SECOND MEETING ON THE CONDUCT OF MONETARY POLICY

HEARINGS BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS UNITED STATES SENATE NINETY-FOURTH CONGRESS FIRST SESSION ON OVERSIGHT ON THE CONDUCT OF MONETARY POLICY PURSUANT TO HOUSE CONCURRENT RESOLUTION 133

NOVEMBER 4 AND 6, 1975

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SECOND MEETING ON THE CONDUCT OF
MONETARY POLICY

TUESDAY, NOVEMBER 4, 1975

U.S. Senate,
Committee on Banking, Housing and Urban Affairs,
Washington, D.C.

The committee met at 10:10 a.m., pursuant to call, in room 5502, Dirksen Senate Office Building, Senator William Proxmire, chairman of the committee, presiding.

Present: Senators Proxmire, Sparkman, Tower, and Garn.

The Chairman. Today we begin our second meeting on monetary policy pursuant to the resolution Congress passed last March which calls upon the Federal Reserve to "consult with the Congress . . . about the Board of Governors' and the Federal Open Market Committee's objectives and plans with respect to the ranges of growth of the monetary and credit aggregates in the upcoming 12 months."

There was another hearing. This is the third, in a sense, because the House had a hearing since our hearing last May.

This morning we will hear from Dr. Burns, Chairman of the Federal Reserve Board, on the ranges of growth planned for the period upcoming. On Thursday, the committee will receive testimony from two of our distinguished economists, Professors Paul Samuelson of MIT and Milton Friedman of the University of Chicago. So we will be hearing a full spectrum of views from three of the most eminent economists with this meeting on the resolution with Dr. Burns, sandwiched between Professors Samuelson and Friedman.

Before you begin, Dr. Burns. I want to welcome you. After your statement of our first meeting on the resolution last May, I said:

I think we have worked out something that I hope will work well in the future . . . I think that by disclosing the Federal Reserve Board's present views on the appropriate ranges of growth in the monetary and credit aggregates for the year ending next March you contributed both to the cause of informed, intelligent government and the development of economic policy that knows where it's going and why.

In retrospect, I think what I said then is correct. I think we have worked out something which is proving to be a positive and constructive force. It lets the public, Congress and the administration know what the basic thrust of monetary policy is. It requires the Fed therefore to think in year-over-year terms as well as month by month. It also should serve as a self-enforcing discipline on those who make monetary policy by signaling unmistakably the need for midcourse corrections when in fact they are called for. Finally, the procedure we have worked out requires that Congress now must do its homework in monetary

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economics, learn its fundamental principles and its nuances so that we can play a constructive role in the consultative process.

Dr. Burns, go right ahead in any way you wish.

STATEMENT OF ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Dr. Burns. I am pleased to meet with this committee to report once again on the condition of the national economy and the course of monetary policy.

When I submitted to you the Federal Reserve's report on May 1, the American economy was at the trough of the deepest decline in production of the entire postwar period. Since then, a recovery of economic activity has gotten underway. Between April and September, industrial production rose almost 6 percent; each month's increase exceeded that of the month before, and the September increase was the largest in over a decade. The scope of the recovery has also been broadening. Production of durable goods has advanced strongly of late and the increase of activity in the nondurable goods sector—which began earlier—has continued. Improvement has spread beyond the Nation's factories, mines, and power plants, and the overall increase in the physical volume of production during the third quarter turned out to be one of the largest in recent years.

As real output moved upward, the demand for labor kept strengthening. Since March, total employment has risen by more than 11/2 million. The average factory workweek has lengthened appreciably. Unemployment has declined from its peak in May despite a sizable increase of the labor force this year. And the increase of employment has become more widely diffused across the economy. Of the 172 nonfarm industries on which the Bureau of Labor Statistics reports, only 17 percent experienced an increase of employment in February. The corresponding percentage rose with considerable regularity in succeeding months and reached 72 percent in September.

As we look back, it is clear that the consumer led the way out of recession and into recovery. Early this year, when price concessions became fairly common, consumer purchases began to pick up. Consumer buying was further buttressed over the spring and summer months by tax rebate checks and supplementary social security checks. Retail sales of nondurable goods rose briskly; and as confidence improved, consumers also became more willing to dip into savings or incur new indebtedness in order to purchase big-ticket items. This is clearly evident in the automobile sector, where sales of new cars have been running recently at an annual rate of around 91/2 million—a considerable advance from the 7 million rate of last November.

A sharp turnaround in foreign trade also helped to pave the way for economic recovery. Our trade balance was unfavorable throughout 1974, and the deficit reached an unprecedented $9 billion annual rate in the third quarter of last year. But a deep cutback of imports—especially of fuel and industrial supplies—occurred during the recession, while the demand for our exports held up well. The result was a swing in our trade position to a surplus at an annual rate of over $13 billion in the second quarter of this year. There has been a significant rise of imports recently, as is to be expected during a cyclical expansion.
Nevertheless, our trade surplus is still large, the overall balance of payments remains favorable, and the dollar is again a highly respected currency around the world.

Sustained buying by foreigners and American consumers enabled business firms to make excellent progress in clearing their shelves of excess inventories. Liquidation of inventories got underway around the beginning of this year, and in the second quarter the rate of decline was larger in relation to the gross national product than in any quarter of the entire postwar period. By early summer, stocks were coming into reasonable balance with sales in most consumer lines, and many firms engaged in retail and wholesale trade therefore began to rebuild inventories. Meanwhile, the pace of inventory liquidation slowed considerably in the manufacturing sector. For business firms in the aggregate, inventory liquidation receded from an annual rate of about $30 billion in the second quarter to a rate of $10 billion in the third. This shift in business inventory investment has been a major factor in the recent sharp rise of our Nation's production of goods and services.

The willingness of businessmen to move further in replenishing depleted stockpiles, and thereby provide a continuing thrust to general business activity, will depend heavily on the strength of consumer demand. That in turn will be influenced materially by the real income of consumers, their financial position, and the state of confidence—all of which are linked to inflationary developments and prospects. In the Board's judgment, improvement of the economy is likely to continue at a satisfactory pace only if consumers and businessmen can reasonably look forward to some further abatement of cost and price inflation.

We as a Nation have made notable progress in reducing the rate of inflation that prevailed during 1974. Consumer prices rose over the first three quarters of this year at about half the pace recorded a year earlier. The rise in wholesale prices slowed even more. These improvements resulted mainly from slack demand in product markets and the competitive pressures that forced business managers to watch costs more closely and to enhance efficiency. These efforts have begun to bear fruit; output per man-hour turned up in the second quarter—thus registering the first increase in over 2 years—and rose further in the third.

Of late, however, there has been some worsening in the rate of inflation. Broad measures of price performance indicate a rise in the third quarter at an annual rate of around 7 1/2 or 8 percent—compared with 5 1/2 percent in the second quarter. To be sure, special factors—such as the unexpected Russian need for grain and the further rise of energy prices—were partly responsible for this development. But price increases have also occurred in a number of industries—autos, steel, aluminum, and chemicals, among others—where considerable slack still exists. And the increase in the price of imported oil that went into effect on October 1 may well lead to price advances over a wide range of products in the months ahead.

Some step-up in the rate of increase in the general price level was perhaps unavoidable, in view of the vigor of economic recovery and the persistent rise of wages. Nevertheless, the quickening in the pace of inflation during recent months—in the face of high unemployment and widespread excess industrial capacity—is a clear warning that our
long-range problem of inflation is unsolved and remains a threat to continuity of economic recovery.

Elimination of the long-run inflationary bias of our economy will require progress on numerous fronts, including a marked strengthening of business expenditures for new plant and equipment. Growth and modernization of the Nation's industrial capacity are essential to avoid a recurrence of capacity shortages in critical sectors of the economy, to lay the basis for greater improvements in productivity, and to expand job opportunities for our people.

As often happens in the early months of a cyclical upswing, business spending for fixed capital has lagged behind the recovery in other sectors. The rise that appears to have occurred recently in the production of business equipment is as yet inconclusive. Various indicators suggest, however, that an upturn of business capital investment may not be far away. Contracts for commercial and industrial construction have stabilized during recent months. New orders for non-defense capital goods, though edging off in the past 2 months, are now about 8 percent above their level in March. Moreover, the rate of formation of new business firms—another advance indicator of business capital investment—is moving up again.

Further improvement in the homebuilding industry is also a vital ingredient of a full-fledged economic recovery. The decline in market rates of interest that began in the summer of 1974 bolstered the flow of savings to mortgage-lending institutions last fall, and a substantial rise in mortgage loan commitments soon followed. Early this year, the volume of sales of both new and old dwellings rose, and these sales are continuing to run well above their lows of last winter. With better market conditions, housing starts—especially of single-family dwellings—have been moving up again. The recovery in homebuilding, however, has been weak. Prices of new and existing houses, to say nothing of other costs of homeownership, have risen so drastically that many American families cannot afford to buy a home. Builders, moreover, remain very cautious in view of the overbuilding and financial difficulties of recent years.

Mortgage lenders have also remained cautious, in part because of fears that the enormous financing requirements of the Federal Government would drive up market interest rates and thereby attenuate the flow of funds to thrift institutions. The Federal budgetary deficit during the third quarter was the largest on record. In just 3 months, the volume of Treasury bills outstanding rose by $14 billion. Since commercial banks reduced their purchase of Government securities as loan demands strengthened, a substantial volume of Treasury bills had to be absorbed by the general public. Borrowings by the Treasury in the 2- to 3-year maturity range were also very heavy. A series of such note issues in August and September drove up interest rates, attracted a sizable number of individual investors, and served to reduce the flow of savings to banks and thrift institutions.

These developments left their mark on the residential mortgage market. Lenders became more hesitant to commit funds, and interest rates on new mortgage loan commitments drifted upward. Nevertheless, mortgage rates remain below their 1974 peaks, and funds remain readily available in nearly all areas of the country where unrealistic interest rate ceilings do not impede the flow of credit.
Increases of interest rates have been particularly prominent in the market for State and local government securities. The financial problems of New York City has had widespread repercussions on the cost and availability of credit to State and local governments. Although yields on high-grade municipal obligations have risen about in line with yields in other long-term markets, increased investor caution has resulted in a marked widening of yield differentials between municipal issues of high quality and those of lower quality. Authorities with relatively low credit ratings have experienced pronounced increases in borrowing costs and, in some instances, they have been effectively excluded from the public market. Despite these adversities the municipal bond market continued to function well enough to permit a record volume of long-term issues during the third quarter. In the past few weeks, however, the volume of new municipal issues has dropped appreciably.

Of late, the need of business firms to borrow in the long-term capital market has diminished as their liquidity generally improved, and as the downward adjustment of business inventories and better profits generated an enlarged flow of cash. During much of this year, however, the market for long-term funds has been under pressure—first, from corporate security issues, later from heavy Treasury borrowing and an extraordinary volume of new municipal securities. The Federal Reserve has sought to provide some assistance to the long-term market by shifting the emphasis in its open-market operations from Treasury bills to longer term securities. Since the beginning of the year, the System has acquired over $6 billion of Treasury and agency issues bearing maturities of over 1 year. Of this total, $2 billion was acquired since midyear.

These purchases have been helpful in steadying the bond market during periods of unusual tension, but they can have only an ephemeral influence on long-term interest rates. The fundamental factor forcing up long-term interest rates in recent years has been the high rate of inflation which persistent deficits in the Federal budget kept fueling. Appreciably lower long-term interest rates would, I believe, contribute powerfully to economic expansion, but they are unlikely to be attained unless significant progress is made in closing the budgetary deficit and in bringing inflation under control.

Exercise of fiscal discipline at all governmental levels is badly needed to ease the tensions and uncertainties that have disturbed financial markets this year. The pressure of Federal financing on interest rates during the third quarter resulted not only from the sheer massiveness of the Federal deficit, but also from successive upward revisions in borrowing needs. The sharply higher yields in the market for municipal securities have reflected the heavy borrowings by State and local governments as well as reduced confidence in the finances of some of these governmental units. The climate for economic expansion would be greatly improved by clear evidence that governmental authorities at all levels are finally willing to live within their means and to get along without financial gimmickry.

We in the Federal Reserve fully recognize that monetary policy has an important role to play in maintaining a financial environment that is favorable to sustained economic expansion. The strength of the economic recovery to date has been heartening, but we are still a long way...
from reasonably full employment of our labor and capital resources. The reduction in the rate of inflation accomplished this year has also been encouraging, but we are still a long way from reestablishing reasonable stability in the price level. In light of these facts, the only responsible option open to the Federal Reserve is to pursue a course of moderation in monetary policy—a course that will provide expansion in supplies of money and credit adequate to facilitate further good recovery of production and employment, but not so large as to rekindle the fires of inflation.

To implement this course of policy, the Federal Open Market Committee has projected growth ranges of the monetary aggregates that differ little from those announced previously. For M₁, which includes currency and demand deposits, the projected growth range for the coming year is again 5 to 7 1/2 percent. For M₂, which includes consumer-type time and savings deposits at commercial banks besides the components of M₁, the growth range has been widened by reducing the lower end of the range one percentage point. The growth range for M₃, which includes deposits at thrift institutions besides the components of M₂, has been similarly widened. These adjustments were made in view of recent experience, which suggests that pressures on market interest rates stemming from heavy Treasury borrowing tend to moderate inflows of savings funds to depositary institutions. The growth range projected is thus 7 1/2 to 10 1/2 percent for M₂, and 9 to 12 percent for M₃.

These growth ranges now apply to the period extending from the third quarter of 1975 to the third quarter of 1976—rather than from the second quarter of 1975 to the second quarter of 1976. This updating of the base, I should note, implies a slightly higher level of money balances a year from now than would be the case if the second-quarter base were retained.

Since I last reported to this committee on May 1, growth of the monetary aggregates has been broadly in line with the ranges we adopted earlier. However, month-to-month and quarter-to-quarter changes in the aggregates have been very large, reflecting unusual factors influencing the public's demand for money.

The largest short-term variation occurred in M₁, the narrowly defined money stock. Thus, M₁ grew at an exceptionally high annual rate—1.2 percent—during the second quarter, as the public's holdings of cash bulged during May and June because of the tax rebates and special social security payments authorized by the Congress. As these excess balances were subsequently drawn down, growth of M₁ slowed to a 2.2-percent annual rate from July through September. There were similar, though smaller, variations in the growth rates of M₂ and M₃.

Measured on the basis of quarterly averages, the pattern of monetary expansion was much more stable. M₁ increased at an annual rate of 8.6 percent between the first and second quarters, and 6.9 percent between the second and third quarters. The comparable figures were 1.2 and 10.4 percent for M₂, and 13.8 and 13.1 percent for M₃.

Short-run fluctuations in the rate of monetary growth are practically unavoidable, but they also have little significance for the functioning of the real economy. That is why we use quarterly average levels of money balances as the base for specifying longer run objectives for
monetary expansion. However, we cannot ignore the short-term movements of money balances in the conduct of monetary policy, since it is necessary to be alert to any large and protracted departure of monetary growth rates from longer run objectives.

Around the middle of this year, the major monetary aggregates were increasing at rates far above the longer run ranges the Federal Reserve was seeking. We therefore set forces in motion which helped to return the pace of monetary expansion to the moderate rate desired. More recently, increases in the monetary aggregates have fallen below our projected ranges. Once again, steps have been taken—including a modest reduction in reserve requirements—to encourage a return to the desired path of longrun monetary expansion.

These corrective actions have had some influence on the level of interest rates—particularly short-term rates—which rose conspicuously in late June and early July, but have recently retreated on a broad front. Temporary fluctuations such as these in short-term market interest rates are an inevitable byproduct of efforts to keep the rate of monetary expansion from straying too far from the desired longer run path. It is important to recognize that the Federal Reserve’s conduct of monetary policy conforms in this respect not only to our best judgment, but also to the spirit of House Concurrent Resolution 133.

The longer range growth rates of the monetary aggregates we are now seeking are, we believe, adequate to finance a vigorous further expansion in real economic activity. Let me stress once again, however, that the relation over time between money balances and the physical volume of economic activity is rather loose, since so much depends on the willingness of businessmen and consumers to use their existing money holdings. We know from earlier history that the turnover of the narrowly defined money stock tends to rise faster in the recovery stage of the business cycle than does the monetary stock itself. Recent experience has confirmed this tendency. Thus, between the second and third quarters of this year, M₁ rose—as I earlier noted—at a 6.9 percent annual rate. But the income velocity of M₁—that is, the ratio of GNP to M₁—rose during that period at an annual rate of 8.7 percent.

In deciding on the appropriate target ranges for growth of the monetary aggregates, we at the Federal Reserve must carefully consider the probable movements of income velocity over the course of the business cycle. We must also bear in mind that innovations in financial markets can have large effects on the economy’s needs for money and other assets to finance economic expansion and to satisfy the public’s liquidity preferences.

We are living in a time of rapid changes in the public’s demand for currency, for checking accounts, for savings deposits, and for a host of other liquid assets. Over the past 20 or 30 years, dramatic developments in financial technology have reduced substantially the proportion of spendable funds that is held in the form of currency and demand deposits. More and more corporate treasurers have learned how to get along with a minimum of deposits in their checking accounts. Consumers, too, have learned to keep a larger part of their transactions and precautionary balances in the form of savings deposits at commercial banks, or deposits in savings and loan associa-
tions, or certificates of deposit, or Treasury bills, or other income-earning liquid instruments. Of late, telephonic transfer of funds from savings accounts to checking accounts is accelerating the trend toward holding transactions balances in income-earning form.

Furthermore, as a result of recent financial innovations, liquid assets other than currency or checking deposits are being used to an increasing extent directly for transactions purposes. Since 1970, customers of mutual savings banks and savings and loan associations have been able to authorize payment of regularly-scheduled household expenditures, such as mortgage payments, directly from their savings accounts. This year, authority for such third-party transfers was broadened to include any payment, regardless of purpose, and permission was granted to commercial banks to offer similar services to their customers. And since 1974, commercial banks and thrift institutions in Massachusetts and New Hampshire have been allowed to offer so-called "NOW" accounts to their customers. These accounts pay a rate of interest that practically equals the rate on regular savings accounts, and yet they permit direct transfer of funds through a negotiable instrument comparable to a check.

These changes are having a significant impact on the type of financial assets that the public holds to meet its transactions needs, and on the range of financial institutions that are involved in supplying payments services. Savings and loan associations and mutual savings banks, as well as nonmember commercial banks, are now an important part of the Nation's payments mechanism. And yet they are not subject to the reserve requirements imposed by the Federal Reserve on member banks. As a consequence, the scope of monetary control exerted by the Federal Reserve is being eroded.

The financial innovations that I have described so summarily are also increasing the difficulties of determining the growth rates of the monetary aggregates that are appropriate at any given time. Clearly, the Federal Reserve cannot focus attention exclusively on any single measure of money balances. We must be alert to the possibility that our longer-run projected ranges for the monetary aggregates may need to be altered in view of changes in financial technology as well as more basic economic and financial developments.

Let me remind this committee, finally, that the growth rates of money and credit presently desired by the Federal Reserve cannot be maintained indefinitely without running a serious risk of releasing new inflationary pressures. As the economy returns to higher rates of resource utilization, it will eventually be necessary to reduce the rate of monetary and credit expansion. The Federal Reserve does not believe the time for such a step has yet arrived. But in view of the economic recovery that has been underway since last spring, we are closer to that day now than we were 6 months ago.

Our Nation is confronted today with a serious difficulty in its search for ways to restore full employment. Highly expansionist monetary and fiscal policies might, for a short time, provide some additional thrust to economic activity. But, later on, the rate of inflation would accelerate sharply—a development that would create even more difficult economic problems than we have yet encountered. This committee's report on monetary policy, issued in June, recognized this basic truth in stating that "if inflation is rekindled, any recovery will be short-
lived and will end in another recession, one almost certain to be more virulent than the present one."

Conventional thinking about stabilization policies, as I tried to explain in a recent address at the University of Georgia, is inadequate and out of date. Stimulative financial policies have considerable merit when unemployment is intensive and the price level is stable or declining. But such policies do not work well when the price level keeps on rising while there is considerable slack in the economy. Experience both in our own and other industrial countries suggests that once inflation has come to dominate the thinking of a nation's businessmen and consumers, highly expansionist monetary and fiscal policies do not have their intended effect. That is, instead of fostering larger consumer spending and business investment, they may well lead to larger precautionary savings and sluggish consumer buying.

The only sound fiscal and monetary policy today is a policy of prudence and moderation. New ways must be found to bring unemployment down without becoming engulfed in a new wave of inflation. That is why structural policies require far more attention than they are being accorded by academic economists or Members of the Congress.

Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Burns, thank you.

You referred to the New York City difficulties as being responsible at least in part for the increase in interest rates on State and municipal issues and I think that's unquestionable.

I'd like to ask you about this problem that has engaged this committee, as you know, and will engage the Senate and the House in the next few weeks. The New York City loan guarantee bill has relied very heavily on your advice. As a matter of fact, you have been responsible I think for greatly improving its strength and helping us put together a responsible package that will enable us to protect the Federal Government and ease the burden on New York if it's going to avoid default.

You suggested, for example, that we might require the State of New York to impose a tax equal to about one-half of its operating deficit. We took that advice. It was protested by the New York State legislature but we took your advice and incorporated it into the bill.

Then, in the second place, you suggested that New York City bond or note holders be required to stretch out their maturity and reduce their rate of interest in a substantial amount. This has been a bitter pill to swallow on the part of many note holders but we have written that into the bill through the Stevenson amendment, as you know, but that was very largely—I think Senator Stevenson would agree—helped by your advice and your encouragement that we do that.

You also suggested some reduction in the burden imposed on the city under present pension and retirement plans. Now we met that in two ways. First, we direct that as a condition of providing a guarantee that the burden of pension and retirement plans be reduced and, second, we provide the three-man board on which you would serve, together with the Secretary of the Treasury and the Secretary of Labor, the authority to impose whatever additional conditions that you and Secretary Simon and Secretary Dunlop feel to be necessary to make the plan work. Also, the fact that you would serve on this board together with Mr. Simon and Mr. Dunlop it seems to me would assure that before the guarantee would be approved that you would have to be
satisfied that it would be practical and workable; otherwise, no guarantee and they have to go the default route.

Now in view of the risk which I think you have acknowledged a number of times—the risk certainly to New York City, the risk to New York State, and possibly—we don’t know the extent of it, but the risk to the United States as a whole—do you feel that we might go this route? Do you see that we have anything to lose by passing this legislation?

Dr. Burns. Let me say first of all that while I have not studied the bill that you have written very closely, I have a strong impression that it is an excellent bill.

In addressing myself to the New York City problem in recent months I have found that my concern over the possible consequences of a New York City default has become greater; as I noted in recent testimony, it’s greater now than it was 3 months ago or even 3 weeks ago. I have not yet reached a point, however, where I believe that it would be wise for this country to legislate financial assistance to New York City.

It’s my business to respect facts and I may change my mind. I must tell you in all candor that I’m keeping a daily log on every financial market in the country and if I find that the financial markets are deteriorating I may indeed change my mind and come before this committee without delay. But I’m not at that point now. If the President’s recommendation is followed and there is no financial assistance legislation by the Congress, and if we are lucky—it’s going to take a bit of luck, Senator, I recognize that—we may have a turning point in this country as far as fiscal policy is concerned—not only at the State and local levels but also at the Federal level.

New York City’s difficulties have been dramatized. New York City has been living beyond its means, as have many communities within our country and as has the Federal Government itself on a very large scale in recent years. In view of the degree of attention that has been paid to the New York problem, I think that if the President’s recommendation is followed and if we are lucky—I must repeat that—it may mark a major and most useful turning point in fiscal policy in our country at all levels of Government.

So, while I admire the bill that your committee has drawn, and while I think that there is a good case to be made for legislation, I am as yet not convinced that that is the wiser course to pursue.

The Chairman. Well, I agree with almost everything you say, everything except your conclusion. There’s no question if we’re lucky this could be an extraordinarily useful lesson. I agree that there’s no question that the lesson is just as clear as it can be. But my feeling—and I hope you will consider this—my feeling is that the lesson is already dramatically clear, that New York has taken action in the last 2 or 3 months to sharply reduce their number of employees; they have frozen wages for 3 years. They have a plan for a balanced budget which they are in a very good position to achieve because all the revenues that come in go to their financial emergency control board and are disbursed by that board which has an absolute commitment to proceed toward a balanced budget and it seems to me that having taken that painful step and having to face the fact that they are going to have to have sharp reductions in spending, that this is a lesson.

Nevertheless, I can’t possibly quarrel with your conclusion that it would also be a very good lesson to the country if New York did de-
fault, but also the risk, if we're lucky—if we're lucky—and it's an enormous risk. If we're lucky this could precipitate very serious economic repercussions I think, including a deeper recession, including more unemployment, including great difficulties for our cities and this may not happen but it's a very serious risk.

Now the second question I'd like to ask you is in connection with the President's proposal to reduce taxes by $28 billion and to condition that upon a reduction in spending, but the reduction in spending would seem to take effect after the reduction in taxes. As I understand, the reduction in taxes would be effective in the coming calendar year. The reduction in spending would not be effective until beginning October 1, 1976. Therefore, there's a lag and much of what you say here which so consistently emphasizes fiscal responsibility and the impact of fiscal policy on monetary policy would seem to be conditional on what the Congress and the President finally do with respect to the tax reduction.

Can you give us your reaction to that proposal to reduce taxes by $28 billion and then reduce spending later?

Dr. Burns. I would be in favor of such a reduction in taxes provided a reduction in expenditures was made simultaneously rather than after some lapse of time. In other words, I would want the two reductions to become effective at precisely the same time.

The Chairman. Well, as a practical matter, then, if you're going to reduce taxes in this present fiscal year, in view of the fact that the budget for the current fiscal year has already been acted on. We have already passed a number of appropriation bills. The next budget doesn't begin to take effect until October 1, 1976. I take it that you would then say we shouldn't reduce taxes unless we reduce them for the following year—that is, calendar year 1977—because that would be coexistent. Is that right?

Dr. Burns. That's one possibility, and if you were to stay with the strict procedures of the Budget Reform Act, you probably would be driven to that conclusion. But Congress in the past has set an expenditure ceiling, and Congress might do that again.

The Chairman. Now, if we follow the President's proposal, how would that affect monetary policy? Would that make it necessary if we did reduce taxes first and had a period in 1976 of further increased deficit, would that make it necessary for you to follow a policy of more stringent control of the money supply, a slower growth in money supply?

Dr. Burns. That's very difficult to judge. An increased deficit would, of course, be a matter of some concern to us, but there are psychological factors that play on financial markets which I find very difficult to predict. It's entirely possible that evidence that the Congress is strenuously curbing Federal expenditures might have a beneficial effect on expectations with regard to inflation and so forth, and therefore that the pressures on interest rates might not be increased by the larger deficit. Because of the difficulty of predicting these psychological factors, I can't tell you what the response of monetary policy would be.

The Chairman. As a member of the Appropriations Committee, it's very difficult for me to see how in fact we can reduce the spending in this fiscal year. We do have a very important appropriation measure still before us, the defense appropriation bill, but it's unlikely that that would change very much with this kind of consideration in
mind. So that I think we really have to look forward as a practical matter to 1977.

Supposing we keep the tax cut now due to expire and cut taxes further, as the President has suggested, together with spending effective next October.

Dr. Burns. I don't take warmly to that suggestion. As I stated, I think the two ought to be concurrent. One should accompany the other, and I believe—

The Chairman. Well, if I could just interrupt, I think we have to recognize the fact that if we don't keep the tax cut about to expire, we'll have a de facto tax increase. Isn't that correct?

Dr. Burns. Let me put it this way. Whenever, after a temporary tax cut, taxes return to their original level, you can describe that as a tax increase or you could describe—

The Chairman. That's the effect on the economy, is it not?

Dr. Burns. Or you can say the temporary tax cut has come to an end and taxes are not increased at all. You can describe it either way.

The Chairman. From the standpoint of the effect on the economy, what would concern you, it would have the same effect as a tax increase.

Dr. Burns. Well, I was not enthusiastic about the tax cut in the first place. For an economy of the size of ours, I don't think its expiration would make a great deal of difference, and evidence of financial conservatism by the Congress might have a very salutary effect on business and financial thinking across the country.

The Chairman. All right. Now, in the course of your very thoughtful and helpful presentation, you have to make assumptions. Can you tell us, on the basis of the assumptions that you have made, what you think will happen to unemployment over the coming year?

Dr. Burns. I'm a very poor prophet. I expect unemployment to decline over the coming year, but I don't know by how much it will decline. In that respect, I'm like everybody else, except that many are inclined these days to throw numbers around more readily than I am.

The Chairman. Well, my time is about up. I would just persist a little on this, however, by contending that policies that we followed in Congress, of course, depend on what assumptions we have to make, implicit or explicit, on what unemployment and on inflation, and you can give us expert advice. Congress has great faith in your judgment, and this committee has shown our faith by following much of your advice on the New York City bill recently, for example, and on many other things.

So if you could give us some notion of whether you would expect unemployment to decline maybe 1 percent, inflation to stay at a level of around 6 or 7 percent or a range or something like that, it would be very helpful. Can you do that?

Dr. Burns. I would go some small distance in that direction, Senator.

The Chairman. Well, I like that answer, but unless you say whether you think unemployment is going to go down to 7 1/2 percent or be in the range of 7 to 7 1/2 percent or something like that, I don't see that I have much that I can find useful.
Dr. Burns. Senator, I know more about the past than I do about the future. In past recoveries, unemployment has frequently fallen by 2 percentage points within the first year. I think that if we have a normal recovery—and it seems to me to be developing in that fashion—a year from now unemployment ought to be down to below 71/2 percent. That would be my practical judgment, but I would want to repeat that all such numbers must be taken with a grain of salt.

You have a different problem than we have at the Federal Reserve. You in the Congress deal with fiscal policy, which is a very clumsy, awkward instrument. We at the Federal Reserve deal with monetary policy, which we can adjust within a month, within a day, and even within an hour. For our purposes, precise forecasts are not necessary; if we see we are not on the track we’d like to be on, we can shift course. That’s much more difficult for you, and I therefore understand your concern and your desire for projections and predictions.

Yet I sometimes wonder whether fiscal policy cannot be made more flexible than it has been in the past. I wonder whether, instead of relying on the numerical predictions, Congress might not take inventory, say, once every 3 months, and decide whether stimulative measures—or whatever the fiscal policies in effect at the time—have gone far enough or have gone too far; and depending on the conclusion, then either move further in the same direction or reverse course. There might be greater possibilities of this kind than have yet been utilized. But it would take time to work them out, so that’s something for the future, assuming it can be done at all.

The Chairman. My time is up. Senator Tower?

Senator Tower. Dr. Burns, to pursue the question of Senator Proxmire in terms of reduction of expenditure, we tend only to look at the so-called controllables, not at the so-called uncontrollables. Don’t you think that Congress would be wise, if it’s serious about reducing projections for growth in spending, to perhaps take a hard look at some of the so-called uncontrollables.

Dr. Burns. I couldn’t agree more. Actually, I have banished the term “uncontrollable” from my personal vocabulary, and I would recommend that Members of the Congress do the same.

Senator Tower. I think that’s good advice. I don’t think anybody realistically thinks that Congress can act in a timely way to prevent default by New York City. Maybe there’s some things they can do within the State that could postpone default or prevent it, but in the event that efforts at preventing default fail, do you hink that we should then move in the direction the President has recommended and restructure the Federal Bankruptcy Act to accommodate New York and provide for some sort of emergency assistance for essential services?

Dr. Burns. I would hope that no matter what happens to the legislation that your committee is recommending to the entire Congress, the Congress will move on bankruptcy legislation. In the last analysis you don’t know whether the bill reported out by your committee will be passed or not, and we ought to have a revision of chapter 9: we need it badly. In the absence of revision of chapter 9, there may be a great deal of confusion and turmoil in New York City. The revision ought to have top priority, and I don’t think it has anything to do one
way or the other with the merits of the New York City legislation reported out by your committee.

Senator Tower. Would you comment on the argument that a Federal Government guarantee of New York obligations would not cost the taxpayers anything? Do you subscribe to that?

Dr. Burns. I take it that those who argue that way assume that in time New York City will pay off its debt completely. I think that is a reasonable assumption; cities in this country that have gone into default have almost invariably worked off their default very decently, and I would expect that a city of the stature of New York would do that.

But the cost cannot be reckoned solely in financial terms. If we guarantee debt for New York City, before very long we may be guaranteeing debt for any number of other cities. While each of these cities may in turn work off its debt in the course of time—so that Federal Government expenditures might not rise on that account or might not rise appreciably—the Federal Government would still become involved in managing the affairs of many local governments and the doctrine of separation of powers which has stood our country well over the years would no longer be a part of our practice. This would mean a further centralization of government, and the larger Federal responsibility might have all sorts of indirect effects on Federal expenditures.

Senator Tower. Let me go a step further on that and ask you what you think the impact would be on the municipal bond market if we guarantee New York City paper but do not guarantee the paper of other borrowing authorities at the State and local level?

Dr. Burns. A guarantee of New York City paper would, of course, improve the market for those securities. It would have a slightly adverse effect in the short run on securities of other municipalities, but the market is very large and I would not expect that effect to be either lasting or very significant.

Senator Tower. To move to another subject, the so-called Government Sunshine Act is going to be before the Senate shortly and I'm curious as to how you feel that this act would affect the meetings of the Open Market Committee and the Fed's ability to conduct monetary policy.

Dr. Burns. I must say to you that there's no piece of legislation under consideration by the Congress that has caused me greater concern than the Government in the Sunshine Act. I wish I had had the opportunity to testify on that bill. I was never accorded the opportunity. No central bank in the world functions under the kinds of restrictions that the bill would impose. The authors of the bill probably had in mind agencies such as the Interstate Commerce Commission, which regulates freight rates. Offhand, I would see no difficulty at all in discussing the case for raising or lowering particular freight rates in an open meeting. But we at the Federal Reserve Board deal with the most sensitive issues of financial policy. We regulate commercial banks in this country and have dealings with central banks around the world. To discuss publicly the difficulties that individual commercial banks face, and to discuss publicly our dealings with other central banks, some of which come to us for assistance when in difficulty, would cause endless embarrassment to the banks involved, to our Government, and to our country.
Moreover, for the Federal Reserve to be put under the umbrella of this type of legislation would suggest to people abroad that the Congress lacks confidence in its central bank. I don’t think that would help our country at this juncture of history.

It’s perfectly true that the bill specifies certain exemptions under which we could have closed meetings. However, a transcript of the discussions at those meetings would have to be kept, and under the Public Information Act this or that transcript might have to be made available very shortly to the general public. As you know, the Federal Reserve—although it’s frequently accused of being a secretive organization—makes all of its decisions known to the public. Some decisions—most of them, in fact—are made available promptly, and some after a certain lapse of time.

I think the Government in the Sunshine Act is a very dangerous piece of legislation and I hope that Congress will deliberate hard before subjecting the Federal Reserve to it. For that matter, while I’m not here to argue anyone else’s case, I’m a citizen of this country as well as Chairman of the Federal Reserve, and I don’t see how you can subject the Securities and Exchange Commission to the Government in the Sunshine Act. That could cause endless financial trouble. The Congress obviously is seeking to improve the welfare of the country, but I can’t begin to see how the country’s welfare would be improved by bringing under this legislation financial agencies that deal with highly sensitive matters.

In all honesty, I don’t see how the Federal Reserve could function under this legislation. We’d have a choice between living under the law and taking great chances with this country’s present and future welfare, and breaking or circumventing the law by making our decisions outside of our board room. We certainly are not going to do the latter, and I hope that you will not put me and my colleagues in the Federal Reserve in a position where we have to injure this country, which is what the Government in the Sunshine Act may force us to do.

My language is plain but I’m answering your question, Senator.

Senator Tower. I think my time is running out. One final question, Governor Burns.

The committee voted to repeal the prohibition against the payment of interest on demand deposits in our Financial Institutions Act. I’d be interested in your views on the implications on monetary policy of interest being paid on demand deposits and how it will affect current banking practices.

Dr. Burns. I think before you legislate on that you ought to hold hearings and this matter ought to be deliberated. I think personally that we will, and should, go in that direction. But if I were doing it, I’d go a little more slowly than seems to be the mood of the banking committees of the present time. I would certainly hold hearings and canvass the opinion of informed financial leaders of the country. Bankers are divided on this issue, as I think you know.

Senator Tower. Thank you, Mr. Chairman. No further questions.

The Chairman. Senator Sparkman.

Senator Sparkman. Mr. Chairman, I shall be very brief. Did I understand you correctly as saying that we were enjoying some degree of economic recovery?

Dr. Burns. At the present time?

Senator Sparkman. Yes.
Dr. Burns. Yes, I think we are experiencing a good recovery, Senator, at the present time.

Senator Sparkman. And you're optimistic that that will continue?

Dr. Burns. Reasonably optimistic, yes.

Senator Sparkman. Did you say that unemployment has come down during the present year and you feel that it would continue to come down?

Dr. Burns. That's my judgment.

Senator Sparkman. Now I'd like to ask you to go back to this old subject of the New York situation. If I understand correctly the Stevenson proposal, it would require New York to do very much those things which I understand the President feels that they should do. Is that not correct?

Dr. Burns. I think that that is substantially correct. The President might go a little further than the legislation prescribes, but it certainly goes strongly in the President's direction.

Senator Sparkman. I believe that's all, Mr. Chairman.

The Chairman. Senator Garn.

Senator Garn. Mr. Chairman, may I compliment you on your testimony today. I'd like to compliment you, too, for resisting pressures. When you were here before there was a great deal of talk about 9, 10, 11, 12 percent expansion. You told us at that time you felt we ought to just sit back, take a look, see what happened, and I think that was very wise advice at the time because we're getting a recovery as you indicate and without going into double digit inflation as a lot of us feared. So I compliment you on sticking with your 5 to 7 1/2 percent looking at the economy rather than setting targets without looking at what's happening in the economy, trying to prove that we can set a particular figure. I hope some of my colleagues will look at what has transpired since you were last here and recognize that what you told us is pretty much what's happened and take your advice in the future.

Unfortunately, the same thing hasn't been true on the fiscal side. We continue to spend more money. I'm not going to repeat what I said at that time, but we haven't learned the discipline the Federal Reserve has, so rather than continuing attempts by this body to interfere more and more with the Federal Reserve, maybe the Federal Reserve could take over the Congress and see if we could get a little more discipline on the fiscal side.

But to get to New York again, which most of us are kind of tired of after the last 3 weeks, you seem to have come along since your first statements feeling that it is a more serious problem than you did to begin with. Do you feel that part of this is really a self-fulfilling prophecy that because of so much talk and so much propaganda from New York officials that part of what has happened in the bond market is happening because they have said it will happen.

In my opinion, if this Congress had said no, 2 or 3 months go, I think New York City and New York State might have come up with a solution and would not be defaulting.

Dr. Burns. I think in part it is self-fulfilling prophecy, but I would not emphasize that. Many financial observers, looking to the facts as they see them, fear the consequences for State and local government expenditures, the effects on the banking system, and the effects on individual investors who hold these securities in large volume.
I do think that if the Congress several months ago had taken up legislation and said flatly "no" to New York, some of these fears would have vanished by now, because New York City and New York State would have taken measures which neither has yet taken. I think there's been a belief in New York City and New York State that sooner or later, one way or another, the Federal Government would come along and bail New York City out. Long before either New York City or New York State took any measures to straighten out the finances of New York City, State and city government leaders came to Washington and argued that the Federal Government would have to solve the problem because New York City and New York State could not, and without Federal help there would be a default which would bring disaster to our Nation.

Actually, as Senator Proxmire pointed out, New York State and New York City have by now gone a considerable distance in helping to solve their own problems. One reason they have done so is that the Federal Government did not move in at an early stage.

Senator GARN. Well, I would agree with you completely. That's been my analysis, that if we had said no earlier they would have solved their problem. Because of the delay they have gone much further than they intended to. If we had caved in earlier and done something for them they would have expected a full bailout. They have weakened their demands all along.

I mention one thing very briefly that I would like to emphasize. One of the troubles with this bill as I see it, it is upsetting normal intergovernmental relationships far more than I would like to see it happen. As you well know, I have been very active in mayor circles and municipal government. Over the past few years I have seen that eroding with more and more power to the Federal Government and less for the local level. If we are to send help with guarantees, you as part of the Federal board to run the affairs of New York City I think that distorts the normal intergovernmental relationship too much in favor of the Federal Government and I'm afraid it would set a precedent in the future for other cities and more for more Federal takeovers and dictation in cities where they're having financing difficulties.

One thing else that disturbs me about the legislation we reported out of this committee. Do you feel we ought to be guaranteeing tax-free municipals? We've got this legal problem of this committee not being able to deal with taxable bonds because that isn't within our jurisdiction, but aren't we taking bad paper then if we guarantee it to the tune of $4 billion or $7 billion as in the House and making it better than cities with AAA bond ratings and good credit who are getting record low loans at this point?

Dr. BURNS. This would be the best paper on the market. It would be better than that of other municipalities. It would in a sense be better than Treasury paper. However, I would expect interest rates to adjust to this quality differential and to reflect it. That would take a little time. But that, in and of itself, does not trouble me very much.

I don't think that the negative consequences for other municipalities would be serious. In fact, one could argue that taking care of New York would improve the tone of the municipal market and that other municipalities would benefit.
Senator Garn. Well, thank you. Just in closing, to get back to your statement, I again compliment you for what you have done in the monetary area and just don't let the politicians push you around. Just hang tough there and don't listen to the politicians who show fiscal irresponsibility on the fiscal side of it—don't let them push you around on the monetary side. Thank you very much.

That's all I have, Mr. Chairman.

The Chairman. Dr. Burns, I just have a couple of questions on New York City and then I have some other questions on monetary problems. The monetary case that you have made is a very interesting one.

You raise as one of your fundamental objections a strong philosophical objection to the guarantee, that if the Federal Government goes down this path it's going to be deeply involved in city and State activities and violating the Federal structure of our country and providing a precedent would be unfortunate.

The difficulty is that I don't see that we have any option. If New York City defaults we are going to have to go down that path anyway in two ways: No. 1, a Federal judge would move in and take over and run the city, and if New York State defaults a Federal judge would move in and run the State to a considerable extent as far as their fiscal decisions are concerned. No. 2, once New York City defaults, this committee after very extensive hearings has come to the conclusion that there would almost have to be—and Senator Brooke agreed and other minority members—some of them at least agreed with the majority—would have to either guarantee loans for the city or would have to make direct loans for essential services and also to make up the fact that New York will lose between $1 and $2 billion in revenue that it would otherwise get absent default. Once it defaults it loses that. It loses part of its tax revenue and it loses the payments made by the State because the State would be in no position once New York City defaulted to follow through with the commitments that they have made.

So the Federal Government would be involved very heavily in a default of New York City and if New York State defaulted it might be involved in the default of New York State, and if New York State defaulted, also Yonkers and possibly other cities in New York would default and very possibly at least a few, and probably a few other cities in the country, all involving the Federal Government becoming engaged in lending or guaranteeing loans and in setting conditions and so forth.

So isn't it true that there is no way under present circumstances that we can assure the Federal Government will escape from this involvement?

Dr. Burns. Your conclusion may be correct, Senator, but I'm not entirely convinced that it is. Let me comment first on New York State. If New York City defaults, I believe that New York State's problems would be eased rather than made more difficult because the albatross that New York State hung around its neck by coming to the assistance of New York City would be cut away. New York State has various funds which come to something like $1.5 billion that it could draw upon and New York State, after all, has the power to raise taxes. My judgment is that there's no real danger of a default by New York
State if New York State acts promptly and energetically enough to deal with its problem.

The CHAIRMAN. You think they can protect their various State agencies?

Dr. BURNS. Yes.

The CHAIRMAN. The Governor was concerned about that and indicated in his view it would be very, very difficult, perhaps impossible, to prevent their agencies from defaulting.

Dr. BURNS. The State has a deficit to begin with of about half a billion dollars, maybe a little more than that. There are various State authorities that issue moral obligation bonds and they need financial assistance. They cannot now go to the public market. But I think that by drawing on the pension and other funds that exist, and by using its taxing power, New York State could work its way out of its problems and be better off after a default by New York City than before.

While I’m fairly confident of that conclusion, I can’t be certain that things will go that way. Even if the Governor comes forward with a proposal for new taxes, the State legislature might not go along. There are many possible difficulties of that kind.

The CHAIRMAN. There are also the tough psychological problems that Mr. Levitt suggested. He said that they have to raise something like $3.5 to $4 billion of money in tax anticipation warranties in the middle of next year and the private market for psychological reasons at least could very well be closed under those circumstances, no place to go, and if that’s the case, they’ll have a default in spite of the fact that they are very sound.

Dr. BURNS. That’s possible. I would be more optimistic. I would argue that a demonstration of financial strength, of financial courage, of the willingness to tax in order to raise the funds necessary to straighten out the financial situation, would open up markets for New York State.

The CHAIRMAN. There is this problem. New York State is the most heavily taxed State in the Union.

Dr. BURNS. It is.

The CHAIRMAN. And they are in a position where taxing can be counterproductive. If they increase their taxes they lose industry; they lose well-to-do individuals. They feel that they are very vulnerable for that reason and the State legislators who have talked to me on this problem were most responsible men who said it would be very hard to raise half a billion dollars in taxes and to raise the larger sums they would have to raise under these circumstances even on a temporary basis would be very difficult or impossible for them. Unlike Connecticut, which has no income tax, for example, and other well-to-do States that are in that position. New York has gone very far in imposing taxes on their citizens.

Dr. BURNS. New York State is one of the most heavily taxed States in the country and perhaps the most heavily taxed. But, a special tax levied for a limited period, a tax designed to redeem the honor of the State, might work wonders in the financial world. Businessmen who have been discouraged by the drift of politics in that State, the drift of expenditures, the drift of taxation, might feel that, even though they will go through a difficult period for a year or two, they now have a future in New York State. So it might have a very beneficial effect.
The Chairman. You have to recognize that almost half the people in the State live in the city. The city would be bankrupt under those circumstances. The city is where a great deal of the income, the wealth of the State resides. That would be seriously affected. So a tax under those circumstances—I agree that that might be an alternative, but it might not be.

Dr. Burns. I'm puzzled by one aspect of your committee's legislation, Senator. Maybe you can clear this up for me. Am I right in thinking that if New York State is in difficulty your legislation would not provide any assistance to the State as such?

The Chairman. That is correct. We have worked on this carefully with the Governor and with the other State officials and they feel that avoiding default would preserve New York State's capacity to continue to use the private markets once the guarantee is in place. They feel this would shore them up and give them the strength they need. Their judgment may be wrong.

Dr. Burns. I would argue a little differently. I would argue that with New York State being relieved of a certain responsibility for New York City, and not needing the special tax in behalf of the city contained in your legislation, but being willing to impose additional taxes for a limited period for the specific purpose of setting the State's financial house in order, the public market would open up for New York State. It's virtually closed now, as you know. It could well, in my judgment, go the other way. But it's a very hard question to answer with any certainty.

The Chairman. Isn't it possible that the market might go the other way inasmuch as the big city, New York City, would be bankrupt, would be unable to meet its obligations, and therefore people having been burned in New York City obligations would be very chary about the New York State obligations?

Dr. Burns. Well, I'm afraid New York State made a blunder in coming to the financial assistance of New York City in the way it did. What the State legislature did essentially, apart from setting up the control authority, was to borrow money to turn over to big MAC, which then would turn the funds over to New York City. But in the process it damaged its own credit standing. Investors in municipal bonds are a very peculiar breed. Who are they? First the commercial banks, which hold about 47 percent of the State and local securities outstanding. Next, casualty insurance companies. And then, individual investors in the upper or middle income classes. These are conservative people, and when conservative people find that a particular municipality or State has made a financial mistake, they would recognize that they don't have to buy the securities of that governmental entity. They can buy other securities.

The Chairman. Dr. Burns. I wonder if that was a mistake. Here's the problem for New York State. The city is their creature. The city is their responsibility. They just can't walk away from their city. Furthermore, when they step in they step in with a financial emergency control board dominated by the State—5 of the 7 members are State people—and furthermore, they get all the revenues that go to the city. They get all of them and then disburse them according to a plan.

I don't know how they could have a more effective system and it's worked quite well, as we all agree. They have cut down their expenditures. They are moving toward a balanced budget.
Dr. Burns. I understand that. But consider what they did essentially. They moved debt out of one pocket into another, in the process enlarging the amount and imperiling the financial standing of the State. If they had done that and one thing more—impose a special tax at the same time—I think New York State's credit standing would be high today. The mistake was not in coming to the assistance of New York City, but in coming to the city's assistance solely by the borrowing route instead of by a combination of borrowing and taxing.

The Chairman. It seems to me that they did impose a $300 million additional tax burden when they moved in.

Dr. Burns. For New York City, not New York State. We're still discussing New York State.

The Chairman. Well, I think you may well be correct. The difficulty, however, is that you have a political situation. You have a Republican State assembly and a Democratic Governor. For them to agree on something like this, a burdensome tax on the people of the State to assist New York City was something very hard to achieve.

I think under the circumstances, given the political realities, they did a great deal. The great difficulty we're having—and even if we go the guarantee route persuading the State to go along with the tax increase in this very heavily taxed State, indicates how hard it would be to go the other way. I see your point and it's a very good point.

Dr. Burns. And I agree with you that if Governor Carey had come forward with a tax proposal he might have had insuperable difficulties in getting his State legislature to accept it. But if he had made the proposal and persuaded the State legislature to adopt it he would now be a national hero. I'll say no more.

The Chairman. Well, his difficulties were insuperable.

Just one other question. Has the Federal Reserve staff made any estimates of the effect of a New York default on the economy?

Dr. Burns. If you are asking whether we think about that question and write about it to one another and talk about it, we are at this business constantly.

The Chairman. Well, it's one of the best staffs, perhaps the best economic staff in Washington. You have great sources as well as great ability there. It would be very helpful to us if the staff would make a study of this and you give us your estimate.

Dr. Burns. We are studying this continuously. I referred to a log that I'm keeping on every financial market. There's been so much rumor and so much opinion in this whole area that unless you have a cold, factual record it's very difficult to arrive at a considered judgment.

Take October 17, the day New York City nearly went into default. I got reports that day from highly responsible sources about difficulties in the foreign exchange market; I was told repeatedly that the dollar was being sold in the foreign exchange market because of fears generated by a prospective New York City default. I was not convinced. I found those reports difficult to believe because our interest rates were then coming down and I thought that what was happening in the foreign exchange market could be explained in cold economic terms—in terms of interest rate differentials alone. I therefore found a way of placing a fair number of telephone calls to highly placed European financiers who I thought would bring objectivity to their
judgment. I found that these Europeans—my sample was carefully chosen, but might still have been a poor one—were not really concerned about the possible effects of a New York City default on the value of the dollar. They noted that the dollar had risen very sharply between March and September, and they thought that the decline during October, which was of limited size, could be explained entirely by the decline in short-term interest rates in this country. That was my own explanation.

As I've said, we're studying this continually. We're keeping a log day by day for the municipal securities market, the corporate bond market, the money market, the Treasury market, the stock market, and the foreign exchange market—and if conditions deteriorate, as they may, I'm not going to be the last one to recognize that fact.

The CHAIRMAN. Well, this is—I don't know what else you can do with respect to studying what is going on—the situation with the present problems we have.

At the same time, I think you would agree that you cannot tell. It's a brand new ball game once New York City has defaulted.

Dr. Burns. You can go wrong either way. We of the Federal Reserve don't minimize the likely effect on the economy of a New York City default. It would clearly be negative; the only uncertainty is the magnitude. Now if the effect is larger than we—or others who are still opposed to financial legislation—presently think, not everything will be lost. The Congress can still act after a default.

The CHAIRMAN. Would you quarrel with the Eckstein estimates that default would probably increase unemployment between 300,000 and 450,000?

Dr. Burns. I have not studied those estimates, but how do they know? This is a guessing game and it can't be anything else. I would consider such an effect very serious. I doubt that it would be that large, but I can't really quarrel.

The CHAIRMAN. It seems to me that what they base it on is a decline in State and local expenditures flowing from the difficulty that New York got into and the difficulty they would have raising money for capital programs.

Dr. Burns. I don't know that I would describe it as a decline; a retardation of growth in State and local expenditures is now under way and will take place no matter what happens to New York City. You could not attribute all of that to a New York City default.

The CHAIRMAN. All right, sir. Now you stay, I take it, within the 5- to 71/2-percent range that you discussed before the M, for the next year and you made a strong case for it. Nevertheless, we still have heavy unemployment, 8.3 percent. We are still operating far below capacity, although there has been some recovery in the last 3 or 4 months. Housing is still in the doldrums and housing is supersensitive to monetary policy. We are faced, as you have just said, with the probable contraction in city and State economic activity, at least it won't grow as rapidly as it has, and with 14 million employees it's one of the biggest employers in the country, and certainly very important from any economic viewpoint.

In view of all that, don't you think there's some case for a somewhat more vigorous monetary policy, an argument that it might be 7 to 9 percent or something of that kind?
Dr. Burns. There must be some case for it since so many highly intelligent and public spirited individuals have been and are still urging it. I would argue only that, as I read the record, we at the Federal Reserve have been proved right.

We have argued consistently that there was no shortage of money, that the growth path we are on is entirely sufficient to finance a good, strong recovery. We have argued that because we have laid heavy stress on a factor that has been neglected, by or underestimated by many economists—namely, the velocity factor. If you contemplate a 15-percent rate of growth in the dollar value of GNP and a money supply growth rate a great deal less than that, you might start wondering whether the money supply will be sufficient to finance the kind of expansion that we ought to have if we are to make any progress with our unemployment problem. But what this line of reasoning neglects is the velocity factor—the fact that the velocity of money, the turnover of money, the willingness to use money, is much more important in the short run than is the stock of money itself. Historically, that has practically always been the case.

We base our projections on past history and so far we have been right. During the third quarter velocity rose very sharply, and it will do so again in the fourth quarter. Once you take velocity into account, the projected rate of monetary expansion appears fully sufficient to finance a very good recovery.

The Chairman. The recovery that we had in the last quarter was what, in real terms, in annual rate of around 10 percent—11 percent?

Dr. Burns. The published figure is an annual rate of 11.2 percent. I think the figure probably will be revised downward in time. My guess is that the actual rise was closer to 9 or 10 percent than to 11 percent.

The Chairman. Let's assume that the rate of growth is 10 percent and let's assume that the inflation rate is 5 percent. That means an increase in transactions to be financed of about 15 percent. With the money growth of between 5 and 7½ percent, isn't it likely if the recovery continues that vigorously—likely to require an extraordinary increase in velocity to prevent interest rates from rising?

Dr. Burns. Not extraordinary by historical standards.

The Chairman. How would it have to respond in order to—

Dr. Burns. On the basis of your assumptions, it would have to be 8 or 9 percent and that is by no means unusual.

The Chairman. Can you tell us—you seem to be adding a new factor in your thoughtful statement on money velocity. In addition to the cyclical element, you seem to say there's an innovation in the markets of various kinds. There have been changes in technology, but you don't quantify how that may have changed the velocity of money or even indicate specifically that it speeded it up. Has it and, if so, how much?

Dr. Burns. I talked about this matter because I wanted to bring it to the attention of the committee. This is something that all of us ought to be more aware of than we are. I wish I knew how to quantify it and I've been after my staff on that score. All that I know is that as a result of new developments the narrowly defined money supply no longer means what it meant 10 years ago, and that it probably will mean something else a year or two from now. But what all this means quantitatively I'm unable to say.
The CHAIRMAN. I have a chart here but let me ask one other question. If M₁ grew faster or slower—let’s say it grew faster than the 5- to 7½-percent rate, how do you estimate that would affect unemployment and inflation?

Dr. BURNS. If the difference were small, I doubt that the effect could be isolated. If the difference were large, I think it would be interpreted by the business and financial community to mean that the Federal Reserve had joined the inflationists and that the rate of inflation would be higher than it has been. I think that would have a negative effect on real economic activity.

The CHAIRMAN. Well, when you say “if the difference were great,” what do you mean? Supposing we had an expansion of 8 percent instead of the 6 or so that we might otherwise expect. Would you consider that to be large enough to have an adverse effect on inflationary expectations?

Dr. BURNS. I think that could have. For example, if I came before your committee today and indicated that our projection was for a rate of growth in M₁ of 7 to 9½ percent, I think that would have a very significant effect on financial markets rather promptly.

The CHAIRMAN. Now I have given you this chart and the chart shows how money, M₁, has grown since last March. The chart shows that the money supply snaked through your target corridor, started below your 5-percent growth quarter and then rose to 7½ quarter before the 10-percent rate. Since early September it’s come back sharply to the 5-percent lower limit.

To what do you attribute the slowdown since September? Was it deliberate and what effect would it have on the recovery in winter and spring?

[The chart follows:]

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Weekly M-1 Against The Backdrop Of The Fed's Planned Range-March 1975 to March 1976-Using $285.0 As The Base for Computing the Corridor
Dr. Burns. A part of that was deliberate, but a part I don't know how to explain. I have found it rather puzzling. The rate of growth of the money supply jumps around a great deal. I have never regarded a stable rate of growth of the money supply as a virtue, but in view of the fact that there are people in this world who do regard it as a virtue, I have tried to measure the Federal Reserve's performance against that of other central banks around the world. I found that the rate of growth of the money supply is far more stable in our country than in other countries. Money growth is something that central banks do not know how to keep on a stable course.

The important question is, does it really matter? Studies that we have made at the Federal Reserve Board strongly indicate that these variations from month to month are sheer noise which have a negligible effect on the real economy.

The Chairman. Well, what I'm concerned about is whether or not this is a trend, whether or not this trend since September which seems to be moving down is likely to continue and therefore perhaps affect the recovery.

Dr. Burns. Is it likely to continue? As I think my statement makes clear, we have taken corrective measures to try to make sure that it does not continue.

The Chairman. Since early summer interest rates have receded from the levels to which they rose in early June and July. I notice this happened in conjunction with slowing of money growth. How do you explain this? Doesn't the interest rate drop coming as it did both with sharply reduced money growth and a vigorously recovering economy—doesn't that fly in the face of economic doctrine? It seems to me that interest rates should be going up with the money supply not going up and the economy recovering, and yet it's going the other way. How do you explain it?

Dr. Burns. Since the middle of the year business demand for credit in the public markets has fallen very considerably, which was unexpected. Of late, there has been some decline in the credit demands of municipal governments; that decline was rather notable during the month of October. And I think the very fact that the Federal Reserve has provided evidence to financial markets that we are concerned about the rate of monetary growth—that we are not going to permit it to get out of bounds—has had a salutary influence on current interest rates by improving expectations with regard to future interest rates.

The Chairman. Is there any role here played by foreign central banks that would—have they been recent buyers of Treasury obligations?

Dr. Burns. I think foreign central banks have been sellers rather than buyers on balance over recent months.

The Chairman. Now the vigor with which the real GNP grew in the summer quarter was welcome news. I understand that many analysts expected a slow market in the fall and winter. Such facts as the retail sales gains are slowing down, some of the inventory increases is not voluntary and inflation is again rising. What's your impression of their analysis—your opinion?

Dr. Burns. In the sphere of retail trade, signs of hesitation certainly appeared during September, but October was a very good month; retail trade moved up rather vigorously during October.
In the sphere of production, the picture is mixed and data for October are late in coming in. Steel production has dropped, but production of electric power, paper board and household appliances has risen. Automobile production was steady in October. On the other hand, automobile sales rose rather materially during the month.

As I indicated in my statement, the Federal Reserve index of industrial production has shown a rise in every month since April, and each month's rise was larger than that of the preceding month; in September the industrial production index rose by 1.9 percent. I expect the index for October to show an increase, but the magnitude will not be anything like that of September.

So, in my judgment, the expansion is continuing. The rate is uneven, as it always is. I don't know of any expansion that has proceeded along a linear path or along some curvilinear path drawn by a mathematician. The rate of change varies. There are hesitations within individual years—for example, in the years 1956, and 1971.

The Chairman. Now you say in your statement at the very end, "The only sound fiscal and monetary policy today is a policy of prudence and moderation. New ways must be found to bring unemployment down without becoming engulfed in a new wave of inflation. That is why structural policies require far more attention than they are being acceded by academic economists or Members of the Congress."

Can you spell out briefly what some of these structural policies are and what we could do? Does this mean a new incomes policy? Does it mean another policy with respect to unemployment? I want to get into that, incidentally. That was a fascinating reference you made to your Georgia speech, one that I think hasn't been given nearly sufficient attention. It's got a lot of potential.

But how about, in the first place, the structural changes that you might have in mind, incomes policy, antitrust, what?

Dr. Burns. I'll try to spell out what I had in mind in the Georgia speech. Let me summarize briefly what I meant by structural policies that we ought to be thinking about.

First of all, we need to seek ways of encouraging improvements in productivity. Larger investment in modern plant and equipment is certainly one of the most effective ways of achieving that end and some overhauling in our structure of Federal taxation should be helpful in that respect.

The Chairman. Well; we followed your advice on the investment tax credit. The President chose to make that permanent, but it's a 10 percent rate. Would you increase that?

Dr. Burns. Beyond 10 percent?

The Chairman. Yes, sir.

Dr. Burns. I must say that I'm not in the mood to give up tax revenues. If we did give up tax revenue in this direction, which I'd like to see, I would want to make it up in other directions.

The Chairman. Then how do we provide the incentive for greater investment in productive equipment?

Dr. Burns. I think I would lower the corporate tax rate rather than increase the investment tax credit beyond 10 percent.

The Chairman. As opposed to President Ford's 2 percent reduction? Is that enough?
Dr. Burns. I think that would be a move in the right direction. Whether it's enough or not, I don't know. I'd like to see that take place before too long.

The Chairman. I'm sorry I interrupted. You said productivity is one area.

Dr. Burns. A second factor that I noted in my Georgia speech was that we ought to reexamine our environment and safety regulations. They have been escalating costs and prices. I don't think we ought to give up what we have been trying to do in these fields by any means, but we could adjust our time tables to try to achieve our environmental and safety goals over a longer period. I think that would be very desirable.

Third, I noted the need for intensifying price competition among our business enterprises. We ought to reassess our laws directed against restraint of trade and we ought to reassess our governmental regulations affecting transportation, etc.

Next, I noted the need to take a very careful look at what we have been doing to our labor markets. We ought to seek noninflationary measures to reduce unemployment, and some readjustments in our legislation governing labor markets could be helpful in that connection. I mentioned the need, as I see it, of revising the Federal minimum wage law which is pricing many teenagers out of the job market. I commented on the Davis-Bacon Act which is continuing to run up costs in the construction area and which is damaging the construction industry, one of our most depressed industries.

I think that our programs for unemployment compensation need to be reviewed. Having unemployment compensation for a period as long as 65 weeks may, I think, be damaging to our country and to the morale of our working people. I noted the need for—

The Chairman. How would you reduce that? You say 65 weeks is too long. What limit would you put on it?

Dr. Burns. In the absence of the kind of program for public service employment that I talked about in the speech, I would return to a 26 week period.

The Chairman. Well, now, if you do that, if you cut unemployment compensation off after 26 weeks, 6 months, we have as I recall something like a million and a half long-term unemployed—that's 26 weeks. It might be a little more than that. Those people would be without any unemployment compensation. They'd have to go on welfare, food stamps.

Dr. Burns. They might get jobs.

The Chairman. Perhaps they could get jobs, but the difficulty, of course, is that the evidence we have is that the jobs aren't available.

Dr. Burns. Many jobs are available which people are unwilling to take.

The Chairman. That's true, but the job vacancies statistics we have suggest they fall far short of anything like the 7½ million people who are out of work. There may be a million and a half or there may be 2 million—

Dr. Burns. We don't have job vacancies statistics which are worth anything. Actually, I believe we have discontinued the poor statistics that we had. I was in favor of and I worked for a comprehensive measure of job vacancies, but the Bureau of Labor Statistics never de-
veloped such a measure they had some kind of a program that wasn't worth very much, and when they sought my advice about discontinuing it I said, "Either do it right or discontinue it and save some money."

The CHAIRMAN. Do you have a memorandum on how it could be done right? I think there's sentiment in the Congress now to require those vacancies statistics.

Dr. Burns. Although I worked in this field extensively some years ago, I would hesitate to prepare such a memorandum now because it would divert me seriously from my current work. But maybe I can get the study done by one of my old colleagues at the National Bureau. I'll try to assist you on that one way or another.

The CHAIRMAN. All right, sir. Now I interrupted you again.

Dr. Burns. I put forward a plan that has been criticized from all sides. I fully expected that, but I wanted to stir up some discussion. Our present policies aren't working well. It is nonsensical to sit around and talk about a 4-percent unemployment rate as corresponding to full employment and have someone say, "Oh, no. It ought to be 3 percent or 2½ percent," or have someone else say, "It ought to be 5 percent or 5½ percent because the character of the labor force has undergone drastic changes." I think we ought to discontinue these arithmetical debates. We ought to strive for an unemployment rate literally of zero. My plan is subject to all kinds of criticisms and I hope that other people will improve on it, but——

The CHAIRMAN. I like the philosophy of your proposal very much. I thought the details were at best unrealistic and at worst cruel, when you proceeded with the notion of having people on unemployment compensation cut off after 13 weeks and required to work at less than the minimum wage. What that will do to the economy as well as what it would do to the individual family would be catastrophic. They say an auto worker's unemployment compensation could be $6,000, which might enable him to keep body and soul together. If he works for a less than minimum wage, that means he works for less than $4,000 a year. That would really torpedo him and his family. They would be on welfare and food stamps and they'd be working but it would be in pretty desperate shape and the country with that kind of a loss in purchasing power, it seems to me, would be pushed down into the kind of situation that we suffered in the 1930's, would it not? Wouldn't that be a danger? I'm not saying that I don't like the idea. I think it's a great idea, but supposing we did this. Supposing we permitted the payment of the unemployment compensation and the cost of going to work, transportation cost—but provided jobs on the same basis you suggest, that everybody would be busy. There are all kinds of things that we could do with 7½ million people that would improve our country, but there would be sufficient incentive for them to work in the private sector and they wouldn't have their lives economically torpedoed by having to work for less than $4,000 a year.

Dr. Burns. Senator, there isn't a chance, as you indicated, that the Congress will go in this direction this year or, in my judgment, within 5 or 10 years. Moreover, I put fences around the Congress by calling for a constitutional amendment, and how long that would take if we ever get it at all——

The CHAIRMAN. I think there's a lot of possibilities. It may take a couple of elections to make things, but there's a great deal of sentiment
from the people out of work that they're fed up with welfare and food stamps and all these things that keep people idle and pay them to be quiet, but instead of that we ought to require people to work if they are going to get an income and if they're able bodied and able to work. I think you're absolutely right on that. I disagree on the detail. I think it is an important idea but I think it is important that you provide an opportunity to work and they be given enough so that they don't suffer the degradation of working for approximately the poverty income.

Dr. Burns. I have only two comments to make. First, I'm very pleased to hear you speak as you just have. Any movement in this direction would have to be gradual, but I would hope that it would continue. I'll tell you why. I think that the Government has a certain obligation in the kind of world we live in with regard to jobs. People are lonely. We have an industrial society. Not many people have farms to go back to. Family ties are no longer as close as they once were.

But I don't think Government has an obligation to provide attractive jobs. Providing a job at an unattractive wage has merit because it would enable an individual to get by in some fashion for a time, while giving him a strong incentive to find a regular job or to create a new opportunity for himself.

This would stir people to industry. It would ignite their imagination. At present, many individuals are building their life around unemployment compensation. In some of our communities they get along well by doing very little work. All they need to do is work for a day or two to supplement their unemployment benefits. Often they don't even have to report that to the Internal Revenue Service. A fair number of people are getting by that way.

But the process is doing damage to the people in our country, which is more important to me than any financial cost. So if you're inclined, Senator, with your great influence to move away from this, you'd be making a great contribution to this country. I would hope to see you continuing to move in that direction and I would like to stimulate you in that direction later on. I find what you say very encouraging.

The Chairman. Thank you very much. I thought that was one of the most significant economic expressions that we have had in a long, long time and it was a most helpful and useful suggestion. The fact that Government as employer of last resort is not a far-out, radical idea. It is a matter of doing it in a realistic way both ways, and it's a matter of also providing strong incentive to get back into the private sector.

Senator Garn, do you have some questions?

Senator Garn. I don't have any more questions. I'd just like to comment that I, too, am encouraged by what the chairman said. When you get liberal Democrats coming around to what we conservative Republicans have been preaching for years and years and I'd like you to know that I believe in the principle of repentance and we're perfectly willing to accept you on our side and I'll help you fight for people who are able bodied.

The Chairman. But in my view, it was the other way around. I thought the Federal Government as an employer of last resort was a liberal idea, if not a radical idea. When one of the most eminent conservative economists in the world, Dr. Burns, says that he thinks the
Government as an employer of last resort was something we should work for, I was enormously encouraged and I thought we were having the great conservative community coming over to our side.

Senator Garn. I'm not going that far. I'm talking about your comment about able-bodied people who can work being required to work and accept all these jobs that you read about in the want ads. There's thousands of them in the Washington Post.

The Chairman. Well, our time is up. I want to thank you so much, Dr. Burns. You have been a most helpful witness as always.

The committee will stand in recess.

[Whereupon, at 12:10 p.m., the hearing was recessed.]
SECOND MEETING ON THE CONDUCT OF MONETARY POLICY

THURSDAY, NOVEMBER 6, 1975

U.S. Senate,
Committee on Banking, Housing and Urban Affairs,
Washington, D.C.

The committee met at 10:05 a.m., pursuant to call, in room 5302, Dirksen Senate Office Building, Senator William Proxmire, chairman of the committee, presiding.

Present: Senators Proxmire and Packwood.

The CHAIRMAN. The committee will come to order.

Today we conclude our second meeting on monetary policy pursuant to the resolution which I introduced last February which calls for the Federal Reserve to consult with Congress about its targets for growth of the monetary and credit aggregates in the year ahead.

On Tuesday we heard from Chairman Burns. He told the committee that the Fed was aiming to increase \( M_1 \) between 5 and 7\( \frac{1}{2} \) percent from the third quarter of this year to the third quarter of 1976; between 7\( \frac{1}{2} \) and 10\( \frac{1}{2} \) percent for \( M_2 \) and between 9 and 12 percent for \( M_3 \). Dr. Burns stated that these "projected," as he put it, rates of growth are "adequate to finance a vigorous further expansion in real economic activity" and although they "cannot be maintained indefinitely without running a serious risk of releasing new inflationary pressures," under current economic conditions they were "not so large as to rekindle the fires of inflation."

Dr. Burns placed considerable emphasis on velocity in his testimony. He told us that the GNP velocity of \( M_1 \) had risen at an annual rate of 8.7 percent in the summer quarter, that the turnover of money tends to rise relatively rapidly in the recovery stage of the business cycle, and that "in deciding appropriate target ranges for growth of the monetary aggregates, we at the Federal Reserve must carefully consider the probable movements of income velocity over the course of the business cycle."

I pointed out that in the last quarter that the real growth of the GNP, was in excess of 10 percent and assuming that we had inflation of 5 or 6 percent that with an \( M_1 \) growth of around 6 percent that there would be a need for a very sharp growth in velocity. He acknowledged this but indicated that he thought we'd get a 9 or 10 percent growth in velocity in the coming quarter.

Finally, Dr. Burns noted that money supply growth had gyrated above and below the target ranges set here last spring and reiterated last summer before the House Banking Committee. He said that

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these gyrations reflected "unusual factors influencing the public's demand for money;" that short run fluctuations in monetary growth "have little significance for the functioning of the real economy," that the Fed was "alert to any large and protracted departure of monetary growth rates from longer run objectives:" that "corrective actions" had and would be taken to return growth rates "to the desired path of long-run monetary expansion" when they departed from it; and that such corrective actions would have "some influence on the level of interest rates—particularly short-term rates," and that "temporary fluctuations in short-term market interest rates are an inevitable byproducts of efforts to keep the rate of monetary expansion from straying too far from the desired longer run path."

Our witnesses today are two of the Nation's most eminent economists. Both have been constructive critics of the Federal Reserve in the past, constantly constructive but not constantly critical, and their views often are different from one another. Our witnesses are Professors Milton Friedman of the University of Chicago and Paul Samuelson of MIT. We are fortunate to have them.

Dr. Friedman, would you like to proceed?

STATEMENT OF PROFESSOR MILTON FRIEDMAN, UNIVERSITY OF CHICAGO, DEPARTMENT OF ECONOMICS

Dr. FRIEDMAN. Thank you, Senator Proxmire.

My written testimony was prepared before I had the opportunity to see Chairman Burns' testimony but my written testimony would not have been very different had I seen it. [I am inserting at the end of this testimony on additional comment on one part of Chairman Burns' testimony.]

I believe that the Concurrent Resolution 133 which your committee and the House committee were responsible for has been the most important and the most constructive change in the structure for the formation of monetary policy of the past four decades so I am honored to testify before you.

The importance of the resolution was that for the first time in the 60-year history of the Federal Reserve it required the Federal Reserve to specify targets for as long as a year ahead. It required the Federal Reserve to state those targets publicly in advance and required the Federal Reserve to express its targets in terms of monetary aggregates.

All of these were innovations. To the best of my knowledge, in the whole 60 years of its experience prior to the resolution, the Fed had never set itself a quantitative target for as much as a year ahead which is rather astonishing since the Fed was established to provide long-run continuity in monetary policy.

In my opinion, the major defect in the Federal Reserve's performance over the whole of its history has been its erratic movement, the tendency for it to move from one extreme of monetary growth to the other, from increasing the money supply too rapidly to increasing it too slowly. Unduly rapid increases produced or fostered the inflations in World War I and II. Unfortunate sharp swings in the other direction produced the great contractions of 1920 to 1921, 1929 to 1933, and 1937 to 1938.
Chairman Burns' testimony, as you have just reported it, suggests that that defect is still with us, despite the emphasis in your concurrent resolution on steady monetary growth.

Table I of my prepared testimony shows rates of monetary growth for the past five years. You will see that those rates of monetary growth show wide swings from a rate of growth of over 7 percent from January 1970 to 1973 in the narrow aggregate, down to less than 1 percent from June 1974 to January 1975, 8.6 percent from January 1975 to July 1975, and 0.3 percent from July 1975 to the most recent 4 weeks.

These swings have, been very undesirable from the point of view of a stable economy. Instead of the Federal Reserve's serving as a source of stability in the economy, it has served as a source of instability. I believe that the crucial immediate question for monetary policy and the question I would hope this committee would increasingly consider is why these swings have occurred. The important point to be emphasized is that these swings have not occurred because the Federal Reserve intended them to occur. They have represented a deviation of actual performance from intended performance. The general thrust of my comments here today will be that I do not differ greatly with the objectives which the Federal Reserve has set in response to your resolution, but I do criticize the Fed severely for its failure to achieve those objectives. I believe it has failed to achieve those objectives because it has continued to follow a method of operation that is not suited to its objectives.

Its procedural method is an anachronistic survival of an earlier day. There are alternative methods of operation which would enable it to achieve its objectives. So I propose to spend just a few minutes discussing the objectives and then spend most of my testimony on techniques of achieving those objectives.

With respect to the very recent performance, the question for the coming quarter is whether the Fed does or does not alter its recent stance. If the Federal Reserve continues for another few months the extremely restrictive policy it has in fact followed since July, I believe that the current recovery would be aborted and that we would relapse into another recession phase. I do not believe that the Fed will continue its restrictive policy. I fear the more serious danger is that it will once again swing too far in the other direction; it will once again swing too rapid a monetary growth rate. If that happens, then the recovery will continue in 1976 but it will be followed in 1977 or 1978 by a reemergence of inflation.

Personally, I favor slightly lower rates of monetary growth than the 5 to 7 1/2 percent for M1, and the 8 1/2 to 10 1/2 percent or more recently the 7 1/2 to 10 1/2 percent rate for M2 that Chairman Burns has specified. However, my difference on this score is minor. While I would favor slightly lower rates, I would not favor drastically lower rates in the immediate future.

Looking farther ahead, I fully endorse Chairman Burns' comments to the effect that continuation of monetary growth at these rates would inevitably spell inflation at an unsatisfactory level. The rates of monetary growth that are incorporated in the Fed's present objectives imply a rate of inflation in the neighborhood of 6 to 7 percent. Now that's not bad for this year or next year, given our past experience, but it is
a rate of inflation that is decidedly too high for the longer period. Therefore, I believe that it will be desirable as time passes to lower the objective gradually. I stress gradually because I believe that we must compromise between the desirability on the one hand of getting to a noninflationary rate of growth, and on the other of avoiding severe shocks to the economy.

Consequently, if I were specifying objectives for the next few years, I would suggest that these rates of growth should be lowered by something like 1 to 2 percentage points a year for the next 3 to 5 years in order to bring them down to the ultimate objective of something like 3 to 5 percent in M₂ and whatever rate of M₁ goes with that.

This suggestion is not inconsistent with Chairman Burns’ verbal statement. However, I believe it would be highly desirable to extend the outlook and to have an explicit numerical timetable rather than simply the statement that sometime in the future the rate of monetary growth will be reduced.

Insofar as objectives are concerned, I have only one other comment to make. The Fed has adopted the practice of shifting the base of its objectives each time it testifies. This means that you do not really have a long-term objective for monetary growth. You have a 3-month objective and then whatever mistake is made in that 3 months is incorporated in the next 3 months because each quarter the Chairman has shifted the base to which he applies his percentages to the actual level achieved during the prior quarter, this time during the third quarter.

I suggest that it would be far more desirable for him to specify a long-term objective and stick to it and not simply each time validate whatever may have been the departure, the difference between the objective and the performance.

In this connection, I think it would be desirable if instead of specifying a range of growth rates he were to specify a time path for the level of the monetary aggregate and then add a range about it of plus or minus 1 or 2 percent. The problem with the present procedure is that you have a range of objectives that widens indefinitely as you go out in the future because you start from a base point and then you say 5 to 7½ percent, and that gives you an increasingly wide margin of tolerance the longer that you have in the future.

Senator PACKWOOD. Excuse me. Would you explain again what you just said? Back up about two sentences and then say it once more.

Dr. FRIEDMAN. The Fed today, as Dr. Burns did the other day, said we plan a 5 to 7½ percent rate of growth from the average of the third quarter, but the average of the third quarter is not what their objective was in the second quarter. In this particular case it happens to be about half a billion dollars higher for M₁.

Senator PACKWOOD. Are you saying that the Feds are saying their objectives for 2 years is “±2” and then you give them a margin of error of 10 percent on the top or bottom side of that range?

Dr. FRIEDMAN. Exactly, and that would be better than having this 5 to 7½ percent which means that the margin with respect to the level gets bigger and bigger as you go out.

Let me turn to what I think is really the much more important and basic issue and that is the issue of performance. When Chairman Burns testified before the House Banking Committee 3 months ago
both $M_1$ and $M_2$ were above the upper limit of the objectives he had specified. When he testified here 2 days ago, both $M_1$ and $M_2$ were below the lower limits of the objectives he had specified. Neither this initial overshooting nor the subsequent retardation were intentional. They were the results of mistakes, as Chairman Burns testified. Of course, he said unforeseen contingencies entered in and caused the money supply to increase too rapidly in the earlier period and too slowly in the later period.

Some observers have concluded from this failure to match the target that the Fed is a helpless giant and cannot achieve its targets and cannot control the money supply. There is a sense in which that is correct, but there's a more fundamental sense in which it is wrong. The sense in which it is correct is that given the way the Fed now operates it cannot achieve its targets. As long as it continues to use its present procedures it will fail to achieve its monetary growth targets, but there are alternative operating procedures that would enable it to achieve its targets.

Let me stress that this is not a new problem. It's of long standing. I have given in my prepared testimony a list of references on page 6 which start from 1963 with a doctoral thesis by William Dewald at the University of Minnesota devoted exactly to this problem. I just offer that list of references to show how extensive is the literature on this subject.

Since before the Fed shifted to a money supply target in 1970 it has been emphasized to the Fed by studies within the Fed, by studies outside the Fed, that the procedure which the Federal Reserve is now using is not a suitable procedure for controlling the money supply and that there is an alternative procedure which would do a great deal better job.

In addition to these problems of procedure, the Fed could modify its current regulations and should modify its regulations about reserves and about other features in a way which would enable it to do a far more effective job in controlling the money supply.

The present procedure is a carryover from the time before 1970 when the Fed had money market conditions as its objectives. The present procedure involves setting a money supply target, the 5 to 7½ percent, for example, that Dr. Burns set the other day, and then asking the staff to calculate what federal funds rate would lead to that money supply target being achieved, and then asking the New York Federal Reserve Bank to peg the Federal funds rate at that level.

Now in principle that method could work. In principle there is a Federal funds rate which would induce the commercial banks, the member banks, to add to their reserves that amount which would be necessary to produce the desired growth target. In principle, therefore, it could work; but unfortunately, there are two major slips between that principle and the practice.

The first slip is that the Fed cannot predict what the right Federal funds rate is. The Federal funds rate that is right depends on the rates at which the commercial banks can lend as well as the cost of funds to them. The Federal funds rate is the cost of the funds but it doesn't tell you anything about the rate at which they can lend.

In order to be able to predict what the right Federal funds rate is, you have to be able to predict the rates at which they can lend. The
Fed has a so-called money market model with which it tries to do that. I have tested that model. It is roughly of zero value. This is a model for predicting the Treasury bill rate and what I said is I'm going to run a race between that model and the simplest model. I'm going to predict next month's Treasury bill rate as the same as this. It turns out that gives more accurate predictions than the Federal Reserve model does. So they cannot predict what the right rate is.

In addition, and more important, if they make a mistake the error is cumulative and self-reinforcing. Let's suppose the Federal Reserve picks too low a rate, as it did in the early part of this year. It picks too low a rate at the time when market forces are tending to raise the rates at which banks can lend. Banks then want to acquire more reserves consistent with the desired monetary growth rate. The Fed gets no information that it has made a mistake except from what happens to the money supply because it's pegging the rate. It looks as if it's doing fine. The rate is staying at say, 6 percent. Even more important, as the Fed feeds out more money to support the Federal funds rate, after a brief interval, that strengthens the forces tending to raise other interest rates because the higher monetary growth stimulates spending, and the demand for loans, and that tends to raise interest rates.

It used to be that it took 6 months before that effect took place. It used to be that for the first 6 months after the Fed pours out money, that would tend to lower rates. But the markets are smart. They have learned this lesson. If monetarists have not persuaded anybody else, they have persuaded people who are operating in the money market, and the result is that there's now only about a 2-month gap between an increase in monetary growth and a tendency for that monetary growth to raise interest rates rather than lower it. The result of additional upward pressure on interest rates is to increase still further the amount of funds that the Fed has to pour out to hold the Federal funds rate. That's what happened from January to July of this year. They kept the funds rate below the market rate and there was a monetary explosion, a 9-percent rate of growth in M1. The opposite happened in 1974. It was no part of the Fed's intention to convert the minor recession of 1973 and 1974 into a major recession from 1974 to 1975, but they did it. Now, why did they do it? Not on purpose, but because they were following this obsolete procedure. They had the Federal funds rate pegged too high. As the recession proceeded, it tended to drive down interest rates. The Fed kept lowering the target Federal funds rates, but they didn't lower it fast enough. The market rate kept falling down beneath them, and they kept having to pull money out of the system in order to maintain their target Federal funds rate. As a result, for a 7-month period, they produced nearly a zero rate of growth in M1, which, in my opinion, was a major factor converting this mild recession into a severe recession.

Of course, once the Fed makes a mistake it doesn't continue indefinitely down that road. It sooner or later adjusts, as I have just described. In 1974, it kept lowering the rate, but it couldn't lower it fast enough. In the period from January to June of this year, it kept the rates stable. It held it constant, too low. Then it suddenly jumped it in June with the result that it overshot the market and produced a drastic shift in monetary growth so that from July to now you have had essentially zero growth.
The Fed has gradually been waking up to this phenomenon and has been trying to lower the rate, but it hasn’t been able to lower it fast enough. As a result, monetary growth is not matching what the Fed says is its objective. Sooner or later the Fed will lower the target Federal funds rate too much. It will overshoot and then you will be off again to the races with another explosion in the other direction.

In short, what the Fed is trying to do is the equivalent of balancing an egg on its small end. In principle, it’s possible to balance an egg on its small end, but you will agree with me it takes extremely fine tuning to hold that egg on its small end, and it takes extremely fine tuning for the Fed to manipulate the money supply by the method it’s now using.

There is an alternative procedure. That alternative procedure is comparable to letting the egg rest on its side. That procedure is to forget about the Federal funds rate, to convert the desired monetary growth rate into an estimate of how much must be added to bank reserves or to high-powered money or the monetary base in order to produce the desired growth rate. This eliminates an utterly unnecessary step in the present procedure. What I have described has to be done now. The Fed must estimate how much reserves must grow in order to increase the money supply by the desired level, but now it takes an additional step—what is the Federal funds rate that will lead the banks to be willing to increase reserves by that amounts?

There is no disagreement on the part of the Fed or anybody else that if the Fed forgot about the Federal funds rate, it could control within very narrow limits the monetary base or total reserves. So the alternative procedure is for the Fed to say, in order to produce a 5- to 7½-percent rate of growth in M–1, we have to produce such and such a rate of growth in high-powered money and they say to the Federal Reserve Bank of New York, “Go out and buy the amount of securities that are necessary for this purpose.”

That won’t give you perfect control. There’s a slip twixt that cup and the lip, too, because there’s a multiplier which connects the total money supply with the base. That depends on such things as what happens to the ratio of currency to deposits, how deposits are distributed between demand and time, and how they are distributed between banks with high reserve requirements and low reserve requirements. But all those ratios are very stable and change very slowly, and there is ample statistical evidence that while that introduces an error, the error over any period of time would be less than the error which is now introduced by the present method of operation.

More important, the error is not cumulative. It is random. From month to month it will average out. The Fed might make just as large an error for a 1-month period, but it is literally inconceivable that the Federal Reserve would have departed as far from its objectives as it has over the past year if it had followed this alternative procedure.

The only serious argument that has ever been made against this alternative procedure is that it would involve more unstable interest rates. I believe that that conclusion is the reverse of the truth. I believe the present procedure destabilizes interest rates over periods of more than a few days or a few weeks. I really need not stress this issue because the argument involved is exactly the same argument
that you people considered or your predecessors considered—though I think perhaps Senator Proxmire was here—back in 1951 and 1952 when—

The Chairman. Thank you.

Dr. Friedman. I guess I'm making you more of a veteran than you are, Senator Proxmire.

Senator Douglas, when he was here, was a leading figure in examining the bond support program of the Federal Reserve. The fallacy in the present procedure of trying to control the money supply is identical with the fallacy in the bond support program. It's identical with the fallacy in a fixed exchange rate system, and that is, rates are stabilized for days or weeks at the cost of letting discrepancies accumulate and having big movements over the months and the years. If you look at the actual movements of the interest rates, they have been destabilized by the attempt to stabilize them. In general, this is the case with any speculative procedure which tries to peg a price. It can peg a price over short intervals, but only at the cost of destabilizing it over long intervals because you let the discrepancies accumulate.

This conclusion has recently been reinforced strongly by a very interesting paper by Prof. William Poole, who is now at Brown University but was at the Federal Reserve Board research staff for many years, and then at the Federal Reserve Bank of Boston, in which he, too, has concluded that the present procedure destabilizes the interest rate.

So I conclude that there is an overwhelming strong argument for replacing the present operating procedure of the Federal Reserve by an alternative operating procedure which would enable it to bring its performance more closely in line with its objectives.

Incidently, I believe that this committee could serve a very important function in this area by setting up a series of hearings on this technical question of methods of controlling the money supply. There is a wide body of literature available on it. There are many people who have studied it carefully. Your committee in the past has done this kind of thing, brought together existing knowledge. I think it is the most important single thing, if I may say so, that this committee could do at the present time to foster good monetary policy.

Over and above this change in procedure, there are changes in regulations that would greatly improve the performance of the Fed. Some years ago George Kaufman, who for many years was an economist with the Federal Reserve System and most recently at the Federal Reserve Bank of Chicago—since then he has been a professor at the University of Oregon—some years ago he wrote and I quote—

By increasing the complexity of the money multiplier, proliferating rate ceilings on different types of deposits, and encouraging banks, albeit unintentionally, to search out nondeposit sources of funds, the Federal Reserve has increased its own difficulty in controlling the stock of money. To the extent the increased difficulty supports the long voiced contention of some Federal Reserve officials that they are unable to control the stock of money even if they so wished, the actions truly represent a self-fulfilling prophecy.

The major mistake of this kind, in my opinion, was the introduction of lagged reserve requirements in 1968. I may say that that change was made for reasons that had nothing to do with monetary policy. It was made fundamentally because it was believed that it would be attractive
to small banks and thus might reduce their tendency to leave the system. The change has not worked out that way. I do not know anybody who has a good thing to say for the lagged reserve requirements system. The small banks don't like it. The big banks don't like it. It has introduced variability into every dimension of Federal Reserve policy and yet you have the standard phenomenon that you are so familiar with, once a bureaucratic change has been made, it is the devil and all to get it changed. But the most important single step at the moment in the regulations the Fed could take would be to eliminate those lagged reserve requirements.

A young man at the Federal Reserve Bank in Chicago, Bob Laurent, has suggested a very ingenious scheme which is to reverse it. Instead of having lagged reserve requirements, instead of having reserve requirements this week, depend on your deposits 2 weeks ago, have reserve requirements depend on next week's deposits.

Now it turns out that that would have the effect of giving almost perfect control to the Federal Reserve over the increase in the money supply because they could make available the required reserves this week which would, in turn, determine how much deposits banks could produce next week. You now have the situation where banks can create all the deposits in the world and they don't have to scramble for reserves for 2 weeks and 2 weeks later the Fed has to provide those reserves. The only question, is, does the Fed provide them in the form of unborrowed reserves or in the form of borrowed reserves? By reversing that relationship you would have the Fed provide the reserves this week and then the banks could figure out on that basis how much they were free to expand next week.

That's only one of a number of schemes that have been proposed. I'm sure that a major change along these lines would greatly improve the precision of Federal Reserve control.

The other change that I think most important is to eliminate the present system under which all banks in the country have a reserve period that ends on Wednesday. This is fundamentally an insane system. It makes no sense whatsoever because all the discrepancies pile up on Wednesday and there are tremendous movements within a week in Federal Reserve so-called defensive operations.

The solution is simple. Let one-fifth of the banks end on Monday, one-fifth of the banks end on Tuesday, one-fifth of the banks on Wednesday, et cetera. Staggering the reserve requirements in that way would even out this process and prevent the sharp swings within a week that now take place.

Those are a few suggestions for the kind of reforms that could be made. Those are the kinds of suggestions that could be explored very well in special hearings that this committee could hold.

Let me conclude that I believe there is today a wide measure of agreement on the part of the Congress, the Federal Reserve System and the financial and academic community about the importance of monetary policy for economic stability for the avoidance of inflation and the fostering of healthy growth. There is still some disagreement with the specific policy that will best foster these objectives. However, I believe there has been growing support both for emphasis on monetary aggregates rather than interest rates as a major instrument of monetary policy, and for a relatively steady and moderate rate of growth in monetary aggregates as a major objective.
That is today the position of the Federal Reserve System itself, as well as many of the most severe critics of earlier Federal Reserve performance. The major issue has shifted, I believe, from objectives to means. The present technique of Federal Reserve operation is a survival of earlier practices. It's not suited to present objectives. It has produced a dramatic discrepancy between the Federal Reserve's announced objectives and its actual performance. It's long past time that the procedure was streamlined to accord with the change in objectives.

The Congress and your committee in particular has played a major role in producing a large measure of agreement on objectives. You could now play a major role by stimulating the Fed to put its money where its mouth is.

The CHAIRMAN. Thank you very much, Dr. Friedman.

[Complete statement follows:]
The rates of monetary growth over the three-year period from 1970 to 1973 were higher than for any other three-year period since the end of World War II. This rapid monetary growth undoubtedly helped produce the rapid inflation of 1973 and 1974, and even our current inflation. A change in monetary growth has a rapid effect on credit markets, but it generally takes some six or nine months before it affects total spending, and then the effect at first is mainly on physical output. In the U.S., it has generally taken some two years before a change in monetary growth has its main effect on prices.

The mild tapering off of monetary growth from 1973 to 1974 was long overdue and highly desirable. A reduction was essential to slow inflation. A gradual reduction was desirable to avoid a severe economic shock. This gradual reduction contributed to the mild recession that began in late 1973, but it also laid the basis for the tapering off of inflation we have been enjoying this year. Unfortunately, the Fed did not continue this gradual policy. In mid-1974, it enforced a sharp slowdown in monetary growth, which greatly deepened the recession beginning in late 1974. That deepening in the recession was the prelude to the concurrent resolution and no doubt did much to stimulate it.

Unfortunately, as the table shows, the concurrent resolution has not as yet ended the propensity for the Fed to swing widely from one extreme to the other. From January 1975 to July 1975, monetary growth jumped to an even higher rate than during the three years from June 1970 to June 1973. That monetary explosion helped end the recession and produce the vigorous recovery that has been in train since April or May, but it also threatened to produce a renewed acceleration of inflation. The slowdown in monetary growth beginning in July was therefore appropriate, but again it has been too abrupt and threatens to go too far. Were it to continue much longer, it would abort the current recovery and plunge us into renewed recession. I cannot believe that that will be permitted to happen. Indeed, I believe that the greater danger is another monetary explosion, another swing from one extreme to the other.

The major current problem for monetary policy is to end these erratic swings from one extreme to the other, and to replace them by a steady rate of monetary growth that declines gradually over several years until it can be stabilized at a level consistent with no inflation.

The erratic swings in monetary policy have not reflected similar swings in the Fed's objectives, at least for the period for which the Fed has specified objectives in terms of monetary growth and for which we know what they were. The swings have rather reflected the failure of actual performance to conform to the stated objectives.

After a brief examination of the stated objectives of the Fed, I shall therefore devote most of my remarks to an examination of the reasons for the discrepancies between objectives and performance and for the changes in current procedure that are required in order to reduce those discrepancies. This seems to me the most urgent current problem in improving monetary policy so as to foster stable and non-inflationary economic growth.

2. THE STATED OBJECTIVES

By requiring the Fed to specify objectives in terms of monetary growth for a considerable period ahead, and by linking the desirable rate of growth to the country's productive potential, the concurrent resolution has gone a long way to assure that the stated objectives will be reasonably well attuned to the economy's needs. That has certainly been the case on the two earlier occasions on which the Fed responded to the resolution. [This statement was prepared without access to the latest response.]

Personally, I have favored slightly lower rates of monetary growth than the 5 to 7½ percent rate for M_2 and the 8¼ to 10½ percent rate for M_3 specified by Chairman Burns on the first two occasions. However, my difference on this score is minor. Similarly, I fully endorse Chairman Burns' repeated emphasis that the maintenance for any long period of rates of monetary growth at these levels would mean an undesirably high rate of inflation, and hence that it is essential to move to sharply lower rates of monetary growth in order to establish the basis for steady non-inflationary economic growth.

The ultimate target should be a rate of growth in M_3 of roughly 3 to 5 per cent a year. That would roughly match the rate of growth in our productive potential. Given the highly stable velocity of M_3 over more than a decade, it would be consistent with roughly stable prices.

Our present knowledge about the short-run effects of changes in the rate of monetary growth is too limited to yield any very precise estimate of how rapidly
monetary growth should be reduced to the desired long-run rate. My own judgment is that a transition period of something like three to five years is a reasonable compromise between ending inflation rapidly and avoiding heavy transitional costs. This would require the stated rates of growth for \( M_1 \) to be reduced by one to two percentage points each year for the next three to five years.

This suggestion is not inconsistent with the verbal statements by Chairman Burns. An explicit numerical timetable along these lines would however be highly desirable. If the attainment of such a timetable can be made credible, it would provide a basis for private economic and financial planning. The salutary effect on inflationary anticipations would greatly ease the transition to a non-inflationary environment.

My only other suggestion with respect to objectives is purely technical: the desirability of expressing them in terms not of rates of growth from a changing base, or not solely in those terms, but of a desired time path of each monetary aggregate plus and minus a percentage band. This suggestion is linked with the desirability of specifying a longer-range timetable. A range of monetary growth rates tied to an initial base produces numerical limits on the aggregate that widen indefinitely, the longer the time that elapses from the base.

3. PERFORMANCE

When Chairman Burns testified before the House Banking Committee on July 24, 1975, both \( M_1 \) and \( M_2 \) were above both the original and revised upper limits of the Federal Reserve objectives. Just before his current testimony before this committee, the latest figures then available were below the lower limits, thanks to essentially zero growth from July to mid-October in \( M_1 \) and a 4 per cent rate of growth in \( M_2 \).

As already noted, neither the initial overshooting nor the subsequent sharp retardation were intentional. Both reflected a failure of the Fed to achieve its stated objectives. These were only the latest of such failures.

Some observers have concluded from these failures that the Federal Reserve does not have the power to achieve its targets, that in this area it is a helpless giant. There is a sense in which that conclusion is correct, but a more fundamental sense in which it is wrong.

The conclusion is correct in the sense that the operating procedures now used by the Fed to implement its policy directives produce major discrepancies between objectives and performance. So long as it continues to use these procedures, it will continue to fail to achieve its monetary growth objectives. But there are alternative operating procedures that have been extensively discussed and explored within and without the system and that are entirely feasible that would enable the Fed to reduce sharply the discrepancies between actual monetary growth and intended monetary growth.\(^1\)

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\(^1\) A few key items in the extensive and growing literature on procedures for controlling monetary growth are:

- The few that are especially relevant to the rest of this testimony are:
- William Poole, "Benefits and Costs of Stable Monetary Growth" (forthcoming).
These alternative procedures would of course not enable the Fed to hit its target on the nose day by day. There would still be sizable errors from week to week or month to month. But by comparison with present procedures, the errors would not be self-reinforcing. As a result the alternative procedures would enable the Fed to avoid the wide swings from one side to the other that have long characterized Fed performance.

The residual errors under the alternative procedure could be reduced still further by changes in Federal Reserve regulations, particularly with respect to required reserves, they are desirable on other grounds.

I shall elaborate these judgments by (a) explaining why present procedures are defective, (b) outlining the alternative procedures, and (c) suggesting the key changes in regulations that would be desirable to improve still further Federal Reserve control over monetary aggregates.

(a) Present Procedures.—Present procedures are an anachronistic survival of an earlier day. Their persistence is an extraordinary tribute to bureaucratic inertia. Before 1970, the Fed took as its prime objective “money market conditions,” i.e., a collection of market interest rates. In 1970, it shifted to money aggregate targets. That was a major and salutary reform but it was stifled at its birth by the failure to adjust the operating procedures to the new target. Instead, the earlier procedures, designed to influence the “money market,” were retained.

The way the Fed now operates is to convert its monetary growth objective into a Federal Funds rate which its staff estimates to be consistent with that rate of monetary growth. It then instructs the New York desk to keep the Federal Funds rate within a specified range. In this way, it tried to adapt the earlier procedure, which had been developed in order to influence money market conditions, to its new objective.

The rate of monetary growth is connected with the amount of reserves acquired by banks through a multiplier which determines the change in the quantity of money per dollar change in bank reserves. The amount of reserves banks wish to acquire at any time depends in turn on the relation between the rate of interest that they can earn on additional loans and the cost to them of acquiring funds. The Federal Funds rate is one measure of this cost. In principle, therefore, there is a Federal Funds rate at each point in time which, if attained, would lead banks to seek to acquire the amount of reserves that would produce any specified rate of monetary growth.

Unfortunately, there are two large slips 'twixt that principle and Federal Reserve practice. The first slip is that the Fed cannot accurately predict the required Federal Funds rate. In order to do so, it would have to predict the whole structure of rates of interest under alternative conditions. The Fed certainly can control the Federal Funds rate if it wishes to. But it cannot control the many forces that impinge on the market for credit and that determine other interest rates, and it is the relation between these other interest rates and the Federal Funds rate that is critical. Federal Reserve operations in the credit market are a minor element in the total credit market. That is why “money market conditions” have proved such a defective guide in the past. It is also why the Fed has such a poor record in estimating the Federal Funds rate that will achieve a desired monetary growth rate.

In estimating the required Federal Funds rate, the Fed uses a so-called “money market model” which, among other things, purports to predict the Treasury bill rate. Some years ago, I tested the model as it then was against the naive alternative model of assuming that next month’s rate would be the same as this. The naive model gave more accurate predictions on the average than the Fed’s sophisticated model. In short, its model had zero predictive power.

The second, and in some ways even more serious, slip is that if the Fed picks the wrong rate and sticks to it, the error cumulates and is self-reinforcing. Suppose, as occurred early this year, the Fed underestimates the required Federal Funds rate, which is to say, that forces outside the control of the Fed, in this case the rebound from the severe recession, are tending to raise interest rates above the levels that the Fed’s model predicts. At the pegged Federal Funds rate, banks wish to add more to their reserves than is consistent with the desired rate of monetary growth. The Fed can peg the rate only by supplying those reserves. So long as it does so, the only sign that the rate is too low would be unduly rapid

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2 As is clear from the references in the preceding note, these issues are of long standing and the defects of the existing procedure, as well as the availability of an alternative, had been discussed before 1970.
monetary growth. After an interval, the higher monetary growth will add further
to the upward pressure on interest rates by stimulating spending and thereby rais-
ing the demand for loans. This interval used to be about six months. In recent
years, however, the interval has shortened drastically as the market has come
to understand the process. If the Fed continues to peg the rate, monetary growth
would accelerate without limit. It was precisely this possibility that finally forced
the termination of the World War II policy of pegging interest rates on govern-
ment securities.

Of course the Fed will not continue down this road. Sooner or later, it will
adjust its Federal Funds target to try to get back to the desired monetary growth
path. But the length of time required to detect that the Federal Funds rate is set
at the wrong level, the cumulative and self-reinforcing nature of the errors, and
the Fed’s commendable desire to change its Federal Funds peg gradually combine
to make this a difficult task, as experience has shown.

Consider just this past cyclical episode. In mid-1974, the Federal Funds rate
target was too high and produced a sharp decline in monetary growth. The Fed
moved to reduce the Federal Funds target. But the recession, and the intensifica-
tion of the recession by the Fed’s own mistake, kept driving market rates down.
They kept falling from under the Fed’s target as it were and the Fed kept trying
to catch up. It did not do so until January 1975, but then it was not sure for a
time that it had done so and kept reducing the Federal Funds target until March,
by which time it was too low. A monetary explosion ensued. However, having held
the Federal Funds rate too high for so long, the Fed was reluctant to change.
Finally, it did so in June, and then, because of the delay, raised it by an unusually
large amount. As a result, it overshot, which brought an abrupt monetary slow-
down. In the past month or so, the New York City financial crisis has increased
the demand for liquidity, by creating uncertainty, which has steepened the yield
curve, and has shifted funds from municipals to other securities, which has
driven rates on them down. These downward pressures on short-term market
rates have reinforced the delayed effects of slow monetary growth, leaving the
Federal Funds target again too high. In order to peg it, the Fed has had to pro-
duce an absolute monetary contraction.

I believe, and hope, that this time the Fed will adjust its target Federal Funds
rate promptly. But even if it does, we shall have had a wholly unnecessary and
damaging swing from one extreme to the other. In principle, it is possible to bal-
ance an egg on its small end—but it takes extremely fine tuning to keep it
balanced.

(b) Alternative Procedure. There is a far better procedure—comparable to let-
ting the egg rest on its side. That procedure is to convert the desired monetary
growth rate into the increase in the monetary base [roughly, currency plus de-
posits at Federal Reserve Banks] required to produce it; and instruct the New
York desk to purchase or sell the amount of securities required to produce the
requisite increase in monetary base. In other words, eliminate entirely the extra
step of what Federal Funds rate is required to produce the necessary increase
in reserves.

This procedure too is not perfect. The multiplier which connects the base to
the money supply is not perfectly stable. It depends on the ratio of currency
to deposits, the distribution of deposits between categories and banks subject
to different reserve requirements, and the like. But the multiplier is fairly stable.
Moreover, the ratios on which it depends tend to change slowly, so that changes
in the multiplier can to some extent be predicted. Some twelve years ago, William
Dewald demonstrated that simply assuming each ratio to be the same next month
as this would produce adequately close control of the quantity of money. Since
then, a number of careful empirical studies done within the Federal Reserve Sys-

tem have demonstrated that a more sophisticated version of this method of
operation yields relatively small errors. Moreover, the residual errors could be
reduced even further by some of the regulatory changes considered in the next
sub-section.

Even if this procedure yielded as large an error for a brief period ahead as
the present procedure, it would yet have one overwhelming advantage: the
errors would not be cumulative and reinforcing; on the contrary, errors in suc-
cessive weeks would be random and offsetting. An error in this procedure does
not set in motion forces which lead to further and larger errors in the same direc-

* See references in footnote 1.
tion. It is literally inconceivable that if the Fed had followed this procedure during 1974 and 1975, it could have departed as far as it did from its own objectives.

The one serious objection to this procedure that I have seen is the contention that it would lead to more variability in interest rates over short periods than the present procedure. I have long believed that it would have precisely the opposite effect except possibly for very short periods, measured in a few days or perhaps several weeks. By delaying interest rate adjustments, the present procedure permits pressures to cumulate. I believe that it thereby produces more erratic and unstable interest rates than the alternative procedure. This judgment has recently been powerfully reinforced by an important paper by Professor William Poole, until recently a member of the research staff of the Board of Governors of the Federal Reserve, in which he reaches the same conclusion by a very different argument.4

Under the alternative procedure, the Fed would have no need for any interest rate targets whatsoever. It could let the Federal Funds rate, and other interest rates, be free market rates determined entirely by market forces. This would have the incidental great advantage that it would help to dissipate the mistaken belief that the Fed can or does control interest rates and the even more mischievous notion that “tight” money is to be identified with high interest rates rather than slow monetary growth and “easy” money, with low interest rates rather than rapid monetary growth.

I have long said that I will believe there has been a fundamental acceptance by the Fed of monetary growth as the appropriate target, rather than merely lip service, when I learn that on coming into his office in the morning, Alan Holmes’ first action is something other than telephoning for interest rate quotes.

One final comment on the techniques of control. Much work has been done inside and outside the System on a highly sophisticated level about the so-called problem of “optimal control.” This work is important as well as intellectually fascinating but in my opinion is concerned with effects of a second order of magnitude. The urgent need is to introduce as rapidly as possible the alternative procedure to correct the first order defects of the present procedures. It will then be desirable and possible to proceed at more leisure to refine the procedures along the lines suggested by optimal control theory. We must not in this area as in others let the best be the enemy of the good.

(c) Desirable Changes in Regulations.—Over the past decade, the Federal Reserve has introduced many changes in reserve requirements, in the classification of deposits subject to interest ceilings and the like, that have introduced additional variability into the multipliers connecting monetary aggregates with the monetary base. In an article on this subject published some years ago, George Kaufman, long an economist with the Federal Reserve System, concluded, “by increasing the complexity of the money multiplier, proliferating rate ceilings on different types of deposits, and encouraging banks, albeit unintentionally, to search out non-deposit sources of funds, the Federal Reserve has increased its own difficulty in controlling the stock of money. . . . To the extent the increased difficulty supports the long voiced contention of some Federal Reserve Officials that they are unable to control the stock of money even if they so wished, the actions truly represent a self-fulfilling prophecy.”

The major change of this kind was the introduction of lagged reserve requirements in 1968. This change has not worked as it was expected to. Instead, it has introduced additional delay between Federal Reserve open market operations and their effect on the money supply, and has rendered such items as free reserves, excess reserves, member bank borrowing, and the like more variable. Perhaps the next most important change has been the proliferation of reserve categories.

It would be highly desirable for the Fed to reform basically the present system of reserve requirements. Three major changes are desirable: first, elimination of lagged reserve requirements; second, consolidation of reserve categories to move toward a single reserve requirement on all kinds of bank liabilities; third, introduction of staggered reserve adjustment periods, so that some banks end their reserve period on Monday, some on Tuesday, etc., instead of, as at

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4 See his forthcoming paper, “Benefits and Costs of Stable Monetary Growth.”

present, all ending on Wednesday. Staggering reserve periods would eliminate a major part of the so-called “defensive” operations of the open market desk that arise from the intra-weekly cycle introduced as a result of all banks ending reserve periods on the same day. This proposal could be accompanied by a lengthening of the reserve period, but need not be.

A more radical reform is to revise the reserve requirement lag by letting this week’s required reserves be satisfied by last week’s vault cash plus deposits at a Federal Reserve Bank. This ingenious proposal, suggested in an as yet unpublished paper by Robert Laurent of the Chicago Federal Reserve Bank, would greatly increase the precision with which the Fed could control the money supply. It deserves serious consideration.

I have not tried to be exhaustive but rather suggestive about the kinds of reforms needed. The issues involved are highly technical and detailed, but the general direction in which change is needed is not.

4. CONCLUSION

There is today a wide measure of agreement on the part of the Congress, the Federal Reserve System, and the financial and academic community, about the importance of monetary policy for economic stability, avoidance of inflation, and the fostering of healthy growth. There is still some disagreement about the specific policy that will best foster these objectives. However, I believe there has been growing support both for emphasis on monetary aggregates rather than interest rates as the major instrument of monetary policy and for a relatively steady and moderate rate of growth in monetary aggregates as the major objective. That is today the position of the Federal Reserve System itself as well as of many of the most severe critics of earlier Federal Reserve performance.

The major issue has shifted, I believe, from objectives to means. The present techniques of Federal Reserve operation are a survival of earlier practices and are not suited to present objectives. They have produced a dramatic discrepancy between the Federal Reserve’s announced objectives and its actual performance. It is long past time that they were streamlined to accord with the change in objectives.

The Congress has played a major role in promoting a large measure of agreement on objectives. It could now play a major role by stimulating the Fed to adopt its procedures to its stated objectives.

ADDITIONAL

On further consideration of Chairman Burn’s testimony since the Hearings, I wish to stress much more strongly than I did then the great importance of one seemingly technical feature of the Chairman’s testimony, namely, his shift of the basis to which he applies the target monetary growth rates from the average of the actual money supply in the second quarter to the corresponding average for the third quarter. Both the shift this time, and the similar shift when Chairman Burns testified before the House Banking Committee on July 24, 1975, were minor in magnitude. However, the principle involved is extremely important.

By adopting the practice of altering the basis each quarter to equal the actual level of the money supply in the prior quarter, the Federal Reserve has done two things:

1. Altered fundamentally one central element of joint Congressional Resolution 133. That resolution asked the Fed to specify targets for one year ahead. The Fed complies in form but, thanks to the shifting basis, it in effect gives targets for only one quarter ahead, thereby reverting to its bad old habit of extremely short-term planning. If the Fed continues this practice, three months from now it will revise the basis to which it applies its stated rates of growth to the actual average of the fourth quarter, in effect starting off again from scratch.

2. Adopted the policy of letting the quarterly average of the money supply be what statisticians call a random walk with drift, which means in effect giving up any attempt to determine its long-run course. Any discrepancy for one quarter between its target and its performance is buried in the new basis, so that the quarterly averages grow at the targeted rate (the drift) plus the cumulation of the random errors between the target and performance. Under this system, suppose the target rate were constant (say equal to 6 percent). Then statistical
theory assures that the longer this procedure is followed, the larger (in absolute value) is likely to be the discrepancy between the actual money supply and a long-run 6 percent growth path.¹

These effects are most unfortunate. They are doubtless inadvertent consequences of what on the surface appears to be a purely technical adjustment to bring matters up to date, and this appearance is reinforced by the minor quantitative magnitude of the adjustment on the first two occasions. But unless this practice is altered, the fundamental aim of the joint resolution will be almost completely frustrated.

STATEMENT OF PROF. PAUL SAMUELSON, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, DEPARTMENT OF ECONOMICS

Dr. SAMUELSON. Let me begin my remarks by addressing myself to the problem that the economy now faces in the second quarter of the recovery from the most serious recession in the post World War II period. The U.S. economy seems now to be in a fairly vigorous recovery. Probably the 11.2 percent annual growth rate reported for the third quarter 1975 real gross national product may be a bit of an exaggeration, attributable to temporary inventory strength that could be spurious and in any case likely to be transient. Still, in comparison with the slow and disappointing recoveries in Europe and in Japan the United States seems to have been doing remarkably well, and this in the face of the troublesome New York City fiscal crisis.

If you will just think back to hearings before you and recall the climate of general public opinion at the turn of the year when prudent men of sober affairs were worried whether we were going into a great depression like that of the 1930's, you will realize how different the present situation is. The economic public opinion polls of the consumer, whether taken by the University of Michigan, by the Conference Board, or by private pollsters, shows that the American consumer in general has been following the Gross National Product returns.

I think that the expansionary fiscal policies which Congressional taxcutting provided for the economy at the year's turn seems to have been vindicated by the actual pattern of events. The pattern of agreement with expectation is not so good as to be suspicious, but it is in the expected general ball park. Moreover, it's a matter of some comfort that we seem to have made slow progress on the battle against what last year was two digit price inflation. The recent reported annual rate of price inflation as measured by the official GNP deflater for the third quarter, which was only about 5 percent, represents a posed shortfall from the 12-plus percent of last year's inflation, it is something of an understatement of what actually happened, as measured by the chain index which does not allow for weight shifts and which shows a 7 percent inflation rate. The fears that the public deficit would crowd out much needed private investment spending, when we compare the pattern of private investment spending against the current variables and against past patterns of experience—those most extreme fears do not seem to have been borne out.

Well, now, what has been the role of the Federal Reserve in this period and what should its role be in the period ahead?

¹ In technical statistical terms, the standard deviation of the difference between the actual and the target money supply increases without limit, the longer the time for which the procedure is followed.
The Federal Reserve was, critics think in retrospect, and many thought at the time, insufficiently militant in its expansion of credit and the money supply during the last half of 1975. Professor Friedman has expressed that opinion and in some measure I would agree with that. But if I use past patterns of timing on the relationship between the money supply and the actual pattern of experience in the last half of 1974, I would have to conclude that the weakness then cannot be explained by the failure of the money supply to grow at an adequate rate in the last half of 1974.

But in any case, under the Federal Reserve's own steam and under the goad of critics inside this committee and outside, the Fed did become more expansionary in the first half of 1975. However, a monetarist cannot use this M expansion to explain the April recovery: the log must be longer than that. Also, the sharp jump in nominal GNP in the third quarter at something like a 15 percent annual rate took place with the M, money supply growing only at about a 7 percent rate, even less by some methods of calculation, in the third quarter. The resulting sharp runup in the velocity of circulation of money cannot be adequately accounted for either by the rather minor increase in interest rates which took place during that period or by the normal pattern of velocity increase at the beginning of a recovery. If one does what every scholar does do, namely benefits from the historical researches of Professor Friedman and Dr. Anna Schwartz, one finds there ended cyclical patterns in the velocity of money. When the Chairman of the Federal Reserve Board refers to such a V rise he's referring to what every well-informed scholar now knows, thanks to the work of Dr. Friedman and others, is a predictable pattern of experience; but much of such a V rise that takes place along with the cyclical rise to be expected in the interest structure.

What we have had here, though, is an unusual residual error or shift in the demand for money, one not normally associated with the cyclical patterns of behavior. So the first thing to realize is that this is a mystery. It's a mystery for all policymakers. It's a mystery for scholars; and we have to ask ourselves, what does it imply with respect to demand for money in the period ahead?

Now if one tries to account for this increase in velocity, calling it an increase in velocity is no explanation. It's simply another way of describing the mystery. It's hard for me to see why the New York City troubles should lower the demand for money rather than increase the demand for money, but I agree with Dr. Friedman that it can explain a drop in short-term interest rates relative to long-term. Nor do the facts of foreign government purchases of our treasury bills work in the right direction. Perhaps a little of the discrepancy can be attributed to movements in the Treasury balances, whose effects are well understood and have some future predictive power. Still, I have to conclude that we are left with the mystery and that, on the basis of past patterns of evidence and the best ways that scholars have learned to interpret evidence, one cannot prudently extrapolate the recent deviation in velocity from past patterns into the future.

I also want to say, and it's very relevant for anyone who wishes to decide now what is the proper money supply 12 months from now and who's willing to stick to that through thick and thin because there's something worthwhile in such a rule itself, that it would also not be...
prudent to decide now that this change in the demand for money is a
temporary thing which is going to correct itself.

There may be some hidden strength in the economic situation, so
that anyone who has a respect for evidence should have a gnawing
doubt in the back of his mind that there may be something stronger in
the economy than the Chase or other econometric forecasts have ex-
pected there to be and than the monetary equations which one moni-
tors and which one uses are now predicting.

The future will gradually reveal itself and this is why, in my judg-
ment—and I will expand upon this latter at the end of my prepared
testimony and in questioning if somebody wants me to—why it is de-
sirable for good optimal monetary policy to have a stance of flexi-
bility.

Well, in order to judge whether the new targets for M1 and M2
announced the day before yesterday by Governor Burns are adequate,
one must first form a judgment on the likely strength in the economy
in the quarters ahead and through the November 1976 election. That is,
the strength of the economy as it would show itself under different
monetary policies by the Federal Reserve, and then I think one may
hope to form a judgment as to what would seem to be the optimal
Federal Reserve policy.

Given the best estimates of only moderate strength in housing and
in plant and equipment spending of business, I'm using now the cur-
cent data against the past patterns of experience of such data—and
given what seems to be an expansionary quirk in recent inventory
behavior, that may be a temporary condition, my best estimate is that
the U.S. economy does need a repetition for 1976 of the 1975 tax cut.
I say this quite independently of my new limits on the growth of
total public spending. In other words, I'm not agreeing with Presi-
dent Ford's program that one should have a tax cut if and only if it
is matched by expenditure savings over what would otherwise have
been the pattern of growth. If the President should get from the
Congress his desired cut in the expenditures, then my desired cut in
taxes would be bigger than the one that I am now talking about.

Senator Packwood. If I might ask there, if we're thinking about ex-
tending the present tax cut, all you're saying is that if we cut $28
billion in spending we ought to match that with an additional $28
billion in tax cuts on top of whatever the other tax cut is that we
come up with?

Dr. Samuelson. Yes, with the qualification, of course, that all
these cuts in spending are cuts in certain growth rates in spending and
are not absolute cuts from, say, the previous fiscal year level.

Senator Packwood. Right.

Dr. Samuelson. Thus, if limitations on defense and other spending
should be decided on, a significant offset to such savings would have to
come in the form of still further tax reductions if the recovery needs of
the economy are to be taken into prudent consideration.

Well, now, turning back to monetary policy, on the supposition that
the tax reduction program will be renewed, quite apart from any
new expenditure limitations other than those which Congress will
impose upon itself, I would name as the safe goal for real growth
in GNP from the third quarter of 1974 to the third quarter of next
year to be somewhere around 7 percent. I won't quarrel with someone
who shades that upward; and I wouldn't feel too terribly disappointed if we fall a little bit short of it. I don't think that 11 percent real growth is a healthy figure. I didn't think the numbers like that as we were moving into the election period of 1972 were healthy. I want this to be a long and sustained recovery. I don't want to tolerate any extra day in which somebody is on the unemployed lines, but to rush the process of reemployment in an attempt to get everybody back to work this month rather than some months from now is likely to have the effect that a couple of years from now they are going to have a worse job situation. An unsustainable acceleration to me would not represent a prudent policy.

I want to call to your attention the order in which I reveal my recommendations with respect to monetary policy. I don't think that I can arrive at a proper monetary policy until I have some ball park feeling for what is the prudent proper real growth policy in this period, and until I have some feeling for what is the price outlook under different policies in the relevant period ahead—say, 4 quarters, 8 quarters, and 12 quarters ahead. Realistically, the rate of price inflation I suspect can at best be counted on to hover around the recent rates of 5 percent. I know there are some analysts whom I respect who think that with the amount of slack we have in plant capacity, with the amount of slack in the labor force, and with what they think is going to happen to the OPEC cartel's control of its own price, that we can hope as we move into the fourth quarter of this year and into next year to do better than 5 percent inflation. But there are also analysts who think that we will be back to 7, 8 percent, and I would also remind you that the Consumers Price Index which is what wage contracts depend upon and which really the person in the street rightly considers to be the important price index, it is not now moving at 5 percent. It is moving at something like 7 or 8 percent.

So, since I think that there are important elements in this price prediction that I have made which in the period of the next four or six quarters stem from strong exogenous influences and could not be brought down by monetary policy without having very severe effects upon the real growth performance, it seems to me we are facing as a prudent goal for policy something like a 12- to 14-percent annual rate of growth in the money GNP. I very much doubt that the recent shift in the demand for money is so persistent that recent weak rates of growth of M1 and M2 are consistent with the continued healthy recovery, and I would like to second Professor Friedman's testimony in that regard.

At the least, I think we shall probably have to move to the upper limits of the recently announced target range. If I had been testifying 3 months ago before you I would have by the same reasoning said we probably have to exceed that range; and I may, if you call me back to testify 2 months from now, return to that position; but I'm left now with the fact that the third quarter was extraordinarily strong and it may be telling us something.

There may be elements in the situation, autocorrelated elements, which the analysts have not yet picked up and which will become more obvious to us and therefore I'm for the moment less dissatisfied with the new target than I was previously.

Let me conclude my prepared testimony with a few general philosophic remarks on monetary policy. I believe there is widespread agree-
ment that money does matter much and I think there is widespread agreement among analysts that long continued rates of M growth, whether you use M₁ or M₃ or M₄ or some variant, which do greatly exceed the feasible real growth rates, that in the long run this will be associated with rising trends of prices. But I’m afraid that there the agreement ends.

I’m not now expressing my opinion about what I think ought to happen, but I’m simply trying to make a roundup of what I regard to be the trends of opinion. I do not see a converging pattern of agreement toward a money rule or tactic that calls for the same monetary aggregate target in season and out. I may say that I do not believe in such a target, but it is not that I believe that there should be an interest rate stabilization target. I think the monetarists target would often be better than an interest rate target, but still not as good as what I think is the feasible optimum. The optimum stabilizing target is essentially a leaning against the wind as best intelligence and analysis of the pattern of evidence based against past historical experience tells you that wind is going to be in the next 6 months and in the next 9 months. I believe that the Federal Reserve would have a better record of performance if they adhered to such a general set of rules.

Now, addressing myself to the climate of opinion with respect to a monetary rule of constant growth applied to a money aggregate, it seems to me that the actual experiences of recent years have undercut rather than strengthened what I would regard as never a strong case for such a monetary rule.

Let me give some examples. Although I embrace the Clemenceau like dictum that money is too important to leave to the monetarists, I never neglect help from any source. And so I monitor the money aggregates I keep a trend chart of what’s happening to the level of the money supply because I find that a much more useful thing to do than to keep my adrenalin running with what’s happening to the rate of growth of a very choppy series in short periods. And my chart of that trend shows that is of mid-1974 the actual stock of money was hugging quite close, to my eye, to the several-year trend. It’s true that if I apply a ruler to the rate of growth it’s choppy around the trend, but the Fed—perhaps because it’s been given a proper fear of monetarists’ criticism—tends if it makes a tack in the one direction from the trend in one period, to make a tack in the next period in the opposite direction, cancelling out extreme deviation.

I also have great confidence in free markets and I believe that free markets composed of intelligent people who have a lot of money riding on the outcome are perfectly capable of doing the smoothing and modulating if the Fed would continue to behave in such a fashion and not behave in the cum-cyclical way that it so often behaved between the wars, which was to create long undulations around no perceptible target that reinforce the business cycles.

So having these trend rates of growth, I applied various monetarists’ equations to the mid-1974 data. Yet I have found no monetarists’ equation with a good prediction performance over the extended past which came anywhere near to explaining the weakness in the economy that revealed itself shortly after the summer of 1974, from August on. That shows to me that the economy in the recent period has had larger residuals of instability from nonmonetary sources and that a money rule would have resulted, if followed, in larger than usual
squared errors and a squared error of deviation in this case means
thinks like human suffering and unemployment and untoward price
behavior.

Let me go on, again attempting to use what wisdom I have been able
to get from the monetarists. I cannot explain the strength of the
economy since last April on the basis of simple monetarists' equations
based upon past experience. The lags which we have learned about over
a long period of time are not so short that the upturn in the money
supply, its rate of growth in the early months of this year could have
had their action so quickly. It was like the case of the great advice
which I gave to candidate and President-elect John F. Kennedy: so
powerful was that advice that within one month after he took office
the economy was in recovery.

The CHAIRMAN. The longest recovery in our history.

Dr. SAMUELSON. Right. Yes. Well, some credit for that—less face-
tiously—can be taken by some of us.

But it seems to me recent experience with monetarist models failures
to match reality in even the usual historical degree suggests that fine
tuning the money supply is not the end all of desirable economic policy.

I think M-growth-stabilization could be done better than it has
been done if it were really something that ought most to be done. But,
if you look at the smoothed out changes in the money supply, look
at annual data or use your own method of smoothing, if you consider
the cost push and exogenous price elements that impinge upon the
modern economy with stagflation and the other bad tradeoff patterns
which we have experienced, then you must conclude that the major
problem is not whether the Fed in one 6-month period is running
ahead of some putative desirable long-run rate and in some other
period running behind. As a matter of fact, I think of those as largely
self-cancelling errors, not doubled errors. I have confidence that the
money market can adjust itself to that type of behavior.

What I object to and what I fear for the period ahead is cumcyclical
reinforcement by the Federal Reserve. I would rather have neutral
behavior than cumcyclical behavior. I think with an election year
coming up there is plenty of evidence that governments can do things
which can change the situation in 6 months, 12 months, 18 months
ahead, which will have consequences for the period thereafter. So
it seems to me that the proper behavior which I hope your committee
and similar House committees will hold the Fed to, in season and
out of season, is that they should not be deciding themselves what is
the appropriate tradeoff between price inflation and unemployment:
it is unthinkable that any governor of the Federal Reserve should
be able to decide that he is little “Peter at the dike” deciding just
how much inflation the American Government can stand, the Ameri-
can system can stand, and how much ought to be put on the backs
of the unemployed in the period in question to fight price inflation.

I think that there is no fourth branch of Government, which is
the central bank. I recognize the Judiciary and the Congress and
the Executive. I don't recognize the Federal Reserve as a fourth
independent branch of government. I think that if the Fed is not
going to be part of the Executive, it should be responsive, not for
its day to day scratching of its ears, to the Congress. It should be
responsive to the Congress on monetary policy. And I think that
its monetary policy should be a leaning against the winds as they can be expected by past evidence to prevail of in the period ahead when the monetary actions of the Fed have their consequences.

So I want to go beyond the steady M-growth goal that’s stated here by Professor Friedman to what seems to me to be an optimal feasible goal. Now what I’m stating is not a fine tuning goal. It’s a mistake to try to fine tune in an engineering situation where you have probability discrepancies, recorded over and over again in history that you’re not able to tell about at the beginning. What you do if you’re an electrical engineering graduate student in optimal control, when you have a stochastic or chance pattern, is to use your best judgment in identifying this mechanism and inferring what the past historical statistical patterns have been of the probabilistic influences. Then you devise a filter system which is not too fast and which is not too slow, but one designed to give you the smallest squared error—which will still be a very large squared error of performance under many circumstances. I have tried again and again to find justifications for a stable rate of growth of the money supply under realistic circumstances. And often I do find that a stable money supply is better than some very bad program. But it is not as good as what I think this Congress can expect from the Federal Reserve and which this Congress can in its instructions hold out as the proper strategies and tactics of Fed policy.

It is right for this kind of committee when the economy is in a recession, as we were last December, to be critical of the Federal Reserve. Just because it says it is lowering interest rates, that should not be good enough for you; when the Fed is unwilling to let interest rates go down faster, it is keeping the monetary aggregates growing too slowly. On such occasions the monetarists and people like myself come before this committee in agreement. If, however, in order to have what seems to me to be the feasible rate of real growth should require a rate of growth of the money supply in the best judgment based upon past patterns of experience of more than the 7½ percent upper limit, I think that it would be wrong, then, to crucify mankind on the basis of a monetary rule. It’s not the worst cross that the system might have to bear, but it’s not a good way of running the system.

[Complete statement of Professor Samuelson follows:]

STATEMENT OF PAUL A. SAMUELSON, MIT

1. The U.S. economy seems now to be in a fairly vigorous recovery. Probably the 11.2% annual growth rate reported for third-quarter-1975 real GNP is a bit of an exaggeration, being attributable to temporary inventory strength that may be spurious and is in any case all too transient. Still, in comparison with the slow and disappointing recoveries in Europe and Japan, the U.S. has been doing remarkably well in the face of the troublesome New York City fiscal crisis.

2. The expansionary fiscal policies that Congressional taxcutting provided for the economy at the year’s turn seems to have been vindicated by the actual pattern of events. Slow progress has been made on the battle against last year’s two-digit price inflation. Even if the recent reported annual rate of price inflation—well down from the 12-% rates of last year—turns out to be an underestimation of what is ahead for the next year, the fears that the public deficit would crowd out much-needed private investment spending has not been borne out.

3. The Federal Reserve, critics think in retrospect and thought at the time, was insufficiently militant in its expansion of credit and the money supply during the last half of 1974. Under its own steam, and under the goad of critics, it be-
came more expansionary in the first half of 1975. Somewhat to the surprise of virtually all analysts, the sharp jump in nominal GNP, at 15% in the third quarter, took place with the M₁ money supply growing only at a 7% rate. The resulting sharp runup in velocity of circulation cannot seem to be adequately accounted for either by the slight increase in interest rates or by the normal pattern of velocity increase at the beginning of a recovery. (Why should the New York City troubles lower the demand for money? There seems to be nothing in the recycling of the oil revenues of OPEC to explain the anomaly. Perhaps a little of it can be attributed to movements in the Treasury balances.)

One cannot prudently extrapolate the recent deviation in velocity from past patterns of experience.

4. In order to judge whether the new targets for M₁ and M₂ announced the day before yesterday by Governor Burns are adequate, one must first form a judgment on the likely strength in the economy in the quarters ahead and through the November 1976 election. Given the best estimates of only moderate strength in housing and plant and equipment spending of business, and given the quirk in recent inventory behavior, my best estimate is that the U.S. economy does need a repetition for 1976 of the 1975 tax cuts. This is quite independent of any new limits on the growth of total public spending. Thus, if limitations on defense and other spending should be decided on, a significant fraction of such savings would have to go into still further tax reductions if the recovery needs of the economy are to be taken into prudent consideration.

5. On the supposition that the tax reduction program will be renewed quite apart from any expenditure limitations, I would name as the safe goal for real growth third quarter to third quarter to be somewhere around 7%. Realistically, the rate of price inflation can at best hover near the recent rates of 5%. Therefore, we are facing as a prudent goal for policy perhaps 12-14% annual rates of money GNP growth. I very much whether recent weak rates of growth of M₁ and M₂ are consistent with a continued healthy recovery. At the least we shall probably have to move to the upper limit of the recently announced target range.

6. Let me conclude with some general philosophy on monetary control. There is widespread agreement that money does matter much; and that long-continued rates of M growth prices. But there agreement ends. There is no converging pattern of agreement toward a money rule or tactic that calls for the same target in season and out. Indeed, actual experiences of recent years have undercut the never strong case for such a monetary rule. Prior to mid-1974, my plot of M hugs a remarkable close for several years to a smooth trend: yet the worst postwar recession followed. Similarly, the upturn in April came so soon after the weak M growth of late 1974 as to lower confidence in over-simple M-only models.

The CHAIRMAN. Thank you, Dr. Samuelson. Thank both of you gentlemen.

We all know, of course, that you're two of the most eminent economists in the world and we are most indebted to you for your testimony.

Dr. Friedman, I intend to write to Chairman Burns and ask for a point-by-point response to your ingenious suggestions of procedure that would enable the Federal Reserve Board to more effectively control the money supply. They seem most ingenious and when we get his response we will make it available to you and I'd be interested in your comments on what he's suggested.

The number of issues—

Dr. Friedman. I may say, Senator Proxmire, that I have had such responses from the Fed rather frequently over the past 6 years.

The CHAIRMAN. We'd like to get them, too.

Dr. Friedman. I appreciate it. I'm delighted that you're going to do it.

The CHAIRMAN. Well, I take it that this last suggestion that you had from Mr. Laurent, that perhaps hasn't been considered.

Dr. Friedman. That's a new one.

The CHAIRMAN. Now, one of the fundamental issues that we have here, and I'd like to ask Dr. Samuelson to address himself to this—
I think the logic of your argument is most compelling. It’s very, very hard to resist it. It makes sense that after all we put the competent people in charge of the Fed with perhaps the best staff in Washington, maybe the best, to use their ingenuity to have a monetary policy that would minimize inflation and maximize growth. We do have times in which it’s clear that it’s obviously desirable to restrain the economy and other times when it’s desirable to expand the economy. Your argument against this view is that the Fed’s management has been so unsuccessful. As you know, Dr. Friedman has documented from the beginning of the Federal Reserve Board—that the Fed has tried to do this but the results have been counterproductive and consistently perverse, that because they somehow can’t forecast that even with the very competent leadership they just don’t seem to be going in the right direction. Therefore, a steady increase in the money supply would let the free market which you said you would rely on permit the kind of adjustment that would be desirable. That is, if you have a steady increase in the money supply and you have a tendency for the economy to move ahead rapidly, then you would have the restraint that that steady increase would exhibit with higher interest rates.

On the other hand, when you have a recession and a deflation that steady increase would provide an abundance of money under the circumstances and provide for lower interest rates and therefore stimulation. The automatic play of the marketplace would be better than the genius of the members of the Board.

What’s your response to that?

Dr. Samuelson. My response is that the inadequacies of past Federal Reserve movements aren’t to be explained by the fact that they have departed from a simple monetary rule and have moved in the direction of trying to predict that which cannot be predicted, thereby only resulting in whipsawing themselves. Their mistakes have been of another kind.

I think that the difficulties of their performance come from a whole set of considerations which would not be important in a world where money is much more neutral than the present world.

Let me give you an example. Suppose that you have, as you did have in 1972 and 1973, a worldwide boom simultaneously—Japan and Western Europe and the United States. Suppose all over the world you are going through a tremendous raw material boom. Every product a country like Indonesia and New Zealand can sell is selling at high bid-up prices. You have harvest failures which add to the price pressure. You have a Mideast war which serves among other things to strengthen the purely commercial OPEC cartel with a diplomatic strengthening. The result is you have an actual inflation rate in being which is about twice the base load inflation rate which on the basis of past patterns of interpreting experience can be attributed to the monetary policy and fiscal policy of that previous period.

Now let’s take that situation. If in that situation the Fed really adhered to a fixed rule, it would succeed in fine tuning the money supply but it would not succeed in keeping the pattern of output steady. It would destabilize the pattern of output. My heart does not bleed for the old New York Federal Reserve view that bond dealers should have an easy time and the Nation should have stable interest rates. I’m not interested in stabilizing that; but I am interested in stabiliz-
ing the approximation that we have to our full employment or high employment potential. And I think that sticking to the monetary rule in those circumstances, particularly not in the flexible way which Dr. Burns does now changing the M targets anew each quarter, but sticking to a real rule for terminal M a year ahead—I think that that would be very destabilizing. That’s an example of what’s bad about the rule with respect to the cyclical pattern of behavior, but let me talk about the long-term pattern.

Any sophomore who looks at the behavior of the money supply and looks at the price level says, “Well, the real mistake of the Federal Reserve is not in its four-quarter movements here and its four-quarter movements there that are sometimes too high and sometimes too low.” On the contrary, this rather stable trend around which the money supply clusters is recognizable to be not a stable trend which is consistent with long-range price stability. And so the sophomore says, “The whole world of the mixed economy is averaging out to 6, 8 and 10 percent annual inflation of prices.” Well, that’s perfectly true, but I don’t think that the reason for the Feds making the mistake in that chronic expansionism direction, if you regard it as a mistake, is a matter of forecasting error. It’s the fact that prices and wage rates are now not flexible downward. With a modern welfare state, when there is unemployment, we all have a compassionate interest in restoring job opportunity and we also have a political pressure to do so, and we all have the compassion and interest in lightening the intolerable burdens of unemployment.

In those circumstances, when the unemployed rate goes from 5½ percent, as it did—that’s where it was just in the summer of 1974—to around 9 percent vicinity where it was in the spring of 1975, that does not have the downward effects upon prices and wages that it used to have. In my opinion, the Federal Reserve is not expressing its independence but is showing itself to be part of the political system when in its deciding what the best cost-benefit policy analysis is in each 18 months ahead, each 24 months ahead, each 36 months ahead, it ends up deciding the thing on the up side.

I don’t know a cure for stagflation. I do not know of any jury of economists who can come together and show agreement among 12 stout jurors that there is a way of having high employment—let’s say 5¼ or 5½ percent—I won’t say 4 percent—the number that was given in an earlier period—and also having both price stability and no incomes policy. I think that the Fed’s mode of behavior, so obvious to the sophomore and to the learned professor of economics, has nothing to do with the question you first asked me about—what the real difficulties are in departing from a stable money growth supply policy in the direction of a stabilizing policy.

Senator Packwood. Did you say that 5½ and 5¾ could not be obtained or did you say there are not 12 good men true in the economics profession who could agree upon a way of getting there?

Dr. Samuelson. What I said was there aren’t 12 representative, informed jurors from the economics profession who can tell you how, if you got there, to 5½ percent, you would be able to run the system, the present welfare state, with price stability at those levels.

The Chairman. Could I ask Dr. Friedman to comment and take into consideration the fact that the quality of the Federal Reserve
Board members and the quality of the staff has greatly improved, particularly the members. We have been through the process of confirming them and there's much less on-the-job training now. These are skillful monetary economists, by and large, who I think are very capable as I think you would acknowledge.

Given that, how about it? Wouldn't it be wise to let them use some discretion? Henry Reuss once said it would take the intelligence of a horse to operate it the way you suggest. All you'd have to do is paw the ground. That's all.

Dr. Samuelson. Even a jackass could do it.

Dr. Friedman. First, I'm delighted to welcome Paul into the company of monetarists. He may deny the label, but I think any careful reading of his testimony would show that on the whole he and I are in far greater agreement, and I may say I'm unaccustomed to that position.

Dr. Samuelson. It won't last.

Dr. Friedman. However, let me point out that Paul did not in fact reply to your question. Your question was not what an ideal group should do. It was not what a jury of 12 men good and true of economists or anybody else would agree on. Your question was, how do you explain the fact that over 60 years men who were public spirited in trying to promote exactly the policy that he described failed to do so? If you look at what the Federal Reserve says its purpose and its objectives were, it was exactly to lean against the wind. Indeed, it was William McChesney Martin the former Chairman of the Federal Reserve, who made that phrase famous.

They were trying to lean against the wind. Yet, as you pointed out, they did the opposite. Now Paul agrees with me and on this point there is no disagreement: That in fact the simple monetary rule would have been better over those 60 years than what the Fed actually did. What he says is he thinks he can do still better. Maybe he can. But I say, as I look back over the record of the Fed, the fact that they have done worse than the rule and consistently worse than the rule, has not been due to the fact that they have had stupid people on the staff. It is true that the present Board members are more technically qualified, but if you look back over the past history of the board they have always had able people on the Board and more particularly on the staff.

So I do not believe there is any empirical reason for supposing that by putting better men in charge you're going to get better policy. I don't believe that is the problem.

In the second place, I agree strongly and have agreed for many years with Paul's position that monetary policy should be determined by Congress, that there is no room for a fourth branch of government. I do not and have never believed in a fundamentally independent central bank. If there is to be a central bank of the kind we have it should operate under rules which are set by Congress.

If there is to be a flexible policy, if money supply is sometimes to go up more rapidly and less rapidly, I agree completely with Paul, what happens over a 2- or 3-month period doesn't matter much. What matters more is what happens over a 6- or 8- or 9-month period. And for this, I would rather see the Congress specify the desired rates of growth than to have the Fed have the independent power to do it. So he and I agree completely on that again.
I note that he criticizes the Fed vigorously, as I do, for their behavior in 1974, and he agrees with me that they would have done far better if they had followed the rule. I could go into many other detailed points.

The Chairman. Let me just interrupt. There's a vote on the floor, and Senator Packwood and I will have to leave. Let me point out we are going to have to vote on an amendment by Senator Javits, which would exempt the Federal Reserve Board completely from the so-called Sunshine Act. We'd like to hear your advice.

Dr. Friedman. What is the Sunshine Act?

The Chairman. The Sunshine Act would require meetings to be open to the public by and large. There is already in the bill an exemption providing that an agency such as the Federal Reserve may close the meetings in order to avoid premature disclosure of information which could either lead to serious financial speculation or seriously endanger the stability of the financial institutions. They have that exemption, but the Fed wants complete exemption by name, and I think your advice, if you care to give it—

Dr. Friedman. I'd be glad to give it. I have long been in favor of the Federal Reserve open market directives being made available immediately upon the completion of their meetings. I see no justification whatsoever for the present 45-day period of secrecy. So I would be opposed to the amendment.

Dr. Samuelson. Later, I must record why my disagreements with Dr. Friedman are much greater than his statement asserted. In connection with the Sunshine Act, I see no useful purpose in giving the public the right to be present at the Open Market Committee's meetings or at the deliberations of the Federal Reserve, but I see no reason why the Federal Reserve should not adopt a policy of announcement much sooner than 90 days.

The Chairman. As I point out, the bill does already provide that they may close the meetings in order to avoid premature disclosure of information which could either lead to serious financial speculation or seriously endanger the stability of the financial institutions. So they have that right, but except for that they would have to conform.

Dr. Samuelson. Speculation aside, there could be some problems. If you were to have television so that nobody could interfere with their deliberations—

The Chairman. They can bar television. This is what they would do. They have to keep a transcript of what goes on, and then that would be open to the public later. That's the effective result.

Dr. Samuelson. I think that if committees like this perform their watchdog function, it won't be important whether the full transcript and the modes of argument at which they arrived at their decisions are matters of public transcript record. I just don't think it's important one way or the other. You will just get a lot of prepared-for-the-record ways of describing what their decisions are that they arrive at. The important thing is that it be the practice to have disclosure of what policies they are pursuing quicker than before, but I think the full Sunshine Act, which is very important in many aspects of Government, is not a useful part of the public interest in this
matter, and I would look with favor upon the Federal Reserve being an exception to it.

Senator Packwood. I have a quick question. You indicated a reluctance to see these tremendous swings in employment and prices, and you said you'd be very wary of getting a person back to work right away and 6 to 8 months from now he's going to be in a worse situation than now. Apart from the fact we may agree we don't know how to keep a consistent employment or price policy, how long should it rationally take us from today, if we follow proper economic policies, to get to a 5- or 6-percent unemployment and a 5- or 6-percent annual inflation?

Dr. Samuelson. Well, I think that given that we work from about an 8-percent amount of unemployment and many industries at only 75 to 85 percent capacity, that we can go for six quarters maybe at 1 1/2 times our growth rate, 6 percent and a little bit better than that, which means we can do a lot better than 5 percent for a long time—six quarters. I think after about six quarters you will find yourself reverting back gradually toward the growth rate but still something greater. One of the very serious costs, in my judgment, of this last—

Senator Packwood. I've got to stop you because if I don't make it over there, I'll miss the vote. But at least a couple of years?

Dr. Samuelson. Yes; some regrettable long time because 11 percent growth rate is injudicious.

Senator Packwood. Right.

[Recess.]

The Chairman. The committee will come to order.

Gentlemen, I want to apologize. We had two votes in a row. Incidentally, the Friedman viewpoint won out on the floor. By a 53 to 36 vote, the Javits amendment was rejected.

Dr. Friedman. I'm glad.

Dr. Samuelson. I was in favor of that, too.

The Chairman. The Javits amendment would have exempted the Federal Reserve completely from the Sunshine Act, and that was defeated.

Well, now, one of the issues that we were discussing and I want to be sure that both you gentlemen have had an opportunity to make adequate argument against it. I think your positions are well known with respect to discretionary authority on the part of the Federal Reserve Board to vary the money supply in accordance with the state of the economy.

Now, I'd like to get into the central problem that I think we have to confront as to whether or not the chairman is right in saying that for the next year and through the third quarter of 1976, we should follow this 5- to 7 1/2-percent path; is that adequate in view of the state of the economy and the outlook for both inflation and unemployment.

Now, I understand you to say in the course of your remarks, Dr. Friedman, that you would prefer a greater growth rate than the Fed had had in the last few months which had been close to zero, but that you think that it should be 3 to 5 percent.

Dr. Friedman. Not for the next year; that the ultimate goal should be 3 to 5 percent.

The Chairman. What should it be for the next year?
Dr. Friedman. As I say, I would have made it a little lower than 5 to 7 1/2 percent. I would have made it 4 1/2 to 7, but it's a minor difference. The main point I would emphasize is that I would like to see those limits reduced over the next 3 to 5 years to bring them into the——

The Chairman. You're kind of varying your fundamental position a little bit?

Dr. Friedman. Not at all.

The Chairman. A little bit. Now, maybe I misunderstood you. At least you're clarifying it in my mind. I understood you to say we should hang onto the 3 to 5 percent ad infinitum.

Dr. Friedman. Absolutely.

The Chairman. But you now indicate it should be 4 or 4 1/2 to 7. Now I assume, in part at least, because of the state of the economy?

Dr. Friedman. No, not because of the state of the economy.

The Chairman. Because we're up to that level and we have to adjust downward.

Dr. Friedman. I have always argued that 3 to 5 percent is the appropriate range and for a long time until about 1970 I was saying that we're close enough to that that we might as well go to that immediately. As we get increasingly far away from it and as that increasing discrepancy got built into the economy, I've said I want to go to 3 to 5, but I believe it is desirable to go from where we are now to where we want to go gradually so as not to introduce unnecessary shocks into the economy.

The Chairman. Well, what assumptions do you make, then, with respect to velocity? It seems to me if you follow your argument and assume you have a 7-percent growth that certainly is a preferred rate of growth, something near that in the coming year, and have 5-percent inflation and then have a 6-percent growth in money supply, that's going to take quite an increase in velocity continuing.

Dr. Friedman. First of all, incidentally, the rate of inflation you have will not be independent of what happens in the growth in the money supply. Now I hasten to add that the rate of inflation is a sticky thing and it ends to have an even longer lag behind the money supply than does output. I believe that you right now have something like a 6-percent rate of inflation built into the economy. If you suppose that you had something like a 6- or 7-percent rate of growth in money supply, the secular velocity increase in $M_1$ growth has been about 3 percent. That brings you up to about 9 or 10. If you now figure that during the course of a cyclical expansion you also have a cyclical rise in velocity, you're up to about 12 percent, and I think that a breakdown of 6-percent real growth and 6-percent inflation would be tolerable. I would rather have an 8-percent real growth and 4-percent inflation, but I think that you can't do that and therefore I think that $M_1$ growth in the neighborhood of 6 percent is not inconsistent with nominal income growth in the neighborhood of 10 to 12.

The Chairman. But you do expect to have a sharp continued increase in the velocity of money to make this possible without higher interest rates; is that right?

Dr. Friedman. No. I won't say without higher interest rates. I believe that the cyclical pattern of interest rates will be upward. I believe that ordinarily during the course of a cycle interest rates have risen during the expansion.
The Chairman. Looking at the straits of housing and at the enormous difficulties municipal obligations have, the fact that housing is so important to the economy, that 14 million people work for the cities and States and they are in great difficulty—just yesterday there was a decision by voters to turn down $7.5 billion in new borrowing in the cities and States—isn't that likely to have a depressing effect on the economy?

Dr. Friedman. I don't believe so. I believe that this is the point of view from which the fiscal policy that the Congress has adopted is important. Congress has decided that it does not want any rapid expansion of housing. It does not want a rapid expansion in business investment.

The Chairman. Congress hasn't decided that.

Dr. Friedman. Implicitly, not explicitly.

The Chairman. I'm in the best position in the Congress in both the House and Senate in this respect because I'm chairman of this committee and I'm chairman of the Appropriations Committee that provides the money for HUD. Other Senators and other Congressmen also have authority and responsibility, but I think I've got as much as anybody, more probably than anybody else, and I can tell you that both on the Republican side and the Democratic side we very much want to move much closer to our housing goals. We don't want to proceed along at 1.3 or 1.4 million housing starts. We want to go at least to 2 million and if possible 2.6 million which is our goal.

Dr. Friedman. Excuse me, Senator Proxmire, but I'm borrowing in this case from my colleague Paul Samuelson's famous demonstration of revealed preference when I say Congress intends it. I don't mean that's their implicit intent. I look at what Congress does and I ask what does it imply? Congress, by following a policy which has involved a very large deficit, a deficit which has been running recently, as you know better than I do, at the rate of nearly $100 billion a year which is scheduled for this fiscal year to run at the rate of something like $70 billion—

The Chairman. Dr. Friedman, you're really playing with me because you know perfectly well that has far less to do with the housing— the Housing Act—we passed an emergency housing bill that was vetoed by the President that would have mandated an additional half million housing starts and he vetoed it. That's the position of the Congress overwhelmingly, the House and the Senate, both parties.

Dr. Friedman. I was speaking about housing plus capital investment and capital formation. There is a total flow of investible funds in this country. Insofar as that flow of funds is diverted to financing government deficits it is not available for financing capital formation.

The Chairman. What you're saying is this is a consequence of the Congress not understanding, and I think that's correct, the implications of its fiscal policy.

Dr. Friedman. Absolutely.

The Chairman. And I'm saying the emphasis is clear on the basis of housing that we want it and we're willing to go much farther than the administration.

Dr. Friedman. Everybody wants to have his cake and eat it too, but you can't.

The Chairman. We could have a piece of it if the President hadn't vetoed the housing bill.
Dr. Friedman. But you would have a smaller piece of capital formation. I believe the people of this country would like to see greater application of capital to the improvement in the capital equipment of this country, as well as to housing. What I'm trying to say—and I'm not criticizing. I'm trying to understand. I'm saying that the policy which has been followed of having a very large deficit has determined the character of this expansion. It explains why this expansion has been so heavily in consumption and has been so weak in housing and in capital formation. From the point of view of interest rates, there are only two things that are going to bring those interest rates down more than temporarily. One of those is a reduction in inflation which would bring the nominal interest rates down, and the other is the reduction in the size of the Government deficit. An expansive monetary policy, a more rapid increase in the quantity of money, will raise interest rates and not lower them after a very brief interval.

The Chairman. You testified the lag is now only 2 months, that if we increase the money supply that within 2 or 3 months the interest rates, instead of going down as you might expect with the greater supply of funds, would go up. I'd like to ask Dr. Samuelson to comment on this.

Dr. Samuelson. Senator Proxmire, I hope that we are operating under the following understanding: that just because I hear something said in my presence and don't object does not mean that I necessarily agree with all that I have heard.

Dr. Friedman. We know that, Paul, and it goes both ways.

Dr. Samuelson. And also, I hope to be able to give a clarifying remark as to whether I think my degree of agreement with Professor Friedman is as great as he thinks it is later, but let me now be responsive to your question.

I don't think that there is a foreordained scheme of total capital formation plus consumption, and the more that is used up in one direction the less there is available in another direction. The size of the cake to be eaten is affected by fiscal policy in the next 18 months and the size of the cake to be eaten has been affected by the recession. We have had less housing and less capital formation because we have had a recession. We have not been talking about dividing up an unchanged full employment pie in different directions. I believe it unlikely, based on past experience, that the velocity will continue to show increases the way that it has, and I believe that if it turns out after 3 months and 6 months that most of the forecasts that I have are correct and that we are not at 11 percent real growth but we are down below what I stated to be the feasible desirable goal of 7 percent, then I think it would be proper for the money supply to be increased to the upper range and even possibly beyond the range. I don't think that anybody has the knowledge now to know and stick with the decision as to what's going to happen with respect to the velocity. The Chairman of the Federal Reserve Board has testified his viewpoint. He's a man of experience. He's always worth listening to. In 1954 he believed that the recovery in 1955 would be stronger than it actually was and he was right. The majority of the experts were wrong and Dr. Burns was right. In 1961 he believed that the economy in the 15 to 18 months after April 1961 was going to be much stronger.
than the experts generally believed. He was just plain wrong. I know he has put into the written record that he thinks it was because President Kennedy antagonized the steel industry and the stock market declined and so forth, but he's always worth listening to.

So when he thinks that the velocity will stretch and be compatible with the desired rate of real growth and his own forecast given before the House Committee was that we in fact are going to grow at 8 percent in real terms in the next year based upon his targeted money supply numbers, he may well be right.

I think where you divide the men from the boys and where the policy problem becomes important is what happens if in the developing pattern of revealed experience he turns out not to be right. Do you then stick with those numbers premised upon his being right. And with the full force of my ability to testify before you, my counsel to you is not to stick with those numbers if velocity does not stretch in that way and be prepared to hold him to the upper range and perhaps modify his ideas and your own as to what is the proper cone in the period that follows.

I believe we are in a vigorous recovery. That's a fact and we should not second-guess the fact, but we should be ready to recognize that if total gross national product growth recedes to where final gross national product growth has in fact been growing and recedes even below that, then monetary policy should be adapted to that.

Dr. Friedman. May I make one more comment?

The Chairman. Yes, sir.

Dr. Friedman. If you will pardon me, I would like to differ with your statement that the basic issue is whether the monetary growth rate specified by Chairman Burns is adequate for the coming year for the following reason: It's a basic issue only if in fact the Fed can deliver what it says it's going to deliver.

The Chairman. What I meant to say is the basic issue before the committee now is whether or not the range is still correct, the range of monetary growth is correct. That's what the resolution is all about. That's what we held our hearings on. That's all I said.

Dr. Friedman. I misunderstood. Because I believe that from a broader perspective the basic issue is whether the Fed can deliver within that range. What difference does it make what they say they are going to do if in fact, as we have discovered over the past, what they actually do deviates so far from what they say they are going to do that their advance statements are not a reliable guide to the event. That's why I would stress on you and urge on you the importance for your purpose of the relation between performance and goals.

The Chairman. Dr. Samuelson, would you agree that these changes in procedures would give the Federal Reserve more control of the money supply and it's desirable that we proceed along that line?

Dr. Samuelson. I think that some of the procedures mentioned could enable better fine tuning of the money supply. I do not think that it is particularly desirable to proceed along those lines. I think it's a very unimportant success if achievable, and if achieved——

The Chairman. Well, if it's achievable, why wouldn't it be important for them to be able to do what they intend to do? Under any circumstances, shouldn't they be able to achieve their goal? If they can't achieve their goal, it seems to me we have a really fruitless situation.
Dr. Samuelson. I think this is an unimportant reform but I have no objection to it.

Dr. Friedman. I don't understand you, Paul. Do you really believe it would have been unimportant if they had achieved their goals in the last half of 1974? In the last half of 1974, month after month they said in their directives that their target money growth rates were in the range of 5, 6, 7 percent for $M_1$, but month after month they were coming in at 1 percent. Do you think it would have been unimportant if they had achieved what they said they were trying to achieve?

Dr. Samuelson. I believe the shortfall of the performance of the Federal Reserve in the last half of 1974 was not materially affected by the difference between the reform now being discussed and the present procedure.

If I may be responsive to your question, time being limited to give you my viewpoint, Senator, let me point out to you as germane to the question that you asked me that the Chairman of the Federal Reserve modified slightly the range with respect to the $M_2$ and the $M_3$ targets and he gave an explanation, which exact wording I do not remember, but as I read it, I discerned in it an implicit prediction that it was quite possible that the deliberate thrust of Federal Reserve policy would turn out to result in disintermediation associated with an increase in interest rates, and I think he's perfectly right that if that is permitted to happen it will show a different calibration between the $M_1$ and $M_2$ and $M_3$ rates than if it does not happen.

Also, in response to your question about housing, I think that if that disintermediation does take place, that one of the prime contractionary incidents of that process will be with respect to housing. Now I have no firm target for the subpart of GNP which is housing and if, because plant equipment expenditure comes back fast and consumption propensities are very strong, it turns out that the housing industry is squeezed by the increase in interest rates which is incident to that process, and if the whole economy is growing at a rate of 7 percent and we are eating into the unemployed, I would not think that that is a bad outcome.

However, if Congress in its wisdom wishes to give a special subsidy to housing and if it can override Presidential vetoes on that, again, that seems to be that that's a problem which macroeconomic policy administrators must adjust to.

But what I think would be a misfortune would be if the disintermediation takes place and if interest rates increase in a developing scenario where the rate of growth of output is only 4, 5, and 6 percent in real terms, and the hard total of average unemployment and the amount of long term unemployment turns out to be a very slow core to melt. So I think as a vigilant watchdog, that your committee will want to see whether the Federal Reserve is showing an undue preoccupation with what is one of our two important problems now: The problem of inflation, as against a proper concern for the rate at which we eat into the very amount of slack in the system now and the amount of unemployment.

If our system does grow at a rapid rate we can have more of all kinds of cake. In the period while you're growing beyond the long run trend potential of the economy, which is now perhaps somewhere in the vicinity of 4 percent, you can have an increment of consumption
and you can have an increment of capital formation divided between housing and other forms—an increment which is transient but which is very desirable that the society have because that's the shortfall which we did not have in the recent recession.

Although the recession became so obvious to everybody after the summer of 1974, it was first looked on as a growth recession. The economy since March of 1973 was proceeding below its trend rate and we were having less of all kinds of cake. The reason for it was in order to fight inflation, and in a measure given what the situation was there was merit in this, but this effort did get out of hand. I think this issue is very important, and that it should really be the main focus of your committees with respect to witnesses like myself and Federal Reserve officials—in order that the desired feasible amount of real recovery not be thwarted by Federal Reserve policy which could be prevented.

The CHAIRMAN. Now along that line, Dr. Samuelson, can you explain what has happened to interest rates over the last 3 or 4 months? We have had a sharp recovery. We have had a diminution in the rate of increase in the rate of money supply and we have had interest rates going down. Now this would seem to confirm what Dr. Friedman has indicated, that as the money supply declines, the market somehow adjusts and you can have a falling of interest rates in anticipation of perhaps less inflation. What is the explanation for this?

Dr. SAMUELSON. I do not have an explanation for the apparent shift in the demand for money downward. Now there are many ways of describing that shift in demand for money downward. You can describe it by saying that interest rates did not grow as much as you would have expected them to grow with the money GNP growing as much as it did and with the money supply not growing any faster than it did, interest rates are lower than you would have expected them to be on the basis of the past pattern of experience.

The CHAIRMAN. What actually happened is that since July interest rates have been falling at the same time the economy has been growing rapidly and at the same time the money supply has not been increasing. That's what puzzles me. Unless we accept Dr. Friedman's notion that the money supply has been increasing at a slower rate and this fact has been somehow adapted by the market and therefore they figure there will be less inflation—I don't understand the mechanism by which this is achieved with lower interest rates.

Dr. FRIEDMAN. I wouldn't want to let that stand as the whole explanation I would give for the month-to-month movement in the interest rates.

The CHAIRMAN. This is the phenomenon that appears.

Dr. FRIEDMAN. I would like to give you an alternative explanation. The initial decline in short term interest rates is what caused the Fed to lower the money supply rate because the market interest rates fell beneath what they thought it was going to be, so they were pulling reserves out. The continuation of the decline is the result of two phenomena: the one you were describing, the market recognition that these slow rates of monetary growth portend slower economic growth, slower inflation, but also there's been a second very important factor in the past month in particular. That has been the New York crisis. The New York crisis, in my opinion, has lowered short term interest rates. It has lowered short term interest rates in two ways. First, the uncertainty
engendered by the New York crisis has caused a great desire for liquidity. Under those circumstances, you have had a widening differential between rates of interest on short term securities and long term rates. It's short term rates that have mostly gone down. You have had a steepening of the yield curve. This also shows up in the municipal market where the rates of interest on very high grade securities have gone down.

The CHAIRMAN. Why is it that the New York crisis has resulted in diminishing demand? That sharply conflicts with precisely the question Dr. Samuelson asked. He said in his statement, "Why should the New York City troubles lower the demand for money?" The implication is that it shouldn't. Why shouldn't it?

Dr. FRIEDMAN. The answer to that is we have to distinguish money from credit. It hasn't lowered the demand for money but it has lowered the demand for certain kinds of credit.

The CHAIRMAN. Isn't that the same thing?

Dr. FRIEDMAN. No, it's not the same thing. Money is money. Credit is credit. And the talk of the demand for money as identical with the demand for credit is, in my opinion, a major source of confusion in the monetary area.

If we go to the credit market for a moment you can understand why the uncertainty engendered by New York has caused everybody to try to be liquid. It has therefore caused people to try to sell long term securities and buy short term securities and this has caused an increase in the demand for Treasury bills, let's say, versus corporate bonds.

Dr. SAMUELSON. And that's lowering interest rates?

Dr. FRIEDMAN. This has lowered the short term interest rates relative to the long term rates because it has produced a steeper yield curve.

Dr. SAMUELSON. The increased demand for Treasury bills lowers their yield?

Dr. FRIEDMAN. Of course. It raises the price of Treasury bills and lowers the yield. The yield is the inverse of the price.

The CHAIRMAN. We have had a general reduction in rates of long and short term.

Dr. FRIEDMAN. Next, the second effect of the New York crisis is everybody has looked at the effect on the municipal bond market and they haven't seen that the drying up of the municipal bond market has released more funds for other things. So municipal bond prices have gone down or yields have gone up and other yields on the average have gone down. So I would say that the New York crisis has done two things. It has steepened the yield curve and it has lowered the yield curve for all securities other than municipal and State securities.

Now I believe this is going to be a temporary phenomenon. It won't last, and I think you ought to reconcile yourself to the fact in a few months, as this New York crisis passes over, interest rates are going to resume their upward march if we have a decent expansion. If the Fed were to keep the money supply growing at zero, then interest rates will not start to go up again, but if the Federal Reserve does what it should do, which is resume a moderate rate of monetary growth, the economy will continue to recover. That will drive up the demand for loans. It will increase the demand for credit and interest rates will start up again in 1976.
The Chairman. Dr. Samuelson?

Dr. Samuelson. Yes; it may well be that I would want to agree with the effect of the New York crisis upon short term rates and I thought in my testimony I stated it as a question because I started out really with the notion that perhaps there's something in the New York City crisis itself which might help to explain this, and then I said it wasn't clearly obvious to me what that something was. As I go back on the airplane and benefit from Professor Friedman's suggestion, I may find myself agreeing with that.

[Professor Samuelson requested the following paragraph be inserted in the record:]

On reflection, I have to agree that the New York scare can help explain why short term interest rates are twisted downward relative to long-term rates. But it is not clear to me why, making people more scared and more desirous of being liquid, should reduce the demand for money, when M is written as a function of the level of money income, the level of short-term interest rates and the level of long-term interest rates.

I would like to give another reason why, given the change in the demand for money—and by the way, that shift in demand for money may be less than we have been talking about because the 11-percent increase in the money GNP may be spurious and on revision come down a little bit. It also may have to do primarily with inventory decisions which really don't require much money to carry them out. But, I think, there's another explanation and this is a fact that there are a number of people in the money market who know what monetarists believe, and whether or not they themselves fully believe in the monetarists' doctrines they are under the impression that somebody else believes in them, including committees like this—and I don't mean to be facetious at all, and I don't mean to be perjorative about the process that I'm talking about. Such individuals when they look at what's been happening to the money supply in terms of the target say to themselves, "Well, Dr. Burns and his colleagues are going to atone for their shortfall in almost moving outside of the range of targeted M growth on the downside. Hence we can be pretty sure that just ahead there's going to be a period of renewed money growth, whatever has been the case in the immediate past." And since they believe that there are at least some months during which an expansion of the money supply will have a depressing effect upon interest rates, they are taking speculative and investment positions in some in the direction of getting in upon this movement of lower interest rates, thereby reinforcing the movement.

I don't think this is an important matter from the standpoint of a year. I think the more important problem from the standpoint of a year is what is happening to price inflation.

I believe that by no mysterious process but by the haggling of the competitive market, that the putative rate of price inflation which is expected for the years to come—and this is a probability spread and not a firm number—is very important in deciding where the equilibrium nominal rate of interest tends to be struck between the buyers and the sellers, between the lenders and the borrowers. We have had some good news on the inflation front compared to earlier in the summer when the Russian wheat deal seemed to be sending up food prices, when there was a drought in the Middle West, when various
oil catchup and energy price outlooks were bad, and when the market was getting to be scared. So there are some movements in the demand for money which you ought not try to explain too carefully because they are part of the regular motion of the wobble of the demand for money as factors operate outside of the few major factors that we pick up in our long-term patterns of experience. These patterns are not multiple correlations with perfect fits in the past.

The question I was addressing myself to in the testimony and in the privacy of my study is whether this money demand or velocity has been a little bigger than usual in this particular period, and I don't think that one quarter makes a glacier ice age. And I don't think that a real significant shift in demand for money can be detected from experience no longer than this.

Dr. FRIEDMAN. I just want to make one brief comment as to long-term interest rates. I hope you recognize how low long-term interest rates are fundamentally compared to historical experience. I happened this summer to be working on the long-term experience of interest rates over a 90-year period. From 1880 to 1970, the average interest was 4.7 percent, but price inflation was only 1.1 percent. So the average real interest rate was 3.6 percent.

Consider today a corporate bond paying 10 percent—let's make it on the high side. If today you're in an income tax bracket in which you pay a 30-percent marginal rate, that leaves you with a 7 percent yield. If the inflation rate is 6 percent, you're left with a 1 percentage point real yield compared to a 3.6-percent yield on the average over the past 90 years. If you're going to get a 3.6-percent rate of return today with 6 percent inflation and if, to take a different example, you're in the 50-percent bracket, you need a 19.2-percent bond yield. So that by any calculation compared to the past you're not going to get long-term rates down unless you get inflation down. No use kidding yourself.

The CHAIRMAN. That may or may not be the case. I think you may be right. But after all, it's a matter of where your money goes, where it can go. It may be that lenders will be in the position that the best they can do is reduce the erosion of their capital to about 2 percent a year. There's nothing fixed or written on the wind that says you're going to get 3.6 percent forever or even 1 percent.

Dr. FRIEDMAN. I agree with you. In that case, they can consume it and they will. We have the evidence from a long period of history, Senator Proxmire. And the real rate of return on capital over hundreds of years has ranged around 3 percent.

The CHAIRMAN. Yes; but this all depends, of course, on expectations.

Dr. FRIEDMAN. Absolutely.

The CHAIRMAN. Let me get into the final question because the hour is late.

We are very, very concerned about this New York situation. I think I understand where you gentlemen stand on it, but it would be most helpful for the record if you could tell us with an understanding of what the options are. The options are two. No. 1, the President has made it very clear that he wants to go the bankruptcy option, and then it's my judgment if we go the bankruptcy option, the Federal Government is going to have to provide a guarantee for the referee in bankruptcy notes that he issues to provide for essential services. That was the unanimous conclusion incidentally of the committee, all Demo-
crats and Republicans, after listening to weeks of testimony; and although there's great difference on the options, that was the unanimous conclusion.

The involvement of the Federal Government in a bankrupt New York would be likely to last for a long time because it would be so hard for the city of New York and the State of New York to get back into the capital markets. Thirty States prohibit the investment by their banks in municipal obligations within 10 years or so of a municipality going bankrupt, including big States. Also, trust accounts are prohibited by law from being invested in such securities. Also, there's a provision in the New York State constitution that would provide for a loss of about 40 percent in property taxes for New York once it goes bankrupt. All of that would have to be made up. Also, you have the situation that when they are bankrupt they have to have some way—find a way of bridging more than a billion-dollar gap in a period of about 7 or 8 months in their operating budget to maintain essential services.

So the Federal Government would be involved either way. The Federal Government would be involved in the first place with a Federal court that would have to go in; in the second place, with a Federal loan.

The option that we provide is that we take advantage of the experience New York City has had and New York State has had, too, over the last 4 or 5 months. That experience has been, in my view, a good experience. They have cut employment 33,000, more than 10 percent of their work force, and it's been pretty ruthless. They have cut 18 percent of their classroom teachers. They have cut 17 percent of their narcotics unit. They have closed down libraries during the evening. They have frozen wages for 3 years.

There's more progress they can make, especially in pensions and in other areas, but they are moving in this direction.

They also have a situation where the Emergency Financial Control Board gets every penny that the State gets in taxes. The mayor doesn't get it. They get it, and they only disburse it according to their financial plan.

What we provide is a very tough board consisting of Simon, Burns, & Dunlop who would have to be satisfied that the guarantee would work out without any loss to the Federal Government. The financial community, the mayor, the Governor are convinced it would work if we gave them a $4 billion guarantee. We require the bondholders to take a writedown. They would have to extend their maturities. They have to reduce their interest rates. We discussed that with the big banks, and they have agreed to do that—not all, because we can't reach the 160,000 lenders, but we can reach the big banks, and we have gotten a substantial proportion, about half of the debt would be written downwards.

So we think we have put a package together which would give them the option of following the honorable policy of paying their debts, standing up and meeting their obligations, rather than what some people would regard as a dishonorable policy or a policy with less honor of going bankrupt, of being on their back, being dependent.

Now, I have obviously not presented this in an objective way, but I have given you my view, and I'm sure both you gentlemen know a
great deal about this and know where I have perhaps gone a little too
far in describing the situation.
So, Dr. Friedman, give me your true opinion and then Dr.
Samuelson.
Dr. Friedman. As you quite properly said, you put me in the posi-
tion of "when did you last beat your wife," and I have to say I did
beat my wife, because despite your persuasive remarks, I'm opposed to
any Federal guarantee of any securities of New York City before or
after default.
The Chairman. Before or after default?
Dr. Friedman. Before or after.
The Chairman. Would you call out the troops?
Dr. Friedman. I believe that is a figment of the political
imagination.
The Chairman. How can that be a figment of political imagination
when you have—here's what you have—
Dr. Friedman. Expenditures on policemen, and firemen in New
York City amounts to 9 percent of the New York City budget.
The Chairman. They have the police, the fire, the sanitation work-
ers, the water system, the transportation system—they have to pay
their electric light bills. They have a tremendous amount of—
Dr. Friedman. I believe that New York City and New York State
together are going to have to work that out.
The Chairman. Would you close the schools?
Dr. Friedman. I'm not deciding New York City's policies. You're
asking me whether I'm in favor of a Federal guarantee. Again, you
keep on asking me when did I last beat my wife.
The Chairman. They have a priority list. Life support services
are first, but you go down the priority list and fifth only before note
and bondholders are schools. So you'd have to throw these kids who
had nothing to do with this situation out of classes, a million of them.
Dr. Friedman. Senator Proxmire, I'm not going to second-guess
what New York City does. I'm not going to try to prescribe how they
should handle it. I think that the restrictions you have introduced into
your bill are excellent, but nonetheless, I would be personally strongly
opposed to the Federal Government guaranteeing any securities of
New York City before or after default, and I realize we could take
hours to discuss it.
The Chairman. Or making any loan after default?
Dr. Friedman. Or making any loan after default. I am in favor of
the Federal Government continuing its expenditures on those pro-
grams for which it is responsible, but not making any guarantees or
any loans to New York City. Now, I recognize that that's a tough, ex-
treme position. Maybe it's wrong. I'm sure we don't have the time now
to go into it in detail, but I'm trying to respond to your question as
fundamentally and as frankly as I can.
The Chairman. All right. Dr. Samuelson?
Dr. Samuelson. I believe that in the absence of Federal support in
one form or another for New York City, that it will go into default.
I believe that after it goes into default, the Federal Government will
in fact find itself in a great variety of guarantee and subsidy programs.
I think that the very occasion of default in all likelihood will leave
the Federal Government in the end with a much more expensive total cost of subsidy than if default can be prevented.

On the other hand, in the absence of default, it will be very hard to bring home to the effective "real-politik" the necessary contraction of expenditure in New York City that would be needed if New York City is ever again to get a loan without Federal subsidy.

So if the Federal Government in advance of default provides a guarantee program it seems to me extremely important to scrutinize it and reinforce it with all of the measures that can increase the pressure upon New York City to live within what is decided to be its necessary budget.

Now I may say—and it's a necessary part of my answer—that I think many of the responsibilities thrown on New York are national responsibilities. The fact that anybody can move into New York City from Puerto Rico or from Appalachia and from the South and so forth is part of the cause of the problem.

Second, anybody can move out of New York who has taxpayer capacity and that's part of the problem. So I think Federal revenue sharing should be more heavily involved.

On the whole, I think that the Nation would end up better off with this rescue bill than without it; but I do expect that there is an open end liability involved in the bill that nobody can at this time realistically assess. I don't mean that it's in the bill and it's written out in black and white. But if it turns out that New York doesn't mend its ways and that the fiscal gap has increased, you haven't the ability any more than you have now, in my judgment, to walk away from the problem.

The CHAIRMAN. We also insist in the bill that they balance their budget in the fiscal year beginning July 1, 1977, which they say they can do and must do and will do. We insist on that. We have the guarantee only a 1-year guarantee and the guarantee expires if they are not on target, if they don't stay on target.

Dr. SAMUELSON. Well, I think that those safeguards are very important, but I don't know whether any person can be sure that in the event the powers that be can live up to their agreement, because it's a pluralistic, democratic coalition of forces you're talking about. If what we do is start putting chips on shoulders of civil servants' unions and start knocking those chips off, it may be a very expensive process, and then the solid agreement is ended and, of course—

The CHAIRMAN. This control board can reject any contract. As a matter of fact, the emergency control board rejected a teachers' contract which had never happened before in New York, and the control board, as I pointed out, is about as tough—and with Dunlop on it, about as capable and successful in this kind of thing as I think you can be.

Dr. SAMUELSON. I applaud and recognize the importance of this, but I think when there's a confrontation and the board has its advice followed and the garbage is then rotting in the streets and the rats are beginning to come out of the manholes, then the problem does not automatically go away.

The CHAIRMAN. That's right. That's the problem, you see Dr. Friedman. You don't have a hundred Friedmans in the Senate and 435 Friedmans in the House. You may have a Friedman as President of
the United States. I'm not sure. I think we may have. But under these circumstances, the Congress of the United States and the Government isn't going to stand still when it confronts this situation of rats coming out into the street and the children coming out of school. We're going to move and that's all there is to it. Perhaps we can argue theoretically that we shouldn't, but we're going to. We're going to get involved.

Dr. Friedman. The rats aren’t going to be coming out in the streets.

The Chairman. Come on.

Dr. Friedman. If I'm Mayor Beame, then this is the picture I paint.

The Chairman. They want to do exactly what you want to do but they want to do it over a workable period. If you try to do this in 3 months, if you try to make this cut in 3 months, the effect can really be catastrophic. The only way you can do it probably is to close down the schools throughout—

Dr. Friedman. I don't believe it.

The Chairman. And put a million kids out of school.

Dr. Friedman. I don't believe it.

The Chairman. We looked at it, the arithmetic of this.

Dr. Friedman. You have much greater evidence on this than I do and I cannot quarrel with you. Maybe if I had gone over the same data as you have gone over I would change my view. But at the moment, I haven’t gone over that data and I'm of the opinion that—

The Chairman. Senator Brooke, who did a very strong job opposing our guarantee bill, wanted to go the default route but he was very firm in insisting we should provide loan guarantees on the default route. In fact, he made a strong fight for it. I think that's the view of most of the people who oppose the guarantee. Senator Jim Allen of Alabama said we have to give New York help, Senator Allen from Alabama. So I think you don't represent what you would call the majority in the Senate with a position of doing nothing.

Dr. Friedman. As you know, that's hardly ever been one of my goals.

The Chairman. That's one of your most endearing qualities.

Gentlemen, thank you very, very much. I apologize for keeping you so late and the long recess.

Dr. Samuelson. May I beg your indulgence so that I may put in the answer to the question which because of the interruption I had just started on?

The Chairman. All right. We may have some more questions for you.

Thank you gentlemen. The hearing is now adjourned.

[Whereupon at 12:55 p.m., the hearing was adjourned.]

ADDENDUM

Dr. Samuelson. Dr. Friedman exaggerates my agreement with his defense of the fixed-money-growth rule. Of course I think that monetary expansion should have been greater in the years 1929–33. But that is in agreement with my own "lean against the wind" optimal-stochastic-control strategy, and only by inadvertent coincidence in trivial agreement with Friedman's money rule. It is a false dichotomy, which I reject, to argue in the Friedman manner: "You must choose between the rule and discretionary policy. In the past Fed policy has often been
cum-cyclical rather than contracyclical, and that is the inevitable consequence of not binding yourself to the rule. Samuelson's discretionary policy might for the sake of the argument be deemed to work out as a more stabilizing procedure than the rule; but it is a species of the genus of discretionary Fed policy, and there is some reliable law of politics and bureaucracy that must convince every reasonable jury which shows that every attempt to use good discretion must result in your actually using bad discretion. Hence the rule is our only salvation.” With respect, this is a tissue of logical nonsequiturs; and it is also a cascaded sets of speculations about the empirical likelihoods of future politics and Fed decisionmaking. Whatever my admiration of Dr. Friedman in the area of permanent income analysis, of penalties that may come from pegged exchange rates, such excursions into the field of political analysis do not encourage my agreements with him. Here I am not trying to insist on the correctness of my views over his, as to make clear that what he calls the great agreement between us rests on an incorrect understanding of my position, its empirical hypotheses and its deductive logic.

Here is just that indicative example. In my testimony I have had to observe that recent variance in nominal GNP has a smaller part of it explicable in terms of variance of the money aggregates. On the hypothetical supposition that the jury agrees on this reduction of $R^2$ of simple monetarist regressions as applied to recent and future events, one asks Dr. Friedman, “Would such a lowering of $R^2$ increase or decrease the divergence between your rule and the optimal stochastic programming strategy?” Dr. Friedman replies that the worse the M fit the more the rule is confirmed. On reflection, I do not think he will want to make so unqualified and paradoxical a statement. There are certainly some causes of a reduction in $R^2$ that could justify the Friedman answer: the case where random errors are imposed upon what was previously a clearcut a[PQ]/am might be such a case; but precisely that case is the one in which fiscal and other policy parameters than monetary policy will most commend themselves to the jury, in defiance of a simplist monetarist view.

In any event, that was not the case envisaged in my testimony. Rather the jury is asked to consider a case in which long autocorrelated waves of exogenous events—harvest failures, OPEC energy price rises, etc.—are newly imposed on a system. In that case $R^2$ properly registers a fall. But with no change in the potency of M, and with the exogeneous errors of a positively autocorrelated sort, it can be shown by the principles of stochastic optimal control that the optimal policy path departs even more from the rule than it did previously. Q.E.D.
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