount of this which is in the economic report on page 50.

The growth of M_2 has slowed greatly, but the growth of large CD's, which are not in M_2 , has accelerated. M_4 , which is M_2 plus large CD's, has grown more in line with the monetary base.

The gradual reduction in the growth rate of the monetary base that the Fed has brought about since October is just about right, in my view, provided that it is continued gradually and steadily for the next several years until about a 3-percent rate, consistent with zero inflation, is attained.

The best speed of reduction is probably somewhere about one-half percent to 1 percent a year. This is a guess on my part. We really don't know too much about that but I think that would be slow enough to involve little risk of creating or exacerbating any recession or depression.

This will take 5 to 10 years. The reduction process should be carried to completion even if we get into a recession. Otherwise, inflation cannot be stopped.

President Carter's wage and price standards can be helpful if they are accompanied by steady reductions in monetary growth. If not, the standards will serve only to erode further the credibility of Government officials who claim to oppose inflation.

The budget deficit automatically rises in recession, and falls in prosperity. This exerts an automatic stabilizing effect. Additional budget stimulus, if it is begun quickly in recession and phased out in recovery, can be helpful.

Changes in Federal spending, unlike changes in the growth rate of the money stock, do not appear to have important delayed effects on employment or prices. Hence they are relatively well suited to countercyclical variations in the deficit.

I might add one reason I believe this is because of some work that Professors Modigliani and Ando did with their econometric model which comes to this conclusion. That is why I differ slightly with the policy recommendation they made in December.

But variations in the deficit must be financed by variations in the Treasury's debt sales to the private sector, not to the Fed, if the growth rate of the monetary base is to be kept steady.

In brief, my recommendation 4 would include the following measures: Abolish the minimum wage law, or at least exempt teenagers. Maintain the unemployment compensation program, and lengthen the period of eligibility to 1 year, but let it begin only after 30 days of unemployment. Continue job training programs for the disadvantaged. Replace the welfare program with a negative income tax. And for the long run, improve elementary and high school education so that every child learns to read and write. A tall order, I know.

In summary, my program is this:

One: Keep the growth rate of the money stock slow and fairly steady.

Two: Keep the budget deficit small on the average, but let it vary countercyclically. Finance its variations by varying Treasury debt sales to private lenders.

Three: Don't use monetary policy for temporary highs of employment, lest you get long-lasting inflationary after-effects.

Four: Work on unemployment with labor-market and human-resources policies.

This program will not abolish all recessions. It will not keep the overall unemployment rate from going above 7 percent sometimes, in recessions. I know of no program that will.

But after an adjustment period of 5 to 10 years, this program will permanently eliminate inflation, permanently lower interest rates, prevent major depressions or at least make them very rare, and bring a modest improvement in unemployment.

Further, it will provide assistance for those afflicted by the consequences of recessions.

Thank you.

[Tables 1 and 2 referred to in Mr. Christ's oral statement, together with his prepared statement, follow:]

TABLE 1.—INFLATION AND THE GROWTH OF MONEY STOCKS

| Period (December to December) | Average annual growth rates (percent) | | |
|-------------------------------|---------------------------------------|---------------|----------------|
| | Inflation (CPI) | Monetary base | M ₂ |
| 1948 to 1961 | 1.7 | 1.6 | 3.4 |
| 1970 to 1978 | 6.9 | 8.4 | 9.4 |

TABLE 2.—MONETARY GROWTH RATES BEFORE AND AFTER OCT. 18, 1978

| Type of money stock | Annual growth rates (percent) | |
|---|-------------------------------|---------------------|
| | First 10 months of 1978 | Since Oct. 18, 1978 |
| Monetary base..... | 10 | 8 |
| M ₁ | 8 | -2 |
| M ₂ | 9 | 1 |
| M ₄ equals M ₂ plus large CD's..... | 10 | 6 |

PREPARED STATEMENT OF CARL F. CHRIST

I am glad to be here this morning to discuss the best mix of monetary and budget policy.

The program I advocate can be summarized in four main recommendations. Let me first list the results that can realistically be expected to occur under this program, after a suitable transition period. They are:

- (a) Zero inflation, permanently maintained.
- (b) Permanently low interest rates.
- (c) Absence, or at least extreme rarity, of major depressions.
- (d) Routine occurrence of mild recessions.
- (e) An overall unemployment rate averaging about 6 percent, varying between perhaps 5 percent in prosperity and 7 or 8 percent in recessions.

The four main policy recommendations are as follows. The third one is listed first.

3. Manage stabilization policy with due regard for the analogy between its effects on the economy and the effects of amphetamines on the human body.

1. After a transition period starting immediately, keep the rate of growth of the M₂ money stock:

- (a) low on the average, about 3 percent a year, and
- (b) fairly steady, usually between 2 and 4 percent, and always between 1 and 5 percent.

(These numbers may need to be revised very slightly, every 5 years or so.)

2. Provide countercyclical variation in the Federal deficit, from about zero in prosperity to perhaps 2 percent of GNP in the normal mild recession, and averaging about 1 percent of GNP.

4. Use labor-market and human-resources policies to reduce unemployment and/or to assist those who suffer from it.

I. LONG-RUN EFFECTS

A. Inflation

The average inflation rate in 1948-1961, as measured by the consumer price index, was 1.7 percent a year. In 1966-1978 it had risen to 6.2 percent a year. And in 1978 it was 9.0 percent, December to December.

In every country and every era of which I have knowledge, the rate of inflation is inseparably connected with the rate of growth of the stock of money. The U.S. is no exception. When inflation was 1.7 percent a year, in 1948-1961, the average annual monetary growth rates were small: 1.6 percent for the monetary base, 2.2 percent for M₁, and 3.4 percent for M₂. When inflation had grown to 6.2 percent a year, in 1966-1978, the monetary growth rates were correspondingly higher: 7.4 percent for the monetary base, 6.2 percent for M₁, and 8.8 percent for M₂.

Theory and experience make it clear that inflation cannot be stopped until these growth rates are reduced to near zero and kept there, whereas inflation will be stopped if that is done. The Federal Reserve System is the agency that controls these growth rates. But the Fed needs some budgetary discipline from the Congress if monetary growth rates are to be brought down and kept down, as we will see in a moment.

B. The money stock

The inflation rate is mathematically equal to the growth rate of the money stock, plus the growth rate of the velocity of circulation of that same money stock, minus the growth rate of real output. Now real output can be expected to grow about 3 percent a year on the average (see last month's ERP, Economic Report of the President, p. 74). The velocity of circulation of M₂ has stayed virtually constant since 1959, ranging between 2.23 and 2.42. If M₂ were made to grow at 3 percent a year in the future, and if its velocity of circulation were to stay constant, and if real

output were to grow at 3 percent a year, then the inflation rate would be zero. This is the basis of my Recommendation 1(a), that the average growth rate of the M_2 money stock should be about 3 percent a year. The reduction should be made gradually, over a period of years, for reasons to be discussed later.

Of course you will have noticed that the different concepts of the money stock do not all behave in the same way. For example, M_1 has grown more slowly than M_2 since World War II, and its velocity has increased gradually. This is because time deposits (which are in M_2 but not in M_1) have become steadily more attractive as compared with demand deposits and currency (which together make up M_1), in two respects. First, interest rates paid on time deposits have increased steadily, while demand deposits and currency yield no interest. Second, the transfer of funds between time and demand deposits has been made progressively easier. The latest development of this kind occurred last November 1, when automatic transfer of funds from time to demand deposits became permissible. Under this arrangement, you keep a zero balance in a checking account, and an interest-earning balance in a time deposit at the same bank. Whenever a check you've written is presented to the bank for payment, the bank automatically transfers the amount of the check from your time deposit to your checking account and then immediately pays the check. Thus you earn interest on all your funds all the time. This innovation induced depositors to shift about \$1.6 billion of balances from demand deposits to time deposits during November and December (ERP, p. 50). The shift will probably continue. Thus the velocity of M_1 will probably continue to increase. Therefore the growth rate of M_2 will continue to be a more reliable predictor of inflation than that of M_1 .

I will venture the prediction that over the next 5 years, 1979 through 1983, the average annual inflation rate (based on the GNP deflator) will be below, by 1 to 5 percentage points, the average annual growth rate experienced during the 5 years 1978-1982 by M_2 , provided that the past relationship is not disturbed by major changes in technology or government regulation (such as price controls, or interest-rate regulation). If such changes do occur, it should be possible to assess the direction and magnitude of their effect, and adjust the prediction accordingly.

C. Interest rates

Since World War II we have seen not only a rise in the inflation rate, but also a rise in interest rates. These two phenomena are closely related. Interest rates set by bids and asks in the market are the sum of two components: the expected rate of inflation over the course of the loan, plus the real rate of return that the parties expect will be paid and received after allowance is made for the decline in the purchasing power of money during the life of the loan. The real rate of return has not changed much. To illustrate, in the 1950's when inflation was at about 2 percent a year, mortgage rates were about 4½ percent, for a real rate of return of about 2½ percent. Recently, inflation has been running between 7 and 9 percent, while mortgage rates have climbed to above 10 percent, again for a real rate of return in the neighborhood of 2½ percent.

The only way to obtain and maintain low interest rates for the future is to stop inflation. Then interest rates will come down, as borrowers and lenders come to realize that the inflation is done with.

In a hearing before the Domestic Monetary Policy Subcommittee of the House Banking Committee on January 30, 1978, I said, "If monetary policy maintains the growth rate of the monetary base at 8 or 9 percent a year in the future, interest rates will rise somewhat more, and will settle somewhat above 8 or 9 percent, in or near the 10- to 14-percent range." In fact the monetary base was made to grow 9 percent in the last 12 months, and in fact mortgage rates and the prime rate are now in the 10- to 14-percent range.

D. The budget

Why did the Federal Reserve cause, or permit, the stocks of money to grow so fast, beginning gradually in 1961, accelerating in 1967, and accelerating again in 1970 and 1971? In 1961 it may have been associated with the attempt of the new Kennedy administration to stimulate the economy in order to reduce unemployment below the 5.5 percent rate which had prevailed in the recovery of 1959-1960. In 1967 it was presumably associated with the deficits incurred by increased Viet Nam war expenditures without a general tax increase. In 1970-71 it may have been associated with the Nixon administration's abandonment of the 1969-1970 policy of monetary and fiscal restriction, in favor of price controls to suppress inflation, and stimulative monetary and fiscal policy to increase employment and output. The budget has been in deficit every year from 1970 onwards. The deficits were unusually large in the calendar years 1975, 1976, and 1977 by post-World War II standards. Expressed as

percentages of GNP they were respectively 4.6, 3.2, and 2.5 percent, on the national accounts basis.

A persistent budget deficit has to be financed by Treasury borrowing, either from the Federal Reserve, which increases the monetary base (in effect printing money), or from private lenders (including foreigners), or some mixture of the two. We have seen that to avoid inflation, the growth rate of the monetary base must be kept small. Hence if we have persistent large deficits they must not be financed by large increases in the monetary base . . . then they must be financed by borrowing from private lenders. But if persistent large deficits are financed by large sales of Treasury bonds on the private market, this will drive up interest rates (even without inflation), and may crowd out the private capital formation that we need for future growth. That is why large deficits create pressure on the Federal Reserve to raise the monetary base. The conclusion is that persistent large deficits are bad, because their financing will either cause inflation, or risk crowding out private investment.

If the deficit were to amount to 1 percent of GNP on the average, this would permit about a 3 percent annual average rate of increase in the monetary base and in the privately held Federal debt, since annual GNP (now \$2100 billion) is equal to about 3 times the sum of the monetary base (\$140 billion) plus private holdings of Federal debt (\$509 billion). This is the basis of the part of my Recommendation 2 that says the deficit should be small, about 1 percent of GNP on the average.

President Carter's fiscal 1980 budget provides for a deficit of \$29 billion, at an estimated GNP of \$2510 billion, which is 1.2 percent of GNP. This is a welcome improvement over the large deficits of 1975-1977. It is just about right. Bear in mind, however, that if 1979 and 1980 bring the recession that some people expect, then the deficit will exceed \$29 billion and GNP will fall short of President Carter's estimate, so that the actual deficit will exceed 1.2 percent of GNP.

E. Unemployment

In the years from 1900 through 1929, the average overall unemployment rate for the U.S. was 4.6 percent. For 1948-78 it was 5.1 percent. For 1970-1978 it was 6.2 percent. The annual figure has not been below 4.9 percent in 1970-1978, and has not been below 6.0 percent in 1975-1978. With present labor-market policies, it appears unlikely that the average unemployment rate over the next several business cycles will be as low as 6.0 percent. I will make a few suggestions about this later.

II. SHORT-RUN EFFECTS

A. Monetary growth

The experience of many countries since World War II indicates that, following a period during which the expected rate of inflation matched the actual, if the rate of growth of the money stock is increased, the first effect is a temporary improvement in output and employment. This wears off after perhaps 3 to 4 years, even if the growth rate of the money stock is maintained at its new higher level. The second effect, if the growth rate of the monetary stock is kept high, is a corresponding increase in the inflation rate.

In the last half-century in the U.S. (i.e., since we have had good unemployment statistics) there have been only 3 episodes in which the annual unemployment rate was below 4 percent for two consecutive years or more. They were all wartime episodes in which the growth rate of the money stock was increased, followed first by temporary low unemployment for 3 to 6 years, and then followed by the return of unemployment to normal levels, together with increases in the rate of inflation. The 3 episodes were in 1943-48, 1951-53, and 1966-69. After the first two episodes the growth rate of the money stock was decreased and the inflation subsided. After the third episode the growth rate of the money stock was increased further, and the inflation accelerated, but the improvement in unemployment was still temporary.

Decreases in the growth rate of the money stock appear to have similar effects, in reverse: first a temporary decline in output and employment, and then (if the lower monetary growth rate is maintained) a reduction in the inflation rate.

Recent research has produced theoretical economic models of this process, incorporating the effects of changes in the public's expectations about inflation. These models are consistent with the experience of the U.S. and some dozen other countries.

The moral is that substantial rapid variations in the rate of growth of the money stock are bad policy. Increases in monetary growth bring good effects on employment and output, but only temporarily, followed later by long-lasting bad effects in the form of faster inflation. In order to get rid of the faster inflation, it is necessary to reduce the monetary growth rate, which brings temporary bad effects on employment and output, and then eventually the long-lasting good effect of reducing the

inflation rate. This is the basis of my Recommendation 1(b) calling for a fairly steady growth rate of the money stock.

It also explains why a transition period would be prudent for reducing monetary growth from the high rates of the last dozen years to the low rates that are imperative for stable prices.

B. The amphetamines analogy

The effect of the amphetamines on the human body is analogous to the effect of changes in monetary growth rates on the economy. An injection of amphetamines produces a short-lived "high." Some people develop a tolerance to the high. They escalate the size of the injection in order to repeat or continue the high. This results in undesirable side-effects: loss of appetite and weight, paranoia, and sometimes violent aggression. In some cases there are withdrawal symptoms. It is better not to embark on such highs in the first place. Similarly, it is better not to use increases in monetary growth rates to achieve highs in output and employment, because the inflationary side-effects become intolerable, and then one must endure the withdrawal symptoms in order to get rid of the inflation. This is the meaning of my Recommendation 3.

C. Current monetary policy

Monetary growth rates were kept high, and fairly steady, insuring continued high inflation, for the twelve years from 1967 to October, 1978. Since October, monetary growth rates have decreased considerably. As compared with the first 10 months of 1978, annual growth rates since October 18 have declined as follows:

| | Percent | |
|---|-----------------------|------------------------|
| | 1978 (1st 10 mos.) | Since Oct. 18, 1978 |
| The monetary base | 10 | 8 |
| M ₁ | 8 | -2 |
| M ₂ | 9 | 1 |
| M ₄ (M ₂ plus large CD's) | 10 | 6 |

The actual decline in the level of M₁ (corresponding to its negative growth rate) arose because of shifts out of demand deposits and into time deposits, in response to the automatic transfer service that became available on November 1. This was noted earlier.

The sharp decline in the growth rate of M₂ is associated with a relative shift of time deposits into large CD's (certificates of deposit, which are not included in M₂) and out of other kinds which are included in M₂. M₄, which is the sum of M₂ plus large CD's, is unaffected by this shift. Its growth-rate decline has been more moderate, from a 10 percent rate to a 6 percent rate, and has approximately matched the decline in the growth rate of the monetary base.

The gradual reduction in the growth rate of the monetary base that has been brought about by the Federal Reserve since October is just about right, in my view, provided that it is continued gradually and steadily for the next several years until about a 3 percent rate, consistent with zero inflation, is attained. The best speed of reduction is probably somewhere around ½ percent to 1 percent a year, slow enough to involve little risk of creating or exacerbating any recession. This will take 5 to 10 years. The reduction process should be carried to completion even if we get into a recession. Otherwise inflation cannot be stopped.

D. The wage and price standards

President Carter's wage and price standards are meant to encourage people to reduce the rates of increase of wage and prices in 1979. Such standards are of course unnecessary once monetary growth rates have been brought down to noninflationary rates and kept there. Standards can be helpful at a time like the present, however, if they are accompanied by steady reductions in monetary growth. If not, the standards will serve to erode further the credibility of government officials who claim to oppose inflation.

E. The budget

Even if the Congress were in a permanent recess, a business cycle would influence the Federal budget. On the revenue side, tax revenues rise and fall with incomes and output. On the expenditure side, many Federal programs automatically in-

crease expenditure when income and output fall. Thus, with no change in the law at all, deficits will increase in recession, and in prosperity they will decline, possibly even changing to surplus (though this has happened only once since 1960). Such automatic variation in the deficit is a good thing in at least two respects. First, the additional expenditures in recession cushion people against the ill effects of unemployment and reduced incomes. Second, the increased deficit reduces the depth of the recession and hastens recovery. Similarly, the decreased deficit in prosperity moderates the recovery and eases the jolt that can occur when the economy comes up too fast against the ceiling imposed by its productive capacity.

In a recession, the Congress usually enacts additional spending programs to combat the recession. There is some debate about what kinds of programs can be turned on and off quickly enough to be worth while. Those that get started quickly, and are phased out when recovery occurs, are probably helpful. Changes in Federal spending, unlike changes in the growth rate of the money stock, do not appear to have important delayed effects on employment or prices. Hence they are relatively well suited to countercyclical policy. This is the basis for the part of my Recommendation 2 that advocates countercyclical variations in the deficit.

If the growth rate of the monetary base is to be kept steady, as I have argued it should be, then the countercyclical variations in the deficit should be financed by variations in the amount of Federal debt sold to private lenders. This will help to smooth out the cycle in interest rates, for the largest Federal borrowing will occur during recessions when private borrowers are lying low and interest rates typically fall.

III. UNEMPLOYMENT

Suppose we decide to keep the money stock growing slowly and steadily, that is, we do not use monetary policy to try to control unemployment. Suppose further that countercyclical deficits do not bring unemployment as low as we would like it. Are any other alternative policies available to deal with it? Yes, there are. They are not the main subject of this hearing, but I want to mention them since I have ruled out monetary policy for this purpose.

The overall unemployment rate appears to be about two percentage points higher nowadays than it was in the 1950's. About half of one percentage point is due to changes in the composition of the labor force (ERP, p. 119). Apart from that, different groups in the labor force have had very different increases in unemployment. Consider these comparisons between 1956 and 1978, both prosperous years. The overall rate rose 2 percentage points. Adult males, both black and white, had small increases: about 1 percentage point. So did adult white females. Adult black females had an increase of 3 points. White teen-agers had increases of 3 points for males and 5 points for females. Black teenagers had by far the largest increases, 19 points for males and 16 for females. Black teen-age unemployment actually rose during the recovery from the recession of 1954, while the overall unemployment rate was declining. Black teen-age unemployment for 1978 was 34 percent for males and 38 percent for females.

Surely the decline in the quality of the high school diploma has been partly responsible. Recently the Baltimore school system announced that henceforth students will not be graduated from high school unless they can pass a so-called survival reading skills test, which requires them to understand a job application form, the instructions on a packaged food product, and the like. This strongly suggests that some students have been graduated in the past without even such rudimentary competence.

The minimum wage, now at \$2.90 an hour or \$5,800 for a year of 50 40-hour weeks, is partly responsible. It is a type of price control. Like all price controls, it has the effect that some of those it is ostensibly designed to protect are excluded from the marketplace altogether.

The strengthening of unemployment compensation is also partly responsible. But is it not a good program anyway?

In brief, my Recommendation 4 would include the following measures: Abolish the minimum wage law, or at least exempt teen-agers. Maintain the unemployment compensation program, at a level significantly below the income lost through unemployment, and lengthen the period of eligibility to one year, but let eligibility begin only after 30 days of unemployment. Continue job training programs for the disadvantaged. Replace the welfare program with a negative income tax. And for the long run, improve elementary and high school education so that every child learns to read and write. A tall order, I know.

IV. CONCLUSION

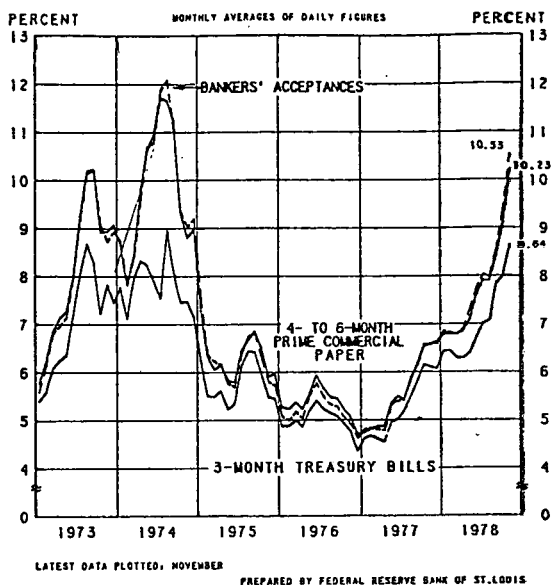
In summary, my program is simple. (1) Keep the growth rate of the money stock slow and fairly steady. (2) Keep the budget deficit small on the average, but let it vary countercyclically. Finance its variations by varying Treasury debt sales to private borrowers. (3) Don't use monetary policy for temporary highs of employment, lest you get long-lasting inflationary after-effects. (4) Work on unemployment with labor-market and human-resources policies.

This program will not abolish all recessions. It will not keep the overall unemployment rate from going above 7 percent sometimes, in recessions. I know of no program that will.

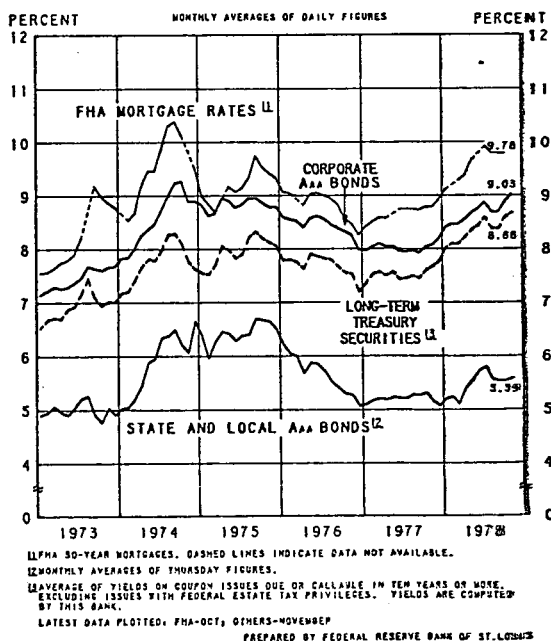
But after an adjustment period of 5 to 10 years this program will permanently eliminate inflation, permanently lower interest rates, prevent major depressions or at least make them very rare, and bring a modest improvement in unemployment. Further, it will provide assistance for those afflicted by the consequences of recessions.

Thank you very much.

MONEY MARKET RATES

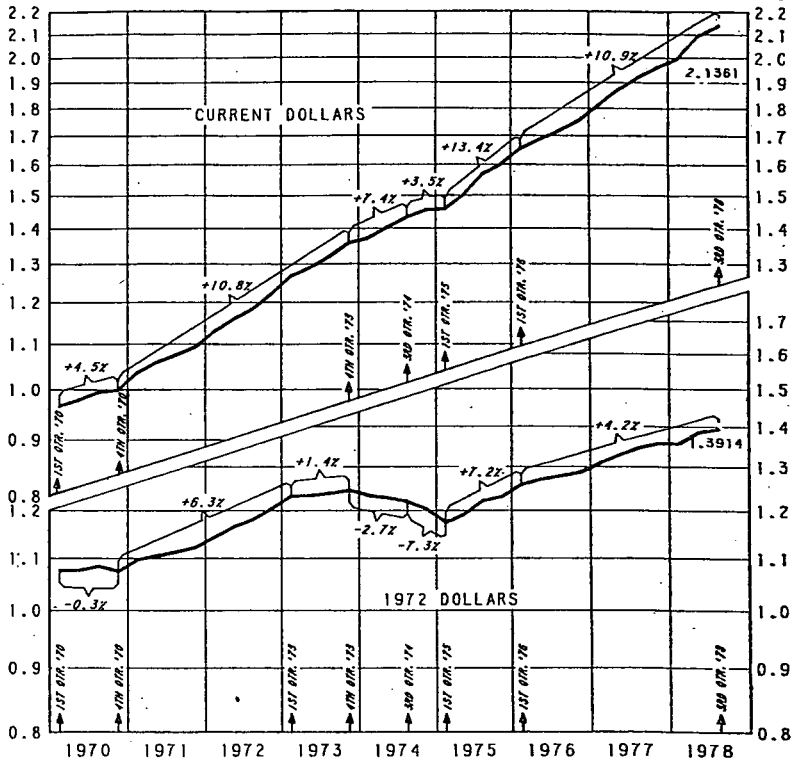


LONG-TERM INTEREST RATES



GROSS NATIONAL PRODUCT

RATIO SCALE QUARTERLY TOTALS AT ANNUAL RATES RATIO SCALE
 TRILLIONS OF DOLLARS SEASONALLY ADJUSTED TRILLIONS OF DOLLARS

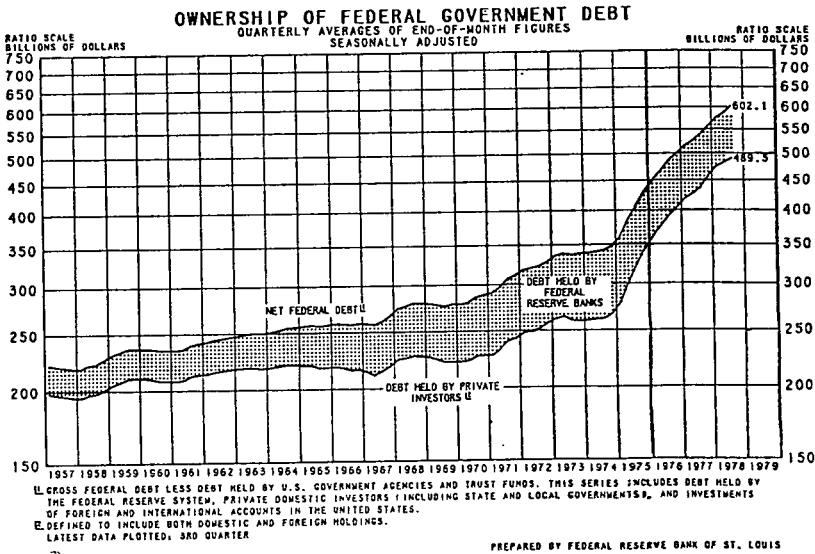
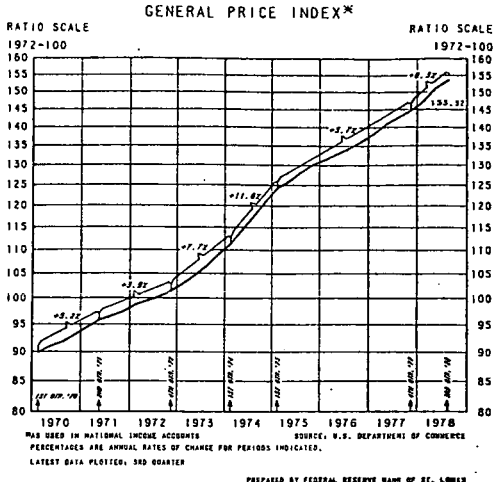


SOURCE: U.S. DEPARTMENT OF COMMERCE

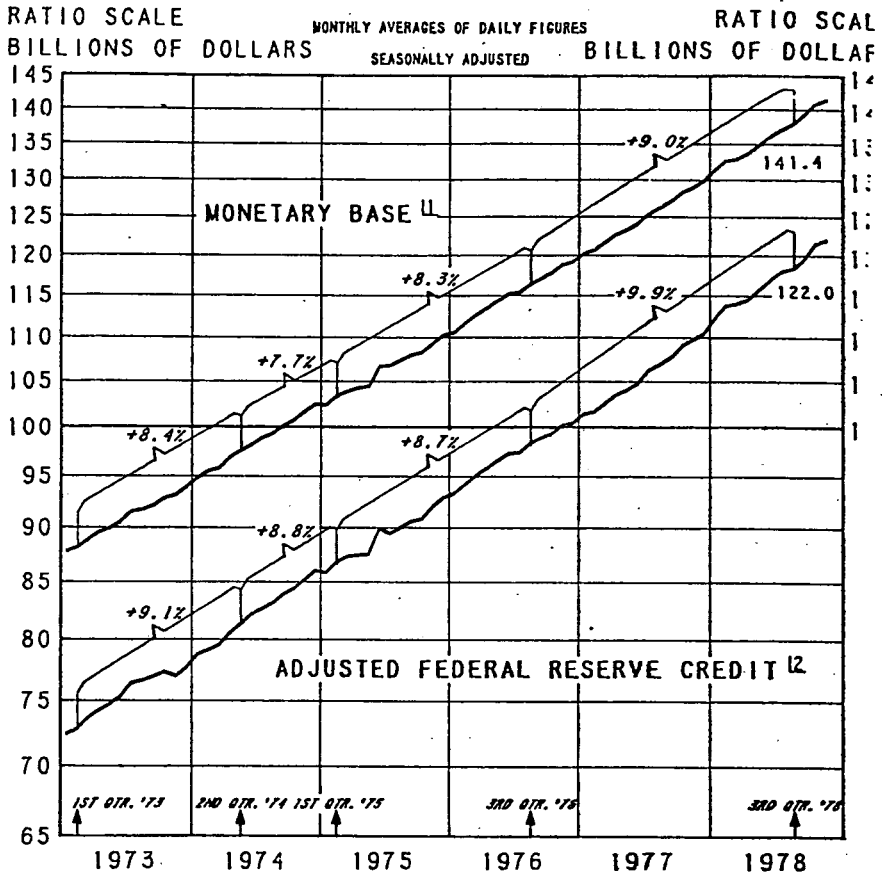
PERCENTAGES ARE ANNUAL RATES OF CHANGE FOR PERIODS INDICATED.

LATEST DATA PLOTTED: 3RD QUARTER

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS



MONETARY BASE AND ADJUSTED FEDERAL RESERVE CREDIT



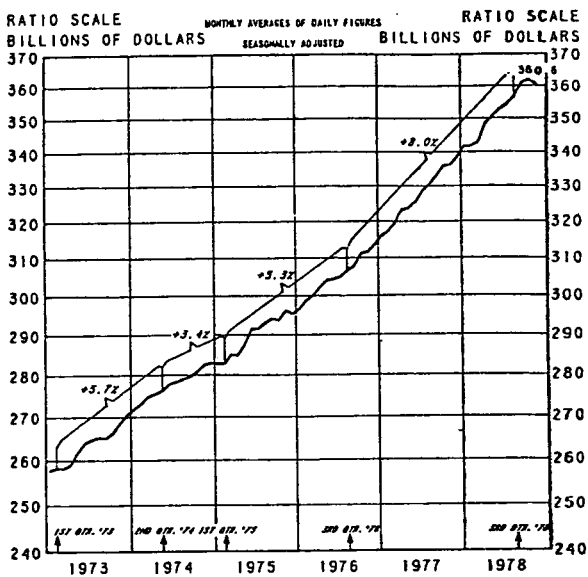
¹¹USES OF THE MONETARY BASE ARE MEMBER BANK RESERVES AND CURRENCY HELD BY THE PUBLIC AND NONMEMBER BANKS. ADJUSTMENTS ARE MADE FOR RESERVE REQUIREMENT CHANGES AND SHIFTS IN DEPOSITS AMONG CLASSES OF BANKS. DATA ARE COMPUTED BY THIS BANK.

¹²FEDERAL RESERVE CREDIT CONSISTS OF FEDERAL RESERVE HOLDINGS OF SECURITIES, LOANS, FLOAT AND OTHER ASSETS. ADJUSTED FEDERAL RESERVE CREDIT IS COMPUTED BY SUBTRACTING TREASURY DEPOSITS AT FEDERAL RESERVE BANKS FROM THIS SERIES, AND ADJUSTING THE SERIES FOR RESERVE REQUIREMENT RATIO CHANGES AND SHIFTS IN THE SAME TYPE OF DEPOSITS BETWEEN BANKS WHERE DIFFERENT RESERVE REQUIREMENT RATIOS APPLY. DATA ARE COMPUTED BY THIS BANK.

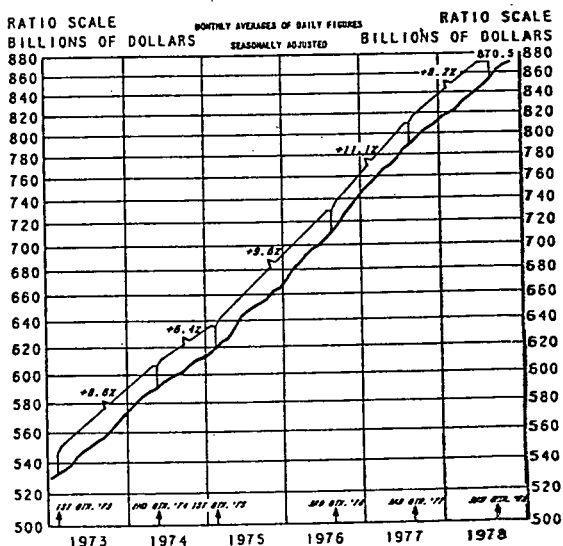
PERCENTAGES ARE ANNUAL RATES OF CHANGE FOR PERIODS INDICATED.

LATEST DATA PLOTTED: NOVEMBER

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

MONEY STOCK (M₁)

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

MONEY STOCK PLUS NET TIME DEPOSITS (M₂)¹

¹CURRENCY, DEMAND DEPOSITS, SAVINGS DEPOSITS, TIME DEPOSITS OPEN ACCOUNT PLUS TIME CERTIFICATES OF DEPOSIT, OTHER THAN NEGOTIABLE TIME CERTIFICATES OF DEPOSIT, ISSUED IN DENOMINATIONS OF \$100,000 OR MORE BY LARGE MEMBER BANKS.

PERCENTAGES ARE ANNUAL RATES OF CHANGE FOR PERIODS INDICATED.

LATEST DATA PLOTTED: NOVEMBER

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

Senator PROXMIRE. Thank you very much, Mr. Christ.
Ms. Barrett, please proceed.

STATEMENT OF NANCY S. BARRETT,¹ DIRECTOR, PROGRAM OF RESEARCH ON WOMEN AND FAMILY POLICY, THE URBAN INSTITUTE, WASHINGTON, D.C., AND FORMER DEPUTY ASSISTANT DIRECTOR, FISCAL ANALYSIS DIVISION, CONGRESSIONAL BUDGET OFFICE

Ms. BARRETT. I would like to turn to the question of the President's recent budget proposals and trends in monetary policy.

As you know, President Carter has proposed a fiscal policy for 1980 that reflects a conscious effort to convince the American people that the administration views inflation as the Nation's No. 1 economic problem and that it is serious about bringing inflation under control.

The President's Economic Report stresses the switch in emphasis away from a budget designed to strengthen growth in real economic activity toward one designed to restrain inflation. The budget proposes spending cuts relative to current policy that would produce a decline of about \$15 billion in the high employment deficit relative to fiscal year 1979.

Interest rates have been rising at an alarming pace since mid-1978. However, until November, it was not clear whether rising interest rates were due to unusually rapid growth in the demand for money, with the Fed attempting to accommodate credit demands at higher interest rates, or to a conscious effort on the part of the Fed to restrain credit.

In November, a major shift in monetary policy was announced that committed the Fed to maintaining high interest rates for purposes of supporting the international value of the dollar.

Since then there has been a substantial slowdown in the growth rate of the monetary aggregates, although there is evidence that this slowdown is partly due to institutional factors and is not directly tied to the defense of the dollar.

My testimony today will address the following questions:

Will the fiscal year 1980 budget proposed by the President and restrictive policies of the Fed have an adverse macroeconomic effect on the economy?

Will these actions help to bring down inflation?

What is the significance of the monetary/fiscal policy mix?

In view of these considerations, what is the appropriate congressional response?

Most forecasters are predicting a mild recession in the second half of 1979. In my view, fiscal policy is not flexible enough to offset the downturn entirely. Substantially lower interest rates, on the other hand, would reduce the likelihood of a recession, since the downturn is predicted on the probable adverse effects of tight credit conditions on housing and consumer demand.

However, it is not altogether clear whether the Fed could, in fact, take actions that would bring down the interest rate significantly by midyear unless inflation expectations are quickly brought under control.

¹ The views expressed in this statement are those of the author and not of any organization with which she is or has been affiliated.

Turning first to the adequacy of the fiscal policy contained in the President's budget, the main question is whether there is enough underlying strength in the economy to keep the recession of short duration as the President's spending cuts are put into place. The answer to that question requires a look at longer term trends in real growth in the economy.

We know that despite robust growth in employment since the 1974-75 recession, the recovery has been problematic. The principal sources of strength have been in housing and spending on consumer durables, both fueled by an inflationary psychology, and until recently, fairly accommodative monetary policy.

Consumer indebtedness has continued to outpace growth in disposable income, and the demand for housing has remained high in the face of rapidly rising interest rates. Most analysts are expecting the household saving rate to rise as consumers are forced to reduce spending to pay off their indebtedness and as a decline in consumer confidence breaks the buy-in-advance psychology.

At the same time, continued high interest rates are likely to have an adverse effect on the housing market. The recovery has been characterized by sluggish business investment, due in part to the severity of the recession that left considerable excess capacity, coupled with a low-pressure economic policy stance.

Low levels of capacity utilization remain even after 3½ years of continual growth. Uncertainties posed by the Government regulatory environment, the future course of energy and raw materials prices, and the possible reemergence of double-digit inflation have also been factors in the general climate of pessimism that has restrained business investment.

Unemployment, too, remains high relative to historical peaks, and slack labor-market conditions together with relatively low levels of capacity utilization have produced a recession mentality that has contributed both to sluggish investment and to poor productivity performance.

In addition, the recession mentality has given impetus to compensatory pricing on the part of firms and to catchup wage demands by workers who have experienced little real gain in purchasing power since the recession.

These practices have contributed to inflation. Rising unit labor costs in recent years have been more the result of this recession mentality than of tight labor markets.

The international economic situation has also thrown a monkey wrench into the recovery. Restrictive macroeconomic policies pursued by our major trading partners have restrained the growth of our exports.

Together with the balance-of-payments problems associated with oil imports, these policies have not only contributed to slow economic growth in the United States, but have placed the dollar under considerable pressure. As mentioned earlier, pressure on the dollar was the primary impetus for the Fed's shift to a more restrictive monetary policy last November.

Of course, lurking behind all these factors is the persistent high rate of inflation which has gained momentum over the past year. Not only does the political reaction to inflation force the Government into a restrictive policy stance, but it also has direct adverse

effects on consumer and business confidence that can slow the rate of macroeconomic activity.

What these observations add up to is a situation of considerable downside risk in the macroeconomic forecast—a downside risk that will be enhanced by the adoption of the President's budget.

If the higher interest rates cause a downslide in housing and consumer spending, and there is already some evidence that this is occurring, the outlook surely will not be good for business investment.

Exports and spending by State and local governments may provide a slight cushion to the downturn, although the latter will certainly be restrained by the momentum of proposition 13-type initiatives.

The main issue is whether monetary policy will ease sufficiently to soften the downturn in housing and spending on consumer durables. There is very little upside risk in the administration's forecast of real growth.

This means that a more stimulative fiscal policy than that proposed in the President's budget would not be likely to generate excessive pressure on aggregate demand, should the Congress prefer to challenge the President's decision to shift toward restraint.

The second issue in assessing the impact of fiscal policy concerns the possibilities for the proposed budget to bring down the rate of inflation. The inflationary momentum that has developed in the economy is not primarily the result of excess pressure on capacity or of tight labor markets.

Undoubtedly, there are isolated bottlenecks and some skills in short supply. But given the proposed mix of spending cuts—reductions in social programs coupled with a real increase in defense spending—there is no indication that the changes in spending being proposed will be a moderating effect on prices and wages.

If bottlenecks and skill shortages occur, they are more likely to be in defense-related sectors than in the labor markets most affected by social programs. Consequently, the only weapon that the President's budget offers in the fight against inflation is psychological, that is, its impact on expectations. And there is no way to predict how effective such a weapon will be.

Although most budget watchers have focused on the spending side of the ledger this year, I would like to call the committee's attention to the problem of fiscal drag that is increasing marginal tax rates at the same time the President is calling for wage restraint.

Not only is inflation pushing people into higher brackets, but payroll taxes are also increasing. These tax increases cannot help but have an adverse effect on the credibility of government to maintain real purchasing power in its wage-price program.

I think we can all agree that the effectiveness of monetary and fiscal management is severely damaged by the persistence of inflation. As a consequence, every avenue should be sought to get inflation under control through policies other than the painful and costly recourse to monetary and fiscal restraint.

Monetary policy, in the past months, has taken a far more restrictive turn than the fiscal policy proposed in the President's

fiscal year 1980 budget. Whether the recent slowdown in the growth of the monetary aggregates is a technical adjustment to various changes in financial practices, or whether it portends a longer term trend is debatable at the moment.

Year-over-year monetary growth has not been unduly restrictive. There is not yet a liquidity shortage as occurred during the disastrous credit crunch of 1974. But if trends of the past few months continue, a serious credit shortage and much deeper recession than is now being predicted would undoubtedly occur, due to the severe impacts on housing and consumer durables.

While there is uncertainty over the intent of the Fed regarding the growth of the monetary aggregates, the November actions that sharply raised interest rates to bolster the dollar were a clear statement of the Fed's restrictive policy stance.

The Federal funds rate reached 10 percent in December and the discount rate at 9.5 percent is at an alltime high. However, interest rates began their sharp, upward climb well before the Fed's November actions, suggesting that increasing demand for money, fueled by inflationary expectations, was at least partly responsible.

There is no question the monetary climate today is different from the liquidity shortage of 1974-75 that produced such a deep recession. There is no liquidity crisis now as there was in 1974.

Consumer indebtedness continues to rise and housing has not yet been seriously impacted by double-digit interest rates. The buy-now mentality of consumers combined with a demand for housing as a hedge against inflation has increased the demand for money, even at high interest rates.

Unlike the 1974 experience, high interest rates have not occasioned a massive outflow of funds from savings and loan institutions to the more lucrative Treasury bill market, because of the new money market savings certificates introduced in spring, 1978.

However, and here I disagree with my colleague, Mr. Fair, even in the absence of a liquidity shortage in savings and loans, if the current high rates of interest persist, housing, and the demand for consumer durables and some types of business investment, particularly new construction, will be adversely impacted. Moreover, a liquidity crunch—that is, unavailability of funds even at high interest rates, would spell disaster.

A decline in interest rates is absolutely essential for the return to normal, prosperous economic conditions. What remains to be seen, however, is whether or not high interest rates are symptomatic of the inflationary momentum referred to earlier or whether they can be reckoned with independently of policies to control inflation.

Because the economic downturn is predicted to occur before the President's fiscal year 1980 budget is actually in place, the ability or willingness of the Fed to reduce interest rates and to head off a liquidity shortage is in the short run far more crucial than Mr. Carter's proposed spending limitations.

Although the ability of the Fed to accomplish a turnaround in monetary policy depends in part on the success of the President's anti-inflation program, the Fed should not be permitted to hide behind the cloak of exchange rate considerations to justify a delib-

erate tightening of credit. It must be kept in mind that a stable exchange rate is not in and of itself a goal of economic policy.

Finally, you asked me to comment on the general issue of the monetary/fiscal mix, particularly with respect to Professor Modigliani's suggestion that there has been a policy bias toward slowing inflation by monetary restraint and then dealing with subsequent recessions by resorting to tax cuts and other stimulative fiscal measures.

Although I have not read Professor Modigliani's testimony, you alluded in your letter to the possible adverse effects of monetary restraint on capital spending and the productivity lag of the last few years.

First, I would like to emphasize that the key issue in macroeconomic policy today is not the monetary/fiscal mix, but how to achieve a full-employment and full-capacity level of economic activity in an inflationary climate.

Economic stagnation, not tight money, is depressing business investment and retarding productivity growth.

This is not to say, however, that the monetary/fiscal mix will not affect the sectoral composition of economic activity. But its effect may be different from what the conventional wisdom would have us believe.

The more heavily monetary relative to fiscal stimulus is relied on, the greater impetus is given to the interest-sensitive sectors of the economy to lead the growth in real output; conversely, monetary restraint will have an adverse impact on the interest-sensitive sectors of the economy.

But the fact is that business investment is not the most interest-sensitive component of aggregate demand. In today's economy, housing and spending on consumer durables will be the most heavily impacted by high interest. Not only are these components of spending more interest-sensitive than most aspects of business investment, but households have replaced business enterprises as the principal borrowers in credit markets.

I have provided a table at the end of my testimony which shows this shift in the composition of private borrowing since 1970, away from a situation in which businesses were borrowing twice as much as households—and I am talking here about nonfinancial businesses—to a situation in which households were borrowing about 50 percent more than businesses.

In 1970, the total funds raised in credit markets by business was around \$47 billion, nearly double the amount raised by households.

In 1977, households far surpassed the business sector in their borrowing activity, raising \$139.6 billion, compared with \$91.3 billion in nonfinancial, nonfarm borrowing. Of this household borrowing, \$96.4 billion was in home mortgages, and \$35 billion was in installment credit.

Business investment has been sluggish throughout the recovery, largely because there has been a prolonged period of widespread excess capacity. Government policies are likely to continue to produce a low-pressure demand environment.

Uncertainties regarding government regulations and the possible resurgence of double-digit inflation have also contributed to the reluctance of business firms to undertake new investments.

It is clear if you are uncertain about the demand environment, if you are uncertain about the regulatory environment, if you don't know what is going to happen to inflation, it is far less risky to expand your output by increasing the number of workers and the labor-capital ratio than by locking yourself into expensive new plant and equipment.

Clearly, a decline in spending on consumer durables and in housing starts would precipitate a decline in business sales, compounding the disincentives for business investment. Moreover, some components of business investment, such as structures, are interest sensitive, so that a more expansionary monetary policy could improve the investment climate, both directly and indirectly.

At the same time, however, the business community is uneasy about what it views as excessive monetary growth. Tax relief in the form of accelerated depreciation or increased investment tax credits has the potential for offsetting the adverse consequences for investment of a tight money policy if an expansion of business investment is desired.

As for the productivity slowdown, it is not clear that the monetary/fiscal mix per se has been nearly as important as the adverse consequences of the prolonged period of economic slack and the recession mentality it has produced. Again, imaginative tax policies could offset some of the disincentives to investment that have crept into the system in recent years.

A final note concerns the timing of shifts in the monetary/fiscal mix, an issue raised by Professor Modigliani. It seems to me appropriate that fiscal stimulus is used to bring the economy out of recession.

Accommodative monetary policy is, of course, desirable, but it is a weak instrument taken alone without a direct impetus to real spending. On the other hand, if monetary targets are set to accommodate a desired level of real income growth, an inflationary upsurge will result in a rise in interest rates.

In such a policy environment, the typical recovery would be led by public-sector demand and would be choked off by a downturn in housing and spending on consumer durables. The potential effects of such cyclical behavior on business investment and long-run productivity growth are probably not nearly as significant as whether the overall level of macroeconomic activity, on the average, has been close or far from potential.

Thank you.

[The table attached to Ms. Barrett's statement follows:]

TABLE 1.—FUNDS RAISED IN CREDIT MARKETS BY HOUSEHOLDS AND NONFINANCIAL, NONFARM BUSINESS, 1970-78

[In billions of dollars]

| | Household borrowing | Business borrowing |
|-----------|------------------------|-----------------------|
| 1970..... | 24.9 | 47.5 |
| 1971..... | 45.2 | 56.1 |
| 1972..... | 64.3 | 72.4 |
| 1973..... | 80.9 | 85.5 |
| 1974..... | 49.2 | 89.2 |
| 1975..... | 48.6 | 39.0 |

TABLE 1.—FUNDS RAISED IN CREDIT MARKETS BY HOUSEHOLDS AND NONFINANCIAL, NONFARM BUSINESS, 1970-78—Continued

[In billions of dollars]

| | Household borrowing | Business borrowing |
|----------------------------|------------------------|-----------------------|
| 1976 | 89.9 | 63.4 |
| 1977 | 139.6 | 91.3 |
| 1978(3) ¹ | 142.1 | 96.2 |

¹ 1978(3) refers to the 3d quarter of 1978 at a seasonally adjusted annual rate.

Source: Economic Report of the President, 1979, table B-62.

Senator PROXMIRE. Thank you.

I want to thank you all for excellent statements and very interesting conclusions and recommendations.

Mr. Greenspan, you were the first witness to testify. You blamed much of our increase in spending on Congress. You indicate that Presidents have been reasonably responsible in recent years but that Congress has gone over the edge. The last study I saw indicated that of the last 25 years, in 24 Congress cut the President's budget and in only 1 year, and I think that was when you were Chairman of the Council, in 1974 or 1975, only 1 year did Congress exceed the President's request; so that in every Ford budget except one, all the Nixon budgets, all the Kennedy-Johnson budgets and Carter budgets, the Congress has cut, reduced below the President's recommendation. That was true in the Eisenhower years, too.

I recall last year the President recommended a budget of \$12.5 billion above what we finally enacted. So, why do you conclude that the main problem is lassoing and hogtying Congress, recognizing that it is both the Executive and Congress sinning here?

Mr. GREENSPAN. Mr. Chairman, I am not certain that is my position. I think I have argued it is the political process in general, and I don't recall stipulating that the Congress has been solely to blame. And I don't recall making a specific statement that Presidents have in general been responsible and the Congress has not. If I did, it is certainly an inadvertence and surely false.

Senator PROXMIRE. One of the reasons I raise that is because, yesterday, I introduced in the Senate—and I had a substantial number of cosponsors equally divided among Republicans and Democrats—a bill, not a constitutional amendment, but a bill that would require that the President submit a budget that would be in balance if the real growth of the economy was 3 percent or better.

It seems to me that that would have a degree of economic reality which a mandated constitutional amendment would not have. It would mean that in the last 17 years, instead of having 16 deficits and one small surplus, we would have had 12 surpluses and 5 deficits. It would mean whenever the real growth of the economy exceeds the average over the last 200 years, which has been about 3 percent, you would have a balance and surplus. Whenever it is below that, we would have some stimulus. We would have a straining of effect in exuberant periods. The budget would have a stimulating effect on the economy in a stagnating or recession period.

What would you think of that kind of proposal? It may be we ought to modify it in general ways. But, generally, the principles?

Mr. GREENSPAN. If it could be implemented, it would be a major fiscal improvement in the fiscal policies of the country. My main concern, Senator, is the difficulty in trying to synchronize the policies. To be sure we know what real growth has been in the most recent period with some degree of accuracy, and we do know basically what our budgetary processes are.

Unfortunately, the leadtimes of initiating significant changes in the budget may make it difficult to synchronize the policies in the direction which you would like to see them go.

Senator PROXMIRE. I understand that. But, you see, the benefit here would be if, for example, in the coming year, instead of the sluggish growth that many anticipate—and these forecasts, as we all know, are subject to error—say, instead of 2 percent growth, instead a deficit, we had 4 percent growth, if it worked out to a surplus without changing the budget, you get that because of course with the 4-percent growth your revenues increase, some of your expenditures in aggregate decline slightly and, therefore, you would have an automatic stabilizing effect.

Mr. GREENSPAN. I am sorry. I think I misunderstood what you were stating.

Are you saying, Senator Proxmire, that you would focus the structure of the budget so that it would automatically balance at 3 percent?

Senator PROXMIRE. Yes; as closely as you could.

Mr. GREENSPAN. I think there is no question that that type of direction for fiscal policy would significantly improve how we run our policy mix and, if it could be implemented, and I suspect there are a number of technical problems, as there are in any proposal, it would work in a very important direction to diffuse the major inflationary imbalances in our system.

Senator PROXMIRE. Mr. Fair.

Mr. FAIR. I see some problems with it, although I have not studied it in detail. You do cut down your flexibility when you put a law like that on the books. You lock yourself into certain spending and tax patterns.

Senator PROXMIRE. It does not do anything to me, and it can be criticized on this basis. If you want to increase spending, you have to do it, but you have to increase taxes at the same time, so the effect on the price level should be more limited and should be more moderate.

Mr. FAIR. I understand, but say that the administration and most of Congress expect, for some reason when they look ahead a year, that there is going to be a serious recession.

Senator PROXMIRE. Of course, they could all be wrong or right.

Mr. FAIR. True, but let's say that in this case they are right. If you have this law on the books, you will not be able to run as expansionary a fiscal policy as you might like, given your future expectations.

Senator PROXMIRE. That is exactly right, and that is exactly why I think it would have benefit. You would not come out of 1974-75 recession like gangbusters, and the resultant 9 percent inflation we had last year.

Mr. FAIR. I understand your argument. All I am saying is you do have less flexibility if this bill is passed.

Senator PROXMIRE. Say we have a military emergency, obviously in a major military demand, you might very well have growth and have to have a deficit. You have had it in the past, and you would have it again, so I would permit a two-thirds vote of both Houses of Congress to set aside this requirement. Of course, the Fed would have flexibility.

Mr. FAIR. You would be giving the Fed more power than it now has to achieve its targets. Say the Fed disagreed with you on what the economy should do. If you lock yourself in, not just a year in advance, but into a set of policies that pretty much go on indefinitely, then the Fed clearly knows what the fiscal policymakers will do and it can work even more through monetary policy to achieve its aims.

Senator PROXMIRE. It is my fault as much as anybody's in the Congress because I am chairman of the Senate Banking Committee, which has oversight over the Fed, and Henry Reuss in the House. If that happens, I think the Congress can, under those circumstances, and might very well take action.

Mr. CHRIST. I would like to comment on this proposal.

I think if it is worded in such a way that it is clear what we are talking about is a 3-percent longrun pattern of growth, then, yes, I would be all for it. But think a moment about what happens if the economy goes through a business cycle. There will be two places in the cycle where the growth rate for a short time will be 3 percent. One will be at the top and one at the bottom, and you don't want the same budgetary stance for both.

Senator PROXMIRE. You would have a surplus in a period of expansion.

Mr. CHRIST. If it is stated in such a way that we look at kind of an average path around which the economy oscillates as it goes through minor recession, and that is a 3-percent growth path, and below that we should have a deficit, and above that we ought to have a surplus, I think that would be reasonable.

Ms. BARRETT. I think it would depend on what you would want your budget to do. There is no reason to think a budget that would be balanced at 3 percent real growth would actually produce 3 percent real growth. That depends on what is happening in the other sectors of the economy, what the trade balance is, how much pessimism or optimism there is in the business community; so, if you want to use your budget as an instrument of fiscal policy, then the balancing rule that would balance the budget at a specified growth rate does not make very much sense.

As Mr. Fair said, you would be putting a lot more pressure on the Fed to conduct macroeconomic policy.

I also think that making rules——

Senator PROXMIRE. At this point, let me just ask: What is the alternative? Is the alternative what we have been doing, for the Congress and President, to be sensitive or perhaps too sensitive to the situation that may be temporary of high unemployment and coming on with a problem that is too stimulative or a restrictive policy that under other circumstances would be too restrictive? Wouldn't it be better to have a policy that we could comment on?

Secretary Blumenthal said the other day to make a long-term commitment. How do you make such a long-term commitment?

One way is to have this kind of law, drafted into law, so the President would abide by it, Congress would have to play by the rules of the games, and it is a long-term commitment in that sense. Anything else is rhetoric. Even if we are sincere about it, we are here for relatively a short period of time, especially in the executive branch. If you are going to have a stable, long-term commitment, it seems to me you have to have a law, maybe a constitutional amendment, but a law I would think at the very least.

Ms. BARRETT. One, the Congress has put into place a budget process which has focused on the deficit, which has tried to give Congress a little bit better handle on controlling the deficit, and that seems to be working well—

Senator PROXMIRE. Not working so well from the standpoint of inflation. We have had the worst inflation that we have ever had in peacetime except the energy inflation we had in 1974-75.

Ms. BARRETT. It seems to me, given the automatic stabilizers that are built into the budget, what will happen as a result of passing any of these balancing the budget or spending cut amendments or laws would be an attempt to redefine budget concepts so as to find a way to keep us in compliance with the amendment or the law, at the same time being able to use budget policy as an instrument to stimulate or restrain the economy.

So I wonder whether or not some of this is not an exercise in futility unless we are really prepared to commit ourselves to a budget concept that is realistic.

Senator PROXMIRE. I would agree we have to have an agreement on definition. You could undoubtedly hook it up so your budget would be a capital budget. That would be one approach.

Let me ask on another issue.

Mr. Fair, you say that tight money policy is ambiguous now on the basis of our experience. Certainly the overwhelming majority of your colleagues in the economic profession would agree. On the other hand, there have been some recent distinguished challenges to that. I would like to ask you about that at the present time.

I am not sure tight money is as restrictive. No. 1, housing is involved, with the 6-month certificates and others. Inflation is widely anticipated and, therefore, the Chairman of the Federal Reserve Board keeps telling us the nominal rate of interest is not very high, and there is something to that, and the experience of the last several months indicates that even a monetary policy that results in very high interest rates does not have much bite.

So, if it does not have much bite and is not restraining demand, what we know it is doing is increasing costs—the costs to the homebuyer, the costs to the business that has to borrow, costs that are passed on to the consumer in higher prices. So, isn't it possible under present circumstances, rather than having a deflationary effect, tight money at least at the present time is having an inflationary effect?

Mr. FAIR. I would not necessarily disagree with that. When I said that my work indicated the net effect is deflationary, this is not always the case in my econometric model. There are times when I run an experiment with the model in which monetary policy is

tightened that the net effect for the first few quarters after the change is inflationary.

Senator PROXMIRE. If you continue to have a continuing inflationary psychology, isn't that likely to persist for some time?

Mr. FAIR. That is quite possible. It is difficult to measure empirically people's view of the future, and although some of this is captured in the work, perhaps not enough. As I said in my testimony, however, this is not the important point with respect to the mix questions. Even if I take your case and you take mine, we would both still argue, it seems to me, for a mix of looser monetary policy and tighter fiscal policy. Even if you feel the inflationary effect is larger than I feel it is, we would still come to the same conclusion about the mix.

Senator PROXMIRE. Let me ask Mr. Greenspan; you heard Mr. Fair's reservoir analogy. I don't know whether it is right or whether it is a pipe dream.

According to you, monetary policy has become kind of a hostage, I guess is how you put it, of fiscal policy. Fiscal policy has been just so dominant that it required a certain kind of monetary policy. According to Mr. Fair, the fiscal policy has to be determined in advance, considerably in advance, and relatively fixed during that period. Monetary policy can change every month, and even though the pipe going into the reservoir is a smaller monetary policy, it has the advantage of being able to have control because it operates on a much shorter time basis. What is your response to that?

Mr. GREENSPAN. If you are asking about the strictly mechanical characteristics of monetary policy, obviously that is true. The time period can change in seconds. You can transmit to the New York money market desk a major shift in monetary policy in a matter of minutes. I think, however, that we overestimate the effect of monetary policy's ability to significantly alter the real aggregates.

The Fed acts on the margin of the overall money market. I think that Professor Christ explained one form of the process in which, if you have an excessive expansion of aggregate credit in the capital markets, that is in excess of the ongoing savings of the private sector, you have a spillover into the commercial banking system or into financial intermediaries generally, in a manner which creates demand for reserve balances by the commercial banks, and drives up the Federal funds rate as a consequence. That process is always confronted by the Federal Reserve by pressing down on the rate of rise in Federal funds, which means they supply reserve funds to the system, expand the monetary base, and thereby ultimately expand the money supply or bank credit, creating at a later date, in my view, an excessive inflationary bias to the system.

On the other hand, if there is an excess of savings, and interest rates are falling, the Federal Reserve endeavors to absorb some of the money market's excess liquidity. The Fed tends to work on the margin of the markets, which is another way of saying that the Federal Reserve really is functioning as a creature of the money market, and it merely reacts to the aggregate amount of credit supplied in the system.

One element of that credit is the Treasury's direct financing requirements. But if we now look at the aggregate direct and indirect credit effects which is what fiscal policy should be defined

as, it is clear that you cannot accurately project in advance the degree fiscal policy pressure if you include in it the actions of Fannie Mae, the Federal Home Loan Bank, Ginnie Mae, that is all the credit transactions. I don't think it is that easy to forecast what the fiscal policy will be.

But further, the presumed tradeoffs between monetary and fiscal policy is more an illusion than a reality. As a consequence the situation is far more complex, both in timing and in interrelationships, than are theories of fiscal and monetary mix questions postulated, say, 5 or 10 years ago.

Senator PROXMIRE. You would conclude that fiscal policy does dominate the monetary policy overwhelmingly pretty much?

Mr. GREENSPAN. Yes.

Senator PROXMIRE. What is your answer to that, Mr. Fair?

Mr. FAIR. I think Mr. Greenspan's argument is—if you consider the water to be real economic activity—that the small pipe is very small and there is not much the Fed can do. As I said in my testimony, my work and that of others indicate that this is not the case, that interest rates have an effect on real decisions in the economy. This is true with respect to such things as consumer durable purchases, as well as housing investment and plant and equipment investment.

Senator PROXMIRE. Mr. Greenspan is indicating the level of interest rates is very largely a function of fiscal policy or all of the activities of the Federal Government, not only the budget but also these other off-budget activities, too.

Mr. FAIR. I will let him speak to that. My view is that the Fed can control interest rates, and that interest rates have an effect on private real decisions.

Senator PROXMIRE. The only thing he said is that the Fed controls the interest rates.

Mr. GREENSPAN. I think the Senator stated it correctly. In the longer run, interest rates, so far as governmental policies are concerned, are largely affected by fiscal policy and that the effects of monetary policy are either to sanction or endeavor to fend off small marginal changes that are created by fiscal policy.

In other words, I think that monetary policy's ability to significantly alter the pattern of interest rates or monetary aggregates is limited, and that the major thrust of governmental policies is more fiscal in the aggregate sense.

Mr. FAIR. I would argue the monetary policy is much more powerful than that, that the Fed can in fact alter long-term interest rates as well as short term interest rates and their real decisions.

I think we disagree,—with respect to the pipe analogy—about the size of the pipe.

Mr. GREENSPAN. We are disagreeing on data interpretation. His econometric model differs from mine and the question gets down to which structure more appropriately captures the nature of the economic environment in which we are working and, where there are no data which neither one of us can adduce to prove our case, what would we expect the data to show if we had it.

Senator PROXMIRE. Mr. Christ, you talked about M_2 expansion in the last 5 to 7 years. Isn't much of this the result of change in what M_2 really constitutes? Haven't there been changes in M_1 and M_2 ?

Mr. CHRIST. There have been very great changes in allocation between M_1 and M_2 . This has been going on for 25 years.

Senator PROXMIRE. Especially with the transfer accounts.

Mr. CHRIST. The automatic transfer has been the latest in the series, but there has been an easing of the barriers to transferring between time deposits and demand deposits and people have been taking advantage of this.

Senator PROXMIRE. How about the 4-, 6-, and 8-year certificates?

Mr. CHRIST. They have not changed that much relative to the rest of M_2 . M_2 has always paid interest and M_1 , since 1933, has not.

The interest gap has widened and that is why M_2 has grown over M_1 over the years.

Senator PROXMIRE. I notice fortunately the Federal Reserve Board, as you know, is about to give us a new aggregate. It will be years before we can get a pattern that will enable us to follow what is going on down there, but, unfortunately, I think we have to do that.

You will agree that M_1 has been changing and we don't know if what is happening to M_1 is a genuine restraint or a change in the content of M_1 .

Mr. CHRIST. Declining M_1 does not indicate to me there is any restraint. The fact that the growth rate of the base has declined about 2 percent from about 10 percent to about 8 percent, that sounds to me like a real decline.

It is very hard to have that, without it amounting to—

Senator PROXMIRE. Then there is the perfectly understandable change Mr. Burns used to point to. Whenever interest rates get high, you have a predictable increase in velocity because people use their money more importantly.

They can sock it away for 10 percent and they will do it. They will not let it sit in a checking account.

Mr. CHRIST. That is certainly true of currency and M_1 but it has not made much difference between M_2 and M_1 because M_2 's velocity stayed between 2.2 and 2.4.

Senator PROXMIRE. You said a \$29 billion deficit in 1980 is about right—\$29 billion in an austere budget with an inflation of 9 percent is about right.

Why should it not be closer to a balance under these circumstances?

Mr. CHRIST. The way I arrived at it is this: We need a gradual increase in the quantity of money in the country if we are not going to have prices going down.

There is no reason for prices to go down. It is hard enough to stabilize prices. Let's settle for stable prices.

If we have stable prices, we need the money stock to grow roughly in accordance with the growth of the country. Where will that come from?

First, it can come from a small deficit on the average over a 10- or 20-year period.

If the deficit is about 1 percent of GNP on the average, then that would add about enough to the money stock to make it grow about

3 percent a year, which is about what we need, and it would also allow the Federal debt—

Senator PROXMIRE. Now you are really getting far out. You are advocating a permanent policy of \$30 billion a year on average?

Mr. CHRIST. On average, yes. If you wanted it balanced, I think it would be practically as good because it would not do great harm to increase the money stock by reducing the national debt a little bit. But once the national debt is all gone, we could not do it any more.

Senator PROXMIRE. You are really relaxed. You must have given us more than an amphetamine analysis. We are really getting to be monetary junkies.

Usually economists get very passionate about these things—a \$29 million deficit, balanced budget, so what.

Mr. CHRIST. The rate of inflation we have had in the past is much more critically related to growth of the money stock than to the deficit.

I went back and looked at individual years. We have had substantial periods of large deficit without much inflation in our history, and we have had substantial periods of surplus without deflation in our history. The budget deficit is not directly connected to inflation.

It impacts on inflation because whenever there is a big deficit there is lots of Federal borrowing and that tends to push up interest rates which causes people to say to the Fed that interest rates need to be eased up; they are eased up, and that creates more inflation.

If the Fed would sit tight and not create more money when the deficit rises, then it would not be necessary to have inflation.

Senator PROXMIRE. You are relaxed on fiscal policy but you are definitely clear but not necessarily dogmatic on monetary policy.

Would you say it would depend on how long or how deep the recession is?

Mr. CHRIST. The rate of growth of the stock of money should be reduced gradually even if we get into a depression. If we get into a depression, interest rates will go down—they always do, somewhat.

Some people will say that is easy money. It seems to me the better definition of easy money is not in terms of what is happening to market interest rates but what is happening to the growth rate of the stock of money.

Senator PROXMIRE. You want it as a growth rate of stock money to continue to slow down even if we get into a recession?

Mr. CHRIST. Yes.

Senator PROXMIRE. Do you do that with 10 or 15 percent unemployed regardless, or is it your argument that it would not go that high?

Mr. CHRIST. That is my argument. But I will stick my neck out and say yes, even if we had 10 or 15 percent unemployment I would like to see monetary growth decline. And I would not object to large deficits brought about by some combination of tax cuts and spending to try to alleviate the unemployment.

I think it would work.

Senator PROXMIRE. You say M_2 normally grows at about the normal rate of GNP?

Mr. CHRIST. It has over the years.

Senator PROXMIRE. What makes you confident that it will slow inflation rather than real growth?

Mr. CHRIST. I think it will slow real growth at first.

Senator PROXMIRE. Why wouldn't it slow it in the long run?

Mr. CHRIST. Because I think growth in the long run is independent of the steady rate of inflation that you have. We have had roughly 3 to 4 percent growth in the United States for, as you said, 200 years, and we had a period from the Civil War to 1880 when the money stock was not growing fast and prices were falling.

We had the same growth rates in stable prices, and again, roughly the same growth rates since we began to embark on this inflationary policy in the 1960's.

It is quite clear to me from looking at all of the countries of the world that there really is a tight connection between the monetary growth rates and inflation.

If we don't some time stop creating money at these high rates, we will not at any time start to conquer the inflation.

Senator PROXMIRE. I agree with that. I am just wondering about the side effects.

Mr. CHRIST. There are side effects, but I am pretty confident they are temporary.

That is why I think the drug analogy is apt. I consulted a pharmacology professor at Johns Hopkins on this and he referred me to a Consumer's Union book entitled "Licit and Illicit Drugs," especially the chapter on amphetamines.

Senator PROXMIRE. That is a time when I wish Senator Humphrey was still with us. He was a pharmacist and he would have enjoyed your analogy.

Ms. Barrett, you say consumer confidence has been undermined by inflation but statistics show continued consumer strength not only in housing and automobiles but also a drop in the percentage saved, close to an alltime high in consumer credit as a percentage of income, and it looks like inflation is stimulating not retarding.

There was a time in the last big inflation, 1973, 1974, and 1975, that it seemed to retard consumer spending. Now it does not seem to be doing that.

Do you see a change in behavior?

Ms. BARRETT. There seems to be evidence that things in the consumer sector will change somewhat, in terms of the psychology that is going on, the buy-in-advance psychology. The consumer expenditure projection surveys now are showing consumer confidence has dropped somewhat. Also because the need to repay installment indebtedness and mortgage repayments will undoubtedly have to drive the savings rate back up. Consumers have gotten locked into higher mortgage payments, higher payments for automobiles and they will have to start repaying those and that shows up as higher savings.

Senator PROXMIRE. Ms. Barrett, you worked in the Congressional Budget Office; is that right?

Ms. BARRETT. Yes, sir.

Senator PROXMIRE. They claim now a current level of service would require outlays of \$551 billion, \$19 billion above the President.

Even with these high outlays, unemployment is expected to be well above the President's level. The deficit is almost \$50 billion.

Are you in accord with CBO's projections or do you regard the President's projections as more realistic?

Ms. BARRETT. The differences have to do with the economic assumptions. They are not talking about differences in programmatic—

Senator PROXMIRE. I realize that, but whom do you think is right?

I realize there is a difference here.

Is it Charlie Schultze or Alice Rivlin?

Ms. BARRETT. I think I would lean more toward CBO's projection of the economy, but I am not sure I could say who is right in terms of projected outlays.

Both CBO and the President in the past have been far off the mark in terms of the spending projections, both because there has been an unanticipated shortfall in spending and because it is very difficult to estimate outlays from the various eligibility programs.

This gets back to the whole question of enacting legislation to balance the budget. Some of these budget numbers are very iffy.

The President's projections, for example, of interest payments in the 1980 budget, are predicated on an interest rate which is substantially lower than the one the Treasury is now paying.

Just a rise of 2 percentage points in the interest rate could add another \$10 billion to the deficit. So, there are a tremendous number of uncertainties about what outlays are going to be even if we knew for certain what the real economic growth would be.

Senator PROXMIRE. I realize there are real uncertainties.

Ms. BARRETT. I think the President is overly optimistic in terms of real growth and in terms of the inflation projection.

Senator PROXMIRE. Do you see any harm in setting outlays almost \$20 billion below the present service level?

Ms. BARRETT. I think that the risks in real economic growth, not in inflation but in real economic growth, are on the down side, depending on very much what happens to monetary policy.

I don't think that the President's budget, if enacted, in terms of the cuts in spending, would precipitate a major recession, but I think that it will weaken the economy relative to the current services level of spending.

Senator PROXMIRE. Are there any areas of services that you think are being seriously neglected?

Ms. BARRETT. Do you mean in terms of the individual components of the cuts?

Senator PROXMIRE. Yes.

Ms. BARRETT. Certainly, some of the employment programs that are being cut back would have an adverse effect on the target populations.

Senator PROXMIRE. Of all the programs, isn't it more logical to cut them back in view of the colossal increase in employment?

Ms. BARRETT. The unemployment rate really has not been going down. We have high unemployment among blacks, for example.

Senator PROXMIRE. The President has tried to target the employment program so that it does provide employment for the blacks

and teenagers and away from this general notion of, for instance, letting municipalities use it to pad their payrolls.

Ms. BARRETT. That is right. The problem is that the cutbacks are being proposed in the CETA program, as I understand them. There is no guarantee at all that the State and local governments will now use the remaining job openings that they have to employ disadvantaged people.

As you know, in CETA, by far the majority of the participants are adult white males with 12 or more years of school. Given the fact that the CETA guidelines are not only vague but have such a multiplicity of target groups, it essentially gives State and local governments the right to hire whomever they want. The ones that are going to lose the most heavily are going to be the blacks and, to some extent, women.

Senator PROXMIRE. Professor Fair, let me come back to a dilemma cited in the opening statement—that is, monetary fiscal policies designed to raise employment and growth will worsen inflation whereas policies to slow inflation will slow growth and increase unemployment.

What should be done about this stagflation dilemma?

Mr. FAIR. I do not believe, and I think Ms. Barrett would probably agree, that aggregate demand policies in the current situation have very much of an effect on the rate of inflation. You don't get very much of a drop in inflation by bringing the economy into a recession. I think this seems to be pretty well accepted.

If this is true, then there isn't very much with respect to fiscal policy that you can do. You can change the mix, as I indicated. Perhaps an easier monetary policy relative to fiscal policy might be—

Senator PROXMIRE. What about what Mr. Christ is proposing, not deliberately pushing us into a recession—nobody advocates that—but a measured, gradual, persistent reduction in the rate of growth.

Mr. FAIR. That is a tight monetary policy. I think Mr. Christ and I differ by miles in our underlying models and in our view of how the economic system works.

Senator PROXMIRE. I think we might argue the recession won't give you ease in inflation for months. It may be 1 year or 2, but if you persist in it year after year, it will.

Mr. FAIR. That is a very high cost if it is in fact the case. I would argue that a much better way—

Senator PROXMIRE. Let me just interrupt to say it is high cost when, for instance, in West Germany they followed a more restrictive policy than ours and they have low levels of unemployment and lower levels of inflation than us in both cases.

Mr. FAIR. But not with the cost I think we would suffer if we tried to do the same thing. Our situation is not exactly analogous to the German situation. If we tried to do that, given the present conditions in the United States, I think the cost in terms of lost output and jobs would be very large over the next decade or so. This seems, from my point of view at least, to be a bad thing. I would argue, as I said, for an easier monetary policy—

Senator PROXMIRE. Why would the costs be large in view of the contention that seems to have some merit that inflation itself is an

element that prevents employment and expansion in growth, if people can be assured of relatively stable prices, that the economy will function better, there will be more jobs, and in the long run greater growth.

Mr. FAIR. There is no question that inflation is bad, but the issue here is if we pursued a restrictive monetary and fiscal policy, if we brought the economy into a recession and held it there for a long time, how would this affect inflation. My reading of the econometric results is that you would have to do this for a long time to bring the inflation rate down very much.

Senator PROXMIRE. In the last 25 years we have had 25 recessions. Each period has been on the average of 9 months, some more, some less, but none of them have been very long.

During much of that period we have certainly had more restrictive monetary policies.

Historically, it would seem that the case is not very strong that we are going to stay in a perpetual recession if we follow moderating monetary policies.

Mr. FAIR. I am not sure I followed that completely. Would you go over that again?

Senator PROXMIRE. I am saying that historically we have had recessions.

I think everybody recognizes that when you have a free system you have recessions, but that is one of the prices you pay for a free economic system.

There have been periods when we have had restrained monetary policy and during those periods there has been no analysis I have ever seen that would indicate the recessions have been longer.

Mr. FAIR. The recessions have not had that much effect on the rate of inflation. Take the 1974 recession. This very serious recession had a small negative effect on inflation, but not all that much, and we are still suffering from—

Senator PROXMIRE. Again, I am not saying that we should get into a recession, but we will get into it regardless of the policy we follow.

There is no way to avoid recession without socializing our economy and making it an economy that does not provide for the general and major economic policies.

We will have periods of recessions and inflation, or don't you think we can avoid inflation.

Mr. FAIR. I don't think we can avoid them. We can mitigate them. I think the recession we may have, say 6, 9, 12 months hence, could be mitigated substantially by an easier monetary policy than probably will be followed.

Senator PROXMIRE. The price you pay for that is less restraint on inflation.

Mr. FAIR. But not much. That is the point. There is not much effect on inflation from these aggregate demand policies one way or the other.

Senator PROXMIRE. Mr. Greenspan.

Mr. GREENSPAN. I want to strenuously argue the opposite case.

We have heard considerable discussion about the short term impacts of anti-inflationary policies on price. Most of this analysis derives from simulations from our macroeconomic models.

By the way we fit those data, we pick up only what we would usually call short term impact multipliers:

We have little ability to capture the type of phenomenon that Professor Christ has raised. It is certainly true that shortrun impacts, ultimately become long term impacts.

It is a very difficult to show significant price effect from anti-inflationary policies, but if there weren't any, you could not explain history.

The post-Civil War period that Professor Christ refers to when prices were falling and real growth was relatively good would not be explainable in terms of our current models.

There is an anti-inflationary policy effect on growth to be sure. The short term impact is a decrease in real economic growth or recession. But at a constant rate of anti-inflation pressure that gradually reverses, and you eventually get fully effective impacts on price with no long term effect on real growth.

I think the evidence on that is rather conclusive.

Senator PROXMIRE. You have been very, very helpful.

In the past 6 months, there has been a deceleration compared to the Fed's target growth for M_1 and M_2 and it is below the lower level of the range and the range is very broad, as you know.

How long should the Fed allow this slow growth to persist?

Mr. CHRIST. In the present circumstance, I think M_1 should be ignored. As we have noted, there now is this arrangement whereby you can keep a zero balance in your checking account and all your money in your savings account, and the bank will pay your checks.

Senator PROXMIRE. M_2 also has decelerated.

Mr. CHRIST. It has decelerated but not as much. M_2 , I think, is a little more meaningful.

When I was looking at the data for this hearing today, I was somewhat surprised at the large decline in the growth rate of M_2 . It grew at a 9-percent rate in the first 10 months of 1978 and it has been growing at an annual rate of 1 percent from October 18 to the last data I had, which was about 10 days ago.

Then I looked at the rate of growth of large certificates of deposit which has increased very markedly during this same period so that the growth of M_2 plus the large CD's has declined from a 10-percent to a 6-percent annual rate.

I think partly what is happening there is that because the interest rates are completely uncontrolled on the larger certificates of deposit of \$100,000 or more, more funds are going into those.

There are, as you know, the money market funds which specialize in taking money from small investors and packaging it in \$100,000 lots and buying these CD's.

A large majority of the bank accounts covered in M_2 have interest rate ceilings, even the 4- and 6-month ceilings, which are far below the going market rate.

Not many people have \$10,000 which they can use to buy money market certificates which became legal in July. We are still discriminating heavily against the small buyers.

Senator PROXMIRE. We have a bill in to reduce that to \$1,000.

Mr. CHRIST. Very good. Why don't you reduce it to zero?

The interest rate ceilings are muddying the water. If you look at the monetary base, which supports all of these financial aggre-

gates, the growth rate of the base is lowered only slightly, so it seems to me the Fed is doing very well in the last 2 months. I say keep it up.

Senator PROXMIRE. I mentioned the view of Professor Modigliani in my opening statement, which is that capital spending has been impeded by a tight money-easy fiscal mix of policy.

Do you agree with Professor Modigliani that this is a serious problem for the economy?

Would you be willing to accept the President's rather tight budget if this were combined with substantial monetary easing?

An alternative view of the capital spending issue is that capital spending has been impeded, not by tight money, but rather by a number of disincentives arising from our tax system.

For example, high marginal rates of income taxation are alleged to have impaired the incentive to save and invest.

Similarly, it is claimed that the insistence that capital assets be depreciated on an original cost basis for tax purposes lowers the real after-tax rate of return when the inflation rate increases and that this reduces capital spending.

I would like the panel to address itself to these questions.

What, in addition to changes in the monetary fiscal mix, should we do to raise investment's share of the GNP?

Ms. BARRETT. As I said before, I think that the main problem is that we still are operating so far from potential, but given that original statement, let me say I think we certainly could use tax policies to offset the potential disincentives of high interest rates.

For instance, better depreciation rules, an increase in the investment tax credit are examples of tax incentives to investment. I don't think we have begun to explore the possibilities for such tax policies. I think I lean more in that direction.

Senator PROXMIRE. I wonder about that. I read an article not long ago which indicated that the Fed is losing control of monetary policy partly because housing has been insulated and housing was a big element in retarding growth.

If you follow what you suggest, you are just saying that you are going to provide tax measures to offset monetary policy and discouragement of high interest rates. The result will be that interest rates will have to go higher and higher before they have a bite that achieves their objectives?

Ms. BARRETT. I am not sure I see that, how that will happen. Basically, what you are talking about is reducing corporate taxes so that more investment would be financed internally rather than externally. This would put less pressure on external credit markets—

Senator PROXMIRE. That is exactly correct. You want to restrain the overall economy. I realize I am on both sides of this, but I wanted to get your reaction because we are not restraining housing at a 10-percent interest rate; 15 years ago, housing would have gone right through the floor. We would have had a dropoff of 1 million housing starts. But now, it has had little effect. Maybe as high rates go on, we might anticipate a 20-percent drop in housing, but nothing like it used to be.

If we move over to the corporate sector, then more and more you have higher and higher interest rates which translates to higher

cost and an increase in the cost of living and an increase in inflation without having the effect of regarding effective demand.

Ms. BARRETT. It seems to me the people advocating monetary restraint are doing it because they want inflation to come down rather than because they want to see interest rates go up and real spending down. I think that that is the position.

So, what we are talking about is a new kind of policy change which is basically a fiscal stimulus to investment. You reduce taxes, but you do it in such a way as to provide a disinflationary impetus rather than an inflationary impetus. So you are shifting away from monetary stimulus to fiscal stimulus.

But it is a fiscal stimulus that is going to favor the investment area.

If you then want to moderate the level or rate of economic growth, you may want to offset that fiscal stimulus by some other measure, such as reducing government spending.

But I am just talking now about a situation where you have a given amount of fiscal stimulus and you want to reorganize the package through tax incentives to business investment and perhaps higher taxes levied elsewhere or lower levels of government spending.

Senator PROXMIRE. Mr. Greenspan, according to the CEA estimates, the decline of the dollar adds about 1 percent to our inflation in 1978. That is a huge impact that then supports the notion we ought to try to achieve a more stable value of the dollar in all currency markets.

My question is this: Was the decline of the dollar in 1978 an independent source of inflationary pressure or was it the means by which U.S. inflationary measures remained bottled up at home?

In other words, if we tried to maintain a fixed rate of exchange, would not some of our internally generated pressures be foisted on the rest of the world and what does this indicate to support the dollar?

Mr. GREENSPAN. There is no way in which we could have unilaterally supported the dollar. By implication, that would have required either, for example, the Deutsche Bundesbank loaning us marks to support the dollar or they themselves creating the marks to absorb dollars in the world market.

In either case, it would expand their monetary base which, of course, would have engendered inflationary forces. To the extent there was support and support was rather substantial, such effects did occur. The expansion in money supply in Germany was far in excess of what they would have preferred.

Certainly in Switzerland, where the money supply went up a remarkable 17 percent when they were trying to hold it to a small increase, indicates that the intervention process does ultimately create monetary expansion in the intervening countries. And while, for the moment, we have not had international inflation transmission, I think that the authorities in Germany, Switzerland, Japan, and the like, are getting extremely concerned about the potential of their own monetary base creating inflation in those countries. In effect, I think we are in the process of transmitting our inflationary forces abroad. And I don't know of any way in which we could have avoided that except by zero intervention, in

which case it is quite probable that the dollar would have fallen still more.

Senator PROXMIRE. Isn't the whole concept unsound, that as the dollar falls, we export more and import less and if there is any elasticity of demand that should fall and that should be somewhat self-correcting as our balance improves?

Doesn't it frustrate that objective to support the dollar, increase the value of the dollar over these occurrences and, therefore, decrease our ability to traffic in imports?

Mr. GREENSPAN. Yes; I think it does.

What we are finding is that international financial stability is largely a function of the range of differences in domestic economic policies and that there is no quick and simple international monetary system which will resolve differences of basic economic policy.

Senator PROXMIRE. The fundamental problem is inflation here at home.

Mr. GREENSPAN. That is true. And until we reduce inflation substantially, and more importantly, communicate that fact to people who hold dollar balances abroad, we are going to have a continuing problem in the international financial system.

Senator PROXMIRE. Mr. Fair, you argued for a larger role for the Congress and the administration in determining monetary policy, especially if we are to do more than throw softballs at the Fed.

I think under Humphrey-Hawkins it will help. The Fed has to have different rates because they must relate the targets to short-term goals suggested by the President. This involves housing.

First, Mr. Fair, would you go further than that and, if so, what would you do?

Mr. FAIR. I think that is clearly a step in the right direction. I think I would go further. I don't have a bill or a proposal to make about what the best way to do that would be. There are many options that one can consider, but I would be reluctant to try to push one particular option. I think, however, that the Congress and the administration should have some mechanism to control the policy of the Fed more than is now done, than merely requiring the Fed to submit what it is planning to do with respect to M_1 , growth and the like.

Senator PROXMIRE. Ms. Barrett, do you have any views on that?

Ms. BARRETT. I essentially agree with Mr. Fair.

Senator PROXMIRE. You don't have any specific recommendations to what we can do to achieve that?

Ms. BARRETT. That is right.

Senator PROXMIRE. I think you are all aware of the independence we have had, and we can always amend the Constitution, but we have been served fairly well.

But there is the argument to the extent they become more politically dominated, their policies will be more volatile or inflationary, less stable.

What would you think of that Mr. Christ?

Mr. CHRIST. I think, in retrospect, the Federal Reserve's actions from about 1948 to about 1960 were probably better than they were before, or than they have been since, until very recently.

There were some anticyclical changes that were made by the Fed during that period of the 1950's, but in terms of the long run, the growth rate was kept fairly constant.

The way in which the monetary policy is organized, as I read the Constitution, is this. The Congress shall have the power to coin money and regulate the value thereof. I take it that that is the job that has been delegated to the Fed.

As you say, it can be taken back from the Fed at any time. I think the Fed is extremely conscious of that.

A Fed staff member once told me, "We are so busy guarding our independence, we try hard to find out what Congress wants to do, and we do that in order that they don't take away our independence."

Senator PROXMIRE. Do you see a difference between Mr. Miller and Mr. Burns in degree of independence, particularly in the executive branch?

Mr. CHRIST. I don't really know the answer to that. It seems to me in the last 3 months, since October, there has been a substantial improvement in Federal Reserve policy.

Senator PROXMIRE. Do you see any contradiction in the Secretary of the Treasury announcing the increase in the discount rate, the biggest increase we ever had? That occurred about November 1. Secretary Blumenthal said increase it at 1 percent. It was not done by the Fed. It was done by Blumenthal.

Mr. CHRIST. No; I did not notice that. That is very interesting.

Senator PROXMIRE. To correct M_1 for the transaction accounts, I understand the suggestion is you add 3 percent to the observed growth rate. That is the estimate of Mark Willis, President of the Fed of Minneapolis.

Would you think that may be about right?

Mr. CHRIST. That is the first time I have heard this so I have to do some fast arithmetic. If you look at the minus 2 percent growth rate of M_1 since November and add 3 percent you get 2 percent. That is the growth rate of M_2 .

I don't know if that is the way he got the figure or not, but that is my first reaction.

Senator PROXMIRE. Mr. Fair, you have argued tighter monetary policy is inflationary. I have one more question and I will yield to Congressman Rousselot.

Mr. Fair, you said the administration's budget is about right provided the Federal Government allows short-term rates to fall by 1 or 2 percentage points in the next year and a half.

The Fed provides policy aims and objectives to the Congress in terms of growth rates and in terms of monetary aggregates.

What is your prescription for growth rates translated into M_1 or M_2 .

Mr. FAIR. It is highly interpretive in part because of the recent financial reforms and changes that have been made, so I am not sure what that would translate into.

To get back to your last question, to require the Fed to give you its interest rate target would be helpful. For those of us who believe interest rates have a real effect on decisions, interest-rate targets would be much more helpful in deciding—

Senator PROXMIRE. I guess we are in real limbo as far as monetary aggregates. We know that we are going to come up with new aggregates.

Mr. FAIR. They keep changing.

Senator PROXMIRE. Most are mystified. Everybody knows, not only Members of Congress, but the general public is well aware of what interest rates mean. I think if we discuss it in those terms we will get a lot more concern and probably more intelligent discussion.

Mr. FAIR. As a first step, I would clearly advocate trying to get more control over the Fed.

Mr. CHRIST. Could I comment on that very briefly?

Senator PROXMIRE. Yes, sir.

Mr. CHRIST. It is true what has been said, yet there is no reason why interest rates should be kept stable but there is good reason why monetary growth rates should, so there is no reason to put the emphasis on the interest rates.

Senator PROXMIRE. I think that is true, but nevertheless you ought to be prepared to discuss and understand and have justified what their target interest rates are and why.

We would have a greater understanding than we have now.

Under most circumstances, you don't get a turnout of members of the committee because they should just figure they don't know what is going on.

We are lucky to get three people here, even when the Chairman of the Federal Reserve comes up. Mr. Burns is a great attraction and so is Mr. Miller. They are fine, articulate, intelligent people, but monetary policy is pretty recondite.

It is something that seems to require 3 or 4 years of graduate work and nobody wants to talk about it and then, after 3 or 4 years of graduate work, nobody really wants to talk about it.

Congressman Rousselot.

Representative ROUSSELOT. Thank you, Senator Proxmire.

First, I am fascinated with your laundry list of suggestions for curing inflation and other monetary problems. I especially like managed stabilization policy and what you regard as its effect on the economy. And then, after a transition period, just starting immediately to keep the rate of growth of the M_2 money stock (a) low on average about 3 percent a year, and (b) fairly steady—usually between 2 and 4 percent, and always between 1 and 5 percent.

You put heavier attention and focus, obviously, on the growth of money stock in contrast to all the attention that is usually given to interest rates.

Mr. CHRIST. That is right.

Representative ROUSSELOT. In the Ways and Means Committee we have had two economists who have said that even though the growth of money stock is a central issue in inflation, we don't really pay attention to it.

Describe again—I know you did for the committee—how you would go about tightening the money supply so as to reduce inflation if you were the Chairman of the Federal Reserve Board.

Mr. CHRIST. I would probably be fired if I were the Chairman of the Federal Reserve Board, but I would be glad to tell you what I would do.

I think that you have stated correctly that the growth rate—

Senator PROXMIRE. Let me interrupt to say that once you become Chairman of the Federal Reserve Board, you can't be fired.

Representative ROUSSELOT. Maybe we will put him up as a candidate.

Senator PROXMIRE. His position is more secure because he is appointed for 14 years. Mr. Burns was persuaded to step down but he could have said no.

Mr. CHRIST. I am aware of the 14-year term but the Congress has great powers to alter these matters.

The history of every country that I have looked at—and I would really be glad if there were an exception, if somebody would tell me about it—makes it very clear that the rate of growth of the money stock over any substantial period of time is very closely related to the inflation rate averaged over that substantial period of time.

There is a good monetary theory that we learn in undergraduate school and in 4 years of graduate work that is consistent with that.

I think if we are going to stop the inflation, we really have to get to a place where monetary magnitudes are not growing so fast.

There are two ways to do it: One is to try to do it all of a sudden and one is to try to go from where we are now to that position gradually.

There are many economists who claim that changes in the rate of growth of the money stock—

Representative ROUSSELOT. Last year, as I recall, it was somewhere around 8 or 9 percent.

Mr. CHRIST. There is a little table on this—I don't know if you have a copy of it in front of you—

Representative ROUSSELOT. Yes.

Mr. CHRIST. It shows—

Representative ROUSSELOT. Did you make this part of the record?

Mr. CHRIST. I would like to.

Senator PROXMIRE. Yes, it is already a part of the record.

Representative ROUSSELOT. We are referring to tables 1 and 2.

Mr. CHRIST. In the second table we see what the growth rates were in the first 10 months of 1978.

As you say, they were high.

Representative ROUSSELOT. M_2 was 9 percent and M_1 was 10 percent, right?

Mr. CHRIST. Yes.

There is a minority of the economics profession which says if you change the rate of growth of the money stock suddenly, you will have a recession—

Representative ROUSSELOT. Or a wrench effect.

Mr. CHRIST. I think there is some evidence that that is correct. That was the source of the amphetamine analysis I put forth. So, I would like to see the rate reduced gradually.

Representative ROUSSELOT. Over what period of time?

Mr. CHRIST. Ten years.

Representative ROUSSELOT. How long would the downturn last if you did that, and if it was known by the general money market, that it would be done over a period of time?

Mr. CHRIST. If everybody believed it would be done over a period of time, which everybody does not believe, then it would be no longer than any normal recession.

If it is really stuck to, then in a year people will begin to believe that it is being stuck to, and then I think after that it might not be much longer than the normal recession, so I would look for a rather short period of restriction of real output if this policy were followed.

Representative ROUSSELOT. What would be the long-term effect of doing that, in your judgment?

Mr. CHRIST. I think one long-term effect would be that after we finish the process 5 or 10 years from now we would have the inflation down to zero.

The other long-term effect would be that we would be in the position of having normal cycles again and we could use fiscal policy to moderate them. I don't think they would be any bigger than they were from 1948 to the present, and maybe a little smaller.

Representative ROUSSELOT. You mention you are in the minority among economists on this thesis.

How many other economists of noteworthy reputation agree with you on this, would you say?

Mr. CHRIST. You might ask the people at the table here and see if you get an answer.

Mr. FAIR. No.

Representative ROUSSELOT. Just a flat no?

Mr. FAIR. No. I don't agree.

Representative ROUSSELOT. Do you want to keep the money stock large?

Do you believe that increasing the money stock helps decrease inflation?

Mr. FAIR. At times that is true, if it lowers interest rates. We discussed, before you came in, that a tight monetary policy, according to my work, raises interest rates, which is a cost. And some of this cost is passed on in higher prices. Therefore, there are times in which a tight monetary policy—high interest rates, low growth of M_1 —leads to inflation. I would not subscribe to a simple relationship between inflation and M_1 growth.

Representative ROUSSELOT. I think your statement was basically about M_2 .

Mr. FAIR. Or M_2 , too.

Representative ROUSSELOT. Would you try to keep money supply constant, or would you be primarily concerned about interest rates?

Mr. FAIR. I would be primarily concerned about interest rates.

Representative ROUSSELOT. Do you want the Government to manage interest rates?

Mr. FAIR. It does now through the Federal Reserve.

Representative ROUSSELOT. You want controls on money interest? Would that stop inflation?

Mr. FAIR. It has some effect on inflation, but not that much.

Representative ROUSSELOT. What has?

Mr. FAIR. The issue is whether you have a tight money policy—

Representative ROUSSELOT. Money stock?

Mr. FAIR. Let me reverse the situation. In the next year, I would like to see a somewhat easier monetary policy, if the budget, as submitted by the President, is enacted.

Representative ROUSSELOT. Easier money stock?

Mr. FAIR. Right.

Representative ROUSSELOT. So, instead of an increase of 8 or 9 percent, you would rather see an 11 percent increase?

Mr. FAIR. I would concentrate on what monetary growth would need to be in order to get interest rates down.

Representative ROUSSELOT. Isn't the interest rate just the price of money?

Mr. FAIR. Yes.

Representative ROUSSELOT. Doesn't the marketplace determine that somewhat?

Mr. FAIR. Somewhat, but the Fed has a lot of control. Open market operations, as we know from many past episodes, can have an important effect on interest rates, particularly short-term interest rates.

Representative ROUSSELOT. Obviously there is a difference in the understanding of the marketplace.

Mr. GREENSPAN, do you want to comment on the recommended formula of a phasedown?

Mr. GREENSPAN. I agree with his formula, but I think his phasing is far more than necessary. But I don't feel we should dramatically wrench the markets.

Representative ROUSSELOT. He is a moderate.

Mr. GREENSPAN. I am a radical in that respect.

Representative ROUSSELOT. What would you say, 3 years?

Mr. GREENSPAN. It depends not so much on monetary policy per se as whether the aggregate of credit preemption by the Federal Government is sufficiently reduced to allow the Federal Reserve to sharply lower the rate of monetary growth without driving interest rates higher. I think that is really a timing question. It is not a monetary question, but a fiscal policy question.

Representative ROUSSELOT. If you were the Fed Chairman, would you do it in a 3-year period?

Mr. GREENSPAN. First, I would harangue the administration, which Federal Reserve Chairmen have been known to do. The reason for that is that it is only if the Treasury and the Federal Government, leaving aside the Board of Governors, create an atmosphere which enables monetary growth to be reduced, that you can accomplish it. I don't think it is strictly an issue of Federal Reserve.

Representative ROUSSELOT. In other words, they need the cooperation of the rest of the Federal Government in not increasing the borrowing requirements in the marketplace?

Mr. GREENSPAN. That is a necessary condition to bring interest rates down. I don't feel that by expanding monetary guidelines, you can bring the interest rates down. If that were the case, one would say a 10-percent growth rate was consistent with 7-percent interest

rates, a 20-percent growth rate in M_2 would be consistent with a lower level of interest rates. I would suspect the evidence is exactly to the contrary.

Representative ROUSSELOT. You have made a good point, and I am sure Mr. Fair will discuss it with you after this hearing is over.

The reason an increase in the money stock helps bring down interest rates is a fascinating theory, and I have never seen it in history—

Senator PROXMIRE. Would the gentleman yield on that point for a moment?

Representative ROUSSELOT. Certainly.

Senator PROXMIRE. I am inclined to agree with the position Mr. Greenspan and Mr. Christ talk about, but I think in all fairness, if you increase the supply of money, you increase the supply of money. It is a matter of demand of my money and your money. If the supply is more available, if the marketplace works, the price tends to fall certainly in the short run.

The difficulty, as I understand it, is that, as you increase the supply, there is an anticipation that this is going to be an inflation, and the attitudes, because of inflation, become translated into higher interest rates. But I think there is a perfectly logical, understandable reason why people say an easy money policy—

Representative ROUSSELOT. Increasing the money supply—

Senator PROXMIRE [continuing]. Tends to reduce the price of money.

Representative ROUSSELOT. Unless there are fewer goods and services being produced, as Bill Simon tried to point out in his book. That is an interesting chapter.

Senator PROXMIRE. It is perfectly logical, if you increase the supply—

Representative ROUSSELOT. Ms. Barrett, did you want to get into this discussion?

Ms. BARRETT. I think everyone will agree there is a relationship. I think what we disagree about is what is driving what.

It seems to me in the period 1974 to 1978, for the most part, the monetary base was driven by the inflation rate, and not the other way around. For example, if you look at what went on in 1974, there was a big upsurge in the inflation rate as a result of a lot of external things that went on.

Representative ROUSSELOT. It was not all external. We don't want to blame it all on oil. They did not have the inflation rate in West Germany or Switzerland where they were depending on foreign oil, too. So we cannot blame it all on the increase in the price of foreign oil.

Ms. BARRETT. That is right, but some countries experienced a larger than normal increase in inflation rate and to a large degree the rate was the result of external factors. It was the result of the pressure on the monetary authorities to accommodate increases in inflation that originated externally.

Representative ROUSSELOT. And an increase in the Federal debt.

Ms. BARRETT. That may have been caused by the automatic stabilizers going into effect.

Going back to Professor Christ's point, in order for his policy to work, we would need also to find ways to get the inflation rate down, to get the inflation, driven by other things, down.

Representative ROUSSELOT. What would you name as the other important items?

Ms. BARRETT. If the President is successful in his program to try to break the inflationary link between wages and prices, Professor Christ's proposal would be far more desirable than where we have the escalating process occurring largely independently of monetary growth and where, at the same time, the monetary authorities are being pressured to accommodate these other inflationary factors through increasing the monetary base. So it seems to me this kind of policy has to go hand-in-hand with other kinds of—

Representative ROUSSELOT. Lower expectations.

Ms. BARRETT [continuing]. Anti-inflation policy. If you don't do that, it seems to me you are going to repeat the situation in which a monetary crunch has more effect in the short run on real growth than on inflation and politically—

Representative ROUSSELOT. Do increased taxes play a role?

Ms. BARRETT. I think so. I think that payroll tax increases coming at a time when you are trying to convince people their real wages will not be eroded by inflation does not make much sense.

It is not a very credible policy.

Representative ROUSSELOT. You would put relief on taxation like we did with proposition 13?

Ms. BARRETT. Definitely, but I would not tie the tax cuts to the spending cuts. It would depend on the outlook for real growth. There is no reason why a tax program should not be part of an anti-inflation program.

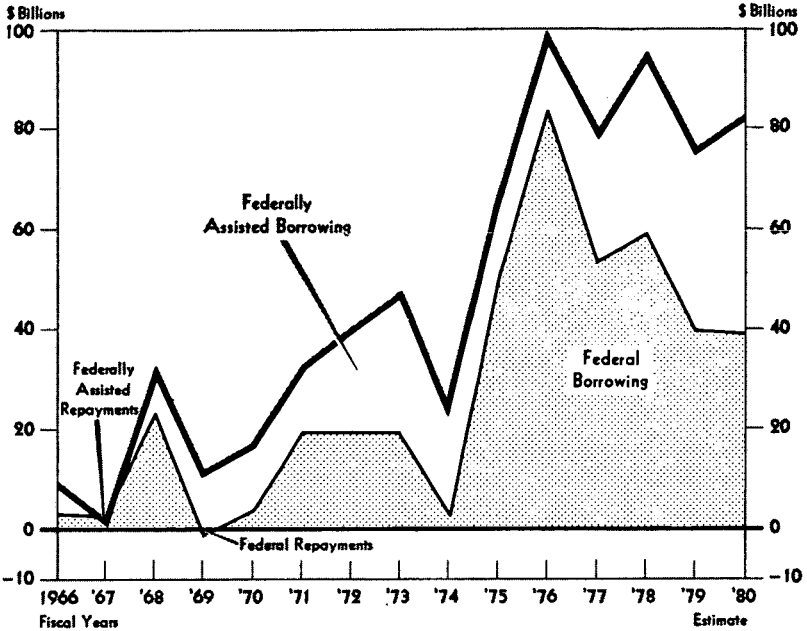
Representative ROUSSELOT. I am glad you partially endorse such a policy. I appreciate your comments.

Mr. Greenspan, I have been interested in the "Special Analysis of the Budget of the U.S. Government, Fiscal Year 1980," by the Office of Management and Budget. They have a fascinating chart on page 131, which I think you have commented on before, which relates—Senator Proxmire, if it is possible, I would like to have the chart as part of the record at this point, so it is clear what we are discussing.

Senator PROXMIRE. Without objection.

[The chart follows.]

Federal and Federally Assisted Borrowing



Representative ROUSSELOT. This chart shows Federal borrowing by the Treasury and also federally assisted borrowing, which I guess is mostly off-budget borrowing, which the Office of Management and Budget projects \$80 billion for 1980. We only hear about the on-budget borrowing that would be required. Would you like to comment on that chart on page 131 and also on the general topic of crowding out in the marketplace as a result of this tremendous amount of borrowing by the Federal Government?

Mr. GREENSPAN. Congressman Rousselot, this type of analysis, which has been around for a number of years, probably should be in the official budget, as distinct from the special analysis, because in many respects it does represent the measure of the impact of Federal Government activities on the private sector. There is no logical reason to merely segregate the so-called on-budget procedures of the Federal budget from what it does indirectly or, by definition, off-budget.

Representative ROUSSELOT. So you think we should include both categories in the total?

Mr. GREENSPAN. Yes, in fact there has been a great deal of discussion on the accuracy of the \$29 billion budget deficit.

But that is not a budget which is obviously out of line or rigged in any way which one could immediately perceive.

On the other hand, when you look at some of the federally assisted borrowing estimates which are quite important in the total economic system, it strikes me that we are considerably underesti-

mating the total fiscal 1980 numbers. I would suspect that, whereas that chart shows a number slightly over \$80 billion for 1980, the more realistic number is probably a good deal closer to \$100 billion, which would put—

Representative ROUSSELOT. \$100 billion instead of \$80 billion?

Mr. GREENSPAN. Closer to it. It is probably in the 1990's. That would put 1980 borrowing and federally assisted borrowing close to its alltime peak of fiscal 1976 and hugely in excess of anything we have historically seen even as recently as the 1960's.

So, if we are looking at the aggregate impact of fiscal policy on the credit markets and, therefore, indirectly on the money supply, there is nothing I envisage in this particular budget document that gives me great hope that we are about to enter a period of sharply reduced fiscal stimulus.

Representative ROUSSELOT. When the Federal Government has to borrow, whether it is called on budget or off budget, then this tremendous amount that you say—around \$90 billion is your estimate—does it in effect tend to compete in the marketplace more aggressively than the private market can absorb?

Mr. GREENSPAN. It depends to a substantial extent what the ongoing flow of savings are. I don't think it is appropriate to add merely different types of Federal borrowing and assistance dollar for dollar.

Technically, the impact differs depending on the degree of so-called inelasticity of demand for funds. In fact, on-budget and legal off-budget borrowing probably has almost nothing to do with the interest rate; that is, the Treasury will borrow what it requires to finance its deficit independent of what the rate of interest is.

I would suspect, however, that at extremely high interest rates some of the federally assisted borrowing which is largely borrowing by the Federal Home Loan Bank Board, and Fannie Mae, would probably be partly curtailed. But there is no question that the aggregate itself is terribly important. In today's environment, with aggregative private credit demands being quite strong, we are seeing, as a consequence of these very large numbers, tremendous stringency in the short-term money markets. The loan deposit ratio for the commercial banking system has now pierced the 1974 peak. So we see extreme difficulty on the part of the financial intermediaries, particularly the commercial banking system in trying to balance the supply and the demand for funds, largely as a consequence of the very large borrowing requirements, directly and indirectly, of the Treasury.

Representative ROUSSELOT. That does not help capital formation.

Mr. GREENSPAN. No, clearly, it is detrimental to it.

Representative ROUSSELOT. I think we have heard that statement. Thank you for your point.

Do any of you want to comment on that?

Mr. FAIR. I would concentrate as I indicated in my testimony, not on the deficit, but instead on the effects of the expenditure and tax proposals on aggregate supply and demand. I consider the deficit to be a residual, the result of the various expenditures and tax decisions. I gave an example where, if the administration forecast is too optimistic for fiscal 1980, then the budget deficit will be larger than the administration expects.

Representative ROUSSELOT. Congressman Giaimo, our Budget Committee chairman in the House, said it would probably be as high as \$30 billion or \$40 billion.

Mr. FAIR. It would seem to me that this is not terribly interesting in itself. You would not say—

Representative ROUSSELOT. Why is it not interesting?

Mr. FAIR. Consider the case in which the administration turns out to be wrong, where there is less expansion, and a larger deficit than expected. I think most people would argue that there would be less inflation in the less expansionary case even though the budget deficit is higher.

Representative ROUSSELOT. Mr. Christ, do you want to comment?

Mr. CHRIST. Just to comment on the effect of growth of the money stock on interest rates: If we increase the money stock faster than we have been doing it before, the short-run effect will lower interest rates. But soon after that—after the inflation rate rises as a consequence—we get higher interest rates.

So, the way to lower interest rates in the long run is to slow down the growth of the money stock. Get rid of the inflation and rates will come down.

Mortgage rates are now 2½ percent above the inflation rate. That is about the same spread as in 1950.

Ms. BARRETT. I think one thing that Mr. Greenspan has pointed out is that the short-run effects on the deficit of fiscal policy changes that we might adopt from year to year are probably far less significant in terms of their impact on credit markets than other things the Government does.

We have been focusing a lot on the crowding out of effects of the deficit. We need to know a lot more than we do, and Congress needs to have more information from economists about what the credit market activities of the Government are, and this should be part of the whole budget process.

And I think the idea of trying to get a handle on what you call the credit budget or the operations of Government in credit markets is an important next step in this whole question of the evolution of the budget process.

Representative ROUSSELOT. The total activity, which point I think we made very well.

Ms. BARRETT. Yes.

Representative ROUSSELOT. Thank you. Senator Proxmire.

Senator PROXMIRE. That pertains to a very interesting little note I saw in the Washington column of the Wall Street Journal. It reads this way: "Smaller pay hikes loom in some firms as guidelines begin to bite."

That sounds like very good news. As one pointed out, one of the problems with inflation is that high wages, particularly with productivity, lead to high prices. There is no question about it. It is inevitable.

I realize this income policy depends very heavily on effective fiscal and monetary policy.

Mr. Greenspan, would you say this would indicate the President may be on the right course with the guideline program he has or would you say it is too early to tell?

Mr. GREENSPAN. As a member of a couple of companies' compensation committees, I can tell you those are cuts in salaries of high-salaried employees.

Senator PROXMIRE. It sounds like it is not only effective but just.

Mr. GREENSPAN. I was about to indicate that, like the expenditure limits in the Federal budget, there are many ways you go around those things. As a consequence, I am inclined to see it as representing a very small number of people.

Senator PROXMIRE. That looks like a very big sample, 624 companies. When Gallup makes a poll of 624 people, they claim the error is about 3 percent.

Mr. GREENSPAN. I think the company number is right, but I think they are only covering the executive group which is a very small number of people in each company.

Senator PROXMIRE. It says management employees will be most affected by the employees and only 26 said management employees would be hardest hit.

That suggests they would not be as drastically hit. The biggest cuts would be at the top.

Mr. GREENSPAN. I have very little experience with this. But I would say companies are behaving as though these controls are mandatory, and the individual corporations have been, as best I can judge, behaving, especially with respect to management salaries, as if they are dealing with a mandatory system. So the results do not surprise me.

Senator PROXMIRE. If there were a reduction, it would be very good news, would it not, from an inflation standpoint?

Mr. GREENSPAN. I would say if it is spread throughout the total economy, it would be. But this is a very small number and I would hesitate to generalize from this particular study.

Senator PROXMIRE. Would you all agree that this can only work in an atmosphere of reasonably restrained monetary and fiscal policy, that if you don't restrain your fiscal and monetary policy, it would not work, but it may be a useful part of any anti-inflation policy, providing you concentrated on monetary and fiscal policy.

Would you agree with that, Mr. Fair?

Mr. FAIR. Yes, I would.

Senator PROXMIRE. Mr. Christ?

Mr. CHRIST. Yes.

Senator PROXMIRE. Ms. Barrett?

Ms. BARRETT. I don't know what you mean by restraint, but disastrously restrictive monetary—

Senator PROXMIRE. I don't think it is restrained enough, but more than the restraint practiced now by the administration?

Ms. BARRETT. Probably.

Senator PROXMIRE. Thank you very much. You have been an excellent panel and you have done a fine job. We are very grateful to you.

I will be happy to call your observations to other members of the committee.

The committee will stand in recess until tomorrow when we have a panel consisting of Herbert Stein, on the economic scene.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 7, 1979.]

THE 1979 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 7, 1979

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:15 a.m., in room 6226, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senator Bentsen; and Representatives Brown and Wylie.

Also present: Louis C. Krauthoff II, assistant director-director, SSEC; Richard F. Kaufman, assistant director-general counsel; John M. Albertine, L. Douglas Lee, Thomas F. Dernburg, Kent H. Hughes, and William R. Buechner, professional staff members; Charles H. Bradford, minority counsel; and Robert H. Aten and Stephen J. Entin, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. Gentlemen, as soon as you are ready, we will get started. I understand that Mr. Eckstein's plane has been diverted to Dulles, and he should be landing about now. He obviously will be late.

Mr. Stein was not scheduled until 11 o'clock.

This morning we are continuing our review of the economic outlook for the remainder of 1979 and for 1980. Over the past few weeks we have heard from administration witnesses like Charles Schultze, Jim McIntyre, Secretary Blumenthal, all of them talented economic analysts, men of impeccable repute, who hold positions of power and influence in the Carter administration.

Today, just in case anyone might disagree with the administration's economic outlook, we are presenting an impressive array of hard-boiled, highly skilled private economic analysts, who will look behind that veil, behind the official mask, and give us an unbiased professional view of where the economy is going—at least that is what it says here.

Actually, as I noted last Friday, our economists keep predicting a recession, but they keep postponing it until such time as they have data to support their prediction.

The Joint Economic Committee is privileged to welcome this morning Mr. Edward Bernstein, the president of E.M.B., Ltd., who will focus on the international situation and its impact on our domestic economy.

He will be followed by Mr. George Perry of the Brookings Institution, who will discuss the economic outlook in general.

We will have Mr. Eckstein, if he can get in from Dulles, and Professor Stein, former Chairman of the Council of Economic Advisers, who will join us at 11 o'clock.

Gentlemen, we hear estimates of the budget deficit ranging all the way from the President's low of \$29 billion to various figures as high as \$55 billion. President Carter suggests a growth rate of 3.3 this year and no recession. At least one forecaster says it will be closer to 1.5 percent, and a whole host of private forecasters are predicting a recession. We really need some enlightenment this morning, gentlemen. I would ask you to proceed, Mr. Bernstein.

STATEMENT OF EDWARD M. BERNSTEIN, PRESIDENT, E.M.B., LTD., RESEARCH ECONOMISTS

Mr. BERNSTEIN. Mr. Chairman, in my opinion, the critical element in the achievement of the forecasts of the Council of Economic Advisers may be the behavior of the foreign sector, that is to say, our balance of payments.

Senator BENTSEN. Mr. Bernstein, I really want to hear what you have to say. If you will, pull that mike closer.

Mr. BERNSTEIN. The critical factor in the achievement of the forecasts of the Council of Economic Advisers may be the behavior of the balance of payments of the United States. Whether the United States can achieve an increase in output and maintain the level of employment that is forecast depends upon what happens to our exports and our imports. Whether the administration approaches the target for slowing the inflation will depend to a considerable extent on the behavior of the exchange rate. It is not generally recognized that a contributing factor in the large budget deficit of recent years has been the deterioration in our trade balance.

It is more than a coincidence that in 1977, when President Carter came into office and sent his first message on the budget, he proposed a stimulus program of \$16 billion. It was almost exactly equal to the deterioration in our trade balance between 1975 and 1976, which was \$18 billion.

In his original budget message for 1978, the President called for tax reductions of about \$24 billion, and, as I said, it is more than a coincidence that that was about equal to the deterioration in our trade balance—that is, the increase in the trade deficit from \$9 billion to \$31 billion.

The depreciation of the dollar from the end of September 1977 to the end of October 1978 averaged about 20 percent relative to the currencies of the large industrial countries. It was an important factor in the acceleration of the inflation. It was a reason given by the oil-exporting countries for the increase in the price of oil.

I think we have to understand that the problem of the U.S. trade balance is much more than a simple question of relative prices or differential rates of expansion. The increase in the imports of the United States from 1975 to 1978, excluding imports of oil, were about 2½ times as large as the increase in the goods output of the United States. This means that a very large part of the growth of domestic demand during this period was diverted to creating output and employment in other countries. It was also, of course, the principal reason for the depreciation of the dollar.

Since the administration began its new program on November 1, the dollar has recovered. Until February 2, it had risen about 8 percent on the average against the currencies of the Group of Ten and Switzerland—the 10 largest industrial countries.

In the last 2 days the dollar has weakened, and it was weaker again this morning. In fact, the price of gold touched \$250 an ounce in London.

The main reason for the depreciation of the dollar and the deterioration of the trade balance is of a structural character. We already had the first inklings of this in the period from 1957 to about 1971.

What happened was that in Europe and Japan the growth of output was on a great scale, much of it in the industries in which we had been specializing for many years, and this manifested itself in a recurrent payments problem for the United States.

Ordinarily, when a country or a group of countries like Europe and Japan grow rapidly, it ought to be good for our balance of payments, that is to say, their demand for imports would increase more than ours. We would be among the suppliers of these imports, and we would expect our trade balance to improve. What happened in Europe and Japan, though, is that the increase in the consumption of their own output, plus the domestic investment in their own output rose very much less than the increase in their production. In short, exports became far more important as a contributor to the level of production and employment in these large industrial countries.

It is astonishing that this should happen. From an economist's point of view, there is only one explanation of how you can have such an enormous increase in output and income and such a limited increase in domestic consumption and investment, that is to say, relative to the increase of output and income: It is because real wages are too low in Japan and in some European countries for their productivity and their real interest rates are too high for their savings.

The two devaluations of the dollar in 1971 and 1973 and the depreciation of the dollar *de facto* in the exchange market since then have not given us a strong payments position. It is because the structural factors have been against us.

The main contributors to the recent structural changes are the rise in the price of oil and the worldwide inflation. Let me explain how these two factors work back on our trade difficulties.

First, a good many countries—in fact, all countries that import oil—found that their balance of payments suddenly had become distorted by the need to make large payments for this oil. For many of these countries the easiest way to solve this payments problem was by exporting more to the United States. In 1974, around January, I wrote a paper in which I pointed out that there was a great danger that with the passive attitude of the United States toward its balance of payments and the exchange market, we would become the residual absorbers of the deficit with the oil countries that other countries were unwilling or unable to accept. Incidentally, this paper was published in a Senate report. I must say that the reality has been much worse than the expectations I had in 1974.

The second reason is the inflation. I don't for a moment want to condone our relative indifference to the inflation problem. We certainly haven't done as well on inflation as Germany or Switzerland or even Japan where the traditional rise in the consumer price index has always been greater than ours.

Our own inflation is not really the reason for our deterioration in the trade position, because the depreciation of the dollar should have offset the greater inflation of the United States and maintained the price competitiveness of our exporters in world markets and our domestic producers in our own market.

What happened is this: In Europe and in Japan the determination to hold the inflation to a minimum resulted in a further deficiency of domestic demand. Their producers confronted with large excess capacity and in some cases with high overhead costs, for example, for maintaining employment, preferred to cut their profit margins sharply in order to maintain the level of output by exporting to the United States. After all, we are an enormously attractive market for any other country that has trouble in maintaining output.

We buy 15 million automobiles and trucks a year. Any country that is having trouble maintaining sales in its domestic market can easily offset that if it can capture another 1 or 2 percent of our market. And this, in my opinion, is one of our basic problems, that the rest of the world finds that the United States is the one great market in which they can sell their output when domestic demand is weak or when demand in other areas falls. I might add, incidentally, that one of the reasons Japan pushes so hard to export to the United States is that it is very sharply discriminated against in its exports to Europe.

Now I am deeply disappointed that we have had no improvement in our trade balance despite the enormous depreciation of the dollar. I don't regard what has happened this year as any indication of an improvement in our trade balance. After all, our trade deficit ran something like this:

It jumped from \$3.6 billion in the fourth quarter of 1976 to an average of nearly \$7 billion in the first three quarters of 1977. It then made a quantum leap to a deficit of over \$10 billion in the fourth quarter and another leap to \$11 billion in the first quarter of 1978.

This sudden jump in the trade deficit at a time when the dollar was depreciating was due to anticipation of depreciation of the dollar. The Europeans and the Japanese wanted to get their exports through our customs before the dollar depreciated much more. In Germany, for example, in the last months of 1977 exports to the United States rose by 40 percent, measured in deutsche mark, compared to the previous year. This was just to build up inventories of goods sold by Germany in this country before the dollar depreciated more.

After the dollar began to become a little more stable, our imports dropped and in the second quarter of 1978 our trade deficit fell to \$7.7 billion and in the third quarter it rose a little to \$8 billion. In the fourth quarter it dropped to around \$7.4 billion. These are quarterly trade deficits on a balance-of-payments basis.

Now, the \$7.4 billion trade deficit is really no sign of improvement. For one thing it includes \$300 million of receipts from the sale of gold in December and smaller quantities in October and November. Besides, the \$7.4 billion trade deficit in the fourth quarter is larger than the \$7.3 billion trade deficit in the third quarter of 1977 that precipitated the flight from the dollar.

I think the dollar has recovered primarily because there is a feeling in the exchange markets that the Treasury and the Federal Reserve won't let it depreciate much more. If the Treasury and the Federal Reserve won't allow the dollar to depreciate much more and interest rates in the United States are raised, why there is a big inducement for those that have been maintaining a short position in dollars to cover their positions, that is to say, not to expose themselves to a risk of recovery in the dollar. There isn't much they can gain in the near future from a further depreciation of the dollar.

I welcome this policy. I think it has been successful so far, but I think we must bear in mind that it is not a policy that can be successful in the longer run, and I am thinking only in terms of 1979, unless the exchange market sees a significant reduction in our trade deficit.

I don't want to sound too pessimistic. The Council of Economic Advisers makes the point that the improvement in our current account from the fourth quarter of 1977 to the fourth quarter of 1978 was a great contributor to the maintenance of output and employment in the course of 1978. I think we ought to bear in mind that this is from the biggest current account deficit that we have ever had, and that if we had measured, say, from the third quarter instead of the fourth quarter of 1977, there would have been no improvement whatever.

It may be that the depreciation of the dollar that has already occurred, the slowing of the growth of output in the United States, perhaps the acceleration of the growth of output in Europe and Japan will bring an improvement in our trade balance; but I think that if it doesn't in the next few months, and that is all really the market is prepared to wait for, then I think it will be necessary for us to take stronger measures to restrict the inflow of finished manufactured goods from the large surplus countries.

Senator BENTSEN. That is quite a closing, Mr. Bernstein.

I think we will go ahead and hear Mr. Perry and then proceed with questions of you gentlemen.

[The prepared statement of Mr. Bernstein follows:]

PREPARED STATEMENT OF EDWARD M. BERNSTEIN

The past few years have been a period of great monetary instability. In the United States, the inflation of prices and costs accelerated. In the foreign exchange markets, the dollar depreciated considerably relative to the currencies of almost all of the large industrial countries. Until the United States succeeds in slowing and halting the inflation, the dollar will be under pressure in the exchange market. And as long as the dollar depreciates, there cannot be an orderly or stable international monetary system.

The greater inflation in the United States than in some other countries, such as Germany, Japan, and Switzerland, would of itself necessitate a depreciation of the dollar relative to the Deutsche Mark, the yen, and the Swiss franc. Unless the dollar depreciated to that extent, the United States would be unable to maintain the price competitive position of U.S. exports in world markets and of domestic products

in the U.S. market. In fact, the dollar depreciated far more than that, particularly from the end of September 1977 to the end of October 1978. Over these 13 months, the dollar fell by 24.2 percent relative to the D-mark, by 32.6 percent relative to the yen, and by 36.0 percent relative to the Swiss franc. Against all of the currencies in the Group of Ten and Switzerland, weighted by their total exports in 1977, the dollar fell by an average of 19.7 percent (Table 1).

The dollar fell sharply in this period because the exchange market lost confidence in the dollar as a result of the deterioration in the U.S. payments position. In order for the dollar to be reasonably strong in the exchange market—that is, to depreciate no more than the relative rate of inflation—there must be an inflow of foreign funds equal to the U.S. deficit on current account plus the loans and investments of the U.S. Government, banks, and business. When the deficit on current account becomes too large, it is difficult to attract an adequate inflow of foreign funds at prevailing exchange rates. As a consequence, the dollar depreciates until either it has fallen so much that the risk of loss to private investors in acquiring and holding dollar assets is more than offset by the prospect of gain, or the monetary authorities intervene to halt the depreciation because it has become excessive and disruptive.

This is what happened in the past three years. In 1975, the United States had a current account surplus of \$18.4 billion, including reinvested earnings of U.S. and foreign direct investment enterprises. By 1978, this had shifted to a current account deficit of about \$16.3 billion. As other current receipts increased much more than current payments, the change was entirely due to the fall in the trade balance from a surplus of \$9.0 billion in 1975 to a deficit of \$34.2 billion in 1978. Not surprisingly, the exchange market regarded such an increase in the trade deficit as evidence of great weakness in the U.S. payments position. Under the circumstances, foreigners did not find investment in U.S. assets attractive and the dollar depreciated far more than could be justified by differences in the rate of inflation. The depreciation was halted only when the Treasury and the Federal Reserve took measures to support and strengthen the dollar.

What is most astonishing is that the large depreciation of the dollar had no effect, at least so far, in reducing the trade deficit. On a quarterly basis, the trade deficit rose from \$3.6 billion in the fourth quarter of 1976 to \$7.0 billion in the first quarter of 1977. The trade deficit fell and rose moderately in the next two quarters but then leaped to \$10.2 billion in the fourth quarter of 1977 and \$11.1 billion in the first quarter of 1978. The trade deficit fell to \$7.7 billion in the second quarter, rose moderately in the third quarter, and fell moderately to \$7.5 billion in the fourth quarter of 1978 (Table 2).

The shift of the trade balance from a moderate surplus in mid-1975 to a moderate deficit in late 1976 could be regarded as a typical response to the more rapid recovery in the United States than in the other large industrial countries. The near-doubling of the deficit to a quarterly average of \$7.0 billion in the first three quarters of 1977 cannot be regarded as cyclical in character, unless one interprets the very large increase of U.S. imports of finished manufactured goods as resulting from the low level of domestic demand in other countries. The leap in the quarterly trade deficit to the \$10-11 billion range in the fourth quarter of 1977 and the first quarter of 1978 was due to the flood of imports from Europe and Japan and the fall of U.S. exports in anticipation of the depreciation of the dollar. The reduction of the trade deficit since then is not an improvement in the U.S. trade position, but a reversal of the previous leads and lags. The fact is that the trade deficit in the fourth quarter of 1978 was larger than it had been in the third quarter of 1977 which precipitated the flight from the dollar.

The persistence of the enormous trade deficit is the result of basic changes that have been going on in the structure of the world economy. The remarkable increase in output and productivity in Europe and Japan until 1975 would ordinarily be expected to have a favorable effect on the U.S. payments position. So it would if consumption and investment in these countries had increased about in proportion to the increase in their output. Instead, the growth of output and employment in these countries has depended on a very large surplus on current account. The development of their economies on the basis of an excessive export surplus shows that their real wages have been too low for their productivity and their real interest rates have been too high for their savings.

This basic cause of imbalance in international payments was intensified by new factors that emerged in the past few years. The sharp increase in the price of oil in 1973-74 placed great strain on the balance of payments of the oil-importing countries. For many of these countries, and they include some large industrial countries, the most convenient way of meeting the much higher cost of oil imports was to

increase their exports to the United States. This danger was foreseen in 1974; the reality has been much worse than expected.

The other factor that has contributed to the intensification of the imbalance in international payments is the emergence of inflationary pressures throughout the world. Some European countries and Japan have succeeded in dampening the inflationary pressures by holding down domestic demand. In order to maintain output, however, their producers have placed even greater emphasis on increasing exports. The United States, with its enormous market for goods of all kinds, is an inviting target for the exporters of other countries. If the domestic market for automobiles, for example, is weak, foreign producers can easily offset it by increasing their share of the U.S. market by an extra 2 or 3 percent. To some extent, they have been helped by the policies of their Governments. In any case, they have not hesitated to cut profit margins to a minimum in order to capture a larger share of the U.S. market.

It should not be overlooked that the enormous trade deficit of the United States is in large part the consequence of the policies of other countries that have resulted in their having an enormous trade surplus. To put it bluntly, the United States would not have a trade deficit of over \$34 billion in 1978 if, say, Germany did not have a trade surplus of about \$22 billion and Japan a trade surplus of about \$25 billion last year. The reason such an imbalance in the pattern of world trade could develop is that the United States takes a passive attitude toward its balance of payments. In fact, other countries believe that the United States should be the residual absorber of whatever balance of payments they regard as appropriate for them. They recognize that the depreciation of the dollar places great pressure on the profit margins of their exporters, but they are reluctant to recognize that this is due to their determination to maintain an excessive level of exports.

All sorts of arguments have been presented to rationalize this unprecedented imbalance in the pattern of trade as somehow necessary and even desirable. The former Minister for External Economic Affairs of Japan (the post has since been abolished) said a few months ago that its bilateral trade with the United States will have to remain indefinitely in surplus because it needs such a surplus in order to help the developing countries. The right way for Japan to help the developing countries is by having a surplus with them which is financed by aid from Japan. A few months ago, a director of the Bundesbank said that the German surplus on current account would be a serious problem only if other countries were to have foreign exchange difficulties because of it. This was not to be expected, he said, as the Federal Republic was a large exporter of long-term capital. Unfortunately, the United States cannot have an acceptable balance of payments, one which is compatible with a reasonably stable dollar, if other large industrial countries have an excessive current account surplus, even if they invest the proceeds abroad.

Arguments have been presented in the United States that the trade deficit is caused by the high level of domestic demand, that the increased imports serve to moderate inflationary pressures, and that our trade balance is a reflection of comparative costs. In fact, the trade deficit is far greater than could have been caused by the cyclical recovery of domestic demand. Since 1975, U.S. imports, excluding oil, have increased about two-and-a-half times as much proportionately as the goods output of the United States. This had a restraining effect on output and employment which the Administration tried to offset by a fiscal stimulus. It is fair to say that the increase in the trade deficit was a contributing factor in the budget deficit. As for its contribution to the slowing of inflation by increasing the supply of import goods, that could be little more than marginal. On the contrary, the depreciation of the dollar as a result of the trade deficit had the effect of raising the prices of all basic commodities and even domestic goods not competing with imports.

What troubles me most is the assumption that the enormous trade deficit is a reflection of comparative advantage and that it must therefore be beneficial to the United States and its trading partners. When trade is based on comparative advantage, we export the goods in which we have relatively greater efficiency and import the goods in which other countries have relatively greater efficiency. The key word is relative. It is inconceivable that one country can have a comparative advantage in nearly everything it produces. It is implicit in the theory of comparative advantage that a country's exports and imports of goods and services will be within reasonable overall balance, allowing for the fact that some countries should be capital exporters and others capital importers. The concept of comparative advantage cannot be stretched to explain the enormous trade surplus of Japan and Germany and the even larger trade deficit of the United States.

On November 1, 1978, the Secretary of the Treasury and the chairman of the Federal Reserve System announced their policies to support and strengthen the

dollar. That has involved a tightening of monetary policy and the accumulation of large resources for intervention in the market in collaboration with the monetary authorities of Germany, Japan, and Switzerland. The policy has succeeded in halting the depreciation of the dollar and in bringing a considerable recovery in its foreign exchange value. In the three months to February 2, 1978, the dollar rose by 7.8 percent against the D-mark, by 12.6 percent against the yen, and by 14.2 percent against the Swiss franc. Relative to the currencies of the Group of Ten and Switzerland, the dollar rose by an average of 7.9 percent over this period.

This has given the dollar an extra element of strength by inducing exchange traders to cover their short positions. The dollar can continue to be strong, however, only if there is clear evidence that the trade deficit will be reduced substantially. There has certainly been enough depreciation of the dollar to give the United States a much better price competitive position in world trade. The slower growth of output in the United States and perhaps the faster growth of output in other industrial countries should be of help in stimulating U.S. exports and holding down U.S. imports. If the trade balance is reduced substantially, the inflow of foreign funds will become adequate to finance the U.S. current account deficit and U.S. foreign loans and investments without a renewed depreciation of the dollar.

The United States is not without fault in its serious payments difficulties. It has not done enough to slow the inflation, it has been too tolerant of the depreciation of the dollar, it has become too dependent on imported oil, and it has been too passive about the trade deficit. The Administration is now dealing more forcefully with these problems. It has placed primary emphasis on slowing the inflation, even though this will require a more modest growth of output and some increase in unemployment. An essential element in achieving the price and cost objectives of the Administration is to avoid a further depreciation and, if possible, to facilitate a continued recovery in the foreign exchange value of the dollar. Intervention to support the dollar can be helpful for a time. In the end, the strength of the dollar in the exchange market will depend on restoring an acceptable trade balance. If this does not occur in the next few months, it may be necessary to reduce the deficit by limiting imports from the surplus countries.

E M B (LTD.)
 79/3

1. DOLLAR EXCHANGE RATES FOR SELECTED CURRENCIES, 1977-78

| | Foreign units per dollar | | | Per cent change in value of dollar to | |
|-----------------|--------------------------|------------|------------|---------------------------------------|------------|
| | September 30 | October 31 | February 2 | October 31 | February 2 |
| | 1977 | 1978 | 1979 | 1978 | 1979 |
| Belgium | 35.742 | 27.580 | 29.670 | -22.84 | 7.58 |
| Germany | 2.3074 | 1.7490 | 1.8855 | -24.20 | 7.80 |
| Netherlands | 2.4565 | 1.8925 | 2.0340 | -22.96 | 7.48 |
| France | 4.9033 | 4.0025 | 4.3250 | -18.37 | 8.06 |
| Sweden | 4.8327 | 4.1800 | 4.4050 | -13.51 | 5.35 |
| United Kingdom* | 1.7465 | 2.0770 | 1.9794 | -15.91 | 4.93 |
| Canada* | 0.9316 | 0.8597 | 0.8342 | 9.75 | 3.06 |
| Japan | 265.45 | 178.95 | 201.55 | -32.59 | 12.63 |
| Italy | 882.25 | 794.50 | 847.38 | -9.95 | 6.66 |
| Switzerland | 2.3385 | 1.4963 | 1.7083 | -36.01 | 14.17 |
| Average change# | | | | -19.67 | 7.85 |

* U.S. dollars per foreign unit.

Increase or decrease in average foreign exchange value of the dollar weighted by the total exports of these ten countries in 1977.

2. U.S. EXPORTS AND IMPORTS, 1975-78

| | Million dollars | | | | | | Per cent change from previous period | | | | | |
|--------|-----------------|------------|---------|---------|------------|---------|--------------------------------------|------------|-------|---------|------------|-------|
| | Exports | | | Imports | | | Exports | | | Imports | | |
| | Total | Agri-cult. | Other | Total | Petro-leum | Other | Total | Agri-cult. | Other | Total | Petro-leum | Other |
| 1975 | 107,088 | 22,242 | 84,846 | 98,041 | 27,017 | 71,024 | 8.9 | -0.8 | 11.8 | -5.4 | 1.6 | -7.8 |
| 1976 | 114,694 | 23,381 | 91,313 | 124,047 | 34,573 | 89,474 | 7.1 | 5.1 | 7.6 | 26.5 | 28.0 | 26.0 |
| 1977 | 120,576 | 24,336 | 96,240 | 151,706 | 44,980 | 106,726 | 5.1 | 4.1 | 5.4 | 22.3 | 30.1 | 19.3 |
| 1978 | 141,819 | 29,864 | 111,955 | 176,008 | 42,307 | 133,701 | 17.6 | 22.7 | 16.3 | 16.0 | -5.9 | 25.3 |
| 1977-1 | 29,477 | 6,219 | 23,258 | 36,502 | 11,574 | 24,928 | -0.8 | 4.2 | -2.0 | 9.6 | 23.9 | 4.0 |
| 2 | 30,629 | 6,480 | 24,149 | 37,263 | 11,536 | 25,727 | 3.9 | 4.2 | 3.8 | 2.1 | -0.3 | 3.2 |
| 3 | 31,009 | 5,974 | 25,035 | 38,277 | 11,306 | 26,971 | 1.2 | -7.8 | 3.7 | 4.9 | -2.0 | 4.8 |
| 4 | 29,461 | 5,663 | 23,798 | 39,664 | 10,594 | 29,100 | -5.0 | -5.2 | -4.9 | 3.6 | -6.6 | 7.9 |
| 1978-1 | 30,689 | 6,485 | 24,204 | 41,808 | 10,020 | 31,788 | 4.2 | 14.5 | 1.7 | 5.4 | -5.1 | 9.2 |
| 2 | 35,092 | 7,974 | 27,118 | 42,812 | 10,588 | 32,224 | 14.3 | 12.3 | 12.0 | 2.4 | 5.7 | 1.4 |
| 3 | 36,955 | 7,902 | 29,053 | 44,918 | 10,985 | 33,933 | 5.3 | -0.9 | 7.1 | 4.9 | 3.7 | 5.3 |
| 4 | 39,083 | 7,503 | 31,580 | 46,470 | 10,714 | 35,750 | 5.8 | -5.0 | 8.7 | 3.5 | -2.5 | 5.4 |

Senator BENTSEN. Please proceed, Mr. Perry.

**STATEMENT OF GEORGE L. PERRY,¹ SENIOR FELLOW, THE
BROOKINGS INSTITUTION**

Mr. PERRY. It is a privilege to testify before the Joint Economic Committee on the subject of the President's economic outlook and economic policies. The emphasis in economic policy has moved toward fighting inflation and away from expanding employment and production. This shift in emphasis is appropriate after several years of recovery during which employment has grown by 10 million and the unemployment rate has declined by 3 percentage points from its recession high.

It is also appropriate that the administration aims to fight inflation while still avoiding a new recession. Although the changes in fiscal and monetary policy aimed at slowing aggregate demand increase the risk of an economic downturn, the administration is not relying on a weak economy as its main weapon against inflation. In addition to demand restraint, it has instituted a program of voluntary wage and price standards, proposed an innovative program of real wage and price standards, proposed an innovative program of real wage insurance to encourage compliance with the wage standard, and promised to reduce the inflationary impact of regulation and other activities of the Government.

I would like to address my remarks both to the prospects for achieving the Government's near-term objectives for employment and inflation, and to the range of antiinflation policies which are being pursued and proposed.

OUTPUT AND EMPLOYMENT IN 1979

The administration forecasts a 2 to 2.5 percent increase in real GNP during 1979—fourth quarter 1978 to fourth quarter 1979. They also foresee somewhat faster growth during 1980, and thus forecast no recession any time in the next 2 years. Although recent developments have increased the probability that the administration will achieve its soft landing, I still expect a recession will start during the second half of this year. My expectations for monetary policy are important in making that judgment.

For some time now a central part of a recession forecast for 1979 has been the expectation that high interest rates would lead to a substantial decline in housing starts and construction activity. Thus far, the efforts by the Federal Reserve Board and the Federal Home Loan Bank to limit the outflow of funds from thrift institutions in the face of rising interest rates have succeeded beyond anyone's expectations. As a result, there is still no sign of a decline in housing.

Not only has the industry been virtually immune to the rise in rates that has thus far occurred, but recently the Federal Reserve has stopped increasing interest rates: The discount rate has not been raised since its historic leap of 100 basis points in early November, the Federal funds rate is only one-fourth point above its

¹ The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

early November level, and market rates declined during most of January.

If interest rates do not rise substantially further, or steps are not taken to limit directly the availability of funds for mortgages, consumers, or business borrowers, I believe the recession could be avoided. I continue to forecast a recession because I expect that the authorities will make tight money bite on the real economy either through higher rates or limited availability, or both. And when they do, it will be hard to take just a nip that slows the expansion, but stops short of causing a recession.

Fiscal policy is not a major source of weakness in the very short-term outlook. But under present budget plans it will be by 1980. Although it is hard to anticipate developments that far ahead, I expect that a distinctly easier monetary policy will be needed to achieve the administration's output goals for next year, even if a recession is avoided in 1979.

The situation in Iran raises some important uncertainties about economic prospects for this year and next. Neither the basic administration forecast nor my own allows for a substantial shortfall of world oil supplies from world demand. World oil stocks are plentiful by historic standards and other producing nations have the capacity to make up much of the loss in Iranian production. But whether they will do so, for how long, and at what price are all important questions to which we cannot have certain answers.

We do have time to do some contingency planning for some possible bad outcomes even if they are unlikely. Such planning should look for ways to maximize our own fuel production, minimize the impact of higher energy prices on our wage-price spiral, and insulate output and employment from the depressing effects of a large increase in imported oil costs.

INFLATION IN 1979

The administration forecasts a rise of 7.25 percent to 7.5 percent in the GNP price deflator during 1979. This would represent a slowdown of about 1 percentage point from the 1978 increase of 8.3 percent. And they project a comparable slowdown in 1980 as well.

I find this forecast reasonable. Barring bad news on food prices or surprising increases in energy prices, the forecast is realistic and could even come out high.

I agree with the Council of Economic Advisers assessment that compensation per hour in the nonfarm economy will rise about 8.5 percent during 1979, and agree also with the reasons for their assessment: Compared with 1978, when hourly compensation rose 9.8 percent, this year the wage-price restraint program will moderate average wage increases; the rise in payroll taxes and the minimum wage will be much smaller; and the upward pressure on wage increases that comes from declining unemployment will be absent.

Based on what has happened in both the recent and distant past, an 8.5 percent rise in hourly compensation should lead to a rise of 6.5 to 7 percent in the price deflator for the nonfarm sector—again excluding any exceptional increases in energy costs. Last year the price deflator rose 1.75 points less than hourly compensation, and that was a year in which the declining value of the dollar put some

extraordinary upward pressure on prices in export- and import-competing industries.

Thus, there is room in the administration's overall price forecast for some extra price inflation from domestic energy prices or farm food prices rising a bit more than the average price level. But I see no hope for keeping the average price level within the forecast if food or fuel prices rise a great deal.

POLICIES FOR INFLATION FIGHTING

We can stop inflation if we care about nothing else. Inflation remains a problem because policymakers do care about other things. They care about the inefficiencies, inequities, and bureaucracies that would be part of a system of rigid wage-price controls. And they care about the loss of output, employment, profits, and investment that would result from applying large doses of fiscal and monetary restraint until inflation was wrung out of the system. The administration's diversified attack on inflation is an attempt to deal with the problem while avoiding these extremes.

To most disinterested observers, the least controversial part of the administration's program is its promise to reduce the impact on costs and prices of regulation and other activities of the Government. These other activities range from agricultural programs to import policies to payroll taxes. There is plenty of scope for affecting the price level, and hence the inflationary spiral, through these activities of the Government. But until interested parties, including the Congress in many cases, are persuaded, this part of the program may promise much more than it delivers. In some cases it may also deliver more than it should—the point is not to abandon the goals of social regulation, but to pursue them more efficiently.

The most visible parts of the program are the voluntary standards for wage and price restraint. By directly orchestrating a slowdown in the inflationary spiral, these standards can speed up the process of disinflation and reduce the real loss in employment and production that accompanies it. We cannot judge how successful the administration's voluntary standard will be, although the early returns seem favorable. There is no verdict from either the past or from economic theory that tells us it is not an attempt worth making.

Real wage insurance is the most innovative part of the administration's program and the most controversial. I am aware of many specific criticisms of that proposal. But I am far more impressed that it is basically on the right track: it encourages the slowdown in wage inflation without intruding on the market economy in a way that should seriously concern anyone. We have no precedent from which to estimate what effect real wage insurance will have on this year's inflation. But even if it takes only a couple of tenths of a point off average cost increases this year, it is worth doing. And if experience with such a program teaches us how to improve it in 1980 and subsequent years, we may evolve a really significant new tool for slowing the present inflation and for reconciling prosperity and price stability in the future.

Attempts at direct wage-price restraint are always messy and always generate skepticism and criticism. The critics often stop

short of describing what other alternatives we have. Realistically, the alternatives are letting inflation continue and possibly worsen, while pursuing high employment; incurring huge real costs in lost output and employment in order to slow inflation through demand restraint alone; or muddling through with something in between—a stop-go policy that leaves us dissatisfied with both inflation and unemployment.

Popular slogans, such as eliminating Federal deficits, are not in the running as an inflation cure. Deficits are not the cause of inflation or even a cause of inflation.

Commonsense tell us this: A dollar of Government spending is neither more nor less inflationary than a dollar of private spending; and a dollar of either is neither more nor less inflationary if it is financed by borrowing rather than spent out of savings or income.

Our own experience tells us this: Except for wartime, when the Government budget has contributed to excess demand inflation, deficits have been largest when economic activity and inflationary pressures have been weakest.

A comparison across countries tells us this: Germany has lately slowed its inflation, yet their government sector deficit is proportionately many times larger than ours.

The planned reduction in the deficit proposed by the administration makes sense as a fiscal policy for slowing the growth of total demand. As such, it has a relevant place in the overall strategy for slowing inflation. But the planned deficit has no special impact on inflation beyond that. In particular, if the economy falls into the recession that the administration hopes to avoid, the deficit will be larger; that will provide no reason for limiting expenditures still further and thus making fiscal policy still tighter.

Even people who should know better are touting balanced budgets as the cure for our inflationary ills. The risk is that slogans will prevail and will get in the way of choosing among the realistic options. Today the mixed strategy of the administration is our most attractive option and deserves support. Thank you.

Senator BENTSEN. Thank you very much, Mr. Perry.

Mr. Bernstein, in your closing statement you said that if we are not able to get an acceptable trade balance in the next few months, it may be necessary to reduce the deficit by limiting imports from the surplus countries.

Would you elaborate on that statement?

Let me say, first, I will put a 10-minute rule in here for a few of us Congressmen. We may have some others appearing, even though the snow has given us some problem, but if you would elaborate on that, I would appreciate it.

Mr. BERNSTEIN. Senator, there is a close connection between the deficit of \$34 billion that the United States had in trade in 1978 and the surplus of \$24.7 billion that Japan had last year and the surplus, which I estimate at a little over \$22 billion, that Germany had.

As I said, I don't want to sound too pessimistic, but if the improvement in our trade balance isn't up to the expectations of the market, the dollar is going to be under pressure once more. I don't think we can afford to have the dollar depreciate further.

The depreciation of the dollar affects every aspect of our economy. In December, after we put in our program of support of the dollar in the exchange market, the Federal Reserve raised the discount rates by 1 percent in a single step, the first time that such an increase had been made by the Federal Reserve since the gold crisis of September 1931, when England went off the gold standard.

Even though everybody was worried about how high interest rates would go, I published a paper in December in which I said that if the dollar appreciated in the exchange market remains strong, interest rates would stop rising, and might even fall, and the closing sentence was that the fall couldn't be very much unless the Federal Reserve accepts this as a reason for easing monetary policy.

This is why interest rates declined in January. The dollar became strong. The interest rate in the Eurodollar market, dropped, and the fall was transmitted to the United States. The Federal Reserve also made it easier for American banks to draw funds, if they wanted to, from the Euro-currency market.

I think we have to pay attention to the improvement in our trade balance in the next few months unless we want to reverse the rise of the dollar we had from November 1 to February 2, unless we want to see the value of dollar bonds, the value of dollar stocks, the value of other dollar assets, and that is why I think we must not wait too long.

Senator BENTSEN. Well, Mr. Bernstein, we had Bill Miller, Chairman of the Federal Reserve, here and he made a somewhat similar comment, that we had the choice between finally going to even higher interest rates or some kind of surcharge, and he would opt for the surcharge on imports from countries that had a substantial trade surplus. It seems to me that at the time someone makes that comment, they put a black hat on and they start talking about the smooth falling in 1929, but we ended World War II by giving some very significant concessions to some of these countries and we did it rightfully at that time, I think, to help restore their economy.

We had the Marshall plan and then we went to trade and now AID and we have expanded, and we have been working somewhat away from that, but still it is very substantial.

I think it is a tool that can be used from time to time and has to be used, not that it is a violation of the trade agreement. That is just not true. That is one of the provisions that you put on, as I recall, and it could go as high as 15 percent for a period of 150 days in trying to take care of that kind of a serious deterioration in the value of the dollar.

I further think that it was effectively used in 1971 to try to bring about some agreement on floating rates. Wasn't it used at that time?

Mr. BERNSTEIN. Yes, sir, I think it was the main inducement to the Europeans and to Japan to agree to an appreciation of their currencies relative to the dollar. They agreed to a lot of other things, some of which I didn't like, even though they accepted them. They agreed to undertake responsibility for supporting the new exchange rate that came out of the Smithsonian Agreement. In my opinion a country like the United States can't say that the

responsibility for maintaining the value of the dollar depends on what other countries are willing to do.

Senator BENTSEN. You want to comment on that, Mr. Perry?

Mr. PERRY. Senator, I really do disagree. It is not an appropriate policy for us to impose trade restrictions on imports. One cannot assume that others would not retaliate in that case. We have based our policy in this area on trying to expand trade, on free trade, and I think that thrust of American policy is an appropriate one. It is the one that we want to continue to aim for in the long run, and I just don't see anything about the current situation that would allow us to reverse ourselves on that matter without getting serious repercussions from our trading partners that would damage our long-run aims.

Senator BENTSEN. Let me say, Mr. Perry, that I think that some of these types of actions are strong, and I can understand that, but I think we have reached that position, and I don't think we can stand a further deterioration of the dollar, and I don't believe that the \$30 billion is going to cut it unless we bring about a dramatic change in the trade surplus of this country, and I don't buy this idea that it is good for the world for us to continue to have a substantial trade deficit, as I hear some of the economists proposing. By the same token, why is it so good for the world to have Japan and Germany with a very substantial trade surplus? They talk about the fact they have taken care of inflation in their countries. One of the reasons is because they have a strong mark and a strong yen, and part of that is because they have a very substantial trade surplus.

Now, the Japanese are tough, hard traders, and they are still one of the most protectionist countries around, and when they try to run their ads in this country and tell us it is an open market, that just isn't true.

You know, the United States is still the great frontier for business, if you are a Japanese businessman; and, when push comes to shove, we can handle that kind of a fight about as much as anyone can.

Now, we have to do something to get the Japanese to remove some of their tariff barriers, and I think it takes that kind of a dramatic action to bring that about. I don't think they are going to do it otherwise.

Mr. BERNSTEIN. Senator, may I answer Mr. Perry?

I wrote the report, at the request of President Truman, which was entitled, "A Trade and Tariff Policy in the National Interest." I am a great believer in free trade.

Senator BENTSEN. Mr. Bernstein, I am running into more ex-free-traders in the last few months than I have ever seen.

Mr. BERNSTEIN. Senator, I am a free-trader still.

Senator BENTSEN. I still am, too, frankly. I want to sit down and reason it out, but I think you have to show some muscle and some willingness and not so much passive response.

Mr. BERNSTEIN. I think it is important to explain to economists like Mr. Perry the economics of our trade balance under present circumstances.

Senator BENTSEN. Let me get that again.

What are you going to explain?

Mr. BERNSTEIN. I want to explain to Mr. Perry, as I do to all other economists who jump on me, the economics of the present trade balance of the United States.

As I said, I wrote the report on "A Trade and Tariff Policy in the National Interest." I took leave from the International Monetary Fund to do this for President Truman. The concept of free trade as beneficial for the whole world is unexceptional under the following circumstances: If countries export the goods in which they have a comparative advantage, if they import the goods in which other countries have a comparative advantage, we will have higher levels of income in both the exporting and the importing countries.

Now, it is unfortunately not true that when a country like Japan provides 40 to 60 percent of the imports of the United States in a wide range of finished manufactured goods, from automobiles to, say, cameras, and many other goods in between, that its exports are based on comparative costs. Not at all.

As I said before, the reason why we are flooded with these imports from other countries is that the level of real wages, is too low for their productivity; the level of real interest rates is too high for their savings.

If we had a world in which wages in each country reflected in real terms its productivity, then, while Japan would have a surplus, it wouldn't be a surplus of \$25 billion, and it wouldn't have half of it with the United States.

Our current account deficit with Japan is as big as it was last year with OPEC. This is a trade relationship that cannot reflect comparative advantage.

Senator BENTSEN. Mr. Bernstein, my time has expired, and I know Mr. Perry wants to respond again, and so do I, but I defer to Congressman Wylie.

Representative WYLIE. Thank you very much, Senator.

I will take my 10 minutes, and I assume we will get back to you because we will have some more time since all of the Members are not here.

I would like to say at the outset, Senator, this is my first appearance as a member of the Joint Economic Committee.

Senator BENTSEN. We are pleased to have you.

Representative WYLIE. I am certainly very, very pleased to be here, and I am really thrilled by the great opportunity this allows me to address some of the very serious economic problems facing the Nation.

Senator BENTSEN. We have had an unprecedented number of Members on the House side and Senate side that sought Joint Economic Committee membership this session and, unfortunately, we could only accommodate two.

Representative WYLIE. And I am one of them.

Senator BENTSEN. We are delighted to have you.

Representative WYLIE. Thank you very much.

Mr. Perry, I do not mean to be presumptuous when I say that I find myself in some disagreement with your statement in that I feel the real culprit in our economic problems is deficit Government spending.

I would like to refer to your statement, because I think for me there is some non sequitur reasons there. Certainly deficits tend to

be higher during recessions, but that does not negate the fact that in periods of high demand, high capacity utilization, and high output, Federal deficits do cause inflation. At least that is my way of thinking. At least I think the key as far as Germany is concerned is that they have a high savings rate, or at least this is according to the German Federal Reserve Board that testified the other day, so they finance their deficits through borrowing instead of printing-press money.

I think the only way to strengthen the dollar is to curtail the dollar supply, and I would like for you to expand on that a little bit for me, if you would, please.

Mr. PERRY. I would be happy to.

In the first place, I think we must differentiate between our monetary policy and the state of the Government deficit. These two things are unrelated. The relationship between monetary policy and inflation is also frequently misunderstood.

Representative WYLIE. You say you think that monetary policy and inflation and fiscal policy and inflation are unrelated.

Mr. PERRY. Monetary policy and Federal deficits are unrelated. If we want to look at the record, sir, when deficits are largest, once again, we tend to have low growth in the money supply or monetary aggregates.

The contention that somehow a deficit forces monetary policy to print a lot of money, more than we otherwise would like, really doesn't square either with how the Federal Reserve operates or with historical facts on money growth.

The money supply does tend to grow, roughly speaking, along with the gross national product. It is not related to how large the Federal deficit is. It is a totally independent policy decision.

Thus, we could, and, in fact, we generally do have slow money growth when there are large Federal deficits, rapid money growth when there are small Federal deficits.

The relation can go any way at all in the normal course of things. So the concept that a Federal deficit forces the money supply or some other measure of liquidity to grow faster than we would like is one I disagree with.

That still leaves the question of how fast the money supply grows and whether that is connected with inflation; that is a rather complicated issue. By and large, the Federal Reserve expands liquidity—money supply, if you like, or some other measure of it—in a sort of pragmatic way. They find themselves partially accommodating, partially not accommodating an inflationary condition. It is not in their power simply to stop the inflation by not expanding the liquidity in the economy.

It is in their power to drive interest rates up and slow down gross national product by not supplying liquidity. Then we have to ask how does that get converted into real output, employment, and into price level effects. The reason inflation is a very difficult, almost intractable, problem is because you don't get any large response on the inflation rate.

If you did, we wouldn't wrestle with the problem of inflation for so long and we wouldn't find other countries wrestling with it so long.

Representative WYLIE. I think we might have a point if we were talking about the short run, but over a period of time the Fed tends to buy a bigger and bigger share of the national debt and when the new debt is large, the buyers buy a bigger share. Of course, if the Federal deficit is large, then it seems to me the Fed takes a larger share of that. I think that you may be accurate in the short run, but what about over the long run where over the years the Fed has been attempting to help in this problem of the decline in the dollar and financing the public debt and acquiring money to pay for our bills which we haven't been able to pay through the collection of taxes or to balance the budget by reducing the amount of expenditures.

Mr. PERRY. I see no presumption that we would be in any different position with respect to the money supply or any other measure of liquidity had we traveled the same path of total employment and output with a very different pattern of deficits in the past, or perhaps with no deficits or with surpluses in the past.

The Federal Reserve would still have had to accommodate the "needs of trade," if you like, through its expansion of liquidity. It might have, as an independent decision, quite unrelated to the deficit, chosen to accommodate less. We would have then had higher interest rates for a time, less GNP growth, and we would have had as a consequence a combination of both less real production and less inflation.

Representative WYLIE. I want to get on to another question and I have a question of Mr. Bernstein and the time is going quite rapidly here, which it usually does.

Historically, the Federal Reserve, in order to help stabilize the Government bond market has gone to the market in an attempt to stabilize the deficit and to try to make up the difference between the amount of money that is coming out and the amount of money which is going out.

They have gone into the marketplace, it seems to me, each time there is a deficit voted by Congress, so to me that means they are directly connected with the money supply problem. But I will leave that there, I think, and go to a statement in your oral statement, Mr. Perry.

As I said, I don't mean to be presumptuous, but I am in disagreement with you.

You said:

I continue to forecast a recession because I expect that the authorities will make tight money bite on the real economy either through higher rates or limited availability or both. And when they do, it will be hard to take just a nip that slows the expansion, but stops short of causing a recession.

I assume this means you are forecasting a higher monetary policy and higher interest rates.

Mr. PERRY. Yes, sir.

Representative WYLIE. This surprises me some and I would like to expand on what you have said there because press reports just this morning have focused on the so-called repurchase agreements used by large corporations and large banks which purportedly are not affected by monetary policy.

Does your forecast include any thoughts about repurchase agreements and their effects on the money supply, and I asked this same

question of Bill Miller, the Chairman of the Federal Reserve Board, just last week.

Mr. PERRY. The use of repurchase agreements is something that has expanded greatly recently and I think it has affected the precision with which the Federal Reserve can conduct its own operations.

It is a way of making money work more efficiently rather than lying idle and not earning interest.

I am glad that you raise the question you did because I would like to clarify that a recession is very much a forecast. We don't have, I think, any evidence in the current numbers of a recession already underway or about to happen.

I expect as the economy shows little sign of slowing or slowing as much as had been anticipated, the Fed will feel that it has to do something in order to get some control over how fast GNP is growing.

I think we were all surprised at how fast GNP grew in the fourth quarter, and if this continues, there will be no evidence of policy restraint beginning to act. I simply believe they will work harder to make it act and they will work harder through one of a variety of channels. The repurchase agreements, as I understand them, are an institutional change which has complicated how we read the numbers. But regardless of whether the Fed will have trouble deciphering the figures it gets, it still knows which way tighter is—tighter is higher interest rates. If it isn't seeing a response in the real economy, it is very likely to move interest rates up higher in the months to come.

This is very much a forecast.

There is no sign of a recession yet. We have to try to anticipate policy moves as well as the basic strength of the economy.

Representative WYLIE. Thank you.

I believe my time has expired. I find this very interesting and I want to try to absorb it.

Senator BENTSEN. We will limit the next round of questions to 5 minutes.

Congressman Brown is on his way over here.

Mr. Perry, if the dollar drops some more in value this year and—for example, I heard this morning that the price of oil went up some more, but let's suppose the \$30 million is not effective and is not sufficient to shore it up—unless we make some significant headway, I don't see how you can turn it around.

But if we don't achieve that and you are opposed to a temporary surcharge—I will try to put a shock to you—what would you propose? Are you talking about higher interest rates.

Mr. PERRY. I think higher interest rates—

Senator BENTSEN. You prefer that to growth?

Mr. PERRY. It is not a question of preferring it. I think if you ask what one prefers, one might say that the worst of a bad lot of choices is to let markets move the dollar somewhat further.

Most people believe that the dollar is already properly valued or perhaps is already on the low side of where it ought to be, and that speculators, those who operate in foreign exchange markets, will come to recognize this and consequently will not speculate against the dollar and drive it down.

At any point in time, that is a very chancy judgment to make. I don't make it, because I don't study this particular aspect of the economy enough to make that judgment. I can imagine a lot of events that could occur in 1979 that would put further pressure on the dollar, not perhaps out of any very rational calculation, but because in past years, the dollar has come under pressure whenever uncertainty has arisen in certain areas.

Now, if the oil situation worsens substantially, and oil prices are raised a good deal further than we now expect on the world market, it would not surprise me if the dollar came under pressure under those circumstances.

Senator BENTSEN. Now, there are some who say, "All right, one of the things we do is we put a substantial increase on the tariff on the importation of oil."

Why can we selectively choose a commodity but we can't selectively choose a country that has substantial export surplus with us and restrains much more import trade than we do in this country?

Mr. PERRY. I don't know that there is an absolute way to answer that. I think it has to be answered in the context of the politics of the international trade community.

I think that a limitation on oil imports would be understood and appreciated perhaps by other countries. Certainly it would help them. The less oil we import, the more everybody else in the world likes it—everyone except the oil exporters—because it reduces upward price pressure on oil and they are all consumers of that product.

I am not sure that trade restraints against other importers would be accepted in the same way. I think there is a real risk that we would see a spiral of trade restraints around the industrial world and then nobody gains.

If it were not for that fact, if we could somehow do this in secret, perhaps you could make a slightly stronger case for it.

Senator BENTSEN. I think to the contrary. I think it is something that should be highly profiled if we do it and the reason is that there are restraints against our products in some of those countries. They have a very substantial surplus with us and, frankly, this economy can't withstand it and the dollar continues to go down and will go down. Once it is corrected, they are really going to take that restraint out.

I am not talking about a zero trade balance, but you have such a disparity here. The Japanese had a surplus of almost \$10 billion in 1977 and they corrected it. They corrected it up to almost \$20 billion last year, a 100-percent increase.

Mr. PERRY. There are many things behind that.

I think everyone agrees the failure of some of our trading partners to go as well as we have is an important factor in the difference of their trading accounts than ours.

I certainly agree in terms of any bilateral negotiations with the Japanese, for instance, concerning a trade policy. I suppose anything is fair gain to the extent that we can legitimately put restrictions on their part. I think we have a good bargainingship to try to reduce those restrictions.

I am speaking against the general proposition of trade restrictions.

Senator BENTSEN. I think I agree with you and my history is of agreeing.

Mr. PERRY. We should understand, of course, that imports are useful to us in that they do subject domestic industries to competition that might not otherwise exist; and when we are trying to fight inflation, we should not remove the pressure of that competition.

Mr. BERNSTEIN. By the same token, we ought to improve the competition with the—

Mr. PERRY. I didn't follow that.

Mr. BERNSTEIN. I think a \$50 billion trade deficit would increase the competition even more.

Mr. PERRY. The \$50 billion trade deficit is not itself a source of competition.

What we are talking about is if we protect the automobile industry from foreign competition, your forecast and mine is the same: domestic car prices would rise faster than they otherwise would.

If we protect the domestic steel industry from foreign competition, your forecast is the same as mine: steel prices would rise faster than they otherwise would.

Senator BENTSEN. Gentlemen, that is on your time.

Mr. PERRY. I rarely get a chance to argue with Mr. Bernstein. It is only in a formal setting like this.

Mr. BERNSTEIN. I don't like this ad hoc approach to what will happen to the dollar—that if the speculators have a gloomy day, the dollar will go down.

We have to look at the basic things first, and the basic things are the following: The dollar can be stable only if there is inflow of foreign funds equal to the current account deficit of the United States, plus the loans and investments of the U.S. Government, U.S. banks, and U.S. business.

I am saying that the experience of the last 3 years shows that you cannot have an inflow of funds from abroad without governmental intervention that will balance our payments when you have a trade deficit of the magnitude we have had in the last 2 years. And it is hopeless to expect that if this trade deficit stays anywhere near what it is today, enough money will be brought into the United States even at higher interest rates.

It really runs the other way. An improvement in our trade balance will strengthen the dollar and put downward pressure on interest rates.

May I submit for the record that article that I published in December saying that interest rates would go down, that money market rates would go down if the dollar appreciates in the exchange market?

Senator BENTSEN. We would be pleased to have it.

[The article follows:]

THE BALANCE OF PAYMENTS, THE EXCHANGE MARKET, AND INTEREST RATES

(By Edward M. Bernstein)

Traditionally, a balance of payments surplus has been associated with lower interest rates and a deficit with higher interest rates. Under the gold standard, a balance of payments surplus meant that the receipts of a country from its exports of goods and services and from capital inflow exceeded its payments for imports of

goods and services and for capital outflow. The excess supply of foreign exchange was bought by the monetary authorities and converted into gold by the deficit country. The surplus country then issued its own currency against the gold. Thus, the money supply and the reserves of the banking system increased in the surplus country and decreased in the deficit country. This change in the monetary situation tended to lower interest rates in the surplus country and raise them in the deficit country.

The automatic effect of gold flows was reinforced by the action of central banks in raising or lowering the discount rate when there was an outflow or inflow of gold. So well established was the policy, at least in the United Kingdom, that it came to be regarded as part of the "rules of the gold standard game". In fact, it was not as widely followed as the practice of the Bank of England would suggest. In the U.S., the effects of the outflow and inflow of gold on bank reserves were moderated by an offsetting change in borrowing at the Federal Reserve Banks initiated by member banks. This was by far the most important form of Reserve Bank credit in the 1920s when open market operations were small and were mainly designed to make the discount rate effective. The passive attitude of the Federal Reserve to gold flows, its failure to ease monetary policy in response to an increase in U.S. gold reserves, was characterised by Keynes as the replacement of the gold standard by a dollar standard [Tract on Monetary Reform, London 1924, p. 198].

It is worth noting that, although the Federal Reserve was reluctant to see a multiple expansion of credit on the basis of an inflow of gold, it did tighten credit when the reserve ratio approached the legal minimum or when there was a threat of a large outflow of gold. In 1920, when the ratio of gold reserves to liabilities of the Federal Reserve Banks fell to 40.9 percent in May, the discount rate was raised from 6 percent-7 percent on June 1. An increase of 1 percent in a single step is very rare and indicates great concern by the Federal Reserve about the monetary situation. In 1931, when the gold reserve fell by \$600 million in September and October (one-sixth of the total) after Britain abandoned the gold standard, the Federal Reserve raised the discount rate from 1½ percent to 2½ percent on October 9 and to 3½ percent a week later, in spite of the severe depression. This was the last time the Federal Reserve raised the discount rate by 1 percent until its action on November 1 this year. As this indicates, the U.S. attitude toward the gold standard was quite different after 1934. Whenever the gold reserve approached the legal minimum, either because of a decrease of reserves or an increase of the money supply, the gold reserve requirement was reduced and finally abandoned.

The effect of the balance of payments on the monetary situation is the same if deficits and surpluses are settled in other reserve assets instead of gold, but different if they are settled by the accumulation of reserve currencies. Thus, if the U.S. draws on the International Monetary Fund, say, in D-marks or in yen, as it has recently, and sells these currencies in the exchange market for dollars, the money supply and bank reserves would be reduced in the U.S. and increased in other countries. That would also be true if the U.S. sold Special Drawing Rights for these currencies and used the proceeds to support the dollar in the exchange market. In the U.S., the dollars derived from the sale of these currencies would be withdrawn from the money supply and from bank reserves. In Germany and Japan, the D-marks and yen acquired by U.S. drawings on the IMF or by the sale of SDRs would be created by their monetary authorities and their sale in the exchange market by the U.S. would increase and the money supply and bank reserves in these countries.

If a U.S. payment deficit is settled by the accumulation of dollars by the surplus countries, it has the same effect on their monetary situation as the accumulation of other reserve assets. Their monetary authorities would buy the dollars in the exchange market with their own currencies and this would increase the money supply and bank reserves in the surplus countries. The accumulation of dollars by foreign monetary authorities, however, would not affect the monetary situation in the U.S. When the dollars are invested in U.S. Government securities or other assets in the U.S., the reserves of the banking system are restored. There could be a minor effect on the money supply, depending on whether the assets acquired by foreign monetary authorities were sold by banks or nonbanks. Drawings by the Federal Reserve under its reciprocal currency arrangements have precisely the same effect on the monetary situation in this country and abroad as the accumulation of dollars by foreign monetary authorities. This is explained in an article in the Quarterly Review of the Federal Reserve Bank of New York, Winter, 1977-1978, Vol. 2, No. 4, "Monetary Effects of Federal Reserve Swaps".

It is implicit in this analysis that the structure of the balance of payments does not of itself have a significant effect on the U.S. monetary situation if the deficit is settled by the accumulation of dollars by foreign monetary authorities. *Prima facie*,

it would seem that a deficit arising from an increase in the net outflow of U.S. funds for foreign loans and investments should raise interest rates, even if there is no effect from a deficit due to a deterioration in the current account. This need not be so. A larger outflow of U.S. funds for foreign loans and investments, with no change in the inflow of foreign private funds, means that the supply of domestic savings relative to domestic investment is being reduced. Similarly, an increased deficit on current account means that supply of domestic savings has been reduced relative to domestic investment and is inadequate to finance such investment. In both instances, the deficit will be financed by the accumulation of dollars by foreign monetary authorities and the consequent inflow of foreign official funds will offset the deficiency in the U.S. savings.

On a quite different track, it is sometimes said that an inflow of foreign official funds that goes into the U.S. money and capital markets, mainly in the purchase of U.S. Government securities, must have a considerable effect in holding down interest rates. As the inflow of foreign official funds has been enormous at times, the effect on interest rates, if there were one, would be expected to be large. In 1971, the inflow of foreign official funds amounted to \$27 billion. The inflow was more moderate from 1972 to 1975, but rose again to \$18 billion in 1976 and \$37 billion in 1977. In the first three quarters of 1978, the inflow of foreign official funds was about \$15 billion. There is no statistical evidence that the level of interest rates was affected by the inflow of such funds, although there may have been a marginal effect on some money market rates relative to others because of the strong foreign preference for U.S. Treasury bills. An analysis based on savings and investment indicates that, regardless of the magnitude of the inflow of foreign official funds, it has no direct effect on the level of interest rates. It merely supplies the deficiency in U.S. domestic savings necessary to finance domestic investment.

In the national income and product accounts (NIPA), the gross savings of an economy must be equal to its gross investment. The gross savings of the private sector consist of personal savings, including those unincorporated business and nonprofit organizations, the undistributed profits of corporations adjusted to a NIPA basis by deducting inventory profits and the difference between depreciation at replacement cost and original cost, and corporate and noncorporate capital consumption allowances, both adjusted to a replacement cost basis. In the public sector, the deficit of the federal government on a NIPA basis is classified as negative savings although the surplus of state and local governments on a NIPA basis is classified as savings, although most of it consists of social insurance funds. The gross domestic savings are used to finance the gross investment of the economy, which includes residential structures, producers' durable equipment, investment in additions to business inventories, and its net foreign investment. In the national accounts, net foreign investment is the same as the balance on current account excluding reinvested earnings of incorporated affiliates of U.S. and foreign direct investment enterprises. Net foreign investment has been negative on a large scale since 1977.

Some of the savings are used for self-financing of investment, as in the case of owner-occupied homes or business investment financed out of retained earnings and capital consumption allowances. Much of the gross savings, however, is transferred from savers to investors through financial markets in some instances with the intermediation of financial institutions. The amount of savings in each category is net of negative savings. Thus, the borrowing for personal consumption expenditures is deducted from personal savings. The same groups may be both lenders and borrowers. Thus, the corporate sector is not only a large borrower of funds, but also a large lender. Similarly, some state and local governments borrow for current and capital expenditure while they accumulate savings in trust funds. Although the balance of payments deficit on current account is classified as negative foreign investment, the funds used to finance it could just as properly be classified as foreign savings available to finance U.S. domestic investment. It should be noted that net foreign investment is not the same as the deficit on an official reserve basis—the overall payments deficit.

In a system of floating rates in which the dollar is not convertible into other reserve assets, the inflow of funds from abroad must equal the balance on current account plus the foreign loans and investments of the U.S. government, banks, and business. If the inflow of private foreign funds is inadequate to finance the U.S. balance on current account and the outflow of U.S. capital, the dollar will fall and the monetary authorities will intervene to avoid an excessive depreciation of the currency. To the extent that the intervention is by foreign monetary authorities, it will result in their accumulation of dollars that they use to acquire assets in the U.S. An increase in the inflow of foreign official funds may be the result of a larger

deficit on current account, increasing the demand for loanable funds; a larger outflow of U.S. funds or a small inflow of foreign funds, both of which diminish the supply of loanable funds in U.S. financial markets.

Changes in the inflow of foreign official funds do not change the relationship of the supply of to the demand for loanable funds and, therefore, have no direct effect on the general level of interest rates. If there were such an effect, it would be shown as a movement of interest rates in the opposite direction from the change in the inflow of foreign official funds. As can be seen from Chart 2, between 1975 and 1978, the yield on three-month Treasury bills tended to move in the same direction as the inflow of foreign official funds. This may have been because cyclical factors acted coincidentally on both series. From the second quarter of 1975 to the first quarter of 1978, the balance on current account tended to fall as U.S. output and income expanded. The deterioration in the balance on current account was accompanied by an increased inflow of foreign official funds, although to an exaggerated extent in the fourth quarter of 1977 and the first quarter of 1978. The yield on Treasury bills tended to decline until the first quarter of 1977, but rose thereafter in spite of the very large inflow of foreign official funds. That was because the Federal Reserve tightened monetary policy, at first for domestic reasons and later in response to the deterioration of the balance of payments.

Although the balance of payments does not affect the general level of U.S. interest rates directly under a system of floating rates, it may do so indirectly through its effect on the exchange markets. With floating rates, exchange rates may change in response to differential rates of inflation without a prior or concomitant change in the balance of payments. In fact, such a change in exchange rates is necessary if a country is to maintain the same competitive position in world trade. Furthermore, interest rates must differ among countries by about as much as the prospective change in exchange rates in order to make the holding of assets equally attractive in the major currencies. Finally, the premium or discount on forward exchange relative to the spot exchange rate for two currencies should equal the difference in money market rates in the two currencies and the difference in their rates of inflation. Changes in exchange rates which reflect this pattern do not have an independent effect on interest rates—that is to say, they are an adjustment to changes in underlying economic conditions including national monetary policies.

The impact of the U.S. balance of payments on exchange rates differs considerably from time to time. It depends not only on changes in the balance on current account, but on the outflow of U.S. capital and the inflow of foreign capital. Sometimes the exchange market pays little attention to the change in the balance on current account, and capital flows are responsive to other factors, perhaps changes in interest rates, but even more to expectations regarding the future rates for the dollar. For example, in the first quarter of 1977, the U.S. trade deficit suddenly increased to \$7 billion from \$3.6 billion in the previous quarter; and current account, including reinvested earnings, shifted from a small surplus to a deficit of over \$2.7 billion. Nevertheless, the dollar rose against the D-mark and the Swiss franc in the first quarter of 1977, although it fell against the yen. The reason for the modest strength of the dollar relative to the European currencies was the large decline in U.S. capital outflow. The dollar depreciated moderately in the second and third quarters of 1977, as the current account deficit changed very little, but the outflow of U.S. funds relative to the inflow of foreign funds, including errors and omissions, increased to a considerable extent.

1.—BALANCE OF PAYMENTS AND CHANGES IN EXCHANGE RATES, 1977-78

| | Billion dollars ¹ | | | | | | Percent change in dollar from previous quarter ³ | | |
|----------|------------------------------|-------------------------|--------------------|------------------------------|--------------------|----------------------|---|-------|-------------|
| | Trade balance | Current account balance | U.S. capital | Foreign capital ² | Official funds | Errors and omissions | Deutsche mark | Yen | Swiss franc |
| 1977: | | | | | | | | | |
| 1 | -7.02 | -2.75 | -1.33 | -2.96 | 5.45 | 1.59 | 1.11 | -5.23 | 3.75 |
| 2 | -6.63 | -2.68 | -12.00 | 6.18 | 7.88 | 0.62 | -2.12 | -3.53 | -3.21 |
| 3 | -7.25 | -2.87 | -6.62 | 6.00 | 8.25 | -4.77 | -1.31 | -0.84 | -4.97 |
| 4 | -10.21 | -6.97 | -14.70 | 4.52 | 15.54 | 1.60 | -8.77 | -9.57 | -14.48 |
| 1978: | | | | | | | | | |
| 1 | -11.20 | -6.86 | -15.04 | 2.34 | 15.76 | 3.80 | -3.90 | -7.33 | -6.57 |
| 2 | -7.80 | ⁴ -3.16 | ⁴ -5.07 | ⁴ 5.15 | ⁴ -5.11 | ⁴ 8.19 | 3.19 | -7.96 | -0.55 |
| 3 | -7.79 | ⁴ -3.75 | | | ⁴ 4.48 | | -6.61 | -8.10 | -16.72 |
| Oct..... | ⁴ -2.45 | | | | | | -9.76 | -4.87 | -3.31 |

¹ Trade balance and current account are seasonally adjusted.

² Excluding foreign official funds.

³ From last day of previous quarter to last day of current quarter.

⁴ Estimate.

The greatest impact of the balance of payments on the exchange rate came in the fourth quarter of 1977 and the first quarter of 1978. That was due to the sharp increase in the trade deficit to \$11.2 billion and in the current account deficit to \$6.9 billion in the first quarter of 1978. There was also a very large outflow of U.S. funds in these two quarters, mainly to foreign commercial banks to enable them to engage in covered interest arbitrage in connection with forward exchange transactions. The reported inflow of foreign capital, excluding official funds, also declined in these two quarters, probably because of expectations of a depreciation of the dollar. In fact, the dollar depreciated by 20 percent against the Swiss franc, by 16 percent against the yen, and by 12 percent against the D-mark in these two quarters. This occurred in spite of an inflow of \$31.3 billion in foreign official funds.

The current account deficit fell considerably in the second quarter of 1978 and there was a large net inflow of capital, including errors and omissions. The dollar recovered against the D-mark and changed very little against the Swiss franc, although it depreciated further relative to the yen. With the more favorable exchange market, foreign official holdings were reduced by \$5.1 billion in the second quarter. In the third quarter, however, the dollar again depreciated rapidly and this continued in October. There was no change in the trade balance in the third quarter and the current account deficit apparently increased. Full data are not available on capital flows, but the outflow of U.S. funds increased considerably, particularly claims of U.S. banks. That was probably mainly to finance covered interest arbitrage by foreign commercial banks, including the foreign branches of U.S. banks, in connection with forward exchange transactions. Astonishingly, the accumulation of foreign official funds was very small in the third quarter, although the dollar depreciated nearly as much as in the fourth quarter of 1977 and the first quarter of 1978. From the end of June to the end of October, the dollar fell by 20 percent relative to the Swiss franc, by 16 percent relative to the D-mark, and by 13 percent relative to the yen. The decline was halted only by the Treasury announcement that large resources were available to support the dollar and by the increase in the Federal Reserve discount rate.

The depreciation of the dollar after the first quarter of 1977 generated forces that caused U.S. interest rates to rise. When the dollar weakened, forward sales for the strong currencies increased, and as the demand exceeded the supply, the forward rates rose relative to the spot rates. The difference between the forward rate and the spot rate was the forward premium on these currencies (forward discount on the dollar), expressed in percent per year. The forward premium measures the expectation of the exchange market on the appreciation of the strong currencies and tends to be equal to the difference in interest rates on funds denominated in dollars and in other currencies. In the first quarter of 1977, the three-month forward yen was at a discount of about 1 percent per year while the three-month forward D-mark was at a premium of slightly less than 1 percent per year. Actually, the dollar rose

relative to the D-mark, but fell relative to the yen in this quarter. By the fourth quarter of 1977, and throughout 1978, the forward premium was greater on the yen than on the D-mark, and this reflected the behavior of the exchange rates for these currencies—that is, a larger appreciation of the yen than of the D-mark.

2.—3-MONTH FORWARD DISCOUNT ON DOLLAR AND EURODOLLAR RATE, 1977-78

| | Percent per annum ¹ | | | |
|-----------------------------|--------------------------------|--------|-------------|-------------|
| | D-mark | Yen | Swiss franc | Eurodollars |
| 1977: | | | | |
| January | -0.68 | +0.69 | -3.82 | 5.25 |
| February | -0.57 | +1.02 | -2.66 | 5.13 |
| March | -0.73 | +1.51 | -2.10 | 5.19 |
| April | -0.84 | +0.32 | -1.98 | 5.19 |
| May | -2.30 | -0.22 | -2.03 | 6.13 |
| June | -1.95 | +0.16 | -2.58 | 5.75 |
| July | -2.28 | -0.11 | -3.34 | 6.19 |
| August | -2.43 | -0.89 | -4.27 | 6.25 |
| September | -2.97 | -2.42 | -4.38 | 6.88 |
| October | -2.96 | -3.27 | -5.21 | 7.19 |
| November | -2.79 | -3.25 | -4.27 | 6.88 |
| December | -4.78 | -5.19 | -5.86 | 7.19 |
| 1978: | | | | |
| January | -4.37 | -4.15 | -6.50 | 7.38 |
| February | -4.34 | -4.72 | -7.36 | 7.38 |
| March | -4.20 | -6.13 | -7.08 | 7.44 |
| April | -4.45 | -5.62 | -6.94 | 7.63 |
| May | -4.70 | -5.19 | -6.95 | 7.88 |
| June | -5.29 | -5.56 | -7.10 | 8.63 |
| July | -4.91 | -6.57 | -6.87 | 8.38 |
| August | -5.57 | -6.34 | -8.28 | 8.88 |
| September | -5.95 | -6.66 | -8.54 | 9.44 |
| October | -7.84 | -8.79 | -11.32 | 11.56 |
| November | -7.78 | -10.08 | -11.09 | 11.75 |
| December ² | -7.36 | -8.48 | -11.10 | 11.31 |

¹ Discount on 3-month forward dollars in these currencies at annual rates. Interest rate on 3-month Eurodollar deposits.

² Dec. 15, 1978.

When the forward premium for the strong currencies rose sharply, the banks entered into the exchange market to supply the deficiency in forward exchange. They bought the strong currencies spot with dollars and sold them forward for dollars. The return to the banks was the forward premium plus the interest on the strong currencies; the cost to them was the interest that they paid on borrowed dollars or that they could have earned on their own dollars. When banks engage in such forward exchange transactions (covered interest arbitrage), they bid up interest rates on the dollars they borrow to buy spot exchange and accept lower rates on the strong currencies they hold as cover for their forward sales of exchange. Interest rates rise in dollars not because the supply has been decreased relative to demand, but because the demand schedule for dollar loans has been raised by those engaged in forward exchange transactions as can be seen in Chart 3; the three-month Eurodollar rate rose almost parallel with the three-month forward premium on the D-mark. It rose considerably less than the forward premium on the yen, but that was because the short-term interest rate on yen funds fell much more than the rate on D-mark funds.

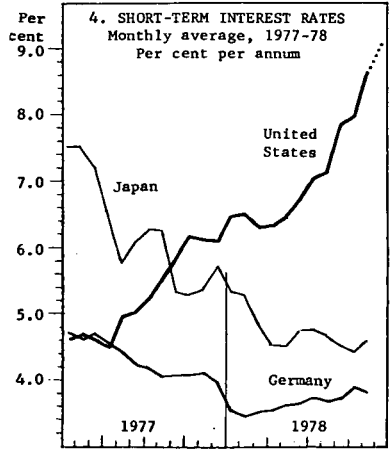
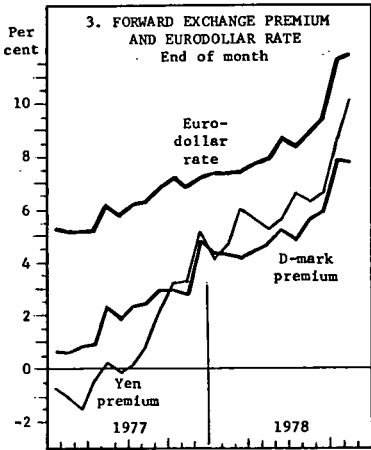
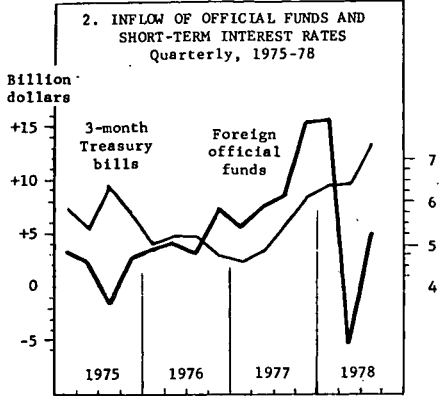
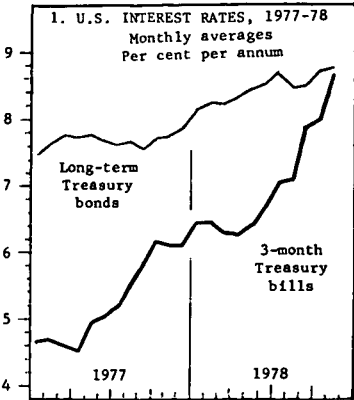
The same forces that caused interest rates to rise on dollar funds caused them to fall on D-mark and yen funds. That was not only because of covered interest arbitrage by commercial banks, but also because official intervention in the ex-

change market resulted in an expansion of the money supply and bank reserves in Germany and Japan. Chart 4 shows the monthly average of short-term interest rates in Germany and Japan published in the Federal Reserve Bulletin and the yield on three-month U.S. Treasury bills. Interest rates fell in Germany and Japan almost coincidentally with the rise in the U.S. It is not suggested, of course, that all of the rise in interest rates in the U.S. and the fall in Germany and Japan are attributable to the changes in exchange rates. Obviously, the monetary authorities of these countries adjusted monetary policy on the basis of domestic and international conditions. Their policies added to and intensified the effect of the depreciation of the dollar and the appreciation of the D-mark and the yen on interest rates in these countries.

At any given time, the forward premium on strong currencies (the discount on weak ones) tends to be about equal to the difference in the interest rates paid on funds in these currencies. This will remain so, however, only if exchange rates on these currencies are expected to rise (fall) at a rate equal to the forward premium (discount). If the U.S. payments position were to improve, the dollar could not be expected to fall relative to the strong currencies at the rate previously assumed, and the forward premium on the strong currencies would become excessive. Under such circumstances, the demand for forward dollars would tend to reduce the premium. It would then become profitable for banks to buy dollars spot with foreign exchange and to hold them for forward sales. Such covered interest arbitrage would raise the spot rate for dollars, but it would also tend to reduce interest rates on dollar funds and raise interest rates on funds in the strong currencies.

Since the new program to support and strengthen the dollar was announced on November 1, the dollar has recovered considerably relative to the D-mark, the yen, and the Swiss franc. The recovery has been due to the covering of short positions in the dollar, the inflow of funds in response to higher interest rates, and the intervention by the monetary authorities. The recovery of the dollar has not brought as large a decline in the forward discount as might be expected. From the end of October to December 12, the forward discount on the dollar in D-marks (three months) fell from 7.84 percent per year to 7.36 percent. The forward discount in Swiss francs fell from 11.32 percent per year to 11.06 percent. On the other hand, the forward discount on the dollar in yen rose from 8.79 percent per year at the end of October to 9.01 percent on December 12. Nevertheless, in the past two weeks the forward discount on the dollar in terms of the yen declined by more than 1 percent from the level at the end of November (10.08 percent). In the meantime, the interest rates on three-month Eurodollars rose from 11.56 percent at the end of October to 11.75 percent at the end of November, but fell to 11.31 percent on December 15.

The OPEC announcement of the increase in the price of oil has caused renewed selling of dollars. While the dollar has fallen relative to the European currencies and the yen, the decline has been limited by official support. The forward discount on the dollar for the strong currencies, however, has changed very little. The larger-than-expected increase in the price of oil will hold down the improvement in the trade position in 1979. If the trade deficit is nevertheless reduced considerably, it will strengthen the dollar not only in the spot market, but also in the forward market. Under such circumstances, U.S. interest rates will tend to decline, although the reduction would be limited unless the Federal Reserve regarded the strengthening of the dollar as a reason for relaxing the present high-interest rate policy.



Mr. BERNSTEIN. As for the notion that if we do something to restrain imports we are touching off a trade war, I would like to make a few points on that.

First, the Reciprocal Trade Agreement Act is a very generous act. We have, in fact, been giving away more under this act than we have been given.

Let me see if I can give an illustration that might persuade my fellow economist.

When the United States reduced the tariff on Brussel's carpets in return for a reduction by Belgium in machine tools, we both gained. That is to say, we had a little bit more of the machine tool market and they had a little bit more of the carpet market.

When the Common Market was established and Germany paid no duty, why, then we got very little out of the benefit of a tax reduction from 25 percent to 15 percent in the duty on machine tools that Germany could bring in for nothing. The compensating adjustments made by the Common Market were not adequate.

As for the Japanese case, it is ridiculous to say that trade between Japan and the United States in any way reflects the kind of economic relations that we as professors of economics used to teach—that is to say, free trade based on comparative costs.

In Japan, a former director for Japan at the International Monetary Fund having fallen in love with his American automobile—I think it was a Mustang—decided to bring it back to Japan. He couldn't get it out of customs for 2 years. This is an executive director for Japan at the International Monetary Fund.

Now, Mr. Chairman, I used to explain at the International Monetary Fund when I was Director of Research what are and what are not restrictions and in my opinion any country which requires a license for imports is restricting because the requirement of a license holds down imports even if you are generous in granting it.

I don't expect any repercussions from a restriction on imports of goods from the surplus countries. I will go further than that. I will say that in my opinion the the Bundesbank and the Swiss National Bank and maybe even the Bank of Japan would be willing to see us restrict imports if that would have a favorable effect on our trade balance and stabilize the exchange rate.

I see no danger of a trade war. What is Japan going to do to us? Representative WYLIE. Mr. Bernstein, if it is all right, Senator—

Senator BENTSEN. Congressman Wylie.

Representative WYLIE. You say the reason for the decline in the dollar is because of an unfavorable trade deficit.

Mr. BERNSTEIN. That is the main cause, yes, sir.

Representative WYLIE. Mr. Greenspan disagrees with you, as you know. He says the real culprit is inflation and that the trade deficit is only a secondary cause. I am sorry to see you fellows disagreeing among yourselves here because that makes it all the more difficult for us.

Mr. BERNSTEIN. I don't think there is any disagreement. I would like to explain. In a world where you have differential rates of inflation, then you need depreciation of the currency with the greater inflation, to neutralize the rise in its relative costs.

That means, if the United States has 5 percent more inflation than Germany, then a depreciation of the dollar by 5 percent relative to the deutsche mark would keep the price competitive position the same.

Incidentally, you would need an equivalent difference in money market rates because if you had a 5-percent difference in the money market rates in Germany and the United States, then there would be no inducement to move money out of the United States, even when the dollar is depreciating because what you would gain on the appreciation of the deutsche mark you would lose in interest rates.

When I speak about the trade deficit causing a drop in the dollar, you will find in the article which I have submitted to you, that I am talking about a drop in the dollar in excess of the relative rate of inflation.

It is in excess of that. I won't say that if we have a bad piece of news on inflation speculators won't sell some more dollars, but the basic fact is that it is the trade deficit that caused the big depreciation of the dollar.

Representative WYLIE. Isn't the decline in the value of the dollar a cause as well as an effect on inflation in the United States?

Aren't people overseas dumping their dollars because they feel there might even be more inflation and decrease in the value of the dollar here?

Mr. BERNSTEIN. Let me put it this way, Congressman.

There are 15 major industrial countries. Half a dozen of them have had big trade problems. This half dozen includes countries like France, Italy, Sweden, the United Kingdom, Denmark, and the United States.

In all of these countries, the inflation has been as high as in the United States and, yet, here we are the only country that has made no improvement in its trade balance.

In Italy, France, Denmark, in Sweden and the United Kingdom, the trade balance has improved materially even though their inflation rate stayed as high as or higher than ours.

The Senator made a very important point before too.

Half of the difference in the rise of prices, the consumer price index, in Germany and in the United States last year was attributable to the depreciation of the dollar and the appreciation of the deutsche mark. It kept their prices down by 2 percent or more; it raised our prices by 1 percent.

The difference between the two was roughly on the order of 5 to 6 percent.

Representative WYLIE. A very elementary question: What do you think about the constitutional amendment to balance the budget?

Mr. BERNSTEIN. I am not in favor of it. I'd like to say to Mr. Perry I enjoyed his exposition. I don't think there is anything in the proposition of balancing the budget by constitutional amendment.

Incidentally, I think we often make a mistake in believing that the budget ought to be the regulator of the level of output and employment, without regard to other factors.

For example, I think if we are going to use a stimulus program of \$16 billion to offset a deterioration of the trade balance by \$18

million, then our trade deficit, which Mr. Perry says is due to the high level of output in the United States compared to other countries, will be reinforced by our budget deficit.

I am not at all against having a budget deficit when it is helpful to the level of output and employment because of a cyclical fall in domestic demand. I think it is a reasonable thing. And I am against saying that the budget must be balanced at all stages.

On the other hand, I don't hold to the view that you can ignore what is going on in the economy and say, well, as long as there is a little more unemployment than we wanted, we ought to remedy it with the budget.

Representative WYLIE. But I don't think it ought to be an ongoing pattern of life to have a budget out of balance.

Mr. BERNSTEIN. I don't think it should be either, Congressman, and I would note this: If you have a trade deficit of the magnitude we have now, the pressures to make it a way of life will be extremely great.

The 1978 Economic Report of the President mentions the trade deficit as a reason for having a budget deficit. I had explained this doctrine to the International Monetary Fund at a luncheon of its economists, including visitors in November 1977, that we were allowing ourselves to impose a budget deficit on the country to offset the trade deficit with which we ought to be dealing.

Representative WYLIE. Mr. Perry, I am going to ask you to comment on what you think about a constitutional amendment or you might even comment on a law which would say that we will balance the budget except in time of war or in case of economic necessity, by a two-thirds vote of the Congress.

Mr. PERRY. I disagree entirely with that Congressman.

Representative WYLIE. I had a feeling you might.

Mr. PERRY. I disagree not only because I don't think it deals with our problem, but because it would be quite counterproductive. It would exacerbate swings in the economy; and it would be a constitutional amendment that we would be violating all of the time even if we were to attempt to live by it.

Senator BENTSEN. That we would be what.

Mr. PERRY. We would be violating it all of the time, even if we attempted to live by it; it would be a good deal worse than prohibition.

Representative WYLIE. I am sorry, I didn't catch that last comment.

Senator BENTSEN. He said it is a good deal worse than prohibition.

Part of the problem would be definition, wouldn't it, whether you are in violation or not?

Mr. PERRY. Well, we add up numbers pretty well in this town. I think the Office of Management and Budget can always tell us whether we had a deficit or surplus in any one year; we could give them a set of definitions and they could give us a set of numbers to correspond to it.

Mr. BERNSTEIN. I thought Mr. Perry was making the point that even if we passed what was called a balanced budget the behavior of the economy might unbalance it.

Is that what you had in mind?

Mr. PERRY. That is a part of it.

Representative WYLIE. Well, the fact is, we might have more production, more sales, more economic activity in the private sector—that is what you are saying—and, therefore, more taxes, depending upon the viability of the private sector.

Mr. PERRY. We do have uncertainties in economic events and if the economy was somewhat overheated we might find ourselves with a large surplus; if we tried to eliminate that to get a balanced budget, it would overheat it worse. If the economy fell into a recession, it would give us a large deficit, and if we tried to live by the Constitution, we would worsen that recession.

Representative WYLIE. We could make it effective October 31, which we must do by law. If, during that year, something happens—if they declare an economic necessity—we could vote a deficit, so there are some safeguards. My bill contemplates a two-thirds vote of the House and Senate to set aside the balanced budget during these emergency periods.

Mr. Perry, you said that you favor the real wage insurance program of the President. What if wages are held to 7 percent and prices rise to 9 percent. Real wage insurance would give a 2 percent rebate, in effect, in the first year.

What about the second year then if wages start out at year "2" at a level 2 percent below prices compared to the previous year starting points?

Mr. PERRY. As I understand the bill that is being proposed, you start all over again the second year. You might have precisely the same law on the books or you might alter the numbers somewhat.

If we imagine keeping the same law on the books, once again the wage standard is 7 percent, real wage insurance would kick in if, in that second year, prices rose more than that.

But if the thrust of the question is do you make up for the 9-percent inflation of the previous year the second time, I think no, that's not the intention of the bill.

Representative WYLIE. Either we let wages catch up or we have a permanent rebate or we hurt workers permanently.

Mr. PERRY. There are times when that is unavoidable. I think part of the problem and part of the reason that we are still mired in the inflationary spiral that we are in is that wages cannot catch up with some of the price increases that have occurred. When the price of oil jumped a great deal in 1974 and 1975, it was wages trying to chase that oil price increase that exacerbated the inflation.

Now, it is not hard to show that there is a real loss to wage earners in that kind of situation and it can't be made up. And the best you can do is try to diffuse it so as not to let it feed into a wage-price spiral.

In the situation you are describing, I think that would have to be the aim of the policy once again. Should we get a big shock in prices this year, we really do have to try to diffuse that and not let it get into the wage rounds, and not let it exacerbate inflation over years to come.

I think life is tough when that happens. But it has to be the objective of policy to isolate that extraordinary price increase and not let it get down into the basic wage-price spiral.

Mr. BERNSTEIN. Mr. Chairman, I think the term "real wage insurance" is a misnomer. I would have preferred if they had called it compensation, because the truth of the matter is, there is no way of insuring real wages. If the growth of productivity is less than had been expected, if crops are poorer than had been expected in this country or abroad, if the dollar depreciates or the price of oil rises even when the dollar doesn't depreciate, there really isn't any way in which you can maintain the real wages of the worker. You can give him something back and make him happier.

I don't try to justify this policy as a piece of fancy economics. I think it is justified as a practical proposition that if this will encourage workers to be more moderate in their wage demands, it is good for the economy.

You are quite right. You can't make up the loss in real wages that arises from the real factors that I mentioned.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Let me hit two points with you, one in the monetary area and the other with reference to unemployment.

We have achieved under the Carter administration, or whoever gets the credit for it—it usually falls to the administration in power—a reduction in the unemployment rate over the last few years, but with that, we still have a massive structural unemployment problem—the blacks, the ghettos—women are higher in unemployment statistics than other categories because women have been entering the market in unprecedented numbers—and we have a very high entry rate of people seeking jobs, and I think one of the highest rates we have ever had historically in terms of the number of people. The participation rate—I think that is the technical term used for it—is very high.

What are we going to do about this structural unemployment problem?

Perhaps where there is a second wage earner in the household as a matter of convenience or when the children leave home and the woman wants to look for a job to get her out, it isn't quite as much of a problem.

But for some families, it may make the difference when they pay the mortgage on the new house. And for teenage blacks, it may make a difference when they survive or go into a criminal career, and a lot of other social impacts that we have to deal with in a budgetary way of public spending.

We have tried the public employment program and it seems to have its downside impacts.

I guess what I am really asking is do you see a method by which we can better translate some of those people from structurally unemployed into the work force in the private area, where they are a tax contributor rather than a tax drag?

Mr. PERRY. I consider that still our most urgent problem. It is unfortunate that we have been calling it an urgent problem for as long as we have and we have still not solved it.

But I think it is our No. 1 economic problem even though our attention has turned, in a political sense, I suppose, to fighting inflation. There are people that work very hard at this and I am sure you know the record better than I do.

Some of the things we are doing right now are useful things. I would hope that in the name of tight budgeting, we do not eliminate any programs that have any usefulness in this area, because I think that would be a very poor form of economizing.

We should also recognize, in the process of slowing the general economy, that we are going to exacerbate the problems you have described, even though these problems are inherently structural in that they exist even when general employment conditions are good; they still worsen when general employment conditions are bad.

Consequently, I think that if some of the more pessimistic forecasts come true, the problems you have described are going to worsen and I don't have any easy answers for this. But I think some of the structural employment programs and youth employment programs and some of the money we have been putting into the urban areas really represents money very well spent.

Representative BROWN. Let me suggest one that might not be easy, but might be a little different in terms of emphasis.

We had one of the alumni of your organization, Charlie Schultze, up the other day, and he pointed out that in the President's budget, there is an increase of the funds allowed for the tax subsidy for hiring the structurally unemployed.

I raised a question with him whether a tax subsidy was really the way. I mean, I have a little business and our accountant at the end of the year takes something of our income and he can look through our statistics and find we hired some additional personnel and all of that, but that is the accountant making a tax decision at the end of the year, rather than hiring at the point where the person is brought into the plant.

I would like to suggest, and I wish you would think of it, a program similar to one that we had a few years ago where the company is actually given a subsidy of a portion of the wage of the structurally unemployed individual that reduces over a period of time, so that he or she is brought on as an employee, trained on the job, and when the subsidy disappears, he is getting full-time wages for full-time work, presumably a trained and capable employee, and you have done both things, you have provided the job and you have provided the training and you have reduced unemployment.

Mr. PERRY. I think, in principle, that is an excellent approach. I suppose that the problem comes in defining who is eligible and avoiding a break point.

Representative BROWN. Maybe it would be someone who is ineligible for unemployment compensation that goes back to work after the kids left the house, or the youngster who has never been able to find a job, or the person who has had a job making bridles and harnesses, and now that is a passé occupation.

Mr. PERRY. These are all categories that deserve the kind of attention you are describing. I think the opposition to such a measure as a step in the correct direction would come from someone not eligible for the subsidy who felt he was unfairly competing for a job.

Representative BROWN. I just described that person that would be eligible for unemployment compensation and would have the

skill to get a job, and so when he exhausts his compensation payment or benefits, then, he becomes ineligible, or does he?

Mr. PERRY. I think that kind of approach is a useful one.

Representative BROWN. Then, the OIC and the National Association of Businessmen and some of these other institutions bring the company and the unskilled trainee together. Then we might have something.

Mr. PERRY. The subsidy might have to be very large in some cases, but it is still money well spent. Any time you consider the alternative, almost anything you do to put some of these groups into the work force is a tremendously good investment.

Representative BROWN. I have another question, but my time is up.

Senator BENTSEN. Why don't you go ahead.

Representative BROWN. Thank you, Mr. Chairman.

Let me ask one other thing. The staff advised me that you made a remark that we can still avoid a recession if interest rates do not get higher. Are you suggesting that money is tight now, but not to a critical point, or are you suggesting that you would encourage money growth sharply?

In other words, the Fed loosens up on the money supply, even though it might raise inflation and raise interest rates in the long run.

Mr. PERRY. If the object is to avoid a recession, then, I think the present posture of policy is about right; that is, interest rates do not seem to be high enough to seriously hamper borrowing, they have not affected the parts of the economy where you expect tight credit conditions to appear, and my guess is that they have had a gradual, modest effect here and there but nothing to really hold the economy back sharply. However, we are at a difficult point in time. The object of the policy is clearly to slow the expansion; it is quite a narrow line between that and causing a recession that is larger than you would like.

Representative BROWN. Slow the expansion or slow the demand for money?

Mr. PERRY. I do not think slowing the demand for money by itself is a productive exercise. It is my view that that is neither worth doing nor worth not doing.

Representative BROWN. When you say expansion, what do you mean?

Mr. PERRY. The growth of the gross national product, employment and output. That is what stabilization policy is trying to contain in terms of the anti-inflation program.

Now, anytime you have an ideal path that you think is just about where you would like to go, you have to recognize that there are substantial risks that you come out well below that path or well above that path. Today I believe policy is quite concerned not to come up well above the path, and for a large number of reasons, most of which I would agree with.

Senator BENTSEN. May I interrupt there and thank you very much. Let me just add to the points that Congressman Brown made on the question of tax credit for employment, since I was the author of that amendment in the Finance Committee in the Senate, that the one in 1976 was opposed by the administration,

and we passed it anyway, and then it became one of the best kept secrets. The administration gave it no publicity whatever, but the Senator from Wisconsin said it was his consideration that it created employment for some 400,000 more.

Now, I, frankly, believe that the targeted unemployment we passed in 1978 is an improvement and that it really does get to some of these people that Congressman Brown is talking about, and his accountant better tell him about it ahead of time because we are talking about a very substantial concession. You see, that allows for up to 50 percent of the first year's salary to a maximum of \$6,000 tax credit and 25 percent of the second year's salary up to \$6,000. So, it is a very major consideration in the hiring of people and employees in the private sector, and I think it will have a significant effect—at least I hope so. You cannot say to 30 or 40 percent of a group like the young blacks, "You know, society has no role for you to fulfill." You do not put them on a shelf for 3 or 4 years. If you do that, we pay a terrible price, a social price, an economic price, and a political price. I think we are just in total agreement on this committee that this is one of the most terrible problems the country has today.

We have kept you gentlemen a long time, and we are very appreciative of your testimony and the comments. I guess we would keep you all afternoon if we could, but thank you very much.

We will go ahead with Mr. Stein now and his testimony. Thank you, Mr. Perry and Mr. Bernstein.

Mr. Stein, we are delighted to have you back. You have either lost a lot of weight or you got yourself a better tailor. You look very good.

STATEMENT OF HERBERT STEIN, A. WILLIS ROBERTSON PROFESSOR OF ECONOMICS, UNIVERSITY OF VIRGINIA; SENIOR FELLOW, THE AMERICAN ENTERPRISE INSTITUTE; AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. STEIN. I have lost a lot of weight, and I lost it the hard way. I apologize for being late. There was some misunderstanding. I was scheduled to appear here and the House Budget Committee both at 10 o'clock this morning. That didn't prove feasible, so I have just run over from their hearing. I will try to say something that is a little different from what I said to them but not too different from what I said to them.

As I said at the House when I saw what the farmers were doing here, I said to myself, "Where are the taxpayers' tractors?"

I am intending to appear here as a small excuse for a taxpayers' tractor.

I will make a brief statement, as you have requested. I attach to this statement copies of two recent articles written for the AEI Economist, which explain my views further and which I would like to have included in the record.

I would like to take this occasion to compliment the Council of Economic Advisers on their annual report for 1979. Although there are many points on which I disagree with the administration's policies, I regard the report as a long step towards realism in the appraisal of our economic situation. I especially welcome the em-

phasis on the need for moderation in setting goals for economic expansion, for unemployment, and for government spending.

With respect to the economic outlook for 1979, I share the view that is expressed in the report and, I believe, common in the economic profession, that both GNP in current dollars and GNP in real terms will rise less than during 1978 and that unemployment will rise a little. Whether the rise of real GNP during the year will be 2.2 percent, as the administration estimates, or 2 percent, or 1 percent, is a question on which I have no comment to make because I don't know, I don't think anyone else knows with any high degree of confidence, and I don't think the answer is very important.

Also, I think the question whether, when history is written, 1979 is designated as a year of recession or not is a trivial question, because the line between slowdowns that are recessions and those that are not recessions is subjective, arbitrary, and devoid of policy significance.

What is significant is that the economy must slow down, it will be better from every standpoint if the slowdown begins sooner rather than later, and apparently the slowdown is going to begin this year. It is important that the slowdown should begin soon because that will increase the chance of making a smooth transition to a lower inflation rate.

I do believe that the administration's forecasts of the inflation rate during 1979, and at the end of the year, are too low. I would expect the rate at the end of the year to be more like 8 percent than the 7-percent the administration is suggesting. Of course, the record is that we forecast the inflation rate poorly, and I would make no point of this difference if it did not reflect a major difference in the evaluation of economic policy. As I see it, the administration's inflation forecast is predicated on a high degree of success in the so-called "voluntary" price and wage control program. My estimate assumes zero success, which I firmly believe to be the assumption better supported by experience and analysis.

In my opinion, the important questions today relate to the desirable behavior of the economy after 1979. The slowdown of 1979 will make little or no contribution to the fight against inflation if it is followed by a rapid expansion of demand. The inflation rate is going to respond slowly to the moderation of demand. We need several years in which the rate of growth of nominal GNP declines, in which real output rises slowly, and in which unemployment is above the present rate. This will lead to a decline of the inflation rate which will be slow at first, but which will gather speed as experience demonstrates the strength of the Government's determination to check inflation.

The administration's longer run plans and targets for the overall performance of the economy are hard to tell now, partly because the projections in the Economic Report and the budget are warped by the need to conform to the arbitrary assumptions of the Humphrey-Hawkins Act. In this way the act has turned out to be an obstacle to long-run thinking about economic policy.

However, even aside from the artificialities imposed by Humphrey-Hawkins, there does seem to be a feeling in the Government and in the country that after a brief and shallow slowdown of the

economy in 1979 or the first half of 1980 we can pump the economy up to rapid growth, even exceeding our long-run growth rate, and still see the inflation rate consistently and comfortably decline. This is a terrible mistake. It is a mistake that was made by previous administrations, including the one of which I was a part. I hope that our mistake may be forgiven as due to lack of experience. But that the same mistake should be repeated by successive administrations is unforgiveable.

I would like to summarize in a few words the prescription I would offer for overall economic policy today:

One: The Government should announce its intention to bring about a steady decline of the rate of growth of GNP in current dollars, as the essential step to reduce the inflation rate. Current-dollar GNP rose by more than 12 percent during 1978. That should be gradually reduced to about 6 percent in, say, 5 years. The Federal Reserve should be guided by this target.

Two: The administration should terminate its so-called "voluntary" wage and price control program. This would be the clearest possible sign of the end of illusion and of commitment to a realistic attack on inflation.

Three: The Government should make as binding a commitment as it can now make to the gradual reduction of Federal spending relative to GNP over the next 4 or 5 years. An appropriate vehicle for this would be the Spending Limitation Act, S. 34, proposed by Senator Roth and Congressman Kemp. This would limit outlays approved by Congress in the Second Concurrent Resolution on the Budget each year to 21 percent of GNP for fiscal 1980, 20 percent for fiscal 1981, 19 percent for fiscal 1982, and 18 percent for fiscal 1983.

Four: With such a commitment in place, the Government could with some confidence enact legislation this year providing for a gradual phase-in of tax reduction which would still yield a balanced budget in, say, 1982. With expenditures in that year equal to 19 percent of GNP, there would be room for a tax cut which in 1982 would amount to about \$60 billion.

This kind of economic policy would, in my opinion, go far to relieve the two great anxieties of the American people—inflation and taxation. It would also contribute strongly to a revival of real economic growth, increasing opportunities for all and helping to reestablish the conditions in which, in President Kennedy's phrase—and I don't quote him very often—"a rising tide lifts all the boats."

[The two articles attached to Mr. Stein's statement follow:]

the economist

American Enterprise Institute for Public Policy Research

December 1978

The New Economic Policy: What Is It? Will It Work? What Next?

Herbert Stein

We have had so many presidential addresses on inflation in the past ten years, so many bold new programs, so many promises. And still the inflation has continued and accelerated. There is no wonder that new programs are greeted with yawns and skepticism.

Still, there is no experience of inflations that go on accelerating forever, and hardly any continue at a high level for a very long time. Big inflations tend to come to an end. Some end in economic collapse, some end with pressure imposed by a foreign power, some end with a radical change of government, and some end with a change of policy by an existing government, supported by a change of public attitudes. Whatever the mechanism, inflations do come to an end, or at least slow down. And that will be true of the current American inflation also, some day.

So one cannot exclude the possibility, despite all grounds for skepticism, that the new policies announced on October 24 and November 1 will begin the end of this decade's round of inflation. Probably no one thinks that the odds on that are high. Even the administration is modest in its claims. But it is worthwhile to try to evaluate the probability, and ask what are the key variables on which success depends, and what options are available if the present effort does not succeed.

Evaluation of the present program is made an unusually speculative endeavor by the uncertainty, which persists more than a month after the President's announcement, about the nature of the program. The administration is still in the process of drafting the wage and price standards to which it expects unions and businesses to conform. The program depends in key respects on congressional

action which is far from assured. The intentions of the Federal Reserve and the administration in the field of monetary policy are unclear. All one can do at this point is to consider the possible implications of alternative meanings of the administration's program.

The Underlying Rationale

Although the administration's reasoning has not been explicit on all points, it seems to run about as follows:

We have a built-in rate of inflation which is very insensitive to reductions of demand or increases of unemployment from the present level. This built-in

The AEI Economist is a monthly report intended to clarify current issues of economic policy in an objective manner. It is edited and in large part written by Herbert Stein, senior fellow of the American Enterprise Institute and A. Willis Robertson Professor of Economics at the University of Virginia, with the assistance of the Board of Editorial Advisers:

William Fellner, *Yale University emeritus; AEI Resident Scholar*
 Thomas F. Johnson, *Director, AEI Economic Policy Studies*
 Marvin H. Kosters, *Director, AEI Government Regulation Studies*
 Paul W. MacAvoy, *Yale University; AEI Adjunct Scholar*
 Paul W. McCracken, *University of Michigan; Chairman, AEI Council of Academic Advisers*

James C. Miller III, *Co-director, AEI Government Regulation Studies*
 Rudolph G. Penner, *Director, AEI Tax Policy Studies*

The authors of the articles are solely responsible for the contents.

American Enterprise Institute for Public Policy Research
 1150 Seventeenth Street, N.W.
 Washington, D.C. 20036

William J. Baroody, Jr., *Publisher*

Subscriptions: \$10 per year. Single copies: \$1 each.
 ISSN 0149-9785

rate of inflation is the result of our past history, the expectations of wage increases it has generated, the patterns of wage increases in one industry following increases elsewhere or following cost of living increases, the pricing policies of business, the cost-raising policies of government, and so on. This built-in rate is not the actual rate of the past few months, which, as measured by the Consumer Price Index, has been around 9 percent. The actual rate presumably reflects some temporary factors, in this case the rise of mortgage interest rates, which might not continue if the rate of inflation levels out. The built-in rate is, therefore, not directly visible, and one can only speculate about what it is. But there is some evidence to suggest that the administration thinks it is about 7½ percent. An attempt to reduce this rate by restricting demand would have little effect on the inflation rate but a serious effect on output and employment.

The present unemployment rate is about 6 percent, and growth of output at the rate of about 3 percent a year would keep the unemployment rate around that level. Growth of demand (total spending for goods and services, or nominal GNP) at a rate of about 10½ percent a year would be consistent with this rate of growth of output and the built-in inflation rate. Unless something else is done to reduce the built-in inflation rate, a slower growth of demand would not significantly reduce the inflation rate but would raise unemployment and impair output. On the other hand, faster growth of demand would accelerate the inflation without increasing output and employment much.

While the built-in rate of inflation is given by the historical background and present institutional conditions, it is not economically necessary, either to allocate scarce supplies or to evoke more output. Therefore, inflation can be suppressed below this built-in rate without adverse economic consequences. This can be done in the private sector by persuading or threatening businesses and labor into raising prices and wages less than they would have spontaneously done. In the public sector it can be done by a reordering of priorities which would rule out many cost-raising actions. Results from such a policy would come slowly, and it would not succeed at all if it were accompanied by excess demand. However, such a policy can be expected to reduce the inflation rate in the next year by about one-half percent below the built-in rate—to about 7 percent. If, then, demand increased at a rate of 10 percent a year this would permit a 3 percent growth of output, holding unemployment steady and avoiding so strong a pressure of demand as to frustrate the direct inflation-restraining policies. In subsequent years

further reduction of the inflation rate can be achieved.

Given this reasoning the appropriate strategy has two parts. The first is a fiscal and monetary policy which will prevent excessive speed-up of demand—that is, which will keep unemployment around 6 percent, real growth around 3 percent a year, and total spending (GNP in current dollars) rising around 10 percent a year. The second part of the strategy is direct action to slow down price increases which would otherwise continue at a high rate even though market conditions would not require them. This direct action consists of an “incomes policy” to slow down price and wage increases in the private sector and intensified resistance to federal policies that raise prices or costs.

This is the same kind of reasoning and strategy that has inspired the administration's anti-inflation program for the past year. Only matters of degree and intensity have changed. The administration has always believed that although some fiscal and monetary restraint was needed, the current inflation rate was not caused by excess demand and that the rate could and should be reduced by direct action on prices and costs. However, at the beginning of the year the administration thought that reduction of the inflation rate would be consistent with economic growth of almost 5 percent in both 1978 and 1979 and budget deficits of \$60 billion in FY 1979 and almost \$40 billion in FY 1980. Now it thinks reduction of inflation will require holding economic growth to 3 percent in 1979, after about 4 percent in 1978, and holding the deficit to \$30 billion in FY 1980, after \$40 billion in 1979. At the beginning of the year the administration thought that inflationary private behavior could be controlled by vague exhortations to slow down, addressed to no one in particular. In April this was escalated to the Robert Strauss effort at salesmanship and arm-twisting, but the standards remained imprecise and the application was spotty. Now the incomes policy has been escalated much further: the standards have become more specific, the application in principle more comprehensive, the sanctions more powerful, and the governmental machinery more elaborate.

The administration's defense of its present mixture of demand restraint and incomes policy is reminiscent of Goldilocks and the Three Bears.

Goldilocks tasted Papa Bear's porridge and found it too hot. She found Mama Bear's porridge too cold. But Baby Bear's porridge was "Juuust right." So the administration finds suggestions for a tighter fiscal and monetary policy to restrain demand are prescriptions for recession, or even depression. And suggestions for stronger incomes policy are really prescriptions for mandatory controls, with all their inequities and inefficiencies. And suggestions for either less fiscal and monetary restraint or less stringent incomes policy are surrenders to inflation. But the administration's combination is "Juuust right." Its fiscal and monetary policy is just right to restrain inflation without causing a recession. Its incomes policy is just right to deter inflationary private behavior without incurring the evil consequences of mandatory price and wage controls.

Of course, no one, in or out of the administration, knows enough to say whether the present program is just right. The fact that the administration has made radical changes during the year, in programs that were once described as just right, is evidence enough of that.

The New Incomes Policy

The program for inducing business and labor to restrain price and wage increases below what they would freely decide on in existing market conditions is the most conspicuous part of the new anti-inflation effort. This program differs from previous "voluntary" incomes policies in this country, and probably from incomes policies in other countries, in a number of respects:

- The standards, or guidelines, are to be spelled out in advance more specifically and precisely than has usually been the case.
- The coverage of the guidelines is intended to be complete except for specified exclusions, such as agriculture, imports, and low-wage workers.
- The sanctions for noncompliance are spelled out clearly in advance. These include loss of government contracts, unfavorable treatment by government regulators, and exposure to public condemnation by the government.
- A fairly large staff is to be created to implement the program.
- Congress is asked to enact a "real wage insurance" program, which would give to groups of workers whose wage increases do not exceed 7

The administration's defense of its present mixture of demand restraint and incomes policy is reminiscent of Goldilocks and the Three Bears. Goldilocks tasted Papa Bear's porridge and found it too hot. She found Mama Bear's porridge too cold. But Baby Bear's porridge was "Juuust right."

percent compensation in the form of tax rebates if the cost of living rises by more than 7 percent.

In general, the new incomes policy comes about as close to mandatory controls as it is possible to come without statutory authority.

There would probably be widespread agreement among students of the matter that such programs have rarely restrained inflation significantly for very long. There would be disagreement over whether such programs have ever worked, or could ever work. However, it is not necessary to resolve this disagreement in order to evaluate the present incomes policy. We can look at the specific content of this policy and at the surrounding circumstances and judge whether it is likely to be among the more successful of such policies or not.

From the limited perspective of five weeks, one must say that the new program has not started off well and does not show great promise of success. There are several signs of this:

- Although opinion polls indicate that the public supports the idea of incomes policy, the present program does not seem to have aroused the public enthusiasm that would assure the President of overwhelming support in a contest with a recalcitrant business, labor union, or Congress. The program did not start in a dramatic way. After the President announced it in a speech on October 24, nothing happened. As far as the man-in-the-street is concerned, nothing has happened yet, unless he knows that an increase in the price of Hershey bars has been approved. The public attention focused on the program by the President's speech has been allowed to wander. Also, the program is not structured so that the consumer can see any benefit from it. That is, he cannot go into a store and see what the permitted price of any item is, and therefore he cannot see that anything is being held down to its permitted price. Moreover,

the program has no spokesman capable of communicating with the public and arousing support.

- The program has been rejected by the top leader of American labor, George Meany. Moreover, a number of leaders of national unions, including Frank Fitzsimmons of the Teamsters, have opposed the wage guidelines. The case of Mr. Fitzsimmons is especially important because the Teamsters will have major contract negotiations early in 1979 and because the President had publicly referred to Fitzsimmons as an example of cooperation.

- The nature of the program gives some substance to the usual labor complaint that the application of the standards will be one-sided. Employers, at least the large ones, will know the standards for permitted wage increases and will use the standards to hold down increases. But no private purchaser, not even a very large one, will know the permitted price for anything he buys. That is because the price standards apply to the *average* price of a seller's entire line and do not limit the price of any particular item. Thus, the concern of purchasers cannot police the price standards in the same way that the concern of employers will police the wage standard. Only the government agency receiving reports from business will be able to tell whether businesses are complying, and they will be able to tell for a significant number of businesses only if the agency has many employees.

- By the administration's own forecasts the inflation rate will probably not get down below 7 percent until late in 1979. This means that during the whole first year of the program labor will be asked to accept wage increases of 7 percent despite cost-of-living increases which have been running and are still running more than 7 percent.

- Whether the administration may legally use its various powers, as it proposes, to enforce compliance with the guidelines is in doubt. Congress has given the executive power to let contracts, to adjust tariffs within certain limits, to bring suits for antitrust violators, and so on. These powers are given for certain purposes and usually are to be exercised according to certain standards. Where Congress has wanted a power to be used for something other than its primary purpose, that has been specified. Can the President legally use these powers for a purpose—enforcing his guidelines—

that Congress has never specified, in contravention of standards that Congress has specified? This question becomes even more acute when asked about the "independent" regulatory agencies, which used to mean independent of the President.

The question of the legality of enforcing price and wage standards by the use of powers not granted for that purpose will be tested in the courts. If the administration loses such a test, it is doubtful whether the program could be reestablished on a "truly voluntary" basis.

- The "real wage insurance" tax rebate now has a key role in the administration's program, because the President has held it out as the carrot to induce labor to sign contracts calling for no more than a 7 percent wage increase. However, congressional approval of such a plan is highly doubtful. Apparently the administration did not obtain assurances of support from the congressional leadership before it announced the proposal, and the chairman of the House Ways and Means Committee has already revealed his skepticism about it.

There are many reasons for expecting difficulty in the Congress. The plan is likely to become the focus of labor's objections to the whole incomes policy, which labor apparently had no adequate opportunity to express to the President. Labor will not buy the plan's implication that it is "entitled" only to keep up with the cost of living, without any real wage increase, which means a net decrease of after-tax income. Many congressmen will find the numbers in the administration's proposed tax-rebate proposal—7 percent wage increase and 7 percent price increase—too arbitrary to incorporate in a tax law. There will be reluctance to provide real income insurance for workers when there is no insurance for others who may be equally in compliance with the guidelines—farmers, other small businessmen and self-employed people, recipients of interest and dividends, retired people on annuities, low-wage earners, and, reportedly, persons earning more than \$15,000 or \$20,000 a year. Even some workers who get less than a 7 percent wage increase will be left out of the insurance plan if they are members of a group of workers who on the average get more than 7 percent.

Also there is concern about the possible effects on the budget deficit if inflation does exceed 7

percent and large payments have to be made under the real wage insurance program. This concern is sometimes answered by pointing out that the inflation would yield revenues which could be used to pay the insurance. The implication is that some taxpayers would be exposed to additional burdens, as a result of inflation, in order to protect others. There are many congressmen who think that a fairer use of the excess revenues generated by inflation would be to return them to the taxpayers who bore the burden, through a general tax indexation scheme.

... probably a fair judgment is that the present "voluntary" incomes program will be irrelevant to the course of the inflation.

The new guidelines program has many obstacles in its way—public indifference, labor opposition, possible upset in the courts, possible rejection of a key element by Congress. Of course, the program is young yet, and it may gather strength later. But that is not the most likely development. Such programs are generally more effective and impressive at first than later. They tend to run downhill rather than up.

There are many uncertainties in such an evaluation, but probably a fair judgment is that the present "voluntary" incomes program will be irrelevant to the course of the inflation. The program will undoubtedly cause some price or wage increases to be smaller than they would otherwise have been. But these cases will probably not be numerous. There will probably be some other cases in which price increases and wage increases are enlarged as the guidelines come to be regarded as setting a floor under increases. Moreover, everyone now agrees that the conquest of inflation is going to take a long time at best—five years or more—and the present program is unlikely to survive for any large part of that period.

Targets for Demand Management

If the preceding appraisal is correct, the new incomes policy will not make a significant contribution to reducing inflation. In that case one

must ask whether the more restrictive demand management policy—that is, the tighter fiscal and monetary policy—involved in the administration program will by itself suffice to reduce the inflation rate.

That is a difficult question because the degree of monetary restraint incorporated in the new program is not known. However, the question may be approached indirectly. The administration is forecasting a condition in which real output rises at an annual rate a little under 3 percent, the unemployment rate is stable around 6 percent, and the inflation rate, aided by incomes policy, declines to 7 percent or less by late 1979. This forecast is not described by the administration as its target, and surely no part of the forecast by itself would be a target. However, the use of these numbers implies that the combination of growth rate, unemployment rate, and inflation rate is feasible—given the incomes policy. It further implies that this is regarded as a satisfactory combination, if not the best of all feasible combinations. Otherwise the administration would take action to bring about some other combination.

Is the combination of 3 percent growth, 6 percent unemployment, and inflation declining to 7 percent by the end of 1979 a feasible combination, on the assumption that incomes policy does not work? A year ago most economists would have said that 3 percent growth and a stable unemployment rate did not go together. It was thought that the increase of the labor force and of productivity required around 3½ percent growth of output to keep unemployment stable. But the old relationships on which economists have relied have not worked well lately. Unemployment has fallen faster than we would have expected with the rise of output actually achieved. So it is not impossible or even highly improbable that 3 percent growth would yield a stable unemployment rate.

A more critical question concerns the relationship between inflation and the unemployment rate, because unemployment is likely to be a more important target for the government than is growth of output. There are many reasons to doubt whether an unemployment rate of 6 percent will be compatible with a decline of the underlying inflation rate. A simple piece of evidence is that as the unemployment rate fell from 7 percent to 6 percent in 1977 the inflation rate accelerated. More sophisticated evidence is provided by the study of

Phillip Cagan, in *Contemporary Economic Problems 1978* (published by AEI), which found a tendency for the inflation rate to decelerate only when unemployment is in excess of 6 percent. Econometric models in common use show the inflation rate falling as low as 7 percent in the next two years only in association with unemployment rates above 6 percent.

Forecasts of the inflation rate have been notoriously unreliable for the past ten years or more. Still, one must say that the odds are against a decline of the underlying inflation rate in the near future—say, the next year or two—if fiscal and monetary policy are directed to keeping the unemployment rate at 6 percent. This may not become evident in the early part of 1979. Inflation will be running below the double-digit rates we have experienced in much of 1978. But this will not really mean any progress. Some of the temporary factors, which have already been discounted in estimates of the underlying inflation rate, may have vanished. But the underlying rate will not have been affected.

As between the other two options of tighter demand management policies and mandatory controls, the government's choice a year or so from now cannot be predicted. That is probably the most hopeful sign in the whole picture. Two months ago one would have predicted the move to mandatory controls as the next step after the voluntary system.

Nevertheless, the government now seems to be aiming at, or at least willing to accept, a level of unemployment and a rate of economic growth much closer to compatibility with reduction of the inflation rate than its targets of 1977 and early 1978. This gradual scaling down of growth ambitions during this year has been the most encouraging recent sign that the inflation may be brought under control. If this adjustment of ambitions has not yet reached the point at which a slowdown of inflation may be confidently expected, neither has the adjustment necessarily reached an end.

One of the key determinants of the success of the anti-inflation effort will be how these targets

are modified as we go through 1979 and 1980. We have suggested that a fiscal and monetary policy aimed at 3 percent growth and 6 percent unemployment, accompanied by the incomes policy now being instituted, will not be compatible with a reduction of inflation. In the past the administration has responded to a similar situation by moving in two directions. It has both reduced its output and employment targets and tightened up the screw of incomes policy. Next steps in either direction will be much more difficult. The output and employment targets cannot be lowered without espousing an actual increase of the unemployment rate, something no administration finds it tolerable to do. On the other hand, there seems to be no room for tightening the incomes policy without crossing over the faint line which divides "voluntary" from mandatory, and this the President has said he will not do.

There may be a third option for the administration next year. It may point out that the rate of price increase has fallen from the 9 to 10 percent suffered in 1978 to, say, 7½ or 8 percent, declare victory in the war against inflation, and go on to other things. This tactic might have some short-run political advantage. However, there would be great dangers in it. The view, already too widespread, that the government would not firmly resist a gradual upward ratcheting of the underlying inflation rate would be further confirmed.

As between the other two options of tighter demand management policies and mandatory controls, the government's choice a year or so from now cannot be predicted. That is probably the most hopeful sign in the whole picture. Two months ago one would have predicted the move to mandatory controls as the next step after the voluntary system. Today one cannot be so sure. The recent moderation of the government's output and employment targets, and the signs of tighter fiscal and monetary policy, raise the possibility that the government will go further in the direction of what was called five years ago "the old time religion" as a way of curbing inflation.

Targets and Policies

The new anti-inflation program must be defined not only in terms of its targets but also in terms of

its policies for achieving those targets. If we are going to achieve something like a 3 percent growth of output and a 7 percent inflation rate, the growth of nominal GNP must be slowed down to something like 10 percent a year. This would be a big cut from the 11.7 percent actual increase of GNP between the third quarter of 1977 and the third quarter of 1978.

The government's new, more restrictive fiscal and monetary policies are intended to bring about the slowdown of GNP. There are, as often in such cases, two views dissenting from the government's assurances that its new policies will be just right for keeping the economy on its desired path.

One view is that the new policy is too restrictive and will soon plunge the nation into a serious recession. The other is that the policy is or will be too loose, that it will not slow down the rise of demand, and that the underlying inflation rate will continue unrestrained or even rise.

Unfortunately, not much can be said about this subject because little is known about the future of monetary policy. The administration's overall plans for budget policy have been described with some precision, but that is not true of monetary policy. The Federal Reserve's announced targets for the growth of various monetary aggregates in the next year cover a range of possibilities from severely restrictive to moderately permissive.

The President has said that his budget for fiscal 1980 will have outlays not exceeding 21 percent of GNP and a deficit not exceeding \$30 billion. Much has been made of the "austerity" of the new budget plan, and no doubt the administration is having difficulty in meeting its goals. However, this program is austere only in relation to the profligacy of fiscal 1978. Before this administration, expenditures had exceeded 21 percent of GNP only in years of war or severe recession. Also, holding the deficit to \$30 billion in 1980 will be difficult only because little progress has so far been made in reducing the deficit from its level of \$45 billion in 1977, despite the recovery of the economy.

Such observations do not deny the fact that achievement of the President's budget goals for fiscal 1980 would be a significant move toward restraint, compared with where we are in 1978. Still, the move does not by itself seem so massive as to create the risk of pushing the economy below the administration's growth targets.

The greater uncertainty is about monetary policy. The increase of the discount rate by one percentage point on November 1 and subsequent increases in other rates led some observers to believe we were entering a regime of monetary tightness that would cause a recession. While that may yet occur, for the present the judgment seems premature. When account is taken of recent rates of inflation and of the rates of inflation that prudent lenders and borrowers must be counting on, present interest rates are not high in real terms. Moreover there are no signs of the lack of availability of credit which has been encountered before recessions in the past.

On the other hand, there are many skeptics about whether significant restraint is going to be exercised from the monetary side. A new theory of the ineffectiveness of monetary policy (the latest in a long series) has surfaced. This holds that restrictive monetary policy has worked in the past through imperfections in the credit markets which no longer exist. In the past when interest rates rose certain sectors of the economy were unable to obtain credit because of legal or institutional inhibitions on the interest rates they could pay or charge. The chief victim was the housing industry. It was this choking off of the supply of funds, rather than the unwillingness of borrowers to pay higher interest rates, which made tight money effective. But now we are approximating a situation in which everyone who is willing to pay the going rate can get the money. Representative of the changes that have brought this about is the new six-month certificate of deposit at a rate tied to the Treasury bill rate, which thrift institutions have been permitted to offer. This enables those institutions to continue to attract funds in a time of rising interest rates. So, it is said, what happens now is that interest rates rise across the board, but credit is generally available and borrowers are willing to pay because they expect inflation to hold down their real debt burden.

There is some point to this argument. It does imply that a rise of nominal interest rates, which only keeps up with inflation and which is not a rise of real interest rates, will no longer have a restrictive effect. But it does not dispute the effectiveness of restraint in the supply of money, which would be accompanied by a rise of real interest rates.

The more serious question is whether the

monetary moves announced on November 1—not only the discount rate increase but also the increase of reserve requirements for certain classes of deposits—signal future restraint of monetary growth. Since that time there has been a slow-down of the money supply, but the monetary base, which influences future monetary expansion, has continued to rise rapidly. In any case, the time has been too short to attach much significance to these movements. Also, as already noted, the targets for future monetary expansion announced by the Federal Reserve include at their upper edge rates of growth sufficient to finance a rapid inflation—aside from the fact that the Fed has in the past frequently exceeded even the upper limit of its target range.

Much has been made of the "austerity" of the new budget plan, and no doubt the administration is having difficulty in meeting its goals. However, this program is austere only in relation to the profligacy of fiscal 1978.

Skepticism about monetary restraint basically derives from past experience. The government—taking all parts of it together—has in the past been so concerned by what it regarded as high interest rates and risks of recession that a consistently anti-inflationary monetary policy has been impossible. Projection of this record makes anti-inflationary monetary policy in the future uncertain. The question is whether something changed radically on November 1. No one, at least no one outside the government, can yet answer that. But neither can one rule out the possibility of a basic change of attitudes and policies.

The concern that demand management policy may be too expansive is not inconsistent with the possibility that we will have a recession in 1979 or 1980—in other words, that growth would fall for a time below the desired rate. As a general proposition one can say that we have not entered an era in which there will be no more recessions and also that forecasts of the time and character of coming recessions are not very reliable, even when agreement among economists is nearly

unanimous. As far as any present evidence goes, the recession commonly forecast for the next year or two is not so certain or so severe as to call now for any departure from the long-run trend of anti-inflationary policy. Neither does it seem likely that the forecast recession will significantly or durably reduce the inflation rate. From the standpoint of the long-run effort to reduce inflation—and also to maintain high employment and growth in the future—the main importance of a recession in 1979 or 1980 is the danger that it would generate an overly expansive policy reaction. That would derail the present effort and require the whole thing to be started over again later and from a higher inflation rate.

Summing Up

Where does this speculation leave us? Probably one must say:

- The new incomes policy will not make much contribution to reducing the inflation rate.
- A demand management policy aimed at 3 percent growth and maintenance of 6 percent unemployment, which seem to be the administration's targets, is probably too expansive to bring about a reduction of the underlying inflation rate in the next several years.
- It is at least doubtful whether monetary policy is going to be sufficiently restrictive to slow down the rise of demand in the degree necessary for a successful anti-inflationary policy.

On the other hand, it is possible to say two optimistic things:

- Attitudes in the country and in the government seem to be moving in the direction of moderating near-term goals for economic growth and unemployment, and while this process has probably not yet reached the point necessary to reduce inflation the process may continue until that point is reached.
- Although there is still no evidence in deeds, as distinguished from words, monetary policy may yet change, in a way consistent with reducing inflation.

Thus, we probably do not now have a reliable anti-inflationary policy, but the chances have improved that we will get one.

the economist

American Enterprise Institute for Public Policy Research

January 1979

The Next "Recession"

Herbert Stein

It is a common, although not exactly sidesplitting, joke among laymen that economists never agree. But the fact is that laymen pay little attention to economists when they do agree. Perhaps they think that if economists agree they must surely be wrong, whereas if they disagree there is the interesting possibility that one camp is right. Or they regard economics as a competitive sport, worth watching only while the contest is under way.

There is fairly general agreement among economists today that the growth of the economy is going to slow down in 1979. This is in itself an important development. However, public interest is not satisfied with that proposition and pushes on to ask more controversial questions. Will there be a recession? When will it start? What should be done about it? We shall get to these more exciting questions later, but first we will discuss the reasons for the agreement that there will be a slowdown, since a "recession" is only a particular form of slowdown, not necessarily very different from slowdowns that are not recessions.

The Consensus Forecast

A survey taken in December by Robert J. Eggert shows how solid is the consensus that there will be a slowdown in 1979. Of forty-five economic forecasters included in the survey, forty-four expected that the rise of real output between 1978 and 1979 would be smaller than the rise between 1977 and 1978. The same forty-four out of forty-five expected that the demand for output, as measured by expenditures for goods and services in current dollars, would also rise less between 1978 and 1979 than it had between 1977 and 1978. And forty-five out of forty-five thought that the average unemployment rate would be higher in 1979 than in 1978. On the question of the inflation

rate there was more disagreement, but, still, twenty-seven of the forty-five forecasters thought that the price level would rise more between 1979 and 1978 than it had between 1977 and 1978, whereas five thought the increase would be the same, and thirteen thought the inflation rate would decline.

Although economic forecasts at this time of year are commonly stated in terms of the change expected from last calendar year to this calendar year, such figures are not the most revealing ones. Part of the change between the two calendar years lies behind us, in the change between the average position of 1978 and the position at the end of 1978. An estimate more closely related to the future is given by the forecast change between the end of 1978 and the end of 1979, which is the change during the year we are just entering.

The AEI Economist is a monthly report intended to clarify current issues of economic policy in an objective manner. It is edited and in large part written by Herbert Stein, senior fellow of the American Enterprise Institute and A. Willis Robertson Professor of Economics at the University of Virginia, with the assistance of the Board of Editorial Advisers:

William Fellner, *Yale University emeritus; AEI Resident Scholar*
 Thomas F. Johnson, *Director, AEI Economic Policy Studies*
 Marvin H. Koster, *Director, AEI Government Regulation Studies*
 Paul W. MacAvoy, *Yale University; AEI Adjunct Scholar*
 Paul W. McCracken, *University of Michigan; Chairman, AEI Council of Academic Advisers*

James C. Miller III, *Co-director, AEI Government Regulation Studies*
 Rudolph G. Penner, *Director, AEI Tax Policy Studies*

The authors of the articles are solely responsible for the contents.

American Enterprise Institute for Public Policy Research
 1150 Seventeenth Street, N.W.
 Washington, D.C. 20036

William J. Baroody, Jr., *Publisher*

Subscriptions: \$10 per year. Single copies: \$1 each.
 ISSN 0149-9785

The AEI Economist / January 1979 / 1

I do not have available a similarly comprehensive survey of forecasts on that basis, but there is a good deal of evidence to suggest that there is also a strong consensus on the general outlines of the changes to be expected during the year. These changes relative to those of the preceding year would look much like the changes based on the

A recession is only a particular form of slowdown, not necessarily very different from slowdowns that are not recessions.

calendar year comparisons, except in the price dimension. That is, both current-dollar GNP and real GNP would rise less during 1979 than during 1978, and unemployment would be higher at the end of 1979 than at the end of 1978. However, prices would rise less during 1979 than during 1978. The range of forecasts shown in the third column of the table would probably encompass the opinions of a large majority of all forecasters.

The Evidence for the Forecast

There are two main routes by which one can arrive at the conclusion that the rate of increase of nominal GNP, or of total spending, will be less during 1979 than it was during 1978. One is to analyze each of the major categories of expenditure on the basis of the evidence available. The other is to attempt to deduce the behavior of total spending from the recent or expected behavior of the money supply, on the hypothesis that the money supply exercises a dominant influence over what individuals and businesses spend.

When the first of these approaches is taken, the following conclusions are usually reached:

- The demand for resources for residential construction, which was approximately flat during 1978, will decline substantially during 1979. The main reason for expecting this is the high level of interest rates and the possible effects of high interest rates in reducing the supply of funds to the institutions that supply the bulk of the money for residential mortgages.

- A rise of business investment in plant and equipment was a strong contributor to the expansion of the economy in 1978. Its contribution to demand for output is expected to be much less in 1979, the main evidence for this being the inten-

tions of businesses as reported to the Department of Commerce and several private agencies.

- The rising burden of consumer debt, and the associated need for repayment, will restrain the rise of consumers' expenditures compared with the rise that occurred in 1978. Some forecasters see the effect of this restraint being offset through all or most of 1979 by the tax cut that took effect January 1. They expect the slowdown of consumers' expenditures to come late in 1979 or in 1980.

- Business inventories at the end of 1978 were not so large, in relation to sales, as to be an independent drag on production. However, they were large enough so that a moderate slowdown of sales arising from other sources would make businesses want to reduce inventories, and that would make the slowdown more serious than it might otherwise have been.

- The behavior of the other two categories of demand—government purchases of goods and services and net exports—is uncertain, but increases of a sufficient magnitude to offset the negative factors, notably housing and business fixed investment, are not likely.

If we look at the future through a more "monetarist" glass, a basic factor is that in the last three months the money supply has been rising much more slowly than the average of recent years. The rate of growth of the money supply is always variable, and the evidence of three months by themselves is not conclusive. However, the marked reduction in the rate of monetary expansion is given added weight by the apparent intention of the Federal Reserve to slow monetary growth, which enhances the probability that recent experience is a forerunner of what will happen in the future. In that case the behavior of the money supply will be working in the direction of slowing down the growth of demand.

The evidence from specific sectors of demand and the evidence from the money supply tend to confirm each other now, which is not always true. It is conceivable that a decline in the rate of growth of the money supply would not lead to a slowdown of demand, if other forces make individuals and businesses willing to increase their spending substantially relative to their money holdings. In other circumstances, what looks like a weakness of private demand may not materialize in a slowdown of actual spending. If the money supply is rising

MAIN ECONOMIC VARIABLES: ACTUAL AND FORECAST
(percent)

| Economic Variable | Fourth Quarter 1976 to Fourth Quarter 1977 | Fourth Quarter 1977 to Fourth Quarter 1978 | Fourth Quarter 1978 to Fourth Quarter 1979 |
|-------------------------------------|---|---|---|
| | Actual | Estimated | Forecast |
| Nominal GNP, change | 12 | 12½ | 8½ to 10 |
| Real GNP, change | 5½ | 3¾ | 1 to 2 |
| Prices (GNP deflator), change | 6 | 8¼ | 7¼ to 8 |
| Unemployment rate, end of period | 6¾ | 5¾ | 6½ to 7 |

rapidly, this, combined with weak demands, may cause a drop of interest rates which supports investment and may even stimulate consumption. However, the situation foreseen for 1979 is one in which the money supply is rising relatively slowly and is not offset by willingness to spend more in spite of reduced money growth.

The fact that forty-four out of forty-five economists expect a slowdown of real output and of total spending does not mean that the odds are 44 to 1 that such a slowdown will occur. It doesn't even mean that economists think the odds are 44 to 1. If each of the forty-four economists thinks that the odds are 60 to 40 in favor of a slowdown, we will get the survey results Eggert obtained in December. But the odds in favor of a slowdown are not better than 60-40, even if all the economists are right in their present estimates of the probabilities.

Many qualifications must be attached to the forecast of a slowdown in demand. For example, a key element in almost all forecasts is an expected decline in the demand for new houses, largely as a result of the rise of mortgage interest rates. But similar forecasts made at the beginning of 1978 turned out to be quite wrong. And it is important to emphasize that even present mortgage rates are not high "real" rates if recent increases in house prices are expected to be repeated. The expectation of a slowdown in business investment expenditures for plant and equipment, based on surveys of businesses, is at variance with the strong pace of equipment orders and construction contracts this fall. The typical forecast of restrained consumer expenditure may underestimate the willingness of

households to incur debt in an inflationary environment, especially in view of the tax deductibility of interest. GNP in current dollars has been rising faster in the last two years than would have been predictable from the behavior of the money supply, for reasons which are not entirely clear, and this pattern could be accentuated in 1979. Moreover, despite the administration's recent performance and statements of intentions one cannot yet take a substantial deceleration of the money supply as assured.

Thus, the forecast slowdown of nominal GNP growth should not be regarded as certain. On balance, however the probabilities are on the side of that happening.

How Much Output? How Much Inflation?

As a matter of arithmetic, a slowdown in the rise of nominal GNP must be reflected in a slowdown in the rise of real GNP, or in the rise of prices, or in both in proportions which add up to the total slowdown of nominal GNP. An important feature of the forecast for nominal GNP in 1979 is that most of the slowdown is seen to be reflected in real output and relatively little in the inflation rate. The typical forecast has the rise of real output during 1979 falling two to three percentage points below the rise during 1978, while the rate of inflation falls by around 1 percent. Forecasts of the relation between output growth and the inflation rate have been notoriously poor in the past, and these figures should be understood to be quite uncertain. Nevertheless, they do reflect something that is probably quite real in our present condition.

Several specific reasons can be adduced for the likelihood of a small drop in the inflation rate and a larger drop in the real output growth rate, and the reasons are important for deciding how to evaluate the development and what response it requires. Basically, these reasons can be divided into supply-stickiness and price-stickiness. Thus, if nominal GNP is forecast to rise by $8\frac{1}{2}$ percent, real output by 1 percent, and prices by $7\frac{1}{2}$ percent, either of two extreme explanations can be offered. One can say that the $7\frac{1}{2}$ percent inflation rate was determined independently of the growth of demand within a significant range, so that if demand grew by $8\frac{1}{2}$ percent real output could only rise by 1 percent. Or one can say that the rise of real output by 1 percent was determined independently of the growth of demand within a significant range, so that if demand grew by $8\frac{1}{2}$ percent prices would have to rise by $7\frac{1}{2}$ percent. Probably most economists would take a somewhat intermediate position, expecting both prices and output to respond to the growth of demand, but there would be important differences among economists in the location of the emphasis.

The more common view is probably that the inflation rate is given, or sticky, especially since inflation is expected to remain little affected at a high rate while unemployment is rising above 6 percent to $6\frac{1}{2}$ or 7 percent. Economists have not been used to the idea that demand can be excessive and inflationary in such conditions. They have sought an explanation for the continued high inflation in nondemand factors, such as wage increases embodied in long-term contracts, the tendency for new wage increases to follow the pattern set by earlier ones, and government actions such as increases in minimum wages and social security.

To explain the combination of slow output growth and rapid inflation now forecast for 1979 on the basis of a limitation on our ability to raise output more rapidly, one would have to start with the proposition that at the end of 1978 output was "too high" relative to its trend and unemployment was "too low." Unemployment was "too low" in the sense that it could have been maintained at its end-1978 level only by continuously accelerating inflation, which is impossible. This does not mean that 6 percent unemployment will always be too low. It means only that in the demographic and institutional conditions of 1978 and 1979, and with the historical background of this period, unemployment can be kept at 6 percent only by a

rising inflation, which leads workers to think they are getting higher wages than they really are. Later, after inflation has been stabilized at a low level, and is expected to remain there, wage demands may become more realistic and unemployment of 6 percent or less may again be consistent with feasible price-level behavior.

If that is the case, the economy must move, at least for a while, to a higher unemployment rate, and in the transition total output will rise slowly and may decline. If during this period the demand for output continues to rise rapidly, inflation will continue at a high, or even increased, rate.

As recently as a year ago this explanation of what is going on in the American economy would have seemed outrageous to most economists and would have been summarily rejected by administration economic officials. But acceptance of the idea that we are at or above sustainable levels of output or rates of growth increased in a year in which inflation accelerated markedly while

A better substitute phrase for "recession" would be "homely baby." The line between a homely baby and a plain one or a pretty one is entirely subjective.

unemployment was in the neighborhood of 6 percent. This change of thinking—including, apparently, thinking within the administration—is one of the most significant economic developments of 1978. But there is still much disagreement about this issue among economists, and it would be misleading to say that we now know which view is correct. In fact, their disagreement about the reasons for the forecast performance of the economy in 1979 is much more important than their disagreement about what that performance will be.

What Is a Recession?

While reminding ourselves of the uncertainty attached to the consensus forecast for 1979 and early 1980, we may now turn to the question whether that forecast means there will be a recession. Unfortunately, to answer that question we must go through the pedantic process of asking what is meant by recession, and that in turn leads to the question, "Why do we care?"

The American economy grows at an irregular pace, rising and falling, sometimes slowly and sometimes rapidly. For descriptive and analytical purposes it is convenient to classify the phases of economic movement into a few categories and to give them names. One of these categories is called "recession." Students classify certain phases of our history as recession and then seek to discover common characteristics of all such episodes in an effort to learn something about their frequency of occurrence, duration, causes, and so on.

A recession is generally understood to be a decline of economic activity of substantial duration, depth and breadth, or comprehensiveness. This definition does not tell how substantial the decline must be to qualify as a recession. Obviously, there have been many declines that did not so qualify, such as the tiny decline of real GNP in the first quarter of 1978. Economists still disagree about the classification of several past episodes.

By convention, economists leave to the National Bureau of Economic Research, a private scholarly organization, the decision whether to call a certain economic development a recession. The National Bureau has studied economic fluctuations exten-

What we are really interested in, or should be, is whether the forecast condition of the economy is satisfactory or whether some additional or different policy action needs to be taken. . . . There can be recessions about which nothing need be, or should be, done.

sively in the past, and there is confidence in its objectivity. The National Bureau does not classify a period as a recession until it is over.

Thus, to ask whether the forecast for 1979 is for a recession is to ask whether the National Bureau will call it a recession when it is over. In close cases there is no way to answer that, and the forecast behavior of the economy for 1979, if realized, would certainly constitute a close case.

There is some tendency, particularly in the press, to take a shortcut to a definition by saying that two consecutive quarters of decline in real GNP constitute a recession. This is based on the observation that since World War II the National Bureau has declared the existence of a recession whenever there have been two quarters of decline, and only when there were two quarters of decline.

However, the two-quarters decline does not constitute a definition of a recession, and the National Bureau does not accept the two-quarters decline as a sufficient test of one. There is no assurance that the National Bureau would designate an episode as a recession simply because there was such a decline, especially if the decline were very small.

A large number of forecasts for 1979 and 1980 do include two consecutive quarters of decline in real GNP. If real GNP is going to rise at an average rate of 1 to 2 percent for a period of, say, six quarters, quite ordinary fluctuations of the quarterly rate around that low average could yield two consecutive quarters of negative growth. However, most of the forecasts which do show such negative quarters show them to be very small declines—smaller than occurred in any of the six postwar recessions so far identified by the National Bureau.

One can think of other rules of thumb by which to predict what the National Bureau will call a recession. For example, the National Bureau has not defined any episode of the postwar period as a recession unless it contained at least one quarter in which real GNP was lower than it had been a year earlier. But the forecasts for 1979 and 1980 do not generally show this condition to be met.

So, if the most common forecasts come true, it is unclear whether the experience will, in retrospect, be "officially" designated a recession.

Does It Matter?

All of this would be of interest only to economists, and probably to only a few of them, if the word "recession" were not commonly understood to mean a bad situation which must be prevented or corrected if possible. That is why policy makers and their critics are eager to demonstrate that there will or will not be a recession. However, nothing in the "scientific," National Bureau concept of recession implies that anything needs to be done about it. If "recession" means "something to be prevented or corrected," then surely the National Bureau is not the judge of that. To give them such a role would be to assign them some of the functions of the president, the Congress, and the Federal Reserve. The National Bureau has never claimed any right to make the policy judgment involved in this decision.

Recognizing, belatedly, the emotional, political, and policy connotations of the word "recession," Alfred Kahn has suggested using the word

"banana" instead. This is progress, but does not deal with the whole problem. A banana is a discrete thing, identifiable by all experts, and not part of a continuum which slides off on one side into flashlights and on the other side to sweet potatoes. But a recession is one of a continuum of economic conditions with no objective dividing lines.

A better substitute phrase for "recession" would be "homely baby." The line between a homely baby and a plain one or a pretty one is entirely subjective. Different people will draw the line differently; the parents will have a different view from strangers. And the designation carries no policy implications; we don't put homely babies on the mountainside to die.

The Optimum Long-Run Path

What we are really interested in, or should be, is whether the forecast condition of the economy is satisfactory or whether some additional or different policy action needs to be taken. This question is not answered by deciding whether the forecast condition of the economy is a recession. There can be recessions about which nothing need be, or should be, done.

If we abandon the notion that the line between "recession" and "not recession" is the line between needing action and not needing action, we shall have to find some other test. We shall have to arrive at some notion of the path we would like the economy to take, so that we can judge whether the economy is likely to be in a satisfactory relation to that path. After twelve years of stubborn and accelerating inflation it is quite likely—indeed, highly probable—that the desirable path of the economy will be one of slow or even negative growth for a time.

The administration seems to have concluded that a path of slow growth, probably not excluding slightly negative growth for a time, is not only acceptable but also desirable in 1979. That is, in my mind, substantial progress, although many will disagree. But what is now missing is any conception of the desirable path of the economy beyond 1979 or the early part of 1980. No reasonable judgment can be formed about the course of the economy in 1979 without a clear idea of what is intended to follow. If the 1979 slowdown is to be followed by a vigorous effort to pump the economy up again and get on the path to the 4 per-

The administration seems to have concluded that a path of slow growth, probably not excluding slightly negative growth for a time, is not only acceptable but also desirable in 1979. That is, in my mind, substantial progress.

cent unemployment goal specified in the Humphrey-Hawkins Act, the expected performance of the economy in 1979 can be judged unsatisfactory from any point of view. On the one hand, it can be said that the slowdown of 1979 is unnecessary and pointless, because it will not have left any lasting mark on the rate of inflation. On the other hand, it can be said that the expected slowdown is much too small and that a sharper contraction is needed to wring some of the inflation out of the system before expansionist policy is resumed.

However, if the 1979 experience is viewed as part of a long-run effort to reduce the inflation rate gradually, the forecast for 1979 looks much more satisfactory. The exact contours of such a long-run effort and how the effort would be implemented are subjects too large for this essay. But the effort would surely include a gradual diminution of the rate of growth of nominal GNP from the 12 percent of 1978 to something like 5 percent, to be achieved in, say, five years. This would leave room in the end for an inflation rate of about 2 percent and annual real growth of about 3 percent, which may then be the normal long-run growth rate. In the course of this slowdown of the growth of demand, output would grow slowly and might be negative for a time, and unemployment would rise at first. But later normal growth would be resumed, the rise of unemployment would come to an end, and the unemployment rate would regain whatever level turns out to be consistent with a stable noninflationary economy.

If that is the path we seek, the forecast performance of the economy seems to be moving along it. And if that is the path the administration and the Federal Reserve seek, it would be desirable for them to make that known. Assurance that we are on the way to a distinctly lower inflation rate would shorten the period and reduce the pain required to get there, by moderating the skepticism which now obstructs all efforts to check inflation.

Senator BENTSEN. Mr. Stein, we are very pleased to have you.

Mr. Eckstein is at 16th and K. He was also supposed to be here, and his plane was diverted from National to Dulles, and he has been skiing into Washington.

Mr. STEIN. I was disappointed to see he wasn't here because I thought we would have the unusual Stein combination—Eckstein, Bernstein, and Herb Stein.

Senator BENTSEN. Without objection, I will place Mr. Eckstein's prepared statement in the record at this point.

[The prepared statement of Mr. Eckstein follows:]

PREPARED STATEMENT OF OTTO ECKSTEIN, PRESIDENT, DATA RESOURCES, INC., AND
PAUL M. WARBURG PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

THE INFLATION PROBLEM AND ECONOMIC POLICIES FOR 1979-1980

The Administration has made the fight against inflation its number one priority. Budget and monetary policies have shifted from expansion to restraint, and the anti-inflation program potentially goes quite far for a "voluntary" program. We are defending the exchange rate of the dollar, both to honor our commitments to our creditors and to bring to an end the inflationary impact of surging import prices. The Administration believes that the shifts in policy can be accomplished without a recession, but is willing to run considerable risk.

The shift in policy was overdue and needed desperately. The United States confronts an inflation problem which is the most serious in its modern history. Over the last two years, the inflation rate accelerated from 4.8 percent to 9.1 percent. The price increases were very general, with energy prices actually rising less than the average.

While the United States was suffering accelerating inflation, our principal competitors in world trade achieved dramatic reductions in their inflation. More conservative demand management policies, weak labor movements and the fruits of rising currencies brought Germany's and Japan's inflation rates down to 2.4 percent and 3.5 percent in the past year.

TABLE 1.—CONSUMER PRICE INFLATION

[Percent change]

| | 12 months ending December— | | | |
|----------------------|----------------------------|------|------|------|
| | 1975 | 1976 | 1977 | 1978 |
| West Germany | 3.6 | 3.9 | 3.5 | 2.4 |
| Japan | -1.2 | 10.4 | 4.8 | 3.5 |
| United Kingdom | 16.1 | 15.1 | 12.1 | 8.4 |
| United States | 6.7 | 4.8 | 6.7 | 9.1 |

It is no wonder that enormous imbalances developed in international trade. While the U.S. suffered a current account deficit of \$17 billion last year, West Germany had a surplus of \$8.4 billion, and Japan of \$16.6 billion. Imbalances of such magnitudes can ultimately unhinge the world monetary system.

Equally serious, the poor inflation performance of the last few years has changed the attitude of American consumers. Inflation is now so accepted that consumers are accelerating their purchases. DRI estimates that 9 percent of all single homes, 4 percent of automobiles and 3 percent of other durables were purchased because of inflation, bringing consumer credit burdens to an all-time peak and lowering the saving rate to 4.8 percent for the most recent quarter, the second lowest reading since 1963. There is nothing irrational in this behavior. Consumer borrowing rates, which are always high, have not risen as much as the inflation, and so the real cost of borrowing today is very modest. This behavior is a sharp shift, however. Traditionally, American consumers have turned cautious when prices got into rapid motion. Knowing that the inflation would be brought to an end through recession, they raised their savings, paid off their credit and got ready for a period of trouble. Once inflation inflames demand, however, a dangerous new loop of instability is created. An upward breakout of demand inflation becomes a real possibility.

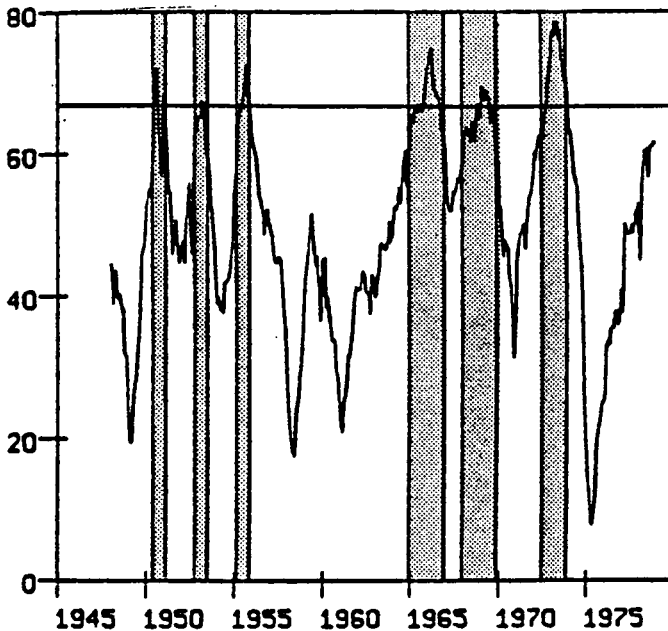
There are other signs of boominess in today's economy. We make much of the well-balanced character of the expansion, and it is true that inventories look moderate, the rate of investment is if anything on the low side, and business liquidity is generally good. But the DRI Boom Monitor, a composite measure of the degree of imbalances of an expansion, is near the flash point. The components which have raised it are principally slow vendor performance in industrial markets, consumer credit, the capacity utilization rate of materials industries, and the DRI index of labor market tightness. The money figures help hold it down.

TABLE 2.—THE DRI BOOM MONITOR

| | 3 Boom periods, average values | | | All boom periods, average | Historic average 47 to 78 | Third quarter 1978 | October | November | December |
|--|--------------------------------|----------------|---------------|---------------------------|---------------------------|--------------------|---------|----------|----------|
| | 64:12 to 66:12 | 67:12 to 69:11 | 72:6 to 73:11 | | | | | | |
| 1. The DRI composite boom index | 67.18 | 64.73 | 71.99 | 66.83 | 50.00 | 59.40 | 60.96 | 61.48 | 61.45 |
| 2. Ratio of consumer credit ext. to disposable income..... | .176 | .181 | .192 | .172 | .164 | .208 | .207 | .208 | (.208) |
| Index ¹ (weight = .105) | 63.09 | 61.08 | 65.74 | 63.03 | 50.00 | 73.59 | 71.41 | 73.40 | (73.07) |
| 3. Per capita car sales..... | .071 | .070 | .078 | .068 | .059 | .070 | .069 | .068 | .069 |
| Index ¹ (weight = .105) | 72.82 | 68.26 | 79.26 | 69.99 | 50.00 | 55.65 | 53.22 | 51.59 | 54.03 |
| 4. Ratio of housing starts to adult population | .011 | 0.12 | .017 | .014 | .013 | .014 | .015 | .015 | .015 |
| Index (weight = .095) | 35.58 | 42.04 | 76.59 | 55.81 | 50.00 | 58.07 | 59.43 | 61.83 | 60.14 |
| 5. The DRI index of labor market tightness | 65.309 | 68.513 | 64.726 | 66.319 | 50.412 | 54.921 | 59.833 | 62.371 | 62.744 |
| Index (weight = .154) | 67.80 | 71.62 | 67.10 | 69.00 | 50.00 | 55.39 | 61.25 | 64.29 | 64.73 |
| 6. Real money supply growth | 2.833 | 3.101 | 3.847 | 2.694 | .425 | 1.340 | .830 | .261 | -.478 |
| Index (weight = .100) | 66.43 | 68.26 | 73.35 | 65.48 | 50.00 | 56.25 | 52.76 | 48.88 | 43.84 |
| 7. Capacity utilization-materials | .901 | .890 | .912 | .892 | .839 | .860 | .870 | .874 | .876 |
| Index (weight = .153) | 72.94 | 68.71 | 76.91 | 69.49 | 50.00 | 57.55 | 61.36 | 62.84 | 63.58 |
| 8. Ratio of capital spending to real trend-line GNP..... | .114 | .111 | .109 | .112 | .103 | .107 | .107 | .108 | (.108) |
| Index (weight = .187) | 75.55 | 69.18 | 62.64 | 69.60 | 50.00 | 59.01 | 59.73 | 60.66 | (60.66) |
| 9. Vendor performance | .697 | .582 | .799 | .669 | .512 | .623 | .680 | .660 | .680 |
| Index (weight = .100) | 70.99 | 57.93 | 82.60 | 67.74 | 50.00 | 62.61 | 69.04 | 66.77 | 69.04 |

¹ Index reflects trend adjustment of base series. Figures in parentheses are DRI estimates.

Chart I
The DRI Composite Boom Index
(Shaded areas represent boom periods)



The condition of the economy is only a partial explanation of the pickup of inflation, as Table 3 shows. Demand is a factor, but program decisions on social security, the agricultural reserve and price policies, as well as the drop of the dollar, also played important roles.

TABLE 3.—What made inflation worse? (Consumer prices, percent change)

| | |
|---|------|
| Trend inflation rate | 1978 |
| Trend inflation rate was aggravated by: | 5.3 |
| Food prices | .7 |
| Policy | .3 |
| Livestock | .4 |
| The dollar's decline | .4 |
| Minimum wage | .1 |
| Social insurance tax increases | .3 |
| Homeownership | .6 |
| Demand | .3 |

Actual change in consumer prices

7.7

¹ For further analysis see "Why Inflation Became Worse," Data Resources U.S. Review, January 1979.

Recession?

The DRI forecast projects a mild recession to begin in the second half of this year. The logic is this: current inflation brings renewed pressure on the dollar and forces the Federal Reserve to raise interest rates for some additional quarters. The interest-sensitive categories of outlays are pushed down. At some point, consumers decide to repay the excessive credit burden. With sales prospects lowered, business fixed investment begins a modest decline.

It is still possible that the slowdown will be accomplished without a genuine recession. The financial system has adjusted remarkably to high interest rates, both through its own adaptation and through the various measures taken to insulate the housing industry's supply of mortgages. But we will require more than our recent quota of luck.

Whether there will be recession depends on two issues: is the economy vulnerable to recession? Will there be shocks? The vulnerability grows mainly out of the high interest rates, the inflation expectations and the consumer debt burden. The potential list of shocks includes an oil supply disruption; an automobile or other strike or a major financial failure at home or abroad. The DRI forecast assumes an automobile strike as the shock that tips the slowdown into recession, but it could as well be an oil supply disruption, a financial difficulty or something else.

The money data

The money supply and other monetary aggregates are showing extremely moderate behavior since September, and if they played their traditional indicator role, one would have to conclude that the slowdown is already upon us. However, the disparity between the money data and the other evidence about the economy is enormous. Payroll employment, the single most reliable indicator for monthly aggregate activity, was up 325,000 in January, and an average of 257,000 over the last six months. These are clearly unsustainable rates of gain. Automobile sales in January were 11.0 million. Housing was still at 2.125 million starts in December, and what little is known of business fixed investment also suggests continued forward momentum. Clearly, 1979 is off to a fast start.

The money data are currently exceptionally difficult to interpret because of a variety of regulatory changes and adaptations to the high inflation. Treasury operations, the growth of overnight repurchase agreements, automatic funds transfer, and a large float are all obscuring the meaning of the figures. While monetary policy has stiffened even on monetarist criteria, with the growth of the monetary base down to 6.9 percent over the last 13 weeks from a 52-week average of 8.8 percent, one cannot get much information from the money data about the behavior of the economy itself because of the measurement problems. In assessing the near-term economy, therefore, policy has little choice but to look at the measures of real activity and nominal demand, which are looking too strong.

The DRI forecast is summarized in Table 4. Table 5 compares the forecast to the official Administration projections. DRI forecasts no growth over the next four quarters compared to the Administration's 2.2 percent gain. But by the end of 1980, the faster recovery that we project brings the economy to almost the same place as the official figures. Thus, the disagreement between the Administration and private forecasters such as DRI is quite limited, and confined to the severity of the temporary slowdown.

TABLE 4.—DATA RESOURCES FORECAST OF THE U.S. ECONOMY—CONTROL 0122

| | 1978 | 1979 | | | | 1980 | | | | Years | | | | |
|--|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| | IV | I | II | III | IV | I | II | III | IV | 1977 | 1978 | 1979 | 1980 | 1981 |
| Real GNP growth rates: | | | | | | | | | | | | | | |
| Gross national product | 6.1 | 2.6 | 1.4 | -0.3 | -3.8 | 6.7 | 3.4 | 5.6 | 5.9 | 4.9 | 3.9 | 2.6 | 2.7 | 4.2 |
| Total consumption | 6.8 | 3.0 | 1.5 | 0.9 | -1.1 | 4.6 | 2.8 | 4.5 | 5.4 | 4.7 | 3.9 | 3.2 | 2.6 | 3.8 |
| Nonresidential fixed investment | 5.2 | 4.1 | 1.3 | -2.8 | -7.6 | 5.9 | 1.2 | 7.6 | 8.3 | 9.1 | 7.8 | 3.0 | 1.3 | 5.9 |
| Residential fixed investment | 0.7 | 2.5 | -10.7 | -18.0 | -19.7 | -1.6 | 16.3 | 27.8 | 23.0 | 20.5 | 3.6 | -5.0 | -0.5 | 12.5 |
| Total Government | 5.0 | -0.5 | -0.6 | 1.5 | 1.9 | 2.3 | 2.4 | 2.1 | 2.9 | 2.4 | 2.2 | 1.8 | 2.0 | 2.3 |
| Unemployment rate (percent) | 5.8 | 5.9 | 6.1 | 6.4 | 6.8 | 6.9 | 7.0 | 6.9 | 6.8 | 7.0 | 6.0 | 6.3 | 6.9 | 6.6 |
| CPI—all urban consumers ¹ | 8.6 | 8.9 | 8.2 | 7.8 | 7.4 | 7.0 | 6.9 | 6.8 | 6.8 | 6.5 | 7.7 | 8.6 | 7.2 | 6.8 |
| Wholesale price index ¹ | 10.9 | 10.5 | 8.8 | 7.6 | 6.5 | 6.8 | 7.0 | 7.2 | 7.4 | 6.2 | 7.7 | 9.1 | 7.1 | 7.0 |
| Compensation per hour ¹ | 8.5 | 11.3 | 8.7 | 8.6 | 8.2 | 10.4 | 8.5 | 8.6 | 8.7 | 8.0 | 9.2 | 9.3 | 9.0 | 9.0 |
| Federal funds rate (percent) | 9.58 | 10.52 | 11.38 | 11.30 | 10.31 | 9.31 | 9.02 | 9.11 | 9.31 | 5.54 | 7.93 | 10.88 | 9.19 | 9.95 |
| New high grade bond yield (percent) | 9.19 | 9.52 | 9.64 | 9.56 | 9.23 | 9.12 | 9.33 | 9.48 | 9.51 | 8.06 | 8.86 | 9.49 | 9.36 | 9.55 |
| Inventory investment (in billions of dollars) | 12.4 | 12.0 | 16.6 | 14.7 | -0.3 | 16.2 | 18.9 | 24.1 | 26.6 | 15.6 | 15.7 | 10.8 | 21.4 | 27.7 |
| Net exports (in billions of dollars) | -6.9 | -6.7 | -6.6 | -4.0 | 0.0 | -0.3 | 0.3 | -1.2 | -2.2 | -11.2 | -11.8 | -4.3 | -0.9 | -1.6 |
| Federal budget surplus (NIA, (in billions of dollars)) | -19.7 | -26.0 | -25.3 | -35.1 | -49.4 | -38.2 | -35.8 | -34.9 | -30.7 | -48.2 | -29.7 | -34.0 | -34.9 | -24.2 |
| Profits after tax ¹ | 39.3 | 6.0 | -3.9 | -12.5 | -28.0 | 59.0 | 10.8 | 21.7 | 17.1 | 11.4 | 15.4 | 6.8 | 9.3 | 15.2 |
| Real disposable income ¹ | 5.1 | 5.8 | 2.7 | 2.9 | -0.2 | 1.9 | 3.4 | 6.1 | 5.6 | 4.1 | 4.2 | 3.9 | 2.7 | 3.9 |
| Industrial production ¹ | 7.0 | 3.7 | -1.2 | -6.4 | -14.5 | 19.2 | 4.8 | 6.0 | 9.0 | 5.6 | 5.8 | 1.9 | 2.7 | 6.0 |
| Car sales (million units) | 11.1 | 10.9 | 10.7 | 10.2 | 9.3 | 11.0 | 10.8 | 10.8 | 11.1 | 11.2 | 11.3 | 10.3 | 10.9 | 11.1 |
| Housing starts (million units) | 2.13 | 2.04 | 1.86 | 1.67 | 1.58 | 1.69 | 1.83 | 1.97 | 2.06 | 1.97 | 2.01 | 1.79 | 1.89 | 2.03 |

¹ Annual rate of change.

TABLE 5.—COMPARISON OF FORECASTS, 1979-80

| | Forecast | | | | |
|---|----------------|----------------|--------|----------------|--------|
| | Actual 1978 | 1979 | | 1980 | |
| | | Administration | DRI | Administration | DRI |
| Percent change 4th quarter over 4th quarter: | | | | | |
| Real GNP: | | | | | |
| Growth | 4.3 | 2.2 | 0.0 | 3.2 | 5.4 |
| Level (in billions of dollars, 4th quarter) | 1412.2 | 1443.3 | 1411.6 | 1489.5 | 1487.7 |
| Annual percent change: | | | | | |
| Real GNP | 3.9 | 3.3 | 2.6 | 2.5 | 2.7 |
| Real consumption expenditures | 3.9 | 3.2 | 3.2 | 2.0 | 2.6 |
| Real business fixed investment | 7.8 | 5.8 | 3.0 | 3.7 | 1.3 |
| Real State and local purchases | 4.2 | 2.3 | 2.5 | 1.8 | 2.5 |
| Consumer price index | 7.7 | 8.2 | 8.6 | 6.7 | 7.2 |
| Unemployment Rate (Level in 4th quarter) | 5.8 | 6.2 | 6.8 | 6.2 | 6.8 |
| Annual average: | | | | | |
| Housing starts (million units) | 2.009 | 1.810 | 1.788 | 1.800 | 1.887 |
| Net exports (in billions of dollars) | -11.8 | -4.0 | -4.3 | 2.0 | -0.9 |
| Unemployment rate (percent) | 6.0 | 6.0 | 6.3 | 6.2 | 6.9 |
| 90-day treasury bill (percent) | 7.2 | 8.8 | 9.4 | 7.6 | 8.1 |

A fiscal policy of restraint

Will a budget policy of restraint make a difference to the inflation? It is true that one year of budget policy has only a small effect, one likely to be swamped by the uncertainties surrounding energy and agricultural prices. Similarly, one year of mild recession will do little more than provide temporary relief through cyclical responses of the sensitive prices, and perhaps some slight moderating effect on the 1979 wage round.

The potential benefit of a policy of restraint is only achieved if it is pursued for several years. Table 6 summarizes some model simulations which measure the impact of different fiscal policies. An expansionary policy was defined as an increase in real government spending of 3.7 percent a year after the current one year moratorium—a return to the growth rate of the period 1971-1979. The restrictive path holds the spending trend down near the 1 percent figure of the current budget for three additional years. The result is a 0.7 percent reduction in the rate of inflation, albeit at the expense of an increase in unemployment. These results are for the first three years of the exercise. If the exercise is continued further, the improvement in inflation would continue, whereas the unemployment would gradually improve.

TABLE 6.—EFFECT OF BUDGET RESTRAINT ON INFLATION AND UNEMPLOYMENT

| | Year 1 | Year 2 | Year 3 |
|--------------------|--------|--------|--------|
| Inflation | 0.0 | -0.2 | -0.7 |
| Unemployment | +0.2 | +0.5 | +0.6 |

Note.—Difference between restrictive and expansionary path results, percentage points.

The figures in Table 6 are not enough to assure success in the campaign against inflation. Other factors could more than undo the effects of the policy of restraint, including program decisions. On the other hand, the policy of restraint is a relatively mild one. Some of the proposals now being advanced are a lot tougher than the policy analyzed here.

Monetary policy

Fiscal and monetary policy must move in harmony. At this time, this requires the monetary policy be restrictive. Indeed, we have been so successful in insulating housing from high interest rates that the bite of the monetary brakes has not yet

been felt. Interest rates probably will have to go higher to assure that the economy will slow down and leave the dangerous boom territory in which it now finds itself.

The Federal Reserve raised interest rates sharply on November 1 as part of the defense of the dollar. Since then, little more has happened. The dollar appeared to be strong and the money figures actually fell below the short-run targets. But this pause of policy cannot be continued much longer. The events in Iran and the continued poor inflation performance in the opening months of this year will bring the dollar under renewed attack. Until the economy has been safely decelerated, both in terms of real activity and prices, interest rates should be moved higher in careful, orderly fashion.

The limits of macro policy and the President's anti-inflation program

The experience of 1977-1978 has taught us that the economy can suffer accelerating inflation as unemployment moves into the 6 percent to 6½ percent range. I do not believe that our society can accept unemployment figures of that magnitude as the limits of our abilities.

The inflation bias in this business cycle upswing did not principally originate in the labor market. Government policies, the legacy of poor inflation expectations, the decline of the dollar, and some capacity limitations were far more important. The response of wages to inflation has, if anything, been incomplete. The economy developed accelerating inflation before full employment was reached.

The President's anti-inflation program is an attempt to supplement the macro demand management policies with other measures to reduce the economy's inflationary bias. The wage and price standards are designed to bring the wage-price spiral down through moral suasion, government pressure and perhaps improved expectations. The intention to improve government regulatory policies and to take a tougher look at proposals in such fields as payroll taxes, minimum wages, agricultural policies and trade restrictions will, if nothing else, help neutralize the government's usual proclivities to make inflation worse.

It clearly would be quite inappropriate to pursue restrictive macro policies without supplementing them with the micro approach. We must do everything we can to bring the inflation rate down, and not just pursue the anti-inflation goal by creating unemployment and idle capacity. It is too early to assess the program. It has been three months since it was set up, and inflation has become worse. There have been no major cases that test the program. Perhaps it is too flexible. I hope the Congress will stand behind the program when the real test comes.

In the long run, the development of effective programs to bring the unemployment rate down without pumping up the economy must be put back near the top of the nation's agenda. We are in a period of budget retrenchment, and we are disappointed that the earlier programs seem to have had rather fleeting results. But the challenge remains and we will have to return to it.

Fight recession?

The recession, if it comes, will be a policy-induced response to inflation. Given that circumstance, the Congress or the Administration should not rush into anti-recession programs. A mild recession would be reversed by the natural forces of recovery once the financial pressure can be relaxed. The psychological gains on the price front would be surrendered through hasty anti-recession actions. Should the recession be deeper or longer, stimulus would have to be undertaken, but so far there is little reason to expect a more severe setback.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

Mr. Stein, it is always a pleasure to see you, and I hope that whatever the reason for your svelte figure that there are no problems associated with that and that you are back in fine fettle. Your sense of humor, of course, is always appreciated and we have always enjoyed it.

Your growth rate alternatives, as given in your statement, seem all to be on the down side and your inflation rate estimates are higher than the administration estimates—I guess one could say on the up side, although I guess the up side in this case is the down side, but if what you suggest is the case, the lower growth rate than the administration anticipated and a higher inflation rate than is anticipated in the Economic Report.

What do you think the impact of that would be on the Federal budget in terms of total deficit?

Mr. STEIN. Well, I think it is going to make the deficit for fiscal 1980 somewhat larger. I made some calculations on the basis of what I consider to be a feasible impact path of the economy—

Senator BENTSEN. Mr. Stein, I am called to another committee. If you will forgive me, Congressman Brown will assume the chair.

Mr. STEIN. I made some rough calculations on the basis of what seemed to be a more realistic path of the economy, not only for fiscal 1980, which depends very much on calendar 1980, but also on subsequent years, and what I come out with is a somewhat larger deficit for fiscal 1980, more like \$35 or \$36 billion, and a slower decline of the deficit than the administration proposes on the basis of its policies and with approximate balance reached in fiscal 1982 rather than fiscal 1981.

Representative BROWN [presiding]. You have looked at the budget in detail, I assume, and made some kind of an assessment of both the political and economic reality of the expenditures indicated, and among those items there may be some that are unrealistic in the political sense.

Every administration since Eisenhower, I believe, has tried to get rid of impacted aid to schools and a few other things, and those also are being undertaken by the Carter administration in this budget and are woven into the fabric of the budget and deficit, as if they could be accomplished in Congress.

Do you feel that the budget for the most part is realistic in terms of its reductions with reference to both what the Congress is likely to do and the uncontrollable expenditures, that are now so much a part of our total Federal outlays?

Mr. STEIN. Well, I won't make any prediction about what Congress will do. Undoubtedly there are many cuts that are proposed that Congress will not enact, and I hope there are some expenditures that are proposed that Congress will accept. I have not tried to make any estimate of the true levels of the uncontrollables. In the figures I have just given you I tried to allow for effects of somewhat higher price level and somewhat higher employment rate on the expenditures and of a somewhat lower nominal GNP on the revenues, but I have not made the kinds of or tried to check their calculations on what the built-in expenditures will be for social security and such.

Representative BROWN. To get to your \$36 billion of deficit, what did you anticipate in terms of unemployment?

Mr. STEIN. I thought the unemployment rate would be in the neighborhood of 6.5 to 7 percent.

Representative BROWN. As an average for the year?

Mr. STEIN. That we would work up to that by the end of calendar 1979, but that would be pretty much the average for fiscal 1980.

Representative BROWN. In your listing of items that ought to be undertaken, I guess I am troubled as much as anything else with semantics. You said, "The Government should announce its intention to bring about a steady decline of the rate of the growth of GNP in current dollars, as the essential step to reduce the inflation rate. Current-dollar GNP rose by more than 12 percent during 1978."

But, of course, in real dollars it was quite limited, and the real dollar figure in 1979 is what, would you estimate?

Mr. STEIN. For 1978, during the year, from fourth quarter to fourth quarter, it was about 4 percent or 3.8.

Representative BROWN. So we have an 8-percent inflation rate and the anticipation in 1979 is that there may be as high or higher an inflation rate, with a lower real growth rate. Is that what you are suggesting?

Mr. STEIN. Right.

Well, the administration forecasts of the nominal GNP for calendar 1979 is 9.8 percent, which, in their estimation, includes 2.2 percent of real growth and something like 7.5 percent inflation.

The point I would like to make is that I don't have any great problem with calendar 1979 prospects. What disturbs me is the estimate that after calendar 1979 then we can resume a much higher rate of growth, getting up to 3 percent and then 4 percent and more than that, and at the same time the inflation rate will continue to decline. I don't think that is a likely probability. I think we are going to have to have several years of rather slow growth.

Representative BROWN. We have had a history of undertaking the expansion of the economy by expansion of the Federal budget, the Federal expenditures and then hoping that the result of an accelerating economy would catch up faster than our budgetary increases on an annual basis; that is, that it would increase the revenues so that you would have declining deficits.

It seems to me that the proposal that you suggest in S. 34 is the opposite of that, trying to hold down expenditures so that the growth would catch up with the expenditures of the Federal Government and give us a balanced budget, and, hopefully, then stimulate further growth, providing this surplus were a tax cut, and that that becomes a strategy for returning as an injection into the economy of the dollars through tax reduction.

The question I want to ask is one of timing, politics, humor, and economics. Maybe it is very important as to what timing is. Should the tax cut come before the spending reduction? Should it come concomitant with the spending reduction or should it be a follow on of the creation of the surplus as a result of the spending reduction and the increase of the income of the Federal Government through growth? In other words, what really fires the further expansion of the economy? Is it tax reduction or the reduction in Federal expenditures?

Mr. STEIN. Well, in my view it isn't either of those things. I think the notion that we manage the overall growth of the economy by managing the Federal budget is becoming less and less credible, except that you can have some longrun effect on the raise of growth or potential output via the tax system, which can either depress or encourage savings, investment, effort, and so on, but those, I think, are longrun consequences.

I would say that the economy will grow and we can bring about a desirable path of growth by the management of monetary policy, and that we should operate so that along that desirable path we will approach the balanced budget over the course of several years, 3 or 4 years.

I would not want to endorse the proposition that we should wait until we have a surplus in hand before we cut taxes because the experience is that the spenders always get to the surplus before the taxcutters do and there is no surplus left by the time the taxcutters get around.

This was Mr. Eisenhower's problem always after the 1954 tax cut. He kept saying we are going to have another tax cut as soon as we build up the surplus that the growth is going to generate for us, and then we will have a tax cut, but every year the spending increase was absorbing that surplus and he never got to make the tax cut. That blessing was left for his successor to confer.

I think a reasonable procedure would be to make the kind of longrun commitment I am suggesting to expenditure restraint and to make a tax cut phased in gradually that will bring us to a balanced budget in fiscal 1982. From my standpoint the year is not as important as the fact we have a commitment to a path that will get us there in some foreseeable year.

Representative BROWN. I am going to ask you about the tax cuts in a minute, but I will yield, because my 5 minutes are up, to Congressman Wylie, who is the new minority member on the House side of the Joint Economic Committee, a colleague of mine for some time in the Congress and also a neighbor physically in terms of his location in our area.

Congressman Wylie.

Representative WYLIE. I might say, Mr. Stein, it is a pleasure to be in your presence again and I read your column for food for thought because many of your ideas parallel some of my own, which have developed over the years.

Congressman Brown referred to the fact that this is my first day here, which it is, and I am pleased to be a member of the Joint Economic Committee. It is a very stimulating experience and one which I look forward to.

I might also say, even though Congressman Brown and I are from adjoining districts or contiguous districts in Ohio, he is better known than I am. Very frequently I get mixed up with Clarence Brown.

Just the other day I was going down the street and I heard a girl say to the other one: "Do you know who that is?" and she said: "Yes, that is Congressman Brown," and some fellow walking behind her I have known for 25 years said: "Hi, Clarence." So what price fame?

Mr. Stein, there is an obvious growing sentiment in this country for a balanced budget amendment. Do you favor this constitutional action?

I asked Mr. Perry that question and Mr. Bernstein, and you might have anticipated what their answers were without having heard them.

Mr. STEIN. Well, that is—

Representative WYLIE. I would like to have an answer coming from a little different direction.

Mr. STEIN. That is a very hard question for me because I suppose if the world were divided into two parts—those that were for it and those that were not—I would be on the side that is for it, but it is not my preferred approach to this problem. I think that expendi-

ture limitation is the key problem and that that ought to be approached directly. I think we can be more confident about how expenditures ought to behave than we can be about how the budget deficit ought to behave.

I think we can be more confident that we want expenditures to grow more slowly than we can be about wanting the deficit to be zero every year.

I am also concerned about the constitutional amendment method. I think that there are still avenues open to the Congress for bringing about a restraint of expenditures and a limitation of deficits which have not been used. I would like to see those avenues tried or at least thoroughly explored before we go to an amendment which would commit us for a long time to a policy whose implications we can't quite foresee, and which involves the kind of technicality specification of terms which is not usual in the Congress.

I wouldn't like to have the Supreme Court decide, for example, whether the Federal financing bank is part of the budget or not part of the budget. I think we could handle those questions in a less legalistic way. But I would go further and say that I think that we still have an opportunity for Congress to demonstrate that it can control the budget more effectively than it has so far by its own actions. If that turns out to be impossible, I think that controlling the budget is so important that an amendment would be a necessary step.

Representative WYLIE. What would be your visceral reaction to a law—not a constitutional amendment, but to a law—which would say that the Government cannot spend more than it takes in in any fiscal year except by declaration of economic necessity or in time of war by a vote of two-thirds of both Houses?

Mr. STEIN. Well, I wouldn't object to that. I would want to pause a little bit over that. I don't know how much of a limitation it would be and, you know, I would want to approach this situation a little—

Representative WYLIE. Pardon me for interrupting, but the point is that it would take a two-thirds vote, which is a little discipline over a 50-percent vote.

Mr. STEIN. I think the fact is we have only just moved to the 50-percent requirement in the Budget Reform Act. Before the Budget Reform Act any combination of minorities could bring about that result and now we are trying to see whether 50 percent works and I think there is room for doubt about whether 50 percent works, so I would not object to that.

I would not want to see it in fiscal 1980 because I would be a little concerned about going from a deficit approaching \$40 billion to a deficit of zero between one year and the next. I think that is too sudden, but I would like to emphasize that I think that our important requirement is to get the expenditures down in relation to the GNP and the taxes down in relation to the GNP and the size of the deficit worries me less than these other two numbers.

Representative WYLIE. We are searching very diligently for answers and I say "we" generically. I know my constituents are very concerned about inflation and they think that government deficit spending and government fiscal policy are the real culprits, as you

do. Is that a fair statement? Mr. Bernstein thinks it is our trade balances.

Mr. STEIN. I don't think the deficit is the main cause of our inflation. I know that is a radical thing to say on my side of the aisle, but I don't think it is.

Representative WYLIE. You don't think it is a primary cause?

Mr. STEIN. No. I think it has some indirect consequences, but I believe that if deficits are financed without excessive monetary expansion they will not be inflationary and that it is within the powers of the Federal Reserve to prevent the deficit from being financed by excessive monetary expansion.

I think the real problem with the deficit is not that it causes inflation, but that it absorbs private savings that would otherwise be available for private investment and that would stimulate the growth of the real economy. That is a serious problem and it is especially serious in an economy where productivity is growing disappointingly slow and that is my reason for wanting to get to a balanced budget, rather than the inflation problem. But I think the expenditures—and especially the burden of taxes are the things that bother people. I think people make a kind of emotional connection between high spending, high taxes, and budget deficits, and those are three rather different things that need to be sorted out. We need to decide which of them we think is the most important, and I guess I think the spending and the taxes are the most important.

Representative BROWN. Mr. Greenspan said that he would favor a two-thirds vote on each appropriation bill, on every appropriation bill, which would be an additional discipline, of course.

What would be your response to that idea?

Mr. STEIN. I don't think that is necessary. That is, I think we can establish the limits on the total, and the appropriate procedure is to require, as some have proposed, a two-thirds limit on the concurrent budget resolution, which calls for expenditures not to exceed a certain amount. But I think, having set the limit on the total budget, we ought to allow the ordinary democratic processes to work in deciding where we spend the money.

Representative BROWN. Like I say, we are all searching for answers. We know we have a problem. We have a declining dollar in the world marketplace, food prices are going up even beyond the inflation rate. Somehow we must come to grips with this problem and solve it.

We heard Mr. Perry and Mr. Bernstein argue among themselves here a little while ago—I wish you were here to hear it—but the fact is, it is very hard to come up with what might be a real answer. I have been reading in the paper that Mr. Friedman has indicated that we ought to somehow tie Federal spending to the gross national product, and in your statement you indicated you would tie government spending to the gross national product. You indicate that you favor lowering the ratio of Federal spending to GNP to 18 percent for fiscal year 1980.

I think that Mr. Friedman has suggested 20 percent perhaps. I was talking to Bill Simon and that is what he thinks, and that is what I put in my bill, and President Carter said it should be 21 percent. He stated that as his goal by 1983.

How did you fix on 18 percent as compared to 20 or 21?

Mr. STEIN. I said 21 percent for 1980, 20 for 1981, 19 for 1982, and 18 for 1983.

Well, 18 percent is approximately the ratio of Federal revenues to GNP in the period between the Korean war and the Vietnam war, and it seemed to me that it would be desirable to get back there and if we are going to get back there with a balanced budget, we have to get the expenditures back down to about 18 percent of GNP, which is approximately also what they were in that interval between the Korean war and the Vietnam war.

Of course, these particular numbers come out of S. 34 and I say that is a starting point. One can argue about the numbers, but I recommended something like this in testimony last year, so the exact origins of it are not entirely clear, but I don't think we should be satisfied to settle for a permanent 21 percent of the GNP.

Now, the Friedman thing proposes that the expenditures would rise at the same rate as GNP except the years when inflation exceeds 3 percent, then the expenditures would rise a little more slowly than GNP. So with the current inflation rates or anything like that, in the course of a few years, the ration of expenditures to GNP would apply.

Representative BROWN. You picked that period between the Korean war and the Vietnam war when the economy was moving fairly rapidly, as I recall.

Wasn't there a lot of production?

Mr. STEIN. Yes; we had very strong economic growth. We had very little inflation. I would say in retrospect, it was a wonderful time for the economy.

Representative BROWN. Is there any way we can get some control over the uncontrollables, or the so-called uncontrollables, in the budget?

Mr. STEIN. The situation that we always come up to is that in next year's budget, a large proportion of the total is uncontrollable. But if you look out now to fiscal 1981, 1982, and 1983, the expenditures to be made in those years are not uncontrollable.

So, the way to get the expenditures under control is to start making plans for the future. I think that an important deficiency of the whole budgetary process is that it is too much next-year oriented.

I just said that in testimony before the House Budget Committee, that we have given a lot of lipservice in the last 10 or more years to a long look at the budget. And every year the budget presents estimates 5 years ahead and the Congressional Budget Office does a 5-year perspective, but nobody ever pays attention to it.

When I was in the Government, nobody on the executive side paid any attention to it and I don't think they do now, and I don't think they do in the Congress. But that, it seems to me, is a way to get control of uncontrollables because they are not uncontrollable 3 or 4 years ahead.

Representative BROWN. How much effect does our trade deficit have on inflationary pressures here at home?

As I said, I heard Mr. Bernstein talk before and he said that is the principal cause of inflation right now, our huge trade deficit, and that we ought to do like some other countries do, to wit,

Western Germany and Japan. They have had inflation pressures, too, but it hasn't had as dilatory an effect on their economy as it has had on ours.

Mr. STEIN. I think that is backward. I think the trade deficit is a result of inflation in large part, rather than inflation being a result of the deficit, and you can think of ways to control or limit the trade deficits which, in themselves, would be even more inflationary.

For example, we can put some physical limits on imports or impose a surcharge on imports which might reduce the trade deficit, but they would be inflationary in the United States.

In a sense, the trade deficit is a way of exporting our own inflation to other countries and reducing its impact at home by sucking more goods from abroad which tends to hold down prices in the United States.

I am sure that all of those Japanese cars are tending to hold down the prices of cars in the United States. We would have higher priced automobiles if we didn't have those Japanese cars.

Representative BROWN. That is where I came out. I asked Mr. Bernstein the same question, "Isn't the declining dollar a cause of inflation in the United States and a reflection of lack of confidence in our economy abroad?" And I got a different answer from him than I did from you, which, as I said, adds to the problems that we have because you experts are having difficulty agreeing among yourselves.

But I thank you very much for appearing here. It is a real pleasure for me to have the opportunity to ask you questions.

Mr. STEIN. Thank you.

I think I have appeared before this committee often enough for me to be entitled to welcome you, Congressman Wylie.

Representative WYLIE. Thank you, Mr. Stein.

Representative BROWN. Let me ask just a couple other questions before we terminate.

You talk about phased regular tax cuts, and legislation has been proposed for the indexing of tax cuts so that individual taxpayers would not have the impact of paying higher taxes as they are moved to higher brackets that do not represent real increases in their wages.

And there also has been legislation proposed to set the real value of the replacement of productive facilities of manufacturing plants and other such operations. The depreciation rates are causing businesses to underdepreciate; and therefore they are having to pay taxes on profits that are unreal and then borrow money to replace equipment when those businesses want to modernize or expand a plant. Other items of similar nature have the same impact of raising taxes.

Now, I am not talking, of course, about indexing the expenditures of the Government as we do in social security, increasing benefits as rates of inflation go up. That becomes a phasing regular tax cut.

Would you accept that?

Mr. STEIN. Yes, I am a strong supporter of indexing the tax system and I would be for that.

I would hope that we could do more than that, that is, in a sense, indexing is less a phased regular tax cut than a protection against a phased regular tax increase.

And certainly that, it seems to me, is the least we should have and I would hope that we could go further and reduce the tax burden. You see, that kind of indexing proposal keeps the tax burden from rising, as I said, and I think we ought to be able to go further and reduce the tax burden.

Representative BROWN. The phased rate of tax cut is done intrinsically by the Congress. In concurrence, the administration, or vice versa, winds up being, over a period of years, not a tax cut at all, but an increase.

We don't seem to have the capacity in Congress or the administration, or maybe I should say, the people don't seem to have the capacity to force us to keep taxes at a relatively low level. They seem to always be inching upwards in notched steps.

I can give you an example of what was done last year with the notorious tax cut that was given to people on their income taxes last year. And then when they got through with it, they found the social security increase and the inflation increase had actually increased their total taxes.

So I am glad that you support that concept of indexing and I am glad I got the question without Chairman Bentsen being here to be able to counter it, because I am having some trouble convincing him of the wisdom of that position. But prayer and thought, I am sure, will accomplish that in time.

But I do want to ask the question now for him because I know he feels very strongly about this and I support him in that position.

Mr. Greenspan pointed out that increases in off-budget borrowing offsets the administration's hoped-for reduction in on-budget borrowing to fund the deficit and that the pressure on the credit markets on the private savings that we mentioned a moment ago will not be less, and the pressure on the Feds to create more money will not be less, if we have an increase in off-budget borrowing as opposed to the reductions in on-budget borrowing.

In addition, there is something I am now beginning to refer to as off-off budget, and that is mandated spending by the Government in the regulatory area, pollution control, OSHA, the energy consumption levels of automobiles, and so forth.

That kind of thing, it seems to me, also ought to be put under some kind of control along with the off-budget items and Senator Bentsen and I have put in some legislation that would call for a regulatory budget—in other words, a spending budget for regulation, since the people must pay for this in the higher costs of items they purchase, just as they pay for the higher costs of direct Government spending in increased taxes or inflation.

Do you support that kind of concept or do you think there is a better way to get at it?

Mr. STEIN. Well, I would distinguish, between these two cases, the so-called off-budget case and mandated spending. I think we do need more general control of the off-budget operations but I would not like to lump the off-budget expenditures in with other expenditures or the off-budget deficit in which the budget deficit, because I think there is a significant difference.

That is, the people are concerned about the Federal deficit because it drains funds out of the credit markets. It has to be noted that most of the off-budget expenditures are awash from that standpoint, that is, they are a means of raising money through some Federal or federally assisted agency and putting money back into the credit markets, maybe into another part of the credit market, usually the housing markets but they do not constitute a net drain on the credit market.

Representative BROWN. Except in times of sharp recession, isn't that true?

Mr. STEIN. Well——

Representative BROWN. I am thinking of the housing market, in particular. When there is not very much expansion in the housing market and you have had to guarantee or you have had to pick up guaranteed loans and then the house sits idle for sometime and the Government is paying, in effect, the mortgage on the house or paying off the loan, doesn't that really become a drain on the Federal budget or the credit market because you must borrow that money to pay back the creditor?

Don't you have to do that?

Mr. STEIN. Well, if the Federal Government is paying the interest, I think that appears in the budget. That is, the off-budget transactions are essentially capital transactions; they are borrowings matched by loans by the Federal Government and these billions of dollars that the Federal Government is borrowing through agencies like Ginnie Mae are being put into the credit market. I think you want to limit the total amount of that because we are concerned about the extent to which the Government is pushing money around within the pool of credit, but I don't think it is a net absorption of funds out of the pool of credit.

Representative BROWN. I think in terms of those little FHA houses. I had some during the last recession in my district which would have been occupied by people and maintained, and the lawn trimmed and so forth, but all of a sudden in the recession those folks lost their jobs, and the guaranteed loan on that house is then picked up by the Government.

The Government pays that loan back to the credit institution that lent the money and the house sits there sometimes for 3 and 4 years unoccupied.

Eventually, the Government may turn the house over to someone else and let them pick up the mortgage, but it is sometimes abandoned for long enough that the houses are in such bad shape after that 3 or 4 years that it is not an available item, it is not an asset to the Government and winds up being turned down, and the Government has had to pick up that loan.

Now, that is an off-budget item until that occurs but it is a sure drag on the credit market that is competing against the Government.

Mr. STEIN. I may be wrong about this but it is my impression when that occurs, then we have a budget expenditure that is not off-budget. That is, if the FHA pays off the defaulted loan, that we then have an expenditure in the budget, but that when the guarantee is made there is no expenditure on the budget.

In any case, I think most people do not propose to include guarantees with the budget; they include direct lending by agencies but not guarantees.

Representative BROWN. But, again, the credit is diverted in that case away from some open market transaction on expansion of a factory to a social purpose that the administration or the Congress may feel is worthy with reference to say the housing market or some other market in the same way. It seems that by requiring pollution controls or the conformity to OSHA regulations, you are forcing an industry to make a nonproductive investment—in other words, an investment that does not increase the productivity of that industry or its ability to compete with a product, but rather it is a direct investment that steals money away from putting in a new blast furnace to make steel or a new stamping plant to make automobile doors or something of that nature.

Mr. STEIN. There is a diversion, but the usual point that is made is that the Federal Government in the off-budget transactions is absorbing funds in the same way it does in its deficit and I think that is different from saying that it creates a diversion of funds within the capital market. Some people are concerned about the Treasury deficit on the grounds that it forces monetary expansion, because it tends to raise interest rates and seduce or forces the Federal Reserve into pumping in money to avoid the rise in interest rates.

This diversion of funds by the off-budget loan transactions does not in itself tend to raise interest rates. It may affect relative interest rates in different parts of the market but I don't think it raises interest rates in total.

In fact, there will be some sense—you know we had a committee to review the budget concept back in 1968—David Kennedy was Chairman—which concluded that the loan transaction then in the budget should be excluded from the budget.

There is a certain anomaly that we have some transactions in the budget that are very much like the off-budget transactions but whether the ones that are in should be put out or the ones that are out should be put in it seems to me is rather doubtful.

I don't suppose you are proposing that these estimated costs imposed by regulations should be included in the budget expenditures.

They are something you want to see. You want to have some figures on them and estimates. Is it your thought we would make the \$500 billion budget into a \$700 billion budget or—

Representative BROWN. We should make some kind of regulatory budget that would limit the amount of required expenditures that the President said the private industry would have to make so we would be sure that we were not overtaxing the capacity of the credit markets in the country vis-a-vis other more productive investments that might be made in a free market circumstance. In other words, what we are doing by these pollution controls and others is mandating spending for positive social purposes—I hope always positive—but in doing that we are in some instances reducing the ability of the industry to produce or the municipality to survive, because we are forcing them to make that expenditure rather than some other expenditure which might be made in the

wisdom of the industry or the municipality that would be more constructive. It would decrease their ability to compete or their ability to satisfy the community's requirements, and the result of that may be that the industry, the municipality would decide to make both expenditures, which has an impact of enlarging the credit demands of the society and increasing the inflation rate and so forth.

Mr. STEIN. I am sure that you want to have some estimate of the cost of these regulations that you are imposing. I am just raising the question whether you want to add that estimated cost to what we consider Federal expenditures and have a budget which says that we are now spending \$700 billion of which \$530 billion is paid out of the Federal treasury and \$170 billion is paid out of various corporations and municipalities at the dictates of the Federal Government. I think those are two rather different things, and you would have the question of what to put on the revenue side of the budget to complement those expenditures.

Representative BROWN. Oh, yes, I agree there should be two different concurrent resolutions and two different budgets, but we do need them both.

Mr. STEIN. You require the United States Steel Corp. to spend \$100 million for eliminating pollution, and you put the \$100 million on the expenditure side of the budget, and the United States Steel Corp. raises the price of steel by a nickel in order to cover that.

Representative BROWN. That is the tax.

Mr. STEIN. Then, you have an excise tax imposed by the United States Steel Corp. on the other side of the budget. Is that the way the budget would look?

Representative BROWN. In fact, that is the tax levied against the individual in the cost of steel. I think the question raised beyond that is, does the expenditure of the \$100 million result in some social benefit that has \$100 million-plus for the society, and, of course, that is the argument about regulation that is made.

When we say we are cleaning up the water, the answer is that we do it because there is a positive cost saving in terms of people having less illness or we enjoy the esthetic value of the fishes in the stream or the rippling brook, being able to see the bottom when we go out on our walks, and so forth. Now, that is all very difficult to equate in a dollar sense, but those are the arguments we are getting, and, of course, you know the Corps of Engineers sometimes builds dams twice to justify some things they do in that way. My first step would be just simply to require the Government to put a price tag—it seems to me it is easily translatable into dollars—on the things they have mandated the individual and the company to do.

If it is raising those fire extinguishers another 3 inches to be 48 inches above the level of the floor, why, let's find out what the cost of that is, and then maybe we will find out it is not worth moving them up from 45 inches to 48 inches above the floor.

Mr. STEIN. I am all for that. My only doubt is whether it adds to clarity of thought to call all of those things the same kind of expenditures as Federal Government expenditures. It is not necessary to put everything in that one big book in order to think about it, and I would suggest that you might have another book.

Representative BROWN. We can put it in a different book, or maybe it would be in the yellow pages of the budget or something like that so we will have a clear picture of it, because right now we mandate all of those things, and nobody seems to have the foggiest notion in Washington about what those off-budget expenditures are that we require.

Mr. STEIN. Well, I am 100 percent for that.

Representative BROWN. If I can just get Senator Bentsen to feel the same way about tax indexing, we could go to lunch together sometime.

Mr. Stein, thank you. It is always a pleasure to have you. I hope maybe with your erudite response to that last question, one of the columns or pieces you can write for AEI might relate to on-budget, off-budget, and off-off-budget, and, if you think of anything, maybe off-off-off-budget.

Mr. STEIN. I will write something about that, but maybe you will not want it.

Representative BROWN. With your style, I am sure I will like it, but it might not agree with me.

Thank you for being with us, and we will recess the hearing until February 22.

[Whereupon, at 12:25 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 22, 1979.]

