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REPORT ON THE RECORD OF THE INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

PREPARED BY
THE STAFF OF THE
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION



DECEMBER 22, 1958

For use of the Committee on Finance

NOTE.—This report has been ordered printed for purposes of information and discussion, but it has not yet been considered or approved by the Committee on Finance or any member thereof.

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LETTER OF TRANSMITTAL

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C., December 22, 1958.

To Members of the Committee on Finance:

There is transmitted herewith a report by Dr. James W. Ford, associate professor of economics at Ohio State University, who was assigned to the staff of the Joint Committee on Internal Revenue Taxation to assist the Committee on Finance in connection with its study of the financial condition of the United States.

While the Committee on Finance decided to make no formal report on this study, it is believed that Dr. Ford's report will be useful to members of the committee in evaluating the testimony presented at the hearings conducted by the committee on this subject.

Very truly yours,

HARRY F. BYRD, *Chairman.*

LETTER OF SUBMITTAL

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D. C., December 22, 1958.

MY DEAR MR. CHAIRMAN: There is respectfully submitted herewith a summary of the testimony presented at the hearings held before the Committee on Finance, United States Senate, in its investigation of the financial condition of the United States.

At your request, Dr. James W. Ford, associate professor of economics, Ohio State University, was appointed temporarily as an economic consultant on the staff of the Joint Committee on Internal Revenue Taxation to assist the Committee on Finance in connection with its investigation of the financial condition of the United States.

While the Committee on Finance decided not to make a committee report on its investigation, members of that committee expressed a desire to have a summary of the testimony presented at the hearings. Dr. Ford has prepared such a digest with certain comments and conclusions. It is believed that this report may be useful to the committee in reviewing the study of the financial condition of the United States.

Respectfully submitted.

COLIN F. STAM, *Chief of Staff.*

REPORT

Mr. COLIN F. STAM,
*Chief of Staff of the Joint Committee on Internal Revenue
Taxation.*

DEAR MR. STAM: I am submitting herewith my report on the record of the testimony and data presented to the Committee on Finance in connection with its study of the financial condition of the United States.

The report is divided into three parts:

Part I. Review of the record with comments thereon.

Part II. Summary of testimony on the principal subjects of the hearings.

Part III. Index of subjects treated by each witness at the hearings.

JAMES W. FORD.

REPORT ON THE RECORD OF THE INVESTIGATION OF THE FINANCIAL CONDITION OF THE UNITED STATES

PART I

A REVIEW OF THE RECORD

A. THE NATURE OF THE INVESTIGATION

When the Committee on Finance of the United States Senate began hearings in its investigation of the financial condition of the United States, in June 1957, the dominant condition was inflation, but when the last hearings were held, in April 1958, the country was in a recession. In his opening statement in 1957 the chairman of the committee, Senator Byrd, said:

The immediate occasion for this study is the existing credit and interest situation and, more important, inflation which has started again with its ominous threat to fiscal solvency; sound money, and individual welfare.¹

In later stages of the hearings, the recession claimed a major share of attention but concern over the possibility of renewed inflation also shaped the course of the investigation.

The printed record of the investigation consists of 2,090 pages of testimony—by 8 witnesses—and accompanying exhibits, and of 67 replies to a questionnaire that the committee sent to the presidents of the Federal Reserve banks, businessmen, trade association officials, and economists. The main theme that runs through this long record is the problem of short-run economic instability, inflation, and depression, but much attention was given also to the question of the effects of a long-run rise in the price level.

The projected scope of the study was very broad: To study, in the words of the chairman's opening statement—

(1) The revenue, bonded indebtedness, and interest rates on all public obligations, including contingent liabilities;

(2) Policies and procedures employed in the management of the public debt and the effect thereof on credit, interest rates, and the Nation's economy and welfare; and

(3) Factors which influence the availability and distribution of credit and interest rates thereon as they apply to public and private debt.²

Many different aspects of these subjects were explored; however, three general questions came to be the main focus of the study:

(1) What were causes of the inflation that began in 1955, and of the recession that followed. In particular—

(a) Was the financial condition of the private economy sound?

(b) Did the price-setting power of big business firms or labor unions cause the inflation?

¹ U. S. Congress, Senate, 85th Cong., 1st sess., Hearings Before the Committee on Finance, Investigation of the Financial Condition of the United States, p. 1. This document is referred to below as hearings.

² Hearings, p. 1.

(c) Did the financial and monetary policies of the Federal Government exert a stabilizing influence on the economy?

(d) Did the Federal Reserve's tight money policy in 1956 and 1957 cause the recession?

(2) Were the monetary policies of the Federal Government, including the policies of the Federal Reserve System, soundly conceived and effectively carried out? In particular—

(a) What were the objectives of Federal Reserve policy?

(b) How was monetary policy related to Treasury debt management and the other financial policies of the administration?

(c) Did the restrictive monetary policy create special difficulties for particular economic activities—such as housebuilding—or particular business groups—such as farmers and small firms?

(d) Would the monetary system be improved by restoring gold redemption of the currency? Should the statutory directives to the Federal Reserve be supplemented or revised?

(3) What were the objectives of fiscal policy and debt management? Were Federal financial policies effectively coordinated and successfully carried out? In particular—

(a) Did fiscal policy contribute to the stability of the economy?

(b) What were the objectives of debt management? How were specific operations decided upon? Were debt operations harmonious with Federal Reserve policy?

(c) Was the public borrowing of such agencies as the Federal National Mortgage Association coordinated with the Treasury's debt management?

(d) Did rapid amortization allowances and the new leeway in depreciation accounting for tax purposes allowed business firms in the 1954 tax law contribute to inflationary levels of business spending in 1955 and 1956?

The following detailed review of the record of the investigation falls into 3 parts, corresponding to the 3 main headings above.

B. CAUSES OF THE 1955-57 INFLATION AND THE SUBSEQUENT RECESSION

The period of inflation and the beginning of recession

The Consumer Price Index began to rise in September 1956 but a better date to take as the beginning of inflation is September 1955, when the Index of Wholesale Prices began to rise markedly. The peak in business activity is now tentatively dated by the National Bureau of Economic Research at July 1957. However, employment did not begin to fall off significantly until the autumn of 1957, so that the beginning of the recession may be placed in the late summer or early autumn of that year.

The meaning of "inflation" and "deflation"

Inflation means a general rise in prices, and is therefore a term descriptive of an economic condition. The condition has a name because it has long been observed that when many prices rise at the same time important economic changes result. Upward movements in price index numbers—in the United States mainly the Wholesale Price Index and the Consumer Price Index—which measure the average change in large groups of prices are usually taken to measure the extent of inflation. Of course, it is never true that all prices change

together in the same proportion and therefore price indexes cannot measure unambiguously change in the limited group of prices each represents, let alone change in all prices. Nevertheless, the main shortcoming of the price indexes as measures of inflation during short periods is not inadequate coverage or the ambiguity of the underlying idea of "average change in prices"; it is rather that the observations of changes in individual prices are not satisfactory. As business conditions change, discounts from list prices, the "extras" included in a sale, and other features of the sale vary, so that changes in list prices are a poor guide to changes in prices actually paid. Compilers of price indexes are aware of this, of course, and they attempt to get information on prices actually paid, but this is sometimes difficult to do and there is no doubt that price indexes are to some extent based on fictitious prices. The result is that upward movements in price index numbers cannot be interpreted without qualification as measuring the magnitude of inflation in any period.

The word "inflationary" is sometimes used not to describe an actual rise in prices but to characterize a force that will make prices rise, or will tend to make them rise. Thus an increase in the money supply or a rise in Government spending is sometimes called inflationary, which means not that these increases in themselves constitute inflation but rather that they will cause prices to rise, or will do this unless some counteracting force holds prices down. There is an important difference between saying that a given force—say, an increase in the money supply—will cause prices to rise and saying that it would cause prices to rise if other conditions were different. Yet it is not always clear which is meant, for example, when an increase in the money supply is said to be "always inflationary."

A further problem about the meaning of these words arises because they sometimes are used very loosely as synonyms for expansion and expansionary, when, for example, any general upward movement in the economy is called inflation, whether it includes price increases or not. This usage is exceptional but the opposite meaning—a general economic decline—is the one usually given to the word "deflation." Deflation once meant a general fall in prices; with the increased attention given to unemployment and declining production in the downswing of a business cycle, deflation has come to mean usually a general short-run economic contraction, and not simply the fall in prices that forms a part of it. With reference to long-run economic change, however, deflation is ordinarily used in its original sense—to mean a general fall in prices.

Inflation and recession, 1955-58

Viewed against the background of the war and postwar period, the behavior of money and prices during the recent inflation and recession have attracted special attention. As the figures in table I show, consumer prices increased more rapidly from the middle of 1955 until the middle of 1957, the period of "creeping inflation," than they had increased on the average during the previous 3 years, the period of "stable prices" from 1952 until 1955. But the experience of the past year shows that this comparison is misleading. For the "creeping inflation" period was the greater part of an expansion phase of a business cycle while the "stable prices" period spanned a much smaller part of an expansion (the preceding cyclical upswing had begun in

October 1949, and consumer prices rose considerably even after the Korea boom stopped in 1951), and all of the ensuing contraction, when prices were falling and the countercyclical action of the Federal Reserve was causing the money supply to increase. It is true that consumer prices continued to increase during the year following the general downturn in business in the summer of 1957 and this makes it appear that the recent period is different from earlier postwar years—a period of steady inflation impervious to monetary control. However, this interpretation, too, is false. In part, the continued “general” price rise in recession is an illusion created by looking only at consumer prices. It was mainly business demand for those commodities other than food that declined during the recession, and the wholesale prices of such goods, which are much more sensitive than consumer prices to changes in business demand, did decline. And the behavior of this part of the wholesale price index is specially vulnerable to the quotation of fictitious list prices, so that it surely understates the actual decline in prices that occurred after the middle of 1957.

TABLE 1.—*Annual percentage rate of growth of money supply, consumer prices, and gross national product in constant dollars, selected periods, 1941–57*

Period	Money ¹	Consumer prices ²	Deflated gross national products ³
1941–45 average.....	20	5	7
1945–52 average.....	3	6	2
1952–55 average.....	2	0	3
1955–57 average.....	0	2	2

¹ Demand deposits adjusted plus currency held by the public, Board of Governors, Federal Reserve System.

² Consumer Price Index, Bureau of Labor Statistics.

³ Gross national product in 1947 prices, Department of Commerce.

Source: Economic Report of the President, 1958.

The statistical illusion of a general rise in prices during the recession is, however, only a minor reason for saying that the behavior of prices in relation to the changes in money and output has not been markedly different since the middle of 1955. Throughout the postwar period, the velocity of money—the rate at which money is spent—has shown a rising trend, which is sharply at variance with the falling trend that prevailed for at least the 70 years prior to the 1930's. The two big economic disturbances of the past 30 years—severe depression in the 1930's and war in the 1940's—broke off the gradual long-run down-trend. The wartime change in velocity is especially striking—velocity fell very sharply to a figure far below the level that would have been produced by continuation of the long-run trend. It may be that the rising trend of velocity since the war is merely a recovery from wartime disturbance. There is good reason to think that the earlier falling trend in the rate at which money was spent was produced by a general desire to hold a higher proportion of cash as real incomes were increased by general economic growth.³ As growth continues, then, this falling trend of velocity may be resumed. But regardless of whether that will be the case or not, the sharp rise in velocity that

³ The foregoing information on the behavior of the velocity of money was taken from a paper by Milton Friedman in the Joint Economic Committee's Compendium of Papers on prices and economic growth and stability. See M. Friedman, *The Supply of Money and Changes in Prices and output*, in U. S. Congress, 85th Cong., 2d sess., *The Relationship of Prices to Economic Stability and Growth*, papers submitted to the Joint Economic Committee (1953).

took place during the inflation of 1955-57 was generally similar to parts of earlier postwar fluctuations around the prevailing rising trend. Prices did rise at a high rate while the increase in the money supply was slowed and brought virtually to a halt, but this has happened more than once since the end of World War II. In short, the relations among money, prices, and output during the recent period of inflation—and the recession that followed—are much like those observed during the other business cycles of the postwar period.

Current theories of inflation

One view of the causes of inflation in the postwar years puts the blame for rising prices on the abandonment of the gold standard in 1934 and the continued though intermittent resort to deficit finance during the past 25 years. According to this view, discretionary management of the money supply and of Federal Government finance is bound to permit inflation, if not actually to cause it through monetary expansion, because business and labor will expect that the money supply will be increased if ever price increases threaten to cause unemployment.

A second explanation of the inflation stresses the importance of private debt, especially consumer debt. According to this view, easier credit terms led to a large increase in consumer purchases of houses, cars, and other durable goods and thus to a general boom. Furthermore, consumer debt grew to unsound proportions and this precipitated the recession.

A quite different view, one that has been popular in recent years, is that the cause of modern inflation is not monetary but instead is to be found in the power of big business firms—as some have it—or labor unions—as others argue—to set higher prices that are subject to very weak competitive pressure, if any. Those who hold that labor unions cause inflation by obtaining wage increases in excess of increases in productivity say that unions have thereby forced business firms to raise prices in order to cover the increased costs. The other variant of the monopoly theory of inflation holds that the market power of big business firms precludes competition and allows these firms to “administer prices”; that is, to set and maintain them above competitive levels. Administered prices have been increased by more than costs have increased, it is argued, and since many of the products whose prices are administered—steel, for example—are used in the production of other goods, the market power of big producers has brought about general price increases. Though the two variants of the monopoly theory of inflation differ on the source of the power that causes prices to rise, they agree on the existence of a wage-price spiral, a process in which cost increases push up the prices of finished goods and these price increases in turn lead to wage increases, which set off another round of price increases.

The three theories of contemporary inflation just described—the managed money theory, the consumer debt theory, and the wage-price spiral theory—challenge, each in a different way, the doctrine that active monetary and fiscal policy can make the economy highly stable, vulnerable to neither inflation nor mass unemployment. This conclusion has been widely accepted and the statement of it in the 1950 report of the Douglas committee⁴ was regarded as setting out the main

⁴ U. S. Congress, Senate, 81st Cong., 2d sess., Monetary, Credit and Fiscal Policies, report of the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report (1950).

lines of stabilization policy and predicting the results that could be expected from its operation. In the Senate Finance Committee's study, the Chairman of the Federal Reserve Board, among others, upheld this view, attributing the recent inflation not to a mistaken diagnosis of the causes of inflation but rather to faults in the execution of monetary and fiscal policy. The inflation was set off by excessively easy money in the counterrecession effort of 1954, he said, and it continued because limitation of the money supply came too late and fiscal restraint was not strong enough; management of stabilization policy was primarily responsible for the inflation.

Disagreement on the causes of the inflation and recession thus encompasses a number of different issues. One of these, the question how different types of monetary systems affect prices, can best be discussed together with other questions about the monetary system in the next section of this review. The remainder of this section will examine the contentions that a wage-price spiral caused the inflation, and the contention that excessive growth of consumer debt was responsible for it.

The wage-price spiral

From 1955 to 1957, wages, the prices of raw materials and intermediate goods, and the prices of finished consumer goods and business plant and equipment items rose together. But this fact is not, of course, sufficient to establish that it was the push of labor costs or other costs that forced prices up. It is plausible that union pressures forced wage concessions in collective bargaining and indirectly drove up wages in competitive markets so that costs increased and businessmen were driven to protect profit margins by raising prices even at the risk of reducing sales volume. But it is equally plausible that employers agreed to higher pay scales, or offered higher pay in competitive markets because they had experienced, or expected to experience, a rising demand for goods and services and it was necessary to compete for the available labor supply. Which of these two possibilities was actually the case can only be established by further examination of the facts. Table 2 presents some comparisons of changes in prices and changes in expenditures for certain categories of goods. The larger price increases—and those accounting for the main part of the movement in the Consumer Price Index—are associated with still larger increases in dollar expenditures, indicating an increase in the quantities purchased. In other words, the rise in prices was mainly a rise in the prices of goods that were in greater demand. The subgroups of goods and services shown in table 2 were selected because they are the only groups for which both separate price indexes and expenditure figures are available. Even for these subgroups there is only a rough correspondence between the group of goods to which the price index applies and the group of goods for which the Department of Commerce estimates the amount of total expenditures. Nevertheless, there is a strongly marked association, for subgroups and for the four main groups, between expenditure changes and price changes. It is not likely that such a pattern is produced by the statistical crudity of this comparison. Detailed figures for hourly wage rates in various industries (published in the Monthly Labor Review) allow rough comparisons to be made of the pattern of wage increases and the pattern of price increases. These

comparisons are less satisfactory than those shown in table 2, but what they show is that average hourly wage rates in nondurable manufacturing increased, from 1955 to 1957, by a slightly higher percentage than wages in durable manufacturing, which, in turn, increased by more than wages in industries producing services. In detail, there is little or no difference, in general, between the percentage increases of wages in industries whose product prices rose considerably and the increases in industries whose prices rose only slightly.

TABLE 2.—Percentage increases in prices and expenditures, 1955-56 and 1956-57

Goods and services	Prices, 1955-56 (percent in- crement of 1956 average over 1955 average) ¹	Expendi- tures, 1955-56 (percent in- crement of 1956 total over 1955 total) ²	Prices, 1956-57 (percent in- crement of 1957 average over 1956 average) ¹	Expendi- tures, 19 6-57 (percent in- crement of 1957 total over 1956 total) ²
Consumer durable goods.....	0	(-3.0)	3.5	3.9
Household furnishings.....	(-1.1)	4.8	1.6	(-.6)
Private transportation.....	1.5	(-14.0)	5.9	10.0
Consumer nondurables.....	1.3	5.3	3.3	5.0
Food.....	.7	4.9	3.3	6.2
Apparel.....	1.7	4.7	1.3	.4
Men's and boys' apparel.....	1.6	5.9	1.5	(3)
Women's and girls' apparel.....	.7	6.1	.5	(3)
Footwear.....	5.3	4.1	3.2	(3)
Solid fuel.....	4.4	2.7	5.1	(3)
Consumer services.....	2.2	7.6	3.8	6.9
Rent.....	1.8	2.3	1.9	(3)
Gas and electricity.....	1.0	10.7	1.1	(3)
Household operation.....	3.2	9.6	3.7	6.8
Public transportation.....	3.9	3.6	3.8	4.7
Medical care.....	3.6	6.1	4.1	(3)
Producer finished goods.....	7.5	14.4	6.2	3.3

¹ Source: Consumer Price Index and Wholesale Price Index, Monthly Labor Review.

² Source: National Income and Expenditure, Survey of Current Business.

³ Not available.

This pattern of wage, price, and expenditure changes casts doubt on the assertion that rising labor costs pushed prices up. But there is another sense in which rising wages are sometimes said to cause rising prices. Higher wages, it is said, cause higher wage incomes, higher demand, and hence higher prices, i. e., there is "wage-income inflation" rather than "wage-cost inflation." It is difficult to find direct evidence that bears—one way or another—on this assertion but there is indirect evidence against it. First, wage increases in themselves cannot raise the total of incomes; at the most they redistribute the total. To say that such a redistribution in 1956 and 1957 led to increased demand and ultimately to higher total income does not fit the fact that business demand for plant and equipment increased as much or more than any other category of demand. Secondly, "wage-income inflation" could operate only if each employer individually either believed that if he agreed to a wage increase the demand for his product would increase, or would pay higher wages at the expense of his profits. The first is highly implausible and the second is ruled out by the fact that profit rates have not fallen as wages and prices have risen.

It cannot be shown conclusively that the recent inflation was not either "cost inflation" or "wage-income inflation" but the foregoing analysis gives reasons for thinking that neither of these explanations fits and that it was a rising demand for goods and services—not originating in wage increases—that caused prices to rise.

This leaves unanswered the question, What caused the general increase of demand in 1955 and the fall in 1957? Many different answers were advanced in the oral and written replies to the Finance Committee's questions: easy money and low interest rates followed by monetary stringency; an increase, and a reduction 2 years later, in the rate of Federal expenditures; business optimism, later checked by tight money; and so on. It is significant that no one claimed to give a simple and clearly correct answer to this question; all the factors mentioned were advanced as tentative and partial answers. This is an accurate reflection of the state of knowledge on the subject, and it shows how important is the basic research that is carried on in this field.

Private debt in the inflation and recession

The implications of the rapid rise in private debt since 1954, consumer debt in particular, have attracted much discussion. In the Senate Finance Committee's study, the question was repeatedly asked whether an unsound increase in debt had been an immediate cause of the inflation and, later, had set the stage for recession. It seems clear that, for business debt at least, the answer to this question is "No." The increase during 1955 in business debt was mainly an increase in short-term debt, of which about half represented not additional borrowing but an increase in income-tax liability and other accruals. Business borrowing from banks did increase unusually much, however, in both 1955 and 1956 and these funds, together with the proceeds of an increased volume of bond issues, were an important source of finance for rising business investment outlays. But internal sources of business funds—retained profits and depreciation quotas—also increased substantially, so that the boom in business investment spending was by no means financed exclusively by borrowed money. Nor does it appear that the volume of debt to banks on the books of business firms rose to critical proportions. Bank loans to business grew only moderately in 1957, as the volume of new bond issues increased, and there was no liquidation crisis, but only a moderate reduction of bank loans, accompanying the recession. In brief, the sharp rise in business investment spending in 1955 and 1956 was financed partly out of borrowed money. Undoubtedly the easier terms on which business was able to raise both debt and equity funds stimulated business spending but it is doubtful that restrictions on the amount or terms of business borrowing would have moderated either the inflation or the recession.

With respect to consumer debt, the conclusion from the figures themselves is not so clear. Noncorporate debt—the indebtedness of families, farms, and unincorporated businesses and institutions—increased by more than corporate debt in 1955 and the largest increases were in family borrowing—consumer debt and mortgages on 1- to 4-family houses. Although this latter type of debt had increased in every year since 1951, the 1955 increases were unusually

large, amounting to nearly \$20 billion, as against \$11.6 billion in 1952, the largest previous annual total. In 1955 consumers in the aggregate apparently borrowed a larger portion than in previous years of the purchase price of the goods and services they bought. There are no comprehensive figures that show directly the fraction of consumer expenditures financed by borrowing but there are strong indirect indications that this fraction rose in 1955. Consumer debt increased in that year by an amount equal to 2.5 percent of the year's consumption expenditures; during the previous 5 years the yearly increase in debt had averaged 1.4 percent of annual consumption expenditures. This is not conclusive evidence that consumer borrowing constituted a bigger fraction of expenditures, because the larger net increase in debt during 1955 may have reflected mainly lower repayments of debt in that year. It is not likely that this was the case, however, and there is little reason to doubt that increased borrowing, attributable at least in part to easier credit terms and lower interest rates in 1954 and 1955, stimulated consumer purchases of houses and durable goods. Purchases of durable goods increased from 12 percent of total consumer expenditures in 1954 to 14 percent in 1955.

While it seems clear that increased consumer borrowing affected the composition of total expenditures, it is not so certain that the amount of expenditures, and hence the upward pressure on prices, would have been less if consumers had somehow been prevented from borrowing as much as they did borrow. If they had not borrowed and bought durable goods, consumers might well have spent more for other kinds of goods, or have exchanged more of their liquid assets for durable goods. A lower volume of consumer borrowing would have meant more favorable conditions for business borrowers, so that business investment might have been still larger. Inflationary booms in the past have been based on many different patterns of expenditure: commodity speculation, security speculation, construction booms, and so on. There is no reason to conclude that inflationary booms can no longer arise in these ways, and therefore no reason to conclude that contemporary inflation is caused by consumer borrowing, in the sense that without an increase in consumer debt inflation would never occur. Nor is there any evidence that a particular inflationary episode, such as the recent one, could not have happened with a different pattern of expenditure.

The belief that inflation would not happen, or would be less severe, if the terms or volume of consumer borrowing were explicitly controlled has led to suggestions that controls be adopted. Such controls would be more difficult to administer than present monetary controls and they are advocated mainly because it is thought that present controls are not adequate to prevent inflation. This conclusion is premature in the present state of knowledge about business fluctuations. The evidence from the recent inflation and recession is at least as strong for the opposite conclusion: that present controls can be operated to make the economy more stable than it has been. Neither conclusion can be firmly established without further fundamental study of business fluctuations. For the present it would seem to be good policy to attempt to make a simpler set of controls work better rather than to adopt more elaborate controls, when the need for them is not clear and their effects difficult to predict.

C. THE FEDERAL RESERVE SYSTEM, 1955-58

The basis of the Federal Reserve's powers

The Finance Committee's investigation raised fundamental questions about the Federal Government's use of its monetary powers, as well as questions about Federal Reserve policy itself. The committee questioned Treasury officials, Federal Reserve officials, and others about the present place of gold in the monetary system; about the scope of the discretionary power held by the Federal Reserve Board of Governors, and by the paid officers and the directors of the 12 Federal Reserve banks; about the effectiveness of Congress' control of the Federal Reserve; about relations between the Treasury, the fiscal agency of the Government, and the Federal Reserve, the monetary agency. These are perennial questions about the proper exercise of monetary powers and they have often been raised at a time of monetary disturbance. That these questions continue to resist final settlement is not surprising since a choice among alternative monetary arrangements must be based on experience under different types of monetary standards and rules. Such experience continues to accumulate and, as it does, to demand new evaluations of existing monetary arrangements and possible alternatives. In the present inquiry the views expressed by Government officials and others did not support the contention that a differently constituted monetary system would have moderated or avoided altogether recent monetary disturbances. Nevertheless, it may be that further experience will change the prevailing view, so that a strong demand arises for, say, a return to the stricter discipline of pre-1933 gold arrangements, or, on the other hand, for relaxation of the present centralized system of discretionary control.

Restoration of gold redemption of the currency

Under present international monetary arrangements, it is unlikely that either restoring the circulation of gold coin or requiring the Treasury to buy and sell gold bullion on demand at a fixed price would make monetary policy very different from what it has been in recent years. If the currency were redeemable in gold, the public could affect Federal Reserve policy and the amount of money in circulation by exchanging currency for gold, or vice versa, and thus changing the gold reserve. In particular, if, when prices were rising, people decided that holding gold was better than holding money, the demand for gold in exchange for currency would compel the Federal Reserve to take restrictive action. But under present international monetary conditions, the world price of gold is dominated by the United States Treasury's official price and it would pay to hold gold rather than money only if an increase in the official price were likely. Only a very large monetary expansion—much larger than any experienced since World War II—is likely to create the expectation that the Treasury would be forced to raise its gold price. Therefore, it is only a very large monetary expansion in normal times—in the extraordinary circumstances of a war or a deep depression, it is likely that gold redemption would be suspended—that would be ruled out if the currency were redeemable in gold.

The essential effect of gold redemption is that it sets a limit on the discretionary powers of the monetary authorities; gold redemption is only one among many different way of doing this. It is an interesting

fact that gold redemption would not work as well as would other systems of more or less automatic control to prevent sharp changes in the money supply. For example, the simple rule that the rate of increase of the money supply should be kept within fairly narrow bounds, say 3 to 5 percent per year, would avoid the larger movements likely to occur occasionally under a gold standard, and would therefore have better stabilizing effects.

The question of restoring gold redemption of the currency in the United States is often dismissed as an out-of-date and unnecessary question. But the essential issue raised—automatic versus discretionary control of the money supply—is an issue of great importance. Therefore, serious consideration ought to be given to two questions: (1) Would the economy be more stable if the element of discretion in monetary policy were reduced or eliminated altogether? (2) If the answer to (1) is "yes," which is a better system of automatic regulation of money, one that is widely known but has technical drawbacks or one that has better technical features but no popular appeal?

Federal Reserve policy, 1955-57

General concern over rising prices during the 1955-57 period evoked much discussion of Government economic policy, especially monetary and fiscal policy. Criticism of monetary policy ranged from the view, at one extreme, that since the middle 1930's the Federal Reserve has allowed the creation of too much money in the name of economic growth, to the nearly opposite criticism, that tight money in the recent period has been ineffective against inflation, if anything it has made inflation worse, and has raised interest rates, reducing residential construction, and hurting small business by raising loan costs to small firms more than to big firms. The first of these extreme views overlooks the fact, pointed out by the Chairman of the Federal Reserve Board and others, that a growing money supply does not necessarily lead to inflation in a growing economy, and the fact that prices in general have not increased continuously during the past 20 years. The criticism of tight money during 1955-57 makes several different points. One is that tight money had no effect against inflation. This contention derives mainly from the belief, discussed in the previous section of this review, that cost increases were responsible for the inflation. But that belief is very likely wrong, for reasons given above; in any case, the fact that increased demand for goods and services was part of the process of inflation carries the necessary implication that Federal Reserve control must have been partly effective against inflation. As it was, the volume of bank loans expanded sharply; had the banks been permitted to add more to their loans and investments, clearly they would have done so and the resulting increase in the money supply would have allowed prices to rise more. There is abundant evidence from other experiences of a similar kind that a greater rise in the money supply is associated with a greater increase in prices. The conclusion is clear that the tight money policy did restrain inflation. This is not to say, however, that the choice of measures and their timing was perfect, but only that what was done did work in the intended direction at the time it was done. The timing of Federal Reserve action is discussed below.

A closely related issue is the question of the effects of tight money on interest rates. Increased demand for bank loans and for funds

raised in financial markets forced interest rates to rise. Could the Federal Reserve have prevented the rise in interest rates by permitting the money supply to expand more rapidly? A more rapid expansion of money would have, at least initially, prevented or moderated the rise in interest rates, but only at the cost of a more rapid rise in prices than actually occurred. Furthermore, once the expectation of increasing prices was established, additional upward pressure would have been exerted on interest rates as lenders sought compensation for the declining value of the dollars lent, and the rate at which money and prices grew would have had to be increased further. It is questionable whether in fact the money supply could have been increased fast enough to prevent interest rates from rising when the demand for borrowed funds was increasing. The huge increase in money and prices resulting from the Federal Reserve's support of Government security prices during and after World War II was not sufficient to keep interest rates from rising. Interest rates rose during the 3 years after the end of the war despite the fact that a \$25 billion reduction in the national debt offset in part the increased demands of other borrowers. It is a characteristic of inflations that interest rates rise; in 1956 and 1957 more money would have meant more inflation and, in all likelihood, no reduction in interest rates.

As for the contention that the tight money policy had discriminatory effects, it is undoubtedly true that rising interest rates priced some consumers and businesses out of the market for borrowed money and reduced the amounts that others could afford to borrow. And it may be true that the rates paid by certain groups—small business firms, for example—rose by more than rates paid by other groups, big firms taken together. Whatever the facts are, however, they do not help to decide whether the tight money policy was sound. On the evidence from previous episodes of "cheap money" policy, expansion of the money supply might have failed to keep interest rates from rising, and, in any case, would have caused more inflation. Critics of the tight money policy who say that its effects were discriminatory are certainly not prepared to argue that the only alternative, a policy of inflation, would have been more fair. The critics have not taken sufficient notice of the facts that market pressures were forcing interest rates up and the Federal Reserve could have affected the situation, if at all, only at the cost of more inflation.

The same comment applies to the contention that tight money needlessly raised the costs of the national debt.

Federal Reserve policy in the 1955-57 period is more vulnerable to the criticism that its timing was faulty. In his testimony, the Chairman of the Federal Reserve Board of Governors said that in his view the Federal Reserve had in 1954 made money too easy and had waited too long in 1955 to take opposite action. Other witnesses criticized the Federal Reserve for keeping money tight too long in 1957, after signs of falling demand had begun to appear. In fact, as can now (October 1958) be seen, business reached a turning point in the summer of 1957, whereas it was October before the Federal Reserve began open market operations designed to make money easier. Hindsight validates these criticisms of the Federal Reserve; at the time that the decisions had to be made, it was not easy to know which way the economy was going. However, the very fact that assessment of the

current situation is difficult gives strong reason to question the soundness of a policy of alternating tightness and ease as the immediate situation seems to require. Moreover, it is very likely, as Chairman Martin said, that easy money in 1954 and early 1955 acted with a delay on the economy, keeping inflation going in 1956 and 1957 even while the growth of the money supply was reduced almost to nothing. It is also likely that the spell of tight money exerted a delayed influence during the recession, even while the money supply was growing at an annual rate of 5 percent or more. Analysis of business cycles in the United States shows that turning points in general economic activity follow with a lag of many months, changes in the rate of growth of the money supply.⁵ Apparently, the first effects of Federal Reserve action are regularly felt some months after the action is taken; this seems to have happened during the most recent business cycle.

The goals of Federal Reserve policy

In the Senate Finance Committee's study, as in many recent discussions of monetary policy, questions were raised about the general objectives or goals of Federal Reserve policy: What are these goals? Where are they specified? And what ought they to be? In answering these questions, Chairman Martin referred usually to the Employment Act of 1946, which declares that a principal objective of Federal economic policy is the securing of "maximum production, employment, and purchasing power." The Federal Reserve Act of 1914 states the purposes of establishing the Federal Reserve System but the objective stated there of providing an elastic currency seems outdated and is seldom if ever referred to in discussions of monetary policy. In today's discussions, the question most frequently asked is which of two goals that are said to be conflicting—full employment or price stability—the Federal Reserve ought to pursue. The Federal Reserve's own view, expressed in the testimony of Chairman Martin and in the joint reply of the Federal Reserve bank presidents to the Finance Committee's questionnaire, is that the two goals are not conflicting. Mr. Martin said:

There is no validity whatever in the idea that any inflation, once accepted, can be confined to moderate proportions * * *. In the past, an inflation once started, has continued until it was stopped, usually either by appropriate monetary and fiscal policy or, failing the adoption of such policies, until it collapsed from imbalances it had generated. * * * Prices as well as employment are likely to react when an inflation stops as the result of major imbalances.⁶

In fact, it is not true that moderate inflations, unless stopped by monetary or fiscal restraint, have always ended in runaway prices and a crash. The United States experienced a 20-year period of "creeping inflation," from 1895 to 1914. It is true that the period was interrupted by business-cycle downswings, but so also have been the periods of long-run declining prices or constant prices—1873–95 and 1921–29. Historically, creeping inflation has not been an unstable condition. Nevertheless, the Federal Reserve is certainly right that if the monetary authorities were willing to permit prices to increase at any rate so long as unemployment was low, the economy would experience a crash. There is abundant evidence that periods of sharply rising prices, such as 1919 and the first half of 1920 in the United States, end in crisis and slump. The strongest proponents of

⁵ See the paper by Milton Friedman cited above.

⁶ Hearings, pp. 1228, 1267.

full employment as a goal of monetary policy recognize this and agree that the price level cannot be left altogether out of account. On the other hand, those who argue that price stability ought to be the prime goal of monetary policy recognize the importance of stabilizing employment; their position is that stable prices would insure full employment. A useful way to interpret the controversy is to say that the disagreement is not about goals but about the best strategy to use in trying to achieve goals that both sides accept. The issue is not whether unemployment of 6 percent is "too much," or whether a price increase of 4 percent a year is "too much." The issue is whether short-run business fluctuations, which are certain to occur in a predominantly free enterprise economy, can best be limited by monetary—and fiscal—action aimed at preventing unemployment from ever exceeding a predetermined figure, or by action aimed at preventing prices from ever changing by more than some predetermined annual rate, or by action guided by some other criterion. What is needed to resolve the issue is not some kind of formula expressing the relative importance of stable prices and full employment but rather more knowledge about the probable effects of different strategies of stabilization. Claims made by the proponents of various rules for monetary and fiscal action need to be analyzed carefully and checked against available facts.

Despite the great interest in stabilization policy, in the voluminous discussions much has been taken for certain that is not certain and that could be tested. It is widely accepted, for example, that full employment and price stability cannot exist together. Yet this contention is usually not made specific and examined in the light of the facts. It is clear that economic change is bound to cause price indexes to change and to cause the number of unemployed to fluctuate. No one expects to achieve full employment or stable prices in the extreme sense of eliminating all fluctuations. However, for admissible definitions of price stability and full employment, the evidence that the two are inconsistent is not convincing. It is mainly the belief that, at least in the postwar years, wage increases have caused prices to rise which underlies the contention that price increases can be stopped only if unemployment rises sufficiently to check wage demands. But this view is probably wrong. Therefore, there is no need as yet to conclude that strategies for monetary and fiscal action face the dilemma that whatever is done to make prices stable will cause unemployment and whatever is done to maintain a high level of employment will cause prices to rise.

Clarification of the facts about the effects to be expected from different types of monetary and fiscal action is the primary requirement for improving stabilization policy. Changing the statement of goals or adding additional goals—making explicit the goal of price stability, for example—is likely to do much less to clarify issues and make policy sounder and more effective.

Independence of the Federal Reserve

Questions were raised during the Senate Finance Committee's study about the influence of private financial business on Federal Reserve policy, and about the relation of administration policy to Federal

Reserve policy. The answer to the first question appears to be that no evidence has ever been advanced to show that Federal Reserve policy has been made to serve private interests. It is true that during the tight money period, bank profits rose substantially. But the increased demand for bank loans would, in the last analysis, have led to higher bank profits whatever the policy of the Federal Reserve. However, the decisive fact in this matter is that the Federal Reserve had clear reasons for thinking, whether rightly or wrongly does not matter in this connection, that tight money was in the general interest.

On the matter of the administration's influence on Federal Reserve policy, the view was advanced that the Treasury in its management of the national debt tried to raise interest rates and that the Federal Reserve had helped in this. The evidence on the Treasury's policy will be presented below in the section on fiscal policy and debt management. Whatever the Treasury's policy was, there is no reason to conclude that the Federal Reserve was trying to do anything other than stop the rise in the price level. Chairman Martin said that the Federal Reserve had no reason for wanting interest rates to be high; on the other hand, it would do nothing that would permit prices to rise faster. No evidence has been advanced that contradicts this statement.

In a quite different way, however, Federal Reserve action was influenced by the financial problems of the Treasury. As officials of both agencies testified, there was consultation on monetary policy, fiscal policy, and debt management. Each agency ultimately made its own decisions but the Federal Reserve clearly was constrained, at least in choosing times at which to take action, by the debt operations of the Treasury. In the period between December 1954 and July 1958, the Federal Reserve did not support new Treasury issues by making purchases for its own account. However, Chairman Martin stated that the Federal Reserve did both advise the Treasury on money market conditions and seek to smooth the way for Treasury issues by preventing any sudden or temporary tightening of the market. Since the Federal Reserve felt obliged to do this, the timing of its monetary measures was necessarily influenced by the Treasury's plans.

As a practical matter, the Treasury's financial problems may not have had any important effect on Federal Reserve action during the last few years. Nevertheless, the principle that Federal Reserve action should not be influenced by the Treasury's financial problems is important. It is sometimes said that the Federal Reserve ought not to be independent of the Treasury since, as agencies of the Federal Government, the two should work together. It is, of course, desirable that different measures of stabilization policy be consistent with each other. But it is important that the problems of financing government not be allowed to bear on monetary policy. This is not to say that Federal Government ought never to finance expenditures by monetary expansion, but only that this ought to be done only when the interests of the economy require it—not when the exigencies of government finance make it convenient. Given the Federal Reserve's present wide powers of discretionary action, it is an important safeguard to make the Federal Reserve independent of the Treasury.

D. FISCAL POLICY AND DEBT MANAGEMENT

Fiscal policy and changes in the size of the national debt

Whereas the record of the Senate Finance Committee's study contains much disagreement about the appropriateness of the Federal Reserve's tight money policy, there is almost complete agreement, in which the Secretary of the Treasury and the Undersecretary for Monetary Affairs shared, that Federal Government cash surpluses for the fiscal years 1956 and 1957 were too small. Table 3 shows that during the fiscal years 1956 and 1957, the national debt was reduced \$3.8 billion. The portion of the debt held outside the Federal Government fell by a much larger amount, \$8.9 billion. However, it is important to note that this reduction in Treasury borrowing was offset in part by a \$2.5 billion increase in the public borrowing of certain Federal agencies—the Federal National Mortgage Association and others empowered to borrow directly on their own account. The overall result, then, was that during fiscal 1956 and 1957, total Federal debt outstanding was reduced \$6.5 billion. Commenting on part of this record, the Undersecretary of the Treasury for Monetary Affairs, Mr. Burgess, said:

TABLE 3.—*Public debt of the United States: Total and amounts held outside Government investment accounts on selected dates, 1955-57*

[Billions of dollars]

Date	Total public debt	Amount held outside
1955—June 30.....	274.4	223.9
Dec. 31.....	280.8	229.1
1956—June 30.....	272.8	219.3
Dec. 31.....	276.7	222.7
1957—June 30.....	270.6	215.0

Source: Treasury Bulletin.

We have had a \$1.6 billion surplus this past year with a \$2.2 billion debt reduction. That is not very much. I would like to see it bigger.⁷

Why, then, was a larger surplus not achieved? In Mr. Burgess' words, the reasons were:

* * * the cold war * * * and * * * the various pressures for expenditure of one sort or another.⁸

These statements are highly significant. It seems to be a lesson of the recent period of rising prices that unless the Treasury is under a rigid obligation to achieve a surplus of a specified size in time of inflation, other considerations will inevitably crowd out the objective of a sizeable surplus. The proposals for a "balanced budget at a high level of economic activity," which carry the implication of a surplus increasing in amount as inflation mounts, gain added point in the light of recent experience.

Borrowing by Federal agencies

As was pointed out above, the outstanding debt of certain Federal agencies that borrow directly from the public increased sufficiently during fiscal year 1956 and 1957 to offset about one-quarter of the reduction in the Treasury's own outside borrowing during the period.

⁷ Hearings, p. 1006.

⁸ Hearings, p. 1007.

An offset of this magnitude could seriously reduce the effect on the economy of Treasury fiscal policy. At present the agencies consult with the Treasury about their borrowing but the Treasury cannot control the amount of their borrowing. The effectiveness of fiscal policy would be increased if the Treasury were able to fix the total amount of this outside borrowing.

Rapid amortization of defense facilities and the new treatment of depreciation

Although tax policy was not treated extensively in the study, two provisions of tax law were discussed at some length, in relation to the inflation. It was agreed, by Treasury officials among others, that the Treasury's continuing to award the certificates that allowed rapid writeoff of so-called defense-related facilities had contributed in some measure to the incentive to build new business plants and had therefore been inflationary. This was also the effect of the 1954 change in the tax law that permitted firms a choice of methods of computing depreciation on tax returns. The position of the Treasury on these matters was that the rapid amortization allowances were no longer useful and should be stopped, but that the new provision about depreciation was sound and should be kept: the year 1955 turned out to be a bad year in which to introduce the new depreciation option but in the long run its effects would be desirable. This appears to be a sound conclusion on both issues.

Treasury debt operations and interest rates

Since the Treasury is the largest single borrower in the United States, its debt operations are bound to have marked effects on financial markets. In the markets for short-term credit, the weight of Federal borrowing is much greater than it is in long-term markets. The volume of Treasury bills outstanding in recent years has been about 10 times the volume of private short-term paper—commercial paper and bankers acceptances. In the bond market, Federal debt outstanding is a much smaller proportion of the total. But to show the effect of Treasury borrowing on changes in interest rates it is necessary to compare not totals outstanding but changes in the totals. During the calendar year 1956 and the first half of 1957, increased Treasury bill issues accounted for over half the total increase in short-term securities outstanding. The higher Treasury demand for short-term credit must have contributed importantly to the rise in short-term rates. Treasury intermediate and long-term securities outstanding, however, declined below 1954–55 levels, while the total of other obligations increased. Therefore, the change in Treasury borrowing must have moderated the upward pressure on long-term rates of interest.

It has been suggested that the Treasury may have influenced interest rates in another way, by issuing securities with higher coupons, for the purpose of forcing market rates up. This contention is not supported by the facts. Issuing securities with higher coupons would not in itself force bond yields up: a marketable security bearing a coupon corresponding to a yield above the going market rate would simply increase in price, the yield declining correspondingly. The Treasury could have increased yields only by increasing its borrowing enough to bring interest rates up. But total Treasury borrowing was reduced during 1956 and 1957, as table 3 above shows.

Another point in this connection is that in 1956 the initial prices quoted on Treasury offerings of intermediate and long-term securities averaged only one point over par, and in 1957 (through May) the average was exactly par. This suggests strongly that the Treasury was attempting to issue its securities at the lowest cost the market would permit and was not seeking to force interest rates up.

Debt management and the maturity of the debt

The objective of lengthening the maturity of the debt—by replacing maturing short-term debt with bonds and by issuing bonds with a term longer than 10 years—has continued to influence debt management. In fact, however, the average time to maturity of the outstanding obligations decreased slightly in 1956 and 1957. In a period of relatively high interest rates, the cost entailed in issuing bonds, especially long-term bonds, seemed to the Treasury prohibitive. As with the objective of reducing the size of the debt, other considerations militated against stretching out the maturity. In order to evaluate the seriousness of this fact, it is necessary first to be clear on the costs and advantages of lengthening the maturity of the debt. As to costs, there would probably be savings in marketing costs if issues were less frequent and the Treasury bill turnover were smaller. On the other hand, the interest cost of a longer dated debt would be higher. If, for example, 10 percent of the amount of Treasury bills outstanding on the average in 1956—a figure of about \$2.4 billion—had been funded into bonds of 5- to 10-year term, the resulting increase in the annual interest cost of the debt can be calculated, on certain assumptions about the effects on interest rates of this change, to have been about \$19 million. This would have been an increase in the total interest cost of the debt of about one quarter of 1 percent. Would such an increase in costs have been excessive? Of course, this calculation gives only a rough approximation of the correct figure; and the hypothetical “funding operation” to which it relates was chosen arbitrarily. The point is that some estimate of costs is necessary if a judgment is to be made on the desirability of lengthening the debt. The Treasury did not present such figures to support its contention that issuing longer dated securities in 1956 and 1957 would have been too expensive; the lack of such figures makes the contention inconclusive.

As advantages of lengthening the debt, two chief points are claimed: first, that reducing the frequency of Treasury issues would make the Federal Reserve’s task easier; and, second, that to change to longer dated securities during inflation would help to check private spending. Undoubtedly, frequent large issues of Treasury securities poses awkward problems for the Federal Reserve. But were the problems during 1956 and 1957, for example, more than technical complications in the Federal Reserve’s job? Did they actually inhibit monetary control? As for the second point, replacing maturing short-term securities with bonds during inflation probably would help to control the inflation. In fact, however, other pressures on the Treasury have often led to the opposite change, as happened in the recent inflation. It is interesting that the presidents of the Federal Reserve banks in their joint reply to the Finance Committee’s questionnaire conclude that countercyclical debt management is probably not feasible, and that

the objective should be rather to minimize the interference of debt operations with other policy.⁹

The probable effects on Federal finance of lengthening the maturity of the national debt are not clear, nor are the effects on monetary control and the economy at large. It seems to be taken for granted that the change would be desirable but the costs and advantages need to be clarified if the case for a change is to be convincing.

E. MONETARY AND FISCAL POLICY IN THE RECESSION

Monetary policy in the recession

In the second phase of the Finance Committee's study, attention shifted from inflation to the recession that was by then under way. Although the committee's questionnaire, sent out in March 1958, related to inflation as well as to recession, the answers reflect the same shift of interest to the problem then current. However, both the answers and the testimony in the hearings themselves reflect concern over the possible return of inflation.

Federal Reserve policy after October 1957 was much less controversial than the tight money of the previous 2 years. But some expert observers criticized the Federal Reserve for not doing more to expand the money supply. A comparison of the change in the total of commercial bank deposits and currency held by the public during the first 9 months of the recession with the behavior of the same total in 4 previous downturns shows that the Federal Reserve's action was unusually strong:

Change in commercial bank deposits plus currency held by the public

First 9 months after downturn in—

	<i>Billions</i>
June 1929.....	-\$1, 056
May 1937.....	- 694
November 1948.....	-2, 000
July 1953.....	+3, 100
July 1957.....	+6, 400

These figures do not, of course, demonstrate that the Federal Reserve took "adequate" action to counter the decline. They do show, however, that, compared to past recessions, these were unusually strong measures.

Fiscal policy in the recession

Controversy over fiscal policy in the recession centered mainly on the merits of a special tax cut, an emergency increase in expenditures, or both. The official position of the administration was that the effects of reduced tax rates or increased expenditures would come too late to aid recovery and would, instead, give a strong impetus toward renewed inflation. Critics of this position argued that the recession was more severe than the administration and others who agreed with it recognized, and that without special measures the decline would continue for some time and would reach lower levels than the recessions that began in 1948 and 1953. Disagreement was mainly over the correct diagnosis of the economy's condition, and only to a lesser extent over the magnitude and timing of the effects of changes in expenditures and taxes. At this writing, it is too soon to be certain

⁹ Joint and Supplemental Comments of the Presidents of Federal Reserve Banks in Response to the Questionnaire of the Committee on Finance, pp. 50, 51.

about who was right. Present appearances are that an upturn came in the spring of 1958 and that by the early autumn recovery was well underway. If this turns out to be true, then the administration will be proved correct: special tax or expenditure changes adopted in early 1958 would have produced their main effects only after recovery was well underway. But it is too soon to know.

F. CONCLUSION

The Senate Finance Committee's study presents much relevant data on the monetary changes and fiscal experience of the past 3 years and raises a number of important questions about the period. Perhaps the most important question concerns the nature of the recent inflation. It appears that the inflation, and the recession that followed, were not different in essential respects from previous economic fluctuations. Though it is not possible to show conclusively that price increases resulted from the pressure of increased business and consumer demand, it can be shown that demand increased early in the inflation and that the pattern of price increases among different industries is related to the pattern of demand increases. It is also clear that when demand stopped rising and then fell, production and employment declined and, with a lag, prices stopped rising and then fell.

Both monetary and fiscal policy during the period were free of many of the errors charged to them. However, important questions remain unanswered about the soundness of presently accepted principles of stabilization policy. In the case of monetary policy, the problem is mainly uncertainty about the timing of the effects of Federal Reserve action. This uncertainty has important implications for the fundamental question of the effectiveness of discretionary control of the money supply.

PART II

SUMMARY OF THE TESTIMONY ON THE PRINCIPAL SUBJECTS OF THE HEARINGS

INTRODUCTION

This summary of the views expressed by each witness on the principal subjects considered in the hearings is arranged according to subjects, to facilitate comparison of the views. Under each heading, or subheading, the statements appear in the order in which the witnesses appeared before the Finance Committee.

At the end of each section there are brief comments on the main issues raised in the statements. These comments are based on the analysis presented in part I of this report, where the points are stated more fully.

The witnesses were:

Hon. George M. Humphrey, Secretary of the Treasury
Hon. W. Randolph Burgess, Under Secretary of the Treasury
Hon. William McChesney Martin, Jr., Chairman, Board of
Governors of the Federal Reserve System
Hon. Bernard M. Baruch
Marriner S. Eccles, former Chairman of the Board of Governors
of the Federal Reserve System
Sumner H. Slichter, professor of economics, Harvard University
Seymour E. Harris, chairman of the economics department,
Harvard University
Charles C. Abbott, dean of Graduate School of Business Adminis-
tration, University of Virginia

A. CAUSES OF THE INFLATION AND THE RECESSION

(1) *The inflation*

Mr. Humphrey.—Inflation is now [June 1957] “perhaps our most serious domestic economic problem” (p. 8). Current price increases are caused by the pressure of rising consumer and business demand, financed by bank loans (pp. 13, 103–107, 112–118, 181–186, 188–194, 223–224, 340, 602, 634, 635). Rising interest rates have not been an important cause of price increases (pp. 31–33, 40). However, the high level of Government spending has contributed to the inflationary pressure (p. 6).

Mr. Burgess.—Causes of the inflation are (1) the delayed effects on rents and other prices of cost increases in earlier periods (p. 736); (2) current cost increases (pp. 1050, 1051); and (3) rising demand for capital goods (pp. 736–738, 831, 848, 1040, 1043, 1074, 1085). The high level of government expenditures, especially armament expenditures (pp. 1127–1130), has also caused inflationary pressure (pp. 738,

739). Higher interest rates have restrained rather than stimulated price increases (pp. 739, 858, 1033).

Mr. Martin.—A general increase in demands for goods and services bid prices up, beginning in 1955 with the prices of industrial goods (pp. 1262–1264). An important cause of higher business and consumer demands in 1955, 1956, and 1957 was the easing of credit by the Federal Reserve in 1954 (pp. 1304, 1305). Higher interest rates have restrained inflation (pp. 1268, 1269); on the other hand, higher labor costs were an independent cause of price increases, working through a wage-price spiral (pp. 1848, 1872, 1873).

Mr. Baruch.—"The main cause of inflation today is the deficit financing of war—the enormous borrowing in World War II and Korea" (p. 1639). The wage-price spiral is the aftermath of inflation; it has kept inflation going, though it was not an original cause. The wage-price spiral will inevitably be checked by consumers' refusal to pay higher prices (pp. 1676, 1677).

Mr. Eccles.—The four principal causes of the recent inflation were (1) the excessive growth of consumer borrowing, resulting from easier terms of credit offered in 1954 and 1955; (2) the boom in house purchases, also stimulated by easier credit; (3) an increase in capital expenditures by business, which was induced principally by the automobile and housing booms but which was stimulated also by the continuation of accelerated amortization allowances and the new treatment of business depreciation allowed by the 1954 change in the tax laws; and (4) higher labor costs, which have resulted from the strong bargaining power of labor union monopolies in a period of high demands for goods and services (pp. 1694, 1695).

Mr. Slichter.—Mr. Slichter did not make a direct statement on the causes of the inflation but his remarks on wage-push inflation were clearly intended to apply. He said:

* * * rising wages are a principal cause of rising prices.

They are not the only cause but the issue had been confused by the honest belief of many people that rising wages simply reflected a strong demand for goods.

Wages have continued to rise throughout the recession in the face of falling demand for labor and goods (p. 1843).

Mr. Harris.—Mr. Harris also did not make a direct statement on the causes of the inflation. His testimony contains the following remarks relating to the subject: An investment boom preceded the recession (p. 2015); during the boom, the lending of Federal credit agencies, life insurance companies, and other nonbank financial institutions rose considerably (pp. 1989, 2004, 2005). Nonfinancial corporations also drew on large cash reserves to finance additions to capital equipment (pp. 1990, 2005). Higher labor costs, which in some industries led to price increases in excess of the rise in costs, were a cause of the inflation (pp. 1990, 2014, 2037, 2038).

Mr. Abbott.—Current inflation is wage-push inflation. When the money supply is flexible, " * * * wage increases inevitably push up prices" (p. 2061). Other causes of the increases in the price level since the 1930's are the Federal deficits, the increased national debt, the rise since 1945 in the rate of turnover of bank deposits, farm price supports, the increasing amount of services purchased by consumers, and the larger fraction of national output going for military purposes of foreign aid.

(2) *The recession*

The witnesses who appeared in 1958 also gave their views on the causes of the recession that was by then in progress.

Mr. Baruch.—The recession is the result of inflation; consumers' refusal to pay higher prices caused unemployment (p. 1637).

Mr. Eccles.—The recession developed because high prices and the redistribution of buying power caused by inflation reduced the volume of goods and services purchased. Other causes of the fall in demand were the high rate of durable goods purchases during the previous 2 years, the high level of consumer debt, and the overbuilding of business plant and equipment (p. 1696). Restrictive monetary policy brought on the recession sooner than it would otherwise have occurred but, in any case, a recession would have followed the boom (pp. 1707, 1708).

Mr. Slichter.—The recession is concentrated in durable goods manufacturing, mining, construction, and transportation (p. 1818); it came as a reaction to an unusually high level of investment spending during 1956. The tight money policy, the reduction of Federal expenditures in 1957, and the unpopularity of the 1958 cars also were causes of the recession (pp. 1822–1825).

Mr. Martin.—The recession was a reaction to the investment boom of the preceding 2 years, in which business added to its plant and equipment faster than the growth of consumer demand warranted (pp. 1848, 1849). The excessive growth of private debt also finally reduced consumers' spending (p. 1863). Monetary restraint slowed down the inflation but did not cause the recession (pp. 1892, 1918).

Mr. Harris.—The recession was caused mainly by excess capacity but it was made worse by the Federal surpluses of fiscal 1956 and 1957, and by the tight money policy (pp. 1988, 2014, 2015).

Mr. Abbott.—The recession is concentrated in the heavy goods industries (p. 2058); it was caused by declining business purchases of plant and equipment and by a reduction of business inventories (p. 2060). The upward push of wages had made prices inflexible, so that output and employment have decreased as demand has fallen (p. 2061).

Comments on the causes of the inflation and the recession

(1) All the witnesses except Mr. Humphrey and Mr. Baruch listed the push of labor costs—or both labor costs and administered prices—among the causes of inflation. Mr. Baruch described the wage-price spiral as an aftermath of inflation and Mr. Humphrey did not mention it. There is strong evidence to support the view, criticized by Mr. Slichter, that price increases were the cause rather than the result of higher wages. This evidence is the fact that the largest price increases, and the increases in the most important segments of the Consumer Price Index, were associated with increases in the quantities of goods and services purchased. Furthermore, wages continued to increase during the recession only where demand continued high or where there existed previous commitments, including escalator clauses, to increases.

What caused demands to increase so rapidly and then to fall sharply in 1957 is another question, to which, it appears, no conclusive answer can be given in the present state of knowledge.

(2) It is unlikely that government control of consumer credit or of lending by nonbank financial institutions would have exerted any additional restraint on spending. There is no evidence that the amount of private debt was a cause of the recession.

(3) The inflationary effects of government expenditures, a point discussed by several witnesses, needs to be clarified in two respects. First, government expenditures for weapons—and for many other purposes, e. g., paying the salaries of Federal judges—are like private consumption expenditures in that they absorb goods and services into uses that do not—in most cases—make possible more output in the future. However, all increases in today's expenditures add to current demand and may raise current prices—investment expenditures are potentially as inflationary as any other. Whether future prices will be lower because of today's investment is another question.

Secondly, there is a point in saying that weapons expenditures are inflationary even when financed by increased taxes but the point is often overstated. If consumption goods had been produced instead of weapons, the additional goods on the market would have tended to hold prices down. But, on the other hand, higher taxes tend to reduce the private demand for goods and services, because taxpayers are, in effect, compelled to purchase weapons and their incomes available for purchasing other things are reduced. So much must be subtracted, as it were, from the statement often made, that weapons expenditures are inflationary because incomes are earned in the production of weapons and there is no corresponding production of goods for private markets. However, a point still remains: experience shows that private spending will not fall by the amount of the increased taxes (which, by hypothesis, equals the increase in government spending), therefore, total spending will rise and prices may rise. There have been no attempts to compute the magnitudes involved, allowing for all relevant factors, but it is clear that the increase of prices, if any, must be less than is implied by the statement of the point referred to above.

B. THE FEDERAL RESERVE AND MONETARY POLICY

(1) *The gold standard*

Mr. Humphrey.—It would not be wise to return to unrestricted gold redemption of the currency (p. 480); present arrangements for monetary control are sound (pp. 480, 529). Foreign governments can purchase gold with their dollar balances and the total of such balances is large in relation to the Treasury's gold stock (pp. 480-483, 524-525); nevertheless, there is no danger that the gold stock will be inadequate to meet the demands on it.

Mr. Burgess.—Return to the gold standard should be an objective of monetary policy, but unstable international conditions make it unsafe to return to gold now (pp. 1021-1024).

Mr. Martin.—It would not be safe to return to gold redemption of the currency now, because of the danger that agents of unfriendly countries would disrupt the monetary system by demanding large amounts of gold (pp. 1461, 1474-1479). Ultimately, we ought to return to gold, but the present monetary system is sound (pp. 1485,

1488, 1494, 1495, 1550, 1555). The present gold reserve is adequate (p. 563).

Mr. Baruch.—Under present international political conditions, a sound decision cannot be made on the long run question of returning to the gold standard (p. 1684).

Comments on the gold standard

It is doubtful that if the currency had been redeemable in gold, monetary policy and the behavior of the money supply would have been very different during the past 7 years. However, the fundamental issue raised by the question of restoring gold redemption is whether the present scope of discretionary monetary control ought to be reduced. This issue deserves serious consideration.

(2) *Federal Reserve policy*

Mr. Humphrey.—Monetary control ought to be flexible, aiming at ease during recessions and at restraint during inflations (p. 176). The Federal Reserve System ought to be independent of the administration (p. 24); during the past 4 years, the Treasury and the Federal Reserve have discussed monetary problems but the Federal Reserve has been free to make its own decisions on monetary action (pp. 232, 233).

The recent tight money policy has been “* * * in the best interest of the great majority * * *” (p. 27). The Federal Reserve did not seek to raise interest rates but the restrictive monetary policy was one cause of higher rates. A more important cause was the increased demand for credit (pp. 545, 546).

Mr. Burgess.—The Federal Reserve should be independent of the administration in reaching decisions on monetary policy, though it should consult with the Treasury (p. 742). The Federal Reserve has not sought to raise interest rates (p. 1051); rising demand for credit rather than Government policy has been mainly responsible for rising rates. The Federal Reserve’s policy of monetary restraint has been sound (p. 1056).

Mr. Martin.—The Federal Reserve Act and the Employment Act of 1946 prescribe the objectives that guide Federal Reserve decisions (pp. 1898, 1899). Federal Reserve policy since 1955 has aimed at stopping the rise in the price level (p. 1850); the Federal Reserve has not tried to raise interest rates (p. 1327). The Federal Reserve has regarded the control of inflation as essential for economic growth (pp. 1301, 1302).

Mr. Eccles.—The general lines of Federal Reserve policy during the inflation were sound (p. 1702). The Federal Reserve should have the power to control consumer credit and mortgage credit (p. 1738).

Mr. Slichter.—The Federal Reserve policy of restraint was correct but restraints were kept on too long (p. 1844).

Mr. Baruch.—The Federal Reserve did not try to raise interest rates (p. 1669).

Mr. Harris.—The primary objective of Federal Reserve policy now is a stable price level (p. 2002). The Federal Reserve ought not to be independent of the administration (pp. 2046, 2047). Federal Reserve action against the recession has been too weak (pp. 1991, 1992).

Mr. Abbott.—The correct objective of monetary policy is to offset economic forces, including Federal fiscal operations, that create infla-

tionary or depressive tendencies (p. 2064). The Federal Reserve should be independent of the administration. The Federal Reserve should be given power to influence the operations of Federal lending agencies (p. 2080).

Comments on Federal Reserve policy

(1) The question whether price stability or full employment should be the principal aim of monetary policy requires clarification. What is at issue is not what the aims of policy ought to be (there is agreement about what is desirable in general), but how the aims can best be achieved. There is disagreement on the probable effects of different strategies of monetary action; resolving this issue requires further study of past experience.

(2) There is a strong case for separating monetary control from government finance. During the hearings Treasury officials admitted that fiscal expediency took precedence over control of inflation in decisions on taxes and expenditures during the 2 previous fiscal years. It is difficult to avoid this when pressures for expenditure are strong and decisions on expenditure and taxation are not well coordinated. If the Treasury also exercised control of the money supply, these pressures would bear on monetary policy as well as on fiscal policy. Therefore, the interests of economic stability are better served by not allowing the Treasury to have discretionary powers of monetary control.

(3) There is no evidence that the Federal Reserve tried to raise interest rates during the inflation.

C. FINANCIAL POLICIES OF THE FEDERAL GOVERNMENT

(1) *Taxes, expenditures, and fiscal policy*

Mr. Humphrey.—The administration succeeded in reducing Government expenditures, reducing taxes, and eliminating planned deficits (pp. 9–11). Present levels of taxation are too high (pp. 66, 67). The principle of a limit on the national debt is sound and the [then] current limit ought not to be increased, except temporarily (p. 86). It is no longer desirable to allow rapid amortization of defense-related facilities; the issuance of new certificates has been curtailed (pp. 248, 249).

Mr. Burgess.—The budget surpluses achieved in fiscal 1956 and fiscal 1957 were too small; pressures for expenditures made it impossible to realize larger surpluses (p. 1007). Reducing expenditures is better than increasing taxes as a fiscal measure against inflation. The principle of a debt limit is sound (p. 1060). As a long-run measure, the 1954 change in the tax law that allows firms an option in the method of computing depreciation on tax returns is sound; the timing of its introduction proved unfortunate and it has contributed to inflation (p. 1093).

Mr. Martin.—During inflation, the Government should reduce expenditures and achieve a budget surplus (pp. 1271, 1272). The surplus in fiscal 1957 and the prospective surplus (in April 1958) for 1958 are too small (p. 1271). Deficits during recession may be helpful but their benefits are often overstated (p. 1317). A tax change that increased incentives to produce would help to achieve economic stability (p. 1856). A tax cut now would not aid recovery and its later effects would be undesirable (pp. 1855, 1867, 1868).

Mr. Baruch.—In the present recession, taxes should not be cut and any increases in expenditures should be paid for out of increased taxes (pp. 1634, 1635). The Government ought to adopt a regular schedule of debt amortization (p. 1638). Deficit financing during World War II was unsound and has caused the subsequent inflations (p. 1639). It is sound to issue Government bonds for certain purposes, provided that taxes are increased to pay for the cost of interest and amortization (p. 1642). A statutory limit on the national debt is desirable (pp. 1670, 1671). Congress should have the service of an expert staff to study proposals for expenditures (p. 1643).

Mr. Eccles.—Budget surpluses and a reduction of the national debt ought to be used during inflation to offset the growth of private debt. During depression, when private debt is contracting, there should be deficits and an expanding public debt (p. 1703). The deficits should be created by tax cuts rather than increases in expenditure (p. 1704). In the present recession, tax collections should be reduced by 6 to 7 billion dollars through the elimination of certain excises, a reduction in the rate of corporate income tax, and a reduction in the rate on the first \$2,000 of individual incomes (pp. 1698, 1699).

Mr. Slichter.—Surpluses should be planned for periods of high private spending and inflation, and deficits for periods of recession (p. 1833). Ideally, increased expenditures would be authorized in advance and put into effect when a recession occurred. Procedures for timing such authorizations correctly do not exist, however; it will be 10 years before they can be developed and put into operation (p. 1828).

It is now (April 1958) too late in the present recession to cut taxes; the increased expenditures already authorized will produce a deficit large enough, though timed too late, to do all that fiscal policy can do to overcome the recession (p. 1838).

Mr. Harris.—The budget should be in surplus during inflation and in deficit during recession (p. 2032). Present (April 1958) expenditures ought to be increased and the tax rate applying to the first \$2,000 of individual income ought to be reduced, to give a deficit of \$7 billion for the calendar year 1958 (pp. 1996–1997). The administration has made changes in programs and accounting procedures for the purpose of reducing current expenditures; it is questionable whether the resulting reductions in the budget are genuine decreases in spending (pp. 2048, 2049).

Mr. Abbott.—Except in times of extreme crisis, the aims of fiscal policy ought to be only (1) to protect the Government's credit and (2) to make as small as possible the effects on the private economy of Federal financial operations (p. 2064). Raising Federal expenditures is an inefficient remedy for unemployment, because the effects are slow and because there is no direct provision of jobs for those out of work (p. 2059). As a means of stimulating business spending now and as a long-run reform, tax law should be changed to permit business firms to deduct depreciation according to any time pattern they choose, provided that the pattern is not changed (p. 2062).

Comments on fiscal policy

(1) The controversy over the merits of special fiscal action against the recession was mainly about the seriousness and expected duration of the recession; there was relatively little

disagreement about the timing of effects to be expected from special action.

(2) Control of government expenditures is aided by maintaining the rule of a balanced budget but the rule has important defects in the face of economic fluctuations. It is not likely that the rule will be adhered to in a recession; if it were adhered to, the recession would be deepened. During inflation, tax collections rise; if tax rates were reduced or government expenditures increased, as the rule would require, prices would rise more. On the other hand, recent experience shows again that to have no fixed principle also is unsatisfactory, because it is difficult to time ad hoc changes correctly and because fiscal expediency may exert a strong influence on the relation between expenditure and revenue.

One principle that has been suggested as a replacement for the balanced budget rule is that the budget be balanced at a high-employment, noninflationary level of national income, and the tax rates and expenditure level thus established be maintained over the business cycle. As national income rose during inflation, an increasing surplus would be generated; during recession, the deficit would automatically increase as the recession deepened.

2. *Debt management*

Mr. Humphrey.—The Treasury has tried to lengthen the maturity of the debt, to reduce the fraction of the debt held by banks, and to increase individuals' holdings of savings bonds (pp. 17–18). During the recent period of high interest rates, however, it has been necessary to sell more short-term securities in order to keep interest costs down (p. 17). Though the large volume of Treasury borrowing inevitably affects interest rates, the Treasury has not tried to establish any level of market rates, but rather to borrow as cheaply as possible, in keeping with the objective of lengthening the debt (p. 631).

Mr. Burgess.—The Treasury has tried to lengthen the debt and to sell more savings bonds (pp. 668, 669); however, the average time to maturity of the outstanding obligations has increased only very slightly (p. 671). In setting the rates to be offered on new issues, the Treasury has been able to anticipate very closely actual market rates at the time of issue (pp. 683–687). The Treasury has not tried to raise interest rates (p. 759). January 1954 was the last previous time that the Treasury sold securities directly to the Federal Reserve (p. 898); however, it is a regular practice for the Federal Reserve to aid the Treasury by insuring that the bond market is not in a period of temporary tightness at the time when a Treasury issue is sold. In planning its issues, the Treasury receives advice from the Federal Reserve and from private financial firms (p. 682).

Mr. Martin.—In a recession, the Treasury should issue mainly short-term securities and during inflation it should emphasize long terms (pp. 1232, 1233). The Federal Reserve advises the Treasury on bond market conditions and attempts to avoid tightness in the market at the time of a Treasury issue but the Federal Reserve does not peg prices and, since 1952, only in exceptional circumstances has it bought securities directly from the Treasury (pp. 1422–1424).

Mr. Baruch.—The issue of a large volume of short-term securities has made debt management difficult and expensive; during the period of low interest rates, short-term securities should have been funded into long dated debt (p. 1637).

Mr. Eccles.—The Treasury should issue long-term securities during inflation, and short-terms during recession. In recent months, the Treasury has issued intermediate and long-term securities that have competed with private borrowing and tended to keep long-term interest rates high (p. 1697).

Mr. Harris.—By selling short-term securities during 1957 and intermediate and long-term securities during the recession in 1958, the Treasury worked against the monetary measures of the Federal Reserve (p. 2004).

Mr. Abbott.—The Treasury should provide the types of securities needed by the economy. Debt management should not be made a part of stabilization policy. The Treasury should try to sell its securities to investors other than banks (p. 2064).

Comments of debt management

(1) Although little or nothing is known about the actual magnitude of the stabilizing effects to be expected from countercyclical debt management, on general grounds it seems likely that the effects would be weaker than the effects of monetary and fiscal policy.

(2) On some occasions, notably in the spring of 1953 and again in the spring of 1958, Treasury debt operations and the expectations attending them have caused sharp fluctuations in the prices of Government securities. Regardless of the techniques used by the Federal Reserve and the Treasury, large, discontinuous Treasury operations are very likely to cause the market to be unstable from time to time. There is therefore a strong case for making Treasury debt operations as regular and continuous as possible. This improvement would probably do more than would the adoption of cyclical changes in the maturities of new issues—or any other change in debt management—to make the economy at large more stable.

PART III

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