

SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

March 7, 1975

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## Policy Recommendations of the Shadow Open Market Committee Meeting

March 7, 1975

The economy is now in the second quarter of a sharp business contraction following three quarters of mild contraction. The worsening is due to a sharp deceleration in the growth of the money supply from June 1974 to February 1975. At its meeting today, the Committee considered policy actions designed to reverse the business decline without reviving inflationary pressures.

### Monetary Policy

The problems we face have been made much worse by recent Federal Reserve monetary actions. From December 1971 to June 1973, the money supply grew at an annual rate of 8.4 per cent. This excessive growth rate reinforced inflationary tendencies already at work. The 3-percentage point reduction in the monetary growth rate to 5.5 per cent in the year ending June 1974 was sufficient to produce the mild recession we experienced in the first three quarters of 1974, and to achieve a gradual dampening of inflation. Had the Federal Reserve maintained the 5.5 per cent growth rate in the year ending March 1975, the prospects of restoring full employment and gradually reducing inflation would be much better. The current recession would be much less severe. Instead, the Federal Reserve cut the growth rate of the money supply a further 4 percentage points from June 1974 to February 1975 to only 1.5 per cent. It is this drastic decline in monetary growth that accounts for the steep rise in the unemployment rate, the steep decline in industrial production, and the current generally depressed economy.

There can be no doubt that the Federal Reserve did not intend to be so restrictive. The published record of the Federal Open Market Committee tells us so. The question is why the Federal Reserve has failed so miserably to achieve the target ranges of monetary growth it has set month after month since June 1974.

Federal Reserve spokesmen describe current policy as "easy" and tell us the economy is "liquid." They cite falling loan demand as responsible for the failure of demand deposits to grow. Interest rates have fallen in recent months but not because the Federal Reserve has actively pushed them down. They fell because a receding economy lowered the demand for credit. Similarly, the decline in the discount rate followed the decline in market rates and contributed no expansive stimulus. Even with falling credit demand, an expanded flow of reserves to banks raises monetary growth. Excess reserves are negligible in size and have shown no increase. Banks expand their assets in one way or another in response to large injections of reserves. They typically add to their portfolio of securities when loan demand is weak. Whether a bank purchases a security or extends a loan of similar magnitude, demand deposits increase.

The fact is that it is the Federal Reserve's own operating procedures that account for the recent anomalously low rate of monetary growth. The Federal Reserve sets a money supply target growth rate but its actual operations are carried out with a Federal Funds target rate. If the Federal Funds rate is pushed by market forces to a lower level than the target, the trading desk at the New York Federal Reserve Bank resists the pressure by reducing the growth of reserves below the level that would achieve the target money supply growth rate. This is what typically happens under Federal Reserve operating procedures in a recessionary period. In a boom period, the Federal Funds rate is pushed by market forces to a higher level than the target, so the trading desk expands the flow of reserves above the level that would achieve the target money supply growth rate. The basic problem with the Federal Reserve's procedure is that it tries to stabilize market interest rates, and sacrifices control of the money supply.

We strongly urge the Open Market Committee to discontinue setting target ranges for the Federal Funds rate. The Federal Reserve should concentrate on achieving the target growth rate of the money supply. To do that, the trading desk should be instructed to provide banks with a flow of reserves adequate to achieve the target growth rate. The market will adjust to whatever interest rate emerges.

We renew the recommendation made at our September meeting that the growth rate of money be held at 5-1/2 per cent. However, growth should not start at that rate from the current low level. We recommend that the money stock be brought to the level it would have reached in March 1975, if our policy had been followed. A one-time increase in money -- currency and demand deposits -- to \$290 billion should be announced and provided by April 15. This increase would put the money growth rate back on the path leading the economy toward full employment at lower rates of inflation than in recent years.

#### Fiscal Policy

Our current estimate is that the Treasury will issue between \$75 and \$80 billion of debt during calendar 1975. Treasury borrowing must be financed by domestic private saving, by the Federal Reserve and foreign purchases. These same sources must also finance the growth of capital and the production of new housing.

If there is a large increase in the growth rate of money -- to an 8 or 10 per cent permanent average in calendar 1975 -- the Federal Reserve will finance \$10 to \$12 billion of the federal government deficit. This will amount to an addition of approximately \$25 - \$30 billion to the money supply. Inflation will accelerate in 1976 and 1977. If the growth rate of money is kept in the 5.5 per cent

range we recommend, more of the federal government deficit must be financed by domestic saving and by foreigners. This method of financing the federal government deficit reduces the amount of real saving that becomes available to finance housing and private capital formation. We favor the free flow of capital. If the free flow of capital in 1975 results in a capital inflow, we welcome it irrespective of its source.

The policy of crowding out private capital and housing to finance budget deficits is not attractive, but it is the least unattractive of the choices before us. In recommending this alternative, we emphasize that interest rates may and probably will rise to clear the market for credit.

#### The Case Against Credit Allocation

The restricted volume of lending that is left to finance housing, plant and equipment, and inventories may stimulate Congressional efforts to impose credit allocations on banks. Credit allocation is not a solution but a source of new difficulties. We strongly support the Federal Reserve in its opposition to credit allocation. Such allocations would attempt to shift credit in ways that are most unlikely to improve the market's decisions about where credit should flow, and would not succeed in significantly changing the way credit is actually allocated except in the short run.

#### The Balance of Payments

Before August 15, 1971, a U.S. balance of payments deficit was a serious matter, but with the United States floating, none of the published balances makes sense. The Department of Commerce should drop all of them. All data should be continued but no balances should be struck. We urge that the balance of payments

statistics be published without reference to deficits and surpluses. The exchange rate change is a better measure, a more readily available measure, of the pressures on the value of the dollar.

The Federal Reserve defends its concern for the level of interest rates on the ground that the dollar depreciates when capital flows abroad as a result of falling interest rates here. This should not be a concern. The floating rate permits us to adopt whatever monetary policy we want, when we want it without regard to the state of the balance of payments or the exchange rate. It gives us freedom to determine our own level of employment, prices and output.

#### Prospects for Dampening Inflation and Promoting Recovery

As noted, the large budget deficit to be financed in 1975 is likely to push interest rates up later in the year and attract foreign lenders, so the Federal Reserve's current concern will diminish. The Federal Reserve in this situation must guard against two dangers: (1) implementing monetary growth rates at 8 or 10 per cent, or higher, to finance the budget; (2) delaying or retarding the rise in interest rates and thereby increasing the growth rate of money above the target level it sets. If it does not guard against these dangers the Federal Reserve will, as in the past, be the main engine of inflation.

We will not achieve full employment, stable growth, and stable prices unless we stop shifting from excessive to inadequate to excessive monetary growth rates. By continuing stop and go policies, we guarantee that past experience will continue. High inflation will be followed by recession and recession by higher inflation.

If the Federal Reserve begins now to put money growth back on the path of a 5.5 per cent rate, we can look forward to recovery by the last quarter of 1975 and a sustained dampening of inflation. Long-term stability will require ultimately reducing the monetary growth rate to a lower level consistent with the growth of real output.

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MONETARY POLICY AND THE ECONOMIC DECLINE

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Position Paper Prepared for the 4th Meeting of the Shadow Open  
Market Committee - March 7, 1975



The last meeting of the SOMC occurred at the edge of a precipitous decline in economic activity. The current decline will be substantially larger and longer than all the previous post World War II recessions. The largest economic downswing since 1937/38 unavoidably favors memories of the early 1930's. The ghosts of 1930 could even usefully direct our attention to important and still unresolved policy problems. The mismanagement of monetary policy by the Board of Governors of the Federal Reserve System converted the downswing of 1929/30 into the Great Depression. The basic misconceptions guiding policymaking in the 1930's unfortunately still affect in a somewhat modified form recent monetary policies. The U.S. economy entered this winter a crucial period of great anxiety and the course of monetary policy will decisively influence the length of the downswing, the timing of recovery and the future path of inflation.

The position paper presented one year ago for the 2nd meeting of the SOMC commented on Senator Proxmire's letter to the Chairman of the Board of Governors of the Federal Reserve System and the Chairman's reply. Senator Proxmire directed the Chairman's attention to the critique advanced by the SOMC and others. Congressional concern about the management of our monetary policy substantially widened in recent months. The Senate Committee on Banking and Currency introduced a resolution requiring the Fed to raise monetary growth over the near future above the levels recently observed and also maintain over the long-run a growth path consistent with a stable price level. The new

Chairman of the House Committee on Banking and Currency attempted to legislate credit controls and direct the Fed to lower interest rates on long term securities. These Congressional initiatives raise a fundamental issue concerning the nature of monetary control and confronts the Fed with serious questions about its responsibilities.

Two different but related problems require thus the attention of the SOMC; the proper course of policy and the institution of monetary control. Section I submits my recommendation after surveying recent monetary trends and policy. Section II examines the Senate Committee's proposal and considers the Fed's implicit denial of monetary control expressed in interpretations about recent events published in the media.

#### I. Recent Monetary Trends

Tables I to III summarize the major patterns. Table I presents monetary growth from year to year between corresponding months in successive years. We note a persistent decline in this monetary growth by just about 50% from (6/72-6/73) to (12/73-12/74). This longer-run decline was essentially due to an acceleration in the currency ratio  $k$  and the time deposit ratio  $t$  moderated by a slowing decline of the adjusted reserve ratio  $(r + 1)$ . The monetary base grew over the 12 month spans at a comparatively even rate. The increase in currency and time deposit ratio were thus allowed to lower monetary growth by the full extent of their negative contribution. It should be noted that this deviation of monetary growth from the path followed by the base was larger and lasted longer than projected in my position paper prepared for March 8, 1974...

TABLE I. ANNUAL RATE OF CHANGE (in Percentage) OF MONEY STOCK  
 $M_1$  BETWEEN CORRESPONDING MONTHS IN SUCCESSIVE YEARS AND THE  
CONTRIBUTIONS MADE BY THE PROXIMATE DETERMINANTS.

Period	M	B	k	t	(r+1)	d
6/72- 6/73	8.36	7.96	- .29	-2.16	2.88	-.01
12/72-12/73	5.96	7.31	- .98	-2.38	1.94	.07
12/73-12/74	4.15	8.31	-2.55	-3.03	1.29	.13

M = money stock, B = monetary base, k = currency ratio, t = time deposit ratio, (r+1) = adjusted reserve ratio, d = Treasury deposit ratio.

TABLE II. ANNUAL RATE OF CHANGES (in Percentage) OF MONEY STOCK  
 $M_1$  BETWEEN SUCCESSIVE 3 MONTH PERIODS

Period	M	B	k	t	(r+1)	d
3/73- 6/73	9.63	7.07	.57	-2.06	3.42	.63
7/73-10/73	1.55	5.88	-2.39	-2.56	.58	.04
2/74- 5/74	6.82	8.71	-1.67	-3.11	2.74	.16
7/74-10/74	2.61	7.49	-3.25	-2.32	.42	.28

The dates are located in the middle month of each three month period.  
The data used in the computations were seasonally adjusted.

TABLE III. ANNUAL RATE OF CHANGE (in Percentage) OF MONEY  
STOCK M<sub>1</sub> BETWEEN NON-OVERLAPPING FOUR WEEK PERIODS.

Period	M	B	r+l	k	t	d
6/26/74	9.56	5.12	2.09	2.51	-1.65	1.50
7/31/74	- .23	8.36	-5.42	-1.06	-3.62	1.50
8/28/74	3.25	1.22	7.86	-4.93	-1.73	.82
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10/27/74	- .58	3.93	2.79	-3.22	-2.52	-1.56
12/11/74	9.98	14.52	-3.87	-1.01	.55	- .21
1/22/75	-9.41	1.42	3.95	-6.03	-8.91	.18

The data used in the computations were seasonally adjusted.

Table II provides some information about shorter run movements within a 12 month period. The data show monetary growth and the contribution made by proximate determinants between non-overlapping successive three month periods. The monthly dates in the table refer to the center month of a three month period. The first row states the peak reached in the summer of 1973. The large swings in monetary growth from the summer 1973 to the fall of 1974 were dominated by the variations in currency ratio  $k$  and the adjusted reserve ratio  $(r + 1)$ . The negative contribution of the currency ratio to monetary growth reached in the fall 1974 a record level. The increase in the currency ratio lowered from (June-August) to (September-November) the money stock, by itself alone, by 3.25% p.a. This was reenforced by a falling contribution from the adjusted reserve ratio and also the monetary base.

The last table describes the shortest run movements between non-overlapping successive four week periods. The weekly dates in the table indicate the terminal week of the later four week period used in the comparison. The first row shows the situation just before the last meeting of the SOMC. Monetary growth had collapsed to slightly below zero. The positive contribution of the base was more than offset by the negative contribution from currency and time deposit ratio and the Treasury's management of its tax and loan accounts at commercial banks. The following phase lasting to the middle of last December substantially moderated the negative contribution of the currency ratio and actually reversed the contribution made by the time deposit ratio. This movement is consistent with the general projection made in the last

position paper. The large acceleration of the monetary base was however particularly important. The growth rate of the base increased from about 4% p.a. to 14.5% p.a. over the fall period. This acceleration collapsed completely in the subsequent period. The growth rate of the base declined from 14.5% to about 1.5% p.a. The radical retardation of the base was reenforced by a dramatic reversal in the movement of currency ratio and time deposit ratio not included in my general projection made last September. The increase in the currency ratio lowered by itself from the middle of December to late January the money stock by about 6% p.a. Such patterns have not been observed for many decades and do conjure up pale ghosts of the early 1930's. The large deceleration of the base by about 90% inspite of the expanding currency drain pushed monetary growth to a low of almost minus 10% p.a. in January.

The information in table III suggests that the acceleration of the money stock in the fall and the subsequent deceleration just about cancel each other. This is confirmed by a survey of the data over the past 13/14 months. The money stock increased from January 1974 to June 1974 by about 8% p.a. and the base by about 7% p.a. From June 1974 to the last week of January 1975 the money stock expanded on the other hand by a negligible margin. An approximate 4% rise in the base from June 74 to January 75 was offset by an approximately 4% downward drift of the monetary mulitplier as a result of repeated increases in currency and time deposit ratio. It is remarkable however that over the period experiencing the worst increase in the currency ratio the monetary base decelerated with dramatic proportions. It barely

increased from the end of December until late February. The decline in the growth rate of the base noted above was determined by a reversal in the movement of Federal Reserve Credit. This magnitude rose by almost \$4 billion in the late fall (early November to late December) inspite of a decline in bank borrowing of about \$.8 billion. Federal Reserve Credit fell on the other hand by about \$1.5 billion from the end of December to the middle of February. The reduction in bank borrowing contributed only about \$.4 billion to this fall. The Federal Reserve thus lowered its net purchases of securities by almost \$6 billion between late fall and early 1975, inspite of the FOMC's decision of December 1974 (as reported by the Chairman to Congress) to maintain monetary growth between 5%-7% p.a. This decision was well conceived and consistent with the SOMC's recommendation made in September 1974. But the Fed failed to execute its plan. This failure cannot be attributed to a vague array of imaginary villains "out there in the financial markets". The Fed reversed its own behavior and contradicted its own instructions. Net open market purchases of about \$4 billion over November-December were replaced by net sales of about \$1 billion over January-February. This failure of Federal Reserve policy is serious and regrettable. It prolongs and amplifies an already substantial economic downswing quite unnecessarily.

The weakening economy combined with the inherited rate of inflation motivated the SOMC last September to recommend a maintained monetary growth of about 5.5% to 6%. This recommendation implied

that the money stock for January 1975 should be around \$285 billion. We note thus with interest that the acceleration of the money stock achieved over the fall (early October to end of December) actually realized the desired level of \$285 billion in early January. Continued growth along the track proposed would have dampened the ongoing down-swing and raised the probability for a turnaround in activity this summer. The Fed's disregard of its own decision delays the recovery by months.

We still should insist at this stage on an immediate return to the monetary growth proposed in our last recommendation. This implies that the money stock for March 1975 be raised to around \$290 billion or about \$15 billion above the level realized in March 1974. The proposal thus involves a large increase (by about \$8 billion relative to early February) of the money stock to the desired level, an increase distributed over a few weeks. Once on track, the Fed should maintain for the balance of the year a growth rate of about 5.5% to 6% p.a. It is noteworthy that my recommendation is quite compatible with Senator Humphrey's suggestion that the money stock should grow at 8%-10% p.a. over the next six months. The path laid out by the proposal implies a growth rate from Early February to August of about 10 5% p.a. The substantial "front-loading" implicit in our recommendation involves in my judgment a necessary correction required by the current trend in economic activity and the recent mistakes in policy.



## II The Central Issue; Monetary Control

The failure of monetary policymaking experienced over the past months dramatizes the relevance of Congressional concern. The Senate Resolution introduced by the Senate Committee on Banking and Currency seems particularly appropriate at this time and deserves our fullest support. The Fed's behavior over the past months exhibits a dangerous inclination to do actually the opposite of what it says it plans to do. Its own behavior thus demonstrates at a critical time that a major institution responsible for our macro-policies has really learned very little since 1930. In a manner reminding observers of discussions in the Fed's policymaking body during the 1930's, Chairman Burns objects (according to newspaper accounts of recent Congressional Hearings) to "releasing the monetary brakes". This objection is particularly addressed to the first paragraph of the Senate Resolution requiring an increase in monetary growth beyond recent (almost) zero growth levels. The Chairman fears apparently that a release of the brakes "produces later a monetary explosion" whenever the private sector's credit demand expands again. This justification essentially denies the possibility of monetary control and fails to appreciate a Central Bank's opportunities to control monetary growth.

The dangerous misconceptions guiding Federal Reserve policymaking have been clearly revealed by several statements recently published in the Press. These statements probably reflect more or less indirectly views and briefings made available by Federal Reserve officials and are thus relevant material for our examination. These statements

essentially suggest the general undesirability or impossibility of the kind of monetary control implicitly proposed by the Senate Committee.

An editorial of the New York Times appearing on February 15, 1975 asserted that the Fed has definitely moved to raise the monetary stimulus applied to a sagging economy. The editorialist also complained that "despite all these efforts" (to expand the money stock) "the money supply has been growing very sluggishly. In the latest three months it actually seems to have declined slightly". The editorial emphasizes in particular that the money stock was "growing too slowly to reverse the real decline in the economy". So far so good, but now we encounter the crucial point: "It is far from obvious, however, that this is the fault of the Federal Reserve". And it is "far from obvious" because banks used base money injected by the System to "improve their liquidity position" and the public (business and households) lowered their demand for credit. Moreover, with interest rates already falling "it would be risky for the Fed to make much greater injections of reserves into the monetary system". Some worsening of "the U.S. balance of payments deficit" is listed among the risks.

Two days later appeared a column in the financial section of the New York Times commenting on the "apparent easing by the Reserve" which has been "seen". It is noted that "the U.S. economy is mired in its deepest recession since World War II. Additional "monetary ease" seems thus in order. But "the Fed remains stymied in its effort...

to foster growth in the money supply". And we also read one day before the editorial in another column of the financial section of the New York Times that the money stock "decreased...during the latest three months, despite Federal Reserve efforts to make it grow faster". And so we are told again after 40 years, "the Fed can't push on a string".

An article by Auerbach, a former official at the Federal Reserve Bank of New York, published in the Sunday Times on February 16 reenforced the general trend of ideas supporting a traditional Federal Reserve position. We read that the Fed "demonstrated since early December, through actions it has taken to ease monetary policy, that it wants to step up the money supply growth rate". The approach according to Auerbach was "essentially to lower short term interest rates". But declining demand for bank credit and lower money demand make it apparently impossible for the Fed to raise the level of monetary growth. And so Auerbach concludes that "not unless interest rates are reduced to virtually zero levels, is it likely that the Fed can succeed in stepping up the expansion of the money supply simply by adding to bank reserves".

The basic pattern of these arguments is quite familiar and has been propagated by the Federal Reserve authorities since the early 1930's. The pattern involves two components: first it is asserted that the Fed has taken actions to raise monetary growth and stimulate the economy; and secondly, the absence of any relevant observations supporting the first assertion must be attributed to obstructions over which the Fed has no control. And so we are told that "one cannot push on a string", or "horses led to the trough may not drink", or one may quote suitable

passages from Shakespeare. Indeed, the slippery behavior of cups of wine, the obstreperous behavior of horses and the low pushing quality of strings seem the best established results of Federal Reserve attempts at research conveyed to a broader public. So we encounter an old game with potentially dangerous consequences for the current environment. The old legend of a well designed policy obstructed by reality was already debunked by Laughlin Currie in his book on the U.S. money supply published in 1934. He showed that the Fed never engaged in any expansive actions during the year 1930. Nothing was achieved because nothing was done.

The patterns shown in the previous section discussing recent trends thoroughly rejects the allusions and allegations made in the New York Times. We note foremost that there is no support for the contention that the Fed actively shifted to foster monetary growth and raise the level of monetary stimulus. Our data show on the contrary that the Fed actively lowered monetary growth over the past three months and substantially contributed to lower the money stock. The money stock accelerated over the late fall when the Fed rapidly expanded Federal Reserve Credit and monetary growth collapsed at the turn of the year when Federal Reserve Credit declined and the base decelerated from a growth rate of 14.5% p.a. to 1.5% p.a. A reversal in open market operations from net purchases of about \$5 billion in November-December to net sales of \$1 billion is more appropriately described as a "pulling by the hair" than a "pushing on a string". We observe also in this context that the reduction in bank borrowing was actually larger in November-December than in January-February and

the contribution made in the latter period by the adjusted reserve ratio still positive. There is thus no shred of evidence that banks' attempt "to improve their liquidity position" stymied the Fed's expansive actions.

A second order but still important factor in recent monetary growth, the contribution made by the currency ratio, is totally disregarded in the comments under consideration. It has nothing to do with any of the arguments advanced. In particular, it did not result from falling demand for credit or money. Somewhere during the 1960's the Fed discovered the existence of a money demand and has used this entity diligently for its purposes. It has argued on frequent occasions that the behavior of the money stock, and so monetary growth, simply reflects the movement of credit demand and money demand. Legends and bad analysis die hard and so we repeat once more: Variations in these demands are transformed into corresponding movements of monetary growth under the institution of an interest target policy. This is amplified by the effect on the time deposit ratio of falling market rates of interest induced by weakening credit demand. The time deposit ratio frequently expands under the circumstances and this process was certainly operative in recent months. But the deceleration of the base still exceeded the retardation in the contribution of the time deposit ratio. Moreover, an interest target policy expresses the choice of strategy by the Federal Reserve authorities. And it was precisely the determined adherence to this ancient strategy which translated downward pressures on interest rates produced by rapidly weakening demand into a declining Federal Reserve Credit and a decelerating base.

It should be clearly understood that interest rates did not fall because the Fed actively pushed them down. They fell because a receding economy lowered the demand for credit. This description of the relevant circumstances extends to the discount rate. The discount rate followed the market rates and contributed no expansive stimulus. The observation of a persistent decline in bank borrowing at the Fed does not support claims of an "expansive discount policy".

An interest target policy misleads monetary authorities and many spectators to believe that expansive (or restrictive) actions have been initiated when nothing has been done or even worse, when actually restrictive measures have been introduced. A decline in interest rates resulting from falling credit demand possesses no expansionary meaning and simply reflects one aspect of the ongoing deflationary process. Its interpretation as an expansive action by the Fed is a dangerous illusion obstructing the useful application of actually expansive policies. One last point need be emphasized. An accelerated injection of base money raises monetary growth even with falling credit demand. Interest rates will be lowered relatively and generate the required increase in money demand. Banks expand their assets in one way or the other. They can always expand their portfolio of securities in response to large injections of base money. Most importantly, we note that the evidence indicates a clear responsiveness of monetary growth to movements of the base in many different periods and different countries. Even in the depths of the Great Depression the money stock responded with comparatively little modification by the monetary

multiplier to the momentous acceleration in the base from April 1933 onwards, and it also reflected immediately the hard deceleration of the base in 1936/37 initiated by the Fed's policy measures.

Recent observations confirm a general pattern which has been repeatedly observed over many different periods. Changing credit demand operating via variations in interest rates on the time deposit ratio, the banks borrowing from the Fed or the adjusted reserve ratio exert in the average over many decades a substantially smaller influence on monetary growth than changes in the base supplemented by a changing currency ratio. The responsibility of the monetary authorities thus remains and should not be obfuscated with irrelevant metaphors and inadequate analysis. The Senate Resolution assumes under the present circumstances a really crucial importance. It offers an opportunity to remove obsolete procedures of policymaking and confronts the Fed squarely with its central responsibility. The relevance of the intended Resolution is also strongly supported by a remarkable development among European Central Banks. The Deutsche Bundesbank, the Banque de France, the Banco de Espana and the Swiss National Bank all accepted the idea of monetary control and moved over the recent past to implement such control over monetary growth. The change in procedures and policy conception has been motivated basically by a determined attempt to cope with inflation and to improve the range of stabilization policies. This European experience offers some useful lessons for our purposes. It demonstrates the feasibility of monetary control under very different arrangements. But it also cautions us that passage of the Senate Resolution will not be sufficient. The divergence between the FOMC's

decision of last December and the subsequent behavior of the Fed indicates the nature of the problem. Effective monetary control requires suitable implementation and appropriate procedures. The current procedures are quite inadequate for the purpose. Monetary control will not function until the desired growth rate over one quarter or two quarters has been translated into a specific volume of net purchases to be executed by the account manager over a shorter run in the near future with appropriate revisions in the magnitude as new information accrues.

Effective monetary control also requires some adaptations of inherited institutions. The nature of these adaptations has been discussed on several occasions. They include radical simplification of reserve requirements, the manner of computing required reserves and the constraints on liability conditions banks can offer. Lastly, there remains the measurement problem. We still hope that the committee constituted by the Fed to study improvements in the measurement of the money stock will arrive at some useful proposals. This attempt has been used unfortunately by Chairman Burns to obfuscate the problem of monetary control by introducing eight distinct measures of the money stock without any indication of relevant analysis or comparative behavior. We suggest that for most serious issues over the past 10 years, or even since the Fed emerged in 1914, all relevant measures of the money stock would have yielded the same information for the policymakers and offered the same answers to questions what to do.



Revised 3/5/75

MONETARY POLICY AND THE ECONOMIC DECLINE

Karl Brunner  
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Position Paper Prepared for the 4th Meeting of the Shadow Open  
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TABLE I. ANNUAL RATE OF CHANGE (in Percentage) OF MONEY STOCK  
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CONTRIBUTIONS MADE BY THE PROXIMATE DETERMINANTS.

Period	M	B	k	t	(r+1)	d
6/72- 6/73	8.36	7.96	- .29	-2.16	2.88	-.01
12/72-12/73	5.96	7.31	- .98	-2.38	1.94	.07
12/73-12/74	4.15	8.31	-2.55	-3.03	1.29	.13

M = money stock, B = monetary base, k = currency ratio, t = time deposit ratio, (r+1) = adjusted reserve ratio, d = Treasury deposit ratio.

TABLE II. ANNUAL RATE OF CHANGES (in Percentage) OF MONEY STOCK  
M<sub>1</sub> BETWEEN SUCCESSIVE 3 MONTH PERIODS

Period	M	B	k	t	(r+1)	d
3/73- 6/73	9.63	7.07	.57	-2.06	3.42	.63
7/73-10/73	1.55	5.88	-2.39	-2.56	.58	.04
2/74- 5/74	6.82	8.71	-1.67	-3.11	2.74	.16
7/74-10/74	2.61	7.49	-3.25	-2.32	.42	.28

The dates are located in the middle month of each three month period.  
The data used in the computations were seasonally adjusted.

TABLE III. ANNUAL RATE OF CHANGE (in Percentage) OF MONEY  
STOCK M<sub>1</sub> BETWEEN NON-OVERLAPPING FOUR WEEK PERIODS.

Period	M	B	r+1	k	t	d
10/27/74	- .58	3.93	2.79	-3.22	-2.52	-1.56
12/11/74	9.98	14.52	-3.87	-1.01	.55	- .21
1/22/75	-9.41	1.42	3.95	-6.03	-8.91	.18

The data used in the computations were seasonally adjusted.

Table II provides some information about shorter run movements within a 12 month period. The data show monetary growth and the contribution made by proximate determinants between non-overlapping successive three month periods. The monthly dates in the table refer to the center month of a three month period. The first row states the peak reached in the summer of 1973. The large swings in monetary growth from the summer 1973 to the fall of 1974 were dominated by the variations in currency ratio  $k$  and the adjusted reserve ratio  $(r + 1)$ . The negative contribution of the currency ratio to monetary growth reached in the fall 1974 a record level. The increase in the currency ratio lowered from (June-August) to (September-November) the money stock, by itself alone, by 3.25% p.a. This was reenforced by a falling contribution from the adjusted reserve ratio and also from the monetary base.

The last table describes the shortest run movements between non-overlapping successive four week periods. The weekly dates in the table indicate the terminal week of the later four week period used in the comparison. The first row shows the situation just before the last meeting of the SOMC. Monetary growth had collapsed to slightly below zero. The positive contribution of the base was more than offset by the negative contribution from currency and time deposit ratio and the Treasury's management of its tax and loan accounts at commercial banks. The following phase lasting to the middle of last December substantially moderated the negative contribution of the currency ratio and actually reversed the contribution made by the time deposit ratio. This movement is consistent with the general projection made in the last

position paper. The large acceleration of the monetary base was however particularly important. The growth rate of the base increased from about 4% p.a. to 14.5% p.a. over the fall period. This acceleration collapsed completely in the subsequent period. The growth rate of the base declined from 14.5% to about 1.5% p.a. The radical retardation of the base was reenforced by a dramatic reversal in the movement of currency ratio and time deposit ratio not included in my general projection made last September. The increase in the currency ratio lowered by itself from the middle of December to late January the money stock by about 6% p.a. Such patterns have not been observed for many decades and do conjure up pale ghosts of the early 1930's. The large deceleration of the base by about 90% inspite of the expanding currency drain pushed monetary growth to a low of almost minus 10% p.a. in January.

The information in table III suggests that the acceleration of the money stock in the fall and the subsequent deceleration just about cancel each other. This is confirmed by a survey of the data over the past 13/14 months. The money stock increased from January 1974 to June 1974 by about 8% p.a. and the base by about 7% p.a. But this pattern disappeared in June. From June 1974 to the last week of January 1975 the money stock expanded by a negligible margin. An approximate 4% rise in the base from June '74 to January '75 was offset by an approximately 4% decline of the money multiplier as a result of repeated increases in currency and time deposit ratio. It is remarkable however that over the period experiencing the worst increase in the currency ratio the monetary base decelerated with dramatic proportions. The base barely

increased from the end of December until February 19.

The retardation of the base was determined by a reversal in the movement of Federal Reserve Credit. This magnitude rose by almost \$4 billion in the late fall (early November to late December) inspite of a decline in bank borrowing by about \$.8 billion. Federal Reserve Credit fell on the other hand by about \$1.5 billion from the end of December to February 19. The reduction in bank borrowing contributed only about \$.4 billion to this fall. The Federal Reserve thus lowered its net purchases of securities by almost \$6 billion between late fall and early 1975, inspite of the FOMC's decision of December 1974 (as reported by the Chairman to Congress) to maintain monetary growth between 5%-7% p.a. This decision was well conceived and consistent with the SOMC's recommendation made in September 1974. But the Fed failed to execute its plan. This failure cannot be attributed to a vague array of imaginary villains "out there in the financial markets". The Fed reversed its own behavior and contradicted its own instructions. Net open market purchases of about \$5 billion over November-December were replaced by net sales of about \$1 billion over January-February. This failure of Federal Reserve policy is serious and regrettable. It prolongs and amplifies an already substantial economic downswing quite unnecessarily.

The weakening economy and the inherited rate of inflation motivated the SOMC last September to recommend a maintained monetary growth of about 5.5% to 6%. This recommendation implied that the money stock for



January 1975 should be around \$285 billion. We note thus with interest that the acceleration of the money stock achieved over the fall (early October to end of December) actually realized the desired level of \$285 billion in early January. Continued growth along the track proposed by our recommendation would have dampened the ongoing downswing and raised the probability for a turnaround in activity this summer. The Fed's disregard of its own decision delays the recovery by months.

We still should insist at this stage on an immediate return to the monetary growth proposed in our last recommendation. This implies that the money stock for March 1975 be raised to around \$290 billion or about \$15 billion above the level realized in March 1974. The proposal thus involves a large increase (by about \$8 billion relative to early February) of the money stock to the desired level, an increase distributed over a few weeks. Once on track, the Fed should maintain for the balance of the year a growth rate of about 5.5% to 6% p.a. It is noteworthy that this recommendation is quite compatible with Senator Humphrey's suggestion that the money stock should grow at 8%-10% p.a. over the next six months. The path laid out by the proposal implies a growth rate from early February to August of about 10.8% p.a. The substantial "front-loading" implicit in the recommendation involves in my judgment a necessary correction required by the current trend in economic activity and the recent mistakes in policy.

## II The Central Issue; Monetary Control

The failure of monetary policymaking experienced over the past months dramatizes the relevance of Congressional concern. The Senate Resolution introduced by the Senate Committee on Banking and Currency seems particularly appropriate at this time and deserves our support. The Fed's behavior over the past months exhibits a dangerous inclination to do actually the opposite of what it says it plans to do. Its own behavior thus demonstrates at a critical time that a major institution responsible for our macro-policies has really learned very little since 1930. In a manner reminding observers of discussions in the Fed's policymaking body during the 1930's, Chairman Burns objects (according to newspaper accounts of recent Congressional Hearings) to "releasing the monetary brakes". This objection is essentially addressed to the first paragraph of the Senate Resolution requiring an increase in monetary growth beyond recent (almost) zero growth levels. The Chairman fears apparently that "a release of the brakes" produces later "a monetary explosion" whenever the private sector's credit demand expands again. This justification denies the possibility of monetary control and fails to recognize a Central Bank's opportunities to control monetary growth.

The dangerous misconceptions still guiding Federal Reserve policymaking have been clearly revealed by several statements recently published in the Press. These statements probably reflect more or less indirectly views and briefings made available by Federal Reserve officials and are thus relevant material for our examination. These statements

suggest that monetary control implicitly proposed by the Senate Committee is either impossible or undesirable.

An editorial of the New York Times appearing on February 15, 1975 asserted that the Fed has definitely moved to raise the monetary stimulus applied to a sagging economy. The editorialist also complained that "despite all these efforts" (to expand the money stock) "the money supply has been growing very sluggishly. In the latest three months it actually seems to have declined slightly". The editorial emphasizes in particular that the money stock was "growing too slowly to reverse the real decline in the economy". So far so good, but now we encounter the crucial point: "It is far from obvious, however, that this is the fault of the Federal Reserve". And it is "far from obvious" because banks used base money injected by the System to "improve their liquidity position" and the public (business and households) lowered their demand for credit. Moreover, with interest rates already falling "it would be risky for the Fed to make much greater injections of reserves into the monetary system". Some worsening of "the U.S. balance of payments deficit" is listed among the risks.

Three days later appeared a column in the financial section of the New York Times commenting on the "apparent easing by the Reserve" which has been "seen". It is noted that "the U.S. economy is mired in its deepest recession since World War II. Additional "monetary ease" seems thus in order. But "the Fed remains stymied in its effort...

to foster growth in the money supply". And we also read one day before the editorial in another column of the financial section of the New York Times that the money stock "decreased...during the latest three months, despite Federal Reserve efforts to make it grow faster". And so we are told again after 40 years, "the Fed can't push on a string".

An article by Auerbach, a former official at the Federal Reserve Bank of New York, published in the Sunday Times on February 16 reenforced the general trend of ideas supporting a traditional Federal Reserve position. We read that the Fed "demonstrated since early December, through actions it has taken to ease monetary policy, that it wants to step up the money supply growth rate". The approach according to Auerbach was "essentially to lower short term interest rates". But declining demand for bank credit and lower money demand make it apparently impossible for the Fed to raise the level of monetary growth. And so Auerbach concludes that "not unless interest rates are reduced to virtually zero levels, is it likely that the Fed can succeed in stepping up the expansion of the money supply simply by adding to bank reserves".

The basic pattern of these arguments is quite familiar and has been propagated by the Federal Reserve authorities since the early 1930's. The pattern involves two components: first it is asserted that the Fed has taken actions to raise monetary growth and stimulate the economy; and secondly, the absence of any relevant observations supporting the first assertion must be attributed to obstructions over which the Fed has no control. And so we are told that "one cannot push on a string", or "horses led to the trough may not drink", or one may quote suitable

passages from Shakespeare. Indeed, the slippery behavior of cups of wine, the obstreperous behavior of horses and the low pushing quality of strings seem the best established results of Federal Reserve attempts at research conveyed to a broader public. So we encounter an old game with potentially dangerous consequences for the current environment. The old legend of a well designed policy obstructed by reality was already debunked by Laughlin Currie in his book on the U.S. money supply published in 1934. He showed that the Fed never engaged in any expansive actions during the year 1930. Nothing was achieved because nothing was done.

The patterns shown in the previous section discussing recent trends thoroughly contradict the allusions and allegations made in the New York Times. We note foremost that there is no support for the contention that the Fed actively shifted to foster monetary growth and raise the level of monetary stimulus. Our data show on the contrary that the Fed actively lowered monetary growth over the past three months and substantially contributed to lower the money stock. The money stock accelerated over the late fall when the Fed rapidly expanded Federal Reserve Credit, and monetary growth collapsed at the turn of the year when Federal Reserve Credit declined and the base decelerated from a growth rate of 14.5% p.a. to 1.5% p.a. A reversal in open market operations from net purchases of about \$5 billion in November-December to net sales of \$1 billion is more appropriately described as a "pulling by the hair" than a "pushing on a string". We observe also in this context that the reduction in bank borrowing was actually larger in November-December than in January-February. Moreover,

the contribution made in the latter period by the adjusted reserve ratio was still positive. There is thus no shred of evidence that banks' attempt "to improve their liquidity position" stymied the Fed's expansive actions.

A second order but still important factor in recent monetary growth, the contribution made by the currency ratio, is totally disregarded in the comments under consideration. This factor has nothing to do with any of the arguments advanced. In particular, the sustained increase of the currency ratio did not result from falling demand for credit or money. Somewhere during the 1960's the Fed discovered the existence of a money demand and has used this entity diligently for its purposes. It has argued on frequent occasions that the behavior of the money stock, and so also of monetary growth, simply reflects the movement of credit demand and money demand. Legends and bad analysis die hard and so we repeat once more: Variations in these demands are transformed into corresponding movements of monetary growth under the institution of an interest target policy. This result <sup>is</sup> amplified by the effect on the time deposit ratio of falling market rates of interest induced by weakening credit demand. The time deposit ratio frequently expands under the circumstances and this process was certainly operative in recent months. But the deceleration of the base still exceeded the retardation in the contribution of the time deposit ratio. Moreover, an interest target policy expresses the choice of strategy by the Federal Reserve authorities. The determined adherence to this ancient strategy translated downward pressures on interest rates produced by rapidly weakening demand into a declining Federal Reserve Credit and a decelerating base. With a strategy directed to continue the growth

rate of the base realized in the late fall, the money stock would have continued to grow inspite of receding demand for credit by business. It should be clearly understood that interest rates did not fall because the Fed actively pushed them down. They fell because a receding economy lowered the demand for credit. This description of the relevant circumstances extends to the discount rate. The discount rate followed the market rates and contributed no expansive stimulus. The observation of a persistent decline in bank borrowing at the Fed does not support claims of an "expansive discount policy".

An interest target policy misleads monetary authorities and many spectators into believing that expansive (or restrictive) actions have been initiated when nothing has been done or even worse, when actually restrictive (expansive) measures have been introduced. A decline in interest rates resulting from falling credit demand possesses no expansionary meaning and simply reflects one aspect of the ongoing deflationary process. Its interpretation as an expansive action by the Fed is a dangerous illusion obstructing the useful application of actually expansive policies.

One last point need be emphasized. An accelerated injection of base money raises monetary growth even with falling credit demand. Interest rates will be lowered relatively and generate the required increase in money demand. Banks expand their assets in one way or the other. They can always expand their portfolio of securities in response to large injections of base money. Most importantly, we note that the evidence indicates a clear responsiveness of monetary growth to movements of the base in many different periods and different countries. Even in the depths of the Great Depression the money stock responded with

comparatively little modification by the monetary multiplier to the momentous acceleration in the base from April 1933 onwards, and it also reflected quite rapidly the hard deceleration of the base in 1936/37 initiated by the Fed's policy measures.

Recent observations confirm a general pattern which has been repeatedly observed over many different periods. Changing credit demand operating via variations in interest rates on the time deposit ratio or via the banks borrowing from the Fed and the adjusted reserve ratio, exert in the average over many decades a substantially smaller influence on monetary growth than changes in the base supplemented by a changing currency ratio. The responsibility of the monetary authorities thus remains and should not be obfuscated with irrelevant metaphors and inadequate analysis. The Senate Resolution assumes under the present circumstances a really crucial importance. It offers an opportunity to remove obsolete procedures of policymaking and confronts the Fed squarely with its central responsibility. The relevance of the intended Resolution is also strongly supported by a remarkable development among European Central Banks. The Deutsche Bundesbank, the Banque de France, the Banco de Espana and the Swiss National Bank all accepted the idea of monetary control and moved over the recent past to implement such control over monetary growth. The change in procedures and policy conception has been motivated basically by a determined attempt to cope with inflation and to improve the range of stabilization policies. This European experience offers some useful lessons for our purposes. It demonstrates the feasibility of monetary control under very different arrangements. But it also cautions us that passage of the Senate Resolution will not be sufficient. The divergence between the FOMC's



decision of last December and the subsequent behavior of the Fed indicates the nature of the problem. Effective monetary control requires suitable implementation and appropriate procedures. The current procedures are quite inadequate for the purpose. Monetary control will not function until the desired growth rate over one quarter or two quarters has been translated into a specific volume of net purchases to be executed by the account manager over a shorter run in the near future with appropriate revisions in the magnitude as new information accrues.

Effective monetary control also requires some adaptations of inherited institutions. The nature of these adaptations has been discussed on several occasions. They include radical simplification of reserve requirements or in the manner of computing required reserves. All prohibitions on interest payments on deposits (demand and time) should also be removed. Lastly, there remains the measurement problem. We still hope that the committee constituted by the Fed to study improvements in the measurement of the money stock will arrive at some useful proposals. This attempt has been used unfortunately by Chairman Burns to obfuscate the problem of monetary control by introducing eight distinct measures of the money stock without any indication of relevant analysis or comparative behavior. We suggest that for most serious issues over the past 10 years, or even since the Fed emerged in 1914, all relevant measures of the money stock would have yielded the same information for the policymakers and offered the same answers to major questions.

# QUEST FOR A STABILIZING MONETARY POLICY<sup>1</sup> \*

by  
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## INTRODUCTION

I have long been of the view that the public, through its elected officials in Congress, should have a more active role in monitoring and formulating monetary policy. With the consent of the Committee, I would like to submit for the record an article entitled "Proposal for a Federal Reserve Annual Monetary Plan," written by me on August 29, 1968 and published December, 1968 in a Compendium prepared by the House Committee on Banking and Currency. I argued then, and still believe, that the Federal Reserve should be required to submit to responsible committees of Congress a periodic review of its performance, along with a monetary plan for the future, and that the ensuing discussion freely be made available to the public which will inevitably reap the benefits or costs of said policies. On February 5, 1975, in testimony before the Subcommittee on Domestic Monetary Policy of the House Banking and Currency Committee, I made a similar proposal.

In 1968, as now, monetary policy formulation and execution were enshrouded in well meaning but costly secrecy, in contrast to fiscal policy which was, and is, subjected to intensive public scrutiny

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<sup>1</sup> The views expressed are those of the author and not necessarily those of his employer.

\* Testimony presented on Concurrent Resolution on monetary policy before Senate Committee on Banking, Housing and Urban Affairs, Washington, D.C. February 26, 1975.

and debate. Now is the propitious occasion for amending the serious flaw in monetary policy formulation and execution.

#### RATIONALE

Let me briefly make my case. Many of us believe, based on extensive empirical research, that monetary policy as reflected by growth in the money supply, is the principal or at least a major determinant of changes in national income and gross national product. It therefore follows that rapid monetary growth will induce, with a suitable lag, a rapid growth in expenditures on goods and services. If the rise in spending is in excess of the capacity of the economy to produce goods and services, inflation will ensue. Conversely, severe monetary restraint will precipitate slow growth in spending and recession with all its attendant costs. A proper monetary policy can and should avoid the extremes of serious inflation and recession and contribute to the achievement of stable non-inflationary growth.

What are the facts? In my opinion, since 1965 monetary policy has been excessively stimulative, thereby contributing in a major way to the recent double digit inflation. Also, it has often been highly erratic, thereby causing volatile economic performance in financial markets and national income creation. In recent years the record has worsened rather than improved as knowledge concerning monetary effects increased. For example, in the four years ending last June, annual growth in  $M_1$  averaged nearly 7%, a rate far in excess of the ability of the economy to absorb without experiencing serious inflation. Since mid-year 1974 annual monetary growth has

plummeted to about 1%, a rate which will deepen the recession and impede recovery. In the past two months monetary restraint has been especially severe as  $M_1$  declined at an annual rate of about 5%.

#### THE CONGRESSIONAL RESOLUTION

The proposed Congressional Resolution offers the best hope for returning to a stabilizing monetary policy. I support the view that in the near term action should be taken "to increase the money supply at a rate substantially higher than in recent experience and appropriate to actively promote economic recovery." Otherwise, this recession will be needlessly long and severe. I also support the view that the Federal Reserve should "maintain long-run growth of the money supply commensurate with the economy's long-run potential to increase production, so as to effectively achieve the goals of maximum employment and stable prices." In operational terms, it is my view that in the short run, growth in  $M_1$  should be about 6%, but after recovery is well under way every effort should be made to gradually reduce the secular growth in  $M_1$  to about 3%, a rate consistent with non-inflationary growth. These numbers are meant to be suggestive and should not be incorporated in the resolution.

I also fully endorse the directive that "the Federal Reserve shall consult with Congress at semi-annual hearings before the Committees on Banking about its money supply growth targets and other monetary policy actions required in the upcoming six months."

#### ELABORATION

Let me add three brief points. (1) Not only should monetary growth be moderate but it should also be relatively stable compared

to recent experience. (2) I urge the Congress to explore with the Federal Reserve the linkage between monetary policy target formulation and its execution. In my judgment, major errors in monetary policy execution result from the persistent attempt of the Federal Reserve to estimate the federal funds rate that will yield the desired growth in money rather than from a deliberate attempt to promote volatile monetary expansion. During periods of rapid growth in credit demands as occurred last spring, an attempt by the Federal Reserve to restrain increases in the federal funds rate results in money supply overshoot. Conversely, the recent weakness in private credit demands which placed downward pressure on the federal funds rate resulted in monetary growth shortfall. There is no stable relation between the level of short-term interest rates and monetary growth. In implementing policies, the Federal Reserve can control either short-term interest rates or monetary aggregates, not both. Although the relation between growth in the monetary base, subject to control by Federal Reserve authorities, and the money supply is not perfect, it is much to be preferred. In other words, Federal Reserve authorities should attempt to promote stable and moderate monetary growth by operating directly on the monetary base, not the federal funds rate. (3) Finally, it is my view that monetary policy and execution would be improved if the Federal Reserve released the minutes of the policymaking Open Market Committee immediately after the meeting rather than delaying their publication for ninety days. Under such a scheme, there would be no opportunity for competitive advantage and the practice should contribute to improved performance of capital markets and the financial system.

CONCLUSION

In conclusion, the process of devising a better means for achieving a stabilizing monetary policy should not be a partisan issue. It should be noted that if Congress is to expand its monetary role, it is incumbent on the Banking Committees to exert a beneficial influence. Currently, many analysts fear that large deficits in years immediately ahead will generate enormous pressures to increase the money supply substantially. If that occurs, renewed double digit inflation and accompanying instability in financial markets are inevitable. To avoid this result, the money supply should only grow "commensurate with the economy's long-run potential to increase production." Furthermore, the Federal Reserve must retain sufficient initiative and jurisdiction to enable it to exert an independent influence. Better structured cooperation between the Administration, the Congress and the Federal Reserve should improve coordination between monetary and fiscal policies. The proposed Congressional Resolution probably can be improved over time. Presently it offers the best available hope for achieving a better monetary policy in these uncertain times.

PROPOSAL FOR A FEDERAL RESERVE \*  
ANNUAL MONETARY PLAN

August 29, 1968

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Economic Policy and Government Responsibility

The Employment Act of 1946 charged the Federal Government with the responsibility for the promotion of maximum employment, production, and purchasing power. This Act also created the Council of Economic Advisers and the Joint Economic Committee, new governmental units responsible for administration and review of economic policies. The Joint Economic Committee was to (1) make a continuing study of matters relating to the Economic Report of the President; (2) study means of co-ordinating programs in order to further the policy of the Act; and (3) file an annual report with the Senate and the House.

The language of the Act was sufficiently broad to permit each unit to develop over time in a way that would facilitate the attainment of the Employment Act objectives. The passage of the act implies that an early, and, incidentally, continuing, purpose was the development of a centralized focus of economic information and analysis. The passage and administration of the Act implies the objective of developing and enunciating a co-ordinated program of policies to be taken by the many arms of Government in order to maintain economic stability.

There are many aspects of Government policies which directly or indirectly influence the attainment of the objectives of the Employment Act. However, most of them may be subsumed under the broad categories of monetary and fiscal policies. For purposes of this paper fiscal policies

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\* Published in Compendium on Monetary Policy Guidelines and Federal Reserve Structure, Pursuant to H.R. 11... Subcommittee on Domestic Finance of the Committee on Banking and Currency, House of Representatives, 90th Congress, Second Session, December 1968)

are concerned with the economic impact of Government spending, taxing and debt management decisions. Monetary policies are concerned with the economic impact of Federal Reserve decisions influencing the quantity, cost and availability of money. Current administration of the Employment Act results in an annual presentation of the economic policy plans of the President and their review by various Congressional committees including the Joint Economic Committee, which conducts an annual critical review of the President's Economic Report. This report deals primarily with the fiscal plans of the Administration. No similar monetary plan is presented by the Federal Reserve System and hence no Congressional review is conducted of the plans and administration of monetary policy even though monetary change has a major impact on income, employment and prices. It is the thesis of this paper that the objectives of the Employment Act of 1946 would be more readily achieved if machinery was devised under the broad authority of the Employment Act for the annual presentation by the Federal Reserve System of its monetary plan followed by a critical review by the Joint Economic Committee and other interested Congressional committees.

#### Federal Reserve Responsibility

The original purposes of the Federal Reserve System, as expressed by its founders, were to give the country an elastic currency, to provide facilities for discounting commercial paper, and to improve the supervision of banking. From the beginning, and especially since the Employment Act of 1946, it was recognized that the particular original purposes were in fact parts of a broader objective; namely, "to help counteract inflationary and deflationary movements, and to share in



creating conditions favorable to sustained high employment, stable values, growth of the country, and a rising level of consumption".<sup>1</sup> In other words, it is now generally recognized and agreed that it is the major responsibility of the Federal Reserve System to contribute to the achievement of the Employment Act objectives.

Yet it is also argued that the Federal Reserve should remain independent of the existing Administration. This concept represents a particular application of the practice of applying a system of checks and balances within the U.S. form of government. Independency means that the Federal Reserve System has some autonomy in formulating and executing monetary policy. It does not mean that the need for co-ordination of monetary policy with other economic policies is removed. And, in fact, an informal group of basic economic policy-makers currently maintain close contact with each other and the President. This group includes the Chairman of the Federal Reserve Board, the Secretary of the Treasury, the Director of the Bureau of the Budget, and the Chairman of the Council of Economic Advisers. Although the latter three officials are forced by law to submit their plans for the ensuing year to public scrutiny and possible amendment, such public disclosure is not required of the Chairman of the Federal Reserve System.

Furthermore, there is little evidence that the advice of the Joint Economic Committee is even considered in the formulation of monetary policy. For each of the past two years both the majority and minority reports of the Joint Economic Committee asked for greater

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<sup>1</sup>The Federal Reserve System, Purposes and Functions, Fifth Edition, Chapter 1, page 1.

stability in monetary growth. This advice followed the development of a highly erratic and frequently destabilizing monetary policy and was, in turn, followed by the same policy. For example, following the excellent economic results dating from 1961 to mid-1965 when a fairly stable monetary growth of 3% was maintained, volatility has increasingly become the practice. By mid-1965 the economy had at long last achieved approximate full employment of labor and capital resources. If expansionary economic policies were appropriate for an underemployed economy, as is generally agreed, then less expansionary policies were appropriate for a period characterized by full employment of resources and developing inflationary pressures. Yet beginning mid-1965 the budget shifted to a larger deficit position as the Vietnam war accelerated and monetary growth also accelerated. During the ensuing nine months the money supply grew at a 6% annual rate, double the prior rate of growth. However from the spring of 1965 to the fall of that year, the money supply contracted at a 2% annual rate. Severe monetary restraint, accompanied by ceiling rates on savings institutions, resulted in serious "disintermediation," a collapsing housing market, and a near domestic monetary panic.

Beginning in the fall of 1966 and extending through 1967 the money supply grew at a 6.5% annual rate. In the first instance the move to an easier money policy was undoubtedly for the purpose of cushioning a weakening private economy brought on by the prior tight money policy. But the policy of ease extended well past the point in time when a recession was a reasonable possibility. In fact the rate of monetary growth continues to rise even up to the present time, despite serious inflationary pressures. In the past year the money supply

has increased 6.5%; the rate of growth rose to 7.6% in the past six months and accelerated to 10.8% in the last three months.

Although the Federal Reserve System is very reluctant to specify its guides to actions as well as its policy objectives, it appears fairly clear that the continued policy of excessive ease represented an attempt to prevent a sharp rise in interest rates. If so, the attempt was unsuccessful since interest rates were recently near the highest level since the Civil War. Many believe the present high level of interest rates is in fact due to the very easy money policy existing most of the time since mid-1965. These policies resulted in accelerating inflationary pressures and consequent discounting of inflationary fears in the level of interest rates.

#### Monetary Policy and Economic Performance

The evidence is becoming increasingly clear, as emphasized by the Joint Economic Committee, that volatile monetary growth inevitably results in volatile economic performance. Unfortunately, there are serious and largely unpredictable lags between monetary change and eventual economic change. Therefore, a growing number of observers argue that more stable monetary growth is desirable. Yet currently there is little evidence that the Federal Reserve System shares this objective.

Although in the early post-war period the economics profession generally argued that monetary change was a minor factor influencing economic activity, views have in recent years changed markedly. The prevailing view is now that monetary change is a dominant factor influencing subsequent economic performance. This change in view is probably due to the voluminous research on money compiled by such careful students

as Clark Warburton, Milton Friedman, Anna Schwartz, Karl Brunner, and Allan Meltzer, and most recently Frank de Leeuw and Edward Gramlich who prepared an econometric study under the sponsorship of the Federal Reserve System.

Proposal for an Annual Monetary Plan

The submission of a carefully developed annual monetary plan by the Federal Reserve would offer many potential advantages to the various arms of Government as well as to interested private citizens. Perhaps the fundamental result would be the possibility of estimating the combined monetary-fiscal impact of planned economic policy. The new unified budget makes possible a reasonable estimate of the effect of Government spending plans on the allocation of resources between the public and private sector of the economy. It is not possible to make a useful estimate of the fiscal impact of the budget unless you argue the method of financing is irrelevant, a position that appears indefensible. It is true that a method of financing section of the unified budget does make estimates of the portion of the projected deficit to be financed by changes in cash balances and the portion to be purchased by the public, commercial banks and Federal Reserve banks. It gives little insight into the critical question of whether the deficit will be financed by new money creation or savings. The method of financing will be greatly influenced by monetary policy. Knowing how much Government debt the Federal Reserve plans to purchase will not answer the question since other Federal Reserve actions could readily offset or augment the deficit financing impact. Although the maintenance of Federal Reserve "independence" may well be desirable, there can be no substitute for knowing Federal

Reserve plans for money and credit expansion or contraction if a reasonable estimate of the monetary-fiscal impact of economic policy is to be achieved.

Furthermore, the submission of a monetary plan by the Federal Reserve open to public scrutiny and debate offers some hope of an improved monetary policy. Although much monetary expertise resides within the Federal Reserve System there is little evidence that other Government agencies and private analysts are devoid of appropriate knowledge. The reluctance of the Federal Reserve System to emphasize the importance of more stable monetary growth for the achievement of economic stability suggests, in the light of much evidence assimilated by private economists, that some improvement of Federal Reserve plans might well result from exposure and analysis.

Some private observers argue that the Federal Reserve System has demonstrated a pervasive tendency to react in an ad hoc manner to short-run economic changes. Concentration upon somewhat longer range monetary objectives, at least once a year, might well reduce the erratic and volatile performance of monetary policy. If the above objectives could only partially be achieved it follows that such a monetary plan might well contribute significantly to the attainment of the objectives of the Employment Act.

Undoubtedly, there will be several objections raised to the above proposal. For example, Federal Reserve officials might complain that their independence of action would be severely restricted. Such a result appears unlikely since the Federal Reserve would be solely responsible for presenting their proposed plans. There would, of course,

be the necessity of co-ordinating Federal Reserve plans with other economic policies, but such is desirable under present circumstances. Only through careful co-ordination can desirable overall results be achieved. Although the Federal Reserve System might be induced to modify plans as a result of public exposure and critical analysis, this would be done only if improvement was to be expected.

Some might argue that it would be difficult to specify with precision the variables to be manipulated and controlled. It is certainly true that monetary authorities now disagree as to the best measure of monetary policy change. Preferred measures now include such diverse variables as free reserves, interest rates, bank reserves, the money supply, the money supply plus time deposits, etc. Debate will undoubtedly continue until empirical evidence definitely establishes the best measure or measures. However the plan submitted by the Federal Reserve System could emphasize whatever variable or variables they consider most appropriate. At a minimum, the public would be better informed as to what variables the Federal Reserve believes is most relevant. Outside research might be of aid in perfecting the objectives of policy, if disagreement with stated objectives developed.

It might be argued that since the future cannot be known with certainty it would be impossible to make projections of relevant monetary variables. But the same objections apply to budget projections which must be based on what appears to be the most likely set of future events. Since the future will not be exactly as projected this means that a stabilizing monetary and fiscal policy must be appropriately adjusted. Contingent monetary plans could readily be prepared as must

now be done with the Federal budget. There is no reason for believing that planning for future monetary contingencies would limit flexibility to change as the future unfolds.

#### Means of Implementation

It would appear appropriate for the Federal Reserve to present its monetary plan subsequent to the presentation of the Federal budget and the President's Economic Report. Consequently monetary policy could be formulated to provide the appropriate counter or reinforcing pressures needed to achieve economic stability. If there appeared to be inconsistency in the dual monetary-fiscal plan, Congressional committees, especially the Joint Economic Committee, would have an opportunity to critically evaluate and offer suggested changes. Since it is contemplated that more frequent amendments of the Federal budget will be presented to Congressional committees it might well prove desirable to also request more frequent adjustments of the monetary plan than once a year.

#### Summary and Conclusion

It has been argued that an annual monetary plan presented by the Federal Reserve System would enhance the performance of the U. S. economy and aid in achieving the objectives of the Employment Act. Presently, fiscal plans are submitted to public scrutiny and critical debate. But monetary policy is enshrouded in secrecy and plans are not available for critical debate until well after the event. It is to be hoped that open debate of the above proposal will result in its improvement and subsequent adoption.

February 4, 1975

Economic Research Office

ECONOMIC PROSPECTS THROUGH 1975

By most measures, the current recession is among the most severe since the 1930s. Although there has been a great deal of expectation and speculation about initiating stimulative measures, no such policies have yet been put into effect. Owing to the lags involved between implementing stimulative policies and the impact on business activity, a continued downturn is forecast for the first half of 1975. The unemployment rate is expected to move up to the 8% area during the first quarter and to remain in the 8% - 9% range for the balance of the year.

While business activity in real terms is projected to fall during the first half, the speed of the decline will be less than at year-end. Industrial production, which fell by an estimated 7% between October and January, will decline about 2% - 3% more before the economy hits bottom. Part of the rationale for a slower decline is first, while monetary growth continues to be weak, the increase during the past four months has been greater than during the July to September period. This shift should mean that, at worst, there is no further deterioration in sales and incomes growth and, at best, there could be some modest improvement. Second, the rate of inflation has been reduced significantly at the wholesale level and there are growing signs that consumer price increases are also easing. Slower inflation with no further deterioration in sales and income growth would mean an easing in the pace of the downturn.

Prospects for a recovery in the second half are largely dependent on an immediate shift to more stimulative monetary and fiscal policies. On the fiscal side, the forecast assumes that Representative Ullman's tax policies are approved. This would include a \$6 billion rebate on personal income taxes for 1974 (an impact of \$24 billion at an annual rate in the second quarter). Also, an \$8 billion per year permanent tax cut for individuals is assumed to take place starting in the third quarter. For corporations, tax cuts are assumed to total almost \$4 billion for the entire year with about \$3 billion attributed to an increase in the investment tax credit to 10% and just over \$1/2 billion attributed to applying the lower 22% corporate tax rate on the first \$35,000 of corporate income instead of the current \$25,000 limit:

In the area of energy taxes, the forecast assumes that none of these are approved by Congress and that the President's import duties are repealed. These moves suggest that the Federal budget deficit for calendar 1975 will approach \$65 - \$70 billion.

Monetary policy is assumed to be expansive with a growth of about 7% at an annual rate between the first and fourth quarters. This rate of increase suggests that the Fed resists some of the pressure for excessive stimulus. It also implies that interest rates may reverse their downward trends somewhat earlier than mid-year.



## Inflation

The deepening recession and increased unemployment has resulted in growing signs that inflation is slowing. The last remaining stronghold of inflation is in the prices for services, where price increases remain in the double-digit range. Further pass-through of energy-related price hikes for utilities as well as the labor intensive character of many services suggests that inflation in this area will recede slowly. Nonetheless, substantial downward pressure on commodity prices is likely to bring about a significant reduction in inflation during 1975. By the latter half of the year, price increases are forecast to slow to annual rates of between 5% and 6%.

## Personal Income

Personal income growth has slowed from the 9% - 10% a year range over the past three years to increases of only 2% at an annual rate in the closing months of 1974. Further job losses and moderating wage demands are expected to hold the growth in personal incomes to 3% at an annual rate during the first quarter of this year. After-tax income will get a huge boost in the second quarter, assuming the \$6 billion tax rebate is approved, and the pick-up in personal income in the last half of 1975 combined with a permanent tax cut gives a further lift to incomes. From the first quarter through to the fourth, after-tax income growth averages about 8%, or about 2% - 3% greater than the rate of inflation.

## Consumer Purchases

The prospect of a reversal in real take-home pay is likely to raise consumer confidence and boost sales of durable goods from the depressed levels of the fourth quarter. Furthermore, the price reductions or rebates on new cars will also stimulate sales. In the fourth quarter sales of domestically produced autos averaged 6.1 million units (seasonally-adjusted annual rates). During the first 20 days of January the rate was down to 5½ million units. However, the factors mentioned above are expected to boost sales to between 6.5 and 7.0 million units in the first quarter and an average annual rate of 7.5 to 8.0 million for the remainder of the year.

Purchases of other consumer durables such as furniture and appliances have been extremely weak, in part because of the depressed housing sector. Although the boost in real take-home pay that is forecast to begin in the second quarter will serve to boost consumer durables other than autos to some extent, significant sales increases in this sector are unlikely before the latter half of the year. By that time housing completions should begin to rise and expenditures for all durables will improve.

### Business Fixed Investment

The deepening recession has cut capital spending plans to only 5% above 1974. Even this appears optimistic in the face of a rapid increase in unused capacity. Although a boost in the investment tax credit may serve to increase capital spending by 1976, its effect in the current year is expected to be negligible. Overall, capital spending is forecast to decline moderately over the next four quarters in both real and current dollars.

### Government

Huge budget deficit figures totaling \$87 billion for fiscal 1975 and 1976 were announced by Treasury Secretary Simon, and it is conceivable that Congressional initiatives will push this total even higher. The major positive element on the budget side is that tax cuts, not spending increases are being used to provide the bulk of the fiscal stimulus. Large tax cuts and huge deficits are likely to force Congress to hold spending increases to a modest amount.

### Profits

In spite of the sharp decline in business activity during the fourth quarter, preliminary indications suggest that operating profits (pretax profits and IVA) remained fairly stable. Inventory profits were about \$20 billion lower (annual rate) than in the previous quarter and so reported pretax profits fell by about \$20 billion. The apparent stability in operating profits for the fourth quarter may be a statistical fluke or an aberration. Such profits were expected to decline sharply in the fourth quarter as well as during the first half of 1975 before rebounding later in the year.

Even allowing for a substantial decline in pretax operating profits during the first half, the forecast assumes only a 4.6% decline in 1975 from 1974. (Reported profits show a larger decline because of a much smaller gain in inventory profits than during the previous year). Since the corporate tax liability drops significantly -- the result of lower inventory profits combined with a tax cut -- after-tax operating profits show a significant year-over-year increase.

### Financial Markets

A continued tight monetary policy over the past seven months has depressed business activity. Loan demand, which showed little change in December, is declining in January. The drop in loan demand, combined with attempts by the Fed to increase the money supply has led to a substantial drop in most short-term interest rates during the past month. Commercial paper rates (4 - 6 months) fell from 9% at the end of December to 6½% at the end of January. The prime rate fell from 10¼% to 9% - 9½% during the same period. As loan demand continues to weaken and as the Fed tries more aggressively to stimulate monetary growth, short-term rates should continue to fall with the prime dropping

to around 7%. A turnaround in short-term rates would normally not be expected until business activity began to improve. However, the huge financing needs of the Treasury is likely to provide upward pressure on short-term rates in the second quarter. The extent to which the Fed will attempt to offset this pressure with a sharp increase in monetary growth is a key unknown at this time. The forecast assumes that the short-term interest rates reach a low point in the second quarter and then move slightly higher in the latter half of the year.

Long term rates have shown general declines over the past two months with double A utilities yielding just over 9% at the end of January compared to about 10% in the fourth quarter. These yields are now consistent with an expected future inflation rate of about 6% per year. The deepening recession and the probability of a significant improvement in inflation in 1975 may heighten expectations that long-term inflation could be less than 6%. If this occurs then long-term rates could drop in the months ahead. However, the memory of double-digit price increases and the prospects of inflationary budget deficits are likely to keep the declines in long-term rates from dropping below the 8% - 9% range.

#### Summary

Although economic policies have yet to become stimulative, such a move is imminent. Even so, the lags involved between stimulus and impact suggest that the economy will not bottom out until mid-1975 or the third quarter. Owing to the substantial amount of unutilized capacity now on hand, the economy is capable of a strong recovery in real terms over the next several years.

Robert J. Genetski  
Associate Economist

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Tables attached

E R R A T A: Forecast tables dated January 29, 1975 have several errors pertaining to personal income taxes, disposable income and the saving rate for the third and fourth quarters of 1975. Please ignore those tables and use the attached which are dated January 31, 1975.

ECONOMIC OUTLOOK  
(BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES)

JANUARY 31, 1975

	ACTUAL				FORECAST				ANNUAL 1971	ANNUAL 1972	ANNUAL 1973	ANNUAL 1974	ANNUAL 1975
	74:1	74:2	74:3	74:4	75:1	75:2	75:3	75:4					
GROSS NATL PRODUCT	1358.8	1383.8	1416.3	1428.0	1436.0	1453.0	1481.5	1514.1	1054.9	1158.0	1294.9	1396.7	1471.2
%CH	4.5	7.6	9.7	3.3	2.3	4.8	8.1	9.1	8.0	9.9	11.8	7.9	5.3
CONSTANT DOLLAR GNP	830.5	827.1	823.1	803.7	792.1	789.2	793.5	801.1	746.3	792.5	839.2	821.1	794.0
%CH	-7.0	-1.6	-1.9	-9.1	-5.7	-1.4	2.2	3.9	3.3	6.2	5.9	-2.2	-3.3
PRICE DEFLATOR	1.6361	1.6731	1.7207	1.7768	1.8130	1.8410	1.8670	1.8900	1.4133	1.4610	1.5429	1.7017	1.8528
%CH	12.3	9.4	11.9	13.7	8.4	6.3	5.8	5.0	4.5	3.4	5.6	10.3	8.9
CONSUMPTION EXPENDITURES	840.7	869.1	901.3	896.8	912.5	932.5	950.5	968.6	667.1	729.0	805.2	877.0	941.0
%CH	8.5	14.2	15.7	-2.0	7.2	9.1	7.9	7.8	8.0	9.3	10.4	8.9	7.3
DURABLES	123.9	129.5	136.1	121.5	124.0	128.5	132.5	136.0	103.9	118.5	130.3	127.7	130.2
%CH	-1.3	19.3	22.0	-36.5	8.5	15.3	13.0	11.0	13.8	14.0	10.0	-2.0	2.0
NONDURABLES	364.4	375.8	389.0	391.5	397.0	406.0	413.0	420.6	278.4	299.7	338.0	380.2	409.2
%CH	14.7	13.1	14.8	2.6	5.7	9.4	7.1	7.6	5.6	7.6	12.8	12.5	7.6
SERVICES	352.4	363.8	376.2	383.8	391.5	398.0	405.0	412.0	284.8	310.9	336.9	369.1	401.6
%CH	5.9	13.6	14.3	8.3	8.3	6.8	7.2	7.1	8.5	9.2	8.4	9.5	8.8
INVESTMENT EXPENDITURES	210.5	211.7	205.8	207.6	196.0	186.5	191.5	198.0	153.7	179.4	209.3	208.9	193.0
%CH	-22.6	2.3	-10.7	3.5	-20.5	-18.0	11.2	14.3	12.8	16.7	16.7	-0.2	-7.6
NONRES FIXED EXPEND	145.2	149.4	150.9	152.7	151.0	149.5	148.0	148.0	104.6	116.8	136.7	149.6	149.1
%CH	9.6	12.1	4.1	4.9	-4.4	-3.9	-4.0	0.0	4.0	11.7	17.1	9.4	-0.3
PRODUCERS DUR EQUIP	93.9	97.2	99.9	98.4	99.0	98.0	97.0	97.0	66.7	75.7	89.7	97.4	97.7
%CH	5.7	14.8	11.6	-5.9	2.5	-4.0	-4.0	0.0	3.5	13.6	18.6	8.5	0.4
BUSINESS STRUCTURES	51.3	52.2	51.0	54.3	52.0	51.5	51.0	51.0	37.9	41.1	47.0	52.2	51.4
%CH	17.2	7.2	-8.9	28.5	-15.9	-3.8	-3.8	0.0	4.9	8.4	14.3	11.1	-1.6
RESIDENTIAL STRUCTURES	48.4	48.8	46.2	40.5	35.0	34.0	38.0	45.0	42.9	54.0	57.2	46.0	38.0
%CH	-33.5	3.3	-19.7	-40.9	-44.2	-10.9	56.0	96.7	37.3	26.0	6.0	-19.7	-17.3
INVENTORY CHANGE	16.9	13.5	8.7	14.4	10.0	3.0	5.5	5.0	6.3	8.6	15.4	13.4	5.9
NET EXPORTS	11.3	-1.5	-3.1	1.2	0.0	0.0	0.0	0.0	-0.1	-6.0	3.9	2.0	0.0
GOVT PURCHASES	296.3	304.4	312.3	322.4	327.5	334.0	340.0	347.5	234.3	255.7	276.4	308.8	337.2
%CH	14.7	11.4	10.8	13.6	6.5	8.2	7.4	9.1	6.7	9.1	8.1	11.8	9.2
FEDERAL	111.5	114.3	117.2	122.8	123.0	124.5	126.0	129.0	97.7	104.9	106.6	116.5	125.6
%CH	11.9	10.4	10.5	20.5	0.7	5.0	4.9	9.9	1.5	7.3	1.6	9.3	7.9
MILITARY	75.8	76.6	78.4	83.5	83.0	83.5	84.0	86.0	71.2	74.8	74.4	78.6	84.1
OTHER	35.7	37.7	38.8	39.3	40.0	41.0	42.0	43.0	26.5	30.1	32.2	37.9	41.5
STATE & LOCAL	184.8	190.1	195.1	199.6	204.5	209.5	214.0	218.5	136.6	150.8	169.8	192.4	211.6
%CH	16.4	12.0	10.9	9.6	10.2	10.1	8.9	8.7	10.8	10.4	12.6	13.3	10.0

NOTE: PERCENTAGE CHANGES AT ANNUAL RATES; PRELIMINARY DATA FOR 74:4

	ACTUAL				FORECAST				ANNUAL 1971	ANNUAL 1972	ANNUAL 1973	ANNUAL 1974	ANNUAL 1975
	74:1	74:2	74:3	74:4	75:1	75:2	75:3	75:4					
PRETAX PROFITS* & IVA %CH	107.7 5.0	105.6 -7.6	105.8 0.8	105.9 0.4	98.5 -25.2	98.0 -2.0	102.0 17.4	107.0 21.1	78.7 13.7	92.2 17.2	105.1 14.0	106.2 1.1	101.4 -4.6
INV VAL ADJ (IVA)	-27.7	-33.4	-51.2	-29.8	-20.0	-10.0	-12.0	-12.0	-4.9	-7.0	-17.6	-35.5	-13.5
PRETAX PROFITS* %CH	135.4 48.3	139.0 11.1	157.0 62.8	135.7 -44.2	118.5 -41.8	108.0 -31.0	114.0 24.1	119.0 16.7	83.7 12.9	99.2 18.6	122.7 23.7	141.8 15.6	114.9 -19.0
TAX LIABILITY %CH	52.2 23.7	55.9 31.5	62.7 58.3	53.9 -45.5	42.9 -59.8	39.1 -31.0	41.3 24.1	43.1 18.7	37.5 7.8	41.6 10.7	49.8 19.9	56.2 12.8	41.6 -26.0
AFTER TAX PROFITS* %CH	83.2 66.9	83.1 -0.5	94.3 65.8	81.8 -43.3	75.6 -27.1	68.9 -31.0	72.7 24.1	75.9 18.7	46.1 17.5	57.6 25.1	72.9 26.5	85.6 17.4	73.3 -14.4
PERSONAL INCOME %CH	1112.5 4.9	1134.6 8.2	1168.2 12.4	1186.4 6.4	1195.0 2.9	1209.0 4.8	1232.0 7.8	1258.0 8.7	864.1 6.9	944.9 9.4	1055.0 11.7	1150.4 9.0	1223.5 6.4
TAX & NONTAX PAYMENT %CH	161.9 5.1	168.2 16.5	175.1 17.4	177.8 6.3	179.3 3.4	157.7 -40.1	177.8 61.5	-182.1 10.0	117.6 0.9	142.4 21.1	151.3 6.3	170.7 12.8	174.2 2.1
DISPOSABLE INCOME %CH	950.6 4.9	966.5 6.9	993.1 11.5	1008.7 6.4	1015.7 2.8	1051.3 14.8	1054.2 1.1	1075.9 8.5	746.5 7.9	802.5 7.5	903.7 12.6	979.7 8.4	1049.3 7.1
PERSONAL OUTLAYS %CH	866.3 7.9	894.9 13.9	927.5 15.4	923.2 -1.8	939.5 7.3	959.9 9.0	978.3 7.9	996.9 7.8	685.9 7.9	749.9 9.3	829.3 10.6	903.0 8.9	968.6 7.3
PERSONAL SAVINGS %CH	84.3 -20.9	71.6 -48.0	65.6 -29.5	85.5 188.6	76.2 -36.9	91.4 106.6	75.9 -52.5	79.0 17.3	60.5 7.6	52.6 -13.1	74.4 41.6	76.7 3.1	80.6 5.1
SAVING RATE(%)	8.9	7.4	6.6	8.5	7.5	8.7	7.2	7.3	8.1	6.5	8.2	7.8	7.7
EMPLOYMENT %CH	85.826 0.8	85.970 0.7	86.346 1.8	85.804 -2.5	84.500 -5.9	84.200 -1.4	84.200 0.0	84.500 1.4	79.097 0.6	81.699 3.3	84.432 3.3	85.986 1.8	84.350 -1.9
LABOR FORCE %CH	90.532 2.9	90.637 0.5	91.359 3.2	91.812 2.0	91.700 -0.5	91.700 0.0	91.900 0.9	92.200 1.3	84.093 1.6	86.535 2.9	88.735 2.5	91.085 2.6	91.875 0.9
UNEMPLOYMENT RATE(%)	5.2	5.1	5.5	6.5	7.9	8.2	8.4	8.4	5.9	5.6	4.9	5.6	8.2
PRODUCTIVITY* %CH	9.677 -7.7	9.621 -2.3	9.533 -3.6	9.367 -6.8	9.373 0.3	9.373 -0.0	9.424 2.2	9.481 2.4	9.435 2.7	9.699 2.8	9.940 2.5	9.549 -3.9	9.413 -1.4
INDUSTRIAL PRODUCTION %CH	1.249 -6.5	1.255 1.8	1.254 -0.1	1.216 -11.7	1.150 -20.0	1.140 -3.4	1.150 3.6	1.165 5.3	1.067 0.0	1.151 7.9	1.254 9.0	1.243 -0.8	1.151 -7.4
MONEY SUPPLY %CH	273.1 5.9	278.0 7.4	280.5 3.7	282.9 3.5	265.0 3.0	290.0 7.2	295.0 7.1	300.0 7.0	230.7 7.0	245.6 6.4	263.8 7.4	278.6 5.6	292.5 5.0
INCOME VELOCITY OF MONEY %CH	4.976 -1.4	4.978 0.2	5.049 5.8	5.047 -0.2	5.039 -0.7	5.010 -2.2	5.022 0.9	5.047 2.0	4.572 0.9	4.715 3.1	4.909 4.1	5.013 2.1	5.029 0.3

\*NOTE: PROFIT % FOR 74:4 ARE ESTIMATES; PRODUCTIVITY IS CALCULATED CONSTANT DOLLAR GNP PER WORKER

	ACTUAL				FORECAST			
	74: 1	74: 2	74: 3	74: 4	75: 1	75: 2	75: 3	75: 4
GROSS NATL PRODUCT	1359.	1384.	1416.	1428.	1436.	1453.	1482.	1514.
%CHYA	8.8	8.3	8.2	6.3	5.7	5.0	4.6	6.0
CONSTANT DOLLAR GNP	830.5	827.1	823.1	803.7	792.1	789.2	793.5	801.1
%CHYA	-0.3	-1.2	-2.1	-5.0	-4.6	-4.6	-3.6	-0.3
PRICE DEFLATOR	1.636	1.673	1.721	1.777	1.813	1.841	1.867	1.890
%CHYA	9.1	9.6	10.5	11.8	10.8	10.0	8.5	6.4
CONSUMPTION EXPENDITURES	840.7	869.1	901.3	896.8	912.5	932.5	950.5	968.6
%CHYA	7.6	8.8	10.4	8.9	8.5	7.3	5.5	8.0
DURABLES	123.9	129.5	136.1	121.5	124.0	128.5	132.5	136.0
%CHYA	-6.4	-2.0	2.8	-2.3	0.1	-0.8	-2.6	11.9
NONDURABLES	364.4	375.8	389.0	391.5	397.0	406.0	413.0	420.6
%CHYA	12.7	13.0	13.1	11.2	8.9	8.0	6.2	7.4
SERVICES	352.4	363.8	376.2	383.8	391.5	398.0	405.0	412.0
%CHYA	8.1	8.9	10.6	10.5	11.1	9.4	7.7	7.3
INVESTMENT EXPENDITURES	210.5	211.7	205.8	207.6	196.0	186.5	191.5	198.0
%CHYA	5.8	3.3	-1.5	-7.5	-6.9	-11.9	-6.9	-4.6
NONRES FIXED EXPEND	145.2	149.4	150.9	152.7	151.0	149.5	148.0	148.0
%CHYA	11.3	10.2	8.6	7.6	4.0	0.1	-1.9	-3.1
PRODUCERS DUR EQUIP	93.9	97.2	99.9	98.4	99.0	98.0	97.0	97.0
%CHYA	9.3	8.7	9.7	6.3	5.4	0.8	-2.9	-1.4
BUSINESS STRUCTURES	51.3	52.2	51.0	54.3	52.0	51.5	51.0	51.0
%CHYA	15.0	13.0	6.5	10.1	1.4	-1.3	0.0	-6.1
RESIDENTIAL STRUCTURES	48.4	48.8	46.2	40.5	35.0	34.0	38.0	45.0
%CHYA	-17.3	-16.9	-20.5	-24.4	-27.7	-30.3	-17.7	11.1
INVENTORY CHANGE	16.9	13.5	8.7	14.4	10.0	3.0	5.5	5.0
NET EXPORTS	11.3	-1.5	-3.1	1.2	0.0	0.0	0.0	0.0
GOVT PURCHASES	296.3	304.4	312.3	322.4	327.5	334.0	340.0	347.5
%CHYA	10.1	11.4	12.8	12.6	10.5	9.7	8.9	7.8
FEDERAL	111.5	114.3	117.2	122.8	123.0	124.5	126.0	129.0
%CHYA	4.8	7.6	11.3	13.3	10.3	8.9	7.5	5.0
MILITARY	75.8	76.6	78.4	83.5	83.0	83.5	84.0	86.0
OTHER	35.7	37.7	38.8	39.3	40.0	41.0	42.0	43.0
STATE & LOCAL	184.8	190.1	195.1	199.6	204.5	209.5	214.0	218.5
%CHYA	13.7	13.8	13.7	12.2	10.7	10.2	9.7	9.5

PERCENT CHANGES FROM PREVIOUS YEAR

	ACTUAL				FORECAST			
	74: 1	74: 2	74: 3	74: 4	75: 1	75: 2	75: 3	75: 4
PRETAX PROFITS* & IVA %CHYA	107.7 3.7	105.6 0.6	105.8 0.6	105.9 -0.5	98.5 -8.5	98.0 -7.2	102.0 -3.6	107.0 1.0
INV VAL ADJ (IVA)	-27.7	-33.4	-51.2	-29.8	-20.0	-10.0	-12.0	-12.0
PRETAX PROFITS* %CHYA	135.4 12.5	139.0 11.3	157.0 28.0	135.7 10.6	118.5 -12.5	108.0 -22.3	114.0 -27.4	119.0 -12.3
TAX LIABILITY %CHYA	52.2 6.7	55.9 9.8	62.7 25.7	53.9 8.8	42.9 -17.8	39.1 -30.1	41.3 -34.2	43.1 -20.0
AFTER TAX PROFITS* %CHYA	83.2 16.4	83.1 12.3	94.3 29.4	81.8 11.8	75.6 -9.1	68.9 -17.1	72.7 -22.9	75.9 -7.2
PERSONAL INCOME %CHYA	1113. 9.8	1135. 9.2	1168. 9.4	1186. 7.9	1195. 7.4	1209. 6.6	1232. 5.5	1258. 6.0
TAX & NONTAX PAYMENT %CHYA	161.9 12.4	168.2 14.3	175.1 13.6	177.8 11.2	179.3 10.8	157.7 -6.2	177.8 1.5	182.1 2.4
DISPOSABLE INCOME %CHYA	950.6 9.3	966.5 8.3	993.1 8.7	1009. 7.4	1016. 6.8	1051. 8.8	1054. 6.2	1076. 6.6
PERSONAL OUTLAYS %CHYA	866.3 7.7	894.9 8.8	927.5 10.3	923.2 8.6	939.5 8.4	959.9 7.3	978.3 5.5	996.9 8.0
PERSONAL SAVINGS %CHYA	84.3 28.9	71.6 2.9	65.6 -10.5	85.5 -4.4	76.2 -9.6	91.4 27.6	75.9 15.7	79.0 -7.6
SAVING RATE(%)	8.9	7.4	6.6	8.5	7.5	8.7	7.2	7.3
EMPLOYMENT %CHYA	85.83 3.1	85.97 2.2	86.35 1.9	85.80 0.2	84.50 -1.5	84.20 -2.1	84.20 -2.5	84.50 -1.5
LABOR FORCE %CHYA	90.53 3.3	90.64 2.5	91.36 2.7	91.81 2.1	91.70 1.3	91.70 1.2	91.90 0.6	92.20 0.4
UNEMPLOYMENT RATE(%)	5.2	5.1	5.5	6.5	7.9	8.2	8.4	8.4
PRODUCTIVITY* %CHYA	9.677 -3.3	9.621 -3.4	9.533 -3.9	9.367 -5.1	9.373 -3.1	9.373 -2.6	9.424 -1.1	9.481 1.2
INDUSTRIAL PRODUCTION %CHYA	1.249 1.5	1.255 0.5	1.254 -1.0	1.216 -4.3	1.150 -7.9	1.140 -9.1	1.150 -8.3	1.165 -4.2
MONEY SUPPLY %CHYA	273.1 6.0	278.0 6.0	280.5 5.5	282.9 5.1	285.0 4.4	290.0 4.3	295.0 5.2	300.0 6.0
INCOME VELOCITY OF MONEY %CHYA	4.976 2.6	4.978 2.2	5.049 2.6	5.047 1.1	5.039 1.3	5.010 0.6	5.022 -0.5	5.047 -0.0

PERCENT CHANGES FROM PREVIOUS YEAR

\*NOTE: PROFITS FOR 74:4 ARE ESTIMATES; PRODUCTIVITY IS CALCULATED AS CONSTANT DOLLAR GNP PER WORKER

REVISED  
THE REAL OIL CRISIS: /BRIEFING PAPER BY WILSON  
E. SCHMIDT FOR THE SHADOW OPEN MARKET COMMITTEE  
MEETING OF MARCH 7, 1975\*

I. Introduction

There is an oil crisis. Governments are beginning to implement solutions and propose policy changes to solve the oil crisis, a 1-1/2 year old change in the relative price of oil.

These solutions, included in the energy plan and in the continued deform of the international system, are virtually certain to reduce our economic well being. That is the real oil crisis.

II. Is It A Crisis?

There is a great deal of additional evidence in the last few months, as we contended in our earlier meetings, that the international oil problem is not nearly so severe nor dangerous as the early alarms and rhetoric forecast.

A. Cutting Down the Size of the Problem.

Over the year, the estimates of how much the oil producing countries might accumulate by various dates has been substantially reduced.

In July, 1974 the World Bank staff estimated OPEC accumulations at \$653 billion by 1980 and \$1206 billion by 1985. As they were expressed in current dollars, not 1974 dollars, the figures were not entirely clear to the public. The \$653 estimate in 1974 dollars would, for example,

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decline to about \$400 billion. Subsequently, the Vice President of the World Bank, Hollis Chenery, has estimated the 1980 figures at \$300 million. A high official of the U. S. Treasury,<sup>Dr.</sup> Thomas Willett, puts the peak figure at between \$200 and \$300 and leans toward the lower end. Morgan Guaranty Trust estimates the total OPEC accumulations at \$179 in 1980. Finally, Ed Fried in a recent Brookings Institution study drops the figure (in 1973 dollars) to around \$136 billion. In short, the financial problem, though still substantial, seems to be smaller.

#### B. Effects on the United States of America.

The current discussion of the oil problem center on the effects of rising oil prices on the level of employment, output, and prices in the United States.

##### 1. Aggregate Demand.

For example, the Secretary of State, Dr. Henry Kissinger, has stated that the embargo and price increase in 1973 cost us one-half a million jobs, one percent of our national output, added five percentage points to the price index, and set the stage for a serious recession. The 1975 Council of Economic Advisers report explains that oil imports transfer purchasing power to foreigners and thus reduce the demand for domestic goods. The Democrats are seriously concerned about the effect of the President's program on unemployment and on inflation and have proposed an alternative which they believe to be superior. A group of experts, including such notables as Robert Roosa and Armin Gutowski, have emphasized in the January issue of Foreign Affairs the deflationary impact of the oil payments. Long before the recession was acknowledged, in January, 1974, Hobart Rowen of The Washington Post showed how the increase

in the price of oil imports was like a tax on Americans, deflating demand. Fortunately, this reasoning is wrong.

/The reason is that nothing that the OPEC countries did to us had any impact on the stock of money in the United States. Since the changes in the stock of money have been the controlling factor in changing employment, output, and prices in this country for years, most of the concern is misleading in the sense of directing our attention from the real reasons for our problems, our own monetary policies.

The reason why the OPEC has had no effect on our stock of money is that we are floating in terms of most foreign currencies. In the simplest terms, the monetarist position has been that the monetary base (chiefly Federal reserve credit, currency, and gold) ~~determine the monetary base, and that the monetary base~~ determines the stock of money. Since August 15, 1971, the dollar has been inconvertible into gold. As a consequence, foreigners could not take any of our monetary base away from us. Therefore, they could <sup>not</sup> affect our money stock. (We chose to increase it by up valuing our gold, but this was slight.)

Putting it another way, with floating rates, the amount of dollars that go out of the country must exactly equal the number of dollars that come into the country. Changes in exchange rates equate the supply and demand for dollars on the foreign exchange market. To be sure foreign central banks still buy and sell some of our dollars, but these are voluntary transactions. Whatever dollars they buy, they have to leave here because of August 15, 1971. Whatever dollars they sell, the buyer has to leave here.

The common error is to assume the Keynesian, fiscalist, exportist, or perhaps, more correctly, mercantilist position that it is the net level of exports of good and services, after deducting imports of

of goods and services, which determines of the foreign level of aggregate nominal demand in the United States. On that measure, OPEC was a disaster for us. The value of our net petroleum imports rose from \$7.5 billion in 1973 to \$25.1 billion in 1974, taking \$17.6 billion additional income out of the country, roughly 17% of the actual increment in nominal GNP between 1973 and 1974. Since we float, the money had to come back.

We have been roundly criticized abroad for letting interest rates fall at home, causing capital outflows abroad which caused the dollar to depreciate. This underscores the point that the floating rate permits us to adopt whatever monetary policy we want, when we want it without regard to the state of the balance payments or the exchange rate. It gives us the freedom to determine our own level of employment, prices, and output.

This is not to say that the OPEC has had no effect whatsoever. By changing relative prices, OPEC changed the willingness of Americans to buy certain kinds of cars. But it also caused the price of substitutes for oil to rise so that we produced more coal than before, excluding the effects of the strike. These are the kinds of shifts that go on in any enterprise economy where relative prices are permitted to change.

## 2. Real Income.

The key effect of the OPEC action has been on the productivity of the American economy through the four-fold increase in the price of oil since October 1973. It has worsened our terms of trade, or the ratio of our export to import prices. A given volume of our exports buys a smaller amount of imports than before. Between the third quarter of 1973 (just before the oil price hike) and the third quarter of 1974, our terms of trade worsened 17%. Since our exports of goods and services in 1974 ran

almost exactly 10% of our Gross National Product, we suffered a 1.7% decline in our real income through our international transactions. Depending upon what one wishes to assume is our long-term, steady state rate of growth, say 4%, this is only 5.1 months loss of real income.

It is important to note that this is a one-time loss of real income. It is wrong to say, as did the January Foreign Affairs group of experts, that "... the full impact of continuing the present prices of oil deliveries would be in effect to take, in gross payments from the consuming countries as a group, the greater part of any real growth in their per capita gross national product over the remainder of the seventies." It is not the gross out payments that count. They come back in a floating world. It is the change in the terms of trade that count and these obviously are much smaller.

### 3. The Balance of Payments.

The balance of payments problem of oil has preoccupied many. Dr. Kissinger recently said, "Unless we pool our risks and fortify the international financial system, balance of payments crises will leave all economies exposed to financial disruption." Not so, Mr. Secretary. Most of the world is floating.

Before August 15, 1971, a U. S. balance of payments deficit was a serious matter. Before that date, we had to pay out gold and other primary reserve assets to any foreign government which wished to exchange any of its surplus holdings of dollars for gold or such assets. That always meant that foreign exchange could become infinitely expensive to us if our government chose to impose exchange controls which prohibited the purchase of foreign exchange for certain types of uses, e.g. luxury

imports, etc.

Under a floating rate system, there is no chance that foreign exchange can become infinitely expensive. There always will be some supply at some price.

#### 4. The Deficits.

Under the old system, it was terribly important for the U. S. Government to publish deficits in the balance of payments to warn our government of impending shortages of foreign exchange. Perhaps the most significant was the official transactions balance which sought to measure how many surplus dollars central banks bought up to keep the dollar steady in terms of their currencies, dollars they might use to purchase our gold. Another was the net liquidity deficit which, roughly speaking, showed how fast our net liquid liabilities to official and private holders abroad were rising, liabilities which could drain our gold away. And there was the basic balance, combining the flows of exports and imports of goods and services with long-term capital movements, which was supposed to show the long-term trends in our balance of payments. (It, of course, did not really show the long-term trend because there was no satisfactory way to measure the effect of the cyclical state of our markets abroad and at home on the trade balance.) None of these balances make sense in a floating world. The Department of Commerce should drop them along with the net exports of goods and services discussed earlier. They are misleading. In 1974 we ran a deficit on official settlements of about \$8 billion. A very large part -- the figures are not available to permit an estimate -- were undoubtedly purchases of dollars by OPEC countries who made them not to support the dollar but because the dollar assets purchased looked to them

to be good investments.

The exchange rate change does give us a better measure, a quicker measure of the pushes and pulls on the value of the dollar. Since the start of the oil crisis, the effective rate for the dollar has appreciated about 2% through February 14 of this year. From October 1973 through January 1974 the effective average exchange rate for the dollar rose sharply (9.6%), then it fell by 8.7% through May, then it rose by 6.8% through September, and finally fell by 4.3% through February 14.

Because of the oft-repeated complaints that fluctuating rates fluctuate too much, it is worth noting that these fluctuations are almost within the new ranges agreed among countries on December 18, 1971. The rules established then allowed a peso to range from 2.25% above to 2.25% below its par value in terms of the dollar for a total movement measured against the dollar of 4.5%. But, this meant that the peso could move by 9% against sterling. For example, suppose sterling was selling at 2.25% below its par against the dollar while the peso was selling at 2.25% above its par against the dollar. Then suppose that the peso and sterling moved to their other limits. The peso would be selling at 2.25% below its par against the dollar while the pound would be selling at 2.25% above the dollar. The total shift in the exchange rate between sterling and pesos would be 9%.

As for the effect of the oil crisis on the U. S. balance of payments and thus on the dollar, it is very difficult to estimate inasmuch as key data for the fourth quarter are not yet available. My best guess is that the oil crisis washed over the year, as I said it would in our meetings of March 8 and September 6, 1974. We do know from the Department

of Commerce that our trade deficit in oil rose by \$17.4 billion. Against that we know that petroleum producers increased their liquid investments here in 1974 by \$10.2 billion. We also know that through the first nine months of 1974, investment income from the petroleum industry rose by an annual rate of \$3.1 billion. Furthermore, we know that U. S. merchandise exports to petroleum producers rose in 1974 by \$3.5 billion, excluding special category exports. On the other hand, net petroleum direct investment (net of petroleum producers here) rose for the first nine months at an annual rate of about \$3.1 billion. The "hard figures" thus suggest a net loss of \$3.7 billion on petroleum account.

Against this, however, is the fact that the biggest share of the OPEC money (\$21 billion) earned in 1974 went into the Euro-currency market. A great deal of that money must have gone to American banks overseas, which then meant that transfers to American banks at home of these OPEC funds had to be made. I understand that many, if not all, of the majors have not paid for their so-called participation oil which reflects the degree of nationalization which has been undertaken so far; on the other hand, I do not believe that any of the majors have received any payments in 1974 for compensation for nationalization. These nationalization deals are supposed to be completed in 1975. So I would guess it was a wash. But that is only a guess.

In respect to the balance of payments adjustment process between the petroleum producers and the consuming nations, there has been a recent change that may be of considerable significance. Iran decided to peg its currency, the rial, on the SDR instead of to the dollar. The significance of this for the adjustment process is that when the dollar

depreciates vis-a-vis the German mark, assuming no other changes, the rial will appreciate vis-a-vis the dollar in an amount equal to 40% of our depreciation vis-a-vis the mark. Adjustments could occur as frequently as every five days. If the Iranians do not simultaneously adjust the dollar price of their oil, our balance of payments with them will tend to improve. If other OPEC countries do the same, and the Kuwaiti's have proposed for general discussion something that sounds a bit like the same idea, the change may be of considerable importance.

### C. Effect on the Developed World.

Looking at the developed world as a whole, has there been a crisis?

First, since September, 1973, the international reserves of the oil producers for which we have data rose by \$11.4 billion to \$47.4 billion towards the end of 1974, that is it rose by \$36 billion. At the same time total world international reserves rose by \$60 billion. In short, more than enough reserves were created in 1974 to meet the reserves demanded by the oil producers. The rest of the world, as a group, gave up no international reserves to pay for the high priced oil. While the 39% annual rate of increase in world reserves portends serious inflationary pressures in the future, it does mean that the recent change in relative prices, called the oil crisis, did not force general deflationary action because of balance of payments problems. And talk, by the Council of Economic Advisers, of pressures on world capital markets seems unwarranted.

Second, despite the four-fold increase in the price of oil since October 1973, the terms of trade, or the ratio of export prices received to import prices paid, of the developed world declined by only 13% between the third quarters of 1973 and 1974. This is tantamount to a decline in



the productivity of the developed world because a given volume of exports from a rich country now buys a smaller amount of goods from the rest of the world. As exports of goods constitute about 11% of the GNP of the developed world, the net effect of the decline in the terms of trade was the equivalent of a 1.4% loss in real output and income. This is equal to four months real growth in GNP on average between 1968 and 1972.

Third, the private banking system handled the problem of recycling the oil producers reserve gains to the oil consuming nations with considerable dispatch and ease. For the United States, we know that our liquid liabilities to petroleum producers rose \$10.2 billion in 1974; through October 1974 alone, liquid claims on foreigners by U. S. banks rose by \$15.1 billion. The Germany deposit banks increased their foreign assets by \$8.2 billion in 1974.

Fourth, the rate of increase of imports by the OPEC producers has been much higher than probably anticipated by many of the gloom and doom purveyors of a year ago. There are droves of merchants in OPEC land. The German Federal Railways has complained of a breakdown in its system because of the mass/Middle East producers with petrodollars in their pockets. Data from the International Monetary Fund display an import explosion. Here are the increments in the imports of the oil exporters: 1970 to 1971, \$1.9 billion; 1971 to 1972, \$2.5 billion; 1972 to 1973, \$5.8 billion; third quarter 1973 to third quarter 1974, \$13.3 billion. While world imports grew from 1970 to 1974 by 166%, oil producers imports grew by 228%, most of it, obviously, in the last year.

Fifth, the country seemingly most heavily hit by the oil price

hike, namely Italy, appears to have weathered the storm and is returning to better health which, of course, was never too good.

Sixth, the OPEC countries seemed to be spreading their investments in a fairly diversified way across a large number of countries and markets rather than concentrating them, as originally feared, in the United States which would cause major exchange rate shifts. Secretary Simon reported his estimates for 1974: 35% to the Euro currency market; 18.5% to the U. S.; 12-1/2% to the U. K.; 9% to official or quasi official institutions in developed countries other than the U. S. or the U. K.; 6% to the international financial institutions such as the World Bank and the International Monetary Fund; 4% to the LDC's; 15%, unknown. Not surprisingly, the OPEC countries are discriminating against Jewish investment bankers in the placement of their surplus funds, though this has been denied. Like any other kind of discrimination, this undoubtedly costs the discriminator, reducing the net interest income of the OPEC countries.

Seventh, as noted before, Iran has shifted to fixing its currency in terms of the SDR. This may help meet one of the central problems identified by those who worry about the financial aspects of the change in oil's relative price. It is now well understood that the OPEC countries have no choice but to return their earnings to the rest of the world, importing, making short, medium, and long-term investments, or providing aid. (There are no banks on the moon.) But many analysts have been concerned that the OPEC countries might not return their excess earnings to each individual country in proportion to that country's extra import bill for oil. Hence, while recycling is no problem for the world as a whole, there could be a problem of reshuffling OPEC funds among countries. Iran's shift

to SDR fixing helps meet this problem. If the German mark appreciates because, for example, it gets too much OPEC money, while the dollar depreciates because it gets too little, the rial will appreciate in terms of the dollar and depreciate in terms of the mark, helping to shift trade patterns and perhaps investments in directions which assist in the reshuffling process. This point is not especially important since the reshuffling problem could be handled by interest rate shifts between the capital-short, capital-long countries. But nonetheless it helps.

### III. The Real Oil Crisis

Despite the extraordinary performance of the market over the last year in handling the major transfers of purchasing power resulting from the rise in the price of oil, there is real danger that the oil problem will become a true crisis. The reason is that governments are beginning to seek "solutions" for the problem; in implementing them, governments may well make things worse.

The clearest evidence for this is that in January 1975, the members of the International Monetary Fund refused to renew the pledge made in June 1974 that "...in addition to observing its obligations with respect to payments restrictions under the Articles of Agreement (of the International Monetary Fund) it will not on its own discretionary authority introduce or intensify trade or other current account measures for balance of payments purposes that are subject to the jurisdiction of the GATT..." Countries look at their current account positions, roughly their net exports of goods and services, instead of their over-all balance of payments which must balance in a floating world.

The governments proposed responses to the oil crises concern both the financial and the real aspects of the oil problem.

#### A. The Financial Proposals.

Governments have proposed and in some cases agreed upon measures which make it harder to obtain adjustment in their balances of payments. They have continued to deform the international monetary system through changes in the International Monetary Fund which in some cases clearly and in other cases may reduce reliance on exchange rate flexibility and even return us to fixed rates.

##### 1. The Solidarity Fund.

The Administration proposes, as a safety net, a fund of \$25 billion for two years outside of the International Monetary Fund to help meet the reshuffling problem, i.e. helping out the OECD countries whose balance of payments are in difficulty because of the oil problem. Any loans made would require two-thirds of the votes. Any loan of 200% of the borrower's quota would require a unanimous vote. Reportedly, loans would be made at market rates and as a last resort. The G-10 countries agreed on the proposal in January.

It appears from the U. S. budget that our share of the \$25 billion would be \$7 billion. But it is clear from both the statement of Treasury officials and the budget document that it is not expected to get much use, only \$1 billion is expected to be expended in 1976 though the total obligational authority requested is \$7 billion.

One suspects that the purpose of the fund goes further than just meeting financial problems because one of the conditions for participation is active conservation efforts. In this way, it can be seen as a

part of a larger plan to buy European cooperation.

In part, the justification for the fund goes to the recent doubts about the ability of the banking system to continue the recycling job it has done.

The U. S. Government has become extremely concerned about rising ratios of loans and deposits to capital among banks which is attributed in part at least to the rise in credits provided by the United States commercial banks to finance oil payments by other countries. Associated with this is a hint in the United States and real pressure in the United Kingdom for central bank control over the foreign exchange positions of commercial banks.

The U. S. Government has misconceived the problem.

If I pay more for gasoline, my demand deposit is reduced. My money finds its way to OPEC countries which, because we are floating, must leave the money in the United States. If the OPEC countries buy Treasury bills with my former cash, the money shows up in the U. S. Government's checking accounts with the commercial banking system. Alternatively, if the OPEC countries buy some real estate it shows up in the demand deposits in the previous owner of the real estate. Still further, if the OPEC countries leave the money in time deposits or in checking accounts it still remains in the United States. The point is that the extra money that I pay out for oil in no way changes the deposit-capital-equity ratios of the American commercial banking system. The real source of the problem in the United States is the easy monetary policy which allowed banks to

increase their loans and demand deposits at very rapid rates, thus bringing about the allegedly dangerously high deposit-capital ratios. It is not the Arabs but us that cause the problem.

One may object to the foregoing analysis by pointing out that the American banking system in 1974 increased its claims on foreigners by \$15 billion through October with much of the money going to oil consuming countries. This is correct, but that expansion of these loans would have been impossible but for the rise in the monetary base permitted by the Federal Reserve System. The great danger is that the Federal Reserve System and the various inspecting agencies of the United States Government will over-control the American banking system and under-control themselves.

The obvious cost of this solidarity fund is the risk we take on defaults by the borrowing members. Chairman Burns would have nothing to do with the idea, presumably because of the risks involved. More importantly, it reduces the pressures on the OECD countries to adjust their balances of payments through reliance on the float.

## 2. The Oil Facility (The Witteween Fund).

The United States and the other members of the International Monetary Fund also agreed <sup>in January</sup> to extend for one more year the special oil facility which receives contributions from the oil producers (paying them 7%). The United States wanted to keep the fund down in size while others, such as the British, wanted it to rise sharply to \$10-\$12 billion. The final agreement was \$6 billion.

Some important changes in the principles of operation of the Fund may have been agreed in the course of the discussion. In its first year of operation of the oil facility, its lending seemed to be automatic,

based solely on oil import requirements and not on the general balance of payments conditions of the country. And it operated on a formula basis, up to 75% of the increment in oil imports. These procedures may undergo some change. More importantly, the United States pushed, and seemed to get agreement, that more countries should make their currencies in the hands of the IMF usable for lending by the IMF. A large number of countries have not permitted the Fund to lend their currencies, including some of the petroleum producers. This is understandable. When their currencies are used, they earn at most 2% interest from the Fund. The petroleum producers obviously would prefer to lend to the Wittween Fund at 7% than provide their currencies that the Fund holds at a 2% return.

The loans made by the oil facility are guaranteed in SDR's and thus the entire membership of the Fund takes the default burden. Thus, in principle, it is like the solidarity fund. In both cases, we take about one-third of the risk. Also, it reduces the need to shift exchange rates. But there is an important political difference. The Wittween Fund makes the oil-producers look like nice guys. The solidarity fund makes the oil-consumers look self-reliant. Also, the Wittween Fund reduces the pressure from the LDC's on the oil-producers on the oil price question while the solidarity fund is limited to OECD countries, the rich.

### 3. Subsidized Loans to the Most Adversely Affected Countries.

The Administration proposed the establishment, outside of the International Monetary Fund, of a special trust fund to receive payments, chiefly presumably from the petroleum producers, which could be used to subsidize loans made by the International Monetary Fund to those countries most seriously affected by the oil problem. This, too, was agreed to by

the members of the International Monetary Fund.

This part of the proposal is clearly a mistake.

There is a long history of helping less developed countries with very low interest rate loans, e.g. the International Development Association lends at three-quarters of 1%, the Export-Import Bank lends at 6%, the Agency for International Development loans at 2%, etc. But concessionary loans are never the most efficient way to help anybody.

A simple illustration proves this point. Suppose that a less developed country had been adversely affected by the higher price of oil can borrow at home and invest at home at 10%. Suppose the oil producers can invest in the U. S. at 5% and invest at home at 5%. Further, suppose that we want to raise the real income of the less developed country by one dollar per annum for the next thirty years. There are three methods by which we can do this. We could give them an annual grant of \$1.00 each year. Or we could give them a loan of \$100 at 9% (recalling that they can reinvest funds at 10% at home), repayable in 30 years. Or finally, we could loan them \$10.00 at zero interest rate for 30 years (again recalling that they can reinvest at 10%). The less developed country would be entirely indifferent among these alternatives because each would add \$1.00 per annum to its real income. (All this assumes that the less developed country would not default.)

However, the oil producer should not be indifferent. The annual grant costs him \$1.00 per year, the \$10.00 loan costs him 50¢ a year because he can invest funds at 5%. Only the larger and hard loan at 9% is to his benefit for he gains \$4. It is clearly the preferred option.



If we turn the relative yields around so that the less developed countries can invest and borrow the 5% while the petroleum producer can invest and borrow at 10% it turns out that the annual grant is the preferred device to help the less developed adversely affected countries. For example, the annual grant of \$1.00 per year for 30 years costs him exactly \$1.00 per annum. A \$100 loan at 4%, which would yield a net gain of \$1.00 per annum for thirty years for the less developed country, would cost him \$6.00 per annum. And a \$20 loan at a zero interest rate (which again would yield a \$1.00 additional income to less developed countries) would cost him \$2.00 per annum. Clearly the annual grant is the preferred device.

In summary, the soft small loan is never the efficient device for helping countries overseas that we or any other country wish to assist.

#### 4. How Goes the Deform of the System?

The effort to move away from the floating system, which made it possible to handle the oil crisis last year and return to fixed rates continues.

There is some good news. The French, when they floated, said it would be for six months. It is now a year. The Greeks are thinking about floating. But the Swiss are thinking about joining the snake.

The rest of the news is either bad or unclear. Under the bad category is the decision <sup>in January</sup> to increase the quotas of members in the International Monetary Fund by 32.5%. The U. S. favored only a 25% increase. This increases the borrowing power of the members of the IMF by \$22 billion which reduces the need to shift exchange rates by an equivalent

amount. It also, of course, adds to the world's monetary base, threatening more inflation.

In deciding to increase the quotas of the members, it was agreed that the proportion of voting power and quotas owned by the oil-producers would double, that the LDC's should at least retain their proportionate share (which means that the aid-link proposal is at rest if not dead) and the rest of the world would negotiate how to absorb the 5% share they will lose to the oil producers. It was further agreed to shorten the period between reviews of quotas, reducing it from five to three years.

The United States is on record as not wanting to reduce its share of the quotas, which is presently slightly over 36%. Our current assets in the Fund (including SDR's) which can be automatically drawn are \$4.22 billion. Further drawings on the Fund up to \$8.2 billion would be permissible under increasingly stiff conditions from the IMF. The total amount of money is so small relative to the kind of balance of payments problem we could have under a return to the fixed rate system, at one point we ran a deficit at an annual rate of almost \$50, that one wonders if it might just be better to withdraw from the Fund if its members are going to push us back to fixed rates.

No progress was made in the January meetings towards making floating an equal option. The original Outline of Reform stated that it was agreed that the main features of the international monetary system will include "...the exchange rate system based on stable but adjustable par values and with floating rates recognized as providing a useful technique in particular situations." The January 16, 1975 communique

called for draft amendments to be drawn up for the "Provision for stable but adjustable par values and the floating of currencies in particular situations." In short, floating is still the second best option, even after the establishment of the guidelines for exchange rate management which we discussed at our last meeting.

With respect to gold, it is not quite clear whether the IMF moved towards or away from the float. The general objective in much of the reform discussion has been to reduce the role of gold and replace it with the SDR as the centerpiece of the international monetary system. The United States Government's position is to turn gold into just another commodity. One move the United States should consider is simply no longer/report gold as part of its monetary assets and shift their ownership to the Government Services Administration / . That would at least get gold out of our system, if not the world system. Progress in getting gold out of the system was made. It was generally agreed that the official price of gold should be abolished and that obligatory payments to the Fund should be abolished. There was also agreement on the "...freedom for national monetary authorities to enter into gold transactions under certain specific arrangements, outside of the Articles of the Fund, entered into between national monetary authorities in order to ensure that the role of gold in the international monetary system would be gradually reduced."

This last sentence is full of uncertainty. Ever since Italy borrowed in 1973 on the face of the oil crisis, putting up its gold as collateral at a price far above the official price, it has been understood that such procedures were permissible. In Martinique, the United States

and the French went a step further and agreed that countries could value their gold at other than the official price. Several dangers have been seen in all this. In particular it has been seen as a device to go back to gold at a higher fixed price. This, of course, would mean a return to a fixed rate system. The French Prime Minister stated the Martinique agreement was not an effort to devalue the franc in terms of gold and one of his ministers confirmed this subsequently to Iran. What "the specific arrangements" are referred to in the key sentence were not revealed. Hopefully, they would include not fixing the price of gold in terms of currencies. The United States has already shown the way in its auction of gold. And the U. S. position was stated before the <sup>IMF</sup> meeting by Under Secretary Bennett "...we would remove restrictions on governments buying gold but remove it on the basis of some understanding that there will be no governmental agreements to try to peg the price of gold and that no government will increase its holdings of gold over the coming year or two by a substantial amount."

##### 5. The Problem of Foreign Control and Other Investment Fears.

There have been growing fears here and abroad that the OPEC countries would take over important and large amounts of investments in the United States and in other countries. The purchase of a Detroit Bank by an Arab led to a loss of deposits. A Senate Banking subcommittee just began hearings on the question of foreign penetration of American industry through investment. The Federal Republic of Germany is considering restrictive legislation. One American company wrote its stockholders opposing a take-over which indirectly involved an OPEC country because it would hurt its business with Jewish suppliers and customers. Chairman Burns said it

might be all right for the oil producers to invest in Quaker Oats.

These reactions are not surprising. American corporations operating overseas for years have suffered opprobrium from the local press and politicians. It is a natural condition to oppose foreigners. But, from an economic standpoint, it does not make much sense to oppose the inflow of foreign capital, especially for the United States.

The first reason is that if the Arabs behave as profit maximizers as do American entrepreneurs, then their behavior will be no different from that of American owners of these assets. Second, the total amount of real assets in the United States is about 300 billion! <sup>(74<sup>b</sup>)</sup> To suppose that the funds to be accumulated by the Arabs constitute a threat of control over the American economy viewed in the light of that figure borders on the ridiculous. The President made the right decision when he let OPEC money into Pan American.

The ultimate truth is that this nation badly needs more capital, foreign and domestic. As Dr. Paul McCracken recently said, the amount of capital formation so far this decade is about 20% below what we should have had, given the growth of the labor forces.

As Professor William Fellner has recently shown, since 1965, the stock of real capital in the United States has risen 40% but the level of profits after taxes, adjusted for under-depreciation and inventory gains caused by inflation, fell from \$38.4 billion current dollars to \$32.9 billion in current dollars. Secretary Simon estimates that the retained earnings, adjusted for inflation, of non-financial corporations fell from \$20 billion in 1965 to a negative \$10 billion in 1974. The budget deficits of 1975 and 1976 will place enormous drains on our private capital markets, forcing a decline in private investment through higher interest rates or

expansion of the stock of money (and subsequent inflation). In 1974, the Federal government took 30% of all the new capital coming on to the market. Its share is sure to grow. We need to welcome foreign capital for growth.

There is also considerable concern being expressed by governments over the possibility of rising debt service and the inability to repay the debts to the OPEC countries. These fears are quite unwarranted when we consider the experience of the less developed world. There it is often the case that 20 to 30 percent of the total import requirements of less developed countries are financed by external borrowing and for periods of 10 to 20 or more years. The service on their debts has often risen to as much as 20 or 25 percent of their export earnings, and 3 to 4 percent of their GNP. In the light of the less developed countries experience, the problem of handling the debt service implied by the accumulated assets of the OPEC countries appears to be really quite small. U. S. payments of interest, profits, and dividends to foreigners were, in 1973, 9% of our exports of goods and services, and 7/10 of 1% of our GNP.

Still another fear is that the OPEC funds will not be invested in real assets. Curiously this is in exact opposition to an earlier concern discussed. The argument has some validity along the following lines. It is feared that if the OPEC does not invest in real assets, then capital formation in the oil importing countries will decline. The rate of growth of GNP would, therefore, be slowed and this will make it more difficult for the oil importing countries to repay the debts in the future. So far as it goes, the analysis is correct, but

it overlooks a simple fact that if the OPEC countries invest their proceeds in the U. S. Government securities then the United States government can lower taxes on the American people. If, for example, the corporate tax rate in the United States were lowered that would raise the rate of return on capital in the United States, undoubtedly stimulating the rate of capital formation and therefore bringing us faster rates of growth. (This assumes, of course, that the money paid to the OPEC does not come out of savings, but out of consumption.)

B. The Real Side of the Problem.

In his State of the Union Message, the President said: "I am recommending a plan to make us invulnerable to cut-offs of foreign oil. It will require sacrifices. But it will work." According to Secretary Simon we are now importing 40% of our total petroleum consumption. By 1985, he says, the figure could rise to 50%. But the objectives are more complex. In the Fact Sheet distributed by the White House in support of the President's Message, a number of arguments are offered which offer broader justifications for the President's program. The Fact Sheet states, "Our reliance on foreign sources of petroleum is contributing to both inflationary and recessionary pressures in the United States." It refers to high oil prices as causing a massive outflow of collars and a loss of jobs. It refers to the possibility of the economic collapse of European and Asian countries as a result of tremendous balance of payments deficits.

### 1. Petroleum Import Fee.

The President has proposed a rising fee on petroleum imports as a means of restricting domestic consumption of oil.

The balance of payments problem of oil imports was underscored three times by the Secretary of the Treasury in his Memorandum to the President of January 14, 1975 in support of his conclusion that petroleum was being imported in such quantities as to threaten to impair our national security, justifying the proposal of a fee on crude oil imports. But we are floating.

The U. S. Government seems to have forgotten one of the major achievements of the Executive and Legislative branches since 1969, namely the inconvertibility of the dollar and the floating of the bulk of the world's currencies. (Only 25% of/U. S. trade is with countries that consistently fix their currencies on the dollar.)

As explained earlier, international transactions do not present us with balance of payments problems, do not effect our employment, and do not change our price level. The change in oil prices has caused a minor,



one-time change in our real income.

He might have argued that the petroleum import fee would, by restricting U. S. demand, improve our terms of trade. But this argument would be hard to make stick because the United States imports only 13% of all of world production of oil, giving us relatively little bargaining power unless the imposition of the petroleum import fee were made conditional on similar actions by many other oil importers.

The puzzling aspect of the petroleum import fee proposal is that it is coupled with a supposedly equivalent excise tax on domestic oil and on domestic natural gas plus an excess profits tax which, even with the deregulation of natural gas and domestic oil, would seriously blunt the protective effect of the import fee. In short, if we want to reduce our dependence on foreign oil, one would assume that we would wish to give preference to domestic sources of energy. If I understand Secretary Simon's testimony correctly, the actual average price of domestic petroleum would fall as a result of the President's program. At the same time the petroleum import fee and the domestic excise taxes raise prices to consumers. Thus the effort seems to be to reduce imports through reducing total consumption alone, not by raising domestic production through market mechanism. Hence, if only consumption is reduced, the percentage of foreign oil in that consumption is not changed. Opportunities for reducing foreign dependence appear lost in this part of the proposal.

The Administrator of the Federal Energy Administration, Mr. Fred Zarb, appeared to explain why when he told a group of independent petroleum producers that they were in business in 1973 when oil was selling between \$3 and \$4 and the President's proposed base price

effectively doubles their returns over 1973 levels. But that reasoning won't quite sell. The relevant comparison is with the prices prevailing domestically now, which on average have been higher than the ones proposed after all taxes by the Secretary of the Treasury.

The Administration understands that there is substantial elasticity of demand for petroleum. It apparently has yet to learn that there is substantial elasticity of supply as well. As Mr. Zarb said, "In the first crucial years, there are only a limited number of actions that can increase domestic supply."

One final point must be made absolutely clear. If we must restrict imports, the tariff is far superior to the quota as proposed by the Democrats. Both the tariff and the quota raise the price to consumers. But the tariff revenue goes to the U. S. Government, which might use it to reduce our taxes, but the higher domestic price resulting from the quota is virtually certain to go to the OPEC producers, even with sealed bids. Being a cartel, they will just raise the price to absorb the extra price charged by domestic distributors.

## 2. The Floor Price.

Secretary Kissinger, in another major element in the program, is proposing agreement among consuming nations on a floor price for petroleum below which the price of oil would not be allowed to go. The justification for this is that the investment in the domestic consuming countries to reduce dependence on imported oil will not be forthcoming if the local producers have to run the risk that the outside world price might come down. Dr. Kissinger sees a possible bargain: a guaranteed floor price for foreign oil producers for a definite period of time in exchange for a reduction in the current price. Various floor prices have been suggested. One is \$7.70.

Another source put it at a range of \$7 to \$11. The President of the International Energy Agency suggests \$4.50.

There are a lot of problems here. Can one really expect foreign governments to make such commitments? Neither Japan or Italy have domestic petroleum. Could they afford to honor the agreement on the floor price if the price should fall? Would it be possible to enforce the agreement? After all, it is difficult to keep account of prices when they are falling, what with discounts, etc.

The real issue, of course, is whether the United States and other consuming nations should institutionalize the oil cartel. There is a cost to the consumer if the price falls in the future. And there will be a huge burden on the capital markets. Dr. Kissinger put the figure at \$500 billion over the next 10 years in capital investments plus \$10 billion in research expenditures by the government plus whatever the private sector may do in research.

### 3. Indexing.

In discussing the main outlines of his plan for the solution to the oil crisis, Secretary Kissinger held out the possibility that we would be willing to consider indexing the price finally agreed upon between the consuming and producing nations.

This idea, of course, follows logically from setting an agreed price. Neither the consumers nor the producers would want to be unprotected from the ravages of general inflation or deflation. If there were no agreed price, there would be no need for indexing. Private parties always may agree to index their contracts each time they are renewed.

Of course, the basic objection to an agreed price, indexed or not, is that it is certain to lead to a distortion in the world allocation of resources. That is, when oil is in short supply, the price cannot rise by more than the agreed price plus the index; when it is in long supply, it cannot fall to adjust supply except as permitted by the index. The relative price of oil could not change with supply and demand.

#### 4. The International Energy Program.

The Administration last year entered into an agreement with a number of OECD countries (not including France ) that each would build up petroleum inventories equal to sixty (later 90) days of imports. (We have already achieved that goal.) It also entered into an agreement that if a supply disruption occurs, each participating country would receive its fair share as provided by the agreement. If approved by Congress, the President could, for example, require American oil companies to divert oil to specific countries.

One clear cost of this agreement is that it requires that the American oil companies be granted immunity from anti-trust action. As Mr. Fred Zarb, Administrator of the Federal Energy Agency, stated "...it would be virtually impossible to arrange an international allocation system without such an immunity." (Interestingly, the FTC has the companies under charges for colluding.)

Another question is whether it would work. The Administration has not proposed this agreement as a Treaty. Presumably it could readily be overturned by the Congress once triggered. The recent stiff reaction of the Congress to limiting oil imports through petroleum fees and to accepting the President's proposed targets for import cuts does not

suggest that it would react positively to this plan when it had to be invoked if it cost us some oil. Are other governments likely to react differently? Of course, the other side of the argument is that the last embargo against the United States and the Netherlands was widely subverted by the oil companies. The United States Government did not publish data on oil imports for several months during the embargo for very obvious reasons.

#### 5. The Uncertainties.

It is obvious from the above that the President's and the Democrats programs involve some real costs for Americans.

My preferred solution is to stockpile because that appears to be the cheapest method of meeting the problem of disruption. If we could pass a Constitutional amendment prohibiting price controls on energy, the private market would do it for us.

But the major question is whether, viewed solely in terms of U. S. national interest, the energy program is worth it. Of course, I prefer it over having to go to war in the Middle East. But there recently have been some signs that the cartel is having trouble. Some price shaving has been permitted recently. At least two countries are not prepared further to reduce their output. Abu Dhabi just ordered a 40% increase in production because its budget could not stand the lost revenue.

It is not altogether clear to me what the relative degree of dependence between the producers and consumers is. If, for example, it is true that all the water in Saudi Arabia and all the electricity in Kuwait depends technically on the production of oil, the consumers might not be in so bad a bargaining position as they think.

Finally, it is not clear that the decision should be made just

in the light of energy.

The rest of the LDC's may be on the OPEC coattails now. So, still another question is whether what we do with respect to oil will have to be done with respect to some other raw materials we import. Already the export tax imposed by Jamaica on bauxite was raised from \$2.50 to \$11.02. The coffee producers are seeking to form a cartel. Perhaps most importantly, Algeria, one of the oil producers, is leading the effort (along with the French) to combine the discussions of the oil importers with both oil exporters and other raw material producers. It has been suggested that if we are to gain concessions from the OPEC producers on the oil price we will have to give concessions to the other raw material producers. Some 110 LDC raw material producers are included in these discussions. The United Nation's Conference on Trade and Development is drawing up guidelines for 18 stockable commodities. The U. S. Government has issued a report that durable, non-oil cartels are not possible under present current world conditions. They lack a unifying political objective and adequate foreign exchange reserves or income to carry out an embargo. Where all this will come out cannot yet be seen. But it does make it clear that the cost of any decision on oil could be multiplied by problems with other raw material producers.

## The Case Against Credit Allocations

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Congress is currently considering legislation which would impose a system of credit allocations on ~~all member~~ banks. Yet there is a strong case to be made against this bill and other proposals for credit allocations. As will be argued below a system of credit allocations would, in the long run, have little, if any, effect on the way credit is actually distributed, and, insofar as it has a short run effect, this effect is likely to be deleterious. Moreover, credit allocations would impose substantial costs on the economy, and are an inferior tool to direct subsidies and explicit taxes.

Do credit allocations improve on the market's judgment? It would be foolish to claim that the decisions of the private market are always optimal. But recognition of the weaknesses of market allocations does not suffice to make a case for replacing the free market with government controls. Government controls have their own inefficiencies, which may well exceed the inefficiencies of the free market. Indeed, past experience with government policies on resource allocations do not provide us with any grounds for optimism. The actual results of such policies are usually far from what their supporters originally had hoped. For example, farm price support programs, which were intended to help destitute farmers in the Great Depression, have actually provided most of their benefit to rich farmers. Control over natural gas prices which were to aid buyers of natural gas are about to deprive many of these buyers of their supply of natural gas. Regulation Q which was to provide a breathing spell for hard-pressed thrift institutions has instead provided them with a seemingly permanent crutch, and has had very bad side

effects, such as levying a regressive tax on small savers, and stimulating the potentially destabilizing Eurodollar market.

The characteristics of the credit allocation bill currently before Congress provide little reason for thinking that such legislation would be more successful than some of the previous unsuccessful attempts at improving resource allocations. Thus the bill would channel credit away from "inflationary" uses without showing a clear understanding of what is inflationary. If we want to curb credit that is inflationary we would have to curb "good" credit, such as mortgage credit. Anything that raises current demand relative to the current supply of goods and services is inflationary. And the longer is the life-span of a capital good, other things being equal, the smaller is the volume of goods it currently places on the market (since its output will take place over a longer span of time) and hence the more inflationary it currently is. This would suggest that a credit allocation program to fight the current inflation should discriminate against such long-lived items as housing, public utility investment, etc. This is hardly what the proponents of credit allocations have in mind, or what credit allocations are likely to do in practice.

A credit allocation program may also aim to discourage credit to big business (as opposed to small business) and to consumers. Insofar as lenders discriminate in socially unjustified ways against small business, a program of channeling credit to small business may improve resource allocation. But the extent of such discrimination is not really known. In fact, the evidence for its very existence is far from conclusive. Hence, a program of shifting credit from small to large firms may easily go beyond merely offsetting any existing discrimination, and may generate a net discrimination against large firms. Insofar as this happens there is a tendency for credit to be misallocated, and this would lower the



nation's productivity. If one does not know how far a car is veering to the right, giving the steering wheel a sharp tug to the left may not improve matters.

Another likely target of credit allocations is to reduce consumer credit. But there is little reason to believe that lenders favor such borrowing unduly, or that such credit is more inflationary than are other types of loans. Moreover, using government regulations to limit the availability of credit to consumers hardly fits the current consumerist mood.

Turning to the types of loans that are likely to be favored by a credit allocation system, there are loans to small business, which have already been discussed, mortgage loans, and loans to state and local governments. As far as mortgage loans are concerned there exist two arguments for saying that their volume is insufficient. One is that various government restrictions, i.e. usury laws, Regulation Q, FHA and VA interest ceilings and prohibitions of variable interest rate mortgages, reduces the housing sector's ability to obtain funds in periods of tight money. The answer to this problem is to remove such restrictions. Insofar as this cannot be done it would be better, for reasons discussed below, to solve the problem by direct subsidies rather than by credit allocations.

The other reason for saying that the housing market obtains insufficient credit is the claim that there is a special social benefit to housing which the private market does not take into account, so that insufficient housing, particularly low income housing, is constructed. This is a very questionable argument. It is better to help the poor by giving them a minimum income which they can spend as they see fit, rather than to subsidize, via credit allocations, one particular item they buy, housing. Such a subsidy is received not only by the poor, but also by other consumers of housing, and its cost effectiveness

in helping the poor is therefore extremely low. But if it is decided that housing merits government support, then a direct subsidy is again preferable to credit allocations.

As far as state and local government borrowing is concerned, there is little reason to think that banks and other lenders discriminate against this type of loan. Nor does the empirical evidence suggest that state and local government expenditures are strongly affected by tight money. To be sure, one might claim that this type of credit demand is especially worthy. But if this claim is accepted, the answer is to subsidize state and local government investment directly, rather than use credit allocations.

Beyond these considerations there is a very important argument against credit allocations. Although credit allocations may be flexible in principle--with the Federal Reserve having the power to change their direction and magnitude--in practice, they are likely to be inflexible. It seems to be the case that once the government has given a special benefit to some groups this benefit cannot easily be withdrawn when conditions change, but eventually is looked upon, at least by its recipients, as a natural right. Hence, if, because of certain conditions prevailing now, particular sectors are given preferential access to credit, this preference is likely to continue when it is no longer justified. This consideration is similar to the argument against imposing tariffs to protect "infant industries." Such industries try to cling to their "infant" privilege until well into senility.

Can Credit Allocations Work? There is little question that a credit allocation system, be it a system of credit ceilings, or credit minima, or else a preferential reserve requirements system, can work in the short run. However, it is unlikely to be effective in the long run. This is so for two reasons. First, existing

financial institutions learn techniques of avoiding its impact. In the past, when we imposed consumer credit controls, lenders and sellers of durables developed a number of ingenious loopholes, for example, raising both the trade-in value of the old car and price of the new car, so that the trade-in met the minimum downpayment requirement. There is little reason to doubt that, over time, lenders could develop similar schemes for eliminating a considerable part of the effect of a credit allocations system. In a number of countries which use import licensing a market in import licenses has developed. Credit allocations are likely to lead to a similar thing.

Second, and more fundamentally, credit allocations are imposed on financial intermediaries rather than on ultimate lenders. If financial intermediaries are constrained in the types of loans they make, their profitability is reduced, and their interest payments to the ultimate lenders decline. This gives the ultimate lenders an incentive to avoid the financial intermediary. They can do this in two ways. One is to reduce the loans they make indirectly through the financial intermediaries, and to make loans directly to the ultimate borrowers. The other way is for new financial intermediaries to develop, which are not constrained by credit allocations. Or if only some intermediaries, such as banks, are controlled, and others are not, these other intermediaries expand at the expense of banks. A good example of this is what has happened with Regulation Q. Large lenders could make direct loans, and hence the Federal Reserve had to give up its attempt to control interest rates paid on large CD's. Moreover, to help the small saver get out from under Regulation Q, money market funds are now developing rapidly. If credit allocations are imposed there will be a similar development; new institutions whose credit decisions are not subject to control will proliferate. And as the Federal Reserve extends its authority to include these institutions, still others will develop.

A third factor weakening the effect of credit allocations is that money is fungible. A borrower can borrow de jure for one purpose, and yet, in effect, can finance a quite different activity with the funds thus obtained. This could be the result of outright evasion, but it need not be. For example, if the interest rate on mortgage loans is kept low by credit allocations a borrower has an incentive to take out a mortgage loan, rather than, say, a business loan, and then to use his own funds which are freed by the mortgage loan to undertake business investment. All in all, it is reasonable to expect that after a transition period, during which the economy learns to cope with a credit allocation system, there would be little effect on the types of investment actually undertaken.

Disadvantages of Credit Allocations. Since credit allocations are ineffective in the long run, it may seem that while they do no good, they are also harmless. But this is not the case; they have several serious costs and disadvantages. One of these, obviously, consists of enforcement and compliance costs. A second disadvantage is that those intermediaries that are subject to credit allocations are put at a competitive disadvantage in bidding for funds, and tend to contract, at least relatively. Hence, a clearly inequitable burden is placed on their owners and employees who may have to find new jobs, or at least are faced with a reduced market for their skills.

Third, the development of new institutions is not costless. Not only are there physical costs to the creation of new unregulated institutions, but also there is a (probably quite substantial) cost of learning as financial specialists have to learn how to set up and manage new institutions, and as customers have to become familiar with these institutions. Fourth, financial intermediation is reduced as the ultimate lenders escape credit allocations by making direct

loans. The making of such direct loans is less efficient than the use of financial intermediaries, for otherwise the lenders would not have used financial intermediaries in the first place.

Fifth, as new institutions develop the economy may become less stable. For example, the growth of the Eurodollar market, which was given a powerful impetus by Regulation Q, has probably made the financial structure more vulnerable. To be sure, in principle, the development of new institutions could also increase the stability of the economy. But this is not probable, because new institutions are likely to arise in ways which free them, not only from credit allocations, but also from other regulations.

Sixth, as new institutions develop the Federal Reserve has an incentive to bring them under the regulations too. This means that some of the intellectual energy of the Fed, which should be directed towards making monetary policy as efficient as possible, is directed instead towards a new and never-ending regulatory task. Furthermore, as the Federal Reserve tries to bring new ways of financing under the pervue of credit allocations, the net of controls spreads further and further over the economy. Economic freedom is diminished, and government regulations proliferate.

Taxes and Subsidies as Alternatives to Credit Allocations. If certain types of investment are to be favored, and others to be inhibited, it would be better to do this through direct subsidies and taxes rather than by credit allocation. One advantage of taxes and subsidies is that they are much more in the public view than are the hidden implicit taxes and subsidies resulting from credit allocations. Hence, there is a better chance that they will be removed when they are no longer needed. Second, a system of explicit taxes and subsidies would affect the overall cost of certain activities, rather than the cost of just one particular input

into these activities, namely credit. Credit allocations (unless they happen to offset some market imperfection raising credit costs) give producers an incentive to use too much capital relative to other factors. A tax or subsidy system, by placing the reward on the volume of output rather than on the use of a particular factor of production (bank loans, or perhaps total borrowing) does not interfere with the incentives to produce in the socially most efficient way.

Summary. To sum up, the case against credit allocations consists of the following points. First, although the way credit is distributed by the free market is not ideal, credit allocations are likely to result in a worsening of, rather than an improvement in, the way credit is distributed. Second, credit allocations would work only in the short run. In the longer run the market would get around them. Third, the techniques used to avoid credit allocations would reduce the efficiency of the financial structure, and thereby impose substantial costs on the economy. Fourth, if one wants to change the investment mix of the economy the way to do this is by direct subsidies and explicit taxes rather than credit allocations.

## Statement on Credit Allocation

Congress is currently considering legislation (the Reuss bill) which would impose credit allocations (perhaps on a voluntary basis) on banks. We believe that credit allocations would have an unfavorable impact on the economy, and we strongly support the Federal Reserve in its opposition to this legislation. Our main reasons for opposing credit allocations are that (1) such allocations would attempt to shift the allocation of credit in ways that are most unlikely to improve on the free market's decisions about where credit should flow, (2) that, in any case, they would not succeed in changing significantly the way credit is actually allocated except in the short-run, (3) that they would impose substantial costs on the economy, and (4) that, if Congress does desire to change the allocation of resources, a conventional tax or subsidy system is a more efficient way to do this than are credit allocations.

## Comments on the Future Fiscal Policy Actions

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March, 1975

Perhaps the only thing which changes faster than the general economic environment these days is the official forecasts of Federal Government receipts and expenditures. At our meeting last September, I discussed in some detail the then current estimate of the official unified budget deficit of 11.4 billion dollars for fiscal 1975, and why I thought that it was grossly implausible. I felt at that time, that in view of a likely slowdown in economic activity receipts were likely to be less than officially estimated, and actual expenditures were likely to be above estimated, and that the unified budget deficit could likely materialize as high as 20 billion dollars.

The current official estimate of the unified budget deficit for fiscal 1975 of 34.6 billion, makes my September estimate look like a drop in the bucket. I am afraid that I am as skeptical of these numbers as I was last Fall, but this time in the other direction. Table 1 presents estimate of the unified budget receipts and expenditures at various points in time, and is an update of a similar table which I constructed last Spring. The major changes from last Summer for the current fiscal year are an increase in estimated expenditures of 8 billion dollars, and a reduction in estimated revenues 15.2 billion dollars. The current estimates of receipts and expenditures on a National Income and Products Account basis are 287.6 billion and 323.7 billion, or approximately 10 billion dollars of adjustments for different accounting on both sides of the budget.

Some information is available on a quarterly basis of receipts and expenditures on a national income and product accounts basis during



the current fiscal year. For the second half of 1974 expenditures (NIA basis) were at an annual rate of 311 billion (Economic Report of the President, February, 1975, Table C-67) and a preliminary guess of receipts on the same basis at annual rates for these six months is 298.7 billion. This information suggests that OMB is estimating that for the first half of 1975, receipts on a NIA basis will drop at annual rates by about 22 billion dollars to 276.5 while expenditures will rise at annual rates by about 13 billion dollars to an annual rate (NIA basis) of 336.4, for a deficit at an annual rate over the current six month period of 59.9 billion dollars (since the adjustments to a unified basis are approximately the same on both sides of the budget, this is a good approximation to the annual rate of deficit over the current six months on a unified budget basis also). It can be seen from Table 2 (Economic Report of the President, February, 1975, p. 24) that these estimates are virtually unaffected by the multitude of proposed changes in expenditures associated with the administrations energy and stimulus programs. At an annual rate, these programs add 2 billion to total NIA expenditures. On the receipts side, these programs are estimated to have an impact of 6.8 billion at annual rates, essentially all of which is expected to occur in the second quarter of 1975.

Consider first the growth of expenditures from the first half of the fiscal year to the second half. Even eliminating any consideration of the energy and stimulus proposals this increase (334.4-311.0) is at an annual rate of 15 percent. This would seem to be predicated on the administration's inflation forecasts of 11 percent on the GNP deflator for the whole of 1975, trailing off to 7 percent by the fourth quarter.

A rapid reduction in the inflation rate, as we presumably are in the process of observing is likely to reduce the realized value of government expenditures over this period.

The receipts side of the budget for the remainder of the year is so uncertain that it is virtually impossible to assess the accuracy of the official forecast. A reduction of receipts of approximately 15 billion dollars (at annual rates) exclusive of the energy and stimulus proposals, from the first half of the year to the second seems extremely large. On the other hand the economy has softened up rapidly, and if the inflation rate quickly subsides below the administration's forecasts as I think likely, then receipts could be diminished even more than they project. Finally, the tax relief proposals which are beginning to grind through Congress appear to offer the possibility of substantially more reduction than the administration has proposed. On the other hand, even with Congress making every effort to process this legislation with the utmost speed, there seems to be a good possibility that no legislation will become effective until after the end of the fiscal year.

So much for fiscal 1975. What about 1976. Here the official estimates are for a record peacetime deficit of approximately 52 billion dollars. If the administration has overestimated the length of time that it will take for recent inflation rates to subside, then it might be expected that both the receipts and expenditures numbers presented are overestimated. Since it is likely that the elasticity of taxes with respect to the inflation rate (particularly the individual income tax), is somewhat higher than the elasticity of expenditures with respect to the inflation rate, it is likely that a rapidly receding

inflation rate could cause a 'shortfall' of receipts greater than that of expenditures, which would cause a deficit for fiscal 1976 larger than that currently projected.

Second, the official projections assume the adoption of a specific package of energy and 'stimulus' tax actions. The broad outlines of this proposal in terms of receipts and expenditures was outlined in Table 2. In terms of specific tax changes, the proposal was for 12 billion in personal income tax cuts in two installments, May and September 1975. In the bill just cleared the House Ways and Means Committee (February 19), this reduction in taxes has been increased to 16.2 billion. The administration proposal was for a 4 billion reduction in corporate tax liabilities, primarily in fiscal 1976, mainly through an increase in the investment tax credit (for most firms from 7 to 12 percent), for investment ordered or installed during calendar 1975. The house bill proposes a reduction in corporate taxes by 5.1 billion mainly by increasing the investment tax credit from 7 to 10 percent (nonutilities) and, as reported out of committee, making no changes in the current 22 percent depletion allowance allowed on petroleum. Thus the bill presented to the House will offer 21.3 billion in tax cuts compared to the administrations proposed 16 billion.

In addition to possibility increasing the size of the tax cut, the outlook is that Congress will probably delay the effect of any of these proposals. The decision to leave the depletion allowance intact is not going to go unchallenged, and the best guesses at the present is that this will delay House consideration of the Measure until March. At this pace, it seems unlikely that anything will take effect before the beginning of the next fiscal year. This should cut down on the rate at which the deficit is accumulated during this

Spring, and add to it during the Fall.

A second fundamental proposition in the administration's package is an increase in tariffs on imported crude oil by three dollars a barrel in successive steps which has already begun. As is well known, this has encountered considerable opposition in Congress, and a bill has passed to at least temporarily prevent the imposition of the increased tariff rate. The administration has announced its intention to veto the bill, but it seems quite possible that the veto can be overridden. In which case, it would seem that the so called energy program will be in complete turmoil for the near term future. If nothing happens here, then all aspects of the budget will probably remain unchanged, since the administration plan was to rebate the revenues generated primarily through cuts in other taxes, although partially through increased Federal Government purchases (see Economic Report of the President, February, 1975).

As these things go, there is probably some chance that some of the tax cuts or increases in expenditures which were originally conceived of as part of this program will get enacted, without the accompanying increases in excise taxes designed to reallocate consumption away from energy sources.

All things considered, there is just too much uncertainty at the present time to be able to give any estimates of the stance of fiscal policy during fiscal 1976 with any precision. My guess would be that revenues will be lower than the administrations projections (in dollar terms), expenditures may be lower in dollars, but likely to be higher in real terms (assuming that the inflation rate will subside much more quickly than officially projected), and the deficit

will probably be larger than the current projections.

This brings us to the question of financing deficits of the order of magnitude projected. My personal feeling is that here there is a major problem that the Fed may start up the money stock roller coaster again. Certainly there will be considerable pressure on the Fed to monetize large amounts of the deficit. The House has just killed a bill which would have required the Fed to produce lower nominal interest rates, and force the president to allocate credit to various sectors of the economy. Even the Council of Economic Advisors seem amenable to another burst of the printing press:

One way of preventing significant displacement of private investment in a substantially underemployed economy would be to increase the rate of money supply growth to reduce Federal financing pressures. Under such conditions, an increase in monetary growth need not be inflationary in the short run, especially if there is a large unsatisfied demand for liquidity. On the other hand, should large deficits continue well after the recovery has taken hold, maintaining such a course of monetary accommodation could spark an increase in the rate of inflation. For this reason it is essential that any monetary accommodation to large fiscal deficits be permitted only so long as the effective underemployment of resources remains large and there is ample room for above-average growth.

Economic Report of the President, February, 1975, p. 25.

This statement strikes me as an extremely dangerous prescription. It suggests that as long as we are currently experiencing less than full utilization of resources, we can run the printing press full blast, as long as we shut it off as we approach full utilization. The first problem with such a position is that it does not recognize that the effects of such a monetary action are not felt at the time that the money is printed, but at some point down the road, when we are likely to have moved a lot closer to full resource utilization.

This is the well recognized lag effect in policy actions. The Council's position seems to suggest that they feel the lag is zero for monetary policy. Second, the statement never defines how we recognize full utilization of resources, so it never suggests when, even under the zero lag hypothesis, it would be appropriate to shut off the monetary binge.

The Council's position sounds like a rerun of the arguments for monetary expansion which were given in 72 and early 73. My best, and extremely pessimistic guess is that the Fed will come under tremendous pressure in the Fall of this year, and next Spring, by the administration, by Congress, and by the low nominal rate advocates, that it must do everything that it can to keep down interest rates to prevent 'choking off the budding (or imminent depending on the then current circumstances) recover.' If the Fed succumbs to such pressure, then it seems to me that the stage will be set for the great inflation of 77-78. Given the magnitude of monetary growth that is likely to be necessary to accommodate both government and private demands for loans at constant interest rates later on this year and early next, the next bout of inflation would probably make the most recent experience look like a minor problem.

Finally, I would like to present an update on some charts which I prepared a year ago for our meeting, which attempted to present some measures of how the Federal government was using its expenditures to affect economic activity. Experience of the recent past continued into 1974. Real Federal Government expenditures on goods and services continued to fall from 1973 to 1974, while remaining constant as a percentage of real GNP at slightly under 7 percent. The redistributive

function of the government, as measured either by the ratio of transfer payments to persons to personal income, or as transfers, plus grants in aid to state and local governments, plus net subsidies continued to grow rapidly, (from about .09 to .10 and from about .13 to .135 respectively during 1974). Both of these phenomena are largely due to recently observed inflation, and not as the result of the initiation of new government programs. The current budget proposals suggest a continuation of these trends on the expenditure side, accompanied by discretionary tax reductions to attempt to provide a stimulus to the current high unemployment situation.

*Recompute on basis of 1974*

Table 1:

## Official Budget Forecasts-Unified Budget

## Date of Official Forecast

	<u>Jan 73</u>	<u>July 73</u>	<u>Jan 74</u>	<u>July 74</u>	<u>Jan 75</u>
<u>Fiscal 72</u>					
Receipts	208.6				
Expenditures	231.9				
<u>Fiscal 73</u>					
Receipts	225.0	232.0	232.2		
Expenditures	249.8	249.8	246.5		
<u>Fiscal 74</u>					
Receipts	256.0	266.0	270.0	266.0	264.9
Expenditures	268.7	268.7	274.7	269.5	268.4
<u>Fiscal 75</u>					
Receipts			295.0	294.0	278.8
Expenditures			304.0	305.4	313.4
<u>Fiscal 76</u>					
Receipts					297.5
Expenditures					349.4