96th Congress } SENATE { Report
1st Session } { No. 96–63

FIRST MONETARY POLICY REPORT FOR 1979

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW ~~95–523~~

APRIL 9, 1979

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
39–010 WASHINGTON : 1979

LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS,
Washington, D.C., April 9, 1979.

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

DEAR MR. PRESIDENT: Transmitted herewith is the First Monetary Policy Report for 1979 on the Conduct of Monetary Policy, pursuant to Public Law 95–523 and oversight hearings held on February 20 and 23, 1979.

Sincerely yours,

WILLIAM PROXMIRE, *Chairman.*

CONTENTS

Tables and Charts

FIRST MONETARY POLICY REPORT FOR 1979

I. INTRODUCTION

The Senate Committee on Banking, Housing and Urban Affairs held its first hearings on the conduct of monetary policy for 1979 on February 20 and 23, 1979. At these hearings the Federal Reserve conveyed to the committee its first report on monetary policy for 1979 as required by the Full Employment and Balanced Growth Act of 1978 which was signed into law on October 27, 1978 (Public Law 95–523).

On February 20, 1979, G. William Miller, Chairman of the Board of Governors of the Federal Reserve System reported the Board of Governor's and the Federal Open Market Committee's objectives and plans with respect to the ranges of growth of the monetary and credit aggregates for calendar year 1979, and the relationship of those intended policies to the short-term economic goals set forth by President Carter in his Economic Report.

On February 23, the committee received the testimony of Dr. Allen Sinai, Director of Financial Economics, Data Resources, Inc.; Mr. H. Erich Heinemann, Vice President, Morgan Stanley & Company, Inc.; and Professor Edward J. Kane, Everett D. Reese Professor of Banking and Monetary Economics, The Ohio State University.

II. FEDERAL RESERVE REPORTS TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

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.

The reports to the Congress by the Federal Reserve are now held pursuant to Public Law 95–523, The Full Employment and Balanced Growth Act of 1978—the Humphrey-Hawkins Act—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.

Under the new reporting requirements there will be an expanded discussion of monetary policy and its relationship to the achievement of the Nation's economic goals. The economic goals of the President are now 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 own 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 process of congressional review of monetary policy is based on the following major provisions of section 2A of the Federal Reserve Act.

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 year as 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 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 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 current economic upswing which began in the spring of 1975. It ranks among the most durable in this Nation's history. The past four years have seen sizable gains in production and employment. Between the first quarter of 1974 and the fourth quarter of 1978, real gross national product rose more than 20 percent and more than 10 million jobs have been created.

Real GNP increased 4.3 percent from the fourth quarter of 1977 to the fourth quarter of 1978—a bit slower than the average pace over the earlier part of the expansion, but still well above the trend growth of potential output in the economy. The persistent strength of aggregate demand was demonstrated by the surge in activity during the final quarter of last year, when GNP grew at an annual rate in excess of 6 percent. Available indicators suggest that the economy has remained generally strong in the opening months of 1979.

Residential construction, which provided a good deal of impetus to the early recovery, continued at fairly high levels last year, even the interest rates rose dramatically and building costs continued to increase rapidly. Household demands for shelter have been bolstered by demographic trends and by the desire of many people for a hedge against inflation. The sustained advance in economic activity also has been fostered in good part by strength in consumer spending. A marked turnaround in the willingness of consumers to spend—reflected a sharp drop in the personal savings rate—provided much of the impetus to over-all expansion in the early stages of the economic recovery, and consumption expenditures have remained unusually robust throughout the upswing.

In the business sector, spending on new plant and equipment has continued to rise, but there have not as yet been the large increases seen in some earlier cycles. Business fixed investment actually declined during the initial quarters of the economic expansion, as firms concentrated on the repair of strained financial pos tions in an environment of low capacity utilization. Capital spending policies have continued to be characterized by considerable caution, and it was not until mid-1978 that the previous peak level of real outlays was reattained. Firms also have exercised caution in managing their inventory positions, and stocks generally have remained lean relative to sales.

Government purchases of goods and services rose briskly at both the Federal and State and local levels during the second half of 1978. The over-all budgetary position of the Government sector, including transfer payments and revenues, has remained stimulative throughout the expansion, albeit in diminishing degree.

An improving net export position contributed to the expansion of GNP during the early recovery phase, but deterioration in the trade balance was a decidedly negative factor from 1976 to early 1978. The U.S. trade deficit did narrow over the course of 1978, however, owing in part to the strengthening of economic expansion in other major industrial countries.

The proportion of consumption in gross national product has held at a high level over the course of this upswing. In prior cycles this share typically fell as the expansion matured. In particular, household spending for durable goods has hovered at around 10 percent of GNP throughout the past three years, while during other economic expansions it accounted, on average, for about 7½ percent. This exceptional strength in consumption and the associated rapid increase in installment credit and low savings rates can be attributed, in part, to the higher relative number of younger households. But it also appears to be in some degree a reaction of households to persistently high inflation rates—many consumers have been buying durable goods in anticipation of price increases.

Real business fixed investment rose 8¼ percent over 1978. This was nearly the same pace of advance as in the two previous years and almost twice the rate of expansion in aggregate activity. Recently, nonresidential construction activity has become an important source of business investment growth. In 1978, real spending for such structures increased 12¾ percent as outlays for commercial and industrial building showed particularly impressive gains. Investment in producers' durable equipment grew about 6½ percent in real terms during 1978 compared with increases of more than 10 percent in each of the previous two years. Demands for motor vehicles, which were exceptionally strong earlier in the expansion, began to tail off in 1978, while machinery outlays continued to advance at about the same moderate pace experienced since early 1976.

Investment in business inventories was characterized by caution in 1978, as it generally was in the three previous years. As a result, aggregate inventory-sales ratios remained at or below historical averages. This caution, which can be traced back to the severe inventory cycle of 1974–75, appears to have been responsible for the avoidance of the types of overhangs that preceded several prior cyclical downturns.

The rate of private housing starts advanced briskly during the 1975–77 period and in 1978 they were sustained at the high annual rate lf 12 million units. Spending for residential construction in real terms increased at an average annual rate of 21 percent from the 1975 through the leveling off in 1978. Interest rates on both construction loans and long-term mortgages rose appreciably in 1978 and by year-end they had reached usury ceilings in a number of states and record postwar highs in many other areas. Even so, the variable-ceiling six-month money market certificates introduced in June of last year buoyed deposit growth at thrift institutions and helped maintain the high rate of housing construction.

Within the housing sector, the rise in single-family starts led activity early in the recovery. More recently, multi-family starts—supported by an increase in Federally subsidized rental units—have increased while single-family starts have remainedabove their 1972–73 peak levels. Indeed, in the fourth quarter of 1978, total housing starts averaged an annual rate of 2.1 million units, the same as a year earlier.

After providing some initial stimulus to economic growth during the early recovery period in 1975, the U.S. balance of trade began deteriorating. In large part this reflected the relatively stronger rate of economic expansion in the United States compared with our major trading partners. The deficit in net exports narrowed during 1978, however, as activity abroad picked up in contrast to the moderation in the U.S. expansion. In addition, the more favorable trade balance reflected a 20 percent rise in agricultural exports last year, associated with unusually poor harvests of wheat and soybeans in the Southern Hemisphere.

Growth of purchases by the Federal Government has been uneven in this expansion. In real terms, such purchases increased little during 1975 and 1976, rose substantially in 1977, and then—despite a surge in the second half of the year—declined slightly in 1978. Total expenditures, however, have risen consistently, reflecting increased grants to State and local governments and transfers to individuals for Social Security, food stamps, and retirement benefits. Revenues have increased even more than outlays over the past several years, so that the Federal budget deficit has declined from $66.4 billion in fiscal year 1976 to a projected $37 billion for the current fiscal that ends next September.

State and local government purchases also have grown irregularly over the past four years. In real terms, outlays by this sector for goods and services expanded at a 2¼ percent annual rate during the second half of 1978, matching the average pace over the expansion as a whole. This is well below the trend rate of increased experience during the 1960's and early 1970's. The slowing of growth reflects changing requirements for services, associated with demographic developments, and a degree of fiscal conservatism prompted partly by the financial difficulties encountered by some communities in recent years. In 1978, however, a tendency toward tax relief—occasioned in part by voter preferences expressed in California's Proposition 13 and like measures elsewhere—outweighed the impact of spending economies on budgets. As a result, although the aggregate operating surplus of State and local governments totaled $6 billion for the year, this was only half the size of the 1977 surplus.

Labor demand has been strong throughout the current economic expansion. During the three years following the cyclical trough in early 1975, nonfarm payroll employment advanced at an average annual rate of 3.7 percent—compared with a 2.8 percent median rate of gain during the five previous postwar expansions. During the past year—at a stage when in earlier cycles employment levels had begun to level off or even fall—payroll employment has continued to advance at a 4.2 percent annual rate. Over the almost four years of expansion, employment has increased by 12 million, and today the ratio of employment to total civilian population aged 16 and over stands at the highest level on record.

A significant factor in the expansion of the work force has been the continued rise in the participation rates of adult women. The longer-run trend, which reflected low birth rates as well as changing attitudes and social trends, apparently was augmented in the 1970's by a desire of families to maintain their material living standards in the face of rapid inflation. As a result of these participation rate patterns, the total civilian labor force grew 3 percent during 1978—about the same as in 1977, but up considerably from the 2¼ percent annual rate during preceding years of the decade.

With the growth of employment outstripping even the large increase in the size of the labor force, the unemployment rate fell one-half percentage point over the course of 1978 to just under 6 percent. The improvement in employment conditions during the current expansion has not been uniform. Despite the gains made by many groups. unemployment rates for younger workers, minorities, and the unskilled were still unacceptably high at the end of 1978. For example, the unemployment rate for teenagers at the end of 1978 was 16¼ percent, more than four times the rate for workers 25 to 54 years old; for minority youth the rate was over 35 percent. Younger workers between 16 and 24 years of age accounted for about one-half of all joblessness in the fourth quarter of 1978.

Output per hour of work rose only slightly over the four quarters of 1978. Much of the slowdown in productivity growth last year occurred outside the manufacturing sector; output per hour in manufacturing increased 3½ percent during 1978. This poor performance of labor productivity continues a trend toward slower growth evident since the late 1960's. During the period from 1947 to 1967, productivity in the nonfarm business sector rose on average by 2⅔ percent per annum, and accounted for almost 70 percent of the gain in output for this sector. Since 1967, the rise in output per hour has slowed, with average annual gains of only 1.2 percent recorded since 1973. As a result, less than 50 percent of output growth over the last five years can be attributed to gains in efficiency.

The deterioration of productivity performance in recent years is a complex phenomenon that is not completely understood. It appears, however, that a crucial factor has been the failure to maintain an adequate rate of capital formation. Indeed, the Nation's stock of capital has shown little growth relative to the size of the labor force over the past decade; in contrast, the capital-labor ratio trended upward rapidly in the preceding 20 years. Other factors that may have contributed to reduced productivity growth in recent years are the influence of environmental and safety regulations that divert resources to uses not measured in the National Income and Product Accounts, and the increase in the proportion of young and inexperienced workers in the labor force.

Since the early 1960's there has been a marked trend toward slower growth of the stock of business capital in the United States. Although real gross business fixed investment last year surpassed the 1973 record, still stronger investment activity will be needed if there is to be a sustained reversal of this trend. Net investment—that is, gross investments less the depreciation of existing capital goods—adds to the capital stock, and real net investment has yet to reach its previous peak level. Because the fraction of the capital stock in the form of relatively short-lived equipment has been increasing in recent years, a higher level of gross investment is now needed simply to maintain the existing capital stock.

From the mid-1960's through the early 1970's, the U.S. merchandise trade balance moved gradually from surplus to deficit. Then, during the 1974–75 worldwide economic slowdown the United States suffered disproportionately sharp contraction, so that—despite an enormous increase in our outlays for imported oil—the U.S. trade balance swing into surplus in 1975. The surplus proved temporary, however; the subsequent economic recovery was stronger here than abroad, and this played a major role in the steep increase of our trade deficit from 1976 through early 1978.

The trade deficit in 1978 was $34 billion, slightly larger than in 1977. But the deficit peaked at an annual rate of $45 billion in the first quarter of 1978 and developments in both exports and imports contributed to a narrowing of the imbalance to a rate of about $30 billion in each of the subsequent quarters.

The growth of exports accelerated in the second quarter. The step-up was partly attributable to temporary causes—for example, demand for U.S. agricultural commodities was stimulated by poor Southern Hemisphere harvests. More important, however, was a strengthening of economic activity abroad and the improved competitiveness of U.S. goods resulting from the substantial depreciation of the U.S. dollar that began in the fall of 1977. The real volume of non-agricultural exports increased 6 percent in 1978, and growth picked up strongly in the second half of the year. Prices of exports increased in line with the general pace of domestic inflation, and the total value of merchandise exports rose 17 percent from 1977.

The relatively moderate rise in the volume of imports in 1978, following two years of very large increases, resulted primarily from a slower increase in nonoil imports, but it was reinforced by some decline in petroleum imports. Although total U.S. petroleum consumption is estimated to have increased 3 percent, the higher demand was more than met by increased Alaskan production and by a drawing down of inventories from unusually high levels. The total value of imports increased 16 percent in 1978 with the gain spread over most major commodity categories. Almost half of this increase was in volume terms as imports responded to the continuing strength in U.S. economic activity. Prices of nonoil imports were boosted by the decline in the international value of the dollar.

The current account deficit in 1978, estimated at $17 billion, was slightly larger than in 1977. As in other recent years, net receipts from service transactions provided a substantial offset to the merchandise trade deficit. Earnings, fees, and royalties from foreign direct investments have shown a strong uptrend during the 1970's.

The dollar began to depreciate markedly against most major foreign currencies in late September 1977 as forecasts for 1978 suggested that the U.S. trade deficit would be no smaller than in 1977. The decline continued through the end of 1977, despite large intervention purchases of dollars by foreign central banks. An announcement in January 1978 that the U.S. Treasury would join the Federal Reserve in exchange market intervention in German marks, followed by an increase in the discount rate, improved market sentiment only temporarily, and by early April the dollar had declined about 10 percent on a weighted-average basis. Between early April and mid-May, a relative firming of U.S. interest rates contributed to a recovery, but the dollar declined fairly steadily thereafter in response to continuing concerns about the size of the U.S. trade deficit and increasing fears that U.S. price performance was deteriorating.

Although some depreciation of the dollar was justified by the need to restore external balance in the face of differential growth rates in the United States and major foreign economies and a relative worsening of U.S. inflation, by midsummer it was clear that the dollar's decline was becoming excessive in trading that was increasingly disorderly. In

August the Federal Reserve announced a ½ percentage point increase in the discount rate and reduced to zero reserve requirements on borrowings by member banks from the Eurodollar market. The Treasury subsequently announced that it would increase the size of its regular monthly gold auctions. These measures produced a brief rally and then a few weeks of stability for the dollar. However, the dollar's slide soon resumed. After the President announced his wage-price program on October 24, the decline steepened alarmingly, threatening to undercut the anti-inflation effort at home and abroad. By late October, the dollar had fallen 21 percent from its September 1977 level.

On November 1, the Federal Reserve increased the discount rate by 1 percentage point and imposed a 2 percentage point supplementary reserve requirement on large time deposits. To increase the availability of foreign currencies for exchange market intervention, enlarged swap lines were arranged with the central banks of Germany, Japan, and Switzerland. The U.S. Treasury simultaneously announced its intention to draw on its reserve position in the IMF, to sell SDR's, and to issue foreign currency denominated securities. In addition, the Treasury announced a doubling in its rate of gold sales.

The aim of these measures was to correct the excessive depreciation of the dollar and thereby to counter upward pressures on the domestic price level. When viewed in its entirety, the policy initiative of the Administration and the Federal Reserve System indicated that the United States recognized the need for an integrated approach in addressing domestic and international economic concerns. The announcement of these measures on November 1 produced a dramatic jump in the dollar's exchange value. On that day alone the dollar advanced by 5 percent on a weighted-average basis. Heavy cooperative central bank intervention over the following few weeks provided support for the dollar as market participants tested the authorities' resolve, but the need for such intervention abated in January. As of mid-February of this year, the dollar was more than 7 percent above its October low on a weighted-average basis.

Inflation moderated during the first stages of the cyclical recovery in 1975 and 1976. The earlier extraordinary pressures associated with the rise in oil prices, the sharp escalation in food prices, a worldwide boom in other commodities, and domestic price decontrol subsided, and the considerable slack in labor and product markets restrained wages and prices. Inflation began to speed up again in 1977, however, the prices then surged in 1978. The Consumer Price Index, the Producer Price Index, and the fixed-weight price index for gross business product all registered increases of around 9 percent during 1978, about 2 percentage points more than in the preceding year.

The acceleration of inflation last year reflected importantly the pressure of rising labor costs. Wage rates in the private nonfarm sector increased 8¼ percent, compared with about 7½ percent in each of the preceding two years. A boost in the Federal minimum wage contributed appreciably to the accelerated rise of wages; the impact was especially noticeable in the trade sector, which has the largest concentration of lower-wage workers and saw average wage increases of more than 9 percent last year.

Hourly compensation, which includes, in addition to wages, the costs to employers of social insurance contributions and of privately negotiated fringe benefits, rose 9¾ percent—about 2 percentage points faster than in 1977. About one-quarter of the acceleration resulted from increased Social Security taxes and unemployment insurance contributions. In addition, private fringe benefits continued to rise faster than wages.

Given the weak performance of labor productivity, the larger compensation gains were translated into rapid increases in unit labor costs, the general level of prices was affected considerably in 1978 by developments in the farm and food sector. Retail food prices rose 12 percent over the year—the largest increase since 1974. The increases at the retail level reflected a rise of almost 20 percent in farm prices during 1978 following little change in the preceding year. Meat price increases were particularly rapid, as beef production continued to decline.

The decline in the foreign exchange value of the dollar also aggravated inflation. Aside from the direct impact of higher prices for imported merchandise, the price-restraining pressure of foreign competition was weakened for many domestic products. Large price increases for domestically produced automobiles and other durable goods reflected both of these effects. The inflationary pressures associated with the steep depreciation of the dollar that began in September 1977 appear to have accounted for about 1 percentage point of last year's rise in the Consumer Price Index.

At the producer level, the inflation of prices of capital equipment accelerated considerably less than that for consumer finished goods. But crude materials prices, for both food and nonfood items, increased sharply, and prices for construction materials also rose rapidly. In the first month of this year the continuing strength of inflationary forces was demonstrated by a 1.3 percent jump in the Producer Price Index; although consumer foods posted an especially large increase, all of the major groupings of finished goods and materials showed accelerated advances.

Interest rates generally declined during the early part of the current economic expansion. Interest rates began to move upward in the Spring of 1977, however, as the Federal Reserve acted to restrain accelerating growth in money and credit. Over the course of 1977, yields on short-term market instruments generally rose about 2 percentage points, while corporate and Treasury bond yields increased around ¾ percentage point.

With inflation picking up, the margin of unutilized resources narrowing, and the dollar under downward pressure in foreign exchange markets, the Federal Reserve applied increasing restraint to the expansion of money and credit in 1978. This was reflected in further increases of 3 to 4 percentage points in most short-term rates over the course of the year. The combination of rising short rates and heightened inflation expectations resulted in increases of roughly 1 percentage point in bond yields. By year-end, a number of interest rates were near or above the peak levels of 1974.

The monetary aggregates have exhibited some unusual patterns of behavior during the past several years. This has been especially true with respect to the narrow money stock, M_1. During 1975 and 1976, growth in M_1 averaged just over 5 percent per annum. Given the concurrent decline in interest rates, the sizeable increases in M_1 velocity—that is, the ratio of GNP to M_1—were much larger than would have been predicted on the basis of previous historical relationships among money, income, and interest rates.

The moderation of the public's demand for M_1 may have reflected to a degree an unusually strong cyclical swing in confidence and increased willingness to spend out of existing cash balances as the economy recovered from a severe recession. However, there is also considerable evidence that other factors played an important role. The unprecendentedly high level reached by interest rates in 1974 stimulated the creation and adoption of new cash management techniques that permitted individuals and businesses to economize on nonearning demand deposits. This development apparently continued to exert a significant influence even after interest rates turned downward, and it was reinforced by several important legislative and regulatory developments and innovations affecting the payments system. These included the development of money market mutual funds and the authorization of NOW accounts in all of New England, of savings accounts for businesses and governmental units, and of preauthorized third party and telephone transfer privileges for personal savings accounts.

By the beginning of 1977, the level of M_1 was well below that predicted by most standard econometric models of the demand for money, This downward shift in money demand abated in early 1977, however, and growth of M_1 generally conformed to historical patterns until the final months of 1978. M_1 expanded 9 percent during 1977 and at about the same pace over the first three quarters of 1978; rising interest rates and slowing economic expansion worked to moderate M_1 growth over this span, but these influences were offset by the effect of accelerating inflation on transactions requirements.

On a quarterly average basis M_1 growth in the fourth quarter of 1978 was at a 4.4 percent annual rate, but the average level of the money stock in January was slightly below that for October. A portion of this weakness is the direct consequence of the introduction of automatic transfer services (ATS) last November 1; many individuals have shifted their transactions balances from checking accounts to savings accounts from which funds are automatically transferred to cover checks. According to the Federal Reserve these shifts appear to have reduced M_1 growth rates by roughly 3 percentage points per month, on average. However, growth in M_1 has been weaker than might have been expected in light of the recent expansion of income and spending. It may be that, as in 1974, interest rates have reached a high threshold level at which households and businesses are induced to seek out and adopt cash management techniques that permit major economies in demand deposit holdings.

The behavior of the interest-bearing components of the broader monetary aggregates—M_2 and M_3—was generally in line with historical patterns during the first three years of the economic upswing, but there has been a marked deviation since last June. Commercial banks and thrift institutions experienced rapid growth of savings and small denomination time deposits until the latter part of 1977. At that point a gap began to develop between interest rates on short- and intermediate-term market securities and the rates permitted on insured deposits by Federal regulations. As the gap grew, inflows to savings and small time accounts gradually diminished through the spring of 1978. Also, commercial banks found it necessary to rely more heavily during this period on large time deposits and other managed liabilities to fund their lending activities, and savings and loan associations borrowed heavily from Federal Home Loan Banks.

The Federal regulatory agencies authorized two new time deposit categories effective June 1 in order to prevent a repetition of past episodes when markedly reduced deposit inflows led to an abrupt curtailment of credit to home buyers and others reliant on the depositary institutions for credit. One was an 8-year account paying up to 7¾ percent at commercial banks and 8 percent at thrift institutions. The other was a 6-month money market certificate whose maximum rate varies weekly with the average yield on newly issued 6-month Treasury bills. Given rate relationships, the 8-year certificate has not added significantly to over-all deposit flows, but quite the contrary is true of the 6-month certificates. During the first 5 months of 1978, time and savings deposits subject to rate ceilings at commercial banks, savings and loan associations, and mutual banks grew at a 7.9 percent annual rate; since the beginning of June, these deposits have grown at a 10.3 percent rate despite substantial further increases in market interest rates. MMC balances at the end of January totaled about $105 billion and accounted for 7¾ percent of savings and small time deposits at banks and almost 13 percent at thrift institutions.

Although accelerating inflation has tended to dampen the impact of rising nominal interest rates on credit demands, there has been a perceptible flattening of the overall pace of borrowing in the economy over the past year. Total funds raised in credit markets by the private domestic nonfinancial sectors have expanded only moderately since the second half of 1977 after having risen rapidly during the earlier part of the economic expansion. Although the liquidity of depositary institutions has declined over the past 2 years, the introduction of the 6-month money market certificates has prevented the disintermediation that accompanied previous interest rate cycles and permitted banks and thrift institutions to continue to account for a very large share of the funds advanced to ultimate borrowers.

Households, in particular, are heavily reliant on depository institutions for credit, and their demands for funds have remained strong. Home mortgage borrowing in 1978 was slightly larger than in 1977, and consumer installment borrowing rose to a new record as households financed purchases of autos and other large ticket items. The aggregate flow of credit to households in 1978, at more than $160 billion, was 15 percent greater than in 1977 and three times the volume recorded in 1975.

The build-up of indebtedness by households over the last 3 years has outstripped both the growth of this sector's financial asset holdings and of disposable income. Repayment burdens have reached record proportions. Although loan delinquency data indicate that families have not as yet encountered significant difficulty in meeting their obligations for debt service, the diminished liquidity of household financial positions suggests a greater fragility and vulnerability to any deterioration of income flows.

The nonfinancial business sector also experienced some decline in liquidity in the past year. The gap between corporate capital spending and internal cash flow widened, and firms met a substantial portion of their external financing needs through short-term borrowings—particularly from commercial banks. While commercial mortgage borrowing increased and private bond placements remained large, many of the big, highly rated industrial firms that have ready access to the public bond markets evidently preferred to defer long-term financings in the expectation that long-term rates would eventually decline. As a consequence, the aggregate ratio of liquid assets to short-term liabilities in the nonfinancial corporate sector declined over the course of 1978, to a level only slightly above the 1974 low.

State and local borrowing was about the same in 1978 as in 1977. Advance refundings again accounted for a sizable share of tax-exempt bond issuance, but such operations virtually ceased after August owing to the combination of restrictive IRS regulations and rising interest rates. Despite some rise in the past few months, the ratio of yields on municipal bonds to those on taxable obligations has remained relatively low by historical standards, reflecting in part the continued demand for tax-exempt securities by casualty insurance companies, commercial banks, and individuals.

Borrowing by the U.S. Treasury has declined over the past year, reflecting the diminution of the Federal budget deficit. Government borrowing from the public totaled $59 billion in fiscal year 1978, but is projected by the Administration at about $40 billion in the current fiscal year. The preponderance of the increase in outstanding Treasury debt during 1978 was absorbed by State and local governments, which purchased a large volume of nonmarketable Treasury securities with proceeds of advance refundings, and by foreign official institutions, which invested dollars obtained in exchange market intervention.

Commercial banks satisfied a substantial proportion of the credit demands of households, businesses, and State and local governments during 1978. Total bank credit expanded 10.9 percent over the course of the year, with loan portfolios increasing by 14.6 percent. To meet loan demands many banks had to liquidate holdings of Treasury securities and to borrow either from correspondents or in the open market through the issuance of large CD's or nondeposit liabilities such as Federal funds and repurchase agreements. Aggregate bank liquidity ratios declined appreciably, expecially among the smaller and regional institutions that have experienced the strongest business loan growth during this expansion.

Thrift institutions experienced considerable cash flow pressure during the first half of 1978, but they have been able to rebuild their liquid asset positions since the MMC's began to bolster deposit growth. Thrift institution mortgage lending declined moderately during 1978, although there was some upturn in the final quarter in lagged reaction to the midyear pick-up in deposit inflows. Outstanding loan commitments also rose during the second half, but in December were slightly below the year-earlier level.

Life insurance companies and pension funds have continued to experience large inflows of investable funds. In 1978, as in previous years of the economic expansion, these institutions absorbed the bulk of the net issuance of corporate bonds. The insurance companies also have supplied a large share of commercial mortgage credit.

TABLE I.—SELECTED EMPLOYMENT AND UNEMPLOYMENT DATA

[Monthly data seasonally adjusted]

	1976	1977	1978	1977–78						1978–79					
				Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.
Total civilian employment (millions)	87.5	90.5	94.4	90.9	91.2	91.4	92.2	92.6	93.0	94.7	95.0	95.2	95.8	95.9	96.3
Total civilian unemployment (millions)	7.3	6.9	6.0	6.8	6.6	6.7	6.6	6.2	6.3	5.9	6.0	5.8	5.9	6.0	5.9
15 weeks and over (millions)	2.3	1.9	1.4	1.8	1.8	1.8	1.8	1.6	6.6	1.2	1.3	1.3	1.2	1.2	1.3
Unemployment rates (percent):															
Total civilian	7.7	7.0	6.0	7.0	6.8	6.8	6.7	6.3	6.3	5.9	5.9	5.8	5.8	5.9	5.8
Men 20 and over	5 9	5.2	4.2	5.1	4.7	4.9	4.7	4.5	4.6	4.1	4.1	4.0	3.9	4.1	4.0
Women 20 and over	7.4	7.0	6.0	7.0	6.9	6.8	6.9	6.5	6.2	5.9	5.9	5.6	5.8	5.8	5.7
White	7.0	6.2	5.2	6.1	6.0	5.9	5.8	5.4	5.5	5.2	5.2	5.1	5.0	5.2	5.1
Black and other	13.1	13.1	11.9	11.4	13.2	13.6	13.5	12.6	12.8	11.5	11.3	11.3	11.7	11.5	11.2
Household heads	5.1	5.4	3.7	4.5	4.3	4.4	4.1	3.9	3.9	3.7	3.6	3.5	3.4	3.5	3.4

Source: Economic Indicators, January 1979 and data accessed from the files of Data Resources, Inc.

TABLE II.—CHANGES IN PRODUCTIVITY AND RELATED DATA[1]

[Percent change: Quarterly data at seasonally adjusted annual rate]

	Output per hour	Compensation per hour	Unit labor costs
Private business sector:			
1965–73 (average)[2]	2.1	6.8	4.6
1973	1.9	8.2	6.2
1974	−3.0	9.1	12.5
1975	2.1	9.9	7.7
1976	3.5	8.7	5.0
1977	1.6	8.1	6.4
1978	.4	9.3	8.9
1977: IV	.4	6.7	6.3
1978: I	−4.5	12.1	17.4
1978: II	1.2	8.1	6.8
1978: III	3.5	10.4	6.7
1978: IV[3]	2.1	8.7	6.5
Nonfarm business sector:			
1965–73 (average)[2]	1.8	6.6	4.7
1973	1.7	7.8	6.0
1974	−3.1	9.1	12.6
1975	1.9	9.9	7.8
1976	3.5	8.4	4.7
1977	1.3	8.1	6.7
1978	.6	9.4	8.8
1977: IV	.5	7.6	7.1
1978: I	−3.1	12.2	15.7
1978: II	1.7	8.2	6.4
1978: III	2.3	9.6	7.1
1978: IV[3]	2.3	9.1	6.7

[1] Output per hour or labor productivity, measures the volume of goods and services produced per hour. Compensation per hour includes wages and salaries of employees plus employers' contributions for social insurance and private benefit plans. Unit labor costs measure the labor compensation cost required to produce 1 unit of output and are derived by dividing compensation per hour by output per hour.
[2] Calculated from a least squares trend calculated from the logarithms of the numbers.
[3] Preliminary.

Sources: Economic Indicators, January 1979 and U.S. Department of Labor, Bureau of Labor Statistics.

TABLE III.—CHANGES IN PRICE INDEXES

	1975	1976	1977	1978	1977:IV	1978:I	1978:II	1978:III	1978:IV
Consumer Price Index[1]	7.0	4.8	6.8	9.0	4.5	8.0	10.9	8.6	8.4
Commodities less food	6.2	5.1	4.9	7.7	4.4	6.1	6.5	7.4	9.7
Services	8.1	7.3	7.9	9.3	5.6	7.4	11.3	10.8	8.1
Food	6.5	.6	8.0	11.8	3.6	12.4	20.0	7.0	6.9
Producer Price Index finished goods[1]	6.6	3.3	6.6	9.1	5.9	9.5	11.2	6.8	10.9
GNP implicit price deflator price deflator[2]	9.6	5.2	5.9	7.4	5.5	7.2	11.0	6.9	8.1

[1] December-to-December yearly increase or quarter-to-quarter increase at seasonally adjusted compound annual rates.
[2] Year-to-year increase or quarter-to-quarter increase at seasonally adjusted compound annual rates.

Source: Economic Indicators, January 1979.

TABLE IV.—SELECTED INTEREST RATES, 1975–79

	1975	1976	1977	1978	1978				1979, January
					March	June	September	December	
3-mo treasury bills (new issues)	5.84	4.99	5.26	7.22	6.32	6.71	7.84	9.12	9.35
10-yr treasury securities (constant maturity)	7.99	7.61	7.42	8.41	8.04	8.46	8.42	9.01	9.10
Corporate Aaa bonds (Moody's)	8.83	8.43	8.02	8.73	8.47	8.76	8.69	9.16	9.25
Prime commercial paper, 4–6 mo	6.33	5.35	5.60	7.99	6.80	7.63	8.44	10.43	10.32
Prime rate charged by banks	7.86	6.84	6.82	9.06	8.00	8.63	9.41	11.55	11.75
New home mortgage yields, FHLBB series	9.01	8.99	9.01	9.54	9.26	9.46	9.73	10.02	(1)
Federal Reserve discount rate	6.25	5.50	5.52	7.52	6.50	7.00	7.75–8.00	9.50	9.50
Federal funds rate	5.82	5.05	5.54	7.93	6.79	7.60	8.45	10.03	10.07

[1] Not available.

Sources: Board of Governors of the Federal Reserve System, Federal Home Loan Bank Board, and Moody's Investors Service.

TABLE V.—MONETARY AND CREDIT AGGREGATES

[Percentage change, seasonally adjusted annual rates]

	1975 [1]	1976 [1]	1977 [1]	1978 [1]	1977: IV [2]	1978: I [2]	1978: II [2]	1978: III [2]	1978: IV [2]	Federal Reserve targets: 3d quarter 1978 to 3d quarter 1979
Monetary aggregates:										
M_1	4.6	5.8	7.9	7.3	7.5	6.9	9.5	8.4	4.4	2.0–6.0
M_{1+}	8.8	12.6	9.3	5.3	6.8	5.1	7.4	6.2	2.5	4.0–6.5
M_2	8.4	10.9	9.8	8.5	8.1	7.2	8.6	10.3	8.0	6.5–9.0
M_3	11.1	12.7	11.7	9.4	10.5	8.3	8.7	10.8	9.7	7.5–10.0
Deposits at nonbank thrift institutions	15.6	15.6	14.5	10.6	13.8	10.0	8.8	11.5	12.2	NA
Bank credit [3]	4.1	8.1	11.2	11.5	10.1	10.6	15.9	11.3	8.3	8.5–11.5
Reserves:										
Required	−5.9	.1	3.8	11.0	6.4	8.7	6.7	9.0	20.0	NA
Nonborrowed	−2.7	.2	1.2	11.1	3.5	15.4	−.1	6.7	23.8	NA
Monetary base	7.6	8.4	8.8	9.6	9.3	10.4	8.2	9.7	10.1	NA

[1] From 4th quarter of previous year to 4th quarter of year indicated.
[2] From previous quarter.
[3] Total loans and investments at commercial banks.

Sources: Board of Governors of the Federal Reserve System and Federal Reserve Bank of St. Louis.

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

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

	1975	1976	1977	1977(IV)	1978(I)	1978(II)	1978(III)
Total funds raised, by instrument	220.2	301.3	399.4	438.2	491.3	454.5	428.4
Investment company shares	−.1	−1.0	−1.0	.9	−.2	−.9	−1.8
Other corporate equities	11.2	12.4	4.8	6.5	1.2	2.1	1.0
Debt instruments	209.1	289.8	395.6	430.9	498.2	453.3	428.3
U.S. Government securities	98.2	88.1	84.3	91.7	105.1	92.9	97.5
State and local obligations	15.6	19.0	29.2	25.0	22.2	35.8	37.6
Corporate and foreign bonds	36.4	37.2	36.1	40.1	29.9	33.7	34.2
Mortgages	57.2	87.1	134.0	152.4	137.3	137.9	134.2
Consumer credit	9.4	23.6	35.0	36.2	38.0	51.6	43.4
Bank loans, n.e.c.	−13.9	6.4	32.2	30.9	67.3	33.5	26.6
Open market paper and Rp's	−2.4	13.3	19.8	15.0	50.8	36.7	21.4
Other loans	8.7	15.3	25.1	39.6	39.7	31.1	24.5

Source: Board of Governors of the Federal Reserve System.

IV. THE ECONOMIC OUTLOOK FOR 1979

A. The Economic Outlook of the Administration

The following information, taken from the 1979 Annual Report of the Council of Economic Advisers which is included in the Economic Report of the President, indicates the outlook for 1979 according to the CEA.

> In 1979 the economy will enter its fifth consecutive year of economic growth, making this the second largest recovery in postwar history. As a recovery matures, sustaining a satisfactory pace of expansion becomes more difficult. Housing, in which starts have more than doubled since early 1975, is only one example. Given current demographic trends, a high level of starts is sustainable, but housing could not be expected to add much to growth even under the most favorable circumstances in financial markets. The saving rate has fallen to very low levels by historical standards, and the rise of consumption may consequently drop behind the growth of disposable income. In addition, business fixed investment in real terms has

already regained its prerecession ratio to gross national product (GNP), and hence a slower growth of business capital expenditures is likely. All these factors will combine to check the pace of economic expansion next year.

As Chapter 2 makes clear, a reduction in economic growth from the rate of the last 2 years is needed both because idle labor and capital resources have been cut considerably and because inflation has accelerated. The task for aggregate demand policies will be to provide a climate in which inflationary pressures can begin moderating, but to avoid restraint so severe as to generate a recession.

Real growth is projected to average about 2¼ percent for the 4 quarters of 1979, a lower growth rate than in 1978 but positive throughout the year. If the anti-inflation program succeeds, as is anticipated, the rate of growth of consumer prices should slow to less than 7½ percent over the 4 quarters of 1979, and to an annual rate of slightly under 7 percent by the end of the year. According to initial indications, business and labor groups are taking the President's voluntary standards seriously, but success cannot yet be assured. Widespread compliance with the anti-inflation program is essential to maintenance of a strong and healthy economy.

In 1980, real growth is expected to rise to a rate of 3¼ percent over the 4 quarters, largely as a result of an upturn housing, while inflation will continue to slow, dropping below 6½ percent. Here also success in the fight against inflation will contribute materially to sustaining economic growth by reducing the pressures on credit markets and strengthening confidence among consumers and businesses.

Employment is expected to rise by about 2 million a year in both 1979 and 1980. Productivity is expected to grow at about the same rate in 1979 as in 1978, with some improvement in 1980. It is likely to remain well below its trend rate of increase of about 1½ percent. With the labor force expected to continue growing at a rate above the long-term trend and real growth slowing, the unemployment rate is likely to increase to 6¼ percent by the end of 1979 and remain near that level in 1980.

The course of fiscal policy that is appropriate for 1979 and 1980 was described generally in Chapter 2. In specific terms, Federal outlays are projected to be $493 billion in fiscal 1979, an increase of over 9 percent from the previous year. In fiscal 1980 the President's budget calls for outlays of $532 billion, an increase of less than 8 percent. This 1980 figure includes a small real increase in defense spending, a constant level of real spending for domestic programs, and restraint in or deferrals of new spending initiatives. Because existing legislation mandates contined real growth in some programs, such as health care and social security, zero real growth in domestic spending can be achieved only through reductions in real outlays for a number of other programs. Holding outlays to $532 billion will require strenuous efforts by government agencies as well as cooperation from the Congress.

The combined effects of rising inflation and efforts by the Federal Reserve to hold down the growth of the monetary aggregates carried interest rates last year to near record levels. More restrained growth of the monetary and credit aggregates is an appropriate complement to the other parts of the anti-inflation program. It will help to moderate the rate of economic expansion. Additionally, higher U.S. interest rates make dollar-denominated assets more attractive than those denominated in foreign currencies and thus contribute to sustaining the value of the dollar in exchange markets.

Many private forecasters anticipate a recession in 1979, partly because they expect that current high interest rates will substantially depress housing and business investment. High interest rates are likely to dampen aggregate demand in 1979, but to a lesser degree than one would expect from past experience because of institutional changes in financial markets. Our judgment that economic growth in 1979 will be sustained reasonably well and that a recession will be avoided depends in part on our analysis of why the effect of monetary restraint is different from what it used to be.

During most of the postwar period, intervals of substantial monetary restraint were followed by recessions. Curbing aggregate demand through the use of monetary restraint disrupted financial markets because the depository institutions experienced a large outflow of deposits when interest rates on market instruments rose above the rates these institutions were permitted to pay to attract consumer savings. This disintermediation sharply reduced the availability of credit for those borrowers most dependent on commercial banks and thrift institutions for credit. These included small businesses and some units of State and local government, but the sector most severely hit was the mortgage market. As mortgage credit became not merely more expensive but unavailable, residential construction dropped precipitously, and this sharp drop was often important in tipping the entire economy into recession.

Table 19 shows periods of such cyclical declines in acquisitions of mortgages by financial institutions and the associated declines in single-family and multifamily housing starts. In the 1965–66 period the sharp decline in residential construction contributed to a slowing of overall economic growth, but the expansion of Federal outlays was sufficiently strong to maintain economic expansion. The 1959–60, 1969–70, and 1972–74 episodes were all followed by recessions. Of course, factors other than the decline in housing were also involved in each of these recessions, but the speed with which the decline in housing occurred had a destabilizing effect for which it was difficult to compensate elsewhere in the economy.

TABLE 19.—CYCLICAL CONTRACTIONS IN MORTGAGE CREDIT AND HOUSING STARTS, 1959–74

[Percent change at seasonally adjusted annual rate, except as noted]

Period	Interest rate [1]	Mortgage acquisitions [2]	Housing starts	
			Single-family	Multifamily
1959 II to 1960 II	1.27	−12.7	−17.3	−16.4
1965 III to 1966 IV	1.41	−28.9	−28.5	−36.1
1969 I to 1970 I	1.35	−28.2	−23.1	−30.1
1972 IV to 1974 IV	3.36	−24.8	−22.9	−53.2

[1] Percentage point change in the quarterly average market yield on 6-month Treasury bills from the beginning of the period to the peak reached during the period.
[2] Acquisitions by financial institutions.

Sources: Department of Commerce (Bureau of the Census), Board of Governors of the Federal Reserve System, and Federal Home Loan Bank Board.

As discussed in Chapter 1, the principal reason for this higher growth was the new regulation that permitted the issuance of money market certificates beginning last June. This change followed upon similar, but much smaller, steps taken in 1970 and 1973. In those instances interest ceilings were raised on longer-term certificates of deposit, thus reducing somewhat the vulnerability of thrift institutions to deposit outflows (Passbook and shorter-term certificate ceilings were also raised slightly in 1970 and 1973.)

Institutional changes have also occurred in other financial markets. Commercial banks no longer depend primarily on liquidating U.S. Government securities to obtain funds for business lending, as they had done through the early part of the postwar period. The advent of liability management (exemplified by the issuance of negotiable certificates of deposit and the use of nondeposit sources of funds) has enabled most banks to obtain the funds they want for lending, provided they are willing to pay going rates of interest. Moreover, large firms can increasingly shift their borrowing between commercial banks and open market commercial paper, and between foreign and domestic sources, in response to differences in the cost and availability of funds. Their direct access to credit markets makes them less dependent on intermediation by institutional lenders. The expansion of trade credit provides a mechanism through which large firms extend this benefit to smaller customers and suppliers.

The result of these institutional changes has been to smooth the response of the economy to increased restraint in financial markets. In place of sharp changes in availability of credit, there is now a more gradual response of credit users to changes in the cost of credit. Measured application of monetary restraint has become more feasible. The degree of restraint required to achieve the desired growth in private demand is difficult to judge, however, because the response of the private sector is likely to occur more slowly and to be diffused more widely than in the past. Moreover, the indicators showing the degree of restraint have changed, and experience in implementing monetary policy under present circumstances will come only gradually.

Over the near future, nominal interest rates are likely to remain relatively high by historical standards. It will take time to reduce the rate of inflation and the inflation premiums contained in interest rates. As inflation recedes, the maintenance of are strained monetary policy will consistent with a decline in nominal interest rates.

The economy is entering 1979 with substantial momentum, and economic expansion will be bolstered by the recent enacted tax bill, which will help to sustain consumer expenditures during the first half of the year. Later in the year, as the effect of the tax cut wears off, a slower expansion of consumer purchases is foreseen. Partly as a response to current high interest rates, housing starts are expected to decline and the growth of business fixed investment to diminish during the year (Table 21).

TABLE 21.—ECONOMIC OUTLOOK FOR 1979

Irem	1978 [1]	Foremost range 1979
Growth rates, fourth quarter to 4th quarter (percent):		
Real gross national product	4.3	2 to 2½
Personal consumption expenditures	3.8	1¾ to 2¼
Nonresidential fixed investment	8.3	4 to 4½
Residential investment	−.8	−8½ to −9½
Federal purchases	−.3	¾ to 1¼
State and local purchases	3.5	1¾ to 2¼
GNP implicit price deflator	8.3	7¼ to 7½
Compensation per hour [2]	9.8	8¼ to 8¾
Output per hour [2]	.5	¼ to ¾
Level, 4th quarter: [3]		
Unemployment rate (percent)	5.8	6 to 6½
Housing starts (millions of units [4])	2.1	1½ to 1¾

[1] Preliminary.
[2] Private business sector; all persons.
[3] Seasonally adjusted.
[4] Annual rate.

Sources: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and Council of Economic Advisers.

Growth is likely to be stronger in the first half of the year than in the second half. Housing starts are expected to bottom out during the fourth quarter of 1979 and begin to move up in 1980 as pressures in money and credit markets ease with the decline in the rate of inflation. The upturn in housing is a principal reason for the anticipated increase in the rate of economic growth in 1980.

The rate of increase of the GNP deflator is expected to decline from 8.3 percent in 1978 to slightly under 7½ percent during the 4 quarters of 1979; a further drop to just under 6½ percent is probable during 1980, partly as a result of a tightening of the pay and price standards. Inflation is likely to remain high during the first half of 1979, however, because of the minimum wage increase in January, the delayed effects on import prices of the decline in the value of the dollar, the oil price increases by the Organization of Petroleum Exporting Countries (OPEC), and the continued rise in food prices. As the year proceeds, these factors will put less upward pressure on prices, and the effects of the President's anti-inflation program should be increasingly felt. Consequently the increase in consumer prices is expected to fall to an annual rate of below 7 percent by late in the year.

B. The Economic Outlook of the Federal Reserve

In its report to the Congress the Federal Reserve included the following summary of their qualitative interpretation of the Economic outlook for the next year. The Federal Reserve has not made public its quantitative forecast for 1979.

> Despite the surge in real GNP during the fourth quarter, it appears that underlying economic and financial conditions will lead to a moderation of economic growth in the year ahead. The absence of the sorts of distortions and imbalances that have often precipitated economic downturns in the past indicates that is should be possible to slow the pace of expansion—and thereby relieve inflationary pressures—without promoting a recession. However, any further acceleration of inflation or the occurrence of severe shortages of critical commodities, such as oil, would imperil this outcome.
>
> The monetary restraint applied over the past year by the Federal Reserve is expected increasingly to affect the residential construction sector. Higher costs of credit will cause land developers and builders to put aside marginally profitable projects, and the combination of higher house prices and mortgage rates will lead some families to defer home purchase. Nonetheless, owing to the MMCs and various institutional developments that have broadened the sources of mortgage funds, as well as to the strong underlying demand for shelter, the decline in housing activity should be moderate by comparison with past cycles.
>
> Business fixed investment likely will continue to grow during 1979, but at a slower rate than in 1978. There has been some indication in the past few months of a slowing in the steep upward trend of contracts and orders for plant and equipment, and this is generally consistent with surveys of capital spending plans which point to smaller gains in outlays this year than last. On the other hand, the climate for investment can be expected to improve as business managers begin to perceive some progress in retarding inflation and become more confident about the sustainability of expansion.
>
> Government spending probably will post only a small increase in real terms this year. Indeed, real Federal purchases could decline during the first half due partly to expected repayments of Commodity Credit Corporation loans (which are, in effect, sales of agricultural stocks). At the State and local level, slower growth of Federal financial aid and the pressure for tax relief will tend to hold spending increases to small proportions.
>
> Foreign demand for U.S. exports should tend to strengthen during 1979. Economic expansion abroad is generally expected to continue at its recent more rapid pace, and the effects of the substantial depreciation of the dollar on the

U.S. trade position should become more evident as the year progresses.

On balance, the aforementioned sectors are likely to provide a reduced impetus to income growth during the year ahead. As a consequence, consumer spending is likely to grow less vigorously, Moreover, the substantial debt repayment burdens faced by many households and generally reduced liquidity of the household sector could prompt households to increase their recent relatively, low savings rate. The demand for imports also should moderate this year, not only because of the slower expansion of domestic income and production, but also because of the lagged effects of the 1977–78 decline in the international exchange value of the dollar. Inventory investment is likely to be relatively flat in the projected economic environment.

With a slower growth of activity, pressures on productive capacity should ease a bit. Industrial capacity utilization rates, which in the manufacturing sector are not now far below past cyclical peaks, should decline slightly. In labor markets, the growth of employment should moderate from its recent rapid pace. Labor force increases likely also will diminish, as the growth of the working age population slows slightly and as labor force participation rates—expecially for youth—respond to the slackening in economic expansion. Together, the prospective changes in employment and the labor force point to a small increase in the over-all unemployment rate during 1979.

The moderation of demand pressures in labor and product markets will tend to slow the advance of wages and prices and thus to reduce the present, unacceptable rate of inflation. However, uncertainties will remain as a result of highly volatile and largely exogenous influences such as farm prices and oil prices. It now appears that food prices will increase somewhat less this year than last. Unfortunately, the price of imported oil will be boosted substantially this year as a result of the decisions taken by OPEC in December, and the unsettled situation in Iran raises the possibility of even larger price increases.

Setting aside these special factors, a key determinant of the rate of inflation this year will be the performance of unit labor costs. Although there may well be some improvement in productivity in the next few years as the work force tends to become, on average, somewhat older and more experienced, there is little reason to expect any marked acceleration of productivity growth during 1979. Consequently, if there is to be a noticeable slowing in the rise of unit labor costs, compensation gains will have to moderate significantly.

Toward this end, the Administration's wage-price program can play an important role. By providing a standard for constructive behavior on the parts of both business and labor, the program can be a vehicle for helping to brake the wage-price spiral. Broad compliance with the Administration's standards would make a significant contribution to the slowing of inflation. Of course, the wage-price program can be successful only if there is complementary restraint in monetary and fiscal policy—to contain aggregate demand pressures and to assure the public of the Government's commitment to the restoration of price stability.

C. Economic Outlook of Congressional Budget Office

The following material is taken from the Congressional Budget Office report to the House and Senate Budget Committees made in January 1979.

The CBO current policy forecast

Forecasts of economic activity and inflation depend critically on assumptions about fiscal and monetary policy. The CBO economic projection is based upon the following policy assumptions:

Federal tax and spending policies in fiscal year 1979 are as given in the budget resolution enacted last fall; the same policies are also assumed to continue in fiscal year 1980. Current policy outlays are estimated to total about $494 billion in fiscal year 1979 and $551 billion in fiscal year 1980.

Neither the real wage insurance proposed by the Administration as part of its wage/price guidelines program nor any tax changes, other than those already enacted, are included in the forecast. Expenditure cuts proposed by the Administration are also not included.[1]

Monetary authorities are assumed to continue in the recently announced program to reduce inflation and prevent further depreciation of the dollar. This policy is assumed to prevent the growth in the broadly defined money stock (M_2) from exceeding Federal Reserve targets and to result in a further rise in short-term interest rates through the second quarter of 1979.

Given those assumptions, the CBO forecast, shown in Summary Table 1 is as follows:

Growth in constant dollar gross national product (GNP) will slow from over 4 percent last year to a 0 to 2 percent range from the fourth quarter of 1978 to the fourth quarter of 1979. During 1980, real economic growth will recover moderately, rising to a 3 to 5 percent range.

Unemployment is expected to rise from current levels to a range of 6.2 to 7.2 percent by the last quarter of 1979, with little change in 1980.

Prices are expected to rise by 7.0 to 9.0 percent during 1979, moderating somewhat, to 6.5 to 8.5 percent, in 1980.

SUMMARY TABLE 1.—SUMMARY OF CBO ECONOMIC PROJECTIONS UNDER CURRENT POLICY, CALENDAR YEARS 1979 AND 1980

Economic variable	1976:4 to 1977:4 (actual)	1977:4: to 1978:4 (actual)	1978:4 to 1979:4	1979:4 to 1980:4
GNP (current dollars, percent change)	11.9	12.9	7.0–11.1	9.7–13.9
GNP (1972 dollars, percent change)	5.5	4.3	0 – 2.0	3.0– 5.0
Consumer Price Index (percent change)	6.6	8.9	7.0– 9.0	6.5– 8.5
Unemployment rate, end of period (percent)	6.6	5.8	6.2– 7.2	6.2– 7.2

[1] A CBO forecast based upon the Administration's fiscal assumptions will appear in the CBO document, "An Analysis of the President's Budgetary Proposals for Fiscal Year 1980" (January 1979).

The economy is not projected to weaken immediately. Available data on real activity do not yet show the widespread imbalances that typically precede a downturn. But CBO does foresee a modest decline in real GNP beginning in the second half of 1979.[2]

Sources of uncertainty

The Major Uncertainty.—The outlook for the economy in 1979 is unusually uncertain. The critical factors in this uncertainty are the future course of inflation and the response of monetary policy. Restrictive monetary policies already in place have increased the probability of a downturn in economic activity in the year ahead, and most forecasters, including CBO, expect credit conditions to tighten further in response to continued rapid inflation. But that outcome is by no means assured. Forecasts of inflation are subject to substantial error, and the Federal Reserve's policy response to inflation and other developments in the coming months is also uncertain. If inflation slows significantly in the months ahead, the Federal Reserve may be able to avoid a prolonged period of credit restraint, which would considerably improve the prospects of avoiding a recession this year.

Other Sources of Uncertainty.—Other events that could significantly affect the outlook include: the possibility of major strikes, in response to business firms' efforts to comply with the Administration's wage/price guidelines; prolongation of the current "buy-in-advance" psychology, born of a general expectation of rising prices; fuel shortages, arising from the political disturbances in Iran or other causes; a sharp shift in the value of the dollar in foreign exchange markets, despite stabilization efforts; and exceptionally large or small harvests, causing large unexpected movements in food prices.

Reasons for a downturn in 1979

Although the economy does not yet show significant signs of weakening, continued high rates of inflation appear to be sowing the seeds of a downturn. The momentum of inflation is very strong and CBO expects that the Administration's wage/price guideline program will not quickly slow that momentum. Thus, the Federal Reserve, which has responded to accelerating prices by tightening credit, is expected to continue to pursue a tight monetary policy. The prospect of continued high and rising interest rates for many months makes a subsequent downturn in economic activity the most likely outcome.

Tight credit conditions are expected to slow housing activity and business investment. But the predicted decline in housing starts has been delayed longer than in earlier periods of high interest rates. The availability of funds for mortgage lending has not been reduced to the usual extent because deposit flows have been boosted by the six-month money market savings certificate introduced by savings institutions last spring. Virtually all analysts, however, expect a decline in housing activity during 1979, both because of declining demand and reduced availability of mortgages. Recent surveys of business investment plans also indicate a slowdown in 1979. More-

---

[2] The CBO forecast satisfies the popular definition of a recession—two consecutive quarters of decline in real GNP—but it may not conform to the National Bureau of Economic Research definition of recession, which takes many other factors into account.

over, retail sales appear vulnerable. Indications of slower future growth in consumer spending include:

High rates of inflation, which have eroded real income growth and contributed to a buy-in-advance psychology that may have improved recent sales at the expense of sales later in the year;

A decline in consumer confidence; and

Historically high consumer debt burdens.

Reasons for a mild downturn and recovery

Although some forecasters now expect a deep recession beginning late this year, CBO concludes that the projected late 1979 downturn will be neither deep nor prolonged because:

Businesses appear to have maintained relatively lean inventories; hence, any inventory adjustment should be mild;

Net exports are projected to be a source of considerable strength, as a result of an expected improvement in the economic growth of U.S. trading partners and because of the depreciation of the dollar last year;

The cut in income taxes early in 1979 is expected to provide stimulus to business and consumer spending throughout the year;

Large backlogs in orders in capital goods industries will provide support to total spending during the slowdown; and

The state and local sector is expected to continue to work down operating surpluses.

CBO predicts a less robust recovery in 1980 than the typical postwar upswing because the downturn is expected to be mild and inflation is forecast to remain high. As a result, monetary policy is not projected to respond as much as usual to the elevated unemployment rates. Furthermore, federal fiscal policy (with current policy) will exert a drag on economic activity in 1980, as the interaction of inflation and the progressive tax structure causes effective personal income tax rates to rise.

V. THE SHORT-TERM ECONOMIC GOALS FOR 1979 AND 1980 IN THE PRESIDENT'S ECONOMIC REPORT:

The Full Employment and Balanced Growth Act of 1978 required that the President set forth in his Economic Report short-term goals which are consistent with achieving the unemployment goals (4 percent overall and 3 percent adult) and the inflation goal (3 percent) by 1983. The short-term goals cover the year in which the report is transmitted and the following year, and the Federal Reserve is expected to indicate the relationship between its own policy objectives and plans and those goals set forth by the President.

The Economic Report indicates that the short-term goals for 1979 and 1980 represent "a forecast" of how the economy will respond over the next two years not only to the budgetary policies proposed by the President for fiscal policy in 1979 and 1980 but to the anti-inflation program announced on October 24. The Full Employment and Balanced Growth Act declares that improved and coordinated fiscal and monetary management is needed to reduce the rate of inflation. Thus, implicitly the economic goals set forth in the Economic Report must also assume that monetary policy will be conducted in a manner consistent with achieving the short-term goals. For that reason, the Act requires that the Federal Reserve explain the relationship between its intended policies and the economic goals. The Congress has in the legislative history of the Act indicated that:

> In explaining the relationship of the Board's objectives and plans to the short-term goals established by the President in his Economic Report and any subsequent goals established by the Congress with a full discussion concerning the extent to which the Federal Reserve's intended policies would help to achieve those goals.

This language was agreed to by the Federal Reserve Board.

The Administration's goals, along with the comparable figures for 1978, are summarized in the following table:

THE PRESIDENT'S ECONOMIC GOALS

Item	Actual 1978	Goals 1979	Goals 1980
Level, 4th quarter:			
Employment (millions)	95.6	97.5	99.5
Unemployment rate (percent)	5.8	6.2	6.2
Percentage change, 4th quarter to 4th quarter:			
Consumer prices	8.9	7.5	6.4
Real GNP	4.3	2.2	3.2
Real disposable income	3.3	2.9	2.3
Productivity	.2	.4	1.1

VI. THE FEDERAL RESERVE'S OBJECTIVES AND PLANS FOR MONETARY POLICY AND THEIR RELATIONSHIP TO THE PRESIDENT'S ECONOMIC GOALS FOR 1979 AND 1980

The Federal Reserve has informed the Congress that the objective of monetary policy 1979 is "to foster financial conditions conducive to a continued, but more moderate, economic expansion during 1979 that should permit a gradual winding down of inflation and the maintenance of the stronger position of the dollar in international exchange markets."

The Federal Reserve's monetary policy plans are summarized by ranges of growth in monetary and credit aggregates that have been established as targets for calendar year 1979. Those target ranges are summarized in the following table which shows target ranges and actual growth during similar previous periods:

FEDERAL RESERVE SYSTEM TARGET RANGES AND ACTUAL GROWTH RATES

Period	M_1 Target	M_1 Actual	M_2 Target	M_2 Actual	M_3 Target	M_3 Actual	Bank credit Target	Bank credit Actual
1975:Q4 to 1976:Q4	4.5–7.5	5.8	7.5–10.5	10.9	9.0–12.0	12.7	[1] 6.0–9.0	[1] 8.0
1976:Q4 to 1977:Q4	4.5–6.5	7.9	7.0–10.0	9.8	8.5–11.5	11.7	7.0–10.0	11.3
1977:Q4 to 1978:Q4	4.0–6.5	7.3	6.5–9.0	8.5	7.5–10.0	9.4	7.0–10.0	11.4
1978:Q4 to 1979:Q4	1.5–4.5	NA	5.0–8.0	NA	6.0–9.0	NA	7.5–10.5	NA

[1] The credit aggregate used as a target for monetary policy was the bank credit proxy. After November 1976 the aggregate used was total bank credit.

NA—Not applicable.

Definitions:

M_1: Private demand deposits plus currency in circulation.

M_2: M_1 plus time and savings deposits at commercial banks other than large negotiable CD's at weekly reporting banks.

M_3: M_2 plus deposits at mutual savings banks, savings and loan associations, and credit unions.

Bank credit: Total loan and investments at commercial banks.

The Fed's growth rate range for M_1 calls for a marked deceleration from the pace of recent years. This reflects the expectation that there will be significant shifting of funds to savings accounts with automatic transfer (ATS) features and to NOW accounts recently authorized for depository institutions in New York State. The Board's staff has projected that such shifting of funds from demand deposits will dampen M_1 growth by about 3 percentage points. This estimate is based on data reported on ATS and NOW's over the November 1978 to January 1979 period and an analysis of the experience in the New England States when NOW accounts were first authorized. The Board's report to the Congress indicates that this projection carries a broad range of uncertainty.

The Board's report also indicates that the FOMC is not fully satisfied that the recent flatness in M_1 relative to historical experience among money, income, and interest rates is transitory or one that is likely to persist. That considerable uncertainties currently exist is indicated by the wider growth range—3 percentage points versus 2—for M_1. The Board admitted that M_1 may continue to be a "somewhat ambiguous" indicator of monetary policy.

The Federal Reserve indicated that there are also questions regarding the behavior of the interest bearing components of M_2. It is expected that M_2 growth will be somewhat stronger in the months ahead, buttressed by "further sizable increases in the large denomination time deposits included in the total and abatement of the recent unusually large withdrawals of funds from savings deposits."

The range for M_3 implies a continued substantial growth of deposits at non-bank thrift institutions, partially due to the issuance of six-month money market certificates.

The projected range for bank credit expansion reflects an expectation that loan demand will be less intense in 1979 than in 1978.

In explaining the relationship between the Federal Reserve's monetary policy plans and the short-term goals set forth by the President, the Board indicated that "the monetary growth ranges and the Administration's 1979 economic goals appear reasonably consistent". There was no Federal Reserve comment in the relationship between intended monetary policy and the economic goals for 1980. Rather, the Board's report indicated that "considerably greater uncertainties naturally are encountered with respect to the Administration's goals for 1980 * * *".

With regard to the output-price mix, the Federal Reserve has indicated that the Administration's economic goals for 1979 implies an expansion of nominal GNP of 9¾ percent from the fourth quarter 1978 to the fouth quarter 1979. In testimony before the House Banking Committee Chairman Miller indicated that his own view of the output price mix may be a little less optimistic than that of the Administration with real GNP growing at 1.75 to 2.25 percent as compared with the Administration's 2.2 percent target and inflation of 7.5 to 8.25 percent versus the 7.5 percent target. No similar breakdown was given by Chairman Miller for 1980. However, the Administration's targets for 1980 are for 9¾ nominal GNP again with real GNP growth of 3.2 percent and inflation about 6.4 percent.

The midpoint of the Fed's target range for M_1 is adjusted for the expected impact of shifts of funds from demand deposits to ATS and NOW accounts. This growth in M_1 would be consistent with nominal GNP growth of 9¾ percent provided an increase in M_1 velocity on the order of 3½ percent. This is somewhat above M_1 velocity's longer-term trend, but the Fed believes this would be reasonable "in light of the lagged effects of the recent substantial increases in interest rates and the downward shift in money demand that has been occurring." The upper limit of M_1 growth of 7½ percent after adjustment would allow for less velocity growth, while the lower bound of 4½ percent would foster velocity growth.

With regard to the employment and productivity goals the Federal Reserve has indicated that the Administration's forecasts for 1979 "appear consistent with the output goal." No further analysis was given. The goal for unemployment—6.2 percent for the fourth quarter 1979—"seems" according to the Federal Reserve "consistent with reasonable assumptions about labor force growth in the projected economic environment." No further explanation was given. The 1980 unemployment goal of 6¼ percent by the fourth quarter would, however, "require considerable progress in the lowering of inflationary expectations," again without further explanation.

The Federal Reserve's report also indicates that the Administration's 1980 forecast can serve as an appropriate goal for Congressional budgetary planning for fiscal year 1980. They continued that if inflationary pressures subsequently should prove stronger than the 6.4 percent projected by the Administration, the prudent course would be to exercise a substantial degree of restraint "even if it risks less real growth in 1980 than the 3.2 percent goal."

VII. ANALYSIS OF THE FEDERAL RESERVE'S MONETARY POLICY OBJECTIVES AND PLANS

Inflation is by any measure the Nation's most pressing economic problem. The solution to the inflationary problem must come from many fronts, including but not necessarily limited to more moderate fiscal and monetary policies, moderation in the rates of increase of prices and wages, a review and perhaps a reduction in inflationary governmental regulations, increases in productivity, and lowering of inflationary expectations. This process should not be expected to be successful instantly; it will probably take several years. The Federal Reserve's announced objective of fostering financial conditions conducive to continued but more moderate economic expansion during 1979 in order to permit a gradual unwinding of inflation is both appropriate and necessary. However, care must be taken by the Federal Reserve in its approach to its objective so as to moderate economic expansion rather than to stop it completely.

At this time it is very difficult to judge the economic outlook for 1979. As the following table indicates the Administration and the Federal Reserve are more optimistic with regard to both inflation and economic growth than is the Congressional Budget Office which expects a recession to develop later in the year and little improvement on inflation. The Committee also heard testimony from outside witnesses that a recession later this year was probable.

SUMMARY OF ECONOMIC OUTLOOK FOR 1979

	Actual 1978	Administration's goals for 1979	Administration's economic outlook for 1979	CBO outlook for 1979	Federal Reserve Chairman Miller, 1979
Nominal GNP	12.9	9.9	9.25–10	7.0–11.1	9.75
Real GNP	4.3	2.2	2.0–2.5	0–2.0	1.75–2.25
Inflation (CPI)	8.9	7.5	7.25–7.5	7.0–9.0	7.5–8.25
Unemployment rate, 4th quarter 1979	5.8	6.2	6.0–6.5	6.2–7.2	6.2

The Federal Reserve's monetary policy plans are expressed in terms of growth rate ranges for M_1, M_2, M_3 and bank credit. Recent financial innovations has made the interpretation of the growth of these aggregates vis-a-vis intended monetary policy extremely difficult. In particular growth of M_1 is distorted by automatic transfer savings accounts authorized last November and transfers to NOW accounts authorized for New York state institutions last fall, and by the inducement high short-term interest rates has given to usage of cash management techniques including repurchase agreements, overnight Euro-dollars, and liquid asset mutual funds. The growth of M_2 and M_3 may also be distorted by these factors and by the 6-month money market certificates introduced last June. These certificates have now attracted over $100 billion. Thus, at least during this transition period growth of the monetary aggregate may not give a true indication of the Federal Reserve's monetary policy stance. A broader and better set of monetary policy indicators is needed. At the Committee's hearings other indicators of policy were mentioned. They included interest rates, the monetary base, and non-borrowed bank reserves which is a component of the monetary base. It would also be desirable to have an indicator or indicators of credit availability in the various financial sectors.

The intent of the new reporting requirements established by the Humphrey-Hawkins Act is to gain a better understanding of just how the Federal Reserve's monetary policy plans relate to the economic goals for the economy. The Federal Reserve has and should place special emphasis on a reduction of inflationary pressures within the economy. At the same time, it should explain how its policies would encourage a reduction of inflation. For example, monetary policy could be effective in a demand-pull situation if restrictive policies worked to limit demand for credit to finance purchases of goods and services. In a cost-push inflation with unutilized capacity and unemployment, monetary policy might not be as effective in reducing inflation. The Fed's monetary policy report would be improved if it explained the manner in which monetary policy is designed to work toward the achievement of the specific economic goals in more detailed and precise terms.

The actual economic performance this year and the next year will depend on the mix of fiscal and monetary policies. Both must be more moderate now and in the future than they have been in recent years. Importantly, however, Chairman Miller told the Committee that in his view it would be appropriate for monetary policy to become somewhat less restrictive should the economy enter into a recession provided that fiscal policy maintained its current posture. This change in the mix of fiscal and monetary policies has been advocated by the Committee in previous reports. Not only would a more restrictive and stable fiscal policy and somewhat less restrictive monetary policy provide for conditions conducive to the moderation of inflation, but it would also permit the gradual reduction in interest rates. This, in turn, could have saluatory effects on private investment and capital formation, which would lead to increases in productivity. Increases in productivity would help reduce both inflation and both unemployment.

The housing market has been partially protected from high and rising interest rates during the last year by the introduction of six-month money market certificates available since last June. Housing starts in January declined to 1.6 million units, about 20 percent lower than the average of 1978. In February, total starts declined further to 1.4 million units. However, it is unclear whether these declines indicate a significant change. They may in large part be related to seasonal and adverse weather conditions in various parts of the country rather than a sharp fundamental slowing of the housing sectors.

VIII. VIEWS AND RECOMMENDATIONS

Pursuant to the Full Employment and Balance Growth Act of 1978 (Public Law 95-523) the Committee on Banking, Housing and Urban Affairs reports the following views and recommendations with respect to the Federal Reserve's intended monetary policies for 1979.

1. The Committee believes that the slowing of inflation is our number one economic priority and that it is of fundamental importance to the long-run economic and social well-being of the Nation. The Committee further believes that the economy is approaching the point where excess demand pressures are beginning to increase our present inflation. Accordingly, the Committee believes that the Federal Reserve should restrict the availability of money and credit in order to moderate the rate of economic expansion and that this restrictive policy should be continued until significant progress has been made in reducing inflation.

2. Growth of the monetary and credit aggregates has become difficult to interpret because of recent regulatory changes and financial innovations. M_1 growth has been and will continue to be difficult to predict because of ATS, NOW accounts, and security repurchase agreements. Growth of M_2 and M_3 will depend in large part on developments relating to six-month money market certificates. The Committee believes that there is significant uncertainty with regard to the meaning of recent and prospective growth of the monetary aggregates. The monetary and credit aggregate growth rate ranges set forth by the Federal Open Market Committee have been lowered from previous levels, which is appropriate; however, those ranges are far too wide to be meaningful indicators of Federal Reserve policy. The Committee believes that the Federal Reserve should move forward quickly with its review of the appropriate definitions for the monetary aggregates. The Committee also believes that the Federal Reserve should consider using alternative indicators of monetary policy. Non-borrowed reserves and the monetary base have been recommended to the Committee as possible alternatives and/or complimentary indicators of monetary policy. Interest rates and the availability of credit in various

sectors of the financial markets are additional indicators of monetary policy that should be monitored closely. Since the economy is pressing close to capacity in many sectors the Committee believes the Board should pay particular attention to credit availability as an indicator of monetary policy.

3. The Committee believes that the Federal Reserve should not be forced to carry a disporportionate share of the burden in fighting inflation. Most importantly, the Administration and the Congress must practice a greater degree of fiscal restraint if inflation is to be dampened and the inflationary psychology is to be broken. Difficult as it may be, increases in federal spending must be restrained and priorities for spending established. The Federal Reserve's task of gradually reducing the growth of money and credit will be made easier and more achievable if the Federal deficit is eliminated over time and federal credit demands are moderated. Accordingly, the Committee believes that Federal spending should be reduced below the amounts proposed by the President for fiscal year 1980 and beyond.

A tighter fiscal policy would permit a somewhat less restrictive monetary policy which in turn would help hold down interest rates, thereby stimulating more private sector investment. Capital investment in the private sector will help to increase productivity and to decrease both unemployment and inflation. The pursuit of a moderate rate of growth in money and credit would be conducive to achieving this goal.

4. The Committee believes that coordinated fiscal and monetary policies to reduce inflation at the macro-economic level must be complimented by structural programs to reduce inflation and unemployment. With respect to inflation those programs should include elimination of federal government regulations that are inflationary and not necessary, encouragement of capital formation and increased productivity, improvement in our trade balance and the maintenance of a strong and stable dollar, and moderation in wage and price increases. Special programs are also needed to deal with structural unemployment and to increase youth and minority employment. The approaches to deal with unemployment that were laid out in the Full Employment and Balanced Growth Act of 1978 are a necessary part of our economic strategy.

ADDITIONAL VIEWS OF SENATORS SARBANES AND WILLIAMS

We share the views expressed in this Report on the necessity of slowing the rate of inflation, for the success of such an effort is fundamental to the long-run economic and social well-being of the Nation. We support the announced objective of the Federal Reserve Board to foster financial conditions conducive to a continued but more moderate economic expansion during 1979 in order to bring about a reduction in the current rate of inflation. We would reject any interpretation of the announced Federal Reserve Board monetary and credit policies that would countenance throwing the economy downward into a recession in the name of fighting inflation, and would oppose such a policy.

Recent experience has amply demonstrated that economic decline does not solve the problem of inflation. Because recession entails serious costs—in lost production, in declining tax revenues, and in increased public outlays to compensate for the rise in unemployment—it does not serve to stabilize the economy but it is rather a further destabilizing element. Moreover, the economic consequences of recession, translated into individual, family and community terms, place a serious strain on the social fabric of the Nation.

It is therefore important that the Federal Reserve Board pursue an appropriate balance in its monetary and credit policies that will facilitate the national effort to control inflation, while taking care to ensure that a recession is not added to our list of economic problems.

We concur in the Committee's view on the need for exercising appropriate restraint in federal budget decisions. However, in putting forth a budget level below that proposed by the President, the Committee is premature since the well-developed Congressional budget process, which includes both the Budget and Appropriations Committees, is just beginning. In the end it is likely that the Congress will approve a budget figure lower than the President's as it has in every year since the Congressional budget system went into effect. The budget is a complex matter, and our concern should be to arrive at budget decisions that will contribute most effectively to strengthening the Nation's economy. The Budget and Appropriations Committees play critical roles in enabling us to reach such decisions. In the five years of its existence, the Congressional budget process has significantly improved not only our budget-making procedures but our understanding of the ramifications of budget decisions. It seems advisable therefore for an overall position on the budget to await a review of the materials and recommendations which the Budget Committee will soon report to the Senate, and for more specific positions on particular budget areas to have the benefit of the Appropriations Committee's review.

PAUL S. SARBANES.
HARRISON A. WILLIAMS Jr.