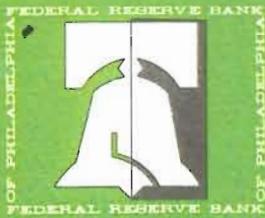


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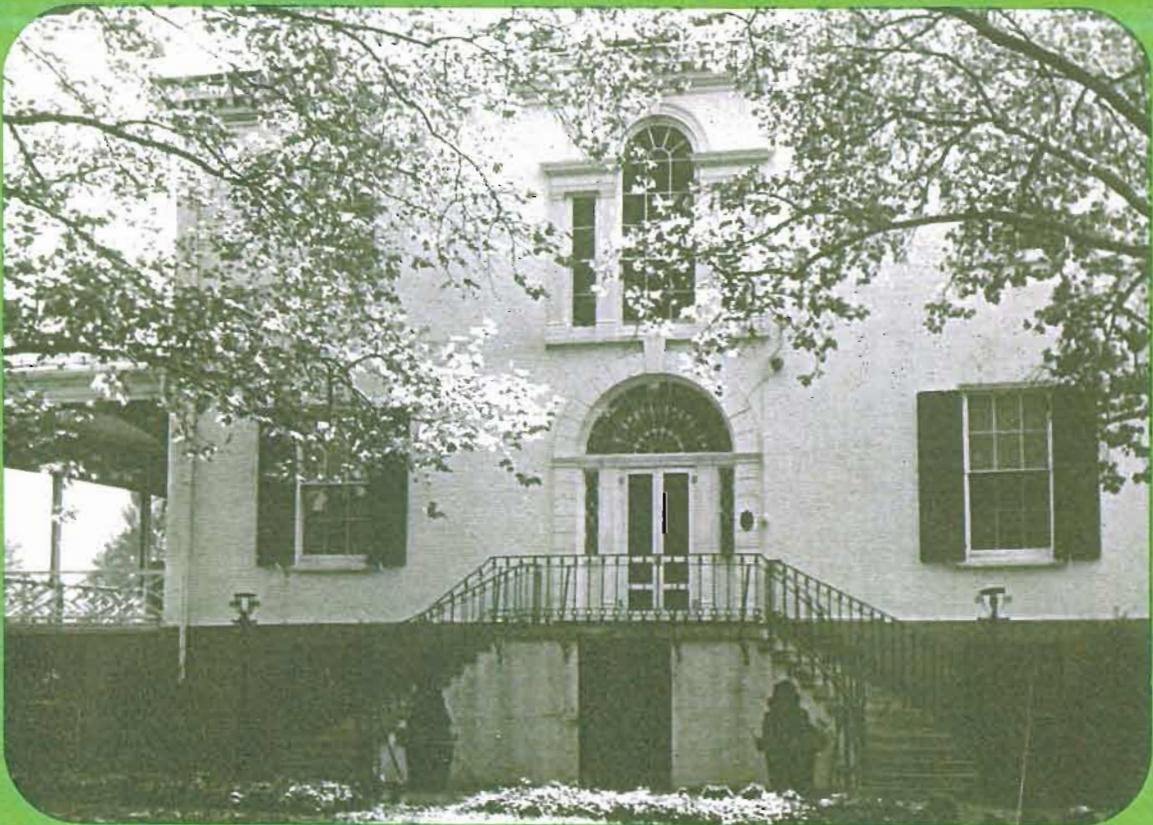
Central Banking across the Atlantic:
Another Dimension

Inventory Valuation Adjustments
Greatly Influence Corporate Earnings

A Perspective on Stagflation

FEDERAL RESERVE BANK of PHILADELPHIA

business review



1975

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. . . Some U. S. officials want the Fed to imitate its foreign cousins by allocating credit for "social priorities," but such a task may be easier said than done.

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A Perspective on Stagflation

. . . Expectations of future price increases provide the key for understanding stagflation—a simultaneous rise in unemployment and inflation.

On our cover: Lemon Hill, located in Philadelphia's Fairmount Park, is a notable example of Federal period architecture. Its chief historical association is with Robert Morris, a signer of the Declaration of Independence and a financier of the American Revolution, who owned the original estate of 42 acres and occupied it up to 1799. The present mansion was built by the purchaser of the estate, Henry Pratt, a Philadelphia merchant and philanthropist. It was acquired by the city in 1844 and dedicated a public park in 1855, marking the commencement of Fairmount Park. Lemon Hill is now maintained by the Colonial Dames of America. (Photograph by Sandy Sholder.)

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Central Banking Across the Atlantic: Another Dimension

By James M. O'Brien

The Federal Reserve is the only major central bank in the world which has refused to assume a responsibility for allocating credit to socially important sectors of the economy. . . . It is high time we brought the Federal Reserve Board into the 20th century.

—Senator William Proxmire

Fed watchers are continuously active and full of proposals. Some want to harness the System's responsibilities in monetary matters. Yet, others want it to assume greater responsibilities. A movement is currently underway in Congress and elsewhere to get the Fed to imitate some of its foreign counterparts by directing credit flows at low interest costs to "social priorities."¹

¹See statements of Senator William Proxmire and Professor Lester C. Thurow in U.S., Congress, Senate, Subcommittee on Financial Institutions of the Committee on

Scrutinizing the practices of West European central banks does evidence a concern for credit costs and allocation. Toward this end, these foreign central bankers have adopted a variety of tools that are largely outside the experience of Uncle Sam's financial policymakers. But rerouting credit to favored activities may be easier said than done. The West European experiences appear to raise more questions than they answer—especially those dealing with the costs of credit

Banking, Housing and Urban Affairs, *Selective Credit Policies and Wage-Price Stabilization: Hearings on S. 1201 and H. R. 4246*, 92d Cong., 1st sess., 31 March, 1 and 7 April 1971, pp. 1–3, 145–49; of Representative Wright Patman in U.S., Congress, House, Committee on Banking and Currency, *Activities by Various Central Banks to Promote Economic and Social Welfare Programs: A Staff Report*, 91st Cong., 2d sess., December 1970; and of Representative Henry S. Reuss in U.S., Congress, House of Representatives, *Congressional Record*, 93d Cong., 2d sess., 1974, 96, H5920.

controls, their effectiveness, and their adaptability to the home economy.

WEST EUROPEAN CENTRAL BANKS: A CONCERN FOR CREDIT ALLOCATION

Inflation, unemployment, balance of payments—these are the “traditional” concerns of central bankers. At the Federal Reserve they are part and parcel of its policy actions (see Box for discussion of Fed policy goals and tools). But for many central banks in Western Europe attempts to funnel credit to government-set priorities at relatively low interest costs represent still another impor-

tant policy dimension. Favored activities have generally been those industries believed important for economic growth and modernization, including the export industries and housing.²

²The countries whose central banking practices are reviewed are the United Kingdom, France, Italy, West Germany, Sweden, The Netherlands, and Belgium. This review was prepared using the material from a number of recently published studies on foreign central banking which are listed in the Bibliography. Among these, the most important source of reference is Donald Hodgman, *National Monetary Policies and International Monetary Cooperation* (Boston: Little, Brown, and Company, 1974).

A LOOK AT THE FED

At least since the early 1950s, Fed money managers have directed much of their monetary policy efforts toward the ultimate goals of price stability and full employment of resources. Fed policymakers have also been mindful of keeping down sharp interest-rate fluctuations in the money markets and have traditionally given some weight to balance of payments considerations. But Fed watchers generally agree that the nation's balance of payments has taken second place in deference to domestic objectives, particularly the goal of full employment.

In pursuing its primary goals of an acceptable inflation rate and full employment, the Fed has relied mainly on those tools that change the outstanding volume of its own liabilities—cash reserves in the banking system and currency in the hands of the non-bank public. These consist of open market operations, lending to member banks, and changing reserve requirements that member banks must observe. The first of these is the Fed's most important monetary tool. Through open market operations it buys or sells Government securities in the marketplace. When securities are bought, the amount of cash in the banks or that held by the nonbank public is increased. This inflates the nation's money supply and stimulates the economy. The process is reversed when the Fed sells securities.

Lending cash to banks and setting the terms of the loans, while not insignificant, plays no more than a supportive role in monetary policy. The same has been true with respect to changes in reserve requirements of member banks.

Thus, the Fed's main policy *tools* have not included direct controls either generally on financial markets or specifically on the banking system. Nor have the Fed's policy *goals* generally included the allocation of credit. There have, however, been some exceptions: administering the regulation of consumer and mortgage credit during World War II and the Korean War, controlling down payments on stock purchases, setting interest-rate ceilings on bank deposits, and, in the '60s, using moral suasion to persuade bankers to curb loans to certain borrowers. But these exceptions remain just that and have not been an integral part of the Federal Reserve's financial policies.

Credit allocation constitutes a measurable part of the policy goals of the central banks in the United Kingdom, France, Italy, Sweden, and Belgium. The Bank of England, for example, makes some attempt to keep credit flowing to priorities such as shipbuilding, exports, “productive” investment and, more generally, to activities undertaken by the government. Across the Channel, the Banque de France has broadly aimed its financial policies toward modernization of the French economy. In doing so, it has sought to re-route credit flows as mandated by the government’s five-year plans.

Italy’s monetary authority, the Banca d’Italia, also undertakes policies designed to influence the allocation of credit among different uses. It backs investment projects that boost economic development and growth—particularly government or government-related investment. Sweden’s Riksbank, too, has traditionally supported government financing needs and, especially, homebuilding. Belgium, like France, Italy, and Sweden, is deeply committed to controlling the use of credit, and the Banque Nationale de Belgique plays a sizable role in the government’s credit allocation programs.

Central banks’ support for investment in “social priorities” has not been limited to direct attempts at rerouting credit flows. Endeavors to regulate interest rates are also made. For example, the Bank of England and the Banca d’Italia have sought to keep interest rates on government debt lower and more stable than free markets would permit. At least in part, this policy is designed to aid the respective governments in financing relatively large deficits resulting from sizable government spending programs. Moreover, these central banks and those in France, Sweden, and Belgium have attempted to control market rates on various types of private credit as well.³

³Beginning in the late 1960s and early 1970s some West European governments have had to abandon, at least partly, low-interest rate policies because of mounting balance-of-payments deficits.

All central banks in Western Europe pursue some credit allocation policies. However, those of The Netherlands and West Germany differ from their West European cousins in maintaining only a minimal amount of selective credit policies aimed at resource allocation. On this point, they are more like the Federal Reserve System. Both the Nederlandsche Bank and Bundesbank have primarily aimed their policies at inflation and balance of payments objectives.

TOOLS FOR INFLUENCING CREDIT FLOWS AND INTEREST RATES

Long-Term Credit Markets. Among the countries striving to route credit flows, only Great Britain has refrained from interfering with the long-term credit markets (and only since 1959). Countries concerned with the placement of long-term funds—France, Italy, Belgium, and Sweden—have relied on two main devices. One is direct control over the floating of securities on the capital market. Those wishing to issue marketable securities must get permission for both the issue and its terms from a capital issues committee. The committee’s job is to provide a favorable market for securities issued by the government or by private firms to finance high-priority investments. In Sweden, for example, the business sector has been limited to about 20 percent of capital-market bond issues since 1960, while housing issues have accounted for about half the funds raised in the capital market. Italy goes even further. Besides controlling issues of capital market securities, private firms have had to pay a 38-percent tax on the interest cost of bond issues. Government and government-related bond issuers are both exempted from the tax and receive priority access to the capital market. Some central banks—for example, the Riksbank and the Banca d’Italia—serve as capital issues committees.

In France, Italy, Sweden, and Belgium, substantial control over credit institutions also helps to determine the direction of long-term credit. Control is exercised in various

ways. Important in each of these countries are public savings institutions—often including the post office. And in France, Italy, and Belgium there are nationalized savings banks. Also in France, both public and private savings banks have had to turn all funds over to a government institution. In all of these countries, and especially in Italy, there exist public or semi-public credit institutions that obtain funds from the (controlled) capital markets. These specialized institutions then provide various high-priority industries with medium- and long-term credit. National commissions, committees, or “agreements” coordinate the control of this institutional lending. It’s at this level that governors of the central banks often play important roles as supervisors, chairmen, or executive agents.

Shorter-Term Credit Markets. Monetary policies of central banks impinge most immediately on short-term credit or money markets, including commercial bank behavior. Because of this, credit allocation policies of West European central banks have been mainly directed at the short-term credit markets and the financial policies of commercial banks. To a large degree, the objective has been to coordinate the central bank’s stabilization policies with the government’s credit allocation goals.

For instance, at least until most recently, central bank loans to commercial banks have been an important tool for controlling money supplies in West European countries. In some of these countries—France, Belgium, Italy, and even West Germany—loan requests are honored partly on a basis of whether the commercial banks’ intended use of the funds satisfied a social priority. Bank lending ceilings have also been a major stabilization tool for most central banks in Western Europe (only West Germany has abstained from this form of policy). The ceilings are invoked during periods when the central banks try to slow the overall pace of economic activity. However, except for The Netherlands, they are imposed in a selective

manner, allowing loans for favored activities to be either exempted or to exceed the ceilings.

Special “reserve requirements” are another tool for stabilization and allocation purposes. These requirements specify that bankers must hold a “reserve” in the form of certain types of assets. Often expressed as a percent of the bankers’ deposit liabilities, the requirement has been used in France, Italy, the U.K., Belgium, and Sweden. The objective has not only been to restrict deposit and loan growth generally, but also to spur the demand for assets which finance investment in social priorities. For example, government securities in Great Britain and housing credit in Italy and Sweden have been assets which can help satisfy banks’ “reserve requirements.”

An even more direct control on credit is central bank review of individual loans by commercial banks. This practice has been quite important in France. Commercial banks report to the Banque de France all business loans and obtain from business clients dossiers on their financial status and use of funds. The Banque then uses this information in rationing its loans to commercial banks.

Attempts to control short-term interest rates—especially those on government debt—have been an integral part of these selective credit policies. Several methods are important for controlling short-term rates. Supplying cash reserves to the banking system and discount houses in amounts sufficient to provide a strong and steady demand for government securities is one procedure. This has been practiced in England, Italy, and Belgium.⁴ Another method is the formal or informal tying of bank loan and deposit rates to the central bank’s discount rate. This has been used in Great Britain, France, Sweden, Belgium, and (more informally) in Italy.

⁴The supplying of reserves or currency is effected through either central bank discounting or open market operations.

IS THE FED WITH IT?

Because of a concern for domestic credit allocation and, specifically, the “uneven” incidence of tight-money policies, U.S. lawmakers have been considering the possible use of selective credit controls.⁵ Ideally, these controls would help offset market-determined patterns of credit allocation and result in more funds flowing to government-set priorities. In attempting to make the Fed incorporate selective credit policies into its monetary policy procedures, advocates have touted their importance in the policy repertoires of foreign central banks. However, before making these foreign experiences the guiding light, inquiry should go beyond merely establishing that “everyone (or at least almost everyone) is doing it.” There are important issues still to be unraveled.

At What Cost? Few things in life are free, and critics of the West European experiences have argued that concern for credit allocation has been at the expense of other objectives. For one thing, it is suggested that credit allocation goals may have an inflationary bias. The argument is that efforts by a central bank to see that favored activities have “adequate” or low-cost financing could militate against those policies aimed at combating inflation. Tight-money policies designed to dampen excessive spending will tend to have “loopholes” in the form of priority-borrowing classifications. The flow of funds through these “escape hatches” can be expected to increase as financing elsewhere becomes more difficult. The authorities must be willing to tighten up on nonpriority credit categories, and even allow for some restriction on priority items when total spending is excessive. Otherwise, excessive monetary expansion and more inflation may result.

⁵Currently there are two bills in Congress which would have the Federal Reserve direct some form of selective credit controls: S.887 sponsored by Senator Richard S. Schweiker and H. R. 212 sponsored by Representative Henry S. Reuss.

Hard evidence concerning an inflation-social priorities tradeoff is difficult to come by. However, it has been argued that the relatively high rates of inflation in France, England, and Italy can be partly traced to difficulties in coordinating policies aimed at supporting high-priority borrowers with those employed to reduce inflation. For example, to guarantee ample financing for a gamut of favored activities, the Banque de France has at times had difficulty restricting the growth of its own liabilities to a level consistent with low inflation. In the U.K. and Italy, the continual obligation to support government debt markets is also suggested to have produced excessive monetary growth and inflation.⁶

An even more general criticism leveled at the West European experiences is the adverse effect of credit controls on the functioning of financial markets. One argument notes that controls tend to expand. An example sometimes cited is that of Great Britain. Initially, in the early '60s, clearing (commercial) banks were the only institutions subject to credit controls. As time wore on, the clearing banks began losing business to other uncontrolled and more competitive financial institutions. Moreover, the banks themselves began evading the controls by acquiring other unregulated lenders as subsidiaries. In response to these growing leakages, unregulated lending sources came under restriction in the late '60s.⁷

⁶For a discussion of the French experience with credit allocation policies and inflation, see Hodgman, *op. cit.*, pp. 27–52; and Jacques Melitz, “Selective Credit Controls: The Lessons from French Experience,” Federal Reserve Bank of Philadelphia, unpublished, 1972. The reference to the Italian experience with inflation is from Hodgman, pp. 85–125. With respect to the U. K., see Hodgman, pp. 117–25; and his “British Techniques of Monetary Policy: A Critical Review,” *Journal of Money, Credit, and Banking* 3 (1972): 760–79; and Brian Griffiths, “Monetary Policy in the Float,” *The Banker*, July 1972, pp. 1023–25.

⁷See, for example, Hodgman, pp. 158–96 and Paul Davidson, “Discussion Paper,” David R. Croome and Harry G. Johnson, eds., *Money in Britain: 1959–69* (Lon-

However, this growth in the scope and complexity of regulation cuts down on the efficiency with which financial markets are able to channel savings into investment. For example, it is argued that where comprehensive systems of controls have evolved, lenders have found it difficult to cut the costs of financing or to attract customers in other ways. Moreover, the central banks have traditionally found it advantageous to support programs designed to minimize bank competition in order to maintain an environment conducive to credit control. Officially sanctioned banking cartels or cartel-like agreements have, at least until most recently, characterized the banking systems of Italy, France, Belgium, Sweden, and the U.K. It is through these cartel arrangements that the respective central banks have sought to make their controls effective.⁸

In fact, these defects have caused concern even among users of selective credit policies. In France, for instance, a high-level government commission has recommended significantly reducing the government's control over credit flows in order to make for a more competitive and efficient financial structure and to give the Banque de France more control of the money supply. And, in 1971, England embarked on a "credit reform" de-

signed to end bank credit ceilings and the Bank of England's responsibility for supporting the government securities market. The reform has also attempted to reduce the restrictive practices of clearing banks and, in the process, give competition a stronger hand in determining lending rates.⁹ For many years the West German government had regulated deposit interest rates for reasons other than credit allocation. During 1965-67, the Bundesbank experimented with deposit and loan rate controls as a part of its monetary policy. The objective was to shield borrowers from exorbitant interest costs and credit institutions from "cutthroat" competition. However, in 1967 all interest rate controls were revoked with the official explanation that the controls were unworkable, biased against the smaller wealthholder, and damaging to the efficient working of financial markets.

How Effective Are Credit Policies? A second issue is the ability of the West European experiments to achieve their goals. How much resource reallocation toward priorities has actually been effected through selective credit policies? Or how low and stable have interest rates been kept? Up to now, few persons have bothered to ask these questions seriously. Moreover, a casual look at the numbers does not obviously indicate that those countries allocating credit through controls perform better than other countries in terms of economic growth, low interest rates, or inflation (see Table).

More detailed evidence is fragmentary and

don: Oxford University Press, 1970), pp. 189-96. For a review of similar experiences with the few long-term selective credit and interest controls used in the U. S., see James M. O'Brien, "Interest Ban on Demand Deposits: Victim of the Profit Motive?" *Business Review of the Federal Reserve Bank of Philadelphia*, August 1972, pp. 13-19; and "Federal Regulation of Stock Market Credit: A Need for Reconsideration," *Business Review of the Federal Reserve Bank of Philadelphia*, July-August 1974, pp. 23-33.

⁸Hodgman, *National Monetary Policies and International Monetary Cooperation*; Brian Griffiths, "The Welfare Costs of the U. K. Clearing Banks Cartel," *Journal of Money, Credit, and Banking* 4 (1973): 61-77; David A. Alhadeff, *Competition and Controls in Banking: A Study of the Regulation of Banking in Italy, France, and England* (Berkeley and Los Angeles: University of California Press, 1968); *Activities by Various Central Banks to Promote Economic and Social Welfare Programs*.

⁹However, in the case of Britain, one reviewer reported that since the credit reform of 1971, the authorities have greatly expanded the money supply in the hope of furthering economic growth. The inflationary pressures of excess monetary growth and an accompanying large deficit which the monetary authorities were called on to finance has helped to produce a good measure of dissatisfaction with the new system. It is suggested that, while the old system of controls may not be reinstated, other forms of controls may be deemed desirable in the future. See Marcus Miller, "Discussion," *Credit Allocation Techniques and Monetary Policy* (Federal Reserve Bank of Boston, 1973), pp. 173-77.

**COUNTRIES ALLOCATING CREDIT THROUGH CONTROLS
DO NOT GENERALLY OUTPERFORM OTHER COUNTRIES
IN TERMS OF ECONOMIC GROWTH, INFLATION, OR
INTEREST RATES (1961-70)**

Countries Substantially Using Credit Controls For Allocative Purposes	Growth in Output*	Inflation Rate*	Long-Term Government Interest Rate**
Belgium	4.9	3.2	6.38
France	5.9	4.2	5.80
Italy	5.3	4.2	6.71
Sweden	6.3	4.1	6.03
United Kingdom	2.7	4.1	6.97
Other Countries			
The Netherlands	5.3	4.5	5.57
West Germany	4.8	2.8	6.78
United States	4.2	2.9	4.77

*Federal Reserve Bank of St. Louis, *Rates of Change in Economic Data for Ten Industrial Countries*, October 1974; and Organization for Economic Cooperation and Development, *Main Economic Indicators, 1955-71*. Figures presented are annual average rates of change.

**International Monetary Fund, *International Financial Statistics*, February 1974.

inconclusive. For example, a recent study of bank lending ceilings in Great Britain concluded that although the ceilings effectively reduced clearing bank lending, they also produced continuous adjustments on the part of borrowers "involving the sale of marketable securities, encashment of liquid deposits and substitution for bank loans of both debt and equity instruments."¹⁰ Credit controls in Sweden, it's been argued, have shifted the burden of "tight credit" from housing and government to business (see Chart 1). But the effects of these controls on

the mix of real investment appear less clear (Chart 2). Even over the longer haul, the proportion of investment devoted to housing in Sweden appears to be no greater than that in the U. S. This is despite the much greater emphasis that Swedish credit allocation programs are supposed to give to housing than the freer credit markets in the U. S.¹¹

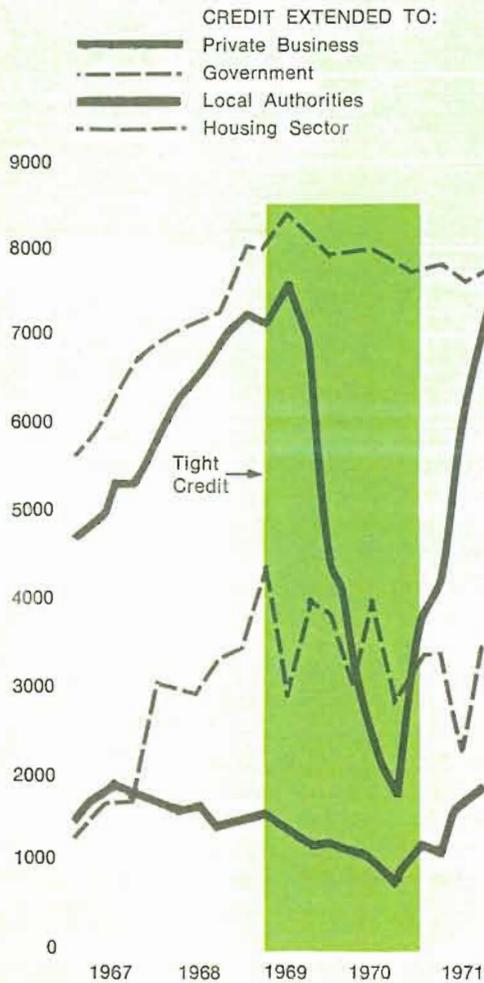
¹⁰Over the period 1960-70, both countries devoted about a quarter of real investment to housing. Prior to 1960 the U. S. appears to have invested a somewhat higher proportion in housing than Sweden. For a description of housing credit programs in Sweden, see U.S., Congress, House of Representatives, Committee on Banking and Currency, *Foreign Experience with Monetary Policies to Promote Economic and Social Priority Programs: Staff Report*, 92d Cong., 2d sess., May 1972, pp. 18, 25-37.

¹⁰Alan Pankratz, "Effects of Direct Lending Controls: An Empirical Case Study of the United Kingdom," *Journal of Economics and Business* 27 (1974): 49-59.

CHART 1

BUSINESS BEARS BURDEN OF TIGHT CREDIT IN SWEDEN . . .

Kronors (Millions)

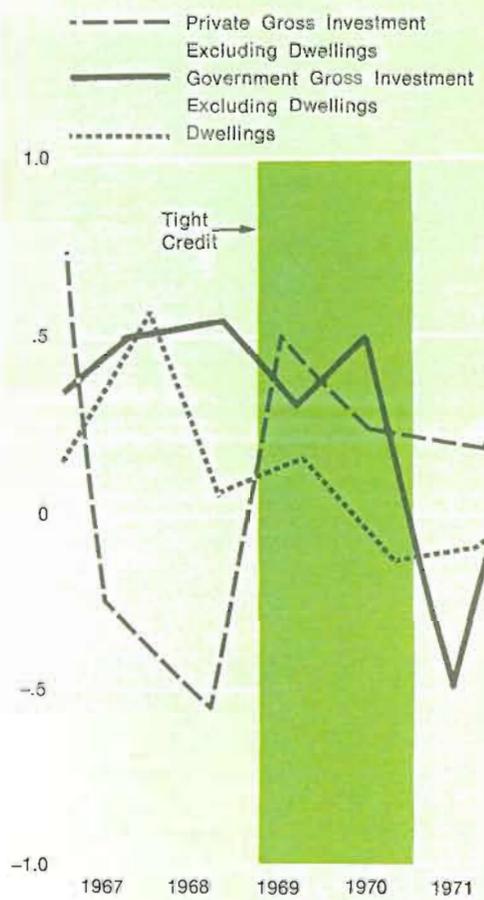


SOURCE: Lund Lars Jonung, "Swedish Central Bank Policy in the Postwar Period: Some Comments," *Kredit und Kapital* 3 (1973): 323-43.

CHART 2

BUT REAL INVESTMENT EFFECTS ARE LESS TELLING.

Percent of Gross National Product



SOURCE: Assar Linbeck, "Some Fiscal and Monetary Policy Experiments in Sweden," *Credit Allocation Techniques and Monetary Policy* (Federal Reserve Bank of Boston, 1973), p. 191. Numbers expressed as yearly changes as percent of GNP are constant (1959) prices.

All of this is not to say that credit control programs have had no effect on the reallocation of credit toward national priorities and at relatively low interest costs. Rather, that how much effect they have had on resource allocation is largely unknown and deserving of more study.

How Appropriate Are the West European Experiences? Several characteristics of the West European economic and political systems are apt to make effective credit controls more feasible than they would be in the U. S. One is the concentrated and cartelized banking structures of Western Europe. Given the currently more competitive environment of American banking, the spirit of cooperation which has existed between West European bankers and their respective central banks is not likely to be seen here. American bankers are likely to be under more competitive pressure to evade the regulations.

Also important is the much greater degree of government economic planning in Western Europe than in the U. S. The credit allocation responsibilities of West European central banks are as much a part of this story as a story in themselves. And if the central banks achieve some degree of success in influencing the allocation of credit, it could depend significantly on the existence of these other controls. Thus, in attempting to shape credit allocation through controls on the banking system (as has been proposed for the Federal Reserve), West European central banks have generally had the support of controls on

other financial institutions and the capital markets.

A SUMMING UP

Unlike the Federal Reserve System, many central banks of Western Europe try to influence directly the allocation of credit and its relative cost, especially bank lending. The objective has been to support investment in "productive" activities and others deemed to be of high priority by their respective governments. Various devices have been employed such as direct control of bank lending and interest rates, and special forms of reserve requirements. The tools have generally been used for both credit allocation and economic stabilization purposes.

Now, some U. S. officials want the Fed to copy its foreign counterparts and become actively involved in credit allocation. But there are important issues still outstanding. For one thing, the foreign experiences have not been without costs—particularly the stunting of competition and the further expansion of controls. Also, very little is known concerning the effectiveness of the foreign credit allocation programs. Finally, experiments with credit controls in the United States are apt to have even tougher sledding than have those in Western Europe. American financial markets are currently more highly developed, less restricted, and more competitive than their foreign counterparts. It may be wise to take a more searching look before we leap.

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