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THIRD REPORT ON
THE CONDUCT OF MONETARY POLICY

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

together with

ADDITIONAL VIEWS

DECEMBER 1978

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS,
Washington, D.C., December 29, 1978.

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

DEAR MR. PRESIDENT: Transmitted herewith is the Third Report on the Conduct of Monetary Policy, pursuant to Public Law 95–188 and oversight hearings held on November 15 and 16, 1978.

Sincerely yours,

WILLIAM PROXMIRE, *Chairman.*

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Third Report on the Conduct of Monetary Policy

I. Introduction

The Senate Committee on Banking, Housing, and Urban Affairs held its semi-annual hearings on the Conduct of Monetary Policy by the Federal Reserve System, pursuant to Public Law 95-188, on November 15 and 16, 1978. At its hearing the committee received testimony from four private sector economists and Federal Reserve Chairman G. William Miller, who reported the Federal Reserve Board of Governors' and the Federal Open Market Committee's objectives and plans with respect to the ranges of growth of the monetary and credit aggregates for the upcoming year.

On November 15, the committee received the testimony of: Dr. Phillip Cagan, professor of economics, Columbia University; Mr. Leif Olsen, chairman of the Economic Policy Committee, Citibank, N. A.; Dr. George L. Perry, senior fellow, The Brookings Institution; and Mr. Albert T. Sommers, senior vice president and chief economist, The Conference Board.

Chairman Miller was the only witness to appear before the Committee on November 16.

II. Federal Reserve Reports to Congress

Since March of 1975 the Federal Reserve has reported its monetary policy plans to the Congress each quarter, alternately to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs. These hearings have been held pursuant to House Concurrent Resolution 133 passed by Congress in March 1975 and Public Law 95–188, the Federal Reserve Reform Act of 1977, enacted in November 1977.

Beginning in February 1979 the reports to the Congress by the Federal Reserve will be held pursuant to Public Law 95–523, The Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins bill), enacted in October 1978. This legislation amends the Employment Act of 1946, the Congressional Budget and Impoundment Control Act of 1974, and the Federal Reserve Act to more fully integrate economic policy formulation with the congressional budget process. Pursuant to Public Law 95–523 the Federal Reserve will report to the Congress by February 20 and July 20 each year, rather than four times a year as required by Public Law 95–188.

The new reporting requirements also require an expanded discussion of monetary policy and its relationship to the achievement of the Nation's economic goals. The economic goals of the President will be explicitly stated in his Economic Report which must be transmitted to the Congress during the first 20 days of each regular session. The Congress may also explicitly state its economic goals in the first and second concurrent resolutions on the budget which must be approved by May 15 and September 15 of each year.

The congressional review of monetary policy will be based on the following major provisions of section 2A of the Federal Reserve Act (as amended):

1. STATEMENT OF LONG-TERM GOALS TO BE PURSUED

The Federal Reserve is required to pursue monetary policies—growth of money and credit—consistent with the economic potential to increase production, and to promote the goals of maximum employment, stable prices, and moderate long-term interest rates. This provision is the same as in Public Law 95–188.

2. MONETARY POLICY OVERSIGHT PROCEDURES

The Board of Governors of the Federal Reserve System is required to submit written reports to the Congress by February 20 and July 20 of each year. These reports are to consist of four parts:

(1) a review and analysis of recent developments affecting economic trends in the Nation;

(2) the monetary policy objectives and plans of the Federal Reserve Board and the Federal Open Market Committee in terms of the ranges of growth of the monetary and credit aggregates for the calendar year during which the report is transmitted (and in the July 20 report for the next calendar year). Those plans and objectives are to take into account past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices;

(3) the relationship of the Federal Reserve's monetary policy plans and objectives to the numerical goals for the current and the next calendar years set forth by the President in the Economic Report for employment, unemployment, production, real income, productivity, and prices or to any revisions to those goals approved by the Congress. In explaining the relationship of the Board's objectives and plans to the goals established by the President and any subsequent goals established by the Congress, it is expected that the Board will provide the Congress with a full discussion concerning the extent to which the Federal Reserve's intended policies will help to achieve those goals; and

(4) if any changes in monetary objectives or plans are made by the Federal Reserve between reports to the Congress, the Board is required to include in the next report an explanation of the reasons for those revisions to or deviations from the previously announced objectives and plans.

After each Federal Reserve report on monetary policy to the Congress the Banking Committees are, under Public Law 95–523, required to submit to their respective bodies a report containing their views and recommendations with respect to the Federal Reserve's intended policies. These reports, and the expanded reports by the Federal Reserve to the Congress will serve to increase public understanding of of monetary policy. Emphasis will be on the goals of economic policy—employment, unemployment, production, investment, real income, productivity, and prices, and how the Federal Reserve monetary policies are designed to achieve those goals. The means to achieve those goals—growth of money and credit—will be more meaningful in this context. Moreover, since the reports will be made twice a year, rather than four times a year, monetary policy will be given a longer-run focus, than is now the case.

III. Economic Background

The pace of economic expansion began to moderate during the third quarter. In real terms, economic growth diminished to slightly less than 3½ percent compared to almost 9 percent during the second quarter, and an average of a little more than 4¼ percent during the first half of the year. The increase in GNP prices, as measured by the fixed weighted price index decelerated to 7 percent during the third quarter from 11 percent in the second quarter (see table 1).

Personal consumption expenditures after increasing by 6 percent in the second quarter increased by only 3½ percent in the most recent quarter. At the same time fixed investment, which had increased by 15½ percent in the second quarter, actually declined by ½ percent, and inventory accumulation, which had shown little change, declined. Net exports, which had increased sharply during the second quarter, showed little net increase. Government purchases of goods and services increased by 9 percent in the third quarter after having declined in both the first and second quarter of the year. Federal expenditures increased by over 21 percent during the third quarter, while State and local expenditures increased by only 2½ percent.

To a large extent the slowdown during the third quarter was expected because of the acceleration in economic activity during the second quarter which followed severe weather and a major coal strike during the first quarter of the year. In addition, there was a downswing in automobile sales from the second to the third quarter which may have accounted for a decline of slightly more than 1 percent in real GNP. The rate of growth of personal consumption expenditures declined to about 3½ percent during the third quarter. Durable purchases which had been at a 25 percent annual rate in the second quarter declined by about 3 percent.

Among the major elements of consumer spending unit auto purchases showed the most significant weakness. Retail sales of new passenger cars declined to 11.2 million in the third quarter of 1978 from 12 million in the second quarter. Second quarter totals, the highest in 5 years, were raised by the makeup from the severe weather in January and February. Sales of nondurable items increased at a 3½ percent annual rate, about the same as the second quarter. Consumer purchases of services actually increased to 5¾ percent in the third quarter from an annual rate of increase of only 2 percent during the second quarter.

Business investment in inventories increased by $10.7 billion during the third quarter following increases of over $12 billion in each of the first and second quarters. This slight decrease reflects the distinct slow down in the growth of consumer purchases. There is no clear evidence that business in the aggregate regard themselves as heavily burdened by excessive stocks. At the same time it does appear that some downward adjustments have occurred in production schedules for autos and other consumer products in response to more closely watched inventory sales ratios that have been typical of the recovery from the severe recession experienced in 1974.

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Real Government purchases increased at a 9 percent annual rate after showing no change in the second quarter. This pattern reflected changes in Federal purchases that were mainly due to the operations of the Commodity Credit Corporation, and which were partly offset by changes in State and local purchases that were mainly due to the severe weather. Purchases increased 21 percent after the decline of 15½ percent in the second quarter. The second quarter decline had been due mainly to a swing to net loan redemptions as a part of the Commodity Credit Corporation agricultural price support operations, while the third quarter increase was mainly due to a cessation of those redemptions. Because the swing in Federal purchases is traceable to Commodity Credit Corporation operations it has important implications for agriculture and the fiscal position of the Federal Government. However, in principal, it had no effect on changes in real GNP.

Consumer prices increased at almost a 9 percent annual rate during the third quarter, somewhat less than the near 11 percent rate of the second quarter. Still this high rate of inflation is cause for considerable concern. This is especially true when the Consumer Price Index measure is adjusted to remove the effects of rising food prices. On that basis, the rate of consumer price increases actually accelerated in the third quarter to a 7.5 percent (table 2) annual rate, up 1 percentage point.

Other measures of inflation also indicate that the underlying inflation problem has worsened this year. Over the first three quarters of this year the GNP price indices both indicate an inflation rate average of almost 8.5 percent compared to about 5½ percent in 1976 and just over 6 percent in 1977. Even if the most recent increases of 7 percent experienced during the third quarter were to be repeated during the last quarter of 1978 the annual increase in prices would be nearly 8 percent, and preliminary price information for the fourth quarter has already been disappointing.

Total civilian employment during the first 9 months of 1978 increased by about 2 million workers (see table 3). However, the unemployment rate has continued in the range of around 6 percent without much change or variation. Although unemployment rates among household heads and men 20 and over has stabilized at relatively low levels, unemployment in other areas, particularly among blacks and others, continued at alarmingly high rates. The outlook for the economy in 1979 does not suggest that major further reductions in overall unemployment rates will be possible in 1979. In fact, the possibility of a recession, and the probability of much slower economic growth, perhaps between 2 and 3 percent of real GNP, suggests that unemployment may increase.

Personal income increased by $45 billion at an annual rate (table 4) during the third quarter compared with $53.5 billion during the second quarter. The deceleration of personal income other than transfer payments amounted to $17 billion. Disposable personal income increased by about 9 percent compared with 12 percent during the second quarter. Price increases decelerated somewhat in the third quarter; however, their deceleration was not sufficient to offset that in disposable income. Consequently, the increase in real income in the third quarter was less than during the second quarter, 2½ percent compared to 3½ percent. Increases in real income have been much smaller in 1978 than in 1977, primarily because increases in consumer prices have been much larger; quarterly increases in real income have averaged 2½ percent in 1978 compared with 5½ percent in 1977. Reflecting the change in disposable income and personal outlays, the personal savings rate slipped to 5.1 percent, the same low rate as that experienced during 1977.

A particularly troublesome area in the past year has been the rate of growth of productivity. In the third quarter productivity increased to 3.7 percent. However, during all of 1978 productivity increased by only 1.7 percent. This is far below the historical average, and probably not sufficient to provide any aid in reducing the rate of inflation.

Manufacturing capacity utilization in the material industry has increased to 85.7 percent during the third quarter versus 84.5 percent during the first quarter of the year (table 6). By comparison manufacturing capacity utilization during 1973 was about 92 percent, and in 1974 was close to about 88 percent. Sufficient capacity remains in the economy for the expansion to continue. Moreover, none of the major materials industries are operating at utilization rates that indicate any major problems in the near future.

During the third quarter the housing market continued to be remarkably strong. New private housing starts totaled over 2 million units at a seasonally adjusted annual rate, only slightly below the level of activity experienced during the second quarter. The latest seasonally adjusted data for October (table 7) indicate that housing starts continue to be strong. In fact, the 2 million plus rate has persisted somewhat longer than many observers had expected. Unlike during previous cycles, housing starts have not fallen off as yet even though interest rates have climbed to near historically high levels.

Home building has been buoyed by special developments in this business cycle. The demand for housing is dependent upon relative prices, income expectations, and interest rates. So far high and rising interest rates have not pushed masses of would-be borrowers out of the mortgage market. Even though mortgage rates have reached 10 percent in many places people have not been deterred from borrowing to to invest in housing, probably because inflation expectations continue to be quite widespread, and housing continues to be one of the best investments and hedges against continued inflation for individuals.

Moreover, on the credit side the new 6-month money market certificates with rates tied to the 6-month Treasury bill rate that are available at depository institutions have provided thrifts with a fresh supply of lendable funds which has helped to meet the continuing demand for mortgage credit. By the end of October the new certificates totaled over $50 billion at all depository institutions. However, the new 6-month certificates may not continue to insulate housing from the full effects of monetary restraint for very long. Some banks and thrifts have begun to limit certificate issues simply because of the current steep rates paid on certificates. Moreover, many savings and loan associations are said to be using the funds obtained through the money market certificates to purchase large certificates of deposit from banks with yields in excess of 11 percent.

Thus, not all the funds obtained by the thrifts through the money market certificate are going into the mortgage market. As rates continue to increase the effect of tight credit on the housing market should begin to be seen, especially in States where mortgage usury ceilings are a binding constraint (see table 8).

Even though interest rates have increased dramatically this year, total credit demands in the economy continue to be quite strong. During the first half of the year total borrowing is estimated to have been approximately $480 billion. During the third quarter funds raised in U.S. credit markets continued to be quite large. As the high interest rates begin to trigger cutbacks in spending, borrowing in credit sensitive sectors—housing, autos, and capital spending—will moderate.

Since the end of 1977 the prime rate charged by banks has increased by 3¾ percent, to 11½ percent currently (table 10). These large increases reflect both continued strong loan demands by business corporations and increases in the Federal funds rate partially due to Federal Reserve policy. Some of the recent business borrowing is said to be in anticipation of tighter credit conditions in the future and the possibility that some form of credit controls may be considered. The Federal funds rate currently stands at close to 10 percent, 3½ percent higher than at the end of last year. Long-term interest rates have increased as significantly, although not as dramatically as short-term rates.

During the third quarter growth of M_1 (currency, coin, and demand deposits at banks) declined slightly from the rapid pace experienced during the second quarter (see table 1). This partially reflects the decline in real economic activity and the increase in interest rates as the Federal Reserve moved to restrain the growth of this aggregate. Even so, the growth of M_1 during the third quarter was at a 7.6 annual rate, far exceeding the desired range previously established by the Federal Reserve. M_2 (M_1 plus savings and time deposits at commercial banks other than negotiable certificates of deposit) growth during the third quarter increased from that in the second quarter primarily because of the new 6-month time certificates with the rate pegged to the 3-month Treasury Bill rate. Even though interest rates continued to increase during the third quarter the fact that banks and thrifts could offer market related yields on these certificates have allowed those institutions to retain funds that might otherwise have been lost to the money markets. This is reflected in the broader money measure M_3 (M_2 plus deposits at savings and loan associations, mutual savings banks, and credit unions) which increased at an annual rate of 10 percent during the third quarter compared to only 7¾ percent annual rate during the first half of the year.

The value of the dollar in international markets continued to decline significantly during the third quarter and through the end of October. On November 1, President Carter announced that the U.S. Treasury and the Federal Reserve had taken significant actions to support the dollar (see below for details of those actions). Since then, the dollar has appreciated sharply.

Any assessment of economic activity during 1979 must take into account the Federal budget and the amount of fiscal stimulus or restraint implied therein. Currently the deficit for fiscal year 1979 is expected to be around $40 billion, which is large for this point in the business cycle even though it is about $10 billion less than in the fiscal year 1978. Moreover, the pressure for more fiscal restraint will be intensified in the period ahead primarily because of efforts to restrain inflation. President Carter has said that he will propose a fiscal year 1980 budget with a deficit of $30 billion or less.

The major element affecting the economic environment that must be taken into account in developing an outlook for 1979, and an evaluation of monetary policy is the inflationary climate that has developed over the past 10 years or so. During the past year the pace of inflation has accelerated, and for all of 1978 the rate of inflation may reach 8 percent or more following a 6.8 percent rate in 1977.

It is likely that the principal objectives of economic policies during the coming year will be (1) to insure that progress is made in curbing the rate of inflation in the domestic economy and (2) to maintain the value of the dollar at reasonable levels by curbing speculation and the maintenance of orderly international currency markets.

TABLE 1.—GROSS NATIONAL PRODUCT—CURRENT AND CONSTANT DOLLARS

[Seasonally adjusted at annual rate]

	Current dollars (billions)	1978			Constant (1972) dollars (billions)	1978			Percent change from preceding quarter (annual rate) 1978		
	1977, IV	I	II	III	1977, IV	I	II	III	I	II	III
Gross national product	1,958.1	1,992.0	2,087.5	2,141.1	1,354.5	1,354.2	1,382.6	1,397.3	−0.1	8.7	3.4
Final sales	1,945.0	1,975.3	2,067.4	2,123.4	1,347.1	1,341.8	1,369.9	1,383.5	−1.6	8.6	4.0
Personal consumption expenditures	1,255.3	1,276.6	1,322.9	1,354.5	876.6	873.5	886.3	893.7	−1.4	6.0	3.4
Durables	187.2	183.5	197.8	199.3	143.0	137.8	145.8	144.6	−13.7	25.2	−3.1
Nondurables	496.9	501.4	519.3	529.4	338.1	333.3	336.3	339.2	−5.5	3.6	3.5
Services	571.1	591.8	605.8	625.8	395.6	402.4	440.2	409.8	7.0	1.9	5.7
Gross private domestic investment	313.5	322.7	345.4	351.7	200.3	205.7	213.1	210.8	2.7	3.6	−1.1
Fixed investment	300.5	306.0	325.3	331.1	192.8	193.4	200.4	200.1	1.2	15.3	−.6
Nonresidential	200.3	205.6	220.1	225.4	132.8	133.8	140.5	140.4	4.2	21.3	−.2
Residential	100.2	100.3	105.3	108.8	60.3	59.5	59.9	59.7	−5.2	2.7	−1.5
Change in business inventories	13.1	16.7	20.1	17.6	7.5	12.3	12.7	10.7			
Net exports of goods and services	−23.2	−24.1	−5.5	−6.5	3.1	2.9	11.3	12.0			
Exports	172.1	181.7	205.4	210.9	96.1	99.1	108.4	109.5	13.7	43.3	3.8
Imports	195.2	205.8	210.9	217.3	92.9	96.2	97.1	97.5	20.7	35.8	−4.5
Government purchases of goods and services	412.5	416.7	424.7	441.3	274.5	272.1	271.9	277.8	−3.5	−.2	9.0
Federal	152.2	151.5	147.2	156.1	103.6	101.2	97.1	101.9	−8.9	−15.3	21.1
State and local	206.3	265.2	277.6	285.2	170.9	170.8	174.8	175.9	−.1	9.6	2.6

Source: Survey of Current Business, U.S. Department of Commerce, Bureau of Economic Analysis, October 1978.

TABLE 2.—PRICES

[Percent change from prior period; quarterly data percent change from 3 mo earlier at seasonally adusted annual rates]

					1978		
	1975 [1]	1976 [1]	1977 [1]	1977, IV	I	II	III
Consumer price index	7.0	4.8	6.8	4.7	7.8	10.9	8.6
Commodities less food	6.2	5.1	4.9	4.5	6.1	6.6	7.4
Services	8.1	7.3	7.9	5.6	7.4	11.3	10.7
Food	6.5	.6	8.0	3.6	12.4	20.0	7.0
Producer price index	6.6	3.3	6.6	6.2	8.8	11.3	5.8
GNP accounts:							
Fixed weighted price index	9.3	5.6	6.3	6.8	7.0	11.0	7.0
Implicit price deflator	9.6	5.2	5.9	5.5	7.2	11.0	7.0

[1] December to December.

Source: Economic Indicators, October 1978, and Economic Report of the President, June 1978.

TABLE 3.—EMPLOYMENT AND UNEMPLOYMENT

[Seasonally adjusted]

	1976	1977	1978 Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.
Total civilian employment (millions)	87.5	90.5	92.9	93.0	93.3	93.8	94.1	94.8	94.4	94.6	94.9
Total civilian unemployment (millions)	7.3	6.9	6.2	6.1	6.1	6.0	6.1	5.8	5.2	6.0	6.0
15 weeks and over (millions)	2.4	1.9	1.7	1.6	1.6	1.4	1.4	1.2	1.3	1.2	1.3
Unemployment rates (percent):											
Total civilians	7.7	7.0	6.3	6.1	6.2	6.0	6.1	5.7	6.2	5.9	6.0
Men 20 and over	5.9	5.2	4.7	4.5	4.5	4.2	4.2	3.9	4.1	4.1	4.0
Women 20 and over	7.4	7.0	6.1	5.7	5.8	5.8	6.3	6.1	6.5	6.1	6.0
White	7.0	6.2	5.5	5.3	5.3	5.2	5.2	4.9	5.3	5.2	5.3
Black and other	13.1	13.1	12.7	11.8	12.4	11.8	12.3	11.9	12.5	11.7	11.2
Household heads	5.1	4.5	3.8	3.6	3.7	3.6	3.7	3.6	3.9	3.7	3.7

Source: Economic Indicators, October 1978.

TABLE 4.—PERSONAL INCOME

[Seasonally adjusted at annual rate]

	In billions of dollars 1975	1976	1977	1977, IV	I	II	III	Percent change from previous period annual rate, 1978 I	II	III
Personal income	1,255.5	1,380.9	1,529.0	1,593.0	1,628.9	1,682.4	1,727.2	9.0	13.1	10.6
Disposable personal income	1,086.7	1,184.4	1,303.0	1,359.0	1,391.6	1,433.3	1,464.7	9.6	12.0	8.8
Personal savings	83.6	68.0	66.9	73.7	82.4	76.3	74.4	47.2	−32.0	−10.2
Per capita disposable income:										
Current dollars	5,088	5,504	6,009	6,250	6,287	6,566	6,696	8.8	11.2	7.9
1972 dollars	4,025	4,136	4,271	4,365	4,370	4,399	4,408	.5	2.6	.8
Savings as percent of disposable income	7.7	5.7	5.1	5.4	5.9	5.3	5.1			

Source: Survey of Current Business, October 1978.

TABLE 5.—PRODUCTIVITY: NONFARM BUSINESS SECTOR

[Percent change; quarterly data at seasonally adjusted annual rate]

	1970–74 (average)	1975	1976	1977	1977, IV	1978 I	II	III
Output	2.8	−2.5	6.9	5.2	3.5	0.7	11.6	3.3
Hours	1.4	−4.3	3.2	3.9	3.0	3.9	9.8	−.4
Output per hour	1.0	1.9	3.6	1.3	.5	−3.1	1.7	3.7
Compensation per hour	7.2	9.9	8.5	8.1	7.6	12.2	8.2	8.9
Unit labor costs	6.2	7.9	4.7	6.7	7.1	15.7	6.4	5.0
Implicit price deflator	5.4	10.6	5.4	5.9	4.0	5.8	10.8	8.1

Source: Economic Indicators, October 1978.

TABLE 6.—CAPACITY UTILIZATION RATES FOR MATERIALS INDUSTRIES

[In percent]

	Materials								
		Durable goods		Nondurable goods materials					
					Textile, paper and chemical materials				
Year: Quarter	Total	Total	Basic metal materials	Total	Total	Textile	Paper	Chemicals	Energy materials
1973:									
1st	92.1	90.6	95.6	93.9	94.1	92.8	98.4	93.2	93.8
2d	92.5	91.6	97.2	93.6	93.7	92.7	99.5	92.4	93.4
3d	92.9	92.3	97.5	93.4	93.9	93.4	98.8	92.5	94.1
4th	92.1	91.4	96.8	93.7	93.7	93.9	98.2	92.4	92.0
1974:									
1st	90.4	88.5	94.7	93.7	93.8	79.4	97.9	92.5	90.5
2d	89.6	87.4	93.9	93.0	93.2	89.6	98.4	92.7	90.3
3d	89.1	87.7	92.0	91.4	91.9	84.5	97.0	92.7	89.4
4th	81.7	79.9	86.0	81.4	81.0	69.3	89.9	82.1	87.0
1975:									
1st	71.5	66.9	75.2	69.9	67.8	60.1	78.3	67.2	86.8
2d	70.7	64.6	67.0	72.4	70.3	70.5	73.5	69.4	85.2
3d	74.9	69.0	70.1	79.8	78.2	81.5	81.2	76.5	84.4
4th	77.1	70.6	69.4	84.3	83.8	86.2	86.4	82.3	85.2
1976:									
1st	79.3	73.8	74.1	85.6	85.1	84.3	89.8	84.0	85.6
2d	80.7	76.7	79.3	85.9	85.2	83.8	90.6	84.0	84.1
3d	81.2	78.4	81.7	84.8	83.7	82.4	89.2	82.6	83.8
4th	80.3	76.5	74.4	84.4	83.2	79.7	88.1	83.0	84.8
1977:									
1st	80.4	76.5	75.0	85.1	83.8	78.7	88.4	84.0	84.5
2d	82.6	79.4	80.2	87.2	86.3	78.1	89.5	87.7	84.8
3d	82.3	79.2	75.3	86.3	85.1	78.8	89.3	85.7	85.0
4th	82.2	79.7	75.2	85.9	84.5	82.4	86.7	84.5	83.7
1978:									
1st	81.7	79.3	75.8	86.7	85.5	80.3	88.9	86.0	80.9
2d	84.5	82.2	80.4	88.5	86.8	81.2	90.3	87.5	84.9
3d	85.7	84.8	NA	87.2	85.7	NA	NA	NA	86.1

Source: Board of Governors of the Federal Reserve System. Accessed from data files of Data Resources, Inc.

TABLE 7.—HOUSING ACTIVITY

[Seasonally adjusted annual rates; thousands of units]

					1978		
	1975	1976	1977	1977, IV	I	II	III
New private housing starts:							
1 unit	892	1,162	1,451	1,550	1,229	1,470	1,453
2 to 4 units	64	85	121	138	103	126	129
5 or more units	204	289	414	458	360	517	497
Total	1,160	1,538	1,907	2,146	1,721	2,114	2,079

TABLE 8.—MORTGAGE INTEREST RATE CEILINGS IN THE 50 STATES, DECEMBER 1978

State	Percent	State	Percent
Alabama	8.	Montana	Discount rate +4.[1]
Alaska	Discount rate +5.[1]	Nebraska	11.
Arizona	12.	Nevada	12 or prime +3.5.
Arkansas	10.	New Hampshire	No limit.
California	No limit.	New Jersey	9½.
Colorado	12.	New Mexico	10.
Connecticut	No limit.	New York	9½.
Delaware	Discount rate +4.[1]	North Carolina	No limit.
District of Columbia	11.	North Dakota	9½ (12 for savings and loans.)
Florida	10 (no limit for savings and loans.)	Ohio	Discount rate +3.[1]
Georgia	10.	Oklahoma	18.
Hawaii	12 and no limit on AMI's.	Oregon	12.
Idaho	10.	Pennsylvania	U.S. bond yield +2.[2]
Illinois	U.S. bond yield +2½.[2]	Rhode Island	21.
Indiana	18.	South Carolina	9 to 12.
Iowa	U.S. bond yield +2.	South Dakota	10.
Kansas	11.	Tennessee	10.
Kentucky	No limit over $15,000.	Texas	10.
Louisiana	10.	Utah	18.
Maine	No limit.	Vermont	U.S. bond yield +1¼.[2]
Maryland	10.	Virginia	No limit.
Massachusetts	No limit.	Washington	12.
Michigan	No limit.	West Virginia	U.S. bond yield +1½.[2]
Minnesota	U.S. bond yield +2.[2]	Wisconsin	12.
Mississippi	10.	Wyoming	18.
Missouri	10.		

SUMMARY

Percent	Number	Percent	Number
8	1	21	1
9½	3	Floating	10
10	12	No limit	9
11	3		
12	8	Total	51
18	4		

[1] Set rate geared to Fed discount rate.
[2] Set rate geared to the Fed's index of long-term government bond rate, or 10-yr bond rate.

Source: American Bankers Association and Mortgage Bankers Association.

TABLE 9.—FUNDS RAISED IN U.S. CREDIT MARKETS

[In billions of dollars; quarterly data are seasonally adjusted at annual rates]

				1977		1978	
	1975	1976	1977	III	IV	I	II
Total funds raised, by instrument	220.2	301.3	399.4	431.8	438.2	491.7	464.8
Investment company shares	—.1	—1.0	—1.0	—3.3	.9	(1)	.4
Other corporate equities	11.2	12.4	4.8	7.5	6.5	.9	1.8
Debt instruments	209.1	289.8	395.6	427.6	430.9	490.9	462.6
U.S. Government securities	98.2	88.1	84.3	105.5	91.7	105.0	88.4
State and local obligations	15.6	19.0	29.2	33.0	25.0	22.3	35.8
Corporate and foreign bonds	36.4	37.2	36.1	43.3	40.1	30.3	32.3
Mortgages	57.2	87.1	134.0	141.0	152.4	137.0	135.5
Consumer credit	9.4	23.6	35.0	32.6	36.2	38.0	51.6
Bank loans, n.e.c	—13.9	6.4	32.2	40.9	30.9	67.6	56.8
Open market paper and Rp's	—2.4	13.3	19.8	8.8	15.0	50.8	36.6
Other loans	8.7	15.3	25.1	22.4	39.6	39.9	25.6

[1] Less than 0.1.

Source: Federal Reserve Bulletin, October 1978.

TABLE 10.—SELECTED INTEREST RATES

	1975	1976	1977	1977, Dec.	1978 Mar.	1978 June	1978 Sept.	1978 Oct.	1978 Nov.
3-mo treasury bills	5.84	4.99	5.26	6.06	6.32	6.71	7.84	7.99	8.64
10-yr Treasury securities (constant maturity)	7.99	7.61	7.42	7.69	8.04	8.46	8.42	8.64	8.81
Corporate Aaa bonds (Moody's)	8.83	8.43	8.02	8.19	8.47	8.76	8.69	9.89	9.03
Prime commercial paper, 4-6 mo	6.33	5.35	5.60	6.64	6.80	7.63	8.44	9.03	10.23
Prime rate charged by banks	7.86	6.84	6.83	7.75	8.00	8.75	9.50	9.94	10.94
New home mortgage yields, FHLBB	9.01	8.99	9.01	9.09	9.26	9.46	9.73	9.84	NA
Federal Reserve discount rate	6.25	5.50	5.46	6.00	6.50	7.00	7.75-8.00	8.25	9.50
Federal funds rate	5.82	5.05	5.54	6.56	6.79	7.60	8.45	8.96	9.76

Source: Economic Indicators; Federal Reserve Bulletin.

TABLE 11.—MONETARY AND CREDIT AGGREGATE

[Percent change; seasonally adjusted at annual rate]

	1975[1]	1976[1]	1977[1]	1977 III	1977 IV	1978 I	1978 II	1978 III	Federal Reserve targets, 3d quarter 1978 to 3d quarter 1979
Monetary aggregates:									
M_1	4.3	6.2	8.0	8.0	7.5	6.2	9.9	7.6	2 to 6
M_1+	8.9	13.2	8.4	8.0	6.7	4.9	6.9	5.3	4 to 6.5.
M_2	8.6	11.4	9.3	9.9	8.1	6.9	7.9	8.9	6.5 to 9.
M_3	11.3	13.2	11.3	11.9	10.6	7.8	7.8	10.0	7.5 to 10.
Deposits at nonbank thrift institutions	15.9	15.9	14.2	15.0	14.4	8.9	6.7	11.6	NA.
Bank credit[2]	4.4	8.8	10.9	11.1	9.9	9.6	13.0	11.0	8.5 to 11.5.
Reserves:									
Required	−5.2	.7	3.8	6.9	6.3	8.4	6.9	8.3	NA.
Nonborrowed	−3.6	1.0	2.0	1.7	3.4	14.5	.3	6.2	NA.

[1] December to December.
[2] Total loans and investments at commercial banks.

Source: Federal Reserve Bulletin, October 1978, and Economic Indicators, October 1978.

TABLE 12.—FEDERAL BUDGET

	Fiscal year— 1975	1976	1977	1978	[1] 1979
Receipts	281.0	300.0	357.8	402.0	448.7
Outlays	326.1	366.4	402.8	450.7	487.5
Deficit	−45.1	−66.4	−45.0	−48.7	−38.8

[1] 2d Concurrent Resolution, September 1978.

Source: Economic Indicators, October 1978.

TABLE 13.—FOREIGN SECTOR

[In billions of dollars; seasonally adjusted]

	1975	1976	1977	1977, IV	1978 I	1978 II	1978 III	1978 October
Exports	107.6	115.2	121.2	29.8	30.8	35.5	37.7	13.0
Imports	96.6	121.0	147.7	38.5	40.5	42.2	44.0	15.1
Trade balance	11.0	−5.8	−26.5	−8.7	−9.7	−6.7	−6.3	−2.13
Index of weighted average exchange value of U.S. dollar against currency of big-10 countries plus Switzerland (March 1973=100)	98.34	105.57	103.3	95.9	95.9	95.2	90.6	86.0

Source: Economic Indicators, October 1978.

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IV. The Anti-Inflation and Dollar Support Programs

On October 24, 1978 President Carter announced a three-part program for curbing inflation. Then on November 1, 1978 President Carter announced that the U.S. Treasury and the Federal Reserve Board had taken significant actions to support the value of the U.S. dollar in international markets. Both of these programs will have a significant impact on economic policies—both fiscal and monetary—in the coming year. They are summarized here to provide additional background information and to give an indication of what future policies may be directed at achieving.

A. ANTI-INFLATION PROGRAM

Objectives: Both wage and price guidelines have been developed by the administration. If firms adhere to the price standard (which is to reduce the average rate of price increase to 0.5 percent below the average rate of price increase in 1976–77) and wages are held to the guideline of 7 percent or less, the result would be a 5¾ percent increase in prices of nonfood commodities and services.

However, because of wage contracts already signed, and the existence of some uncontrollable cost increases widespread observance of the standard would lead to an overall rate of inflation of 6 to 6½ percent for the year ahead according to administration statement.

Government actions

Budgetary policy

Cut the growth of Federal spending.—President Carter pledged to cut the share of GNP accounted for by Federal spending to 21 percent in Fiscal Year 1980 (Fiscal Year 1979 estimated to be about 22.5 percent).

Reduce the Federal deficit.—The Fiscal 1979 deficit is estimated at $40 billion. The Fiscal Year 1980 budget deficit will be reduced to $30 billion or less.

Federal hiring.—Limits will be imposed on hiring. Only one out of two vacancies will be filled as they occur. For Fiscal Year 1979 this would amount to a reduction of 20,000 jobs.

Regulatory policy

Regulatory agencies are required to analyze major new regulations to identify and compare costs and benefits.

A Regulatory Council has been formed which will coordinate duplicative and overlapping regulations. The new Regulatory Council will also develop a unified calendar of major regulations. This will include a comprehensive list of major regulations to be proposed.

Each executive branch regulatory agency has been directed to include additional regulations that have a major economic impact in the "sunset" reviews that are required.

Private sector requirements

Pay standard—voluntary

Annual increases in wages and private fringe benefits should not exceed the 7 percent guideline.

Workers earning less than $4 per hour and existing contracts are excluded.

Multiyear contracts are to average 7 percent over the life of the contract, with first year increases limited to 8 percent or less.

Increases above the standard would be acceptable to the extent that they reflect changes in work rules and practices that show productivity increases.

Price standard—voluntary

Firms are expected to limit their price increases over the next year to 0.5 percent below the average annual rate of price increase during 1976–77.

If wage increases decelerate by more than 0.5 percent below the 1976–77 base period average, greater deceleration in prices will be required.

The standard applies to a firm's overall average price, not specific products.

Firms that cannot meet the price standard because of unavoidable cost increases must meet a before-tax *profit margins test* in which profit margins are to be maintained to no more than the best 2 out of the last 3 fiscal years.

Real wage insurance (requires legislation)

Workers who are members of groups that meet the pay standard would receive a tax rebate if inflation exceeds 7 percent in the year ahead.

The rebate would be equal to the difference between the actual inflation rate and 7 percent, multiplied by an individual workers pay, with an upper limit to be established.

Incentives for compliance

Increases in excess of either the wage or price standards will trigger actions by the Government such as:

Reexamination of various restrictions on imports, and, where appropriate, relaxing them;

Asking regulatory agencies to review rate levels and other rules; and

Modification in those regulations that set minimum levels for prices or wages in specific situations.

Government purchases

To the extent consistent with legal requirements and ensuring national security, the President will direct Government agencies to limit purchases to firms observing the pay and price standards.

After January 1, 1979 the Government will require firms awarded contracts in excess of $5 million to certify that they are observing the standard. This is to be administered by the Office of Federal Procurement Policy of OMB.

Monitoring

The Council on Wage and Price Stability will be expanded by about 100 persons to monitor adherence to the wage-price standards by firms and employee groups. (This increase in staff will initially be done by borrowing staff from various agencies. A permanent increase would require legislation).

COWPS has authority to require information relating to prices, profits, and wage rates.

COWPS will identify areas of the economy and firms that are not complying with the standards.

COWPS will monitor on a regular basis wage and price developments of individual firms with annual sales in excess of $500 million.

All major collective bargaining settlements will be monitored.

B. THE PROGRAM TO SUPPORT THE DOLLAR

This program involves actions taken by the U.S. Treasury and the Federal Reserve System. The main points in the program are:

An increase in the Federal Reserve discount rate from 8½ percent to 9½ percent.

A supplementary reserve requirement equal to 2 percent of time deposits of $100,000 or more for Fed members. This would raise reserve requirements by $3 billion.

The Fed will increase its currency renewable credit lines with the West German, Japanese, and Swiss Central banks to $15 billion from the current $7.4 billion.

The United States soon plans to issue Treasury securities denominated in foreign currencies in amounts up to $10 billion.

The United States will draw $3 billion in foreign currencies from its reserves at the International Monetary Fund.

The United States will sell $2 billion of its IMF Special Drawing Rights for foreign currencies.

The Treasury will expand its gold sales to at least 1.5 million ounces, starting in December. (Currently they are selling 300,000 ounces each month.)

V. Economic Outlook

Many private economists have revised their economic forecasts for 1979 based on the President's anti-inflation program and actions to support the value of the dollar. Both the administration and Federal Reserve Chairman Miller have publically said that they do not expect a recession. On the other hand, private economists, both conservative and liberals, believe the probabilities are high that there will be a recession in 1979.

The quotations which follow reflect recent views by private economists as to the current outlook for the economy (following the President's actions on inflation and the dollar.).

Milton Friedman: "We have gone beyond the point of restoring the economy without a recession."

Arthur Okun: "A recession is now a probability rather than a possibility for next year."

Robert Triffin: "The new program gives convincing evidence that the United States will fight inflation, but recession is a serious danger."

Joseph Peckman: "The President's program substantially increases the probability of a recession very soon."

Economists of Citibank: Emphatic measures taken to defend the dollar could cause the Nation's money supply to tighten sooner than anticipated. "If it does, the recession would probably begin in the middle of 1979 rather than in 1980."

Alan Greenspan: "It is probably too late to avoid a recession next year" and "Carter's actions simply increase the probability of recession by mid-1979."

Otto Eckstein: "The high money-market interest rates have already begun to cut off mortgage money from housing. Usury laws are taking many financial institutions out of the lending business and even the new 6-month savings certificates cannot keep money flowing into savings accounts. Today's interest rates are also high enough to cause developers to shelve commercial construction plans, and to make corporations reexamine plant and equipment projects. Next year's outlook was moderate even before the new policy. Consumers are overborrowed and housing activity is higher than the long-term needs. Putting the credit squeeze together with an aging upswing makes a 1979 recession probable.

George Perry (Brookings): "By embracing much higher interest rates, the President has raised the risk of recession more than he would like, and certainly more than I would like. He could have tried to roll back the increases in payroll taxes and minimum wages scheduled for January, reduce any rise in energy prices for some time to come, minimize import restrictions and crack down on regulatory measures that raise costs and prices more than necessary. I mean an all-out vigorous assault on every front. I know everyone says, 'But you can't do this, it's politically impossible.' But why is it better to throw a lot of people out of work? The political process may say 'yes' to joblessness more readily than 'no' to special pressure groups. But let's confront that process with the blame for the dreadful choices that the Carter people have had to face this fall."

Lane Kirkland (AFL–CIO): "The White House actions mean another monetary crunch from high interest rates, and another recession. This recession will start from a higher unemployment level than the last one—a million workers more. Higher interest rates could destroy the housing industry and curtail needed investment in plant and equipment.

Sam I. Nakagama: "Now that President Carter has opted for a recession, it is not surprising that many economists are now scurrying to change their forecasts."

The following table summarizes econometric forecasts for the next year prepared by Chase Econometrics, Data Resources Inc., and Wharton Econometric Forecasting Associates. This information was available to subscribers of those services, and made available to the Banking Committee by the Congressional Research Services of the Library of Congress upon request of the committee. Each of the forecasts was made after the announcement on November 1 of the action taken by the U.S. Treasury and the Federal Reserve to support the dollar. Both the Chase and DRI forecasts have at least two quarters of negative growth in real GNP, which satisfies the definition of a recession according to the National Bureau of Economic Research.

ECONOMIC FORECASTS: FOR THE PERIOD 3D QUARTER 1978 THROUGH 3D QUARTER 1979

	Chase	DRI	Wharton
Real growth (percent change in constant dollar GNP)	−0	1.0	2.1
Inflation (percent change in GNP implicit deflator)	6.9	7.0	6.8
Percent change in civilian labor force	2.0	2.4	2.5
Unemployment rate:			
Average during entire period	6.5	6.3	6.1
3d quarter 1979	7.2	6.7	6.1
Percent change in Federal Reserve industrial producton index	−.5	−.3	3.7
Growth of money supply (M_1) (percent)	5.8	5.8	6.3
Federal funds rate 3d quarter 1979	9.21	8.79	9.70

Sources: Chase Econometrics: Higher Interest Rate Forecast of Nov. 2, 1978. Data Resources (DRI): Control Forecast of Nov. 2, 1978. Wharton EFA: Quarterly Model Control Solution of Nov. 3, 1978.

VI. Summary of Testimony: November 15, 1978

On the first day of the committee's hearings on the conduct of monetary policy, four economists presented their views on the economic outlook and the appropriate policy stance of the Federal Reserve Board and the Federal Open Market Committee.

Two weeks prior to the hearings, on November 1, 1978, the Federal Reserve increased its own discount rate by a full percentage point to 9.5 percent, an all-time high for that policy rate. The discount rate interest rate charged by the Federal Reserve banks on loans made to members banks. These loans are usually jade in order to allow the banks to meet a temporary reserve deficiency so that they may satisfy their reserve requirement. The discount rate is generally adjusted from time to time when borrowing at the Federal Reserve banks becomes excessive or when the spread between money market interest rates (such as the Federal funds rate which is an alternative source of funds for banks) and the discount rate widens. As this gap widens member banks are given a strong incentive for borrowing at the Federal Reserve's discount window.

The recent increase in the discount rate was taken, according to the Federal Reserve, to bring that rate into closer alignment with money market interest rates, and to stop the speculative slide of the exchange value of the dollar. In this case, the increase in the discount rate was made in order to close the gap between money market rates and the discount rate, and to give a signal to the money and credit markets, both domestic and international, that the Federal Reserve would pursue tighter monetary conditions in order to fight inflation. This commitment to the inflation fight was seen as strenthening the value of the dollar.

Each of the witnesses was asked for his view of the recent discount rate increase. Mr. Olsen indicated that the discount rate does not usually have a significant effect on other interest rates, and therefore he expected none at this time. Both Mr. Olsen and Mr. Perry indicated that the program to support the dollar had been successful thus far. However, Mr. Olsen expressed some doubt about its long-run effectiveness. And, Dr. Perry expressed concern about pursuing policies which are a response to speculation and foreign exchange markets rather than a response to the economy's domestic needs.

Each of the witnesses was asked for their views on the current economic outlook. Without exception all the witnesses forecast an absolute decline in consumer spending for durable goods. They also indicated that the growth rate of plant and equipment spending would only be sightly above zero and that inventories would probably fall sharply after the end of the year. In his comments, Dr. Sommers stated that the economy would inevitably fall into a recession in 1979. Dr. Perry agreed saying that a recession was very likely with the credit restrictions now in place by the Federal Reserve. Dr. Cagan, while admitting that there was a possibility of recession, indicated that the gradual reduction in the growth of the money supply coupled with increased demand would prevent a recession. Mr. Olsen forecast that monetary policy would become sufficiently restrictive as touse ca a recession sometime in 1979.

Without exception, each of the witnesses expressed deep concern about our inflation problem, and over the crucial role of expectations in the inflationary process. Mr. Olsen said that policy is increasingly becoming "a captive of the market", both the international money markets and domestic markets. Mr. Olsen indicated that to be effective in reversing inflationary expectations, the Federal Reserve must convey a message that it is committed to a long-term policy of gradually slowing the inflation rate. While monetary policy can appropriately vary over the business cycle, an overall trend of slowing money growth must be perceived in both domestic and international markets. At the same time, Mr. Olsen and Dr. Perry were critical over monetary policy's traditional inflation cure of tightening money growth, and falling into a recession—for historically, recessions have not stopped the long-run inflationary problem. In Dr. Perry's opinion, the way the price-wage mechanism works must be examined, as must the role played by the Government. Dr. Sommers expressed concern that the psychological state in the United States already anticipates a recession as shown by the stock market decline and the erosion of liquidity in both the automobile and construction industries. Therefore, Mr. Sommers felt the issue was how to keep the economy going at a moderate pace while dealing with the Nation's liquidity problem.

In his testimony Dr. Perry had indicated that fighting inflation will require more than just restrictive monetary and fiscal policies which slow demand and moderate inflation, although at the very high price of high unemployment and lost output. In his view, eliminating needless Government regulations, procedures, and laws, which add to the cost of prices in the private sector must be the goal of the policy. Dr. Perry also said that the Government must break the wage-price spiral by intervening in the wage and price setting process in the private sector. He offered strong support for the President's new anti-inflation program with his real wage insurance, which he said shows an innovative effort in anti-inflation policy.

Mr. Olsen indicated that the President's wage and price guidelines program will only complicate the Federal Reserve's task of conducting effective monetary policy. He added, that the Federal Reserve should be given greater freedom from political influence, which has resulted in excessive money growth to finance imprudent Government policies.

The witnesses were asked to comment on the housing industry's partial insulation from high money market interest rates and its effect on monetary policy. The reference here was to the increased flow of funds into housing markets because of the new six-month money market certificates that were introduced last June. These money market certificates have provided approximately $50 billion through the end of October to the depository institutions. Mr. Olsen told the Committee that he still expects a decline in the housing industry since the protection offered by the money market certificates will not be sufficient. He noted that with inflationary expectations, the creation of credit by the marketplace favors the bidders for short-term funds, hitting the housing sector very hard. Dr. Cagan indicated that the housing sector can adjust to boom and recession quite easily, and thus it helps to stabilize the economy. However, he said that the housing sector must not bear the full brunt of high interest rates in this inflationary period. Mr. Sommers indicated that even though the housing industry is somewhat sheltered from high interest rates, he expects housing activity to begin to decline in December and that the decline will continue into 1979. Dr. Cagan indicated that one thing that could be done would be for the Government to step out of the credit markets at this time so that credit could go to the private sector. He said, "Some demands for credit have to be cut back and the question is exactly where it should fall? The more evenly it falls, I would say, would be much better."

In response to a question about the current Government deficit causing inflationary pressures, Dr. Perry said that he did not think that gradually decreasing the size of the budget deficit would have altered the present inflation problem. He continued to say that there is no correlation between money growth and Government deficits. Dr. Sommers indicated that most Western countries are running at a deficit although they are not experiencing high inflation. In Mr. Sommers' opinion, it is the credit explosion in the private sector which is pressuring interest rates.

Mr. Olsen added that balancing the budget alone could not cure inflation but that it would help the monetary authorities in controlling money supply growth. Dr. Cagan told the committee that balancing the budget would help decrease Government demand for credit, and thus put less pressure on interest rates to rise. He added that this alone would not cure inflation.

In his testimony Dr. Cagan emphasized that in his opinion, the present monetary aggregates are not sufficient as indicators of monetary policy. He emphasized that there are many substitutes for transactions balances which alter the meaning of narrowly defined money stock M_1. (On November 1, 1978, commercial banks were permitted to offer a new automatic transfer service, in which a bank customer could enter into an agreement with his bank to have the bank automatically transfer funds from his savings account to his checking account to cover any overdrafts which might arise.)

During the questioning, each of the witnesses was asked about their views as to the meaningfulness of the monetary aggregates as an indicator of monetary policy and whether there was any other indicator of monetary policy which the Congress should be following, if in fact the new automatic transfer service renders the money stock M_1, as currently defined, unsatisfactory. Dr. Cagan suggested that while the present aggregates are not sufficient, new monetary aggregates which take into account the new types of transactions balances could be defined, and an overall monetary measure of all transactions balances would be the best. Dr. Sommers indicated that the monetary base would be helpful in this transition period, but that new measures need to be examined. Dr. Perry suggested that M_2 has a closer relationship to economic activity than M_1 anyhow. All of the witnesses expressed their desire to see the Federal Reserve take prompt action to devise a new monetary aggregate which would be a truer reflection of economic activity.

In his recommendations to the committee Dr. Cagan suggested that all transactions balances and their close substitutes be subject to a uniform reserve requirement of 10 percent backed by deposits held at the Federal Reserve banks on a current basis. Included in this definition of transactions account would be all balances that are fixed in dollar amount and can be transferred to third parties within a business week by written or telephone requests. He indicated that the reserve requirements against such transactions balances would give the Federal Reserve more control over the money supply. He also proposed that reserve requirements for all other types of deposits be reduced to zero. Dr. Cagan told the committee that the prohibition against interest rates on demand deposits should be repealed, and that this would eliminate pressure on banks to circumvent the prohibition which has played an important part in limiting the effectiveness on monetary policy.

In his testimony, Dr. Sommers told the committee that given its present powers the Federal Reserve could not have behaved sufficiently different as to alter our current economic condition. He recommended that the powers of the Federal Reserve be enlarged to include tools capable of influencing the demand side of credit markets. He said that sensible credit restraint powers, far short of absolute direction of credit, would help to moderate the business cycle, preserve a steadier course for private investment, permit more effective response on the part of the Federal Reserve's supply-side powers, and produce interest rates both less volatile and lower on average. He also expressed some doubts as to whether the United States could balance its budget in the near future. Yet, with credit restraint in the private sector, the deficit should not be highly inflationary. Dr. Sommers indicated that an effective incomes policy could provide an environment needed to slow inflation provided it receives national support

VII. Summary of Testimony: November 16, 1978

G. William Miller, Chairman of the Federal Reserve Board, was the sole witness before the committee on the second day of its hearings on the conduct of monetary policy. Chairman Miller was reporting to the committee on behalf of the Federal Reserve Board and the Federal Open Market Committee.

Chairman Miller indicated to the committee that continuing domestic inflation, and a sharp decline in the value of the dollar in foreign exchange markets have posed growing threats to the vitality of the United States and world economies.

The objective of the Federal Reserve, according to Chairman Miller, has been to foster monetary and financial conditions that would lead to a reduction of inflationary pressures. while encouraging continued moderate economic growth. He noted that real GNP grew at a 4 percent annual rate so far this year compared with 5½ percent during 1977 and that this slower pace in expansion has been sufficient to achieve substantial gains in employment, while at the same time avoiding a significant overshoot of general levels of resource utilization that might have intensified inflationary demand pressures in both the labor and product markets.

Chairman Miller noted that there had been a marked pickup in the rate of inflation so far this year. Consumer prices have climbed at an annual rate of 9½ percent. This rapid increase was caused by several factors: higher farm prices, legislated increases in the Federal minimum wage, and in employer contributions for social security and unemployment compensation, wage gains, and lagging productivity performance. He also added that the depreciation of the dollar in international exchange markets has raised the prices of imports.

In his testimony, Chairman Miller indicated that President Carter had announced a major program to break the self-destructive cycle of wages chasing prices and prices chasing wages. His testimony included a brief description of the program without explicit endorsement by the Federal Reserve Board. He did note that the administration's anti-inflation program was strengthened by joint action to the

Federal Reserve and the Treasury to strengthen the dollar in the foreign exchange markets.

He also noted that if the cooperation of business and labor that is so essential to the success of the administration's anti-inflation program is to be obtained, and if we are to gain the fullest benefits of the recent dollar support initiatives, it is absolutely essential that monetary and fiscal policies demonstrate prudent restraint. In reviewing recent economic trends in the economy and international markets, Chairman Miller indicated that the current expansion will likely be sustained but at a more moderate pace over the next year or so. Chairman Miller indicated some concern that record levels of borrowing by consumers have played an important role in supporting consumer outlays, and that the heavy repayment burdens that households face are likely to be an increasing constraint on spending in the forthcoming year.

Financial factors, according to Chairman Miller, should induce some tapering off of home building in 1979. Although housing starts have remained on a high plateau, the effects of recent increases in interest rates will soon begin to show through and slow housing production.

During the next year spending on plant and equipment, according to a recent private survey of investment intentions, suggests only a modest increase in real terms. Also, inventories are by and large quite lean in relationship to current sales levels.

Chairman Miller gave the committee his own expectations for the economy for the policy period Q3:1978 to Q3:1979. He indicated that he expected real GNP to increase by roughly 2½ to 3 percent, and that with the labor force growing at a less rapid rate than during the last couple of years that this rise in economic activity should be enough to keep the unemployment rate in the 5¾ to 6¼ percent area. His projection of economic growth and unemployment assume that the inflation rate will slow to the 6¾ to 7½ percent range.

According to Chairman Miller it is the intention of the Federal Reserve to work toward a gradual deceleration of monetary and credit expansion to a pace consistent with price stability. The speed with which this can be done without severely disrupting economic activity is limited by the degree to which inflation has become embedded in our economy. The actual growth of M_1 over the past four quarters was well above the 4 to 6½ percent range for this aggregate set by the Federal Open Market Committee, but growth in the broader aggregate was within narrower ranges. He emphasized that growth in the monetary aggregates has to be evaluated in relation to basic economic and financial forces affecting the public's preferences for money in its various forms.

Chairman Miller also indicated that the pattern of growth in the broader monetary aggregates has been strongly influenced by the introduction at banks and thift institutions of the 6-month money market certificate whose ceiling varies weekly with changes in the 6-month Treasury Bill rate.

At its October meeting the Federal Open Market Committee updated its desired ranges of growth for the monetary aggregates. Chairman Miller said that this task was complicated by the introduction on November 1, 1978 of automatic transfer services which permit customers to authorize their banks to shift funds from savings to demand deposit accounts as needed to cover checks written. This innovation should have a major impact on M_1 as consumers take advantage of the opportunity to reduce their holdings of nonearning demand deposits. He added that the size of this effect cannot be projected with any real precision. Thus, Chairman Miller suggested to the committee that FOMC's objectives with respect to the monetary aggregates for the 1-year period from Q3:1978 to Q3:1979 is more clearly indicated by the broader aggregates M_2 and M_3. Chairman Miller emphasized that growth in M_1 is likely to be quite uncertain during the policy period because the public can be expected to shift funds to take advantage of the new automatic transfer service. However, great uncertainties exist about the speed and the extent to which the public may undertake such shifts. Because of the uncertainties about the relationship between M_1 and the transactions demand for money, and in view of the widening role of financial transactions played by savings accounts, the Federal Open Market Committee has adopted a growth range for a new monetary aggregate, called M_1+ (M_1 plus savings accounts at commercial banks, NOW accounts, demand deposits at mutual savings banks, and credit union share drafts).

Thus, the ranges of growth of the monetary and credit aggregates for the policy period Q3:1978 to Q3:1979, desired by the Federal Open Market Committee (FOMC), ase as follows:

Credit aggregate:	*Percent*
M_1	2 to 6.
M_1+	5 to 7½.
M_2	[1] 6½ to 9.
M_3	[1] 7½ to 10.
Bank credit	8½ to 11½.

[1] No change from previous target ranges.

With regard to M_1, the FOMC changed the range of growth significantly. The previous range to 4 to 6½ percent was lowered in order to take into account the unexpected shifts the public may make between demand and savings accounts to take advantage of the automatic transfer service. The band was widened because of uncertainty about the size and speed of the shifts.

Chairman Miller emphasized to the Committee that distinctions among depository institutions with respect to their deposits have become increasingly blurred, and that existing measures of the monetary aggregates, as a result, have become outdated. The Federal Reserve is studying possible adjustments to the monetary aggregates to reflect the changing institutional environment. The measurement of M_1+ represents an "interim step" in this process while a more comprehensive revision is underway.

Chairman Miller said that the monetary aggregates are useful indicators of financial conditions. However, continuing change in the institutional environment, and in public preferences for different deposits indicates that any single monetary measure, or even a set of several measures, can by no means be the sole focus of policy, He said, "Thus, a broad range of financial indicators—including nominal and real interest rates, credit flows, and liquidity conditions—necessarily must be considered in assessing the stance of monetary policy."

In the question and answer period that followed the presentation of his prepared testimony, Chairman Miller answered questions from the members of the committee which covered a wide range of topics. In response to questions about the Federal Reserve's monetary policies, Chairman Miller made the following points:

Monetary Policy cannot fight inflation alone. A sound fiscal policy and incomes policy, and decreasing Government regulations must also be used;

The President's voluntary wage-price guidelines policy should not be permitted to reduce capital investment in the capital sector due to restraints on profits. Mandatory controls should not be enacted because they create inequities and shortages while only postponing the inflation problem;

The actions taken by the Treasury and the Federal Reserve on November 1, 1978 to stablize the dollar were justified and necessary to restore declined confidence by foreigners in America's ability to combat and fight inflation. Credibility will be established only when international markets perceive an American Government seriously committed to long-term anti-inflation policies;

Monetary policy of the Federal Reserve is consistent with real GNP growth over the next 12 months in the range of 2½ to 3 percent;

Recession is not a good policy alternative. Historically, inducing a recession has not been an effective cure for inflation;

A 3 to 3¼ percent rate of growth of real GNP us required for the unemployment rate to be maintained at any given level. Given the consistency of current monetary policy with real GNP growth in the 2½ to 3 percent range, it is possible that the unemployment rate may increase, perhaps significantly, during the next year.

The housing industry is expected to decline somewhat in 1979 in spite of the new money market certificates which were designed to lessen the impact of high interest rates on that industry;

Although the new monetary aggregate M_1+ will eventually monitor economic activity more closely than M_1, it still fails to segregate the savings deposits which are not transactional in nature from those that are transactional. The Federal Reserve is presently perfecting this new measure, and may introduce further changes in the future;

The Federal Reserve Board has not been asked by the administration to monitor profit margins or interest rate increases in the banking community, as part of the new anti-inflation program. If it is asked to do so it would undertake this task;

The establishment of a special prime rate from small businesses is a desirable innovation. At the time of the hearings, only one major bank had introduced this dual prime structure, but its spread to other banks was encouraged;

The Federal Reserve is very concerned over the estimated $400 to $600 billion of uncontrolled Eurodollar deposits. Only a concerted international bank effort would bring these deposits under closer control; and

If the Congress were to reduce spending, say by $30 billion below what it otherwise might be, there would be an 8 percent reduction in the demand for credit, and a convincing indication of Government actions to restrain inflation. There might be, therefore, a fairly prompt reduction in long-term interest rates.

VIII. The Monetary Aggregates

At its October meeting the Federal Open Market Committee approved a newly defined monetary aggregate, M_1+, for use in the formulation of monetary policy. Chairman Miller announced this change to the Banking Committee during his testimony. The new aggregate is composed of M_1, all savings deposits at commercial banks, all NOW accounts, demand deposits at mutual savings banks, and credit union share draft accounts.

On November 1 automatic transfers services were introduced. These will permit consumers to authorize their banks to shift funds from savings to demand deposits as needed to cover checks that have been cleared. This new service prompted the addition of M_1+ to the array of aggregates used for monetary policy formulation. The new automatic transfer service is expected to have a significant impact on the growth of demand deposits, and thus on the narrowly defined money stock M_1, as consumers take advantage of the opportunity to reduce the average size of their interest-free demand deposits. As Chairman Miller noted in his testimony, it is impossible to predict the speed and magnitude of such adjustments. But, so long as the prohibition against interest payment on demand deposits is in effect, such shifts will take place. The prohibition will also continue to induce regulatory and institutional innovations to facilitate transfers from interest bearing liquid assets such as savings deposits. The recent publication for comment by the Federal Home Loan Bank Board of proposed regulations permitting "payment order accounts" for savings and loan associations is a timely example of this trend.

Such changes make savings deposits more like transactions accounts. However, not all savings accounts will have transactional characteristics. While it is important to have a monetary aggregate measure that is composed of all transactional deposits, the aggregate M_1+ does not accomplish that objective. The proportion of bank savings deposits used to make payment is currently small. Although the growth of transactional savings deposit components is likely to accelerate, a large proportion of savings deposits will always be used for the traditional reasons—that is, as a temporary abode of purchasing power and wealth. Such funds should not be lumped together with demand deposits and other transaction type assets. The increased transactional characteristics of savings deposits due to automatic transfer services, payment order accounts, and the recent authorization of NOW accounts in New York raises important questions for monetary policy that must be addressed in a timely manner by the Federal Reserve Board.

The Federal Reserve should devise a method to clearly distinguish transactional from nontransactional savings deposits. This would allow the correction of a major short-coming of M_1+. Moreover, it would aid monetary control for it would permit the Federal Reserve to adjust the reserve requirement on transactional savings to a level commensurate with the reserve requirement on demand deposits. This would reduce the slippage that occurs currently when transfers are made from demand to savings deposits.

In early 1974, the Board of Governors of the Federal Reserve System asked a group of prominent economists to review the monetary aggregates used by the Federal Reserve in the formulation and implementation of monetary policy. The group, which became known as the Advisory Committee's recommendation to the Board with regard to the definition of the monetary aggregates was as follows:

> Recent financial developments suggest the possibility of radical changes in the Nation's payment order or withdrawal accounts and we do not recommend changes in the definition of M_1 or other monetary aggregates now, we do recommend that the Federal Reserve begin to collect and publish systematically data on new close

substitutes for demand deposits (such as negotiable order of withdrawal and payment order of withdrawal accounts and overdraft facilities if possible), and that it develop experimental aggregates that combine demand deposits with those savings accounts that are readily convertible to a demand basis.

Financial innovation and regulatory changes have been rapid in recent years. Combined with the prohibition of payment of explicit interest on demand deposits and other regulatory changes, high interest rates have stimulated the development of various close substitutes for demand deposits. These substitutes are still relatively small in dollar amounts, but they may be beginning to have substantial effects on the rate at which the currently defined money stock turns over. If these developments continue, they may change substantially the historical relationships between the present monetary aggregates and aggregate demand for goods and services. Thus, the Federal Reserve and other supervisory agencies should begin now to collect and analyze the data needed to understand these new relationships as they develop, including the possible introduction of new aggregates to take new developments into account.

The Advisory Committee's report to the Federal Reserve indicated that important changes have also been taking place that have important implications for the definition of the broader monetary aggregates M_2 and M_3. Since mid-1973 banks have been required to impose staff penalties for early withdrawal of time deposits prior to maturity, a requirement that has sharpened this distinction between savings and time deposits. In recent years the regulatory agencies authorized longer maturity small-denomination time deposits in order to provide depositors with the possibility of higher interest deposits. As a consequence there has been a tendency for small denomination time deposits to become increasingly concentrated in the longer maturities because interest ceilings and rates paid on such maturities makes them relatively more attractive than the shorter maturity deposits. The inclusion of the longer-maturity time deposits—the 4-, 6-, and 8-year certificates—in M_2 and M_3 has resulted in monetary aggregates composed of transactional deposits (demand), liquidity deposits (savings and short-maturity time) and illiquid investment deposits (longer maturity time certificates). Therefore, it is unclear how the behavior of these aggregates vis-a-vis the economy should be interpreted and their usefulness as indicators of monetary policy is somewhat diminished. The Federal Reserve should address itself to this issue since its monetary policies are explained to the Congress, at least partially, by growth targets for M_2 and M_3.

Given the definitional problem with the monetary aggregates and the changing nature of transactional accounts, their usefulness as indicators of monetary policy at the present time is open to serious question. Indeed, Chairman Miller's own statement on this was:

While monetary aggregates are useful indicators of financial conditions, the continuing change in the institutional environment and in public preferences for different deposits indicates that any single monetary measure, or even a set of several measures, can by no means be the sole focus of policy. Thus, a broad range of financial indicators—including nominal and real interest rates, credit flows, and liquidity conditions—necessarily must be considered in assessing the stance of monetary policy.

The committee recognizes the Federal Reserve's problem. It expects that during this period when the monetary aggregate measures are undergoing change, the monetary policy plans and objectives will be expressed not only in terms of the desired growth in the aggregate, but also that further explanation in terms of the desired changes in the broader range of financial indicators suggested by Chairman Miller, will be of the Federal Reserve's policies.

IX. Analysis of the Federal Reserve's Policy Plan

The Federal Reserve announced to the committee that for the period from the third quarter 1978 to the third quarter 1979, its plans and objectives for the monetary aggregates are for growth of M_1 between 2 and 6 percent, growth of M_1+ between 5 and 7½ percent, growth of M_2 between 6½ and 9 percent, and growth of M_3 between 7½ and 10 percent. The Federal Reserve also anticipates that bank credit will expand at an 8½ to 11½ percent rate. The growth rate ranges for M_2, M_3, and bank credit are the same as those previously adopted by the Federal Open Market Committee and announced to the House Banking Committee last summer. The growth rate range for M_1 was lowered from the previous range of 4 to 6½ percent and it was also widened. According to Chairman Miller the modifications in the objectives for M_1 growth reflect the expectation that consumers will shift funds from their noninterest bearing demand deposits into savings deposits to take advantage of the new automatic transfer services, and the uncertainties about the speed and extent to which the public may undertake such shifts. Chairman Miller also told the committee that existing measures of the monetary aggregates are becoming outdated and that the new monetary aggregate M_1+ represents an nterim step toward a comprehensive review and revision that is now underway. Included in this review will be the broader measures M_2 and M_3 because of the lengthened maturity of consumer-type time deposits which makes them less money-like.

The Federal Reserve's policy plan is difficult to judge accurately by looking at the monetary aggregate ranges because of the uncertainties caused by the introduction of automatic transfer services which are likely to affect the growth of M_1, and the introduction of the 6-month money market certificates that have already affected the growth of M_2 and M_3. In fact, Chairman Miller admitted during questioning that the Federal Reserve does not know what is likely to happen to M_1 growth, and the growth of M_1+ is also highly uncertain. During each of the last 3 weeks of November M_1 declined, at least partially because of the new automatic transfer arrangements. Over the month of November, M_1 actually declined at about 6.5 percent annual rate, and over the past year growth has been 7.2 percent, in sharp contrast to the rapid growth of more than 8 percent registered earlier this year. Given this behavior it appears that M_1 will not be a useful indicator of monetary policy in the future. The same may be true also of growth in the other monetary aggregates.

Some clues to the Federal Reserve's likely course for monetary policy during the economic year can be found in Chairman Miller's statements about inflation and his expectations about the economy during the next year. As is customary, the Federal Reserve places special emphasis on reducing the rate of inflation. The objective of the Federal Reserve has been to encourage monetary and financial conditions that would lead to a reduction of inflationary pressures, while at the same time encouraging continued moderate economic growth. According to Chairman Miller an increase in real GNP of roughly 2½ to 3 percent during the coming year is consistent with the Federal Reserve's intended policies. He indicated that this projection assumes that inflation will slow into the 6¾ to 7½ percent range, and that he expects the unemployment rate to stay in the 5¾ to 6¼ percent area.

It is not at all certain, however, that Chairman Miller's expectation for growth in real GNP, and the level of the rate of unemployment are consistent. Chairman Miller indicated to Senator Sarbanes during the hearing that a 3 to 3¼ percent growth of real GNP is needed to keep the unemployment rate at least where it is. Last April Chairman Miller indicated that a 3¼ percent rate of GNP would be sufficient. These estimates of Okun's law are somewhat lower than most economists have made. Whatever the correct relationship the rate of real GNP growth expected by Chairman Miller (2½ to 3 percent) does not seem sufficient to keep the unemployment rate from increasing, perhaps outside the range expected by Chairman Miller.

Each of the witnesses appearing before the committee, with the exception of Chairman Miller said that they believed there is a high probability of a recession next year. Chairman Miller indicated that he did not think there would be a recession. More recently, on December 4, Chairman Miller has been quoted as telling a New York banking audience that it would probably take a "minor miracle" to avoid a recession.

The housing markets have been partially buffeted from high and rising interest rates by the introduction of the new 6-month money market certificates last June. The committee is responsible for housing matters, and is appreciative of the fact that the burden of tight monetary policy has not fallen entirely on the housing sector. Some slowdown in housing activity has been forecast by most economist for 1979. This is to be expected given current interest rates. However, further increases in interest rates could exacerbate the housing situation. Mortgage interest rate ceilings in many States are already cutting into housing finance. Even if mortgage funds are available, further increases in interest rates would effect the ability of many individuals to cover the monthly costs of owning a home.

Fiscal policy was widely discussed during the committee's hearings. It was generally agreed that Federal spending plans and the size of the deficit would need to be moderated in fiscal year 1980 in order to reduce inflationary pressure. Chairman Miller emphasized that it is essential to exercise restraint in fiscal policy because monetary management alone cannot contain inflationary pressure. He also indicated that he thought it would be possible for monetary policy to be somewhat less restrictive if fiscal policy were to become more restrictive. Chairman Miller agreed to have the Federal Reserve's staff examine the trade-off between fiscal and monetary restraint more closely.

X. Conclusions

The committee believes that slowing down inflation should be the principal objective of monetary policy during 1979. The committee supports the previous actions taken by the Federal Reserve to curb inflation and defend the dollar. The committee believes the Federal Reserve should continue to restrict the growth of the monetary and credit aggregates over the next 12 months until significant progress is achieved in reversing the growth of inflation. This will mean the gradual reduction of its monetary targets over the period ahead and pursuit of a policy that will keep the actual growth of money within those reduced bounds. The committee recognizes that a potential consequence of this policy may be a lower rate of economic growth than might otherwise be attainable through a more expansive monetary policy. Nonetheless, the committee believes that inflation is our No. 1 economic problem, and that strong measures are needed to deal with it in order to lay the groundwork for an orderly and steady expansion of our productive capacity in the years ahead. The key to our long run prosperity as a Nation depends upon our getting inflation under control now.

The committee also believes the Federal Reserve needs to devise new indicators of monetary policy that will reflect more accurately the Board's policy objectives. The testimony revealed serious flaws in the usefulness of M_1, M_2 and M_3 as monetary targets. Even the new M_1 plus has serious difficulties. Moreover, the growth ranges for these indicators is so broad as to render them practically meaningless for judging the suitability of Federal Reserve policy. Until a more suitable monetary indicator can be devised, the committee believes the Federal Reserve should consider using increases in the monetary base and Federal Reserve credit as policy targets. Whatever indicator is selected, the committee believes its targeted growth ranges should be substantially narrowed so that Congress and the public have a better basis for judging the adequacy of the Board's policy.

Finally, the committee believes that the Federal Reserve should not be forced to carry a disproportionate share of the burden in fighting inflation. Most importantly, the Federal Government needs to maintain a higher degree of fiscal discipline. Excessive Government regulations need to be eliminated. The private sector needs to practice restraint in reaching wage and price decisions.

The committee notes the President's determination to hold the Federal budget deficit for fiscal year 1980 to $30 billion or less. The committee believes that a budgeted deficit substantially below $30 billion would take much of the pressure off monetary policy, and permit a gradual reduction in interest rates. This change in the mix of fiscal and monetary policies could, in turn, act to stimulate private investment and help restore our unsatisfactorily low rate of productivity growth. An increase in productivity is the best long term method for reducing both inflation and unemployment.

ADDITIONAL VIEWS OF SENATORS SARBANES AND WILLIAMS

We fully recognize the magnitude and the pressing nature of the problem of inflation. A successful resolution of this problem is fundamental to the economic and social well-being of the Nation. However, while approving of many of the anti-inflation measures proposed or initiated in recent months and while recognizing the need to exercise appropriate restraint in budget decisions, we wish to caution against any policy which would combat inflation by moving the Nation's economy downward toward a recession.

The experience of recent years has shown that economic decline does not bring about a solution to the problem of inflation and may in fact compound it. Furthermore, a recession brings with it the high costs of increased unemployment: Costs in lost production, in declining tax revenues, and increased public outlays; costs which, in individual and family terms, exact a tragic toll upon the social fabric.

Since the enactment more than 30 years ago of the Full Employment Act of 1946, the promotion of a strong national economy with maximum employment, production, and purchasing power has been acknowledged as the continuing objective of the Nation's economic policy. The Full Employment and Balanced Growth Act of 1978, Public Law 95–523, elaborates upon that commitment and sets forth a framework for strengthening our economy A healthy economy can be undermined by either inflation or unemployment—our objective must therefore be to deal with both of these economic problems in a coordinated and effective manner. To do less would be to fail to meet the challenge of a responsible economic policy.

PAUL SARBANES.
HARRISON A. WILLIAMS.

ADDITIONAL VIEWS OF SENATORS HEINZ, GARN, TOWER, SCHMITT, AND LUGAR

The Senate Committee on Banking, Housing and Urban Affairs also held hearings on the conduct of economic policy on November 3, 1978. At this hearing, the committee received testimony from the newly appointed Chairman of the Council on Wage and Price Stability, Dr. Alfred Kahn; from the Director of the Council on Wage and Price Stability, Dr. Barry Bosworth; and from White House economic advisor, Dr. Charles Schulze, who presented testimony on the President's efforts to combat inflation through economic monetary policy.

Because the steps announced by the administration in October to deal with inflation and with the decline of the dollar were closely associated with monetary policy, this report provides the only opportunity for the members of the committee to react to the proposals. These additional views are not intended to detract from the full committee report; however, we do feel it appropriate to make our views known with respect to the testimony of November 3.

In both the October White House announcement and the November 3 hearing, the administration stated that inflation is the No. 1 problem of this country. In addition to the monetary policy steps announced in October, the President has proposed a set of voluntary wage and price guidelines intended to control inflation, as well as to reduce the budget deficit.

As was stated in the report proper, we are concerned about deficit spending and believe it is directly related to our problems of inflation. It is our hope that the new budget will itself be within the administration's own proposed voluntary guidelines, a figure which would be well under a $30 billion deficit, and which would serve as an example to the Nation of the President's seriousness of purpose and intent. Unless the Federal Government leads the country in such sacrifices, it is difficult to believe that the private sector would participate in any significant way.

At the same time, we are deeply concerned that the administration's economic policy be made in consultation with the Congress. The Congress, and this committee in particular, have a primary responsibility for the economic policy of the Government. The Supreme Court has long since affirmed the broad authority of the Congress to exercise the powers granted to it by article I of the Constitution with regard to the economy, and specifically in relation to the regulation of wages and prices.

In an effort, therefore, to advise the administration of our concern, the Senate, on September 30, 1978, adopted an amendment in the form of a resolution, to require the President to seek legislative authority from the Congress before imposing any type of wage and price controls. Again, at the November 3 hearing on the administration's economic policy, the committee again went on record as being opposed to the imposition of any mandatory wage and price controls.

The line between voluntary and mandatory controls is difficult to draw. Because the distinctions can be so difficult to discern, it seems to us to be even more important for the administration to consult with the committee and to seek legislative authority for whatever actions it proposes to take which would act as mandatory impositions on the private sector. It is for this reason that the October White House announcements, made without consultation with the committee, so concern us.

The October White House announcements relate directly to this issue, specifically as they led to the issuance of Executive Order 12092, entitled "Prohibition against inflationary procurement practices." This order and its implementing regulations require U.S. contractors, their subcontractors and suppliers, to adhere to certain wage and price standards with respect not only to their work under contract with the Government, but to a vast range of their private business activities. Contractors who do not sign compliance forms with the "voluntary" guidelines will be excluded from doing business with the Government.

For example, the administration has indicated in a written response to the committee, that in an instance where one bidder underbids another in a request for procurement on a Federal contract for goods or services, the award will not be made to the lowest bidder if that entity has not signed the compliance forms. The response provided to the committee, furthermore, averred that the differential in price would be no consideration, whether it be 0.5 percent, 5 percent, 50 percent, or 500 percent.

Leaving aside the entire question of the efficacy of such a rule, we cannot help but to perceive this as employing coercive force by means of Government procurement without any supportive legislative authority. In the past, the Congress has given the President emergency authority to impose some type of controls in the economy. These congressional provisions have, for the most part, circumscribed the standards and procedures as well as the duration for such controls. No such statutory authority presently exists. Recent congressional history, including the hearings covered by this report, make clear the Congress judgment that no such authority should be conferred; no mandatory or quasi-mandatory controls should be issued.

If the President and his economic advisers feel that some controls, whether they may be in procurement or hospital cost containment or whatever, are necessary and beneficial to the economic well-being of this country, the constitutional course would be to seek such authority from the Congress. It is, we believe, our role to consider and provide such authorization based upon the input of the Executive.

In our judgment, there can be no doubt that the Executive order and subsequent regulations seek to employ the full force of the Federal Government's purchasing power to impose mandatory wage and price ceilings. To attempt to relate these regulations to previous statutory authority is insupportable. The Congress has not previously authorized rulemaking with respect to the Procurement Act to permit mandatory controls. The Procurement Act has never before been so used, nor is there any history to indicate even implied congressional acquiescence to this kind of Executive order. Likewise, to say that the Executive is acting in an absence of congressional interest is clearly not the case. When proposals for such procurement regulations were first discussed by the administration, the Senate adopted language specifically indicating congressional concern, as well as one constitutional role with regard to the delegation of legislative authority.

This question is not new. In 1966, Professor Kurland, in commenting on President Kennedy's proposed controls said:

> Compliance resulting from the threat of withdrawal of government contracts, or from the threat of depressing the market through the sale of stockpiled goods—stockpiled on the theory of the exigencies of public defense, or at least those from the threat of withholding allocations from public construction programs can hardly be said to be voluntary. These sanctions—if not that of threat of public infamy must be said to amount to compulsion.

Without question, the President's program is not voluntary for everyone. Those who, for whatever reason, do not choose to sign a compliance form, will lose a contract or simply be ineligible, regardless of whether they are the lowest responsive bidder. We question how this could possibly be construed as congressional intent. Most seriously, we believe this transgresses the constitutionally drawn lines of authority. If the Executive enacts rules in areas which are solely prerogative of Congress, what is to prevent further erosion of congressional authority? And, despite protestations to the contrary, how are we to be assured that the President will not attempt to impose wage and price controls without seeking congressional approval through legislative authority?

We firmly share the commitment to slow down inflation. We have, however, grave misgivings about any economic policy which enacts mandatory controls. These controls have proved ineffective in the past and have merely served to delay the adverse impacts of inflation. We believe that firm action to control monetary policy and spending in the Federal sector rather than the private sector is the key to slowing down the rampant inflation which has so plagued this Nation. To unilaterally usurp congressional authority to impose controls on the private sector—especially when no such controls have been placed on the President's own budget—is an unwarranted decision, lacking both in authority and sound, equitable policy judgment.

John Heinz.
Jake Garn.
John Tower.
Harrison Schmitt.
Dick Lugar.

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