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SECOND REPORT ON THE CONDUCT OF MONETARY POLICY

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

together with

ADDITIONAL AND SUPPLEMENTAL VIEWS

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U.S. SENATE,
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS,
Washington, D.C., May —, 1978.

Hon. WALTER F. MONDALE,
President of the U.S. Senate,
Washington, D.C.

DEAR MR. PRESIDENT: Transmitted herewith is the Second Report on the Conduct of Monetary Policy, pursuant to Public Law 95-188 and oversight hearings held on April 24 and 25, 1978.

Sincerely yours,

WILLIAM PROXMIRE, *Chairman.*

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SECOND REPORT ON THE CONDUCT OF MONETARY POLICY

INTRODUCTION

The Senate Committee on Banking, Housing and Urban Affairs held its semiannual hearings on the Conduct of Monetary Policy by the Federal Reserve System, pursuant to Public Law 95–188 on April 24 and 25, 1978. Public Law 95–188, the Federal Reserve Reform Act of 1977, was signed into law by President Carter on November 16, 1977. It inserted into the Federal Reserve Act a new section, section 2A, which reads as follows:

GENERAL POLICY: CONGRESSIONAL REVIEW

> "SEC. 2A. The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates. The Board of Governors shall consult with Congress at semiannual hearings before the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives about the Board of Governors' and the Federal Open Market Committee's objectives and plans with respect to the ranges of growth or diminution of monetary and credit aggregates for the upcoming twelve months, taking account of past and prospective developments in production, employment, and prices. Nothing in this Act shall be interpreted to require that such ranges of growth or diminution be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions.

This section of the Federal Reserve Act codifies House Concurrent Resolution 133 which was passed by the Congress in March 1975.

At its hearings, the Banking Committee received testimony from five well-known economists, as well as from Chairman G. William Miller, testifying on behalf of the Federal Reserve. On April 24, 1978, the committee received testimony from two panels of witnesses. The first panel was composed of Dr. Otto Eckstein, president of Data Resources Inc. of Lexington, Mass., and Paul M. Warburg professor of economics, Harvard University; and Dr. Leonard Santow, advisor to the Board and senior vice president of the J. Henry Schroder Bank & Trust Co., New York, N.Y. The second panel of witnesses consisted of Dr. Donald Hester, professor of economics at the University of

Wisconsin, Madison, Wis.; Dr. Thomas D. Thomson, vice president and chief economist, Detroit Bank and Trust Company, Detroit, Mich., and Prof. Joan G. Walters, chairman, department of economics, Fairfield University, Fairfield, Conn.

On April 25, 1978, the Banking Committee received the testimony of Mr. G. William Miller, Chairman of the Federal Reserve Board of Governors. This marked the first appearance of Mr. Miller before the committee on the subject of monetary policy.

BACKGROUND

The regular quarterly reports on monetary policy by the Federal Reserve have brought monetary policy more into the public domain where it can be discussed and debated. At each quarterly hearing the Federal Reserve System's objectives and plan for the monetary and credit aggregates for the next 12 months are announced to Congress. These major monetary and credit aggregates—M_1 (currency, coin, and demand deposits), M_2 (M_1 plus time and savings deposits at commercial banks other than negotiable certificates of deposit), M_3 (M_2 plus time and savings deposits at savings and loan associations, mutual savings banks, and credit unions), and bank credit (total commercial bank assets)—are intermediate targets of monetary policy, that is, they link the Federal Reserve's monetary policy variables, such as required reserves and the Federal funds rate, to the ultimate targets of monetary policy, such as real GNP, employment, and prices.

Under the new law the Federal Reserve is required to report information about its plans and objectives for the upcoming 12 months. The requirements include the following:

1. The Federal Reserve's objectives and plans for the ranges of formation about its plans and objectives for the upcoming 12 months. (This means the growth rate ranges for M_1, M_2, M_3, and a credit aggregate selected by the Federal Open Market Committee for the period first quarter 1978 to first quarter 1979.)

2. The report to the Congress is to "take account of past and prospective developments in production, employment, and prices." This phrase is new in the reporting requirements for the Federal Reserve, having been added by Public Law 95–188. A reading of the committee report on the Federal Reserve Act of 1977 indicates that the intent of Congress in adopting this precise wording was to get quantitative information on the Federal Reserve's views as to the future developments of the ultimate goals of economic policy that could be used to assess the impact of the Federal Reserves monetary policy on the economy during the upcoming year. This information is critical, for without it the meaning of the monetary aggregate objectives is open to considerable speculation.

3. The Federal Reserve is expected to discuss past and prospective developments for long-term interest rates, a requirement that follows directly from the provision in section 2A of the Federal Reserve Act that establishes moderate long-term interest rates as one of the objectives of monetary policy.

The Federal Reserve's long-term growth rate ranges for the monetary aggregates as announced to the quarterly hearings held during the past 3 years are contained in the following table:

FEDERAL RESERVE SYSTEM 1-YEAR TARGET RANGES AND ACTUAL GROWTH RATES FOR MONETARY AGGREGATES

[Growth rates in percent]

Period covered	M_1		M_2		M_3	
	Target	Actual	Target	Actual	Target	Actual
1. March 1975 to March 1976	5.0–7.5	5.0	8.5–10.5	9.5	10.0–12.0	12.3
2. 1975:Q2 to 1976:Q2	5.0–7.5	5.2	8.5–10.5	9.5	10.0–12.0	12.0
3. 1975:Q3 to 1976:Q3	5.0–7.5	4.5	7.5–10.5	9.3	9.0–12.0	11.5
4. 1975:Q4 to 1976:Q4	4.5–7.5	5.7	7.5–10.5	10.9	9.0–12.0	12.8
5. 1976:Q1 to 1977:Q1	4.5–7.0	6.3	7.5–10.0	10.9	9.0–12.0	12.8
6. 1976:Q2 to 1977:Q2	4.5–7.0	6.6	7.5–9.5	10.7	9.0–11.0	12.4
7. 1976:Q3 to 1977:Q3	4.5–6.5	7.8	7.5–10.0	11.0	9.0–11.5	12.7
8. 1976:Q4 to 1977:Q4	4.5–6.5	7.8	7.0–10.0	9.8	8.1–11.5	11.7
9. 1977:Q1 to 1978:Q1	4.5–6.5	7.3	7.0–9.5	8.6	8.1–11.0	10.4
10. 1977:Q2 to 1978:Q2	4.0–6.5	N.A.	7.0–9.5	N.A.	8.1–11.0	N.A.
11. 1977:Q3 to 1978:Q3	4.0–6.5	N.A.	6.5–9.0	N.A.	8.0–10.5	N.A.
12. 1977:Q4 to 1978:Q4	4.0–6.5	N.A.	6.5–9.0	N.A.	7.5–10.0	N.A.

M_1=private demand deposits plus currency.
M_2=M_1 plus bank time and savings deposits other than large negotiable CD's.
M_3=M_2 plus deposits at mutual savings banks, savings and loan associations and credit unions.
N.A.=not applicable.

NOTE: Actual growth rate data are based on money supply series of the Board of Governors of the Federal Reserve System as revised in March 1978.
Prepared by Congressional Research Service, Library of Congress.

Unfortunately, the most important questions about monetary policy are not fully explained by reference to targeted and actual monetary and credit aggregate growth. The monetary policy plans and objectives of the Federal Reserve can only be judged by their intended effects on the economy. These intended effects can best be known by considering the rate of growth of real GNP, the level of the unemployment rate, and the rate of inflation that could be expected if the Federal Reserve were to follow its announced objectives and plans strictly. Section 2A of the Federal Reserve Act does not require the Federal Reserve to state its own projections for real GNP, unemployment, and prices consistent with its monetary aggregate growth rate ranges.

The committee recognizes that economic forecasting is an art, not a science, and that economic forecasts are susceptible to large errors and must be taken as likely outcomes of possible events rather than as predictions of fact. Nevertheless, the monetary policy oversight process is somewhat deficient if the Federal Reserve's monetary policy plans and objectives are not related to economic goals. It is not sufficient to know how M_1, M_2, and M_3 are expected or intended to behave. The important questions about monetary policy that should be addressed are: "How well did the economy perform in response to the FOMC's policy decisions?" and "How is the economy expected to perform in response to the FOMC's current policy plans and objectives in the months to come?" Furthermore, similar monetary policies undertaken in different economic settings may have significant differing impacts on the economy. This is an additional reason why the Federal Reserve should explain its policies in precise terms that can be easily understood and that relate to the economy.

Prior to the hearings, in an effort to get additional information for use by the committee members, Chairman Proxmire and ranking Minority Member Brooke wrote to Chairman Miller requesting that the Federal Reserve staff prepare a report on economic and monetary and credit conditions which would include a set of quarterly projections covering both the financial economy (that is, the monetary aggregates and credit flows to the various sectors of the credit markets such as the housing market and the markets for State and local and Federal debt) and the nonfinancial economy (GNP and its components—consumption, investment, government spending, and foreign trade). Such a report has been made available to the Congress on other occasions. In February 1969 Chairman William McChesney Martin included a very excellent staff statement in his testimony before the Joint Economic Committee. In so doing Chairman Martin indicated to the members of the Joint Economic Committee that it was his hope that the staff report would be helpful to the committee in assessing economic events.

In requesting the staff report for the committee, Senators Proxmire and Brooke said:

> We think that this exercise would provide the members of the Committee with valuable information about the economy and monetary policy, and that it would increase our understanding of the monetary policy process.

Prior to the hearings on the conduct of monetary policy, Chairman Miller replied negatively to this request. In his letter he indicated that he did not believe that publication of Federal Reserve staff projections would be in the public interest. He also indicated that staff projections would be interpreted as official Federal Reserve projections, particularly if such projections were to become a regular part of the quarterly hearings. None of the witnesses that testified before the committee on April 24, 1978, agreed with this assessment.

Chairman Miller indicated a willingness to search for ways to increase public understanding of monetary policy. Given this willingness to find ways to expand the dialog on monetary policy and the concerns raised about staff projections—which the Federal Reserve does not consider to be official projections—the committee believes that it perhaps would be beneficial for the Federal Reserve to provide the Congress with projections they consider to be official, so that there would be no misunderstanding of their status.

ECONOMIC OUTLOOK

Shortly before the committee's hearings the Commerce Department announced that the economy slowed substantially during the first quarter of 1978. Nominal GNP expanded at a 6.5-percent annual rate. However, real GNP (GNP adjusted for price changes) declined at a –0.6 percent annual rate, the first such decline since 1975. This poor performance was influenced by the cold winter and the prolonged coal strike. Nevertheless, it extended the trend that began in early 1977 of progressively slower real GNP growth in each successive calendar quarter (1977 Q1:7.5 percent; Q2:6.2 percent; Q3:5.1 percent; Q4:3.8 percent; and 1978 Q1:0.4 percent).

In general, the monetary aggregates followed a similar pattern, although the timing was somewhat different. Growth in the monetary aggregates was relatively rapid during the second and third quarter of 1977, but after that the growth rates declined significantly and continuously. The slowing of these growth rates reflected both the decline in the demand for cash balances arising from a slower rate of economic growth and the lagged effects of the 200 basis point rise in short-term interest rates during 1977.

The rate of unemployment declined by a full percentage point last year, from 7.4 percent in January 1977 to 6.4 percent in December

1977. After falling further in January and February of this year, the rate of unemployment increased slightly to 6.2 percent in March. Employment from January 1977 to March 1978 increased by about 4.5 million jobs. However, unemployment among youths aged 16 to 19 and minorities remains uncomfortably high.

After declining to 4.8 percent in 1976, the rate of inflation—as measured by the consumer price index—increased to 6.8 percent in 1977. Recent price data suggests that increases in consumer prices may be slightly larger during 1978. Especially troublesome have been the increases in the food component of the index during the first several months of this year. In addition, increases are projected by many economists in the overall index later on this year, due to such factors as the coal strike settlement, the increase in minimum wages, the increase in social security taxes, and the depreciation of the value of the dollar.

Manufacturing capacity utilization overall, and for most industries (output as a percent of manufacturing capacity), remains well below the inflationary levels attained in 1973 and 1974. After declining slightly during January and February, manufacturing capacity utilization rose in March to 82.9 percent, about the same level as attained during the latter two-thirds of 1977, but still only slightly above the level of 1 year ago.

Consumer spending has led this recovery and continues to expand. This has been financed by reducing the saving rate below that level probably desired by the consumer. The ratio of saving to income has averaged about 6.3 percent since 1960 but fell to slightly over 5 percent last year. The present very high ratio of consumer debt to income is an indication of the strained nature of consumer finances. In short, consumers may show signs of exhaustion at a time when business investment is having less than a normal cyclical upswing.

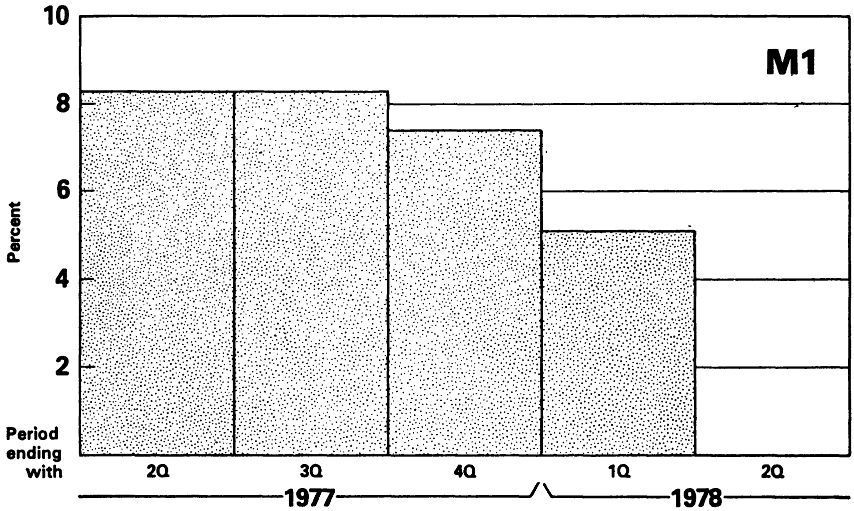
M_1 (currency, coin, and demand deposits) grew at an annual rate of 7.8 percent in 1977 compared to 5.7 percent in 1976. M_2 (M_1 plus saving and time deposits at commercial banks, other than negotiable certificates of deposit) growth in 1977 was 9.8 percent, somewhat less than the 10.9 percent rate of 1976. M_3 (M_2 plus deposits as savings and loans, mutual savings banks, and credit unions) grew by 11.7 percent in 1977, compared to 12.8 percent in 1976.

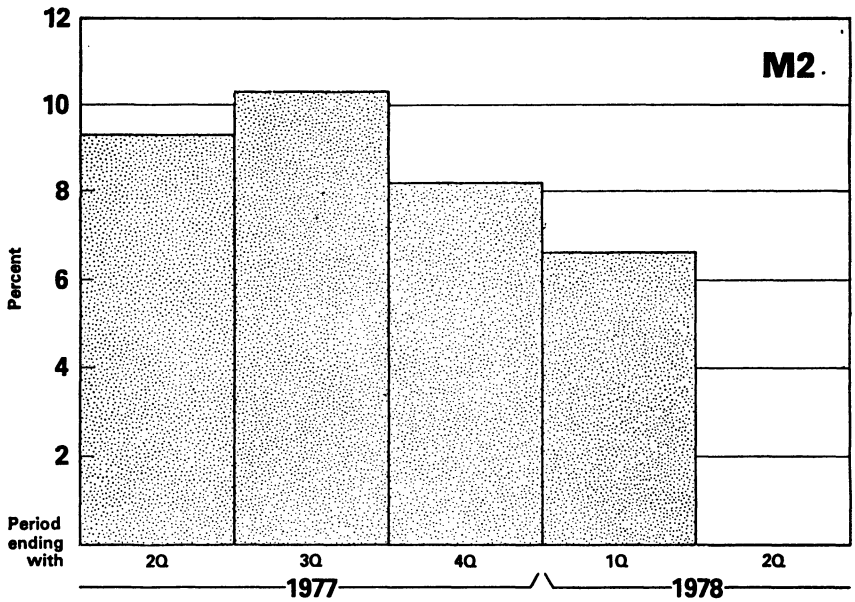
More recently, growth in all of the monetary aggregates has slowed substantially (See accompanying charts). During the last 6 months, from October through March, M_1 grew by only 3.9 percent and M_2 by only 6.1 percent. M_3 growth for the 6 months ending in February was 9.1 percent. The recent growth rates for M_1 and M_2 are below the growth rate targets recently selected by the Federal Open Market Committee which were as follows (for the period ending in the fourth quarter 1978): M_1, 4.5 to 6.5 percent; M_2, 6.5 to 9 percent; and M_3, 7.5 to 10 percent.

Short-term interest rates rose steadily during 1977. This rise has continued during early 1978. From April of 1977 to early April 1978, the Federal funds rate, which is the rate on short-term loans between banks and a key variable for Federal Reserve policy implementation, increased by 2.6 percentage points (or 62 percent) to about 6.8 percent. The 3 month Treasury bill rate has increased similarly, but by lesser amounts, to about 6.4 percent. Both of these rates are closely watched by people and corporations with short-term funds to invest. Also, both of these interest rates now stand at or above regulation Q ceilings on time and savings deposits (at both banks and thrift institutions) with maturities of less than 4 years. In recent months this has resulted in reduced deposit flows to savings and loan associations and mutual savings banks (See charts).

GROWTH OF MONEY STOCK, M1 AND M2, QUARTERLY

(Seasonally adjusted compound annual rates)



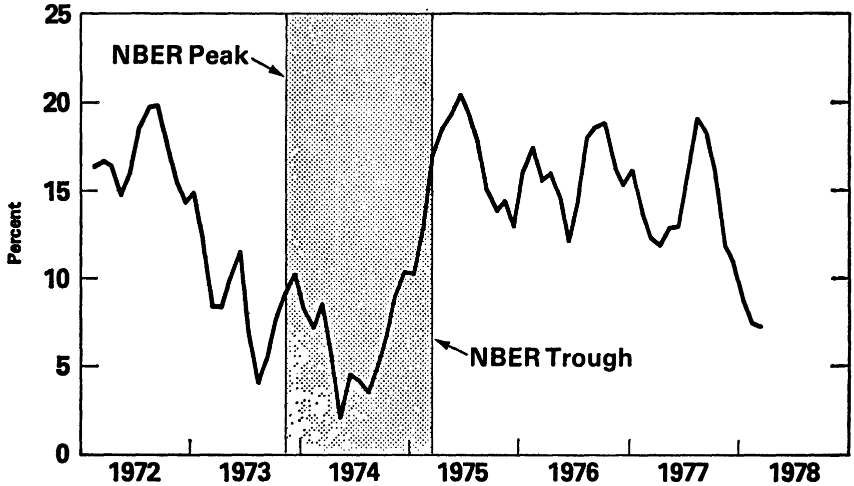


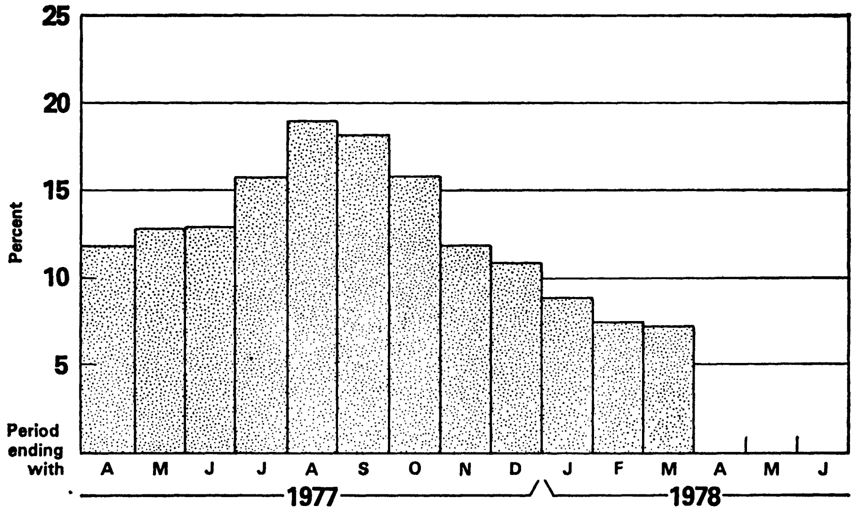
Data Source: Calculated from money supply series of The Board of Governors of the Federal Reserve System, as revised in March 1978.

Prepared by Congressional Research Service, Library of Congress

GROWTH OF DEPOSITS AT SAVINGS AND LOAN ASSOCIATIONS, CREDIT UNIONS AND MUTUAL SAVING BANKS, MONTHLY

(Seasonally adjusted compound annual rates)





Data Source: Board of Governors of the Federal Reserve System
Prepared by Congressional Research Service, Library of Congress

Long-term interest rates have risen during the past year, but by substantially less than short-term rates. Corporate AAA bond rates increased by about ½ percent since last April and now stand at 8.5 percent. Long-term government bonds have risen by a similar amount to about 7.6 percent. Municipal bond rates declined slightly over the same period, probably as a result of improved budgetary positions of many issuers.

The velocity of money—GNP divided by the money stock—was near its long-term trend rate of growth of 3 to 4 percent during each of the four quarters of 1977. During the end of 1975 and the beginning of 1976, the velocity of money had increased to abnormally high levels, peaking near 8 percent.

The value of the dollar in international markets declined significantly from mid-1977 through the first quarter of 1978. The cause of the decline in the U.S. dollar can be attributed to the high deficit in the balance of payments (current account—$20.2 billion in 1977) which itself is due to the very high levels of oil imports and the sluggish world demand for U.S. exports.

Conventional means of intervention to support the dollar—swap agreements under which the United States borrows foreign currencies from other governments and uses them to buy dollars—can have temporary influences on the path of exchange rate movements, but they cannot reverse the trend. If, by Federal Reserve intervention, the dollar is boosted a little on a given day, the effect is chiefly to give it a little further room to move downward the next day. Since the borrowed currencies must be eventually repaid, the failure of the swap agreements and intervention to stop the fall of the dollar will result in losses of money. The committee understands the administration's current policy is to intervene only to help reestablish order in disorderly markets.

During the fiscal year ending September 30, 1977, the Federal deficit was $45 billion. Current projections for fiscal year 1978 indicate a deficit of $53 billion. The proposed budget deficit for fiscal year 1979 is $51 billion, based on the first concurrent budget resolution.

Summary of Testimony: April 24, 1978

On the first day of the committee's hearings two panels of economists presented their views on the conduct of monetary policy.

The Wednesday before this hearing the Federal Reserve moved to tighten monetary and credit conditions by allowing the Federal funds rate to rise to 7 percent. In his opening statement Chairman Proxmire indicated his concern with this action by the Federal Reserve.

The witnesses were asked to comment on the Federal Reserve's action to increase interest rates at this time. Dr. Eckstein indicated that there is perhaps some room for interest rate increases from current levels, but that the margin for error is becoming increasingly small, with disintermediation being a real issue as the Federal funds rate approaches 7½ percent. Dr. Santow said that the tightening was difficult to justify, and that perhaps the Federal Reserve should have waited 2 months to get more information on the growth in the money stock, industrial production, personal income, and housing. Dr. Hester indicated similar concerns about a 7½ percent Federal funds rate and disintermediation. Dr. Thomson said that he was critical of the move by the Federal Reserve to tighten credit, that it was not needed and, given the lags in monetary policies effects, could be dangerous to the health of the economy between mid-1978 and mid-1979.

The witnesses were also asked for their views on the current economic outlook. In each case the witnesses suggested that the economic results for the second quarter of the year would be strong, snapping back from the weak first quarter that was due to cold weather and the coal strike. But after that, the consensus was that the economy would return to slower economic growth, with real GNP average growth slower than the 4.9 percent that was obtained in 1977. Dr. Eckstein's estimate of real GNP growth for the year ending with the first quarter 1978 was 4 percent. Dr. Santow's estimate for the same period was 3 to 3½ percent. While Dr. Thomson gave no specific numbers, he suggested that growth after midyear was not likely to accelerate appreciably.

The witnesses indicated their desire to see money grow near the upper end of the Federal Reserve's ranges in the second half of 1978 because of the pattern of real GNP they expected to see. Consistent with their GNP projections, Dr. Santow and Dr. Eckstein thought that M_1 growth should be in the 6- to 6½-percent range. Some of the witnesses stressed that the impact of currently higher interest rates on money growth at the end of the year would be to dampen that growth. They further added that the Federal Reserve should take into account both the weaker economic outlook and the lags of monetary policy in deciding upon their policy stance at this time.

Each of the witnesses was asked by members of the committee about their views on Federal Reserve reporting. Without exception all five witnesses indicated that they saw no problem with the Federal Reserve reporting their economic forecasts for real GNP, prices, and employment and unemployment to the committee. Dr. Eckstein said that the Federal Reserve should provide the Congress with more information on how they reached their conclusions about current monetary policy.

Dr. Santow suggested that the calendar year be fixed as the Federal Reserve targeting period so that the base-shift problem would not hamper understanding of monetary policy for the coming year. He also indicated to the committee that each quarter the Federal Reserve should indicate how well they are doing with respect to the fixed year targets.

Dr. Thomson said that, in his opinion, the fear of giving out Federal Reserve forecasts is greatly overdone. He added that, while he thought that the Federal Reserve staff did a fairly good job in putting their forecast together, the public would learn quite quickly that the Federal Reserve forecasts are not significantly different than the forecasts made by others in the public and private sector.

Dr. Hester said that in his opinion there would be no harm in the Federal Reserve releasing its forecasts. He also added that he did not think anyone should take the forecasts too seriously because of the large errors that are always made. However, he did indicate that in his opinion the Federal Reserve forecasts are essential for the coordination of Government policies generally.

Dr. Walters also had no objections to the release of staff forecasts by the Federal Reserve, and she added that she hoped the public is aware of the problems that are intrinsic in all economic forecasts.

Several questions were addressed to the witnesses about the relationship between interest rates, inflation, and Federal Reserve policy. Dr. Eckstein told Senator Lugar that there is no question in his mind that the goals of the Federal Reserve are simply more conservative than the goals of the rest of the Government. He added that the Federal Reserve cannot dictate to the rest of the Government or the country what the path of the economy should be. He said that when it attempts to do that, as it did in 1974, the result you get is a very severe recession. In his testimony, Dr. Eckstein indicated that the case against accelerating inflation is clear: physical capacity and labor are in ample supply both at home and abroad. Dr. Eckstein said:

> The critical question for monetary policy—and therefore for the economy—is this: how high can interest rates go before they unloose a cumulative disturbance in the financial system? In considering this question, it should be recalled that there is not a single instance of success in raising interest rates to moderate the economy without creating a major disturbance. The Federal Reserve has carried the policy too far every single time.

Dr. Hester said that he was very doubtful that the Federal Reserve has the tools to reduce the rate of inflation appreciably without inflicting unacceptable damage on capital market institutions and level of economic activity.

In response to a question about inflation causing recession, Dr. Thomson said that he did not hold this view. He said that the appropriate scenario may be that more rapid inflation results in tighter monetary policy, which in turn slows the rate of growth of real GNP.

In his testimony Dr. Eckstein indicated that Data Resources Inc. had performed a set of simulation experiments to test the implications of the various monetary policy scenarios for the coming year. He told the committee that the results of these experiments indicated that there is a zero probability according to the DRI model for money growth to be below the 4-percent bottom end of the M_1 target range currently adopted by the Federal Open Market Committee. He also indicated that there was only about a 25-percent chance that the targets would be exceeded during the coming year. He said that the current monetary target ranges would be the appropriate policy at this time.

In his recommendations to the committee, Dr. Santow suggested that the Congress, through the Budget Committees, should set targets each year for four variables: the budget deficit, the maximum increases to be allowed in Government spending, the path and level of the Federal funds rate, and growth in the money supply.

The recommendations made to the committee by Dr. Hester focused on the ability of the Federal Reserve to control the money stock. There were several technical problems in controlling the monetary aggregates that the Federal Reserve should be concerned about: the lack of uniform reserve requirements, different marginal reserve requirements on different size banks, the flow of funds from banks to their offshore branches and subsidiaries, and incomplete reporting by nonmember banks. He also told the committee that there is a need for reserve requirements to be imposed on deposit balances that American firms and their foreign subsidiaries carry with foreign branches of American commercial banks. Dr. Hester also indicated to the committee that there are growing problems with certain types of financial arrangements between banks and large corporate customers which are called "repurchase agreements." In these transactions the bank purchases idle funds from a corporation before the close of the business day, thus obtaining the use of those funds overnight, while returning them to the corporation at the beginning of the following business day. In this way these funds are never a part of the measured money stock but the bank has the use of them overnight and the corporate customer has use of them during the day. In his opinion these repurchase agreements should be treated as demand deposits, including the imposition of required reserves, and banks should be required to show such repurchase agreements on their call reports.

Dr. Thomson told the committee that the Federal Reserve needs more timely data on nonmember bank deposits to avoid the large types of data revision, such as those recently announced by the Federal Reserve for the money stock during 1977. He suggested that the current reporting system to Congress could be improved upon, and indicated that the moveable base where growth rate targets are calculated using previous quarter averages as the base from which the growth is calculated is procyclical, and that no attempt is made to get the level of the money stock back on path once it deviates. He suggested also that the Federal Reserve be required to report on its expected money growth for the next 2 years, as well as the growth for the current calendar quarter. His recommendation would also be that the Federal Reserve make explicit the complete economic outlook upon which its money stock projections are based—GNP, employment, inflation, and interest rates.

Dr. Walters told the committee that both consumers and businesses are uncertain and hesitant about the economy and government economic policy. In her opinion, the Congress, the administration, and the Federal Reserve should try to allay this uncertainty by clarifying the nation's economic goals. She told the committee that the public's expectations are influenced by monetary policy—both the announcement of the target ranges for the monetary aggregates and the failure of the Federal Reserve to achieve those announced goals. Dr. Walters also stressed to the committee the need for a more appropriate mix of monetary and fiscal policies favoring more fiscal constraint and moderate monetary policies.

Summary of Testimony: April 25, 1978

Chairman G. William Miller was the sole witness before the committee on the second day of hearings.

Chairman Miller told the committee that economic activity is rebounding from a slack period early in the year when economic activity was constrained by severe weather and the long coal strike.

He cautioned that while the prospects for economic growth appear to remain favorable, other prospects of recent economic performance reflect a fundamental problem with regard to inflation. He indicated that the recent increase in prices continues to be cause for concern. The rise in wholesale prices, at a 6.9-percent annual rate for the past 3 months, is well above the already uncomfortably high rates experienced last year. He told the committee that there is little reason to be optimistic about the outlook of achieving a significant reduction in underlying inflationary forces in the near future. He added that rising unit labor costs can be expected to continue to exert considerable upward pressure on prices, and that price pressures have been exacerbated by governmental actions. He also said that there has been the tendency by Government over the years to treat problems of individual sectors within the economy without adequate regard to the cumulative inflationary biases the programs have imparted to the economy.

The pronounced widening of the foreign trade deficit and the weakness of the international value of the dollar were indicated by Chairman Miller to be other disturbing aspects of current economic performance.

Chairman Miller indicated that the Federal Reserve welcomes the initiatives by President Carter in his recently announced program to help deal with the problems of inflation.

Chairman Miller indicated to the committee that for most of the current cyclical expansion, growth in M_1 has been well within the ranges established by the Federal Reserve. However, he added that growth in the monetary aggregates slowed during the latter part of 1977 and in the early months of 1978. This moderation has reflected in part the cumulative impact of restraining actions and the rise of short-term interest rates that began in the Spring of last year. The influence of interest rates has been most evident in the case of interest bearing components of the monetary aggregates, both M_2 and M_3.

With credit demands strong and the slowing of aggregate growth, the liquidity of banks and thrifts has come under some pressure recently. Despite the greater pressures experienced by the depository institutions, Chairman Miller told the committee that credit generally remains in ample supply.

Chairman Miller announced to the committee that the ranges of growth for the monetary aggregates adopted by the Federal Open Market Committee were the same as those that had been earlier announced for the year ending the fourth quarter of 1978. For the year ending the first quarter of 1979, this means that the FOMC's target ranges are as follows:

M_1—4.0 to 6.5 percent; M_2—6.5 to 9.0 percent; and M_3—7.5 to 10.0 percent.

In addition to adopting ranges for the monetary aggregates the FOMC also adopted an associate range for bank credit (that, is total commercial bank assets) that projects an increase between 7.5 and 10.5 percent over the next 12 months.

Chairman Miller told the committee that it was the consensus of the FOMC that expansion of the monetary and credit aggregates within the announced ranges would be consistent with moderate growth in real GNP over the coming year and with some further decline in the unemployment rate. He said, however, that the rate of increase in the average price level may be somewhat more rapid over the year ahead than it was in 1977.

These qualitative views were supplemented by Chairman Miller's own quantitative forecasts for the year ending the first quarter of 1979. These were:

Real GNP	4¼ to 5 percent;
Unemployment Rate	5¾ to 6 percent (by the end of the first quarter of 1979; and
GNP Deflator	6¾ to 7¼ percent

Chairman Miller's closing statement to the committee in his written testimony was that bringing inflation under control urgently requires the cooperative effort of the administration, the Congress, the Federal

Reserve, and the private sectors of the economy. He further added that the Federal Reserve should not be left to combat inflation alone.

In the question and answer period that followed the presentation of his prepared testimony, Chairman Miller and the members of the committee covered a wide range of topics. In response to questions about monetary policy, the following points were established:

The recent increase in the Federal funds rate was a response to increases in the growth of the monetary aggregates in recent weeks.

After an acceleration of real GNP during the second quarter, perhaps to a rate of growth of 6.5 to 7 percent, the rate of growth and real GNP during the second half of the year will moderate to around 4 percent.

A 3¼ percent rate of growth of real GNP is required for the unemployment rate to be maintained at any given level, that is, for unemployment to neither increase or decrease.

Further increases in expansion of real GNP will increase the level of capacity utilization, and impinge on certain areas where shortages exist.

The President's proposed tax cuts should be delayed for 3 months, and this would reduce the deficit for fiscal year 1979 by $8 or $9 billion dollars.

Structural aspects of the current unemployment situation are predominant and, therefore, it may be extremely difficult to reduce unemployment below the 5¾ to 6 percent in the near future.

If the President's tax cut is delayed for 3 months, the possibility exists for significantly lower interest accelerates.

The Federal funds rate might need to increase above the current 7-percent level if the money supply expands too rapidly, if the economy heats up, and if inflation exists.

It is very difficult to control monetary aggregates in the very short range, and it is a mistake to set very short-run target ranges for money and expect to fall within them.

Given a zero probability of monetary growth below the lower end of established growth rate ranges from M_1 and M_2, and the wide width of those ranges, consideration would be given to making the ranges narrower.

Capital formation could be increased effectively if there was a substantial liberalization in depreciation rules.

The dollar declined because of fundamental causes due to the balance of trade and our heavy dependance on imported oil. The dollar will be considerably stronger if, and only if, an effective and dedicated change in the fundamentals takes place.

The Federal Reserve is preparing a proposal to stop the erosion of the Federal Reserve membership and hopes to have it ready for comment by June.

Analysis of the Federal Reserve's Policy Plan

The Federal Reserve announced to the committee that for the first quarter of 1978 to the first quarter of 1979, its plans and objectives for the monetary aggregates call for growth of M_1 between 4 and 6½ percent, M_2 between 6½ and 9 percent, and M_3 between 7½ and 10 percent. These growth rate ranges are the same as those announced by the Federal Reserve to the House Banking Committee during the previous quarter for the one year period ending with the fourth quarter of 1978. However, the level of monetary aggregates in the first quarter of 1978 represents a very small increase over the levels for the fourth quarter of 1977. Consequently, by applying the same growth rates for one year periods beginning in these two consecutive quarters, the Federal Reserve's most recent set of targets represent a slower growth for money stock from the fourth quarter of 1978 to the first quarter of 1979 than would have been the case had money growth been faster during the first quarter of 1978. This development emphasizes the "base-shift" problem that is part of the current reporting requirements.

In addition to the slowdown in the rate of growth of the monetary aggregates in the first quarter, economic activity also slowed, with a negative rate of growth of real GNP for the first time since 1975. However, current information suggests to the committee that growth in both the economy and the monetary aggregates will snap back from relatively low rates of growth recorded in the first quarter to show relatively solid gains during the second quarter and moderate gains for the first half of the year as a whole. Thereafter, most of the economic forecasts heard by the committee indicate that real economic growth will decline to somewhere between the 3 to 4 percent annual rate.

During the week immediately preceeding the committee's hearings, the Federal Reserve took action in the money market to increase the Federal funds rate to 7 percent. In addition, toward the end of the week of Chairman Miller's testimony before the committee, the Federal Reserve tightened credit conditions somewhat further by aiming at a Federal funds rate of 7¼ percent. These two changes in monetary policy strategy increased short-term rates by one-half percent above the rate that had prevailed since early January.

For several reasons, the recent increases in the Federal funds rate to 7¼ percent seem somewhat premature. In the first place, the increase in the money stock observed during the past several weeks may be due to seasonal factors connected with the beginning of the calendar quarter and with the tax date falling on April 17 rather than on April 15. Both of these factors may have caused problems with the Federal Reserve's seasonal adjustment procedures. In addition, the faster rate of money growth reflected the rapid pickup in economic activity in recent weeks.

Economic conditions expected in the second half of this year would indicate that a tighter monetary policy at this time, given the lags between changes in interest rates and changes in the money stock, would result in somewhat slower monetary growth at the same time the economy is weakening. Such a slowdown in the rate of growth of money and credit would most likely tend to further dampen economic conditions, causing slower growth and higher unemployment.

Furthermore, with the Federal funds rate at 7¼ percent, the risks of disintermediation are greatly increased. During the past 6 months or so, the flow of funds into thrift institutions has already fallen off about one-third from the rate of deposit flows recorded a year ago. Although the thrift institutions are said to be in fairly good financial condition for this point in the business cycle, reduced deposit flows or actual deposit outflows could have rather quick and adverse effects on the housing market. Rising short-term interest rates would also result in higher mortgage lending rates.

Finally, the increase in the Federal funds rate is unlikely to have any real effect on inflation. Although inflation has worsened somewhat, with the administration raising its estimate of inflation for this year to 6¾ to 7 percent, the type of inflation we are experiencing is related more to supply and structural problems than to excessive demand. In this situation it is doubtful that the Federal Reserve's actions to increase interest rates could do much to improve the inflation situation. The committee recognizes that some of the factors increasing the rate of inflation are related to increases in minimum wage, higher farm support prices, the coal strike settlement, higher social security taxes, and likely settlements in wage contracts that are coming due this year and next year. The Federal Reserve should realize this also.

The committee hopes that the programs announced by President Carter and cooperation from the Congress, business, and labor would help the Federal Reserve to control inflation without the need for an excessively tight period of monetary restraint. There is no doubt that the Federal Reserve could tighten monetary and credit conditions sufficiently to reduce the rate of inflation, but that would cause serious distortions in the economy with resulting high interest rates, a housing crunch, and higher unemployment. Such a course of action is not in the best interests of the Nation. Monetary policy must be exercised with care if a recession is to be avoided.

The relationship between the Federal Reserve's announced policy intentions, and past and prospective developments with regard to the rate of growth of real GNP, unemployment, and prices give only moderate clues as to the Federal Reserve's intentions with regard to the goals it is trying to foster. It is obvious to the committee that the Federal Reserve is giving added weight to inflation, even though it is understood that there is little the Federal Reserve can do about inflation, short of forcing the economy into significantly slower growth. Given the complex lags between monetary policy actions and their effects on the economy, the committee believes that a better understanding of the Federal Reserve's policy intentions would be fostered by additional information from the Federal Reserve as to both the timing and the likely effects its policies will have in the future on such economic variables as the rate of growth of real GNP, the rate of investment, employment and unemployment, and inflation, and the position of the dollar in international markets.

Additionally, since at current interest rates it is likely that the flow of funds to the housing market may be adversely affected by monetary policy, and the demand for funds by the Federal Government is likely to be large through the remainder of this year and into next year because of the increasing deficit, the Federal Reserve would do well to explain the effects that its policies may have on both the flow of funds to the various sectors of the credit markets and the cost of those funds to borrowers.

The credit aggregate target adopted by the Federal Open Market Committee—bank credit—does not adequately explain monetary policy's intended influences on the credit markets broadly defined, since it reflects only a particular sector of those markets.

During the past year the unemployment rate has declined significantly as the number of jobs has increased by over 4½ million. However, with the unemployment rate at 6.0 percent of the labor force, there are still obviously many people looking for jobs. The committee is concerned by the remarks recorded in the Federal Open Market Committee's policy record for its meeting of March 21, 1978 relating to one member's views on the current unemployment situation. That policy record indicated that one member remarked that the unemployment rate "had come close to the zone that he would characterize as reflecting full employment, suggesting that there was less time than he had anticipated earlier for growth and output to diminish toward a rate that would be consistent that could be sustained for the longer term." (The complete text appears as an appendix to this report.)

Chairman Miller indicated to the committee that he expected the unemployment rate to drop only slightly between now and the end of the first quarter of 1979, perhaps to a rate around 5¾ percent at best. This rate of unemployment is significantly above the 4 percent level indicated as a desirable objective in the Full Employment and Balanced Growth Act of 1978—the Humphrey-Hawkins bill—currently being considered by the committee. By almost anyone's definition of full employment, 5¾ percent is still far from the rate of unemployment that would be considered an acceptable or desirable goal of economic policy.

The committee is also somewhat concerned about the views expressed by Chairman Miller with regard to the rate of growth of real GNP needed to maintain the unemployment rate at any given level. During the hearing Chairman Miller and Senator Sarbanes discussed this point in some detail and Chairman Miller indicated that he thought a 3¼-percent rate of growth of real GNP would be sufficient to maintain the level of unemployment, that is, the rate of growth of real GNP at which unemployment would neither increase nor decrease. This estimate, or opinion, seems far below other estimates of the rate of growth of real GNP generally thought to be consistent with no change in the unemployment rate. For example, the original version of Okun's law held the rate to be 4 percent, and recent estimates by the Congressional Budget Office have put the rate at about 3.7 percent currently. These estimates are based on three factors: the rate of change in the labor force, the rate of change in the average workweek, and the rate of change in labor productivity. Thus, for example, labor force growth of 2 percent during the coming year combined with an increase in the average length of the workweek of 1 percent, and a 1 percent increase in productivity would indicate that a rate of growth of 4 percent in real GNP would be needed for the unemployment rate to remain unchanged. Chairman Miller's relatively low estimate of the sum of these factors, seems inconsistent with recent experience with labor force growth and increases in average weekly hours, unless the rate of growth of productivity during the coming year is extremely limited.

The size of the Federal deficit expected for fiscal year 1979 was widely discussed during the committee's hearings. It was generally suggested to the committee that the size of the deficit was far larger than had been previously experienced during this stage of the business cycle. The adverse inflationary effects of this size deficit were also noted by many witnesses. Chairman Miller's concern with the size of the deficit and the President's proposed tax cuts, and his suggestion that the tax cuts be delayed from October 1, 1978 to January 1, 1979, were also discussed at the committee's hearing. It is clear that the Federal Reserve is very concerned about the adverse inflationary effects that the deficit could have on the economy. Chairman Miller indicated that should the tax cut be delayed for 3 months, it was his opinion that the Federal Reserve could relax its relatively tighter monetary policy stance, with the possibility of importantly lower interest rates.

CONCLUSIONS

At this time the economic outlook is uncertain, as is the likely fiscal policy package to be decided upon by the Congress. This would indicate to the committee that the Federal Reserve's monetary policy plans and objectives should continue to be flexible in the months ahead. The reduction in the President's proposed Federal deficit for fiscal year 1979, and substantially weaker economic outlook for the last half of this year and early next year may allow for a less restrictive monetary policy by the Federal Reserve, and thus lower interest rates.

The unemployment rate is currently 6 percent, and with industrial output still far below levels that would indicate any intense inflationary pressures, there is still substantial room for improvement in the economy. While some slowdown of M_1 growth from the rapid pace of 7.8 percent experienced during 1977 appears justified, the committee received testimony that less than 6- to 6½-percent growth in M_1 might prove harmful for a continuation of the economic expansion. Moreover, it is unlikely that significantly slower growth in M_1 would have a perceptible effect on the rate of inflation. The Federal Reserve should carefully monitor developments with regard to output, employment and unemployment, and inflation in deciding upon an appropriate monetary growth during the period ahead.

There are two policy dilemmas confronting the Nation at this time. First, the rate of inflation is increasing while the outlook for the rate of growth in production and jobs is not strong. It would be desirable to reduce both the rate of inflation and the rate of unemployment simultaneously. However, the current mix of monetary and fiscal policies would seem to be working in the opposite direction. Fiscal policy at this point with a deficit of $51 billion projected for fiscal year 1979, could add to inflation, while the restrictive stance of monetary policy taken by the Federal Reserve recently may lead to slower growth in production and employment during the remainder of the year. The committee believes that a more prudent approach to policy to consider at this point might be a reduction in the size of the deficit and a somewhat less restrictive monetary policy.

The second dilemma is that inflation is in part the result of relatively low-productivity growth. Productivity might be improved if the rate of capital formation were to increase. However, a more restrictive monetary policy with rising interest rates would not be conducive to increasing investment expenditures. Higher productivity would reduce the rate of inflation, yet an easier monetary policy to stimulate investment would, according to the Federal Reserve, increase inflationary expectations.

This set of monetary policy oversight hearings underscores the need for an expanded dialog on monetary policy between the Federal Reserve and the Congress. The monetary aggregates alone are insufficient to understand how Federal Reserve monetary policies relate to both past and prospective developments with regard to employment, prices, real GNP growth, and productivity. Such factors as the flow of deposits to thrift institutions, the Federal budget deficit, and the level and increases in interest rates have important influences on the monetary policy decisions made by the Federal Reserve. In order to understand monetary policy, the Congress should receive from the Federal Reserve not only its plans and objectives for growth in the monetary aggregates but also its own quantitative forecasts of where the economy is likely to be over the next several quarters in response to monetary policy actions currently being taken. Also, the current reporting procedures which incorporate the shifting time frame from one quarter to the next make it more difficult to analyze exactly what the Federal Reserve policy prescription is intended to do. The committee believes that a sharing of additional information and the recognition of economic goals set by the Congress and the administration would assure a more logical and balanced approach to consideration of monetary policy.

Finally, the committee is very concerned about the current level of short-term interest rates and the move by the Federal Reserve to increase the Federal funds rate by three quarters of a percentage point recently. With the Federal funds rate at 7½ percent, disintermediation from thrift institutions becomes more and more of a threat each day. Current interest rates in the money market suggest that the availability of lendable funds at those institutions providing funds to the housing markets will decrease in the months ahead. The falling supply of mortgage money could lead to serious problems later this year and early next year. Clearly at this point the danger lies in excessive credit tightening by the Federal Reserve.

[Federal Reserve Press Release, Apr. 21, 1978]

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on March 21, 1978.

Such records for each meeting of the committee are made available a few days after the next regularly scheduled meeting and are published in the Federal Reserve Bulletin and the Board's Annual Report. The summary descriptions of economic and financial conditions they contain are based solely on the information that was available to the committee at the time of the meeting.

Record of Policy Actions of the Federal Open Market Committee

MEETING HELD ON MARCH 21, 1978

1. Domestic policy directive

The information reviewed at this meeting suggested that growth in real output of goods and services in the first quarter of 1978 had been adversely affected by unusually severe weather and by the lengthy strike in coal mining but that the underlying economic situation had changed little. It now appeared that growth in the current quarter had slowed from the pace in the fourth quarter of 1977, estimated by the

Commerce Department to have been at an annual rate of 3.8 percent. Staff projections suggested, however, that the shortfall in growth from the rate expected at the time of the February meeting would be about made up over the next quarter or two and that on the average over the four quarters of 1978 output would grow at a good pace.

The rise in average prices—as measured by the fixed-weighted price index for gross domestic business product—appeared to have stepped up in the first quarter from the annual rate of 5.4 percent estimated for the fourth quarter of 1977, mainly because of large increases in prices of farm products and foods. It was expected that over the remaining quarters of 1978 the rate of increase in prices would be below that of the first quarter but would remain above that of the fourth quarter of 1977. It was also anticipated that the unemployment rate would move downward gradually over the year.

In the first quarter, according to staff estimates, expansion in final sales in real terms had slowed much more than growth in output, and the rate of business inventory accumulation had picked up from the sharply reduced pace in the final quarter of 1977. Consumer expenditures for goods in real terms—which had grown at a rapid pace in the fourth quarter—apparently declined in the first quarter, at least in part because of the severe weather. Moreover, construction activity—public as well as private—was adversely affected by the weather.

The staff projections for the rest of 1978 suggested that consumer spending for goods in real terms would rebound in the second quarter and would continue to grow therafter—particularly in the fourth quarter, following the reduction in personal income taxes assumed to take effect on October 1. It was anticipated that business fixed investment would expand moderately, owing in part to stimulative modifications of the investment tax credit that were assumed to be retroactive to the beginning of the year, but that residential construction would begin to edge down after midyear in response to the less favorable mortgage market conditions that appeared to be developing.

In February the index of industrial production rose 0.5 percent, recovering more than half of the decline in January that was attributable in large part to the severe weather and to the coal strike. Unfavorable weather in some parts of the country continued to restrict output in February, and the ongoing strike held coal mining at a reduced level. Dwindling supplies of coal in some areas caused limitations on industrial use of electric power, but secondary effects of the strike appeared to have been small.

Nonfarm payroll employment increased considerably further between mid-January and mid-February. Employment in the service-producing industries continued to grow at about the average rate of the second half of 1977. In maufacturing the gain in employment was sizable for the third successive month, and the average workweek recovered part of the weather-induced decrease of January. As measured by the survey of households, total employment edged up in February while the labor force changed little, and the unemployment rate declined 0.2 of a percentage point to 6.1 percent—1.5 percentage points below a year earlier and the lowest figure since late 1974.

According to the Census Bureau's advance estimate, total retail sales in February had recovered only a small portion of the substantial decline of the month before, at least in part because of continuing unfavorable weather. Unit sales of new automobiles—domestic and foreign combined—rose 5 percent, retracing half of the January drop, and sales rose further in early March.

Private housing starts—which had declined from an annual rate of 2.20 million units in December to 1.55 million units in January—recovered only to 1.58 million units in February, as adverse weather apparently remained a significant inhibiting factor. Regionally, changes from January to February were quite diverse: Starts rose 43 percent in the North Central States and 5 percent in the West, while they declined 10 percent in the South and 39 percent in the Northeast.

The latest Department of Commerce survey of business spending plans, taken in late January and February, suggested that spending for plant and equipment would expand 10.9 percent in 1978, whereas the survey taken in late November and December had suggested an increase of 10.1 percent. However, the increment of 0.8 of a percentage point reflected a downward revision in the estimated level of spending for 1977. The expansion in 1977 now was indictaed to have been 12.7 percent, compared with the previous estimate of 13.7 percent.

The index of average hourly earnings for private nonfarm production workers was unchanged in February, after having increased sharply in January when higher minimum wage rates became effective. Over the 2-month period the index rose at an annual rate of 7.6 percent, about the same as the average rate of increase during 1977.

The wholesale price index for all commodities rose 1.1 percent in February, compared with 0.9 percent in January and an average rise of 0.6 percent in the preceding 3 months. In February the increase in the index for prices of farm products and processed foods was more than twice as large as the average for the preceding 4 months. Average prices of industrial commodities continued to rise at a somewhat faster pace than in the latter part of 1977.

In foreign exchange markets the trade-weighted value of the dollar against major foreign currencies rose sharply on March 9 and 10 in anticipation of the conclusion of discussions between the governments of the United States and Germany. In a joint statement on March 13, 1978, U.S. and German authorities announced that continued forceful action would be taken to counter disorderly conditions in exchange markets and that close cooperation to that end would be maintained. Included in the cooperative effort were an increase of $2 billion in the system's swap arrangement with the German Federal Bank, an arrangement for the U.S. Treasury to sell SDR 600 million (approximately $740 million) to purchase German marks, and a willingness of the United States to draw on its reserve position in the IMF (automatically available in amounts up to approximately $5 billion) if and as necessary to acquire additional foreign exchange. The authorities also announced that developments during the first quarter of 1978 would be particularly important in determining the course of economic policies in Germany directed toward the objective of noninflationary growth and that in the United States high priority would be given to swift and resolute action to conserve energy and to develop new sources. Nevertheless, market participants apparently were disappointed by the announcements, and the value of the dollar receded to about its level in the last few days of February.

The U.S. foreign trade deficit remained very large in January. Interpretation of the data for recent months had been complicated by the 2-month dock strike that had ended on November 29 and by changes in the method for compiling the statistics, but it appeared that imports had continued to rise along with expansion in economic activity in the United States, while exports had shown no upward momentum.

At U.S. commercial banks growth in total credit during February was close to the sizable rate in January and about in line with the average for 1977. In February bank holdings of Treasury securities expanded substantially following a series of monthly declines. However, growth of total loans slowed, reflecting a sharp contraction in loans to finance holdings of securities. Growth in real estate and consumer loans apparently slowed a little, while expansion in business loans remained at about the average pace in 1977. Large banks significantly expanded their lending to manufacturing companies and to wholesale and retail trade concerns, but their lending to public utilities declined as the utilities drew down their inventories of coal.

For nonfinancial businesses the general pattern of short-term borrowing in February was little changed from that in January. Coninued strong expansion in borrowings from banks was offset only in part by a further net runoff of outstanding commercial paper. Utilities accounted for much of the further decline in outstanding commercial paper issued by nonfinancial businesses.

At this meeting revised measures of the monetary aggregates incorporating the effects of new benchmark data for deposits at nonmember-banks and revised seasonal factors were available to the committee. These revised data, scheduled for publication on March 23, indicated that in February M–1 had contracted at an annual rate of about 1 percent. On the basis of the revised series, M–1 had grown at an annual rate of about 4¼ percent during the first 2 months of 1978 and about 7¾ percent during 1977. After revisions M–2 had grown at rates of about 4½ percent in February, 6¾ percent over the January-February period, and 9¼ percent during 1977.

Inflows to commercial banks of the interest-bearing deposits included in M–2 were about maintained in February, but they consisted almost entirely of large-denomination time deposits (in amounts of $100,000 or more) exempt from regulation Q ceilings on interest rates. Inflows of time and savings deposits subject to such ceilings slowed to a low rate, as yields on market instruments of comparable maturities remained above the ceiling rates throughout the month. To finance credit expansion in the face of the slowing in overall inflows of deposits included in M–2, large banks issued a substantial volume of negotiable CD's and raised a sizable amount of funds from nondeposit sources.

Deposit growth at nonbank thrift institutions remained slow in February. Like the savings and smaller time accounts at commercial banks, deposits at the thrift institutions continued to be adversely affected by competition from market securities. Only the longest-term deposits at the thrift institutions provided effective yields above those available on competitive market securities.

At its February meeting the committee had decided that operations in the period immediately ahead should be directed toward maintaining about the prevailing money market conditions, provided that the monetary aggregates appeared to be growing at approximately the rates then expected. Specifically, the committee had sought to maintain the weekly-average Federal funds rate around 6¾ percent, so long as M–1 and M–2 appeared to be growing over the February-March period at annual rates within ranges of 1 to 6 and 4½ to 8½ percent, respectively. The members also agreed that if growth in the aggregates appeared to be approaching or moving beyond the limits of their specified ranges, the operational objective for the weekly-average Federal funds rate should be varied in an orderly fashion within a range of 6½ to 7 percent. It was understood that in assessing the behavior of the aggregates, the manager of the system open market account should give approximately equal weight to the behavior of M–1 and M–2.

As the inter-meeting period progressed, it became evident that in February M–1 had contracted somewhat and M–2 had increased relatively little. Staff projections for the February-March period suggested that M–1 would grow at a rate below the lower limit of the range specified by the Committee and that M–2 would grow at a rate close to its lower limit. It also appeared, however, that the weakness in the aggregates might reflect the prolongation of the coal strike and the severe winter weather and thus would prove to be temporary. Against this background, and in view of recent developments in foreign exchange markets, the committee voted on March 10 to instruct the manager to continue aiming at a Federal funds rate of 6¾ percent for the time being. For the full inter-meeting period, the funds rate averaged 6¾ percent.

Market interest rates in general changed little over the inter-meeting period, reflecting the stability in the Federal funds rate and, apparently, more or less of a balance among developments affecting the public's expectations concerning monetary policy—namely, some slowing of the economic expansion and of growth in the monetary aggregates on one side, and some pick-up in the rate of increase in prices and continuing uncertainties in foreign exchange markets on the other. However, Treasury bill rates declined somewhat, in large part because of demands for bills from foreign central banks.

Borrowing by the U.S. Treasury remained relatively strong during the inter-meeting period. In addition to regular debt rollovers, $3.3 billion of securities were auctioned to raise new money—$3 billion of short-term cash-management bills and $300 million of bills added to the regular weekly and monthly auctions. Incoming data on Treasury receipts and expenditures and on the cash balance implied, however, that Federal financing through the first quarter would be significantly smaller than had been suggested in late January. Borrowing by federally sponsored credit agencies rose to $1.6 billion in February from the already expanded volume of $1 billion in January, in large part because of the midquarter financing of the Federal Home Loan Bank System.

Mortgage lending by private institutions apparently continued to slacken in February from the record pace of late 1977. At commercial banks the increase in mortgage loans was the smallest in about a year. In January, the latest month for which data were available, mortgage acquisitions by savings and loan associations slowed significantly. Also, mortgage lending commitments outstanding at these associations declined for the first time in 3 years.

In the committee's discussion of the economic situation and prospects, the members agreed—as they had at other recent meetings—that the expansion in activity was likely to be sustained throughout 1978. The range of views with respect to the average rate of growth in real GNP over the four quarters of the year was not wide. Half of the members present believed that real output would grow at about the rate projected by the staff; of the remainder, some thought that output would grow somewhat less than projected, and some thought that it would grow somewhat more.

One of the members who thought that growth in real GNP would fall somewhat short of the rate projected by the staff believed that the shortfall would be concentrated in the second half of the year. In his view, the second-quarter rebound in growth from the weather-retarded pace in the first quarter might be greater than projected by the staff, and the magnitude of that rebound—in conjunction with some acceleration in the rate of inflation—might generate forces that would adversely affect construction activity and consumer spending in the second half.

Attention was drawn to the considerable improvement in the employment situation in recent months. The pace of growth in payroll employment over the past 6 months was regarded as indicative of near-term strength in the expansion of output. One member remarked that the unemployment rate had come close to the zone that he would characterize as reflecting full employment, suggesting that there was less time than he had anticipated earlier for growth in output to diminish toward a rate that could be sustained for the longer-term. However, another member noted that the substantial decline in the unemployment rate in recent months—from 6.7 percent in November to 6.1 percent in February—reflected in part a sharp deceleration in growth of the civilian labor force. If, as he suspected, that deceleration proved to be an aberration in the statistics, the decline in the unemployment rate might well be reversed to some degree in coming months.

The Committee members agreed that the rate of price advance was likely to remain relatively rapid in 1978, and they expressed a great deal of concern about this prospect. The comment was made that the pace of increase in prices appeared to be accelerating in this country while decelerating in European countries. Several members observed that inflation led to recession, and it was suggested that the greater the inflation, the worse the ensuing recession. For that reason, it was suggested, special emphasis should be given to the committee's long-standing objective of helping to resist inflationary pressures while simultaneously encouraging continued economic expansion. It was noted that an effective program to reduce the rate of inflation had to extend beyond monetary policy.

At its meeting in February the committee had agreed that from the fourth quarter of 1977 to the fourth quarter of 1978 average rates of growth in the monetary aggregates within the following ranges appeared to be consistent with broad economic aims: M–1, 4 to 6½ percent; M–2, 6½ to 9 percent; and M–3, 7½ to 10 percent. The associated range for the rate of growth in commercial bank credit was 7 to 10 percent. It had also been agreed that the longer-run ranges, as well as the particular aggregates for which such ranges were specified, would be subject to review and modification at subsequent meetings.

In the committee's discussion of policy for the period immediately ahead, it was suggested that an easing of money market conditions would be inappropriate in light of the outlook for prices, the recent behavior of the dollar in foreign exchange markets, and the likelihood that the demand for money would strengthen substantially again as growth of nominal GNP picked up. It was also suggested that a firming of money market conditions in the absence of actual evidence of excessive growth of the monetary aggregates would be premature, given the weakness of recent economic statistics, the still unsettled coal strike, and uncertainty about the strength of the prospective rebound in economic activity. However, a number of members favored some firming of money market conditions during the inter-meeting period with a view to keeping under control the anticipated pickup in monetary growth, unless data for the first 2 weeks of the period suggested that monetary growth over the March–April period was likely to be significantly weaker than expected. There was also some sentiment for a slight easing if the incoming data suggested unexpected weakness in monetary growth.

These differences of emphasis notwithstanding, members of the committee did not differ greatly in their preferences for operating specifications for the period immediately ahead, and all favored a return to basing decisions for open market operations between meeting dates primarily on the behavior of the monetary aggregates. In its previous five directives the committee had called for giving greater weight than usual to money market conditions in conducting operations in the period until the next meeting.

For the annual rate of growth in M–1 over the March–April period most members favored ranges with an upper limit of 8 or 9 percent and a lower limit of 4 or 4½ perecent; one member indicated a preference for a range of 2 to 7 percent. For the growth rate in M–2 over the 2 months, the members' preferences for the upper limit ranged from 9 to 10 percent and for the lower limit from 5 to 6 percent.

All of the members favored directing open market operations during the coming inter-meeting period initially toward the objective of maintaining the Federal funds rate at about the prevailing level of 6¾ percent. Views differed somewhat with respect to the degree of leeway for operations during the inter-meeting period in the event that growth in the aggregates appeared to be deviating significantly from the midpoints of the specified ranges. Some members favored retaining the present range of 6½ to 7 percent for the funds rate but others preferred 6¾ to 7¼ percent and one advocated 6¾ to 7 percent. Some who wished to retain the 6½ to 7 percent range suggested an understanding to the effect that operations would not be directed toward a rate below 6¾ percent before the committee had had an opportunity for further consultation.

At the conclusion of the discussion the committee decided that growth in M–1 and M–2 over the March–April period at annual rates within ranges of 4 to 8 percent and 5½ to 9 percent, respectively, would be appropriate. It was understood that in assessing the behavior of these aggregates the Manager should continue to give approximately equal weight to the behavior of M–1 and M–2.

It was the committee's judgment that such growth rates were likely to be associated with a weekly-average Federal funds rate of about

6¾ percent. The members agreed that if growth rates of the aggregates over the 2-month period appeared to be deviating significantly from the midpoints of the indicated ranges, the operational objective for the weekly-average Federal funds rate should be modified in an orderly fashion within a range of 6½ to 7 percent. It was also agreed, however, that a reduction in the rate below 6¾ percent would not be sought until the committee had had an opportunity for further consulation.

As customary, it was understood that the chairman might call upon the committee to consider the need for supplementary instructions before the next scheduled meeting if significant inconsistencies appeared to be developing among the committee's various objectives. The members also agreed that in the conduct of day-to-day operations, account should be taken of emerging financial market conditions, including the conditions in foreign exchange markets.

The following domestic policy directive was issued to the Federal Reserve Bank of New York:

> The information reviewed at this meeting suggests that growth in real output of goods and services has been adversely affected in the current quarter by unusually severe weather and the lengthy strike in coal mining but that there has been little change in the underlying economic situation. In February industrial production recovered much of the decline of the preceding month, and nonfarm payroll employment increased considerably further. The unemployment rate declined from 6.3 to 6.1 percent. Retail sales picked up somewhat from the sharply reduced level of January. The pace of the rise in prices stepped up in February, reflecting large increases in farm products and processed foods. The index of average hourly earnings was unchanged, after having advanced sharply in January when higher minimum wages became effective.
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> The trade-weighted value of the dollar against major foreign currencies rose sharply in anticipation of the U.S.-German announcements on March 13. Subsequently, the dollar declined to about the level at the end of February. The U.S. trade statistics reported for January showed a continuing large deficit.
>
> M–1 declined and M–2 increased relatively little in February, apparently in part because of the economic effects of the coal strike and the severe weather. Inflows to banks of the interest-bearing deposits included in M–2 were about maintained, but the inflows were almost entirely into large-denomination time deposits exempt from ceilings on interest rates. Inflows to nonbank thrift institutions remained slow. Market interest rates have changed little in recent weeks.
>
> In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster bank reserve and other financial conditions that will encourage continued economic expansion and help resist inflationary pressures, while contributing to a sustainable pattern of international transactions.
>
> At its meeting on February 28, 1978, the Committee agreed

that growth of M–1, M–2, and M–3 within ranges of 4 to 6½ percent, 6½ to 9 percent, and 7½ to 10 percent, respectively, from the fourth quarter of 1977 to the fourth quarter of 1978 appears to be consistent with these objectives. These ranges are subject to reconsideration at any time as conditions warrant.

The committee seeks to encourage near-term rates if growth in M–1 and M–2 on a path believed to be reasonably consistent with the longer-run ranges for monetary aggregates cited in the preceding paragraph. Specifically, at present, it expects the annual growth rates over the March–April period to be within ranges of 4 to 8 percent for M–1 and 5½ to 9 percent for M–2. In the judgment of the committee such growth rates are likely to be associated with a weekly-average Federal funds rate of about 6¾ percent. If, giving approximately equal weight to M–1 and M–2, it appears that growth rates over the 2-month period will deviate significantly from the midpoints of the indicated ranges, the operational objective for the Federal funds rate shall be modified in an orderly fashion within a range of 6½ to 7 percent. In the conduct of day-to-day operations, account shall be taken of emerging financial market conditions, including the conditions in foreign exchange markets.

If it appears during the period before the next meeting that the operating constraints specified above are proving to be significantly inconsistent, the manager is promptly to notify the chairman who will then decide whether the situation calls for supplementary instructions from the committee.

Votes for this action:

Messrs. Miller, Volcker, Baughman, Coldwell, Eastburn, Jackson, Partee, Wallich, Willes, and Winn.

Votes against this action: None.

Absent and not voting: Messrs. Burns and Gardner.

2. Authorization for foreign currency operations

Paragraph 1D of the committee's authorization for foreign currency operations authorizes the Federal Reserve Bank of New York, for the system open market account, to maintain an overall open position in all foreign currencies not to exceed $1 billion, unless a larger position is expressly authorized by the committee. On February 28, 1978, the committee had authorized an open position of $2 billion.

At this meeting the committee authorized an open position of $2.25 billion. This action was taken in view of the scale of recent and potential Federal Reserve operations in the foreign exchange markets undertaken pursuant to the committee's foreign currency directive.

Votes for this action:

Messrs. Miller, Volcker, Baughman, Coldwell, Eastburn, Jackson, Partee, Wallich, Willes, and Winn.

Votes against this action: None.

Absent and not voting: Messrs. Burns and Gardner.

3. Procedural instructions with respect to operations under the foreign currency documents

Paragraph 1B of the procedural instructions with respect to the conduct of operations under the committee's foreign currency authorization and directive instructed the Manager to clear with the Foreign Currency Subcommittee or, under certain circumstances, with the chairman of the committee any transactions that would result in gross transactions (excluding swap drawings and repayments) in a single foreign currency exceeding $100 million on any day or $300 million since the most recent regular meeting of the committee.

At this meeting the committee amended paragraph 1B to raise the levels of gross transactions beyond which clearance is required to $200 million on any day and to $500 million since the most recent regular meeting, and to clarify its intention that the measure of gross transactions used for this purpose should exclude not only swap drawings and repayments but also purchases and sales of currencies incidental to such repayments. This action was taken to relax the dollar limits on gross transactions, which had on occasion hampered ongoing operations, and to remove an ambiguity in the language.

As amended, paragraph 1B read as follows:

> 1. The Manager shall clear with the subcommittee (or with the chairman, if the chairman believes that consultatation with the subcommittee is not feasible in the time available available):
>
> *   *   *   *   *   *   *
>
> B. Any transaction which would result in gross transactions (excluding swap drawings and repayments, and purchases and sales of any currencies incidental to such repayments), in a single foreign currency exceeding $200 million on any day or $500 million since the most recent regular meeting of the Committee.

Votes for this action: Messrs. Miller, Volcker, Baughman, Coldwell, Eastburn, Jackson, Partee, Wallich, Willes, and Winn.

Votes against this action: None.

Absent and not voting: Messrs. Burns and Gardner.

4. Review of continuing authorizations

This being the first regular meeting of the Federal Open Market Committee following the election of new members from the Federal Reserve Banks to serve for the year beginning March 1, 1978, the committee followed its customary practice of reviewing all of its continuing authorizations and directives. The committee reaffirmed the authorization for domestic open market operations, the authorization for foreign currency operations, and the foreign currency directive, in the forms in which they were presently outstanding. The committee also reaffirmed the procedural instructions with respect to operations under the foreign currency documents not affected by the action described in the preceding section.

Votes for these actions: Messrs. Miller, Volcker, Baughman, Coldwell, Eastburn, Jackson, Partee, Wallich, Willes, and Winn.

Votes against these actions: None.

Absent and not voting: Messrs. Burns and Gardner.

In reviewing the authorization for domestic open market operations, the committee took special note of paragraph 3, which authorizes the Reserve Banks to engage in the lending of U.S. Government securities held in the system open market account under such instructions as the committee might specify from time to time. That paragraph had been added to the authorization on October 7, 1969, on the basis of a judgment by the committee that in the existing circumstances such lending of securities was reasonably necessary to the effective conduct of open market operations and to the effectuation of open market policies, and on the understanding that the authorization would be reviewed periodically. At this meeting the committee concurred in the judgment of the Manager that the lending activity in question remained reasonably necessary and that, accordingly, the authorization should remain in effect subject to periodic review.

5. Agreement to "warehouse" currencies for the Exchange Stabilization Fund (ESF)

At its meeting of January 17–18, 1977, the committee had agreed to a suggestion by the Treasury that the Federal Reserve undertake to "warehouse" foreign currencies held by the ESF—that is, to make spot purchases of foreign currencies from the ESF and simultaneously to make forward sales of the same currencies to the ESF—if that should prove necessary to enable the ESF to deal with potential liquidity strains. Specifically, the committee had agreed that the Federal Reserve would be prepared, if requested by the Treasury, to warehouse up to $1½ billion of eligible foreign currencies, of which half would be for periods of up to 12 months and half for periods of up to 6 months. It was noted that the agreement to warehouse currencies would be subject to review by the committee at its organizational meeting each March in connection with the regular review of all outstanding authorizations. At this meeting the committee reaffirmed the agreement.

Votes for this action: Messrs. Miller, Volcker, Baughman, Eastburn, Jackson, Partee, Wallich, Willes, and Winn.
Vote against this action: Mr. Coldwell.
Absent and not voting: Messrs. Burns and Gardner.

ADDITIONAL VIEWS OF MESSRS. BROOKE, TOWER, GARN, HEINZ, LUGAR AND SCHMITT

We believe the monetary targets set by the Federal Reserve for the year ahead will provide ample room for sustaining the current economic expansion. At the same time, those targets set a realistic ceiling on growth in money and should be exceeded only at the risk of adding further to the problem of inflation.

We are, of course, concerned over the effect which higher interest rates could have on the course of economic activity. But recent efforts to tighten monetary policy reflect a failure on the part of the Federal Reserve to bring the growth in money down to noninflationary rates during previous months. This has forced the Federal Reserve now to attempt restrictive monetary measures as a means of countering an excessive rate of growth in money during the earlier period. This is an unfortunate turn of events about which we expressed concern in previous committee reports on the conduct of monetary policy, particularly in the committee's last report issued in December of 1977.

The rate of monetary growth since mid-March has exceeded by far the upper bounds of earlier set targets and has been in excess of what can be considered prudent under existing economic conditions. If allowed to continue, this rate of growth would add a new and powerful influence to higher prices throughout the economy. In the end, it would mean more inflation, an even more restrictive monetary policy in the future, and higher interest rates than those presently being experienced.

We also recognize the effect which deficit spending has had in frustrating efforts to reduce interest rates. However, there appears to be a growing awareness in the Administration, and apparently in the Congress also, of the need to bring deficit spending under control. In any case, we do not believe that monetary policy should accommodate and underwrite deficits of the magnitude now being envisioned. All too often in the past, monetary policy has accommodated large deficits in a shortsighted effort to force interest rates downward. The end result has only been a rapid expansion in the money supply, more inflation, higher interest rates and a disruptive reversal in monetary policy at a later date.

We do not believe that inflation is intractable. The rate of inflation was reduced significantly in 1976 and 1977, when the economy was making great strides toward full economic recovery. The need for prudence and caution is no less now than it was then. If anything it is even more important, now that the economy is closer to full employment than at any time in the last 3 years.

The fact that unemployment is higher than desirable, or that there is still some unutilized capacity remaining in the economy, should not be used as an excuse to pursue a monetary policy that is anything less than prudent, particularly when the inflationary risks are so high.

Much of our current unutilized capacity represents high-cost capital and would be expensive to operate. It cannot be expected to increase productivity enough to offset increasing labor costs. With this in mind, monetary policy should be conducted with a view to creating an inflation-free environment in which capital investment will be encouraged. This new capital is vitally needed if productivity is to be increased significantly over the period ahead. We must avoid using monetary policy to achieve short-run gains on the employment front at the expense of sustained economic growth and permanent jobs over the long run.

Public Law 95–188, and House Concurrent Resolution 133 which preceded it, set the proper tone, we believe, for the conduct of monetary policy. The Congress, in this legislation, called on the Federal Reserve to expand the monetary aggregates at rates that are in line with the economy's long-run ability to increase real output. That was an appropriate directive for the Congress to give the Federal Reserve at the time this legislation was enacted. We do not believe it should now be ignored when the economy is so susceptible to the threat of increased inflation.

Edward W. Brooke.
John Tower.
Jake Garn.
H. John Heinz III.
Richard G. Lugar.
Harrison Schmitt.

SUPPLEMENTAL VIEWS OF MR. SCHMITT

According to recent public opinion polls, inflation has become the public's number one concern. The rate of inflation, as shown in the Consumer Price Index for March of this year, was at an annual rate of 9.3 percent—a threshold point approaching the double-digit rates which seemed finally and permanently behind us only 14 months ago. According to the Council of Wage and Price Stability, inflation will in all likelihood remain at that level for the next several months.

The administration's response has been to ignore much of the inflationary pressure generated by a $50 billion to $60 billion deficit while asking the American people to forgo the wage and price increases, and tax reductions that will allow them to keep up with inflation. The Administration efforts are thus misdirected against the victims of inflation rather than the true cause, which is a long series of irresponsible fiscal policy decisions in this and preceding Administrations that have been supported by the Congress. Efforts at "jawboning" with business and labor on the subject of wage and price increases would be more likely to be meaningful if combined with policies that will reduce inflationary pressures generated by the Congress and the administration.

Among recent governmental actions which are contributing to inflation are the following:

I.

(1) New social security taxes for 1978 will add $6.8 billion to employers' payroll costs and therefore to the consumer's costs of goods and services. Over the next decade, the total increase in social security taxes will amount to $226 billion divided between employers and employees, according to the House Ways and Means Committee.

(2) Proposed energy taxes will mean higher fuel costs for utilities, industry and consumers, and continued dependence on high-priced foreign oil. According to testimony given by Treasury Secretary Blumenthal before the House Ways and Means Committee, under the Carter energy plan, if enacted as proposed, the American people would have faced $177 billion in new taxes by 1985. Other estimates are much higher than the administration's.

(3) The cost of compliance with unnecessary Federal regulations for the businessman and consumer alike represent purely inflationary costs. Regulatory costs do not add to the productive capacity of the business enterprise; they do not increase productivity nor generally add to the quality of goods and services produced. The following summary represents the estimates of the annual costs of some of the "big ticket" regulatory programs. (These costs reflect 1976 data):

Energy and environmental regulations-cost: $7.8 billion.
Consumer health and safety regulations-cost: $5 billion.
Regulation of financial transactions-cost: $1.1 billion.

Cost to the Federal Government administering its regulations-cost: $3.2 billion.

All other regulatory costs: $47.9 billion.

Costs to individuals and business of federally generated paper-work-cost: $34.5 billion to $41.5 billion.

The cost of federally generated regulations and the attendant paperwork annually add over $100 billion in inflationary pressures, according to a study by Murray Weidenbaum for the Joint Economic Committee.

(4) Business decisions are largley based upon business confidence in the future health of the economy. Decisions which require new capital formation are particularly sensitive to expectations for the future. At current rates of inflation and taxation, that confidence is missing. Businessmen are not certain that double-digit inflation may not be present in the near future, and this gives rise to caution when contemplating large investments. Tremendous cost overruns in capital projects in both business and government have become increasingly prevalent in today's economy. Inflation is an important contribution to this trend. As a result, job-producing investments are more frequently postponed or cancelled during economically uncertain times, with further detriment to long-term economic expansion.

Objective evidence of the economy's performance has not been encouraging. The Dow Jones average declined 14 percent in absolute terms during the "recovery" between January, 1977, and April, 1978. When inflation is taken into account, the decline is a substantial 23.2 percent, and this during a period of economic expansion in other areas of activity.

A recent poll of American business opinion by Gallup and the U.S. Chamber of Commerce produced the following results:

44 percent feel we will have mandatory wage and price controls in the next two years.

56 percent expect government to do a poor job of fighting inflation.

2 percent expect government to do a good job in managing the economy.

International opinion has shown a similar line of thinking. With the dollar at, or near, all time lows when measured against the other major world currencies, confidence in the sincerity of the administration's efforts to reduce inflation has never been less. European hopes that American dependence on foreign oil could be reduced have been disappointed by the absence of a noninflationary, production-oriented energy plan that could harness American technological know-how to establish energy self-sufficiency.

(5) Taxes. The administration's tax policy has failed to take into account the "ratchet effect" of inflation on the taxes Americans pay. As the rate of inflation increases, personal incomes also appear to rise. Yet as wages increase so, too, do the Federal income tax rates which wage earners and small businessmen pay. The inflationary cycle makes it practically impossible for wage earners to catch up. Pay raises which increase their earnings also increase their tax rate so that much of the raise goes right to the federal treasury. The result has been that since 1971, the federal government has reaped a hidden $36 billion in windfall taxes, according to James T. Lynn, former Director of the Office of Management and Budget. By 1980, this figure may increase by an

additional $40 billion. Thus, as the Administration continues policies that further the inflationary spiral, it finds itself reaping additional revenues.

MONETARY AND FISCAL POLICY

The current economic environment requires a careful mix of monetary and fiscal policies designed to bring about a gradual and steady reduction in the current unacceptable rate of inflation. We must establish trends today that will bring future long-term success.

A monetary policy that gradually reduces the rate of growth of the supply of money cannot alone bear the burden of fighting inflation. Too much restraint will result in higher rates of interest that can seriously affect the housing market, small businessmen, large capital intensive industries like utilities, and the economy as a whole. Neither should the Federal Reserve accommodate large budget deficits with an expansionist monetary policy that will only lead to further inflation and higher interest rates later. The Federal Reserve must give a clear signal to Congress and the Executive Branch that fiscal restraint is essential if the Nation is to avoid higher rates of inflation, or credit shortages, as a result of shortsighted fiscal policy. The Administration must summon the moral and political courage to gradually eliminate unnecessary and wasteful spending programs so that taxes can be gradually reduced. This will free valuable resources for investment in the private sector and will contribute greatly to economic expansion and the creation of more jobs. The Federal Reserve should be outspoken in informing the Executive Branch, Congress, and the public of governmental actions which will increase the rate of inflation, so that the inflationary impact of government programs may be more clearly recognized.

DEFICIT SPENDING

More of the burden of reducing inflation should be placed on fiscal policy. This can best be accomplished with further reductions in the budget deficit. Spending levels should be reduced significantly, while tax cuts to the productive, job-producing sector of the economy should remain in place to promote further economic expansion. Tax relief should move toward creating greater capital formation and long-term investment in greater research and development, and in technology that will lead to increasing productivity.

The committee report makes little reference to the unusual size of the federal deficit at this point in the business cycle. With the recession of 1973–74 now 3 years behind us, the economy is in much stronger condition. Traditionally, budget deficits tend to be reduced as the economy picks up and unemployment declines. Massive stimulus of the economy at this point will only fan the flames of inflation. Yet the President's budget contains at least a $50 billion deficit. This will have a strong influence on interest rates and/or the money supply, placing pressure on the Federal Reserve to tighten credit to avoid further long-term increases in inflation. The immediate effect of the massive Treasury borrowing needed to finance this deficit is to reduce the availability of credit to the productive sectors of the economy. As interest rates rise, borrowers are crowded out, and slower economic growth is the result.

UNEMPLOYMENT AND THE HUMPHREY-HAWKINS BILL

The committee's report suggests that a rate of 5¾ percent unemployment "is significantly above the percent level indicated as a desirable objective in the Humphrey-Hawkins bill." The interjection of this legislation into the committee report is unwarranted, particularly in light of the comments the committee has received to the effect that the 4 percent unemployment figure specified in that legislation is unrealistically low. The provisions of the Humphrey-Hawkins bill are not relevant to this discussion.

The report goes on to express "concern" over the remarks of one member of the Federal Reserve Board with regard to the unemployment situation. The report states that a Fed member remarked in an open market meeting that unemployment "had come close to the zone that he would characterize as reflecting full employment."

In spite of its difficulties, our economy continues to employ more and more new workers. Many economists, including Dr. Arthur Burns, former Chairman of the Federal Reserve, contend that the current unemployment rate, particularly the 2.9 percent rate in the first quarter of 1978 for adult married males may mean that the economy is very near the full employment level. This development calls for a new approach to the unemployment problem which must focus on the difficulties which specific components of the job force, the structurally unemployed, encounter in seeking jobs.

Monetary policy at this point in the current expansion is not an appropriate instrument for dealing with structural unemployment, particularly when inflation has become a threat to economic stability and the continued creation of new jobs in the private sector.

"ECONOMY WEAKENING"

The Committee makes reference to a "weakening of the economy" in the second half of the current year. While it is widely anticipated that following the severe winter, there will be a strong comeback in the second quarter, it is not accurate to describe the leveling off of these extremes in the second half of the year as a "weakening of the economy."

This use of language is all too familiar to those who view the free market system as one that is perenially unwell. For the past three years, the economy has picked up considerably, and unemployment has fallen significantly. In spite of the relative prosperity indicated by these conditions, many economists choose to call this situation "a recovery," as if the economy is either in a recession, or recovering from one, at all times. It would be equally, if not more accurate, to characterize our system as one that is generally healthy, but which experiences periodic slowdowns. If recessions have grown deeper and expansionary periods less vigorous as years go by, it is largely because of Government economic policy that invariably intervenes at the wrong time.

For example, the economy was at essentially the same point in the business cycle in 1964 as it is now. However, the administration's tax cut was originally only half of the amount of the 1963–64 Johnson tax cut of $51 billion. Now, at $15 billion, it is less than a third, and it is dwarfed by the pending increase in social security taxes and energy taxes. In addition, the administration's tax relief is small for business, only a fifth of the total. This is the smallest proportion set aside for business in more than 20 years. The result can only be a decline in real investment, slower economic growth, and fewer jobs created in the private sector.

RECOMMENDATIONS

It is clear that the most critical economic problems facing us domestically and internationally are government created inflation, declining productivity, unemployment and overregulation of the economy. Although the symptoms of these problems reinforce each other, there are common sense solutions to each problem. If we begin to solve the problems, the symptoms will begin to recede.

(1) Inflation

The Federal Government's 5-year fiscal policy should (1) reduce the net Federal deficit by about $10 billion per year, (2) permanently reduce taxes on the productive portions of our economy by about $10 billion per year, (3) permanently reduce capital gains taxes to 25 percent, and (4) reduce the rate of growth of the Federal budget by about two percentage points per year until it falls below the rate of growth of the GNP.

The Federal funds rate should be held as close to 7 percent as possible so that the credit market can stabilize and related pressures toward a recession can be reduced or eliminated.

Monetary policy should aim to gradually reduce the gap between the quarterly averaged growth of M_1 and the quarterly averaged growth rate of real GNP until rough equality is reached. By showing this restraint, the Federal Reserve will encourage others in the public and private sectors of the economy to show a similar restraint.

Congress should allow for variable mortgage rates to reduce any short-term adverse effects on housing by possible increased interest rates as a consequence of tighter money growth.

Management and labor policy in the private sector must jointly bear the burdens of reducing demands for wage and price increases as a strong incentive for the Government to show a similar restraint.

(2) Unemployment

Tax policy should establish annual permanent decreases in personal and business taxes which will (1) encourage small business development and hiring, (2) create increased long-term demand, and (3) create investment in increased industrial production and productivity.

Congress should increase the incentives for able-bodied persons on welfare to seek private sector employment or training for future private sector employment.

Monetary policy and fiscal policy should follow courses of restraint so that business and investment confidence can contribute directly to the creation of private sector jobs.

Social Security taxes and minimum wage legislation should be considered in light of their impact on unemployment so that the bottom rungs of the economic ladder to success can be restored for unemployed youth and for those with dreams of starting their own business.

(3) Energy

Regulatory and tax policy should create the incentives for production and efficient use of our vast domestic resources of oil, natural gas, coal, uranium, geothermal and solar energy, so that energy costs can be driven down by competition and increased low-cost domestic supply.

The administration and the congressional majority have failed to recognize that the high cost of energy is caused by Federal regulation that prevent the increases in domestic production that can break the back of the OPEC cartel. It is not caused by too little energy regulation and taxation.

The guarantee of a free market price structure for new domestic oil and natural gas would rapidly begin the discovery and production of a resource base of at least 300 billion barrels of oil and 700 trillion cubic feet of natural gas. That would provide several decades of supply while the Nation develops alternatives as fast as possible but without the threat to our national security and national economy that we now face.

(4) Regulation

Federal regulatory policy must be streamlined so that Congress can review major regulatory programs for their inflationary impacts on the economy before they become law. The method proposed in the Regulation Reduction and Congressional Control Act, S. 2011, should be examined as one mechanism for congressional approval or disapproval of major regulations to be implemented by Federal agencies.

(5) Finally, to aid the committee in its discussions on monetary policy, it would be useful for the Federal Reserve to provide a detailed commentary on specific governmental actions which contribute to inflation.

This commentarv could take the form of a comprehensive and quantitative listing of the specific components of the current inflation rate, an explanation of their sources, and actions on the part of the Congress that would tend to reduce the inflationary impact of each of these components. The report should chart the inflationary impact of specific governmental programs in the past and project them into each of the next 4 years.

Because the Federal Reserve cannot solve economic problems alone, it must be more outspoken in informing the administration and Congress of economic implications of legislative and policy decisions.

HARRISON SCHMITT.

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