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READING GUIDE

AND

PRELIMINARY COMMENT

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THE MONETARY PORTION ONLY

OF

THE JOINT ECONOMIC COMMITTEE'S

REPORT

ON

"EMPLOYMENT, GROWTH AND PRICE LEVELS"

156 pages - about 78,000 words
Published - January 26, 1960

86th Congress - 2nd Session

Joint Economic Committee:

Paul H. Douglas - Chairman
Wright Patman - Vice Chairman

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Prepared solely for personal
desk reference.
Wednesday, January 27, 1960.
James L. Knipe

JLK

MONETARY POLICY

General Comment

General monetary policy has tried to do an impossible job and has, therefore, done a poor job in recent years, it is contended.

> "In fact, the general tightening of money and credit had its main impact in limited areas...and not in those areas where the price rises were largely taking place." p. 30

The Federal Reserve System is said to be out of touch with the modern needs of the economy.

> "...its approach to monetary policies has become increasingly more classical...its policies have been reshaped in the image of the 1920's." p. 31

The Committee will recommend against the removal of the 4-1/4-per cent ceiling on long-term Government bonds until changes have been made.

> "It is our recommendation that the 4-1/4-per cent ceiling on long-term Government bonds...not be removed until major reforms in fiscal, monetary, and debt management policies are instituted."... p. 36
>
> "It may well be that only by refusing to remove the ceiling can these major reforms be brought about." p. 47

The minority makes a strong retort to this position taken by the majority, with respect to the 4-1/4-per cent ceiling.

> "This is nothing but political blackmail--with the public the main loser." p. 86

Otherwise, the minority commends the temperance of the monetary position taken by the majority.

> "In view of the extreme positions taken in the staff report on monetary policy, we are somewhat relieved at the moderation, and even diffidence, with which the majority toys with the idea of cheap money. It asks only a moderate increase in the rate of growth of the money supply, a modest lowering of interest rates, and only occasional Federal Reserve intervention in the long-term Treasury bond market." p. 84

General Comment (continued)

Within the Democratic majority, Mr. Patman breaks completely with his colleagues. He submits his own, personal report, filled with criticism and denunciation of the Federal Reserve. Some typical quotations will illustrate his attitude.

> "In periods when interest rates are being raised, these spokesmen are given to making such statements as the Federal Reserve is 'simply following the market' and otherwise suggesting that the events of the day are natural phenomena over which the Federal Reserve has no influence or control. Only in recession periods, when interest rates are being lowered, do these spokesmen take credit for actions which reveal that credit availability and interest rates are, after all, products of their decisions." ... p. 65
>
> "The Federal Reserve System should be brought back into the Government from whence it has seceded..."... p. 65
>
> "It is my view that until these fundamental reforms are made, Congress should, at the beginning of each year, pass legislation specifying the rate at which the Nation's money supply shall be increased during the year." p. 65

Senator Butler, of the minority, pays several graceful tributes to the System, welcome to the reader who had just finished going over Mr. Patman's remarks.

> "...the fact of the matter is that an unusually fine job was done during the past 6 years by those who maintained the delicate balance between ample credit to meet the Nation's proper needs and yet avoided stoking the fires of inflation." p. 124

The "Bills-Only" Doctrine

As might have been anticipated, the "Bills-Only" doctrine receives its usual manhandling by the majority. But, very interestingly, the tone of the statements is moderate. Only Mr. Patman, in his separate report, states the extreme view. The calm attitude of the majority appears at a number of places.

> "...It would appear that an important power was given up for no appreciable gain.
>
> "It may be that after a long period of pegged interest rates something like 'bills only' was required to impress upon investors the fact that the Federal Reserve was no longer going to peg them."... p. 32

The "Bills-Only" Doctrine (continued)

> "We are not advocating that the Federal Reserve peg the long-term bond market. We are advocating that the Federal Reserve System assume responsibility for the orderly behavior of our credit markets." p. 42

It is true that the majority goes on, in the very next paragraph, to a position far beyond the one just stated above, but even this is not anywhere nearly as extreme as the views expressed by many critics in recent years.

> "A method by which the interest rate structure can be improved and the long-term bond market strengthened as a consequence, without, in any way, expanding the money supply or pegging the bond market or producing inflationary effects, is by changing the mix in the holdings of the Federal Reserve portfolio.
>
> "In 1951, the Federal Reserve held about $5 billion in long-term bonds which was 21.5 per cent of its total portfolio holdings of $22.7 billion. As of the end of October 1959, the Federal Reserve held only $1.5 billion in long-term bonds which was only 5.7 per cent of its total portfolio of $26.3 billion. There is no reason why the present ratio should not be improved." p. 42

What the Committee seems to overlook is that, once the ~~demand~~ desired ratio had been reached, the bullish influence on the long-term bond market would no longer be felt. As a matter of fact, there might be a depressant in the overhanging effect of a mass of $6 billion or so of long-term bonds. Does the Committee anticipate substantial sales of longs at some future date?

The Committee is not clear in its exposition on these points, but it would appear that the position taken is sufficiently reasonable that a clarification of the meaning of "Bills Only" as a doctrine, and perhaps a slight modification of Reserve operating practices, would produce a situation wherein the Committee would not be excessively critical.

Mr. Patman, of course, goes far beyond the majority position:

> "It should maintain a ceiling of 2-1/2 per cent on long-term Government bonds now. It should--to use a dirty word--'peg' Government bonds." p. 67

Consumer Credit Controls

The Committee agrees with its Staff Report's attitude that consumer credit control is a tool which the Federal Reserve System should have and should use.

> "More monetary tools rather than less are necessary... Credit for consumers and the supply of funds for most business investment are very little affected by monetary policy...
>
> "We recommend that legislation for standby regulation of the downpayment and of the maturity terms of consumer loans be enacted... sudden surges of consumer credit have from time to time been an important source of instability... the rapid rate of expansion of consumer loans in some periods has contributed to inflation through its effect both on prices and wages." p. 33

Mr. Patman, again, is in opposition to his own Party's majority view. He objects to the authorization of standby consumer credit controls on a number of grounds.

> "...but selective controls first and foremost over business credit--both for inventory speculations and expansions of productive capacity."...
>
> "If we eliminate competition in these services, then elimination of competition in interest rates is almost sure to follows."...
>
> "...it provides no means for stimulating consumer demand when it is too low, which is the more usual state of affairs." pp. 67-8

Rediscounting

The Committee takes a very definite stand on the question of rediscounting: it should be abolished.

> "Rediscounting should be eliminated as a general practice. It should be allowed only when a member bank encounters potentially serious difficulties not of its own making."...
>
> "If rediscounting is not eliminated entirely, at least the use of the rediscount rate as an influence on interest rates should be. The discount rate should be made a penalty rate, and only adjusted for the purpose of keeping it so." p. 32

Rediscounting (continued)

Mr. Patman, once more, is in disagreement, on the ground of regional needs, and on the additional ground of difficulties which the country banks might encounter in buying and selling on the open market. p. 68

The Reserve Requirement Tool

The Committee contends that the Federal Reserve System is at fault in not having raised reserve requirements since 1951.

> "The Federal Reserve, in extensive hearings and questioning, has been unable to provide us with an economic or monetary justification for preferring lower reserve requirements instead of the open-market method of expanding the money supply when necessary." p. 44

It is implied that the Federal Reserve is guided by the banks' profit motives and that this is pushing the System to an ill-chosen goal.

> "It appears to be aiming at a general reserve requirement level of about 10 per cent which, in the opinion of this committee is not necessary nor in the public interest."... p. 43

> "In fact, if instead of the policy of lowering reserve requirements, the expansion of credit which was created by this means since 1953 had instead been created by open-market operations, the net increase of revenue to the Treasury at the bond rate would have amounted to a total of almost \$500 million and at a present annual rate of some \$112.7 million." p. 44 and table p. 45

Mr. Patman agrees in this case, but would like to go a great deal further.

> "It would not restore to the public the Government securities which the Federal Reserve System has given away from the vaults of the Federal Reserve banks in the course of its successive reductions in reserve requirements since 1951. There should be a restoration of reserve requirements and a return of these assets to the Federal Reserve System." p. 72

The Money Supply, and the "Bills Only" Doctrine

The Committee considers the problem of the long-run growth in the money supply and comes up with the thought that the way to increase the money supply would be for the Federal Reserve to purchase about $750 million per year (at the beginning) of Government securities.

> "If such secular expansion were to take place under present conditions, it would appear that the purchase of long-term securities for this purpose would be warranted. This would help to lengthen the debt structure, increase the price of bonds, and have the effect of lowering the long-term interest rate." p. 46

It is not made clear whether or not this proposed purchase program for long-term bonds is or is not in addition to the suggestion that the System work back toward a figure of around 21% in long-term issues in its portfolio.

JH.

READING GUIDE

AND

PRELIMINARY COMMENT

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THE STAFF REPORT ON

"EMPLOYMENT, GROWTH AND PRICE LEVELS"

485 pages - about 240,000 words
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Joint Economic Committee:

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Wright Patman - Vice Chairman

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* * * * * * * * * * * * * * *

Prepared solely for personal
desk reference.
Wednesday, January 20, 1960.
James L. Knipe

INTRODUCTORY COMMENT

This is not a partisan report in any obvious sense. It goes out of its way from time to time to direct some small criticism at earlier Democratic administrations. It is partisan and disingenuous, though, in a much subtler, wider, and more important sense. This is repeatedly illustrated in the way it skims over the self-interested actions of the great, voting groups, and concentrates instead on the alleged faults or weaknesses of elected or appointed officials, such as the Federal Reserve or the Treasury or the Budget Bureau.

Any report on the inflationary processes of recent years which claims to be non-partisan, "scientific," must constantly emphasize that the main forces behind the price rise are:

the organized power of labor,
the market power of manufacturing, and
the political power of agriculture.

It is these groups, promoting their self-interest with skill and unrelenting tenacity, which wreak the damage on

preachers,
teachers,
Government employees,
career members of the Armed Forces,
holders of insurance policies,
bondholders,
retired people,
annuitants, and
pensioners.

Regardless of how courageously any elected or appointed group may wish to protect the dollar, as a matter of justice, the effort is often thwarted by the three great power groups.

Perhaps this is the way it should be in a democracy. If the three great power groups represent, say 80% of the people, and those harmed by inflation amount to only 20%, then perhaps the moral principle of an honest currency should be ignored. Shocking as this may seem, perhaps the self-interest of those who have learned to ride the whirlwind of inflation should be the determining factor. It has certainly been so in recent years. Of course, some of the elected or appointed leaders who are trying to safeguard the currency make every effort to convince the inflation-promoters that it is not truly in their self-interest to chip away at the dollar, if regard is paid to the longer pull. These warnings have, so far in the last fourteen years, fallen largely on deaf ears.

The Report treats the activities of these large power groups quite casually, especially in the cases of labor and agriculture. One would almost think that a few officials in Washington might, if they only possessed a bit more intelligence and courage, enact laws and establish procedures which would reconcile the irreconcilable and thwart the will of the 80% or so who are enjoying the inflationary years so thoroughly.

The evasiveness in this Report may be irritating, but it is not much worse than the same characteristic in the writings of some of those who are endeavoring to protect the currency. The real inflationary culprits are never named and the writings are filled with economic double-talk which serves to remove a large percentage of the meaning for many readers.

The Report is stimulating and interesting, lucidly written in some of its most difficult sections. Within the limitations imposed by this reluctance to offend the large groups of inflation-promoters, it gives the appearance of intellectual honesty and of imaginative analysis, along with many traces of the rankest amateurishness.

There is an impression here and there of brashness and overstatement. This is inevitable when bright young men are trying to jar their elders out of their intellectual ruts. In so far as the apparent brashness stems from disregard of facts, it should properly be criticized, but in so far as it stems from a cheerful disregard for unsupported, and unsupportable, theories of academicians who, to these young authors, seem to be out of touch with the world, it might be applauded.

A more important question is whether or not the Report is realistic. Will all, or most, of the things be done which are recommended as needed to reconcile full employment, growth, and dollar stability? The answer is, of course, negative. At most, a few things will be done. Therefore, the Federal Reserve will, a few years hence, probably still be struggling along as the loyal defender of the dollar, with few allies and beleaguered on all sides by critics. Holding a beach-head of economic integrity may, however, in the long run, lead to winning the war for a stable unit of currency in the United States.

Coming down to the Report's comments on the detailed operations of the Federal Reserve System, are the suggestions and criticisms logical and helpful? These questions are taken up in the body of a preliminary outline of the Report, which is attached, following a one-page summary.

ONE PAGE SUMMARY

Almost constant full employment, strictly defined, together with rapid growth, optimistically defined, are twin policy goals which far outweigh the honest dollar goal. Policies should be geared, first, to these two objectives, with purchasing power stability an important, but definitely secondary, goal.

General monetary policies have not been very effective in the postwar years and this is just as well, because if they had been as effective as their proponents expected the results would have been disastrous.

Inflation has arisen primarily out of the unrestrained use of market power by labor and management, especially in the steel and automobile industries. Management's market power should be restrained. There is not much that can, or should, be done about labor's market power. The enormous corporate profits of postwar years may be the most important factor in the process of inflation.

Federal fiscal policy has been so thoroughly inept, at least since 1952, that it has accentuated cyclical tendencies, instead of exerting the proper contracyclical pressures. Many reforms are recommended.

All of this has left the Federal Reserve with an extremely difficult job, which it has not performed with any particular skill or imagination. The System needs to think through a number of its basic philosophical attitudes, as well as some of its procedures.

The big questions are:

(1) Why not use a selective control on consumer credit?

(2) Would a selective control for inventory be possible?

(3) Is there a way to devise a selective control for plant and equipment?

The small questions are:

(1) Is the discount rate policy properly thought out and administered?

(2) Why have reserve requirement raises not been used in recent years?

(3) What is the policy now generally called "bills only"?

(4) Can policy administration be streamlined?

HISTORY AND THEORIES OF INFLATION

Burden and Danger

In a large Report, prepared by a number of writers in a short time, it is to be expected that inconsistencies will be found here and there. Comments with regard to the burden of inflation afford a good example of this sort of thing. Inflation is spoken of as though it were dangerous and unjust at times, and at other times as though it were not really very important:

> "Stable prices are a desirable attribute of the American economy. When inflation occurs, some groups gain and others lose in a pattern which is unjust." p. 7

> "The hazard of a creeping inflation turning into a gallop is truly perennial, and requires constant anti-inflation efforts." p. 11

And yet the Report makes this remark, in connection with the hypothetical imposition of price and wage controls:

> "The imposition of price and wage controls . . . would be wholly unjustified by the small increases in the price level which have occurred." p. 29

In another place, it is implied that escape from the burdens of inflation is not particularly difficult or unusual. Discussing the rise in common stock prices since 1939 (350%), and of real estate (200%-250%), the Report says:

> "On the other hand, the cost of living has advanced only by approximately 110% . . . a household that had divided all its assets between real estate and common stock and had at the beginning of the period financed one-half of its total assets by borrowing, would at the end of the 20-year period not only have preserved intact the purchasing power of its net worth, but would actually have increased it by 60 per cent." p. 113

It is not easy to generalize as to the basic attitude of the Report toward the burdens and dangers of inflation, but it certainly seems fair to say that the authors are a great deal less concerned about the damage and injustice brought on by inflation than, say, officials of the Treasury, or of the Federal Reserve System.

History of Post-World War II Inflation in the United States

The fourteen-year period, 1946-1959 (September) inclusive, showed three main periods of rising price levels. These were:

	Consumer Price Index		Wholesale Price Index		
(1) 1946-48 (3 years)	Up	24.9 points	Up	33.2 points	
1949 (1 year)	Down	2.1 points	Down	5.1 points	
(2) 1950-51 (2 years) (Korean War)	Up	12.5 points	Up	15.3 points	
1952-55 (4 years)	Up	1.5 points	Down	1.1 points	
(3) 1956-59 (Sept.) (about 4 years)	Up	10.6 points	Up	7.8 points	
Nearly 14 years	Up	47.4 points	Up	50.1 points	From table p. 104

Referring to the Consumer Price Index, this upward movement in prices amounted to 61%, with a little more than one-half of the increase occurring in those three disastrous years, 1946-47-48, a little less than one-quarter during the two-year peak period of the Korean War, 1950-51, and about one-quarter in the last four years, 1956-59, of so-called creeping inflation.

The Report fails to emphasize at this point that it was only the drop in such things as agriculture and textile prices that kept the so-called creeping inflation from showing up in the Indexes as early as 1952. The creeping inflation, if one looks at some important component series in the Indexes, is really a phenomenon of the last eight years, 1952-59, rather than of just the last four years, 1956-59.

It is not easy to understand how the Report can refer to a 61% rise in the Consumer Price Index as ". . . the small increases in the price level which have occurred." p. 29

In looking at the Consumer Price Index, it is seen that the "All Services," with a weight of 32.1, and a rise of 50.7% from 1947 to 1958 (compared with an increase of 29.3% for the entire Index in those twelve years), made a huge contribution to the inflationary process. A similar effect of "Services" shows up in the GNP Deflator. From table p. 105

<u>History of Post-World War II Inflation in the United States</u> (continued)

Another sector which gave a strong push to the price level was "Construction." As shown in the GNP Deflator for 1947-1958, "New private construction" has a weight of 8.5 and went up 48.4% as compared with 33.4% for the GNP Deflator as a whole.

As measured in the Wholesale Price Index, for these same years, "Machinery and Motive Products," with a weight of 19.3, pushed upward 61.9 per cent, compared with 23.7% for the Index as a whole, and contrasting with declines of 6.6% in "Textile Products" (weight of 7.5) and 5.1% in "Farm Products" (weight of 10.7).

Also in the Wholesale Price Index for these years, "Metals and Metal Products," weighted 13.5, rose 64.7%. The report stresses the significance of these two groups, "Machinery and Motive Products," and "Metals and Metal Products.":

> "The two latter groups not only account for almost one-third of the direct weights in the WPI, but also have a very considerable immediate impact on the prices of other goods which use steel and other metal or metal parts, and a longer run impact on other prices through their effects on costs of machinery and equipment. These two sectors also account for a large part of the 55 per cent increase in the 'producers' durable equipment' index in the GNP deflator." p. 105

The Report takes a more detailed look at each one of these industries mentioned as playing a meaningful role in the climb of the price indexes. First, some remarks about "The Service Industries," which gave powerful aid in the rise of the Consumer Price Index and the GNP Deflator.

It is pointed out that "Services" have not only shown large price increases but have also moved upward in every year since 1945, p. 130 during recessions as well as booms. In view of this relentless price rise, it is significant that:

> ". . . the services industries provided the most important sources of employment expansion after the war. After one year of no net increase from 1947 to 1948, employment in services has risen annually. From 1953 to 1957, the average annual rate of increase in services employment has been 3.4 per cent. This contrasts sharply with a drop of approximately 1 per cent per year in manufacturing, mining, and 'transportation and public utilities,' and to a rise of only

History of Post-World War II Inflation in the United States (continued)

> 1.7 per cent per year in construction and 1.8 per cent in trade. Put another way, the very great bulk of the expansion of employment in the economy as a whole after 1953 can be traced to the services industries." p. 130

Additionally, services have claimed an increasingly important share of total consumer expenditures, growing from about 32% to 38% of the consumer's budget, from 1947 to 1958. p. 130

While the term "services" is often spoken of as some sort of a homogeneous mass of labor, it is really no such thing, as the Report makes clear. It consists of such diverse elements as utilities and transportation (regulated by Government), medical care (highly skilled in many phases), barbers, repairmen (medium skilled), and laundry workers, domestic service, etc. (low skills), Comments or analyses must necessarily take up such differing categories as separate subjects for discussion. p. 133

In discussing the unskilled occupations, the Report affords a good example of reticence and understatement, together with what certainly looks like naivete. One needs only to have observed unskilled workers at their jobs in recent years to realize that their productivity must have dropped sharply as compared with men and women on factory production lines. It is perfectly clear why it is often cheaper to throw away a piece of household equipment, and buy a new one, than to attempt to have it repaired. But, the Report treats this situation with great delicacy:

> "The final variable which may explain the price movements in services is productivity. Here no reliable data are available. The nature of the occupations involved, however, is such that it is quite probable that productivity increases have been considerably lower in these sectors than in the goods-producing industries. . ." p. 135

Similarly, the spreading effects of union power are shrugged off as of little importance:

> "Except in so far as the wages in services have been increased more than otherwise by the indirect influence of union pressures elsewhere--a possibility not generally supported by the data available--the higher prices in the unskilled services appear to be the result of normal competitive market forces." p. 135

History of Post-World War II Inflation in the United States (continued)

The authors' conclusion would seem to be that there is no very accurate way to generalize about the price rise, since the skilled workers appeared to have been affected largely by "pure demand and supply," while the unskilled workers presumably allowed their productivity to decline, and also may have been affected by other factors. No attempt is made to point up the obvious fact that the supply and demand situation during almost constant full employment has exerted a great influence toward lower productivity on most unskilled workers who are not subject to the discipline of a factory production line. p. 136

Turning to the construction industry, the analysis is so contradictory and inconclusive as to be thoroughly confusing. This is especially true with respect to the market power of labor unions. At one point it is asserted that

> "An examination of the trends in real output in the industry suggests that at least a good part of the explanation may be found on the demand side of the market . . . Under these conditions, it is most difficult to believe that demand did not constitute the major underlying cause of the inflation which occurred during this period." p. 128

But twenty-two pages later:

> "Average hourly earnings in the construction industry also rose by considerably more than those in manufacturing from 1947 to 1953 and by an amount about equal to those in manufacturing from 1954 to 1958. The nature of the construction industry is such as to create conditions which are very favorable to the exercise of market power by unions. First, the industry is strongly organized by several unions representing highly skilled craftsmen, who are limited in supply. Second, the competitive area of the product market is almost completely local, so that no problem of outside competitive pressures or of 'runaway' shops exists. Third, bargaining is conducted very largely by autonomous local unions, subject to considerable interlocal rivalries. And, finally, the settlements negotiated in the residential sector of the industry are often determined by the terms established by the same local unions in the industrial and commercial sectors, where the economic environment is generally more favorable

to relatively liberal wage-fringe adjustments. Taken together, all these considerations would suggest that union power has been a factor underlying the relatively high wage increases in the industry.

"On the other hand, however, there was considerable evidence presented in the previous section of this chapter that output and employment trends were extremely favorable, at least until 1955, and that they continued to be quite favorable in nonresidential construction through 1956 and 1957. Under these conditions, it is difficult to assert that demand considerations did not also play an important role in the rising wages and prices in this industry. On the basis of the available data, it is impossible to pass judgment on the relative importance of demand versus market power in the determination of wages in the construction industry." p. 150

What the Report is attempting to do in these industry analyses is, of course, nearly impossible, in that the effect exerted by demand for labor can seldom be clearly separated from the effect exerted by supply of labor as controlled by the market power of labor unions. A constant situation of full, or nearly full, employment (high demand) affects not only the demand side of the market but, also, indirectly, the supply side, in encouraging more aggressive actions by unions and in discouraging productivity improvements. Therefore, while these brief analyses are of some interest, they do not throw too much additional light on the processes of inflation.

The authors never quit trying, though, and they do not hesitate to make a sweeping generalization with regard to the machinery industry:

"The most important finding of the machinery study, however, was that demand pressures rather than market power played an important role in the 1955-57 inflation." p. 124

Here they are referring to the market power of industry, rather than to the market power of labor. In this case, as in all others in which they are treating the market power of either industry or labor, they can come nearer to making a case, one way or the other, when they are dealing with industry, because a lengthening of profit margins carries more specific meaning to most analysts than does an increase in wage rates. The extraordinary growth in profit margins in the machinery industry, together with the strong pressure on productive capacity, p. 124
would seem to lend considerable validity to their contention

that the machinery case represented a good example of demand pressure in the major role, rather than market power, either of industry or of labor.

With respect to steel, the Report comes to nearly the opposite conclusion as to the reason for the price increases. Presumably the argument as to the way in which the steel industry differed from the machinery industry is based on the fact that steel production did not press hard on capacity, although that is not made clear. So, although the reasoning is not fully revealed, an explicit conclusion is drawn:

> "In effect, these two factors reflected a situation in which two strong groups attempted to bring about a redistribution of income, each in its own favor, with the result that the rest of the economy suffered....
>
> "Neither the increase in steel wages nor the increase in steel prices can satisfactorily be explained by demand factors alone. The wage and price behavior of the steel industry represents an important instance of inflation caused to a substantial degree by the exercise of market power. This type of inflation cannot be controlled by policies aimed solely at restricting total demand." (Underlining supplied.) p. 124

Thus, the implication is that the authors believe general credit restriction might be of some help in holding down the prices of (1) services, and (2) machinery, but it would have little effect on (3) construction, and it would be likely to have practically no effect on (4) steel.

While the reasoning may not be wholly clear, and the documentation inadequate, these sections of the Report are useful, as an attempt to be a bit more specific than the usual generalization, which might run something like this, "General credit policies are handicapped by the fact that in certain industries, such as steel, the market power of both industry and labor are so great as to generate inflationary price rises almost without regard to the state of overall demand in the economy."

Wages and Profits

In a section devoted to more general discussion of what has been happening to wages, profits, and prices, and to an attempt to separate out the effects of demand as contrasted with the effects of market power, the Report is similarly interesting but by no means entirely

Wages and Profits (continued)

convincing:

> "It is by now almost universally agreed that the sharp rise in prices immediately after World War II and the second wave of manufacturing price increases during 1950-51...can be attributed primarily to demand forces... p. 119
>
> "After 1955, however, the increase in output continued at a very low rate... By this point in time, there can be little doubt that pressure on productive capacity can no longer be considered a reasonable explanation of the continuing rise in manufacturing prices." p. 120

Moving on to the question of just how this market power functioned, it is not necessary to pay any particular regard to the Report's thesis that market power was especially important only from 1955 onward. Their reasoning is of interest, whether it applies only to 1955-59 or to, say, the entire thirteen years from 1947 through 1959.

No relationship was found between changes in hourly earnings and employment in each industry, nor between changes in hourly earnings and output, nor between changes in hourly earnings and productivity. p. 147

What was found was that wage changes in nineteen manufacturing industries were related to (1) the level of corporate profits in the industry, and (2) the degree of competition in the product market, as p. 147 measured by 1954 concentration ratios. The study also attempted to check the relationship between changes in hourly earnings and "estimated union strength." The conclusion was:

> "There was no generally applicable relationship p. 149 evident between union strength and wage changes, however."

This last conclusion is a challenge to one's common sense. It would seem to be impossible to measure "estimated union strength," and it would seem much more likely that union strength, if properly estimated, would simply be added to corporate profits and corporate market dominance (concentration) as the third principal determinant of changes in hourly earnings. It is not necessary to argue this point with the authors while considering the principal result of their study--the shocking fact that changes in hourly earnings are not related to output or productivity or employment. If they have really established this as a fact, as they contend, then they have struck a great blow at all the traditional ideas about how to control inflation.

Whether or not most other analysts agree with them, there can be no doubt that this general view is widely held today among economists and financial analysts, and it is back of the contention that traditional control methods are not always as useful as in the past.

Continuing their survey of the wage trends of recent years, especially as influenced by corporate profits and corporate competitive position, they describe the development of wage "patterns," based on "key" settlements. p. 150 et seq.

> "In the summer of 1955, the 'key' bargain was negotiated in the automobile industry, which was enjoying its second most profitable postwar year, with sales of over 7 million cars...profits after taxes were 21 per cent.. Shortly thereafter, the steel industry negotiated a wage increase... Output in steel had also risen sharply from the 1954 recession...1955 profits... after taxes, 13.5 per cent... Before the year was out, the leading firms in several other major industries... had negotiated similar contracts, many on a 3-year basis. p. 154
>
> "The results of these two 'patterns,' negotiated during periods of high output and profits, continued to be felt throughout the declining years of 1957 and 1958. p. 155
>
> "It was, then, a combination of market power in both the product and labor markets, initiated by rising demand and high profits, which accounted for the developments in these industries." p. 158

There is no reason to question the broad statement of the last paragraph above. If market power (of industry and of labor) is as strong as implied here and elsewhere in the Report, then the challenge to unquestioning acceptance of the entire body of traditional monetary control doctrine is very real.

Theories of Inflation

The Report lists first the traditional "pure demand-pull" type of inflation, and points out that it can be controlled in the traditional fashion:

> "The policy implications of a demand pull inflation are likewise quite clear. Since the basic cause is an excess of aggregate purchasing power, policy must be

Theories of Inflation (continued)

> directed toward reducing that purchasing power by aggregate fiscal and monetary policies. And since markets are competitive and wages and prices flexible, this result can be achieved without developing any serious unemployment." p. 115

Then there is the "cost-push," or "administered price," or "sellers" or, the term preferred in the Report, "market power" inflation. Toward a "market power" inflation, there are obviously two major policy approaches. The first is the traditional monetary and fiscal approach, because unless aggregate demand keeps rising the two great power groups, industry and labor, cannot exercise their market power. p. 116

The third type is called "structural," and refers to a type of inflation wherein aggregate demand in the economy is not excessive but upward price thrusts occur"...in particular sectors of the economy because of substantial and rapid shifts in demand toward those sectors." Continuing, p. 116

> "A net inflationary movement can result, however, partly because of the immobility of factors of production--which prevents supply from adjusting quickly to shifts in demand--but more importantly, because of the lack of downward flexibility of prices and wages in those sectors in which demand has declined." p. 116

Conceptually, this is merely a sort of special case of "market power" inflation, in that it is the exercise of market power which prevents the normal, downward, counter-balancing wage and price adjustments in the sector from which demand has moved. It seems unlikely that "structural" inflation can very often be identified. The inflationary movements in the United States during recent years have embodied all three types, and so it follows"...therefore, that any public policy designed to deal with the problem must itself be diverse and flexible." p. 160

But these public policies are often so politically impracticable, it is suggested, that there is not much point to giving them serious consideration. For example, in the exercise of traditional monetary and fiscal controls, the restriction must be strong enough to reduce market power. That is the only way it can work. Then comes the question of whether or not a level of unemployment high enough to produce an effect will be socially "acceptable," or "tolerable." It was only eight short years ago (1952) that Senator Douglas defined full employment as 6% unemployed. Now the staff for the Committee of which he is Chairman writes: p. 143

Theories of Inflation (continued)

> "Past evidence suggests, therefore, that unemployment would have to average at least 6 per cent to keep the rate of wage advance no greater than the rate of increase in productivity. Clearly, monetary and fiscal policies that yielded this result would be socially unacceptable." p. 144

If that statement were literally true, then the proponents of the virtues of monetary and fiscal controls would surely be on the horns of a dilemma, and they would be there even if everyone were suddenly to proclaim that monetary and fiscal policies represented the best possible way to fight inflations. It is certainly possible that the quoted statement above is true, that the American public is so interested in full employment that even small deviations from it, in order to protect people from the injustices of inflation, will not be countenanced.

CONTROL OF INFLATION, NON-MONETARY

Antitrust Action

The principal thesis of the Report, that public policies must be diverse and flexible to deal with the modern forms of inflation, leads to the consideration of market power and how to deal with it. Antitrust action comes to mind, and it seems to the authors to have some obvious usefulness when applied to business firms: p. 160

> "This approach has the immense advantage of not only reducing this source of inflationary pressure, but also raising the effectiveness of the economy for growth, for reducing undesirable concentrations of power in private hands, and accomplishing all this without increasing the amount of government intervention in the private economy." p. 432

So, a recommendation is made:

> "We recommend that the basic approach toward the problem of market power should be through a considerably expanded antitrust program." p. 433

This includes a word to the Federal Reserve:

> "A similar evaluation of the effects of the Federal Reserve Board's policies toward bank mergers would be desirable." p. 433

The suggestion made by many people that stepped-up antitrust activity might be a good thing, also, in the case of the labor unions, leads the authors to discover several reasons why the suggestion has no value. They say that the application of antitrust laws to the labor market would ". . . strike at the very existence of unionism and collective bargaining itself." It might be ". . . tantamount to stating that unions per se will be unlawful." p. 434

Dismissing this first suggestion as to how union power might be curbed, the authors turn to two other ideas which have been advanced, (1) the outlawing of industry-wide bargaining, and (2) the outlawing of national union participation in bargaining. After a brief discussion, these two harsh thoughts are also discarded. They quickly wash their hands of all such ideas, and go back to contemplation of how useful it would be to turn antitrust forces loose on business: p. 435 p. 436

Antitrust Action (continued)

> "We believe, therefore, that the antitrust approach to the problem of market power in the labor market is neither feasible nor desirable, and would create many more problems than it would solve. It may well be, nevertheless, that stricter antitrust enforcement in the product market . . . would have favorable indirect effects on wage pressures as well." p. 436

Other Possibilities

Moral suasion, the Report has to admit, is not likely to accomplish very much, if anything. In a competitive economy, business executives and labor leaders do not construe their jobs to be to work for the common good, but for the immediate and direct interests of those who hire them. One proposal, though, might have some slight value, " . . . an annual conference of business, labor, and Government leaders." But it might " . . . become a mere public forum for presenting the viewpoints of special interests." p. 437 p. 437

About the only other thing left along these lines would be an increased Government participation in the price-wage-setting process. In considering this course of action, the Report suggests "no," then suggests "yes," and, finally, tosses it back to the public. Apparently this problem was too hot for even the confident authors to pass judgment on:

> "There is always the danger that Government participation in the determination of wages and prices will interfere with the proper allocation of resources among industries, will have an adverse effect on the incentive of labor and capital in the industry, and will particularly in the long run, create more serious problems than it solves." p. 437

But:

> "Nevertheless, society also has the right to impose limitations on the exercise of private market power, if it is felt that market power is being used in a manner detrimental to the basic interests of society. Our studies suggest that market power has, in fact, contributed to the inflation of recent years." p. 438

So, although they are very willing to pass grave judgments in other places in the Report, here they walk away from the problem:

"The problem of balancing these divergent considerations is, of course, a judgment only society can make." p. 438

In quite another area of action, but one which is also closely tied in with the market power of business, the Report suggests that " . . . we should steadily continue to reduce tariffs." Apparently it is realized that this recommendation is p. 434
not very likely to be acted on, or produce any effects at all, because it is dismissed in one paragraph.

Control Through Fiscal Policy

During the last twenty years it has become accepted doctrine among most economists that a reasonable use of Federal budgetary surpluses and deficits in a counter-cyclical pattern might be of considerable assistance in damping the fluctuations of the business cycle. At the top of the cycle, surpluses would tend to reduce the money supply and, perhaps, the velocity of spending. At the bottom of the cycle, deficits would tend to expand the money supply and, possibly, step up the spending velocity. This neat theory is based on the tacit assumption that the fiscal actions will have no unexpected, additional effects of some sort on business confidence, beyond these conventional effects which have been postulated.

As an additional refinement to the theory, planners would hope that the restrictions at the top of the cycle and the stimuli at the bottom of the cycle might have particular effect on industries which are in need of restriction or stimulation, i.e., that Federal spending increases and decreases would be directed to where they would do the most good, counter-cyclically.

This Report surveys the Federal budgetary record of the postwar years, finds it falling most of the time far short of what the theory demands, and suggests improvements. Even in the cases where a reader agrees with the line of reasoning, some of the suggestions for improvement seem naive. They either cannot be carried out, or will not be carried out. Even a man like Treasury Secretary Anderson, eager to make every possible use of budgetary policy as an economic control tool, points out the practical barriers on the road to accomplishment of some of the widely-accepted theoretical goals.

First, it is pointed out:

"Changes in the volume and character of Federal Government demands, particularly for defense purposes, have been an important source of economic

Control Through Fiscal Policy (continued)

"instability. The postwar period has seen several rising and falling waves of defense procurement activity, in connection with the Marshall Plan, the Korean War, the post-Korean defense program, and most recently the post-sputnik defense program." . . . p. 215

"The postwar record strongly suggests that relatively moderate changes in defense orders for hard goods are closely associated with relatively large fluctuations in total demand for durable goods and in plant and equipment expenditures." p. 262

These shifts in both volume and character of Federal spending seemed to have unfortunate effects at various times, with the sequence of events in 1956-57 as a good example. In early 1956:

"Increases in Federal demands, therefore, were concentrated in the very sectors in which total demand was rising and in which strong upward price pressures were developing, and at the very time at which private demand was at a peak." p. 248

This changed rapidly:

"From mid-1956 through the third quarter of 1957, defense orders for hard goods declined substantially, after a sharp rise in the preceding year. . .

"Total new orders, civilian as well as military, in this industry were $6.5 billion in the second half of 1956 but fell to $3.7 billion in the first half of 1957 . . .

"These simple magnitudes do not convey the full significance of this cutback. Because of the rapidly changing technology in military hard goods, any given change in the volume of orders for such equipment is likely to result in a substantially magnified change in total new orders for durable goods." p. 250-1

The Report takes the stand that nothing much can be done about these swift and largely unpredictable zigzags in defense spending. After all, defense does come first. The recommendation,

Control Through Fiscal Policy (continued)

therefore, is to learn to live with them and to try to make compensatory adjustments in taxes--an unrealistic proposal for a solution to this rough problem. If any counteracting adjustments are to be made, it would certainly appear that they will have to be made in expenditures, not in taxes. Even there, the lag problem is in itself almost insuperable, or so it would seem at this time. However, here is their conclusion and recommendation:

> "Decisions with respect to the volume and character of defense procurement should be made on the basis of judgments about the Nation's long-term military posture. They should be divorced from short-run budgetary considerations and prospects concerning the level of economic activity. On the other hand, these decisions should be a major consideration in formulating stabilization policies" . . .
>
> " . . . Public policy should be prepared to make compensatory adjustments, primarily in taxes, on a timely basis in response to these disturbances originating in changes in defense demands." p. 267

Admiration of the authors for compensatory adjustments in taxes is not entirely clear in the matter of how much affection they have for tax raises. As to tax decreases, there is no question about their enthusiasm. As one reads along through these sections, he has no trouble in finding specific reference to the usefulness of tax cuts, but references to the worthwhileness of tax increases are couched in the vaguest and most general terms. As an example, they like the reductions of 1948 and 1954, despite the paradoxical background of the reductions. They say nothing at all about the disastrous effects in 1955-57 of the reductions of 1954.

> "Discretionary tax changes have not been employed even in the face of strong recessionary and inflationary developments throughout the economy. Reductions in tax rates in 1948 and 1954 certainly contributed to moderating the recessions of 1949 and 1953-54 respectively. In the former case, however, the reductions were enacted despite the general assumption that inflationary, rather than recessionary, influences dominated the economy. In the latter case, the reductions were automatic, pursuant to the Revenue Act of 1951." p. 216

Commenting on the 1957-58 period, when the President so staunchly resisted tax-cut demands from every quarter, the Report dismisses the political courage and economic good sense of President Eisenhower with this curt remark:

Control Through Fiscal Policy (continued)

> "Tax cuts were proposed and explicitly rejected as an antirecessionary policy instrument in the recession of 1957-58." p. 265

Consideration of this subject of compensatory tax adjustments is terminated with the recommendation:

> "In short, more vigorous fiscal policy for economic stability calls for principal emphasis on tax rate changes and minimum reliance on expenditure changes . . ." p. 266

There is some doubt as to (1) whether or not this recommendation really embraces the tax increase side as well as the tax decrease side, and (2) whether or not this proposal is politically realistic enough to have any meaning at all.

The only slightly encouraging factor which can be seen in the Federal budgetary picture is something which is mentioned in several places in the Report, that is, the small stabilizing effect automatically exerted by the tax "take." The authors suggest strengthening these automatic fiscal stabilizers:

> "Automatic fiscal stabilizers should be strengthened, particularly with a view toward increasing their sensitivity to changes in employment.
>
> ". . . The automatic stabilizers, however, have only a limited function to perform: they can damp down fluctuations but they cannot prevent them . . .
>
> ". . . Of the built-in responses, that of the corporation income tax is by far the most pronounced. Its effect in stabilizing corporate outlays, however, does not appear to be particularly great. Changes in individual income tax liabilities, on the other hand, seem to be associated with relatively substantial changes in consumption outlays." p. 266

While the Report provides some stimulating reading on the subject of fiscal history and policy, and their relationship to control of inflationary tendencies, it does not bring to the reader a sense of nearby assistance in the handling of inflation. As in the case of the other non-monetary controls, antitrust action, moral suasion, government wage-price intervention, and tariff reduction, the discussion is interesting but the proposed "solutions" are either so weak as to have limited meaning, or so unrealistic as to make certain that they will not be followed. The responsibility, therefore, for controlling inflation will continue, it would seem, for the foreseeable future to be in the hands of the monetary authorities. If they are to do the job, they must have added public understanding and cooperation. The Report next takes up these matters in the chapter entitled, "Monetary Policy and Debt Management."

GENERAL MONETARY POLICY

The Alleged Price

In this section of the Report, mainly Chapter IX (Pages 315-428), the two principal themes are:

(1) control of inflation solely by general monetary policy involves too great a price, and

(2) general monetary policy is often a crude and clumsy tool, or, to change the metaphor, a shotgun instead of a rifle.

Looking first at what the Report has to say about the price paid for stabilization of price levels via general monetary and credit policy, these quotations are typical:

> "It is doubtful that a secular upward trend in wages and prices can be avoided with an average level of unemployment which is considered socially acceptable, given our present types of anti-inflation weapons." p. 144

Or:

> "Under some circumstances, public policy may have to choose between the price level and the rate of employment as the stabilization objective. In such circumstances, greater emphasis should be placed on stabilizing the rate of employment." p. 264

With respect to growth:

> "A considerable amount of growth was sacrificed in order to prevent inflation; and the policy tools that were employed were not capable of containing inflation." p. 95

These quotations are, of course, simply expressions of opinion.

The Contentions as to Impact

If a line of argument can be sustained that the differences of impact of general monetary policy on various sectors of the economy are so meaningful and so unfair that they more than counterbalance whatever price-level stabilization ensues, then the case for

The Contentions as to Impact (continued)

more extensive use of supplementary or alternative selective control devices might be sustained. This is the line of reasoning pursued by the authors.

First sector explored is residential construction. Here it is initially implied that the impact has been too great. The evidence adduced points out something different, at least as to future possibilities. What develops out of this study is that the sharp, countercyclical effect of recent years has been due almost entirely to the interest ceilings on FHA and VA mortgages. Instead of too great an impact, the more important likelihood is that, if the ceiling were removed, the impact would be so small as to be almost useless. This directly opposite likelihood is stated at the end of the section: pp. 363-368

> "But instead of behaving in a contracyclical fashion, as has been the case in the last few years, it seems likely that the income effect would dominate and the fluctuations would be procyclical, thus contributing to overall instability." p. 368

Based on this theorizing, but with the available historical evidence indicating the opposite situation, the authors go on to propose a selective control for residential construction. They suggest that it might be advisable to retain the present interest rate ceilings rather than to try to develop a new control:

> "The question is whether it would be better to keep the present interest rate limitations, recognizing them frankly as a selective credit control, and manipulating them accordingly, or to adopt another kind of selective regulation in the form of variable controls over downpayments and maturities of mortgages." pp. 400-1

None of this is very convincing and the case against general monetary controls in the field of residential construction cannot be sustained with this kind of "evidence." It is merely an expression of an opinion. The treatment of the interest ceilings as a selective control device, though, is a thought-provoking approach.

In connection with the financing of state and local projects, such as schools, hospitals, and water systems, the available yearly dollar totals which are cited seem to indicate that general monetary policy of recent years has had relatively little effect on this financing. If anything, the desired cyclical counteraction effect gives the appearance of being too small, rather than pp. 381-85

The Contentions as to Impact (continued)

too large. However, the authors apparently are convinced that the effects have been too large, and they cite an unfinished study as indicating this. In addition, they express the opinion that the increasing school-age population may be pressing too hard on existing school facilities. If this is meant to suggest that certain public facilities, such as schools, ought to be exempted in some way from the effects of countercyclical monetary control efforts, then this should be frankly stated. Neither the figures nor the prose in this section of the Report are convincing as an argument either for or against general monetary controls. If a social problem like this one is in need of special treatment, and the need can be clearly established, that is a problem quite separate from that of the effectiveness or lack of effectiveness of traditional countercyclical money and credit efforts. p. 383

The financing of small businesses, in contrast to larger ones, has often been suggested as being somewhat more affected by general monetary policies. One's common sense would lead to acceptance of this thought as containing at least a kernel of truth. After all, marginal firms are presumably affected first when available credit is bid for in ever-increasing amounts at the top of an inflationary boom. Marginality is surely associated, in some cases, with smallness. And yet, the Report says:

> "However, as to whether there has in fact been such discrimination in the last few years, the evidence is mixed, difficult to interpret and highly unsatisfactory." p. 378

Quoting similarly indeterminate findings of a Federal Reserve study the authors are left with no tangible evidence on which to rely and so, once more, they theorize:

> "That is, if monetary policy works chiefly through availability and if availability is not a problem for large firms, it follows that when monetary policy is effective in curtailing business spending, its impact must fall mainly on small business." p. 381

No matter how charitably one would like to regard such theorizing, all that can be said for it is that it obviously harbors a small amount of logic. The unprovably strong statement in the last few words of the quotation is not justified.

Glancing back at the three areas examined to here, the results are not too reassuring as to whether the authors are really eager to work with facts or to air their favorite theories. In the case of residential construction, the evidence indicates a large countercyclical response to policy in recent years. However, they quite properly point out that this is largely because of the existence of interest rate ceilings, and then go on to theorize that the

The Contentions as to Impact (continued)

industry otherwise would not respond properly to general monetary controls and so needs a selective regulation. As to state and local projects, the evidence does not back up the thought that general monetary policy has been too effective, i.e., has evoked too strong a countercyclical response. The same thing is true in the case of small businesses. So, in both of these cases, they are left with their own value judgments as the only basis for criticism of general monetary policy. Therefore, a strong statement like the one quoted below represents nothing more than an opinion, unsupported by any substantial evidence. If the opinion were not expressed in such exaggerated terms, one would pay more heed to it as an opinion:

> "General controls are a mirage and a delusion. It is perhaps just as well that monetary controls have not been very effective; if they had been, they might have been disastrous." p. 401

Next areas to look at are the three great originators of imbalance in the American economy, the three great "causes" of cyclical swings. These are (1) inventories, (2) expenditures on plant and equipment, and, less important to many analysts, (3) consumer credit. Whatever control method, or methods, will produce a strong countercyclical response in these three areas will be the one which is truly effective. Evaluation of any method hinges on how well it performs in restraining the sheep-like movements of the business and financial world, in the first two cases, and similar movements of consumers in the third case.

The Report does not agree that changes in the rate of business inventory investment and disinvestment have been a serious factor in producing instability during the postwar period. It is not necessary to debate this point, because the problem of inventory control is treated in the Report as seriously as though the authors thought inventories had been originators of imbalances. p. 399

It is the contention of the authors that general monetary controls do not exert a strong influence on inventory investment: p. 391

> "In any case, there is certainly no evidence that monetary policy has had any appreciable effect on inventory investment and its fluctuations in the last few years." p. 392

Nor, it should be added, is there any evidence that it has not had an effect. The relative moderation of inventory swings of the last nine years, years of actively-practiced general monetary policy,

The Contentions as to Impact (continued)

might at least suggest the usefulness of the countercyclical efforts.

Having rendered their judgment that general monetary policy is not effective in the control of inventories, the authors go on to lay out proposals for how to go about the job. They mention the possibility of a variable secondary reserve requirement as a way to control bank credit--an old idea, possibly a good one, used in some countries, but with some dangers, especially with relation to Federal finance. Another possibility mentioned is the basing of reserve requirements of commercial banks on types of assets, rather than on liabilities. p. 399

All of their discussion on inventory swings, and how to restrain their amplitude, is useful, even though the initial statement of the problem may not be adequately backed by facts. The Federal Reserve System should, it is often said, have under way at all times studies leading to the determination of how effective monetary policy has been in various areas of the economy, and as to how it might be improved. All specialized treatments, such as various forms of secondary reserve requirement plans, need to be re-studied frequently in the light of changing conditions.

When the authors turn their attention to plant and equipment expenditures, probably the greatest single de-stabilizing influence in the economy, they find themselves unable to obtain facts in satisfactory form, and unable to come to any very firm conclusions as to what they think ought to be done. It seems clear to them that they cannot find solid evidence as to how much the rate of investment is restrained by rising interest costs. They recognize that internal financing often decreases the sensitivity of corporations to changes in the interest rate structure. After considering the different aspects of how corporations set their capital budgets, they conclude: p. 368 et seq.

> ". . . that while changes in interest rates and credit availability brought about by monetary policy have some marginal influence over business investment expenditures, these effects are so weak that they are commonly swamped by the dynamic forces of innovation, surging business activity, and rising profits which almost invariably underlie a rapid growth of investment. For example, it is very doubtful whether restrictive monetary policy did more than touch the fringes of the private investment boom of 1955-57." p. 375

The authors proceed to contemplate possible actions to improve on the countercyclical responses to general monetary policy. They mention the prewar experiment, a tax on undistributed profits, p. 397

The Contentions as to Impact (continued)

as one way to increase the influence of the interest rate. Means of controlling at the source the flow of funds into fixed investment are considered. But their conclusion expresses the uncertainty which must plague any analyst who studies this most difficult of all cyclical (and secular) problems: p. 398

> "We may conclude that, while the proposals referred to above and others as well are worthy of study, it is by no means clear that it would be either desirable or feasible to apply selective controls to business expenditures on plant and equipment. Some instability may be the price we have to pay for a generally high rate of capital development; moreover, it is by no means certain that controls would be effective in preventing instability." p. 398

A realistic conclusion, and one which at least implies that general monetary policy is now doing all that could be expected in this volatile sector, while preserving a system of economic freedom in the United States.

Moving to the behavior of consumers in the purchase of consumer durable goods, based to an important degree on consumer credit, the Report cites the sheep-like behavior of both lenders and borrowers, p. 389 which heightens the necessity for stronger countercyclical action, as well as the occasional eccentricities which produce other odd effects, as in 1955-56-57, mentioned in the quotation below:

> "It seems reasonable to conclude that, while general controls almost certainly have some effects on consumer credit, these effects are probably not very great. Moreover, there is another problem that arises when the movements in durable goods get out of phase with the economy as a whole--as in 1956-57 when the automobile industry was depressed at the same time that general business conditions were reasonably good. In such a situation, it may be desirable to tighten credit generally without having an effect on the depressed sector." p. 390

The case for selective controls on consumer credit is summed up quite impressively:

> "A boom in consumer durable goods, especially automobiles, powered by a rapid growth of consumer credit, in 1955, seems clearly to have been a factor in the inflationary expansion of 1956 and 1957, both through its effect on profits and on the three-year wage settlement

The Contentions as to Impact (continued)

> negotiated on the basis of them, and through its effects on other industries. Moreover, the excessive expansion in the automobile industry in that year set the stage for the unemployment and stagnation in that industry in the ensuing years... And, finally, the automobile expansion of 1955 undoubtedly helped to power the boom in plant and equipment in 1956 and 1957, which eventually resulted in overcapacity and unemployment... A similar burst of growth has occurred in 1959...and...is a matter for concern." p. 399

When the Report states that the Federal Reserve System has shown a "clear antipathy" toward selective controls, the adjective may p. 344 be inapplicable and the ~~reason~~ noun may be unfair, but, nevertheless, many people would agree. It might have been wiser for the System, years ago (1) to have described the kind of a statute which would work, (2) to have expressed its reluctant willingness to take on a difficult task, and (3) to have asked for carefully-drafted standby legislative authority. Not having done this, and having permitted the growth of this feeling of "clear antipathy," the System should reassess the situation and reformulate its attitude toward the use of consumer credit control devices.

The treatment of these three imbalance-generators is, on the whole, stimulating. On inventories, they point out the need for different kinds of approaches in order to produce stronger effects. With regard to plant and equipment expenditures, they do the same thing, but they are realistic in recognition of the virtual impossibility of ever reaching a full solution. Stated another way, it might be said that the authors have the common sense to realize that in a system of highly-capitalized production techniques one cannot expect perfect long-range forecasting of final markets. Then in the field of consumer credit they expose the problem so clearly that the Federal Reserve will undoubtedly have to take a new look at an old attitude, or, if the public has misunderstood the Federal Reserve position, explain the position with greater clarity.

Monetary Policy Since World War II

A sketchy, unsatisfactory, and sometimes inaccurate account of the monetary policy of recent years is found between pages 315 and 343. When one sees a statement like the one quoted below, it tends to lessen interest in the rest of the narrative. Referring to the firming ordered by the Federal Open Market Committee in early 1955, it is said:

> "This was the first move toward the application of a restrictive monetary policy which was to be

Monetary Policy Since World War II (continued)

> applied continuously and with generally increasing intensity, until late in 1957." p. 332

For the authors to have missed the controversial policy zigzags of 1956 is not conducive to eager readership and it is not understandable because they mention these 1956 uncertainties twenty-eight pages later. p. 360
Their conclusions are unprovable, somewhat inconsistent, and contribute nothing to an understanding of the flow of events. For example, what should one understand from these two generalizations, only a few lines apart:

> "Monetary policy has been more restrictive thus far in the 1958-59 (sic) than in the same phase in 1954-55." p. 344

Only a few lines before:

> "When restrictive policies have been applied, their general effectiveness does not appear to have been great, due to the fact that the slowing down of the growth of the money supply has been accompanied by induced increases in velocity." p. 343

Following this unsatisfactory, little, historical narrative, there are a few pages on "some limitations on the overall effectiveness pp. 344-
of monetary policy." 362 The shifts of bank assets from loans to securities and back again throughout the course of the business cycle are briefly discussed, as are the cyclical adjustments in corporate liquidity, the activities of financial intermediaries, and the cyclically-varying investment policies of investing groups.

These phenomena, which they call "slippages," soften the ef- p. 359
fect of restrictive Federal Reserve policies. It is not clear, in this summary, whether they think this is useful or not. What seems to come p. 362
out of the discussion is that the general monetary policies are weakened by these institutional escape hatches but that the restrictive effects could not safely be any harsher anyway. This leads them, finally, to:

> "...in light of the structure of the economy and the nature of present-day problems, renders exclusive reliance on general monetary controls an unsatisfactory way of achieving sound stabilization objectives." p. 362

Another matter which is touched on very briefly as a further limitation on general monetary policy is the time lag. Here again the p. 393
analysis is superficial, seeming to ignore, for example, the meaning of all of the preliminary stimulative or restrictive signals which are hoisted before a quantitative change in the money supply appears.

Monetary Policy Since World War II (continued)

Certain of the techniques of Federal Reserve policy require re-thinking and overhauling, the authors feel:

> "Apart from the matter of selective controls, there is some question whether the Federal Reserve System has made optimal use of the general credit control weapons now at its disposal... In addition, some changes in the administrative organization of the System are worthy of consideration." p. 405

The discount rate philosophy, a mystery to so many students of the System, is brought up first:

> "It is not always clear when a change in the rate is meant to be a signal and when it merely represents a passive adjustment to the market." p. 405

Pending further enlightenment by the Federal Reserve as to what the discount rate philosophy really is, two alternative suggestions are tossed into the pot, (1) the Bank of Canada's link to Treasury bills, and (2) the elimination of rediscounting altogether.

Alternative use of the reserve requirement weapon and the open-market weapon is discussed. Explanations offered to date by the System as to why reserve requirements have not been raised during recent cyclical upturns have seemingly not been entirely convincing to the authors, as they have not been to some other analysts: pp. 423-424

> "Reserve requirement adjustments are a rather cumbersome tool of short-run monetary policy, and there is very little that they can accomplish that cannot be done with more finesse by means of open-market operations. However, it is not clear why the System has been adjusting reserve requirements downward secularly nor where it thinks they should eventually come to rest. Lower reserve requirements ...improve the profit position of the banking system..." p. 406

Next technique to be questioned is "bills only." The Report calls for a clarification and takes a stand in favor of extended System responsibility in the market:

> "The policy should clearly be abandoned in its present rather doctrinaire form... The Federal Reserve should certainly take some responsibility for the structure of interest rates." p. 406

Here is the astonishing situation wherein these authors, and other analysts, are critical of the System on the grounds of what it says

Monetary Policy Since World War II (continued)

it does, whereas what it actually does is probably more or less in line with what the constructive critics want it to do--a remarkable communications lapse.

Turning to administrative arrangements, two big questions are raised, (1) would it not be better to have all of the credit control weapons in the hands of the same agency, and, referring to the Open Market Committee, (2) "...some streamlining of this complex machinery..." Getting more specific: p. 407

> "some streamlining of this complex machinery would seem to be in order... Perhaps a reduction of the size of the Board of Governors and the concentration of authority with respect to all of the policy weapons in the hands of this group...would be desirable. Some reform along these lines is vitally necessary if a more complex policy involving the use of selective controls is to be put into operation." p. 407

However one may feel about such unprovable dicta as those in the last sentence above, it is true that many basic changes have been proposed by responsible people in recent years. It would seem that the System should at least have its own thoughts well organized on such questions, as perhaps it has. The public should be told about them at an appropriate time.

A little further along in the Report, the techniques whereby the Federal Reserve System occasionally aids the Treasury in debt management are under discussion. The authors nonchalantly come out with one of those sweeping proposals which make the Report look amateurish in certain places:

> "There is something to be said for emphasizing debt lengthening operations in periods when interest rates are low in order to keep down the Treasury interest costs. If operations timed in this way should interfere with economic stability, the Federal Reserve System should be prepared to offset these effects by appropriate action. In this connection, it would be desirable for the Federal Reserve to abandon the bills-only policy and be prepared to offset in the most effective way possible any undesirable effects which might be produced by Treasury debt management operations following the suggested pattern." p. 419

Have they thought out the meaning and after-effects of "appropriate action?"

CONFIDENTIAL (F.R.) January 6, 1960.

A COMMENT ON "REPORT ON EMPLOYMENT, GROWTH AND PRICE LEVELS" OF JOINT ECONOMIC COMMITTEE STAFF

The "Report on Employment, Growth and Price Levels" prepared by the staff of the Joint Economic Committee for the consideration of that Committee includes, among other contents, a lengthy descriptive analysis and appraisal of postwar monetary and debt management policies, with a number of critical conclusions as to the conduct of those policies. The aim of this note is to point out and discuss one particularly significant fallacy in the premises underlying this appraisal, without attempting to present a thoroughgoing critique of the entire discussion of the subject.

The descriptive analysis of actual developments is on the whole competently done, although some significant aspects are neglected and fault may be found with the tone and slant of some of the treatment. Conclusions as to the effectiveness of monetary policy and debt management and recommendations as to changes that might be made appear throughout the Staff Report, are summarized from time to time, and are frequently repeated in the other chapters, as well as in that dealing specifically with the subject. In many cases -- perhaps most -- the conclusions and the recommendations do not follow logically from the descriptive analysis of the events and are not adequately supported by facts or reasoning. Nor is it demonstrated how the changes in procedures recommended would correct the deficiencies mentioned. The more significant conclusions are threefold:

(1) Monetary controls are generally not effective in contributing to economic stability because of other factors which affect aggregate demand and which are reflected in the velocity of money. These include the holding and use of liquid assets other than money and the operations of various financial intermediaries (although as to the latter the report tends to play down their significance).

(2) The effects of monetary policies on different sectors of the economy are irregular, partly because of varying degrees of sensitivity in their response to interest rate changes. Effects of monetary policies appear to be most pronounced in residential building and to some extent in the financing of State and local governments and of small business, but are weakest with respect to business fixed capital, inventories, and consumer credit, which are alleged to be the greatest contributors to instability.

(3) In those sectors of the economy characterized by rigidly administered prices, general monetary controls are likely to result in curtailment of output and employment. This is an unsatisfactory way of controlling inflation.

Specific suggestions in the Staff Report are not precise or definite. The logic of the analysis indicates a bias toward greater use of selective controls, rather than general instruments of monetary regulation, but there is no specific development of a case for selective controls. Among selective controls mentioned, particular emphasis is given to business fixed investment and inventories, in addition to consumer credit and mortgages, which are commonly considered as the appropriate areas for selective regulation.

The Staff Report contains some vague and qualified suggestions for possible changes in System operating techniques with respect to the discount rate, reserve requirement changes, and "bills only". It also suggests that the administrative machinery of the System should be streamlined. No evidence or analysis is presented to show how these suggestions would correct the deficiencies mentioned elsewhere in the report. One recommendation that may be significant is that the interest rate ceiling on Treasury bonds should be repealed, but this suggestion is always accompanied by a proviso that "modification of the policies that led to the present situation is a matter of much more pressing importance".

Fallacious Underlying Premise -

Aside from many deficiencies with respect to details, the major criticism that may be made of the Report's appraisal of the effectiveness of monetary policy is that it is primarily based on an incorrect major premise. This premise, which is implied throughout and is specifically stated at times, is that the function of monetary policy is to control the total volume of credit -- presumably in a manner that will accomplish desirable social objectives, such as growth and full employment. A minor premise, that is questionable, is that monetary policy exercises its controls principally through interest rates.

On the basis either of actual developments or of deductive reasoning, it can be readily demonstrated that monetary policies have not accomplished and could not effectively accomplish the broad function of controlling the total volume of credit. The Staff Report's criticism of monetary policy is largely based on this limitation.

The Report fails to recognize that the area in which monetary policy operates is limited to supplying, or enabling the commercial banking system to supply, the money that the public wants and is willing to hold as cash balances. The Report contains a comprehensive analysis of the functioning of financial intermediaries and the use of money substitutes and points out the difficulty of controlling these elements through monetary policy. There is no recognition of the fact, however, that it is not a part of the task of monetary policy, strictly speaking, to control these areas.

Bank credit needed to supply the appropriate volume of cash balances is a relatively small part of the total volume of all credit that is supplied out of all savings in the course of time. Annual rates of increase in the money supply, excluding time deposits, have averaged about $3 billion in the past decade; they are unlikely to exceed $6 billion in any one year and annual decreases are rare. Annual increases in the total of all credit have ranged in the past decade between $30 billion and somewhat more than $50 billion, with an average of nearly $40 billion. One of the serious omissions in the Staff Report is that it does not point out or recognize the significance of these relative magnitudes.

This total of all credit supplied is determined by the amount of individual and business savings available for lending. Monetary policy operations, to be sure, might affect the supply of lendable funds by permitting an expansion of bank credit, but if this expansion provides more money than the public wants to hold as cash, that money in being put to use can have a multiple effect on the flows of both money and the demand for goods. This process can continue until savings held in cash increase sufficiently.

Changes in rate of monetary turnover can occur independently of monetary policy actions. Either these changes or those resulting from attempts to expend money beyond the willingness of the public to hold cash are not, as alleged in the Staff Report, an evidence of weakness or ineffectiveness of monetary policies. They are, instead, factors that are largely outside the area of monetary policy control but must be taken into consideration at any given time in determining monetary policy actions. If velocity of cash holdings increases, then less money is needed and less should be supplied; if the public wants to hold larger amounts of cash and velocity declines, then more money should be made available. Monetary policy in recent years has been conducted according to this criterion.

Essential for sustained and stable growth of the economy is an expanding volume of investment and saving -- in appropriate balance with consumption. Monetary creation can contribute only a very small portion to the total needed. The bulk of the saving must come from current income in order to maintain a balance between demand and output.

Monetary policies can to some extent influence but cannot control the volume of saving. Easy money certainly is no inducement to saving. Creating additional money and arbitrarily lowering interest rates would discourage saving. Inducement to saving can be effected only by permitting interest rates to reach the level that brings demand and supply into balance.

Many other factors than monetary policy influence and determine the volume of saving and also the allocation of saving among different channels of lending. Also many other factors determine the aggregate volume and composition of borrowing demands. "Tight money" and rising interest rates are generally not caused by monetary policies but by the growth of total borrowing demands at a faster pace than savings available for lending. For example, of the expansion in the annual increase in total debt from about $40 billion in 1958 to about $55 billion in 1959, very little, if any, could have appropriately been met by expansion in the money supply -- the existing supply, which was increased greatly in 1958, was being used more actively in 1959 and was fully adequate to meet current cash needs. What was required under the circumstances was more saving.

Similarly, monetary policies cannot be blamed -- as is done in the Staff Report -- for the diminishing availability of residential mortgage financing. The principal real reason is the acceleration of other borrowing demands. To some extent, monetary expansion in 1958 made more funds available for mortgages, but the decline in other borrowing demands was perhaps a more important factor, and in any event the monetary expansion could not be continued at the rapid 1958 rate. For the same reasons monetary policies can have but limited and indirect effects upon the availability of funds for State and local government borrowing or for investment in corporate fixed investment. Monetary policies more directly influence availability of short-term bank credit to business, but cannot determine the amount of total credit allocated by banks to this purpose.

General monetary instruments cannot determine the proportion of the total credit supply that goes into consumer credit. Monetary policies, together with customary institutional practices and the pressures of other demands, might to some extent limit the aggregate volume of funds available for such use. Finally, monetary policies cannot make credit available for specific purposes without affecting the total volume of credit and money. This is true because of the potential multiple expansion of bank reserves and because of the ready flow of money from one use to another.

Conclusion -

It might be said that what the Staff Report is groping for, without realizing it and certainly without recommending it, is a system of total credit control, which should be distinguished from monetary control. The latter necessarily operates in a limited area, the scope of which is determined by the need for cash balances. It can and does influence other types of credit and interest rates, but cannot be expected to control either the aggregate amount or relative magnitudes of such credits or the level and structure of interest rates. In fact, the influence of monetary policy on over-all credit is best exercised by permitting interest rates to move flexibly in response to market forces, not by attempting to maintain any rigid level or structure of rates.

Control of the total volume of all credit and of its distribution among different types and uses would be a much more formidable task. The possibility of doing it effectively and maintaining a free enterprise economy is highly questionable. Whether, if attempted, such a control should be determined and administered by a single agency or by separate agencies operating in different areas is an important question. There may even be reasonable doubt as to whether such credit controls, if attempted, should be exercised by the same body that is responsible for monetary regulation. In any event this is a subject that needs much careful study before jumping at conclusions and trying to set up new machinery. In the meantime, monetary policy should not be expected to accomplish all the purposes that such credit controls might be designed to effect and should not be perverted from its true function in a vain attempt to correct all deficiencies in our economic structure or to direct the whole course of economic events.

WOODLIEF THOMAS

2/5

Margaret:

Gov. Balderston asked that I send a copy of this letter to the Chairman.

hbw

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UNIVERSITY OF NORTH CAROLINA

SCHOOL OF BUSINESS ADMINISTRATION

CHAPEL HILL, NORTH CAROLINA

OFFICE OF THE DEAN

February 3, 1960

Mr. C. Canby Balderston
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Canby:

In line with your request I have now gone through the Staff Report on Employment, Growth, and Price Levels. As I indicated, your request came at a time when I was in something of a time-bind but I have gotten back to the report whenever I could. You asked me to give you my reactions, whatever they might be, so here they are. I did go over the entire report but gather after doing so that your primary interest was in my reaction to Chapter 9.

Let me start by saying that I am very much disturbed by the attack which is currently being launched against monetary policy and the Federal Reserve. It seems to me to be gathering momentum and the push, unfortunately, is being helped by a good many people who are basically friendly to monetary policy but who are disturbed about some aspects of the present posture.

I think the general theme of Chapter 9 is summed up in Smith's statement: (401) "General controls are a mirage and a delusion. It is perhaps just as well that monetary controls have not been very effective; if they had been they might have been disastrous." I suggest this is very much like the bystander watching the fire department pour water on an out-of-hand four-alarm fire who suggests they turn the water off for a while since the fire doesn't seem to be going out while the drenching continues--and besides everything is getting all wet!

Smith's factual sections seem to me to be accurate enough but like so many other writings today they tell only a part of the story and leave the impression that monetary policy is not only inept in such periods, but also futile and, ultimately, mischievous in its effects. Smith's presentation is particularly effective because it is made without histrionics for the most part. The case that I see coming through the text of Chapter 9 takes the following sequential steps: (for periods of expansion)

1. A general tightening of monetary policy by the Fed
2. A general upward movement of interest rates
3. A growing pattern of leakages around monetary policy, e. g., commercial bank switch from investments to loans; shifts from banks to intermediaries, etc.
4. Consequent rise in velocity, thus offsetting general monetary policy
5. Further restrictions by the Fed
6. Higher and higher money costs stifling investment and output

This step-by-step denouement, as it is done in this chapter, gives every appearance of a reasoned recital of facts. What it does not explain is how deficiencies elsewhere than on the monetary front have compelled the System to take a posture much more "extreme" than it would have to have taken if these other policy areas had met their responsibilities. To illustrate: I don't think there is much doubt but that an even partially adequate fiscal policy would have taken much of the steam out of the velocity surge and then a moderate restraint from the side of monetary policy would have been feasible. To ride my illustration around the track once more: With those who should have been helping to put out the fire not only failing to use their own extinguishers but even at times pouring gasoline on the fire I don't see anything else monetary policy could have done except continue to drench the flame with all the tools it had at hand. Those who got splashed by the spray aren't going to like it and obviously haven't. But this still seems no reason to withdraw the firemen. I can see too who the fire chief in the midst of his four-alarm affair might not want to incur the wrath of the gasoline pourers and run the risk of their dumping a whole tankload of the stuff onto the structure, but I do think your own failure to disclaim capacity to do the <u>whole</u> stabilization job has contributed to the fix you are in now.

how?

The proposals in Chapter 9 for making monetary policy more effective strike me as largely fantastic. If I read the author correctly, he is here advocating a package of direct controls in the most naive fashion with no comment upon the complexities inherent in such efforts. I suspect that, as an old top-drawer price controller I have more than the average distaste for direct controls, but I think also that Smith is naively simple when he completely passes over the consequences of such a program--particularly in peace time.

a) in re plant and equipment expenditures, does he really mean to do away with interest costs as a deduction under the corporate income tax? This seems to be his thought. If this makes sense, why not eliminate deduction of other expenses? What connection is there between cyclical variations in money management problems and interest <u>as a deductible expense</u>?

Also in connection with plant and equipment expenditures, he apparently thinks well of an undistributed profits tax. We went through this once before and it seems to me a much clearer analysis of the effects of such a proposal should be proffered by Smith in rebuttal of our previous experience if he really means this proposal. Also is it intended to stimulate investment or deter it? Is it merely intended to force corporate profits out into distribution where the corporation must compete for them again? If so, does he feel these extra dividends would stimulate consumption? Would they be saved? Would they be kept in larger idle balances or effectively invested? How does all this relate to making monetary policy more effective?

In this connection (plant and equipment expenditures) he introduces the bills only argument. I won't comment since you have presumably heard all the arguments already. Why he introduces this in the present connection is not clear unless it is that he wanted you to know, at some point, that "in its present rather rigid doctrinaire form" it should be abandoned.

He is more forthright in advocating the removal of FHA-VA interest ceilings, saying "they probably" should be removed. But earlier he had noted that the interposition of your general controls and these institutional patterns had produced strong counter-cyclical effects. Why he now advocates their removal is not clear, particularly since he seems generally disposed toward more direct controls and later on advocates, e. g., direct consumer credit. It seems highly inconsistent of him to advocate selective consumer credit controls and at the same time oppose the FHA-VA apparatus which produces selective control for the construction segment.

I don't know how you feel about his other possibilities such as the proposal that insurance companies et al. be required to place reserves on deposit with the Fed and then apparently give you power to exercise discretionary power over the required level of such reserves. Personally, I think the Fed has about all the wash it can handle without taking on the insurance industry. I'm intrigued also by his proposal for cyclically varying depreciation allowances under the corporate income tax. Presumably he wouldn't have the Fed made these decisions, but with all of his subsequent mistrust concerning discretionary stabilization decisions this proposal, too, seems marvelously inconsistent.

b) in re consumer durable goods, he clearly wants you reconciled to direct controls over consumer credit. My OPA life makes me a biased opponent of such proposals. I wish he would explain how they can be made enforceable rather than simply dismiss this aspect by casually assigning responsibility to you.

c) inventory investment fluctuations which he also pegs for special treatment he apparently proposes to treat by "getting better control over bank loans." Just how this is to be done isn't clear, but he reintroduces the old discussions so familiar to you concerning variations in reserves required on loans as distinguished from investment, etc. I believe a careful reading of Abramovitz on Inventories might suggest that inventory fluctuations are not entirely the product of bank loan variations and "better control over bank credit" doesn't come just for the asking.

d) in the case of residential construction, as I have indicated above, Smith loses me completely in his proposal for elimination of the FHA-VA ceiling structure. Apparently great cyclical instability is preferred to some welfare concept which bothers him having to do

> with who gets housing. He seems to feel the wrong people are getting it now--a view he is certainly entitled to have, but how it relates to his general heading "making monetary policy more effective" is not clear to me.

And so the author of Chapter 9 concludes that general controls are a "mirage and a delusion" and that this is just as well because if they were not the result "might have been disastrous." In their place, or in their support(?) we are presumably to have direct controls as above, except where we take them off, as in the case of housing.

Monetary Policy and inflation--here he is concerned with the consequences of rigidities in cost and price and suggests that general monetary policy pressures induce output and employment reductions. Thus he concludes impact of general tight money anti-inflation policy will be reduced employment and output in rigid sectors and price reductions confined largely to non-rigid areas. This, as you folks know even better than I do, is an issue with largely political (i.e., how much unemployment in key and influential sectors can Washington tolerate?) complexion. An outsider is not much help on this kind of problem and this outsider is not competent. I wish though some attempt were being made to try to force to the front more economic assessment of the issues. On these grounds the case seems to me to be nowhere near so clear as it is to Smith (who presumably offers his views as an economist and not a political expert). For one thing it is economic nonsense to suggest that oligopoly firms and unions should be bailed out for their excesses by imposing on all the rest of the society a tax (in the form of a generally-permitted price inflation) in order to prevent curtailments of profits and jobs by firms and unions which have (presumptively by the oligopoly definition) been getting excessive prices and wages in relation to the rest of the economy where greater competition prevails.

Also do we ask the Department of Justice to take action or do we again make monetary policy carry the load for deficiencies in anti-trust, etc.? I would think that those who are using this theme to discredit general monetary policy might be invited by someone in the administration to give their testimony to the Department of Justice. In fairness to Smith I think he would agree with this conclusion, but it is unfortunate that he presents the theme at a point where he is hammering the idea that general controls are "a mirage and delusion" and this is "perhaps just as well."

Alternative proposals for monetary policy--these are presented as alternatives for those who find the direct controls unpalatable, it is said. And here comes the constant growth of money supply thesis a la Friedman and Shaw (with Shaw now withdrawing from his Arden House position, I believe). This thesis never has made any sense to me--all it seems to introduce is an element of predictability about the money supply, but I don't believe uncertainty with respect to the money supply has been demonstrated to be the cause of the business cycle. I suspect ebbs and surges of investment might still continue to be somewhat induced by varying expectations of income and other such things. And none of the inventory models I have seen have required that their fluctuations be attributed to the money supply.

The next proposal seems to be that "monetary policy should avoid the extreme anti-inflationary bias that has characterized its administration in the past few years." This strikes me again like the case of the bystander watching the fire department.

Techniques and administration--I confess a good deal of sympathy with Smith's conclusions in re the discount rate. There must be a whole package of points which can be made here that no one outside the System understands and I suspect I am walking into all kinds of obvious (to insiders) reasons why this discount rate technique must be kept as it is. But anyway--the discount rate is really twelve rates in spite of your effort in Washington to coordinate--the discount window seems to be a quite different thing from one district to another. If you feel that the discount function is an important service (is it really?) why not one uniform rate revised weekly to the bill yields on a national scale? From the little I know of your internal procedures there must be a tremendous amount of expensive energy spent debating these rates region by region.

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All in all I find this staff paper an incredible performance and particularly so because of its surface element of sweet reasonability and dispassionate appraisal. What it seems to me to condense to is:

1. A general indictment of general monetary policy, without
2. Any balancing introduction of the evidence on inadequacies in other general policy areas which have

forced monetary policy to overcompensate for such deficiencies.

3. No suggestion that a concerted effort to strengthen other general tools might, (a) make a moderate monetary policy effective, and (b) make reliance upon selective (and probably unenforceable) controls less necessary.
4. On the positive side a predilection for selective action, including:
   a) consumer credit control
   b) discretionary variation in depreciation allowances
   c) removal of interest as a deductible expense for tax purposes
   d) bills only be discarded
   e) insurance companies (and other intermediaries?) be required to place reserves on deposit with Federal Reserve
   f) discretionary power be given Fed to vary required level of reserves for such deposits
   g) differential reserves for loans and for investments, with discretionary modification of required level for each (or both).
5. But on the negative side he advocates doing away with selective VA-FHA interest ceiling which is producing countercyclical construction pattern.

I hope all this will be of some use to you.

Very truly yours,

Maurice W. Lee
Dean

MWL/ns