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THE 1969 ECONOMIC REPORT OF THE PRESIDENT

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THE 1969 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 25, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (vice chairman of the joint committee) presiding.

Present: Senators Proxmire and Miller; and Representatives Bolling, Reuss, Griffiths, and Conable.

Also present: John R. Stark, executive director, and Douglas C. Frechtling, minority economist.

Senator PROXMIRE. The committee will come to order. The Joint Economic Committee today continues its hearings on the state of the economy and the administration's economic situation and outlook. On our panel today we are privileged to have four outstanding professors who are experts on fiscal and monetary policy, and who will advise the committee on the proper mix of these two instruments in this year's policy package.

Gentlemen, we are delighted to welcome you and are grateful to have your advice. I believe that other members of the committee will be here shortly. Mr. Conable, I see has already arrived.

Our panel today consists of Prof. George L. Bach of Stanford University; Prof. Martin Bronfenbrenner, Carnegie-Mellon University; Prof. John M. Culbertson of the University of Wisconsin; and Prof. Robert C. Turner of Indiana University.

We hope that each of your can summarize your individual views in 10 minutes, more or less. If it takes a little longer, that is all right. You have short statements and in some cases I presume your whole statement would only take about 10 or 12 minutes. We will include in the record any exhibits that you consider appropriate.

After you have presented your views, the committee will interrogate the panel under the 10-minute rule.

Professor Bach, we will start with you. You may continue in your own way.

STATEMENT OF GEORGE L. BACH, PROFESSOR OF ECONOMICS AND PUBLIC POLICY, STANFORD UNIVERSITY

Mr. BACH. Mr. Chairman, my assignment is to comment on the optimal mix of monetary and fiscal policy. I should like to do so by making seven brief points.

I

There is no such thing as the optimal mix of monetary and fiscal policy for all occasions. What is optimal will vary from one set of circumstances to another, given the national goals of macroeconomic policy specified by the Employment Act of 1946, as clarified by discussion over the past 20 years.

II

In order to achieve the best mix of monetary and fiscal policy to meet shifting situations, clearly monetary and fiscal policy decisions need to be coordinated. Otherwise, positive action taken by one may be offset by inaction or negative action by the other. This was true, for example, in 1966 when restrictive credit policy was in large part offset by expansionary fiscal policy. This need for coordination becomes all the greater when we include equilibrium in the balance of payments among our policy goals. For with a multiple set of policy goals we will often need to coordinate monetary and fiscal policies to achieve the various goals simultaneously.

III

How effectively monetary and fiscal policy decisions have been coordinated depends on how "coordination" is defined.

(*a*) If we mean by "coordination," prior discussion and exploration of the issues by the various policy officials involved, coordination among monetary and fiscal policymakers during the 1960's has been generally good. Federal Reserve officials have been in more or less constant contact with the Treasury, the Council of Economic Advisers, and the Budget Bureau; and they have been in frequent touch with appropriate congressional committees, notably the Banking and Currency Committees and this, the Joint Economic Committee. Similarly, fiscal policy moves have been widely discussed, in the administration, in the Congress, and in other parts of the Government including the Federal Reserve, prior to any significant changes. The dispute of December 1965 over the Federal Reserve discount rate increase is not a counterexample. The evidence there is that there was extensive discussion of the possible need for tighter money in advance of the Fed's action, even though differences of judgment remained after the discussions. Policy differences largely reflected differing judgments on the issues, not failure to explore the issues in advance.

(*b*) If we mean by "coordination" identical timing and direction for monetary and fiscal policy, the record has been unsatisfactory. To examine the evidence, one must specify the indicators of monetary and fiscal policy being used. For fiscal policy, I use the high-employment budget surplus or deficit. For monetary policy, I considered four alternative indicators: (1) the rate of increase in the money stock; (2) the rate of increase in the monetary base (unborrowed reserves and currency in circulation); (3) the level of free reserves; and (4) the short-term Treasury bill rate. Inspection of the evidence indicates clearly that monetary and fiscal policy have sometimes moved together, sometimes in opposite directions. Certainly, for example, they were badly out of phase in 1966, when the Fed tightened dramatically while fiscal policy was moving strongly toward expansion. In 1967–68, fiscal policy was highly expansionary, as was monetary policy as judged by the indicators of the rate of growth in the money stock and the monetary base. Policy was coordinated, but alas in the wrong direction.

(*c*) Different lags in the impact of monetary and fiscal policy on the real economy further complicate the problem of coordination. Monetary policy (open market operations) works partly with a very short lag on the money markets, but the full effect on private investment is probably delayed anywhere from 6 months to 2 years, or even longer. Changes in personal and corporate income taxes exert more of this impact immediately as withholding affects disposable income, but here again the longer run effects on investment and consumption are apparently delayed anywhere from 6 months to as long as a year or more. Thus, if the monetary and fiscal authorities act at the same time, the real effects of their actions are likely to be spread over different periods and to have a different time pattern of effects on different segments of the economy. This makes it very difficult to specify exactly what is meant by coordinated action by the monetary and fiscal policies. There is little evidence that either the administration or the Fed considers these lags of major importance, even though economists and authorities in both areas agree that the lags are real and substantial.

IV

The most serious failures of macroeconomic policy on the domestic front have arisen from the inflexibility, indeed the perversity, of budgetary policy, not from lack of coordination between monetary and fiscal authorities. There can be little doubt that understanding of the potential usefulness of fiscal policy has increased greatly over the past two decades; the tax cut of 1964 to stimulate growth at a time when the budget was already in deficit is major evidence for this point. Similarly, the tax increase of 1968 rests on this reasoning. But in each case, action was extremely slow. First, Presidents Kennedy and Johnson each delayed at least a year before recommending to Congress the tax changes advocated by their economic advisers. Second, and even more important, in each case the Congress delayed over a year before acting on the major recommendations of the President. In the meantime, in 1962–64 the high-employment budget was in substantial surplus in the face of a large amount of unemployment in the economy; and in 1966–68 the budget was highly expansionary at a time of excess demand and inflationary pressure. The dramatic tightening by the Fed in 1966 is largely explainable by the attempt to use monetary policy to damp a developing inflation which was being intensified by expansionary budget policy. It is clear that we have placed too much responsibility on monetary policy for offsetting mistaken fiscal policy, with a result that monetary actions have been overly abrupt and substantially discriminatory in their impact.

Thus, insofar as macroeconomic policy has failed in the past decade, substantial responsibility must be assessed against the Congress and the President. We badly need a more flexible approach to fiscal policy if we are to obtain stabilizing help from the Federal budget rather than destabilizing effects. This assessment does not free the Federal Reserve from criticism for overly abrupt policy changes and for a generally too expansive policy in 1967–68. But it should pose directly to

Congress and the administration a challenge to improve their own fiscal policy procedures.

V

The need for more flexible, responsive fiscal policy and for close coordination between monetary and fiscal policy, is increased when we consider the balance of payments. Postwar moves toward greater freedom of international exchange and capital flows—which are to be welcomed—mean an increasingly close interlinkage among the world's economies and capital markets. With freedom of capital flows, money will move flexibly from one national market to another in response to interest and profit differentials. Thus, the more the world moves toward a one-free-world capital market, the less freedom we will have to use monetary policy flexibly against domestic fluctuations. If, for example, higher interest rates are used to check a boom here but are not matched elsewhere, this restrictive U.S. monetary policy would lead perversely to a capital inflow which would tend to feed the boom here. Conversely, an attempt to lower U.S. interest rates to fight recession here would, if it were not matched by a drop in interest rates abroad, tend to lead to a capital outflow from the United States.

Since the United States is a dominant force in world trade and capital flows, as a practical matter any move by U.S. monetary and fiscal authorities will have a direct impact on the economies of other nations with which we deal, and in a one-free-world capital market, U.S. monetary policy would strongly influence interest rates and the degree of inflation in other nations as well as here. Understandably, other nations would not be happy with this arrangement. If we favor the increasingly free capital flows in the Western World, we must also face the fact that traditional monetary policy against domestic fluctuations will become less feasible, and the need for more flexibility in fiscal policy to damp domestic fluctuations will be further increased. Certainly, in such a world U.S. monetary policy cannot be used effectively to counteract major destabilizing effects of U.S. budgetary policy.

VI

The main implications of this analysis seem to me to be four.

(1) The administration, and especially the Congress, urgently need to reconsider the way in which the Federal budget is handled, so as to avoid destabilizing Federal fiscal policies, and, hopefully, to use them as a stabilizing force. For Congress to achieve a satisfactory mesh between its regular budget responsibilities and the need for economic stabilization is understandably difficult. Nonetheless, Congress needs to face up to achieving precisely this result. Serious consideration should be given to the recommendations of Presidents Kennedy and Johnson and many economists that Congress delegate to the President discretionary authority within a limited range to temporarily change tax rates, subject to congressional veto. If this is not acceptable, Congress needs to establish its own rules for insuring prompt action on Presidential requests for tax changes. Perhaps the solution suggested by Dr. Herbert Stein, that there be a routine annual reconsideration of a surtax on the basic income tax structure, would help provide a solution. Under this plan, as you know, the President each year would recommend changes in the surtax—it might be positive or negative—

on the basic income tax rates, and Congress would consider this in the spring of each year as it faced up to budgetary plans. Such changes hopefully could be completely separated from the time-consuming debates over details of the tax structure.

(2) Closely related, we need to avoid making the monetary authorities carry the full stabilization burden, as was required during the massive Federal expansion of Vietnam spending. In retrospect, clearly the Federal Reserve erred in overtightening abruptly in mid-1966, and then overloosening soon thereafter. Perhaps they deserve criticism for excessively expansionary monetary policy in 1967 and 1968; this is true if one accepts the monetary base or the money stock as the main indicator of monetary policy. One may hope that the Fed has learned from these experiences the dangers of abrupt large shifts in policy, and the virtues of gradualism.

(3) New formal machinery for coordinating monetary and fiscal policy is not needed. The failures of neither the Fed nor the administration are attributable to the absence of adequate coordinating machinery. If failures have occurred, they have tended to be between the administration or the Fed on the one hand and Congress on the other. A way out on the fiscal policy front has been suggested above. A way out on the monetary front might involve clearer congressional guide rules for Federal Reserve action—for example, a specification of a reasonably stable growth rate in the money stock—or monetary base—within a moderate range, as has been suggested by this committee. But overstress on such a rule would be dangerous indeed until we understand more thoroughly the mechanism which connects changes in money and the real economy. The Fed can, and should, be well aware of the need for reasonably stable growth in the money stock or base and at the same time be given discretion to act flexibly under changing circumstances.

(4) There is little in the evidence of the past two decades to suggest that "fine tuning" is as yet an achievable goal through monetary and fiscal policy. Indeed, there are dangers in overreaction, especially given the substantial lags for both monetary and fiscal policy. Again, this seems to me to reinforce the case for gradualism in monetary policy for something like annual reconsideration of the basic tax-expenditure relationships.

VII

My suggestions for the optimal mix of monetary and fiscal policy during the period immediately ahead are implied by what I have said. For monetary policy, a gradual move toward restriction is appropriate; as best an outsider can tell, the Fed is now embarked on such a program. On fiscal policy, a suspended judgment for the next few months seems appropriate. If by late spring the economy is still moving rapidly ahead with inflationary pressures, the surtax should be continued. On the other hand, if the economy should slow substantially, partial or complete elimination of the surtax would be appropriate. By its nature, monetary policy can move somewhat more flexibility than fiscal policy, even if annual congressional reconsideration of fiscal policy needs were established. But we should not let our aspirations outrun our careful assessment of the powers of monetary and fiscal policy. To try to fine-tune the economy through frequent, quick adjustments can readily do more harm than good.

Senator PROXMIRE. Thank you very much, Mr. Bach.

Professor Bronfenbrenner?

STATEMENT OF MARTIN BRONFENBRENNER, PROFESSOR OF ECONOMICS, GRADUATE SCHOOL OF INDUSTRIAL ADMINISTRATION, CARNEGIE-MELLON UNIVERSITY, PITTSBURGH, PA.

Mr. BRONFENBRENNER. Mr. Chairman, ladies and gentlemen, my name is Martin Bronfenbrenner—which you may find hard to pronounce. On the plus side, it means "distiller of brandy." I am a professor of economics in the Graduate School of Industrial Administration at Carnegie-Mellon University in Pittsburgh, and an adjunct professor at the University of Pittsburgh. Before I came to Pittsburgh I was for many years a constituent of Senator Proxmire's at the University of Wisconsin. So you can see I have many coats of ivy cover.

With your permission, I shall start by trying to deconfuse two issues that are often confused, both in public discussion and among professional economists. One of these issues goes by the name of monetary policy versus fiscal policy. The other issue goes by the name of rules versus authorities—or rules versus discretion—in both monetary and fiscal policy. After you are thoroughly either confused or deconfused, I shall then repeat two minor suggestions, one for a monetary and one for a fiscal guideline, which I published 2 or 3 years ago.

The monetary-fiscal issue and the rules-discretion issue, I said, are often confused. And this is probably because a "rules" man tends to be a "money" man. This in turn is because a monetary rule can be made comparatively simple—raise the money supply by 5 percent a year; keep the long-term interest rate on Government bonds at 3 percent; keep the Wholesale Price Index number constant. A fiscal rule tends to be vaguer, once we depart from the sound finance of continuous budget balance. The rule of balance at noninflationary high employment, for example, I think is hard to implement under conditions other than noninflationary high employment, without fancy and tenuous economic projections—this may represent a difference of opinion between Professor Bach and myself.

Also, the level of balance or the size of the budget, makes a difference. A balanced Federal budget at 25 percent of GNP would probably be inflationary under present conditions, while a balance at 5 percent of GNP would probably bring on a major recession.

I have said that a "rules" man tends to be a "money" man. I had better add that a good many "money" men are not "rules" men, and therefore, that a "discretion" man does not have to be a "fiscal" man.

My first positive point is that the monetary-fiscal policy issue is pretty much a sham battle, when put in terms of either/or. Nearly all monetary-policy advocates admit that a monetary expansion, for example, is more expansive when it finances higher Federal spending, or lower taxes, than when it just replaces Government securities in investors' portfolios. And, of course, this admission is an important concession to fiscal policy. And on the other side, most fiscal-policy advocates admit that a budget deficit, for example, is more expansive when the resulting increase in Government securities can indirectly increase the monetary base through purchase by the Fed, than when the same securities must be sold to the public and drive up interest rates. And I would say this administration is a concession to monetary policy.

The principal real issue between monetary and fiscal policy arises at the margin of a little more of one versus a little more of the other. It arises because monetary expansion and fiscal contraction both tend to lower interest rates, and vice versa. People like Chairman Patman, for example, want interest rates low at all times, to encourage investment and economic growth. And such people should, therefore, be more "monetarist" in recessions than they sometimes are, and also more "fiscalist" in inflationary booms.

My second positive point is about rules versus discretion. Discretion implies activism in policy, a considerable assumption of responsibility. It should be distinguished from leaving the economy to the free market, or, at the other extreme, leaving the economy to whatever controls may be established by somebody else. But the implication of a rule is not at all certain. Some rules are purely passive, or laissez-faire. Some rules are long-run active, and they leave the short-term "fine tuning" to the market, or to other peoples' controls. And finally, some rules are as active and as interventionist as you please. The pure or pre-1914 gold standard, like the fiscal balanced budget, is passive. The 5-percent growth rule for the monetary stock, I would call long-run active. The rule for price-level stabilization would be as active as most forms of discretion.

Now, to something more controversial: my own thinking has tended toward rules as against authorities, and therefore, also toward monetary rather than fiscal policy as requiring considerably less discretion. This preference for rules, as against authorities, flies in the face of the obvious principle that God needs no rule to guide His actions. Optimal discretion can never be worse than the optimal rule, and can be better. My preference therefore expresses willingness to settle for a kind of "second best" in the form of a rule, simply as a matter of "risk aversion."

A good policy rule is a kind of insurance against the corruption, incompetence, or malevolence of some few administrators and politicians. More important, it is also insurance against the tendency of a good many more administrators and politicians to put off hard or unpopular decisions until after the next election. This sort of thing can lead to Louis XV's "after me, the deluge." At present, I am not sure which deluge I fear most, for this country may get a mixture of two of them at once, the economic equivalent of freezing rain. One deluge, of course, is open hyperinflation—Latin America, here we come. The other deluge is a set of well-intentioned direct controls like the recent wage-price guideposts or the present restrictions on capital movments, or a permanent straitjacket economy on some wartime model.

Unless you gentlemen convince me that I am really just "Caspar Milquetoast" or "Nervous Nellie," or can provide some insurance policy better than a monetary rule, I shall have to remain heretical for awhile longer.

Of course, there are rules and rules. Some rules would be recipes for disaster, and I shall not regale you with these. The particular rule I favor is monetary, and is a minor extension of the steady growth rule advocated most prominently by Profs. Milton Friedman of Chicago and Edward S. Shaw of Stanford. I think that our econometric fine tuners have reached the point where we can let the monetary growth rate rise when they anticipate a rise in the labor force growth rate, or in the growth rate of man-hour labor productivity, or a fall in the velocity of circulation of money. And vice versa, of course—perhaps I should add that I'm least enamored of the velocity adjustment. Velocity may be sensitive to interest-rate fluctuations, which are themselves sensitive to both monetary and fiscal policies.

If my extra fanciness does not seem worth bothering with, as I gather, it does not to most policy "monetarists," I should welcome the Friedman-Shaw alternative to the status quo, in any of its several evolving forms. Many respected monetarists, including my Carnegie colleague. Allan Meltzer, focus their attention on the growth of the monetary *base*—which is "outside" currency plus bank reserves—instead of the entire monetary stock. The base is more easy to control than the stock is, but I'm still not sure any "monetary base" rule is adequate to prevent "pushing on a string" in case a major deflation would set in—the base expanded, for example, during the great depression, but the total stock did not follow. Nevertheless, I should consider a "monetary base" rule preferable to the status quo.

Chairman Proxmire has proposed a range of monetary stock growth rates, with the Fed required to explain why it has permitted the rate to stray outside the range—in case it does so. This strikes me as an admirable compromise between rules and discretion or perhaps an entering wedge to a stronger rule—this is probably why the Fed opposes it. A similar policy would, of course, be applied to the monetary base as well as to the monetary stock.

Passing to the fiscal side of the "great policy divide," I should like to draw the Joint Economic Committee's attention to the possibility of a double, or percentage expenditure budget. A percentage budget is not exactly a fiscal rule, but, like a fiscal rule, it might be designed as a check on logrolling in our present situation a check on inflationary expenditures.

Let me explain what I mean by a double budget on the expenditure side. The primary budget is the present form, and the total appropriations add to a certain total, which we may call x dollars. The secondary, or percentage, budget is in percentage terms with the total percentages adding to 100. The Congress must then vote on both an overall total and a percentage discretion. And the hooker is that a single overall vote for a total budget of y dollars will give individual Congressmen a chance to express their "economy" or "taxpayer" views and make y substantially less than the x which has been appropriated as the sum of the agency dollar budgets. So that in one vote the Congress can approve a series of departmental budgets, and in another hand they can vote a total budget for something substantially less or greater as the case may be.

Dealing with any particular activity, like post offices in Paducah, in a double budget system, the administration may have two mandates within which to allocate its funds. One limit is a specific appropriation, and the total of these appropriations is x dollars. The other limit, which I would expect usually to be lower, is a percentage pay of an overall total y. Normally, I would expect x times y to be less than the specific appropriation if only because y is less than x. The leeway accorded by this system can give the administration elbow room to maneuver, and to squeeze the fat out of appropriations which are voted by the Congress.

Like Professor Bach, I should also like to express myself in favor of the CED's recent proposal to permit limited administrative positive and negative personal and corporation income surtaxes, subsequent to congressional veto. Perhaps changes, particularly those attractive tax rate cuts, might be banned in the 2-, 3-, or 4-month period preceding the first Tuesday after the first Monday in November of each even-numbered year. This would reduce, but not eliminate, the danger of the surtax becoming a political football rather than an economic tuning fork.

Rather than developing either of these proposals in any detail, I have presented copies of two relevant essays before the committee for possible inclusion in the record of these hearings, and I should like to end my direct testimony at this point.

Senator PROXMIRE. We welcome these essays, Professor Bronfenbrenner. Thank you very much. They will certainly be put in the record.

(See appendix I, p. 578, and p. 583.)

Senator PROXMIRE. Our next witness is Professor Culbertson. You may proceed, sir.

STATEMENT OF JOHN M. CULBERTSON, PROFESSOR OF ECONOMICS, UNIVERSITY OF WISCONSIN

Mr. CULBERTSON. Thank you, Mr. Chairman.

Monetary and fiscal policy in 1968 produced two striking events. First, monetary policy caused an unwanted inflation, thus illustrating both its potency and its uncontrolled status. Second, a very large change in fiscal policy has so far had no discernable effect, adding to the growing evidence that fiscal policy in usual dosages has surprisingly little influence upon economic developments.

The task now facing policy is promptly to slow the rate of growth of total demand, to dampen inflation without causing a recession or a large rise in unemployment. This calls for carefully controlled use of monetary and fiscal policies. Unfortunately, the record of recent years argues that fiscal policy is virtually impossible to control closely with the existing policy machinery, and that monetary policy as conducted by the Federal reserve continues to be erratic, unpredictable, and a threat to the stability of the economy.

To those who follow the hearings and reports of this committee, these lessons will not be strange, but the reader of reports of the Council of Economic Advisers and the Federal Reserve may have a quite different picture of the lessons of recent history. The Council of Economic Advisers Report represented recent fiscal policy as an unparalleled achievement. Such a picture was developed through a biased choice of the actions taken as measuring fiscal policy and of the time periods over which comparisons were made. In truth, when consistently measured by the high-employment surplus, fiscal policy in the past decade was unusually erratic and much of the time unsuited to the economic situation.

Similarly, a favorable picture of recent monetary policy has been painted by the Federal Reserve and the Council by referring to alleged policies of "credit restraint" or "credit ease." These are taken to be evidenced by changes in the level of interest rates. But the error in thinking that interest rates measure monetary policy has been pointed out countless times. The increase in interest rates last year could not have reflected a Federal Reserve policy of monetary restraint, for the Federal Reserve was pumping bank reserves and money into the economy at an unusually rapid rate. On the contrary, the rising interest rates reflected very strong credit demands associated with inflationary expectations. Thus they indirectly reflected the fact that Federal Reserve policy was so expansionist as to be inflationary.

In the present state of knowledge, the most convenient measure of the independent or casual role in the economy of Federal Reserve monetary policy is the behavior of the money supply, or of the Nation's medium of exchange. Each year the economy has some rate of increase in total demand that is most consistent with preservation of full employment and price stability. The money supply should grow at a rate consistent with increase in total demand at this prescribed rate. Usually this implies rather steady growth of the money supply at a rate related to the economy's rate of growth in output potential. Many economists and consistently since 1963, I believe, this committee have urged the Federal Reserve to conduct monetary policy in this way.

This advice has been rejected. The Federal Reserve continued to take actions leading to erratic growth of the money supply: virtually no net growth from mid-1959 to late 1962, then growth at a rate of about 4 percent a year until spring 1965, then 6 percent until 1966, zero percent until early 1967, and then nearly 7 percent during 1967–68.

The question is, looking backward, with the advantage of hindsight, did these ups and downs, or stops and goes, in monetary policy help or hurt the economy? Had the Federal Reserve followed the advice so widely urged upon it and provided steady growth of the money supply, would the economy have performed better or worse than it did? There seems no doubt as to the answer. For this period at least, the position taken by the majority of economists and the Joint Economic Committee was right and the position of the Federal Reserve was wrong. The oscillations in the rate of money growth did not act to offset economic fluctuations, but seem to have been a major cause of economic instability. They contributed to the 1958 and 1960 recessions, the economic slack of 1960–64, the growing inflationary pressures of 1965–66, the subsequent credit crunch and economic softening, and they seemingly were the major cause of the inflationary growth of total demand in 1967–68.

That the Federal reserve last year should persist in an obviously inflationary policy during an obviously inflationary period despite the continued pleas of economists, this committee, and an important part of the press—this may seem somewhat surprising. Surprising it may be, but new, unfortunately, it is not. One who reads over the hearings of the Banking and Currency Committees of 1931 and 1932 must be struck by the parallelism. At that time Members of Congress, a stream of eminent economists, representatives of economic groups urged the Federal Reserve to take decisive action to halt the deflation. It rejected their advice. It continued monetary contraction to its bitter end of 1933, when the matter finally was taken out of its hands.

What argument did the Federal Reserve offer then for sticking with its deflationary policy? The same kind of argument it offers now. In 1931–32, the Federal Reserve would not take action sufficient to halt deflation because it was afraid it would cause excessively easy credit or would "clog up the banks with excessive reserves." Last year the Federal Reserve would not let off pumping money into the economy to limit inflation because it was afraid this would cause excessively tight credit. The Federal Reserve, it seems, does not learn.

In this interpretation of the lessons of the recent past, the control apparatus for monetary and fiscal policies needs reform. Either continued inflation or substantial economic slack in coming years will seriously damage our efforts to meet our domestic and international goals. Existing policymaking institutions do not protect the Nation against such developments.

In reforming fiscal policy, first priority, I think, should go to providing machinery to prevent erratic variations in the high-employment surplus. Such an effective discipline over the basic fiscal position seems a prerequisite to any meaningful use of fiscal policy in an anticyclical way.

Bringing monetary policy under control seems even more urgent, in view of growing evidence of its greater potency. Because of its erratic nature and the hazard of a really serious error, it does not seem to me excessive to characterize monetary policy as formulated by the Federal Reserve as a threat to the security of the Nation. Given the long record of Federal Reserve intransigence, to wait and hope that institution will see the light does not seem a safe policy. Organizational reform is needed.

While more basic reform is sought, perhaps monetary policy can be brought under some degree of control by pressure on the Federal Reserve from the new Council of Economic Advisers—which seems to understand what is needed—and the administration, along with the continued efforts of this committee. New appointments to the Federal Reserve should bring to it men who will apply monetary theory to policy formation rather than men from financial business or those brought up in the Federal Reserve way of doing things.

What should be the nature of basic reform of monetary policy? I do not suggest bringing it under the control of the President. In my judgment, if monetary policy during the postwar period had been controlled by the President, it might well have been worse than it was under the control of the Federal Reserve. The most hopeful direction of reform seems to me for Congress to direct the Federal Reserve to make the Nation's money supply behave in a stabilizing manner, and provide it with presumptive guidelines. I also suggest congressional action to centralize the Federal Reserve organizational structure and eliminate its regional aspects, in order to adapt the institution to the functions it should perform.

Senator PROXMIRE. Thank you, Professor Culbertson.

Our final witness for today is Prof. Robert C. Turner.

STATEMENT OF ROBERT C. TURNER, PROFESSOR OF BUSINESS ECONOMICS, INDIANA UNIVERSITY

Mr. TURNER. Thank you, Mr. Chairman. It is a pleasure to be here.

As I have read the news reports of recent testimony before this committee, I am impressed with the rather large area of agreement as to appropriate economic policy between representatives of the pprevious administration and those of the present one. The differences are of degree and arise in part from slightly different forecasts of the prospective course of economic events. The new Council apparently does not expect the slowdown in the rate of economic expansion in the first half of 1969 to be as pronounced as did the former Council, and, therefore, thinks that a less expansionary policy would be appropriate in the scond half of the year.

They may be right. The absence of any obvious impact of the tax increase of last summer on consumer spending has been noted repeatedly, even to the point of concluding that consumers are impervious to changes in their disposable income. For years, however, I have been teaching my students that consumers are stubborn people, not quick to change their standards of living. Further, because of the existence of numerous prior expenditure commitments, they are more resistant to a cut in their scale of living than to an increase. The tax decrease of 1964 took several months to have its impact. The tax increase of 1968 could be expected to take even longer.

Further, the fact that the 1968 surtax was imposed at a time when (1) the personal saving rate was relatively high, and (2) expectations for rising prices were general, mitigated against a prompt response.

One of the trickiest problems in economic forecasting is estimating the time lags involved in economic causation. These lags do vary appreciably, sometimes for unexplainable reasons—unexplainable, at least, until long after the event. In the present instance, however, there are reasons for believing that the lag in consumer response may have about run its course. As Paul McCracken observed, there are some preliminary indications that the tax boost is beginning to slow consumer spending. The January 1 increase in social security taxes adds an additional constraint and I would suspect that the lag in consumer response to this tax increase will be relatively short, both because of the heavier incidence of the tax on low-income groups and because it is piled on top of a previous tax increase.

Further, because many taxpayers apparently failed to revise their declarations and hence increase their quarterly tax payments when they were supposed to last summer, some of them are in for a rude jolt on April 15.

Although the saving rate has been high by historical standards, it would be a mistake to conclude that it is manifestly out of line with what should be expected under current economic conditions. It is probably correct to say that personal savings, in the aggregate, is not importantly influenced in the short run by changes in the rate of interest. A substantial portion of personal saving is contractual in character and hence does not respond to the attractiveness of high-interest rates. But it is not completely insensitive to the rate of interest. In a period of very high interest rates and high employment, we would expect the saving rate to run near the upper limit of its historical range. And, so long as those conditions persist, we would expect consumers to try to maintain it at that high level. I was not at all surprised to see the saving rate, after having declined to absorb the tax increase in the third quarter of last year, rebound significantly in the fourth quarter.

My own conclusion, therefore, is that we will probably see a significant slowing in the rise in consumer spending in the first half of 1969, especially after removing the effects of the price increases which are built into the system as a result of past events. Indeed, there is some danger that, if current policies continue, we may trigger more of a softening than we bargained for.

This means that the policymakers should be especially alert to the need for a change in policy, should this turn of events come to pass. I agree that, for the time being, the tight money policy should be continued, but I would strongly recommend a prompt easing if any significant signs of softening appear. And I would recommend, if signs of softening do occur, that priority be given to monetary easing rather than to fiscal easing.

The reasons for this latter recommendation are two, in addition to the obvious one that monetary policy is a more flexible instrument—that the administrative lags are shorter. First, in a period of near-capacity operation of the economy, the income effects of fiscal policy are partially, perhaps largely, offset by the monetary effects. A shift to a deficit in the budget would, of itself and after a lag, have an expansionary effect on consumer spending, but the fact that the Treasury has to finance the deficit in a money market when funds are already in short supply—to siphon funds out of a market where investment is already limited by the available supply of funds—means that the investment spending may be curtailed by as much as consumer spending is increased. In effect, fiscal policy in substantial part is self-defeating in a tight money market unless, of course, the central bank is willing to inject reserves in sufficient amount to permit financing of the sale of Treasury issues to commercial banks rather than to the nonbank public.

Permit me, at the risk of belaboring the obvious, to elaborate this point. When Government operates at a deficit, it is a net contributor to the income stream, putting back into the income stream via purchases of goods and services and transfers more than it takes out via taxes. In and of itself, this tends to have an expansionary influence. But Government has to pay its bills; the deficit so incurred has to be financed. In the absence of compensating Federal Reserve action and assuming no change in Treasury cash balances, and so forth, the deficit is financed by drawing on the flow of saved funds available for investment.

In a perfect market, the monetary impact of this deficit spending would be reflected primarily in interest rates. Equilibrium would be restored via a high-interest-induced increase in the rate of saving and a similarly induced decrease in investment. In the real world, both because money markets are imperfect and because certain types of investment are interest inelastic, the impact of the deficit financing is felt in important part through rationing of the available supply of funds by financial intermediaries. Saving, as I mentioned earlier, may respond moderately but, in the short run, probably not substantially.

The major impact of the deficit financing, when the demand for funds for investment purposes is strong, is therefore to reduce investment spending below what it would otherwise be.

In times of depressed economic activity and easy money, however, such an offset to the expansionary effect of a budget deficit is much less pronounced or even absent. Because of the imperfections in the market, absolute surpluses of funds do occur. The market does not clear. The Government is thus able to draw on the available supply of funds without necessarily depriving private borrowers of funds needed to carry out their investment plans.

The converse reasoning, of course, would apply to a surplus in the Federal budget. In a time of strong demand for investment funds, the contractionary effect of the budget surplus on consumer spending may be largely or entirely offset by the expansionary effects of supplying investment funds, via debt retirement, to the money market. But when investment demand is slow and not effectively limited by the ability to finance, and where absolute surpluses of funds do exist, an offsetting expansion in investment spending is not likely.

It is important in policy planning to recognize this asymmetry in the effectiveness of fiscal policy—to recognize that in circumstances of a capital boom and tight money such as we have now, fiscal policy may be largely self-defeating as a means of influencing aggregate demand.

I might mention here that fiscal policy would, of course, be effective in shifting resources between private and public use, and between investment and consumption. But it would be largely self-defeating as a means of effecting aggregate demand.

The second reason for recommending an easing of monetary rather than fiscal policy has to do with the longer run effects of tight money. The inflationary spiral that we now are plagued with cannot be stopped by monetary or fiscal policy except at the unacceptable price of rising unemployment. But monetary and fiscal policy can make a contribution to a longer run solution to the problem. This contribution is to assure that in the future there will be ample plant and equipment capacity to match the high level of employment that we hope to maintain. Monetary policy has its first impact on credit-dependent types of spending, notably residential construction and business investment. If we continue the present tight money policy any longer than absolutely necessary—any longer than needed to moderate the current inflationary boom—we will be running the risk of curbing investment spending unduly and hence inhibiting desired growth in our plant and equipment capacity 2 or 3 years from now. In addition, capacity shortages several years from now would contribute then to inflationary pressures at that time.

I conclude, therefore, that we should anticipate an easing of monetary policy at the first opportunity. If my forecast of a slowing in the rate of rise of consumer spending in the first half of 1969 proves to be correct, that easing should come by next summer if not before.

Senator PROXMIRE. Well, thank you very much, Mr. Turner. I thank all of you gentlemen for very, very interesting and stimulating papers. This is most needful because frankly, I think a lot of us have been puzzled at the ineffectiveness—seeming ineffectiveness—of fiscal policy. We are moving, right now, this is the period when we are moving from a $25 billion budget deficit to a small surplus, and this is the period when we should get a slowdown in the economy; once we level off perhaps the slowdown wouldn't be so expectable.

But you make an explanation here, Dr. Turner, which I think is very interesting. On the other hand, just this morning in the New York Times, Mr. Pierce Rinfret, who I think all of us recognize as a competent economist and a responsible man, said that he has completed a survey of capital spending by private, big private companies and he says that capital spending by private industry will be far, far above what was anticipated; instead of a 7-percent increase in investment in plant and equipment, it will be an increase of 13.8 percent, and of course this is on a very high base.

(See appendix, p. 616, for comment on Rinfret survey.)

Senator PROXMIRE. He says for this reason the estimates of 1969 economic activity are pitifully low. If he's right, this means, he says, an average GNP in 1969 of $935 billion. Yesterday the four economists who appeared before us estimated around $920 billion and, of course, that is close to what the Council estimates, $935 billion. And it means a big inflation, big rise in interest rates, further deterioration in our balance of trade. It would also mean that it would tend to offset part of your analysis which foresees a slowing down in the economy toward the end of the year in the fourth or third quarter.

How would this, if you would accept the Rinfret estimate—I am not asking you to but on the assumption that you might, how would that affect your analysis?

Mr. TURNER. This would be a phenomenal situation. A strong capital boom in the face of a tax-induced tapering off of consumer spending would reflect the fact, I think, that investment spending in part is interest inelastic and that investors have become so convinced of the probability of inflation that they figure they'd better go ahead with their plant and equipment spending now rather than later.

Senator PROXMIRE. That is exactly the conclusion of Mr. Rinfret. He said that investment spending of this kind by private business is inelastic. Interest rates have nothing to do with it. If they go up to 8 or 9 percent, they will still go ahead because of this inflationary psychology.

Mr. TURNER. Yes. Better spend now rather than later because it is going to cost 10-percent more a year from now. If they are in fact able to finance this level of investment, it could bring on the opposite kind of situation I anticipate, one of excess capacity.

Senator PROXMIRE. Well, especially in view of the fact that as I understand at the present time we are operating at 85 percent of capacity. In 1964, when we reduced taxes we were operating at 85 percent. In 1966, we went up to 91 percent. So 83 percent is a low level when you recognize this enormous increase in plant and equipment investment based as you say on the inflation psychology. What can we do about it or should we do about it?

Mr. TURNER. I would find it very surprising if the capital boom should continue long at that rate in the face of a decline in consumer spending. Although they want to build plant and equipment before prices go up, there comes a point where excess capacity becomes obvious to everyone and there is no point in adding to capacity if you can't use what you already have.

Senator PROXMIRE. It is at that point that you would have your depressions.

Mr. TURNER. You might have a break, yes.

Senator PROXMIRE. Or serious recessions.

Mr. TURNER. Yes.

Senator PROXMIRE. Congressman Reuss has proposed—and many people support the notion—that we should repeal or suspend the investment credit. We've tried that once as you know. I doubt if we could get it through Congress now. But it certainly has a lot of merit under these circumstances.

Mr. TURNER. Temporarily repeal it and restore it later on?

Senator PROXMIRE. Well, I think he wants to just eliminate it.

Representative REUSS. Except for very small businesses.

Senator PROXMIRE. Except for small business.

Mr. TURNER. We might want to put it back on later.

Representative REUSS. I hope not. Why would you want to put it back on? It's been an utter dud. Why not get rid of it?

Mr. TURNER. I don't think it was a dud. It had a definite stimulating effect on investment when it first went into effect, and it may well be that a time will come when we will want to stimulate investment spending again.

Senator PROXMIRE. Let me leave that to Congressman Reuss' time.

Dr. Culbertson, you indicated that our efforts to restrain the economy and restrain inflation through fiscal policy had been largely offset, continues to be offset by monetary policy. Is that a fair and correct interpretation of your remarks?

Mr. CULBERTSON. I wouldn't say "offset," Mr. Chairman. One lesson from recent experience has been that fiscal policy does not seem to have been a major factor in determining changes of total demand. When the two operated out of phase, it was monetary policy that seemingly did rule the roost.

If I might add to Mr. Turner's point on this, it seems to me that we should not expect fiscal policy in this environment to be very powerful medicine. The rationale for expecting fiscal policy to have a big effect on total demand was worked out with reference to depression conditions. This was the Keynesian theory. The idea is that there are pools of money around that are sitting idle but that can be tapped to finance Government deficits but not other expenditures. Obviously this situation does not exist presently. Therefore, the presumption is that Government borrowing will offset other expenditures, and vice versa. To work this line of argument out consistently, which I attempted in a book of mine published last spring, seems to require complete reformulation of the theory. If the restraints that are governing the economy are financial restraints, inability to get money rather than inability to find anything to do with one's money—which was the version of Keynesian theory—then fiscal policy basically should not be expected to be very potent medicine. This is not a reason for having an uncontrolled fiscal policy, in my mind, but it does rather affect what one expects of it.

Senator PROXMIRE. You see what we are likely to run into tomorrow when Governor Martin comes before this committee is the argument that if he'd followed a more restrained monetary policy, if they had failed to provide the funds to finance the debt, if they had failed to provide the funds that were in such terrific demand in the private market in recent months, that interest rates would have been higher still and you would have had an almost impossible situation for housing and for small business and for the farmer. In other words, if the money supply had been less, the price of that money or interest would be higher. And your argument is that there is a psychological factor as I understand it that is overlooked here that because the Fed is continuing to feed so much money into the economy, that psychologically inflationary expectations are exactly what is persuading business to invest more and perhaps consumers to invest mode; is that right?

Mr. CULBERTSON. Yes, Mr. Chairman.

Senator PROXMIRE. Anyway, we can quantify this. We know that the money has come in. We know interest rates have gone up. How can we assess the psychological factor?

Mr. CULBERTSON. Indirect effects or feedback. In the first instance, ter of direct effects versus indirect effects.

Senator PROXMIRE. A matter of what?

Mr. CULBERTSON. Indirect effects or feedback. In the first instance, for the Federal Reserve to put more money into the economy pushes interest rates down but this causes additional economic expansion which increases the demand for credit and inflationary expectations and tends to push interest rates up.

Now, it is clear that over any period of time, it is indirect effect that prevails. If one looks at a Latin American economy where the money supply is increasing 30 percent a year, he obviously doesn't find low-interest rates. Interest rates are very high.

The direct effect prevails, if at all in a very transitory manner. So I think it is fair to say if we have high-interest rates in this country, it is because we have inflation, and we have the inflation in substantial part I think because of the very expensive monetary policy.

This is not out of line of course with experience in other parts of the world. Rapid growth in money supply means inflation. Inflation means high-interest rates.

Senator PROXMIRE. Do you think at the present time it would be satisfactory simply to rely on monetary restraint, then to be coupled with the modest fiscal restraint we have, or do you think we should consider the possibility of credit controls, for instance.

Mr. CULBERTSON. Or—what was the last thing?

Senator PROXMIRE. Well, of limiting the, requiring a large down payment, say, a quarter or a third in buying a car or paying for it over an 18- or 24-month period, something of that kind.

Mr. CULBERTSON. This fear of the Federal Reserve that to refrain from pumping money into the economy, if I may put it so, would cause some sort of credit explosion seems to me a curious one. Surely, it couldn't cause anything worse than what it caused in 1966. As we look over the record——

Senator PROXMIRE. That was pretty bad for housing.

Mr. CULBERTSON. It was.

Senator PROXMIRE. We had a real housing depression. Only 850,000 housing starts at an annual rate for several months.

Mr. CULBERTSON. It depends to a great extent on whether one makes a gradual adjustment or a very abrupt one, I think. That was an abrupt adjustment. Actually, we may have had a good deal of adjustment already. The money supply seems not to have increased in the past couple months. Transition from this point that was fairly gradual to a slower rate of growth in money supply, it seems to me, would not have disasterous credit effects.

Sometimes that could be done to limit increases in interest rates, of course, would be legally to cut out a part of the demand of credity, to keep some potential borrowers out of the market. This would prevent interest rates from being pushed up. But that would be very difficult to manage, I think, on short notice.

Senator PROXMIRE. My time is up. I'll be back.

Senator Miller?

Senator MILLER. Thank you, Mr. Chairman. I might ask all of you or Dr. Bach, if you would prefer to answer, just as a matter of philosophy which is the preferable or fairer way for the Federal Government to take purchasing power away from the people of the country, by inflation or by taxation.

Mr. BACH. In general, I would say taxation is a preferable way because we are more sure about the impact of the taking away process if we use taxation.

One of the big objections to inflation is essentially the inequity that arises out of lack of certainty and the fact that many people have greater ability to adjust to that inflation than do others. In general, the people who are least informed, often lower income people, are not very well equipped to cope with inflation.

Mr. TURNER. May I add a comment to that?

Senator MILLER. Yes.

Mr. TURNER. I simply make the point that inflation does not take purchasing power away from the people.

Senator MILLER. What did you say?

Mr. TURNER. That inflation does not in fact take purchasing power away from the people. Inflation is two sided. Because there are two sides to every counter, inflation not only increases the prices that people pay but also increases incomes. Every price paid by one person is income to someone else. If the price of automobiles goes up, the income of someone participating in the process of producing automobiles goes up.

Inflation does not take purchasing power away from people in the aggregate except in a rather technical sense that, because our tax system is progressive, because the income tax is sensitive to variations of the level of economic activity, the effective rate of taxation does rise in an inflationary period.

But except for the minor qualification, I would argue that inflation does not in fact take purchasing power away from people.

Senator MILLER. You wouldn't get very far with the social security recipients I've been talking to.

Mr. TURNER. That's right. There are some people who are definitely hurt by inflation, but there are other people who benefit from it because their incomes go up faster than prices go up.

Senator MILLER. Well, I can understand that, but I don't think you got my question to Dr. Bach. My question was, Which is the fairer or preferable way for the Federal Government to take purchasing power away from the people, by inflation or by taxation?

Mr. TURNER. I would agree with Mr. Bach that taxation is clearly the equitable way to do it. But my other point is that inflation does not in fact take purchasing power away from people in the aggregate, even though it may take it away from certain groups.

Senator MILLER. Well, when on the receiving end, and you are having purchasing power taken away from you as an individual by taxation or by inflation, which is the fair way to do it?

Mr. TURNER. Clearly taxation.

Senator MILLER. Well, then, don't you think that was the underlying philosophy behind the Employment Act of 1946 which set forth as one of the principal goals a stable dollar? Now, that being so, I must say, Mr. Turner, unless you want to elaborate on your statement, I find a rather fatalistic viewpoint here when you say, in your statement, that the inflationary spiral that we now are plagued with cannot be stopped by monetary or fiscal policy except at the unacceptable price of rising unemployment, another way of saying we just simply can't achieve the objectives of the Employment Act of 1946, or do I misread your statement?

Mr. TURNER. That is exactly what I meant to say.

Senator MILLER. Well, then, why don't you advocate that we revise the Employment Act of 1946 to take away one of the objectives?

Mr. TURNER. Rather I would advocate that we use other means of solving the inflation-unemployment dilemma. They have been discussed, I am sure, before this committee many times; techniques for improving the productivity of presently submarginal people, methods of improving mobility in the labor force, increasing the amount of information possessed by potential workers so that they are able to move from where they are to where jobs are, and a variety of other programs to increase the efficiency with which our system works and thus, to use the economists lingo, shift the Phillips curve to the left.

Senator MILLER. Well, in other words, you agree with the objectives. You think they can be attained?

Mr. TURNER. Yes, in time.

Senator MILLER. Your point is that monetary and fiscal policy cannot do so?

Mr. TURNER. Exactly.

Senator MILLER. All right.

Now, Dr. Culbertson, it is generally agreed that the Federal Reserve prematurely eased monetary policy—I think it is generally agreed—after Congress passed its Tax Surcharge and Expenditure Reduction Act last year. To what extent do you believe that this easing of monetary policy by the Federal Reserve vitiated the restraining effect of the legislation passed by Congress?

Mr. CULBERTSON. Well, the picture as I see it is that monetary policy has been continuously very expansive the past 2 years. As I mentioned, there are difficulties in interpreting monetary policy in terms of interest rates or credit ease or tightness. And with our incomplete knowledge to attempt to measure just what the Federal Reserve has been doing as contrasted with other factors affecting interest rates, I suggest that we look at its input into the economy, as it were, the money supply policy by that criterion has continuously been very expansive over the past 2 years. We have had continuous, very rapid growth of GNP so the picture is that the economy has been responsive to this continuously expansive monetary policy. And the change of fiscal policy as yet has not seemed to change matters substantially.

Senator MILLER. Well, I had this question last fall down at just the same place I guess you were at, the Economic Club of Southwestern Michigan, and the question was, How do you reconcile the action of the Federal Reserve Board in easing monetary policy with what you people did in Congress in passing he expenditure reduction and tax surcharge bill?

And I couldn't answer it. I just wonder if you think there was an inconsistency there? And if so, to what extent do you think it may have vitiated what we've done? There has been criticism. Some of my colleagues on the committee have said, oh, the tax surcharge hasn't gotten the job done.

Well, maybe one reason it hasn't gotten the job done is because the Federal Reserve by its monetary action undercut it.

So what I'm asking for is your evaluation of what happened to our policy here in the Congress as a result of this action of the Federal Reserve?

Mr. CULBERTSON. Well, I would agree the monetary policy was inconsistent with the attempt to restrain the economy through fiscal policy, and I think the continued expansion is attributable to this inappropriate monetary policy.

The reason the Federal Reserve behaves this way is that it does not regard this as an expansive monetary policy. Again it looks at interest rates and has some conception of what the interest rate ought to be, so it thinks this is a restrictive monetary policy. If one applies the theory I am suggesting, they are simply wrong about this.

If I might make one other point, though. The current fiscal policy, although less expensive than it was a year ago, is of couse not a really restrictive fiscal policy. The fiscal policy as measured by the high-employment surplus is more expansive now than it was in the year after the 1964 cut, at which time of course it was supposed to be achieving wonders in getting the economy moving again. So this is a less expensive fiscal policy than we had a year ago, but by an objective measure it is not a very restrictive fiscal policy.

Senator MILLER. All right. Now, do you gentlemen have any ideas on what should be the ratio between the increase in the GNP and the increase in total debt, Federal, State, local, and private?

My understanding is that over the last 8 years, the ratio has been pretty nearly 2 to 1. In other words, while our gross national product has increased some $357 billion—a very dramatic increase, I might say—total debt, Federal, State, local, and private, increased some $675 billion. Some people are a little alarmed about the fact that we have to have such a horrible increase in debt in order to have an increase in the GNP. Do you have any ideas on that? Anybody?

Mr. BACH. Well, it is not obvious that the cause and effect is as you put it. It is not clear that we must have that much increase in debt in order to get that much increase in GNP. It would seem to me, though, the main answer to your question is that we have too much increase in GNP in monetary terms. We have a substantial amount of money inflation. Nearly everyone is concerned about it. I guess my answer is that however much debt we had, insofar as that was the cause, was too much.

Senator MILLER. In other words, you think the ratio is too high?

Mr. Bach. The ratio turned out to be too high in that case. I don't think that particular ratio is the critical ratio in understanding the way money GNP is determined, however.

Senator Miller. Any of the other gentlement have a comment on that?

Mr. Turner. What was the period that you quoted, from when to when?

Senator Miller. For last calendar year 1968.

Mr. Turner. Only the last calendar year?

Senator Miller. Yes, sir.

Mr. Turner. Well, first, of course, I think it is clear looking at the think from a longer run perspective, that we cannot assume that a constant ratio of debt to GNP is right.

Senator Miller. I am talking about a debt increase.

Mr. Turner. Well, I'm talking about——

Senator Miller. Increase in GNP versus increase in debt.

Mr. Turner. If that happens, if the increase in debt is greater proportionately than the increase in GNP, that means the ratio of debt to GNP is rising.

All I am suggesting is we can't assume that a constant ratio is necessarily appropriate, because this depends upon changes in the method of financing—whether corporations are financed by stocks or bonds, whether people rent their houses or buy them and take on a mortgage debt, and the like. So that we must make adjustment for changes of this sort in making such comparisons.

Senator Miller. Mr. Bronfenbrenner?

Mr. Bronfenbrenner. My argument would be that the debt ratio, the ratio of total debt to total income, is almost completely irrelevant, because, after all, all debt which is owed by somebody is an asset to sombody else. What difference does it make whether Mr. A. and Mr. B. finance their own activities in such a way that there is no debt, or whether Mr. A. indirectly finances Mr. B or whether Mr. B indirectly finances Mr. A. The activity is just the same. In one case there is a lot of debt. There is a lot of financial intermediation. And in the other case there isn't any. And I just don't think that that ratio of debt to income is of any particular significance at all.

I would, however, like to interject an argument here. It seems to me that much of this increase in debt—I will agree with Mr. Turner—is due to the attractiveness of borrowing money under today's inflationary situation. And the remark I would like to add is that interest rates are not high but low. And the reason is that what is high is a nominal interest rate but not a real interest rate.

Assume that there is an interest rate of 5 percent, but that borrowers and lenders anticipate a rate of inflation of 5 percent a year. Their real interest rate is the 8 minus the 5, or only 3 percent, which is not high, and which makes borrowing, in fact, a very good deal. And I should not be particularly surprised if Mr. Rinfret's analysis of the effect of interest on investment were not perfectly accurate, and that it reflects mainly this anticipation of a rather high inflation rate.

Senator Miller. Thank you. That is a good point.

Senator Proxmire. Mr. Bolling?

Representative Bolling. Mr. Bach and Mr. Bronfenbrenner, I think, both indicated that they felt it would be a good idea to give the Executive limited authority to adjust taxes, and I was curious as to whether the other two gentlemen, who I don't believe had any comment on that—at least I didn't catch it—if they felt that fiscal policy had so little impact on the whole problem that this really wasn't worth doing.

In other words, I am curious as to whether Mr. Culbertson and Mr. Turner feel that it would be worthwhile giving the executive some flexibility to move within limited——

Mr. TURNER. Yes; I do. I would endorse that proposal, even though I did make the point, take the position, that fiscal policy is in large part self-defeating in a high employment, tight money economy. I endorse it for two reasons. One is that, although fiscal policy is largely self-defeating, it is not entirely so. Some contribution can be made by fiscal policy. And, second, in the event of a downturn, it would be very helpful if we could move very quickly to shift fiscal policy in an expansionary direction and discretionary power on the part of the President would help in that respect.

Representative BOLLING. Thank you. Mr. Culbertson?

Mr. CULBERTSON. I would also take the position that fiscal policy should be kept under control, that we should plan a policy on the basis of recognizing the uncertainty of our knowledge. And with uncertain knowledge, it is reasonable to keep all of the branches of Government policy in a position that is suited to the economic situation.

So I would not think fiscal policy unimportant. On the other hand, it seems to me that the proposals for Presidential discretion turning on the idea that fiscal policy should be countercyclical are somewhat out of focus. The basic problem with fiscal policy has been that it has fluctuated erratically simply from the lack of any sort of effective control over Government receipts and expenditures or any effective means of coordinating them.

Taking nominally anticyclical action in a fiscal policy position that is flopping about uncontrollably does not give you a very good response. The crucial question is the lack of control in the basic budget.

Now, if the basic problem is getting the fiscal policy under control, this sort of Presidential discretion perhaps doesn't solve the problem. The relative efficacy of alternative means of getting the fiscal position under control is something I don't have a fixed position on.

Representative BOLLING. What you are saying in effect is it would be far preferable—and I put words in your mouth on purpose—it would be far preferable for Congress and the executive to take a responsible long-run position with regard to the budget. Even as optimistic as I am about the changes that are possible in Congress, I find that beyond comprehension. I think theoretically that is a possibility but practically the Organization Act of 1946 provided for a rather similar approach to one aspect of the budget that you described. I happened to have been here when the Congress undertook it, the one year that it bothered to obey that particular law. It was really a remarkable performance, and that is worth examining, too—almost incredible. It may be that after 20 years there is some hope that we have matured to the point where we could handle the whole budget in one fell swoop.

But even I, probably the most optimistic about the possibility of reform in Congress, find it unlikely that we will achieve that.

Given that for a moment, accept that as a probability, then I return to the question, in the imperfect state of congressional organization and reaction to events present and future, would it not be a good idea to give the Executive a little discretion since Congress has demonstrated, I think, conclusively, its inability to act in a timely fashion on fiscal matters?

Mr. CULBERTSON. Well, faced with those unhappy alternatives, I suppose one could hope that this power might more often be used in a helpful than a harmful way.

Representative BOLLING. Well, I assure you I am not in the majority on my view of the Congress. You may be correct.

The other question that I would like to pose to all of you grows out of the answer that I got from the panel yesterday.

In effect, I said that it seemed to me that under the circumstances outlined by these gentlemen who were projecting the behavior of the economy with certain assumptions—and they were remarkably close to each other rather than remarkably far apart—I suggest that because of two facts, one, that it seemed to me that a certain segment of the poor at least, and perhaps all of the poor, are most damaged by inflation, and at the same time that many of those same component parts of the so-called poor are the ones most damaged by unemployment, that the people who are having the most trouble in the society, and some would say causing the most trouble in society, are the ones who face a year where as far as fiscal and monetary policy are concerned and their impact on inflation, and so on, and so on, and so on, they face nothing but trouble, that this couldn't conceivably be a good year for the poor. Because if we take the steps, monetary and fiscal, necessary to stem inflation this year, it almost surely will increase unemployment substantially, in which case the poor will suffer.

If we don't take the steps to stem inflation in this year, then almost inevitably the poor will suffer.

Are you gentlemen prepared or willing to venture what is the alternative that might make this not so bad a year for the poor?

Mr. BACH. I don't have a good answer, but I will try.

Representative BOLLING. I don't think anybody has a good answer. That is why I asked the question.

Mr. BACH. I think the first thing to say is that the poor are poor, and that is an unhappy state of affairs to begin with. So are you asking, will they be worse off, or are you just saying will they continue to be poor?

Representative BOLLING. I think I am suggesting that they may be worse off.

Mr. BACH. Relatively speaking, than they are now?

Representative BOLLING. Relatively.

Mr. BACH. I think that is an arguable question.

Representative BOLLING. I agree.

Mr. BACH. It is not clear to me that that would be the case.

Representative BOLLING. I agree with you.

Mr. BACH. If indeed unemployment rises, there will be some tendency for it to hit most strongly in these groups, and, incidentally, one could say in passing, his most strongly on profits. So it works on both ends of the spectrum.

Representative BOLLING. I think that the margin for error in profits, perhaps, is a good deal greater than it is with the poor.

Mr. BACH. There is certainly more ability to withstand difficulty there. There is no question about that. But I was going to comment on the inflation question per se.

Some years ago I tried to do an elaborate analysis of who is hurt by inflation, who is not. I think one cannot simply say the poor are all injured by inflation. That doesn't hold up. Some of the poor, for example, seem to be helped a good deal by a little inflation in the sense that they are in debt and the inflation helps to wipe out their debt.

That is perhaps a bad thing to say, but it is true just the same.

The second thing——

Representative BOLLING. It is not a bad thing to say. I think it is accurate, but I don't think it helps their basic condition.

Mr. BACH. No, no. It doesn't help them as much as we would like to have them helped. But again, I am arguing that the inflation per se is not likely to worsen the position of the poor, relatively speaking, to any appreciable extent except in an indirect way. The inflation per se will worsen the position of unsophisticated people, people who are not wise enough to be able to take care of their assets and income position effectively against inflation.

Although the income position of the poor is largely determined in markets over which they have no control, at least they have got something to control; that is, labor. And if the inflation helps, therefore, to give them a job, then in a sense the inflation may be said to help the poor. But basically what helps the poor is the job, not the inflation, and it is not clear we have to have inflation to have more jobs.

Mr. BRONFENBRENNER. I think many of the poor are not in the labor force at all—too young, too old, too sick, and so forth. You could say very definitely that for that particular segment inflation hurts them. There is another segment who may be called the marginally employed. For this segment of the poor, anything that makes it harder for them to get a job will hurt them.

So, insofar as there is a problem, it is that of lumping them together. Poor man A is going to be hurt by deflation and poor man B is going to be hurt by inflation. I think it is a mistake to say that A plus B are going to be hurt by both of them.

I happen to be, with regard to "poverty" policy, rather close to being a guaranteed-income man, more along the lines of Mr. Tobin than along the lines of Mr. Friedman, the negative income tax. It seems to me that that is an issue somewhat aside from overall monetary and fiscal policy, except that I do think that we might be better off on balance, with given aggregate spending, to spend a little more on the poor and a little less on the moon. But that is a very common view among economists.

Representative BOLLING. Do either of you gentlemen wish to——

Senator PROXMIRE. That's all right. Go ahead and comment. I think that's fine.

Dr. Culbertson?

Mr. CULBERTSON. Very briefly, I would hope that a gradual deescalation of inflation would not have substantial damaging effects on the poor, and I think for the long run preserving economic stability and avoiding either sharp recessions, which hit them quite sharply, or inflation would be most beneficial to them.

Senator PROXMIRE. Dr. Turner?

Mr. TURNER. I have nothing to add except to point out there are ways of ameliorating the adverse effects of inflation upon the poor, such as increasing social security benefits, public assistance, and the like. I would hope that we could devise methods of slowing down the inflationary spiral without doing serious damage.

Representative BOLLING. The point of my question really is that it seems to me very clear from the discussion today and yesterday that the solution of the problems of the poor is going to come from a third source, either guaranteed income or some other set of programs that treat their specific ills specifically, that clearly these subjects are not going to take care of their problem.

Thank you.

Senator PROXMIRE. Mr. Conable?

Representative CONABLE. Thank you, Mr. Chairman.

I don't want to overdo this, talking about whether inflation hurts the poor more or the better off, but there are several points that haven't been made. One is that although the poor may owe money, they tend to owe short-term money, and the likely Government response to inflation is going to be to try to keep the interest rate fairly high, which is going to hurt them in that respect even though the money they pay back later on is going to be somewhat inflated money.

Also, I think, generally speaking, ownership of property is one hedge against inflation, and the poor don't own much property. I think it is fairly clear that inflation does hurt the poor more in this respect, too, and that therefore, inflation is something that the poor should very much fear.

I would like to talk to Mr. Bronfenbrenner a minute. He referred to the double budget approach, another side of the fiscal situation that we haven't talked about. In effect, wasn't that what we did with the surtax-spending cut package last year where Congress had looked at all the trees and said, that's a nice tree, that's a nice tree, that's a nice tree, but the forest is a little too big now so we are going to ask the President to cut back on spending by $6 billion. Isn't that in effect what was done then?

Mr. BRONFENBRENNER. Yes; I think that was what was done then, and what I think I am in favor of is having this a standard part of the congressional picture, that you not only vote on departmental budgets in dollars but that you also vote a total budget together with its percentage division. The distribution of the budget was not included in the spending cuts of last year.

The thing which discourages me is Mr. Bolling's statement to the effect that, as he sees the practicabilities, there is just no way to get any kind of a unified budget through Congress; not *nobody*, not *nohow*. I would be inclined to hope that in addition to these departmental budgets in which there is always a tendency to logroll, to do something for one's own district—there can be a total budget put through which the whole may not necessarily equal with the sum of the parts.

Representative CONABLE. Well, one of the great difficulties in this field, of course, is that when you are looking at particular items perhaps if you had, with respect to one department, x dollars to spend and then you were permitted to spend 20 percent more, you might regret having to increase it right across the board. That is what I am trying to say. The President might have quite a different view of what should be cut back on instead from the Congress. There are some very real problems of liaison, if you are going to have an available figure and then an ideal figure, assuming complete availability of money.

Mr. BRONFENBRENNER. Except in my particular version, what is past is not only an overall total, but also a set of percentages so that the administration's room to maneuver is somewhat reduced from the case on which there was only a total.

Representative CONABLE. You had something to say, Mr. Bach?

Mr. BACH. Yes, please.

I suggest that unfortunately Mr. Bolling is fairly near right, certainly on the expenditure side. The experience is very discouraging. I wonder, therefore, if this doesn't suggest that if we are going to get any more flexible, sensible fiscal policy out of the Congress, we don't have to work on the tax side predominantly, and whether Mr. Stein's proposal, which I mentioned in my testimony, may not be a sensible way of thinking about it.

The proposal was in essence that each year the President not try to negotiate the full budget vis-a-vis the Congress in terms of its expenditure and tax implications but there be routinely a consideration of a surtax each year. So that as a matter of course the administration would come in with a basic budget, whatever it happened to be, and then on the basis of that budget expenditure, which the Congress would want to look at, of course, carefully, you put a surtax on top of it. It might be a positive or negative surtax on top of regular income tax rates.

This is an attempt to do two things: First, to routinize the consideration of this in fiscal policy terms, but second, to recognize if you get involved in argument about the whole budget and the whole tax structure the whole thing bogs down completely.

Representative CONABLE. To look at the tax side, I would like to say that I am not optimistic—as a member of the Ways and Means Committee—about the possibility of the President being immediately given the right to vary the tax rates up and down any substantial amount. This is a constitutional prerogative of Congress that has traditionally been viewed very jealously, and I think it will probably continue to be.

Mr. BACH. May I answer that?

Representative CONABLE. Yes.

Mr. BACH. That is exactly the reason I suggested Mr. Stein's proposal rather than just giving the President the power, because the Stein porposal doesn't require that the Congress give the President the power to vary tax rates. It says that each year he comes up with a proposal which is a surtax proposal not affecting the whole tax structure, which the Congress accepts or rejects or modifies, of course.

Representative CONABLE. I am constantly surprised at the extent to which psychology has an impact on the whole field of economics. I don't know whether you fellows are more economists or psychologists when you get right down to it. I am interested in what you might think about the question of the desirability of deciding on the surtax extension early or late.

Admittedly, there are some income factors here, but there are some psychological factors also. We obviously have an inflation psychology at this point, and it might be a desirable thing to decide, let's say, tomorrow the surtax should be expended. On the other hand, if we had some real leveling off—who knows, maybe the stock market motion of the last few days is a harbinger or a turndown—if we had some leveling off, we might reflect having extended the surtax if we did it now. I wonder if there is any comment about that.

Yes, sir.

Mr. CULBERTSON. The position of fiscal policy before adoption of the surtax was an extraordinarily expansive one, almost unparalleled in peacetime history. It is very difficult for me to see that anything that would happen within the next 6 months would make it desirable to go back to that kind of a fiscal policy. Presumably, it could be rationalized only if there were a recession situation. And that seems to be very unlikely.

Representative CONABLE. Well, what *is* happening to the stock market now? I realize this is pretty short-term stuff we are talking about, but here the same financial page of the New York Times that reports this tremendous upsurge in capital investment probability this year, tells us the stock market is falling off very sharply. Certainly the superheat in the capital goods field is strongly inflationary in its implications and yet we find the stock market taking a real nosedive the last few days.

I am not trying to get into an area that is probably more volatile than one can really judge, but I just wonder what it means.

Mr. BACH. I don't think I know what the stock market means. If there is anything we economists know, we don't understand the stock market very well in terms of short-run fluctuations.

Senator PROXMIRE. Who does?

Mr. BACH. I'm not sure, but not we.

In response to your basic question, though, it seems to me that given the uncertainty about the future, it would be rather unwise for the Congress to try to make a firm decision on continuing the surtax at this point.

I say that for two reasons: one, because of the uncertainty, and you might want to change their minds, you know, in another 2 or 3 months. The economy has a nasty way of surprising people.

But the second reason is this. I think you have got most of the advantage already.

Representative CONABLE. Most of the what?

Mr. BACH. Most of the advantage of continuing the surtax. The newspapers are full of talk of continuing the surtax. I suspect most people suspect it is going to be continued, alas; alas, they say, but they still expect it.

If that is the case, you are getting the big impact on their planning by what has happened already I don't think you are going to get much more by having the Congress announce tomorrow it is going to definitely continue the surtax

Representative CONABLE. Mr. Culbertson?

Mr. CULBERTSON. I think the problem here basically is that the surtax should not be regarded as a *surtax*. The fiscal position we have with the surtax is that the budget is in a very reasonable position. There is every assumption that the tax rates will have to be kept at that level permanently unless Government expenditures cease growing, which doesn't seem altogether probable.

The surtax was posed as an anticyclical kind of tool, a stabilizing action. Basically, what it did was to move the basic budget from an untenable position to a more normal one.

It seems to me that if one wanted to impose a surtax, he would have to impose another real surtax on top of the one that we now have. To remove this on the basis that it was temporary would move the budget back not to a normal position but to one that I think would be indefensible.

Mr. BRONFENBRENNER. May I comment briefly on the stock market?

The reason I think that the stock market generation is a *good* thing is that——

Senator PROXMIRE. It is a what?

Mr. BRONFENBRENNER. It is a damned good thing—the stock market downward movement——

Senator PROXMIRE. I thought you said that.

Mr. BRONFENBRENNER. Is a reduction in the degree of the inflationary psychology in the economy. And it may reflect a slowing down of the growth of the money supply. After all, as you know, common stocks, along with real estate, are among our favorite inflation hedges. There has been a great deal of stocks being overvalued, which, of course, they are unless you take into common that they are inflation hedges.

There has been a lot of talk about our inability to get the inflation out of our system without a certain amount of unemployment. I am afraid this may be correct, but I am not sure. I think it is even more true that we cannot work inflation out of our system without a significant decline in the value of most inflation hedges, and common stocks are prime candidates. So it would—it is almost inevitable.

That doesn't mean that this diagnosis is right. It may be too optimistic. But it at least hangs together.

Representative CONABLE. My time is up.

Senator PROXMIRE. Did you want to comment on that, Mr. Bach?

Mr. BACH. I was going to comment on that but on a somewhat related point, so I will try to be very brief about it.

I call to your attention that my colleagues on the panel are explaining the softening of the inflation psychology by the fact that the growth of the money stock is being slowed down. It would be equally rational to explain it by the surtax beginning to have its bite. And I think that the presumption that what we are seeing now is nothing but monetary policy is not an acceptable presumption. It may be, but I think that Mr. Culbertson was overstating the case rather badly, if I may say so, that all of it depends on monetary change and virtually none of it depends on the surtax.

We would have expected, it seems to me, the surtax to be slow in its effect, and I don't find it very surprising that you didn't get much more effect than you did. I think the economy would have been even more buoyant if you had not had the surtax. And one must compare what would have been, not what is.

Representative CONABLE. I can understand this, but not the projections on capital expenditure. That is the one thing that doesn't fit.

Senator PROXMIRE. Well, I should go to Congressman Reuss, but

I hate not to give the University of Wisconsin equal time. But I will go to Congressman Reuss and come back to Mr. Culbertson.

Representative REUSS. I would like to hear what Professor Culbertson has to say.

Senator PROXMIRE. Fine. If you would like to say something on this, Mr. Culbertson, go right ahead.

Mr. CULBERTSON. My proposition was that the experience in general has demonstrated or has suggested fiscal policy is not highly effective. I dont' believe I specifically said that the current economic softening, if there is any—and I am not sure there is one—is due to monetary policy.

Senator PROXMIRE. Thank you.

Representative REUSS. Thank you, Mr. Chairman.

Senator PROXMIRE. Congressman Reuss?

Representative REUSS. Mr. Culbertson, and to a somewhat lesser extent, Mr. Bronfenbrenner, made a fairly devastating case that the Federal Reserve hasn't known what it was doing in recent years. Mr. Culbertson praised this committee for its advice to the Fed; namely, if you gentlemen would just increase the money supply by 3 to 5 percent, all would be well, and let us know if you go outside of the plan.

I wish I were sure that we know what we were doing. My difficulty is I have never quite seen why the money supply, a statistical definition, is all that determinative.

For example, last November I think it was, the Treasury had $3 billion in bank accounts and suddenly needed the money, so it withdrew those demand deposits and presumably paid the money to people who then put it in demand deposits. Well, that meant a large shift in the money supply simply through a rather arbitrary definition—a bank account or demand deposit by the Government isn't counted as a demand deposit.

So there you had a large shift upwards in the money supply without, as far as I can see, any particular economic consequence.

Similarly, when because of the ceiling on certificates of deposit a lot of corporations were liquidating their certificates of deposit and putting at least some of the proceeds into demand deposits, you got a similar upshift in the money supply without much difference having been had. This may have been to somewhat of an extent offset by the lower bank lending performance and creation of new demand deposits as a result of losing the reserve base.

But my point is—and I guess I will ask Mr. Culbertson—is this: If the Joint Economic Committee is going to keep on advising the Fed to increase the money supply by 3 to 5 percent a year, hadn't the Joint Economic Committee better do a little defining, refining, and rethinking of what the basis of this advice is, using perhaps the two examples?

As far as I can see, money supply is meaningful only as people either spend it or get awfully close to spending it. That is what makes the economic difference, yet so bizarre are the definitions of this wonderful thing, money supply. Granted that the Fed is a 100-percent wrong, can the Joint Economic Committee feel very happy about its performance?

Mr. CULBERTSON. Well, we are in a position of limited information, but I think the information on which your advice was based has very solid foundation in economic theory, both of earlier times and of the present. Of course, the basic conception is that the economic system is a system, a structured whole that has certain behavioral properties. In thinking of policy, we are thinking of managing a set of external inputs into that system. We want to manage these inputs in such a way that the behavioral properties of the economic system are made better rather than worse.

The crux of the matter is in a sense measuring the input and then designing a performance criteria or a performance guide for the input to make sure that it improves rather than worsens the economic system.

Now, the trouble with using interest rates as a measure of this input is that they are responsive to forces within the economic system itself.

Going back the other way, the difficulty with using something like the monetary base——

Representative REUSS. By the "monetary base," you mean bank reserves?

Mr. CULBERTSON. Bank reserves and currency—this doesn't measure the input into the economy. If the banks decide they want to hoard excess reserves, we presumably want to offset this, because we are concerned with what gets into the economy, not what is sitting unused in banks. That is not an input into the economy.

When one strikes a middle ground, it seems to me he comes to the money supply as a measure of the input into the economic system that is controlled by this piece of apparatus.

Now to your specific points——

Representative REUSS. Yes, my point which I would like to bear down on is that we have such a cockeyed definition of money supply floating around that I have to sympathize with the poor souls at the Fed a bit for not following our advice, though I don't sympathize with them for what they, in fact, have done.

Specifically, last fall, as I understand it, one day the United States Treasury had $3 billion of demand deposits at banks. They were not included for some reason known by God in the definition of money supply. The next day, because the Fed needed the money, it withdrew that $3 billion and paid it out to whoever they were paying it to, corporations, let's say, who then had demand deposits.

Well, your money supply went up in one day—I am simplifying this a bit—by $3 billion. Now, did we expect the Fed to forthwith neutralize that? Our order to them directed them to do it. And that seems to me to be a game of idiot's delight. I don't see much difference in the economics of one day and the next.

Mr. CULBERTSON. Well, your instruction, I take it, was not for them to stabilize the money supply each day, that some sort—to stabilize on some sort of a monthly average basis. I think these sporadic transactions simply wash out and are insignificant on that basis.

The other point——

Representative REUSS. We don't tell—that isn't what we tell the Fed, though. We say 3 to 5 percent.

Mr. CULBERTSON. Not each day.

Representative REUSS. No, but we haven't told them what they are supposed to do about these vagaries of definition.

Mr. CULBERTSON. I think we want to work with an average of at least a month and these things will wash out and become trivial.

Representative REUSS. Not necessarily, unless in the example I put the Treasury suddenly gets rich again and regains the $3 billion deposits. Let's assume they don't. Are you going to ask the Fed to permanently seal that off just because some person unknown happened to define the money supply as not including U.S. Treasury demand deposits?

I think what I am getting at is, don't we have to put on our thinking cap and look at all this received learning about what constitutes the money supply?

Mr. CULBERTSON. I think the definition of money supply in this case is basically correct. The logic is that Treasury administration of its balance and Treasury behavior again is not an integral part of the economic system. This is another kind of input. This is something outside of the system. The coherent system we are talking about is the system of behavior of excluding the Federal Government.

Representative REUSS. Why?

Mr. CULBERTSON. We are concerned with making the money supply that they hold, input to this system, behave in some sort of appropriate way. Presumably, the behavior of the Treasury and of the Government will not be affected by these changes in its cash balance, at least not affected in the same manner as would the decisions of individuals or business.

Representative REUSS. But is this so? We have all seen examples of large discretionary spending by the President—Kennedy, Johnson, everybody does it.

Mr. CULBERTSON. The idea of policy means that you have a policymaker who is outside the machine upon which he is acting, and this consideration, it seems to me, is governed by that logic.

Representative REUSS. Well, my time is up. I still think that while the Joint Economic Committee is on the right track in telling the Fed to do something, that we need to refine somewhat further what we tell them to do, and this is one area that still bothers me.

Senator PROXMIRE. Mrs. Griffiths?

Representative GRIFFITHS. Thank you very much.

I would like to return to the investment credit. I never was very impressed by the need for it—and I sat on the Ways and Means Committee. It was granted under the theory that it would renew America's plan when it needed to be renewed.

Now, with all of this capital investment, it seems to me that a question should be raised: Is this all we are doing, or are we really effecting vast social changes in the country? And I have a feeling that we are making it easy to effect those changes.

Two of the largest corporations in America are about to move out of the City of Detroit. One has already announced its move and the other one is about to—not out of the State of Michigan, but out of Detroit.

I think investment credit makes it simple.

That's one thing. But, secondly, I think that a fiscal policy other than our own is also having some effect. Detroit has an income tax.

They are moving into an area without that; that's a second thing. But thirdly, in both instances there have been outstanding instances of crime affecting people involved in the corporations. Part of all of this has been created by the Federal Government's fiscal policy in the past, our spending policy, when we tore down housing in the city of Detroit and moved in roads, vast expressways.

Don't you think it would be advisable that we at least ask what we are getting for the investment credit? Are we really only getting a new plan or are we giving those who are using it a new tax situation, a new situation as relates to crime, that is, they are moving into a less taxed area out of the high crime area. Isn't there some possibility that this is what we are doing with the investment credit?

We are making their decisions easy for them. We are helping pay the way rapidly.

Mr. CULBERTSON. Well, I will talk on one aspect of that. The basic rationale of the investment credit or the main rationale was that it was needed as a tool of stabilization. I think that that position is not really tenable. That is, the idea was that monetary and fiscal policy were not by themselves sufficiently powerful to get the kind of increase in total demand that was needed at that time.

I think further experience argues that is not correct. Total demand can be controlled through monetary and fiscal policies: One does not need an investment credit for that purpose.

This implies that if the investment credit is continued, it ought to be rationalized on the grounds that it contributes to a tax structure that is equitable with reference to its treatment of investment as against consumption. I am not sure it can be justified on the grounds. That is to say, the tax treatment of business that would be optimal from a structural point of view perhaps would be somewhat different that what is involved in the investment credit.

Representative GRIFFITHS. The main argument that was made for this before Ways and Means was to renew America's plan, that we were in a noncompetitive position in the world. This was the chief argument.

Mr. BRONFENBRENNER. Your objection is that business firms are not renewing their plans in the same place.

Representative GRIFFITHS. Pardon?

Mr. BRONFENBRENNER. Your objection is they are renewing their plans all right, but instead of renewing them in Detroit they are renewing them outside the city.

Representative GRIFFITHS. Well, what I am asking is, is this really what it is being used for, just to renew America's plan, or is it being used—is it making simple a decision to move out of a crime area or to move out of a more highly taxed area?

After all, what did the stock exchange threaten the city of New York with? Didn't they threaten that if you levy a certain tax, we are going to move?

Mr. BRONFENBRENNER. But this sort of thing occurred long before the investment credit was even heard of.

Representative GRIFFITHS. This is true. But the stock exchange didn't make the threat for the investment credit.

Mr. BRONFENBRENNER. As I remember it, when I was in Michigan, businesses were always threatening to move out of the State.

Representative GRIFFITHS. This is true, but you are making the decision easy now. It is a very easy decision.

Mr. BRONFENBRENNER. But how important is the investment credit?

Representative GRIFFITHS. You are making it considerably easy for them to do this.

Mr. BRONFENBRENNER. Do you have any evidence that it is really important? Is it really that important among all the other tax, and labor, and crime considerations, to pick on that particular one and say it is an investment credit that is doing it?

Representative GRIFFITHS. I don't say it is doing it. I don't say that at all. But I say it is making it easy to consider these other things. And why should we make it much easier for them? Are we really just renewing the plan or are we making it simple for them to make decisions based on other factors?

Mr. TURNER. Quite possibly people in the areas to which these plants are being moved find this a very salutary effect of the investment tax credit.

Representative GRIFFITHS. Not necessarily.

Mr. TURNER. They are getting industry that would not otherwise be there.

Representative GRIFFITHS. The same people will be employed. They are only moving a few miles away. The real truth is that the people in the areas to which they are moving which are now sparsely settled will suddenly discover that their taxes have gone up enormously. These areas will have to put in more sewer lines; they will have to put in more water supply. And they will have to sell the property that they now have.

I was talking with someone the other day just outside the city of Detroit who is not really a wealthy man. They started to put water past the property that he owns. And the bill was $175,000. For that kind of a bill he is going to be compelled to sell. So it is a sort of confiscation. You are forcing upon them sales that they may not necessarily need or desire. So that we are having—the question I am asking you is, is it possible that investment credit is merely being used as a handy tool to make easy other decisions and not really for the purpose it was intended at all? And it certainly isn't stabilizing now.

The thing to do if stabilizing is all you seek, is to move it right now. This would do more than anything else, wouldn't it?

Mr. TURNER. I agree. I think the investment tax credit ought to be suspended, although we may decide a year or two from now that we need it again. True, any interference with the straight calculation of profit prospects on the basis of the performance of the free private market does have unanticipated and unpredictable side effects. And some of these are unfortunate.

What the investment tax credit did was, first, to stimulate aggregate investment and, secondly, to increase the mobility of investment. And whenever you do increase mobility, it hurts some people, and helps other people. You never can completely predict the effects.

Representative GRIFFITHS. If I could return to Professor Bronfenbrenner's suggestion that we have two budgets, I would like to say, also, that I think that this is what the tax-and-spend policy was last year. I didn't vote for that, the surcharge and the cuts, because I felt then, and I feel now, that this puts too much power into the hands of only a few people within this Congress to make cuts.

I am reliably assured that some committee chairmen went to the President and said, "But not in our State, not on this project that we want; you can't cut it there." And they were in a position to enforce that. So that if you give it to the President, you are really giving it to committee chairmen, too, and this is a power that is not operated out in view, in full public view.

Therefore, I oppose that. But I oppose a percentage cut for another reason.

The difficulty would be that in place of a priority, putting it on a priority basis, you would apply the percentage cut to those things that you didn't fund adequately in the first place. And then you would apply it to those things that you didn't need, that weren't really needed and were funded. So that I think it would be quite unfair.

And you have a surprising reaction to voting on cutting all expenditures. The one economy vote that is cast in this body year after year is an increase in the debt limit. People who have all year voted for everything that came up happily vote an increase in the debt limit. So that you have a tendency for people to vote to lower everything on one budget and you would hurt, I think, the projects that need the money most. So I hope you give up this plan.

Mr. BRONFENBRENNER. May I comment very briefly on that.

I think you may have misunderstood what I had in mind. I am not in favor of an overall across-the-board cut in everything in terms of percentages is perhaps unfortunate. All I said was in terms of a percentage budget that you have a total figure and that you vote for a series of percentages, and the series should then add to 100 percent. This does not involve a cut across the board.

I agree with all your statements, by the way, with regard to the raising of the debt limit, and I also agree with the statement that handing over power to the President may often mean, in practice, handing it over to particular Congressmen, particular lobbyists. I do not consider that a very savory point in connection with the proposition.

Representative GRIFFITHS. It would be hidden from the public view and would be, I think, real devastating, and I think it was very bad.

Thank you, Mr. Chairman.

Senator PROXMIRE. Well, I want to follow up along the same line of questioning that Mrs. Griffiths concluded on, by saying, I think, this is a very, very interesting thing, Mr. Bronfenbrenner. As a matter of fact, I have been working on the same kind of thing. A member of the staff has been drafting legislation along this line. I think we just have to concentrate more attention on spending policy.

We are obviously ineffective now. We are neglecting spending policy as an element of fiscal policy almost completely. Most economists as well as most Members of the Congress react to fiscal policy on the tax side only. And I can tell you right now that there is just an overwhelming feeling in this country—I just sent out a questionnaire and got over 10,000 answers, and it is just—I have never seen such a unanimity of opposition to overall Federal spending. And I have had these questionnaires before, but the feeling was never as firm as it is now.

Furthermore, I think Members of Congress—the majority leader has indicated he thinks we have to cut the budget very sharply. I think we have to cut the military budget, public works, space programs, and a lot of others.

At any rate, this is, I think, an ingenius approach, but I think absent this, the notion, the cynical notion that Congress can do nothing and will do nothing on spending policy is completely refuted by what happened last year. What is wrong with setting a ceiling on spending by Congress? We did it last year and it worked. Sure, there were some exceptions.

The President came in with some supplementals. We ended up with about the same amount as originally proposed, but we would have ended up with $6 or $7 billion more if we hadn't had a ceiling. Almost everybody seems to agree that that was a real element in fiscal restraint, not only the surtax but the ceiling.

So I would like to ask you gentlemen to tell me if you feel that from the standpoint of effective policy, from an economic standpoint, this couldn't be a way for Congress to have an economic effect on the economy for these reasons.

An eminent economist, Dr. Suits of Michigan, testified yesterday that spending reduction has had about 25 percent more impact on the economy than a tax increase. I made the point that spending reduction hits more swiftly because you don't have to change spending patterns as you do with a tax increase.

Now, if you put those two figures together, it seems to me you can make a very strong case for concentrating far more attention than we have had so far on expenditure policy, rather than on simply tax policy.

Dr. Bronfenbrenner, do you want to start off on that?

Mr. Bronfenbrenner. I was thinking that that is fairly standard economics, that the "multiplier" for Government expenditure either up or down is higher than that for tax changes either up or down. That 25-percent figure of Mr. Suits seems to me a bit high as an estimate of the differential, but——

Senator Proxmire. He put it in a negative way. He said that the tax increase would have about 75 percent of the effect that a similar amount of spending reduction would have.

Mr. Bronfenbrenner. I would like to see figures. I haven't, of course, seen Mr. Suits' testimony. I would hate to disagree with him since he is a better econometrician that I, but I would think that a little on the high side. But, nevertheless, I agree with the general line of your comment.

Senator Proxmire. Do any of you other gentlemen want to comment on that?

Mr. Bach. I think that Mr. Suits' point as between expenditures and taxes, as Professor Bronfenbrenner has said, is right in principle. One need not argue about the exact detail. However, it seems to me the important thing to say about fiscal policy is that all things considered, it is the spread between taxes and expenditures rather than the level that matters most.

I recognize that the level matters as well. The practical issue is which way can you expect Congress to be more responsive and flexible in reacting on tax policy or expenditure policy. My own reaction from outside is that the Congress has a very tough time when it comes to rapidly lowering expenditures, if that is what one needs to do.

And I would be very skeptical that you could impose and take off expenditure ceilings in a very flexible way.

Senator PROXMIRE. Supposing we did what we did last year in this sense. Supposing, instead of reducing the spending, we just held the line. Suppose we put a ceiling at $186.5 billion on spending, which would be about $10 or $11 billion below what the budget provides. What effect would this be likely to have on inflation?

Mr. BACH. I think it would rapidly move to putting a deflationary pressure on the economy. I don't think there is any question about it.

Senator PROXMIRE. Do you think it would be a good psychological signal, too, if the Congress, or the President, made this kind of move rather than concentrating so much on saying we are going to enact a surtax? And the assumption is we are going to do that, it seems to me fairly sure. It would seem to me that a spending limitation would have a more vivid and powerful effect.

Mr. BACH. Well, I think it might or it might not. One of the questions would be whether the people of the United States believe the Congress and the President when they say that.

Senator PROXMIRE. Well, we did it last time.

Mr. BACH. I don't deny that. I only say that there is some question in people's minds whether a budget is really effective, whether supplementals won't more than overcome the difference. But I would repeat what I said before, that basically the level of the budget, it seems to me, is a longrun fundamental issue, and the fiscal policy aspects, the attempt to move the economy up or down in fighting recessions and inflations, is something that has to be tended to in addition to the basic level of the budget. Whatever the level of the basic budget, you people still have the issue of whether the taxes should just more than cover or less than cover expenditures. And it seems to me, whereas everything you say is correct and very acceptable, that that is probably in the long run the most flexible way of handling fiscal policy.

Senator PROXMIRE. Dr. Turner?

Mr. TURNER. I would like to endorse what Mr. Bach has said. The issue here is really this: When we do need to curb some kind of expenditures for stabilization reasons should the burden of curtailment be imposed on the private sector or on the public sector. I would argue that a very large percentage of the Federal Budget is composed of types of expenditures which should not be manipulated frequently for economic stabilization reasons.

I am not saying that they are at the right level. They perhaps should be reduced or increased for fundamental reasons. Expenditures for defense purposes should be increased or decreased if our evaluation of our defense needs changes. But we shouldn't manipulate defense expenditures for stabilization reasons.

The same goes for social security benefits which are a substantial chunk of the budget. The same goes for interest on the public debt, which is not an insubstantial percentage of the budget. The same goes for a large part of the regular activities of Government, statistics collecting, regulatory——

Senator PROXMIRE. If I can interrupt, there is no question that you made a case for a large part of the budget, perhaps most of the budget, but I think you can also make a case that with regard to public works, for example, we are a going to have the biggest public works program in the history of this country this year, more than $7 billion. It has never had anything this big.

Some of these programs can be deferred. We are going to have a space program again—we are achieving our objectives in 1969, or close to it, July or August anyway of 1969. Here is an area we can postpone. We don't have to go to Jupiter and Mars. Those places will be there.

Then in the military area—now, here is an area where there is a whale of a lot of capital investment, and this is a matter of strategy, and so forth, to a considerable extent. But even there, I think there are a lot of deferrable, postponeable expenditures which we may well need 2 or 3 years from now in the event that we have a softer economy.

Mr. TURNER. I would agree there are plenty of areas in the budget which could be reduced. And if I had my way, I could find them fairly readily. But I would make them regardless of stabilization considerations. I would reduce them because I think, by my value system, they are fundamentally less important than the private expenditures we are having to give up to finance them.

Senator PROXMIRE. I agree with that to a considerable extent. Where your value systems coincide with fiscal, the economic convenience and stabilization——

Mr. TURNER. Let's make those cuts.

Senator PROXMIRE. Congress in its wisdom, it seems to me, must take advantage of it. And you need all the arguments you can summon to get something adopted by this body. So you can use the stabilization argument.

Mr. TURNER. I would hope the Congress is rational enough to reduce expenditures where cuts are needed even when the fiscal signs may suggest that the opposite is appropriate. I would like to see the budget set in terms of our fundamental needs. And when it comes to shortrun fluctuations for economic stabilization purposes, I would think it better to impose that burden of adjustment on the private sector, not on the public sector.

The portion of a cut that is imposed on the public sector is in practice going to be imposed on a very small portion of the total budget, and that portion will include what I would consider to be some very high priority programs, such as programs to solve the Phillips' curve problem we noted awhile ago, programs to increase the productivity of low productivity workers——

Senator PROXMIRE. Well, I certainly would hope that the economies wouldn't be there. I agree with you, those programs are absolutely imperative, although I think the amount there is so relatively small compared to our military budget and the other budgets that we just can't make much of an economy in that area.

Dr. Bach, in your statement you indicated that both the administration and the Fed ignored lags, that is, the lag between the action in fiscal policy and monetary policy, and its actual effect on the economy. Do you feel this is a serious blunder on their part?

Mr. BACH. Well, I didn't say that I know they ignore them. I said the evidence suggests they ignore them.

Senator PROXMIRE. Yes.

Mr. BACH. The answer is yes, I think it is a blunder on their part. I think it is a blunder because in order to make wise policy one presumably is concerned primarily with the impact on the real economy. The evidence of the last 3 or 4 years begins to pile up, I think, more and more convincingly, that the Fed, for example, has a very quick impact on money markets and a quite slow impact on real investment, for example. In the same way, the evidence is piling up that the impact of fiscal policy changes is rather slower than we had thought.

Senator PROXMIRE. Of course, here is the trouble. If we recognize the lags, recognize, for example, an increase in taxes is probably not going to have effect for 6 months after we put them into effect, or if we recognize the monetary policy as a lag of maybe less or more than that, our capability of prediction is pretty small.

I noticed that the National Bureau of Economic Research indicated that some of the best economists in the country that they have studied, including the Federal open market committee's economists, are able to detect the down-turns on the average 3 months after they occur.

Well now, what does this tell us about the wisdom of any kind of economic policy? If we are going to adopt a policy of restraint now and the economy is going to turn down 3 or 4 months from now and the policy isn't going to have much effect until 6 months from now, it is going to be the wrong policy.

Mr. BACH. I think it tells us mainly that we ought to be very cautious and very gradual about abrupt changes in policy, that it ought to be a very clear case indeed for either the Fed or Congress to take as indication for abrupt change. I think it pushes in the direction of the rule or set of rules that you and Mr. Reuss have been pushing, that by and large a fairly stable growth rate is probably the safest way.

Senator PROXMIRE. I have been pushing, and Henry has been questioning.

Mr. BACH. Well, I would like to say, since I have the microphone at the moment, on behalf of Mr. Reuss—I'm sorry he isn't here any longer—I think he gets grade A in monetary economics today. I think it is proper that he should lecture us in the academic realm about how important it is to be careful about the definition of money and how easy it is to be misguided by shortrun fluctuations in this money stock.

I do not agree with Mr. Culbertson that we ought to look at it every month. That is too fast. You get these swings——

Senator PROXMIRE. We ask them to report every quarter.

Mr. BACH. I know.

Senator PROXMIRE. And, as a matter of fact, they are not disagreeing. They are reporting every quarter.

Mr. BACH. I realize that.

Senator PROXMIRE. So we accomplished what we set out to do.

Mr. BACH. It is very important that this committee, since it is widely recognized as one of the main advocates for a monetary rule, so to speak, gets credit for recognizing it is a much more complex matter than many economists seems to think it is.

Senator PROXMIRE. Then you talk about the inflexibility imposed by the responsibility for a monetary policy with regard to international finance as well as the domestic problem.

Mr. BACH. Yes.

Senator PROXMIRE. How can we improve that flexibility? How can we protect ourselves, insulate ourselves?

Mr. BACH. Well, I think that in the long run this is going to become a worse problem, and the answer to your question in my judgment is that there is no easy way of doing this, that the more we get into a one-world capital market we are just going to have to face a worldwide effect, not a domestic one.

I would favor somewhat more flexibility in exchange rates. This does not mean that we, so to speak, float the rate, but if we had a wider band on each side of that stable parity, this could ease very greatly the apparent dilemma that you are referring to.

Senator PROXMIRE. Then I would like to ask—Mr. Bronfenbrenner I guess is the man for this—did you discuss wage guidelines very briefly? Did you mention them?

Mr. BRONFENBRENNER. I just mentioned them.

Senator PROXMIRE. Well, I think you were the only one who did, and I have to bring it up even though this is a fiscal policy and monetary policy panel, because I think that it does affect how much action you have to have on fiscal and monetary policy, whether you have any other restraining factor on inflation.

On February 19, only a week ago, Arthur Okun, President Johnson's principal economic adviser, spoke at San Francisco and he said the following, and I quote, "I sincerely hope that the recent aerial of the wage-price guideposts by the Nixon Administration will be promptly followed by new approaches to dispel any notion that it is now open session for inflationary private decisions. In many areas of this economy, large firms and large unions have an important degree of discretion over prices and wages, and it is essential that the public interest in their decisions be enunciated forthrightly by the Administration and Congress."

Now, the Administration witnesses indicated we are not going to get much of that. The President is not going to jaw bone. He is not going to step in. He doesn't want to dissipate the power of his office perhaps in that way.

Now, I just wonder how important you gentlemen feel some kind of action by the President of the United States, by the executive branch, to influence the private decisions of these big and very influential economic units, how important that is in combating inflation.

Mr. BRONFENBRENNER. Let me make two points: one will be a less direct answer and the second, I hope, a more direct answer.

The less direct answer is that I think guidelines are a very fine shortrun measure. They buy time. They are extremely useful. The difficulty with the guidelines——

Senator PROXMIRE. Those serve educational purposes, don't they?

Mr. BRONFENBRENNER. Not only education—guidelines give you time to see what is going on and react to it.

Senator PROXMIRE. Yes.

Mr. BRONFENBRENNER. I think that in 1962–63, if this time had been purchased and then had been followed by a tighter voluntary and/or fiscal policy, the guidelines might have been a good thing. However, they were not used in this way. They were used in practice to avoid making unpopular decisions more or less permanently. And much of my objection to them is due to the fact that they are not utilized correctly.

Now, my more direct answer to your question is that the administration should take a rather strong view somewhat to this effect: the mix of economic policies which the administration is adopting are intended and are adapted to producing high employment without inflation. If, in fact, decisions are made by unions and/or by employers, if there is collusive rather than collective bargaining, the same policies will result in more unemployment. And if that happens, it will not be the fault of the administration. The finger will be put on the particular industries and unions responsible. The administration will not make fiscal policy easier, and it will not make monetary policy easier just to protect the economy from the errors of particular companies and particular unions.

Senator PROXMIRE. Well, what effectiveness has it, though? After all, if a steel company is able to increase its price regardless of cost, and not reflecting a real justification, or if a union is able to ask for a wage increase far above productivity and not really justified even by the cost of living—and that has happened—if the President doesn't call attention to it, which he can do and only he can do in a national way, and with considerable success as we have found in the past—if he doesn't do that, if he just says it is not my fault, we are still going to get an inflation, which is going to mean that then we get higher prices than you should have in relation to the unemployment level.

Mr. BRONFENBRENNER. Yes, I agree. But remember I said the President or the administration spokesmen will make this particular point. I do not think guidelines should be invoked.

Senator PROXMIRE. I see. I misunderstood you. You say they should make the point.

Mr. BRONFENBRENNER. Yes.

Senator PROXMIRE. They should speak up.

Mr. BRONFENBRENNER. We consider this to be inflationary. We consider that it will produce unemployment somewhere in the economy.

Senator PROXMIRE. OK.

Mr. BRONFENBRENNER. We are not going to counteract it.

Now, since you mentioned steel——

Senator PROXMIRE. Well, we have an import situation there that might be helpful.

Mr. BRONFENBRENNER. I would argue that this is precisely the wrong time to be talking about protecting the steel industry from the effects of its own excessive wage-and-price policies by putting quotas, either gentlemanly or ungentlemanly, on foreign steel producers. This is precisely the wrong thing to do. I have said in Pittsburgh, where my view is even less popular than it is here, that that is a mistake. When the particular industry which is engaged in price-and-wage gouging happens to be one which is subject to foreign competition, the thing to do is to sic the foreigners on them.

Senator PROXMIRE. Any of you other gentlemen want to comment on this wage-price guideline approach?

Mr. Bach?

Mr. BACH. I like what Mr. Bronfenbrenner said, so what I would have said he has already pointed out. I think, however, that it is easy to forget that there is some value in the guidelines, that they can have some value, even when they, in effect, have gone down with the ship as they did in 1965, 1966, and 1967. Clearly, you couldn't sit there and argue a 3.2-percent increase was going to make much sense. I rather like what the outgoing Council did in 1968. Not to argue that there should be direct intervention on every price increase and every wage increase above some rate, but to suggest that if we are going to edge inflation down gradually, the business people and labor people must bear some of the squeeze.

My memory is the Council in their report suggested that something like a 5-percent rate of wage increase made a lot of sense, not that there was anything unique good about that but that——

Senator PROXMIRE. The employer absorb the 1-percent increase in cost without increasing his prices.

Mr. BACH. That's correct. Now, one doesn't have to call that a formal guideline if you like, but we have to somehow face the fact that we can't squeeze the inflation down without having somebody pained a little bit. And public recognition that this has to be in effect has the educational value you people were talking about a moment ago. This education seems to me important, and one can say it without taking a naive view that guidelines are going to do an awful lot about the inflation problem.

Mr. TURNER. I was going to say about the same thing, that wage-price guideposts do perform a valuable function. The first thing they do is rub home the obvious point that real wages for workers as a whole cannot increase more than productivity, and that if real wages are held to productivity increases, there is no necessity for price increases. This is an obvious economic fact that needs to be stated and restated to all participants in the bargaining process. Therefore, I think the wage-price guideposts or some version of them do have a role to play, particularly now when we do have a wage-price spiral started, when wage increases in excess of productivity increases are legitimate because the cost of living has gone up, and increases in prices are legitimate because wages are going up more than productivity.

Once you get a spiral like this started, there is no way to stop it without somebody being the first to take some adverse economic impact. And if we could only impress upon participants in the bargaining process this fact and persuade them to settle for less than they could get, to take some adverse impact, perhaps we can slow down and eventually stop the wage-price spiral.

Senator PROXMIRE. Well, gentlemen, I thank you very, very much. I am afraid I have delayed you, but I have done so because I think it is an excellent panel and the testimony and the comments you have given will be of great help to the committee.

Without objection, I would like to include in the record, as an appendix to today's proceedings, the New York Times article on the Rinfret survey mentioned before, along with a number of other surveys of the economic outlook the staff has collected.

The committee will meet in room 1114, in the New Senate Office Building—this building—tomorrow morning at 10 o'clock to hear the Chairman of the Federal Reserve Board, William McChesney Martin.

The Joint Economic Committee stands in recess until then.

(Whereupon, at 12:30 p.m., the committee recessed, to reconvene in room 1114, at 10 a.m., Wednesday, February 26, 1969.)

APPENDIX I

The following is reprinted from "Graduate School of Industrial Administration Reprint No. 240, Carnegie Institute of Technology, Pittsburgh, Pa. 1966."

A PERCENTAGE BUDGET FOR PUBLIC APPROPRIATIONS

MARTIN BRONFENBRENNER

I

MULTIPLE budgets for governmental bodies are no longer novelties. Neither are proposals for them. The most commonly practiced and proposed breakdown is a bipartite one into current and capital budgets. Separate budgets for defense, for development, and for foreign exchange are also to be found, and have been proposed more widely than they are found. Thus some modicum of temerity is required to suggest, with any pretence to originality, yet another form of multiple budget as a partial solution for a pervasive American fiscal problem at all governmental levels.

This pervasive fiscal problem is a certain financial schizophrenia of the legislative branch. Financial schizophrenia is compounded of compulsive desires for economy, overall and in the large, and equally compulsive desires for extravagance in each particular of the small. The budgetary dualism proposed in this essay (for appropriations only) involves the conventional budget in absolute terms and a percentage budget in percentage terms. Legislative bodies would be required to pass both budgets separately before their work was done. The *percentage* budget should normally be passed first, and would not be considered as passed if its constituent percentages summed to any figure in excess of 100.

In a percentage budget, as this writer envisages it, only a total of authorized expenditures is set forth in dollars. (This total need not be identical with the total authorized in the conventional budget. My expectation is that the percentage budget total will usually be the smaller of the two.) Specific authorizations for specific purposes are set down in the percentage budget only as percentages of the total, so that administrators and legislators must justify one set of percentages rather than another. The percentage breakdown will commonly be less detailed than the line-item breakdown of the absolute or conventional budget, with a single (percentage) line item of the percentage budget combining a number of line items of the conventional one. This is to be expected, since detailed appropriation requests make little sense as percentages of a total, until this total is itself determined. The total of the percentage budget cannot add to more than 100.00 (to however many decimal places seem necessary). Should the assigned percentages add to less than 100, the difference represents slack for the executive and administrative branches to allocate as they see fit, as an additional emergency or contingency fund.

Both in total and in individual items, the executive and administrative branches should be limited to the smaller of two budgetary appropriations, when they differ. As we shall see, however,

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they will ordinarily have room to maneuver in individual projects.

II

Before proceeding further, let us discuss the malady which the dual budget system is designed to alleviate, and which we have called "financial schizophrenia of the legislative branch."

As regards individual appropriation items, the typical legislator is understandably bound to his own constituents and campaign-fund contributors. He sponsors and supports, in the conventional budget, certain expenditures for their primary benefit. More important, to secure approval of these expenditures, he trades his support of similar expenditures sponsored by fellow-legislators for the proximate benefits of *their* constituents and campaign contributors in exchange for their support of his own pet projects. This process is known widely as log-rolling, and is not without both practical and academic defenders.

The total of expenditures authorized under the influence of the log-rolling process is almost inevitably more than most legislators would like to see approved in the aggregate. (Among their constituents and campaign contributors, large taxpayers often figure quite prominently. Hence the dry folk humor about "never voting for a tax or against an appropriation.") Present budgetary practice, however, gives the representative legislator inadequate opportunity to vote his aggregative "economizing" sentiments into the budget as a whole. We are still seeking an effective "moral equivalent of log-rolling" to express the penurious side of financial schizophrenia. (Debt limits are, admittedly, efforts in this direction, but they have proved more than optimally elastic or evadable in practice. When not embedded in constitutions, they are raised; when so embedded, they are construed as not applying to particular public enterprises or instrumentalities.)

The percentage budget is planned to provide legislators precisely such a moral equivalent of log-rolling, in the form of a separate vote on an over-all budgetary ceiling with a set of percentage allocations attached. The ceiling can always, when legislators so desire, be smaller that the sum of the amounts they appropriate *seriatim*. We anticipate that the total will indeed fall short, in most cases, of the sum of its parts as presented in the conventional budget. The percentage budget will thus represent the abstemious side of financial schizophrenia, much as the conventional budget represents the extravagant side. One budget plays the Puritan, the other the drunken sailor. The existence of two budgets will permit legislators to log-roll with a vengeance in the conventional budget, displaying their devotion to their constituents' interest, and simultaneously with clear conscience endear themselves to the taxpayers by voting economy into aggregate appropriations.

A further merit of a percentage budget is to impose on the legislature a second look at the budget as a whole, realizing more directly that percentages cannot add to more than 100. This process keeps the basic economic problem of choice between alternatives more clearly in focus than the conventional budget seems to do.

Too much should not, of course, be expected overnight. A less desirable outcome may be exaggerated extravagance in the conventional budget, combined with exaggerated stinginess in the percentage one. The resulting inconsistencies will then be dumped in the lap of the Executive and his administration, whose aggregate appropriations, as we have said, are limited to the smaller of the two budget totals. It is also quite conceivable that the number and size of supplementary budgets (also dual budgets, under this scheme) will be increased sharply, if the conventional budget's total appropriations run too far above the percentage budget's ceiling figure.

III

Let us now consider a hypothetical budget item, or collection of such items, embodying a new post office, a road repair project, or the running expenses of an established government bureau. In the conventional budget, x dollars have been appropriated for this activity, out of a total appropriation of Σx or X. In the percentage budget, this activity is commingled with other similar activities at p per cent of the percentage budget's appropriation total of Y dollars (less than X), passed by the legislature in righteously abstemious mood. Our analysis does not, however, require that pY be less than x. The larger the number of similar projects combined under a single heading in the percentage budget, the more likely is pY to exceed x in fact.

But whatever the relative sizes of x and pY, the Executive and the administration now have not one expenditure mandate but two Having two mandates, they may find room to maneuver between them. On the other hand (at one extreme) they may spend x dollars for the new post office, the road repairs, or the office running expenses for which that sum was appropriated in the conventional budget. On the other hand (at the other extreme), they may spend nothing at all, provided only that pY dollars are spent for the group of purposes with which this one is commingled. The administration can, in other words, shelve the new post office, postpone the road repairs, or force the bureau to close for lack of funds. Some compromise will probably be more frequent than either of these extremes. Expenditures will be less than x but more than zero. Building projects, for example, will be spread out more often than they are postponed completely, and bureaus undermanned more often than they are starved to death.

In an imperfectly administered world, at least three sorts of difficulty can be expected under this system, particularly in its early years. We can, in the first place, expect to see occasional favored projects of the Executive or administration pushed to the utmost, and regular running expenses skimped at times, with the more or less deliberate intent to blackmail supplementary budgets from reluctant legislators. (Neither the executive nor the administrative branches are constitutionally immune from financial schizophrenia.) A second disadvantage is the economic inefficiency of stop-and-go, spreading out too many projects over too many years, cutting down each year's appropriations at the expense of increased cost for the project as a whole. This problem is particularly acute in activities like road upkeep and flood control, where each year's installment, if too small, can be completely undone before work starts again. The third difficulty is political, and to this writer's mind more serious than the other two. A dual budget decreases the legislative power of the purse, as is obvious. It increases correspondingly the power of the Executive, not only over appropriated finances but also over elected legislators. The Executive, to put it bluntly, gains a new form of political patronage. Between limitations of our two budgets, the Executive can reward its legislative friends and punish its legislative enemies by favoring the pet projects of some men while shelving the pet projects of others. The Executive also gains increased power, in election years, to allocate appropriations in such areas as to increase the electoral chances of the party in power, or of particular individuals and factions within that party.

IV

A dual budget as proposed here is by no means the first attempt to deal with the problem of legislative financial schizophrenia. This writer knows of at least two other proposals; one is an item veto for the Executive on appropriation bills, the other a blanket reduction in appropriations already enacted. The dual budget is in fact a compromise between these alternatives, but seems preferable to either of the others.

The item veto on appropriation bills represents an "all-or-nothing" alternative. More clearly than the dual budget, it requires constitutional and charter amendments, and opens up complex constitutional problems of defining "appropriation bills." Under this plan, the Executive may veto specific appropriations approved by the legislature while signing the remainder of the appropriation budget, but only on an all-or-none basis and subject to legislative over-riding of his veto.

The potential of this proposal against legislative log-rolling is obvious. The merit of its "all-or-nothing" feature is not. This feature reduces flexibility, since the Executive must either approve or veto items at once and *in toto.* He cannot reduce them or stretch them out over time. Neither can he postpone decisions in marginal cases until later periods of the fiscal year. The all-or-nothing feature is also criticized as enhancing executive power over individual legislators, even within the limitations of possible over-riding of individual vetoes. In "veto" terms, the discretion which the dual budget gives the Executive might be called a series of pocket item vetoes, exercisable at any time in the fiscal year and not merely when the budget is passed, and exercisable partially as well as totally. Like other pocket vetoes, this Executive action cannot be over-ridden. On the other hand, lacking the all-or-nothing feature, it can be much less drastic in its operation.

Blanket reduction of appropriations, while requiring no charter or constitutional changes whatever, represents its own sort of fiscal extremism. It has in fact been called the "meat-axe" approach. After appropriations have been made, if the total strains governmental resources uncomfortably, this proposal cuts back each and every item by a fixed percentage—or possibly to a fixed percentage increase above some set of prior-year expenditures.

This is an abdication of legislative responsibility and a gesture of despair. It penalizes the just and the unjust alike, not to mention the honest and the padded. It maximizes the danger of one particular sort of inefficiency—letting all projects wither, not-quite-completed, on the vine instead of completing some and postponing the rest. It avoids increases in executive or administrative power, but abandons legislative power as well—all to an arbitrary rule with no particular appeal in its favor.

The dual budget is intended, as has

been said, to steer a middle course between these various disadvantages, and to include additional benefits in increased flexibility.

V

If, for whatever reason, legislators relish financial schizophrenia, it would not tax parliamentary ingenuity to sabotage the dual budget and evade its discipline. For example, the total of the percentage budget can be set equal to the total of the conventional budget after the latter has passed. The array of percentages could be percentage translations of corresponding line items on the conventional budget. The entire procedure could degenerate early and easily into a time-wasting farce.

The dual budget proposals, however, are based on precisely the opposite premises. We suppose that both legislators and administrators alike distrust financial schizophrenia. We suppose even that legislators are willing, much of the time in many jurisdictions, to accept cooperatively certain limitations on their own power and grant more leeway to the Executive, if such limitations will cure or moderate the disease.

VI

To an economist, the most pertinent critique received by these proposals in their intra-uterine or manuscript life has been that they would hamstring expansionary fiscal policy in periods of recession, low full employment, or fiscal drag, and revive the specter of annual budgetary balance. This result does not follow as a matter of logic, since both of the proposed budget totals may exceed estimated revenue receipts. There may however, be some psychological effect from any "moral equivalent of logrolling."

Two minor points may be raised in minor rebuttal. (1) The proposals were framed with State and local governments primarily in mind. The Federal Budget process seems considerably more rational (less schizophrenic) than the representative State and local one, thanks to the Budget Bureau and the powerful Appropriations Committee. And, with due respect to the Hansen-Perloff thesis in *State and Local Finance in the National Economy,* the Federal Government is the major actor in American Functional finance. (2) The proposals bear some impact of the writer's view that, for the remainder of the century, secular inflation is greater, and slow growth a lesser, problem than one would suppose from current consensus. Pressure favor of "sound finance" *a la* Grandpa and Queen Victoria is accordingly excusable on the nautical principle of "any port in a storm."

MONETARY RULES: A NEW LOOK*

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I

THE case for a monetary rule has recently come to be discussed on what the writer now considers an irrelevant basis, for which he confesses partial responsibility. Responsibility arose from his suggestion that monetary rules might have performed better over time in the United States than did discretionary authorities by exercise of judgment.[1] Rebuttals have indicated that this evidence, not presented as conclusive, was less than persuasive, because (1) attention was concentrated on the single criterion of price level stability, (2) arbitrary lags (first one-year and then one-quarter) were assumed between changes in the quantity of money and their effects on the economy, and (3) the velocity of circulation was assumed, in the short period, to be independent of changes in the quantity of money.

Rather than further jousting along these lines, let us return to the main issue. What is this main issue? It is *not*, let us agree, whether a rule meets normal contingencies better than the judgment of normally perceptive authorities. There is rather a double issue—an issue of meeting economic crises (when judgment sometimes is paralyzed), and an issue of protection against the occasional incompetent appointed or elected to power in the hierarchy of monetary control. Even if, in ordinary times, a given rule performs no better than ordinary authorities, one may advocate it for the same reasons he buys life insurance "loaded" in the company's favor.

As a corollary: in deciding between alternative rules, the question of which one might have performed best "In the reign of James the Second" appears

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[1] Bronfenbrenner, Statistical Tests of Rival Monetary Rules, 69 J. Pol. Econ. 1, 621 (1961). The rebuttals include Tucker, Bronfenbrenner on Monetary Rules, 71 J. Pol. Econ. 173 (1963) and Modigliani, Some Empirical Tests of Monetary Management and of Rules versus Discretion, 72 J. Pol. Econ. 211 (1964).

less important than another question, namely, which rule stands the best chance of regenerating the quasi-religious faith that the gold standard once enjoyed, and holding its own against combined inflationary pressures from organized labor, business, and agriculture. The rule we are looking for should of course have done reasonably well between $(t - 1)$ and $(t - 2)$. More important, it must be at once simple enough to be plausible, and complex enough to avoid unreasonable rigidity in a world where growth rates, monetary habits, and financial institutions all change over time.

II

As a matter of logic, preference for rules over authorities, discretion, or judgment in any branch of public policy can be justified only on some principle of risk aversion, perhaps what welfare economists call "the principle of second best." The optimal discretionary authority (call him Superman) will always outperform any rule limiting his discretion. If a rule is optimal in a given situation, Superman can follow it *de facto* as a matter of judgment. If the rule is less than optimal, he can suspend, modify or disregard it, as he thinks proper.

Making a case against Superman is like making a case against Santa Claus. The first question is, "Does he exist?" There has been Benjamin Strong, who might, had he lived a few years longer, have warded off the Great Depression of the 1930's.[2] (More recently, there has been Robert Roosa.) The second question, however, is, "Does Superman *always* exist, in the right place at the right time?" This time there is a 99 per cent negative consensus. Superman cannot usually provide his own successor, or assure his succession to authority. (Strong's successor seems to have been paralysis-by-committee.) Moreover, it now appears likely that between one Superman and the next, the human errors of monetary authorities will be biased toward either perverse elasticity or inflation, rather than cancelling each other out.

Prior to World War II, the historical record of American monetary management was marred by perverse elasticity, after the establishment of the Federal Reserve System rather more so than before.[3] This error—if we can agree so to call it—was a natural outgrowth of the "real bills," "needs of trade," or "productive credit" theory of financial management. With business booming and prices rising, borrowers "needed" more money to carry on the greater volume of business and to pay the higher prices. At the same time, lending became generally less risky. The banking system expanded its loans, and

[2] Friedman & Schwartz, A Monetary History of the United States, 1867-1960, 413-14, 692 (1963), take this position and assemble the views of other economists to the same effect. For a laudatory biography, see Chandler, Benjamin Strong, Central Banker (1958). J. Kenneth Galbraith, The Great Crash, 33-34 (1955) is less fulsome in his praise of Strong.

[3] Friedman, Program for Monetary Stability 14 (1959).

with them the money supply, often until checked by lack of reserves, thus accentuating the boom and inflating the price level in the process. With business slack and prices sagging, borrowers "needed" less money, and at the same time lending became a riskier venture. The banking system raised its standards of credit-worthiness and contracted its loans, thus accelerating the economy's drift toward depression and deflation.[4]

Since World War II, the over-riding problem of monetary discretion has been secular inflation rather than bilateral perversity. Three breaks with the past seem to have been responsible. The first, under way well before the war, was the organization and strengthening of price- and wage-protecting pressure groups in agriculture and labor, alongside the business pressure groups whose power dates back further in history. The second break was the dethronement of the metallic currency standard from its traditional functions of limiting monetary reserves and checking monetary expansions. The third and most recent break has been the elevation of full employment and rapid growth to attainable goals of economic policy. The combined result of these three changes has been a world of uneasy peace between rival producer pressure groups, obtainable most easily by mildly inflationary concessions all round. Monetary authorities operate without the automatic checks embodied in a metallic standard, and subject to constant urges to validate (by expansionary policies, in the names of full employment and rapid growth), whatever solutions the pressure groups may work out among themselves.

Exercising residual discretion under these constraints, without the added support of a set of rules comprising, in Henry Simons' words, a "religion of money," the present generation of monetary authorities has restrained inflation more completely, since the Korean War, than many would have dared forecast, and paid a greater cost in growth and employment. To advocate the addition of monetary rules and monetary religion to our anti-inflationary armory is less "a surrender of the intellect and abandonment of the objectives of scientific inquiry"[5] than a doubt that later generations of monetary managers can do as well on balance. It involves, to put it bluntly, an implicit forecast of accelerating inflation.

III

This brings me to two controversial notions of the role of the monetary system in economic policy and political economy. The first notion is a degree of independence from democratic political influences, patterned after the

[4] Mints, History of Banking Theory (1945) is concerned primarily with tracing the fallacies of "real bills," "productive credit," and "needs for trade" from the medieval beginnings of commercial banking through the Great Depression.

[5] George W. Mitchell of the Board of Governors, Hearings before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, The Federal Reserve System after Fifty Years, 88th Cong., 2d Sess. 1188 (1964).

Supreme Court rather than a body such as the Tariff Commission. The second notion is a certain concentration on the economic interests of consumers, particularly fixed-income ones.

Such anti-democratic notions derive less from the Chicago seed-bed of policy-automation proposals than from the Wisconsin of John R. Commons, whose institutionalism involved workable compromises between pressure groups *with no major interest left unrepresented.*[6] In monetary policy this implies a monetary authority which would be at once Chief Justice or High Priest, plus a spokesman for groups otherwise unrepresented. These are the consumer, creditor, rentier, and pensioner interests. They have not only been left behind as producer pressure groups exfoliated, but have lost that feature of the gold standard which once provided them an automatic "rentier veto" over inflationary policies. (By shifting their assets from paper to gold, or from softer to harder currency countries, rentiers once could force inflating governments back to "sound finance.") Was not the rentier veto function of the old gold standard a legitimate one? If so, is it not more efficiently replaced by impersonal monetary rules than by discretionary authorities whose arms can be twisted?

The concept of an independent monetary authority with a special tie to fixed-income consumers is simon-pure "consumerism," and heresy under both Soviet and Chinese versions of the Marxist Gospel. More pertinently in a non-Marxist country, it leaves the monetary authorities concerned with monetary policy in a narrow sense, and transfers the supervision of employment, output, and growth to other elements of the administration. It does not over-work the monetary authorities, as does the popular double standard of full employment at stable prices. At the same time, it presents the other elements of the economic administration with pertinent constraints. When these are lacking, the easy answer seems to be collusive bargaining and inflationary erosion at consumers' expense.

IV

Over and beyond its second-best character, the case for a monetary rule suffers from the multiplicity of the rules proposed. When the alternative to judgement is not "rules" in the abstract but some concrete set of rules, it is important to know the particular set we have in mind. Some rules might improve upon discretion, while others would be worse. In this connection the University of Virginia *Monetary Constitution* lectures of 1960-61[7] are help-

[6] Commons himself was during the 1920's an advocate of a price stability rule for monetary policy, and supported legislation to impose this rule on the Federal Reserve System.

[7] In Search of a Monetary Constitution (Yeager ed. 1962). [hereinafter cited as Monetary Constitution].

ful, since they present, and in some degree compare, many of the possible candidates.

The principal monetary rules to attract attention seem divisible into four categories; I shall suggest a fifth in Section V, immediately below—the nub of this essay.

1. "Reactionary" proposals involve return to a gold standard. An extreme one, proposed at Virginia by Murray Rothbard, proposes a purely metallic money supply, convertible into gold at the present gold price ($35 an ounce), and accepts the deflationary consequences of such a change.[8] (It might offset at one fell swoop the inflationary trend which has persisted since the 1890's.) More orthodox gold-standard proposals would permit commercial banks the fractional-reserve privileges they now have—which Rothbard would raise to 100 per cent—but recover for all holders of cash balances the "rentier veto," the unlimited right to buy and sell gold, which their ancestors had before 1914. At the present price of gold, these proposals too would have deflationary consequences.

2. Other commodity-currency rules range from bimetallism at fixed prices for each metal ("free coinage of silver" *à la* William Jennings Bryan) to a multiple-commodity currency with variable prices for each ingredient but fixed prices for the bundle as a whole. These proposals, particularly the last, tie up a significant portion of a country's stock of durable standardized raw materials in sterile monetary reserves, and divert a significant portion of a country's productive resources to increasing this idle reserve stock.[9]

3. The most popular monetary rule of the generation following World War I was the stabilization of one or another price index number. This rule was popularized particularly by Irving Fisher,[10] who coupled it at first with "compensation" in the weight of the gold dollar. Legislation imposing this rule on the Federal Reserve System was discussed seriously in the 1920's. If it had passed, it might have avoided or mitigated the Great Depression; certainly it would not have made it worse!

Since World War II, price-level stabilization has lost favor as a monetary rule. It is difficult to implement quantitatively, considering the time lags between a monetary change and its price-level effects. The choice of the index-number to be stabilized influences the results, and all index-numbers may have biases, due for example to omission of quality changes, delay in including new products, or reliance on quoted rather than actual prices. If

[8] *Ibid.* at 94-136.

[9] A fuller critique of the commodity-currency proposal, associated particularly with the names of Frank and Benjamin Graham, is found in Friedman, Essays in Positive Economics 204 (1953).

[10] The fullest statement of Fisher's position (which however evolved over the years), is probably his Stabilizing the Dollar (1920).

the economy has competitive and oligopolistic sectors, general price-level stabilization may put the competitive sector under constant deflationary pressure. And of course, the doctrine has gained credence that economic progress may in a number of situations be served better by some degree of inflation than by price-level stability.[11]

4. As price-level stabilization declined in favor, its place has been taken in some degree by proposals for steady growth in the money supply, at a rate approximating the long-term growth of the country's real output. Current front-runners among such proposals are those of Milton Friedman and E. S. Shaw.[12] Friedman and Shaw would have the money supply increase at a fixed annual percentage rate of 3 to 4 per cent; Friedman tends to favor higher rates than Shaw. As Jacob Viner pointed out at Virginia in the role of devil's advocate,[13] neither Friedman nor Shaw include any rapid or automatic mechanism for adjusting monetary growth rates to changes in the long-term growth rate of the economy, to institutional changes in "economizing" the money stock, to changes in preference as between money and other assets, or to changes in the forms and "money-ness" of near-moneys.

These proposals are perhaps descended from the "neutral money" thinking of the 1930's, which ran in terms of a constant money supply, with no provision for growth and a slow fall in the money volume per capita. Neutrality advocates, primarily European, had been struck by the association of stable prices with most of the other features of an inflationary boom, culminating in the crash of 1929. According to such writers as Ludwig von Mises and Friedrich Hayek,[14] the price level should have fallen in the 1920's in consequence of technical progress; the "stabilization" measures which prevented its falling were in effect inflationary. These writers were also concerned, as a matter of social ethics, with securing to the rentier a share of the gains from improving technology. They were further concerned, as a matter of resource allocation, with preventing any distortion of relative prices which results from monetary expansion when it increases *A*'s purchasing power in advance of *B*'s.

[11] For an introduction to this argument, and a few references to the literature, see Bronfenbrenner and Holzman, A Survey of Inflation Theory, 53 Amer. Econ. Rev. 593, 608-12 (1963).

[12] The fullest development of Friedman's proposal is his Program for Monetary Stability (1959). For Shaw's plan, developed independently, see his Money Supply and Stable Economic Growth in United States Monetary Policy 49 (1958). The chapter by Richard T. Selden in Monetary Constitution, *op. cit. supra* note 8, also considers suggestions along similar lines by James W. Angell and Clark Warburton at 326-33.

[13] Viner, The Necessary and Desirable Range of Discretion to be Allowed to a Monetary Authority, in Monetary Constitution, *op. cit. supra* note 8 at 255-57.

[14] Among English translations of neutral-money proposals the most influential has been Hayek, Prices and Production (1932).

V

The writer's thinking on monetary rules is influenced by the American boomlets and recessions of 1955 to 1964, when the Friedman-Shaw rules would probably, on balance, have accentuated the inflation which occurred. Starting from the Friedman-Shaw proposals, I have attempted modifications for adjustments to fluctuations in the growth rates of real output, and in the velocity of circulation of money. This section is devoted to the *prima facie* case for this modification, called a "lag rule."[15] In subsequent sections, I shall consider the serious difficulties in quantifying some of the terms involved, and in applying the scheme in present-day America (as distinguished from Cloud Cuckoo-Land).

If we write Fisher's equation of exchange in a form relating to *Income* (here, GNP) rather than to *Transactions*, we have:

$$MV = PY$$

or, in differential-equation form:

$$\frac{dM}{M} + \frac{dV}{V} = \frac{dP}{P} + \frac{dY}{Y}$$

We can also break the income term Y into two components N and π, where N is the labor force and π its average productivity.[16] When this is done, (dY/Y) becomes $[(dN/N) + (d\pi/\pi)]$, and we have:

$$\frac{dM}{M} + \frac{dV}{V} = \frac{dN}{N} + \frac{d\pi}{\pi} + \frac{dP}{P}$$

If price-level changes (dP) are to be eliminated, we can rearrange terms in this equation, and derive a suggested rule for the behavior of (dM/M), the growth rate of the money supply:

$$\frac{dM}{M} = \frac{dN}{N} + \frac{d\pi}{\pi} - \frac{dV}{V}$$

In words; the growth rate of the money supply should equal the sum of the growth rates of the labor force and average labor productivity, less the growth rate of the velocity of circulation of money. Explicit allowance must be taken of the fact that changes in (N, π, V) are observed *prior* to the resulting

[15] Preliminary expositions of the same rule have been made in Bronfenbrenner, Statistical Testing of Rival Monetary Rules, *op. cit. supra* note 2, and Bronfenbrenner, A Sample Survey of C.M.C. Research Papers, 45 Rev. Econ. Stat. 111, 112-14 (part ii) (1963).

[16] Strictly speaking, π is the average productivity of the employed portion of the labor force, excluding those Government employees whose contribution to the national income is arbitrarily equated to their compensation.

change in M. When this allowance is made, the last equation takes on a lagged form:

$$\left(\frac{dM}{M}\right)_t = \left(\frac{dN}{N} + \frac{d\pi}{\pi} - \frac{dV}{V}\right)_{t-1}$$

The common sense of this rule is to propose that the money supply grow as rapidly as the economy would grow at full employment, with a correction for the effects of changing tastes and financial innovations on the velocity of the monetary circulation. If, for example, the growth of financial intermediaries makes the measured money stock circulate faster, the rule counteracts this growth by slowing down monetary expansion in the interests of checking inflation. If, on the other hand, the dominant effect of economic growth is an increase of the proportion of wealth and income people wish to hold in monetary form, our rule counteracts this change too, and accelerates monetary growth in the interests of checking deflation. (Insertion of the velocity term should make it possible to avoid a "switching" expedient suggested by Modigliani,[17] which would involve different rules at different phases of the business cycle.)

This rule might, in the absence of cost-push and downward price rigidities, meet the demand for guaranteed full employment and rapid growth without inflation. (Its chances would be best if it were introduced in a period of price stability and high employment, so that the base-year money supply M_0 would be "right.") The rule would in any case provide the monetary framework for such a target as growth without inflation, by reducing uncertainty as to what money supply could be anticipated. If pressure groups stay within bounds or guide-lines, the target can be reached with little friction. If they do not—particularly, if there were disputes about distributive shares, or reluctance to reduce particular prices as productivity and progress made them "too high"—the result of pressure-group activity plus price-rigidity under this rule will combine to involve both some short-run unemployment and some short-run inflation. But the onus for this unemployment and inflation could be focused where it belongs, and the monetary authorities relieved from pressure to validate inflationary price and wage movements by assuming inflationary postures on their own account. The stronger the plausibility of the rule, and the quasi-religious support which it generates, the sooner can inflationary "strikes" against it be overcome, and the more effective are the monetary restraints upon pressure-group activities and upon the downward rigidity of published prices and wages.

[17] Modigliani, *op. cit. supra* note 2, at 237-239, 242. An earlier "switching rule" on a fiscal-policy base of built-in flexibility, was suggested by G. L. Bach, Monetary-Fiscal Policy Reconsidered, 57 J. Pol. Econ. 383 (1949), reprinted in Readings in Fiscal Policy 262 (1955).

VI

On the other hand, the difficulties of applying this lag rule, as a concrete control device, limit advocacy to suggesting some of the background research requisite for near-future application. Proponents of simpler and less flexible rules—Friedman and Shaw, for example—may doubt that the probable improvements over the simpler rules are worth their cost, but let us see.

1. Difficulties begin, moving from left to right in the lag formula, with the definition of money M, from which the V term follows as the quotient (Y/M). The conventional definition of money supply includes only circulating currency and "adjusted" demand deposits of commercial banks. (The adjustments exclude interbank deposits from M.) Friedman and others have suggested a broader variant, which seems to behave better in terms of the regularity and stability of its relationship to other economic variables, and which is published continuously for a longer period in the United States. This broader concept of M includes savings deposits in commercial banks. One might consider further extensions to include savings deposits in other banks, plus savings and loan "shares" as well;[18] non-commercial banks and savings and loan companies, however, are not (in America) under the supervision of the general monetary authorities.

2. The appropriate lag period between time $(t\text{-}1)$ and time (t) is also problematic. If too long, like the one-year lag of my February 1961 study, a perverse hysteresis effect may be introduced. For example, contractionary medicine (a reduced growth rate of M) may be prescribed for an inflation after it has given way to a recession, or vice versa. In the Keynesian metaphor of the *Treatise on Money*, too long a lag may cause the money doctors to prescribe castor oil for diarrhea and bismuth for constipation.

A lag period which is too short has problems of its own. Delayed reactions to last year's doses of monetary bismuth may be drastic enough to require larger doses of monetary castor oil this year. The castor oil takes no effect until next year, when it leads to larger doses of bismuth than those which disequilibrated the system last year, "and so proceed, *ad infinitum*." We should now be prescribing the right medicine for the current ailment, but in successively larger doses which might eventually kill the patient. This too is a form of hysteresis, giving rise to destabilization by explosive oscillations.

To mitigate the destabilizing effects of errors in estimating lags, some modification or limitation of the lag may be desirable or even necessary, if the true lag period cannot be ascertained accurately or varies erratically.[19]

[18] Modigliani makes these extensions for the purpose of testing the Friedman rule, *op. cit supra* note 2, at 223-227.

[19] The range of variation seems to be between 6 and 9 months, both by Friedman's estimates in The Lag in the Effect of Monetary Policy, 69 J. Pol. Econ. 447 (1961), and those of his critics, including Ando et. al., Lags in Fiscal and Monetary Policy, in Stabiliza-

The best modifications I can currently suggest are 1) making the lag period as short as possible, and 2) setting upper and lower bounds to the annual monetary growth rate, perhaps an upper bound of 8 per cent and a lower bound of 1 per cent, regardless of the formula's occasional vagaries. A 1 per cent lower limit would be too high in case serious destruction or loss of life reduced the labor force or its productivity in any drastic manner. A change in the geographical circulation area of the dollar might make either limit obsolete. (Further constraints might be imposed, in addition, were we simultaneously to restrain short-term interest-rate fluctuations within acceptable bounds.) These problems illustrate the difficulty of framing any economic rule to cover all contingencies without suspension or supplementary legislation. (See Section IX, below.)

3. There is an ancillary problem of seasonal adjustments if a rule is applied to monthly or quarterly movements of M, or if interpolations must be made in annual data for N, π, and V. There is appeal in a heretical suggestion by Friedman, that in the undeveloped state of the black art of time series analysis, a "least-worst" solution may be to take the figures as they come, without attempting seasonal adjustments at all.[20] Before subscribing to this attractive heresy, however, we need more information, both on the magnitudes of the seasonal interest-rate fluctuations which might result from basing monetary policy on the movements of unadjusted data and on the economic consequences which might be expected from such fluctuations, once they can be hedged against to some degree.

4. Passing from M and t to N, the labor force, possible perversity may result from the apparent tendency of the measured labor force to decline in periods of mild recession, and expand in periods of full prosperity. This tendency can lead, other things equal, to cyclical fluctuations of the monetary growth rate during minor cycles, when counter-cyclical fluctuations are desired. The cause for the perverse fluctuations of the measured labor force is the tendency of potential workers to withdraw from the labor force, or to postpone entering it, unless desirable jobs are available or there is acute pressure to "work or starve." If the measured labor force varies perversely, a possible solution for the monetary authorities might be to use for N and dN the resultant of a series of proportions applied to the population by age, sex, and possibly racial groups. (Each proportion should represent the "normal" labor force participation rate for a particular segment of the population; proportions could be revised at regular intervals to adjust for changes in participation habits.) This solution makes no claims to absolute accuracy, and lags behind participation-rate changes. It does, however, avoid systema-

tion Policies 3 (1963). Compare also Friedman, Note on Lag in Effect of Monetary Policy, 54 Amer. Econ. Rev. 759 (1964).

[20] Friedman, Program for Monetary Stability 92 (1959).

tic slow-downs of monetary growth during recessions, which might otherwise make such recessions more severe.

5. The measurement of π, the average productivity of employed labor, is the most complex statistical problem faced by the lag rule. The rule works best if we have labor productivity indexes, monthly or quarterly as well as annual, which embody no perverse fluctuations when part-time employment prevails (in recessions) or overtime increases (during booms), but which will reflect reductions in the average full-time working week and year. We want, in other words, a set of *als ob* productivity indexes, reflecting the course of productivity in a society generally like our own, but in which every employed worker worked a full year with neither part-time nor overtime intervals, but in which the numbers of working hours per week and working weeks per year are not held artificially constant. This is a large order; one cannot tell in advance how well the Bureau of Labor Statistics or any other statistical agency can approximate the recipe (or witches' brew, if you prefer).

VII

No exposition of monetary rules would be complete without considering their impact on the commercial banking system. A long-standing item in "Chicago" proposals has been the transformation of both commercial and savings banking to a 100 per cent reserve basis.[21] This might require new institutions, modeled upon investment trusts, to supply funds to the traditional small-business customers of commercial banks by purchasing their equity securities, and to acknowledge repayments by resale of such securities. At the same time, it would render the banking system dependent for its income upon service charges.

The advantages of this proposal are worth considering. It eliminates any possibility of interference, intentional or otherwise, by banks and bankers with the observance of the monetary rule. It increases the ease with which the monetary authorities can follow whatever rule is adopted, and also the ease with which outsiders can appraise the performance of the authorities in observing the rule. There is also a not inconsiderable fiscal advantage. A hundred per cent system would permit (if the transition period were to avoid sadistic deflation) the monetization of a substantial portion of the Federal debt without inflationary risks. This would save taxpayers a considerable sum in interest payments—at the expense of bank depositors, who would pay higher service charges.

It may eventually turn out that a transition to 100 per cent reserves is necessary for the operation of a monetary rule. For the short term at least,

[21] Tolley, 100 Per Cent Reserve Banking, in Monetary Constitution, 275-304, *op. cit. supra* note 8.

it seems preferable to avoid burdening one admittedly drastic proposal, the substitution of rules for discretion, with another and possibly unnecessary one, 100 per cent reserves. Clark Warburton has taken the same position in an unpublished paper.[22]

Transition to a regime of monetary rules, or specifically to the lag rule, would nevertheless require for the banking system certain changes, most of which have already been discussed at length by the Commission on Money and Credit, at Congressional hearings, and elsewhere. The most important change seems to be a revision of the standards for insurability by the various Federal deposit-insurance agencies, so that no bank or savings and loan association can obtain insurance without adhering to the reserve requirements of the Federal Reserve System. A second change might be the imposition of uniform reserve ratios on all types of deposits by the Reserve System itself, so as to remove any inducement to shift between demand and time deposits for purposes of avoiding the consequences of the monetary rule. A third change would relax the present restrictions on the power of the Federal Reserve System to alter reserve requirements, or to institute secondary-reserve requirements, as required to anchor the growth rate of the money stock to its formula value. This suggestion departs from Friedman's proposal to limit the monetary authority to the single tool of open-market operations in carrying the monetary rule into effect. It is difficult to see the value of such single-string virtuosity, which might unsettle the Government securities markets. For similar reasons, I should also retain unchanged the present rediscounting authority of the several Reserve Banks.

Inclusion of savings and loan associations among the institutions to be subjected to reserve requirements (by the back door of deposit insurability regulation) does not imply whole-hearted acceptance of the controversial Gurley-Shaw thesis that financial intermediaries are serious obstacles to monetary controls, either by rule or by discretion.[23] Its purpose is to minimize discrimination between borrowers in periods of monetary stringency, on the basis of the type of institution from which they habitually borrow.

VIII

A common criticism of many proposed monetary rules is their unconcern with the country's balance of international payments. This criticism applies to

[22] I owe my knowledge of this paper, tentatively entitled, "Testing a Hypothesis," to Selden, Stable Monetary Growth, in Monetary Constitution, *op. cit. supra* note 8 at 326-331.

[23] The earlier presentations of the Gurley-Shaw hypothesis are more pointed and helpful than the more ambitious later ones. Gurley and Shaw, Financial Intermediaries and the Saving-Investment Process, 11 J. Finance 257 (1956) and The Growth of Debt and Money in the United States, 1800-1950: A Suggested Interpretation, 39 Rev. Econ. and Stat. 250 (1957).

our lag rule as well. The conventional rebuttals, depending on the rule advocated, have usually been to leave international adjustments to the automatic operation of the pre-1914 metallic standard, or to the equally automatic operation of "floating" exchange rates.[24] Leaving aside the metallic-standard proposals as irrelevant to the lag rule, the exchange-rate flexibility system seems more adequate for "country *a*" in an international-economics textbook than for a so-called key currency country like the United States.

Primarily because of confidence in the international value of the dollar, foreigners have chosen to hold substantial portions of their international reserves in dollars. This choice has made the dollar an international key currency. Should the United States so alter its monetary arrangements as to increase substantially the likelihood of downward drift in the international value of the dollar, an early result would be the withdrawal of these foreign balances, largely by conversion to gold, and an exacerbation of the chronic American balance of payments problem.

Even accepting flexible exchanges as eventual consequences of our monetary rule, we must consider the transition problems to any such system in a key currency country, particularly one with balance of payments problems. (How much easier it would have been for the United States to have adopted a monetary rule during the dollar-shortage decade 1945-1955!) For transitional arrangements, and to gain time, the following might suffice:

1. A promise, concurrently with the adoption of a monetary rule, to peg the dollar against depreciation for a significant period—at least two years, the length of a Congressional term, and preferably longer.

2. Concurrent freeing of the entire American gold stock for the settlement of international transactions. This step requires the repeal of existing legislation still requiring gold backing for Federal Reserve note circulation.

Over the longer term, the suggested monetary rule would presumably moderate the demands of American pressure groups by re-imposing a form of rentier veto on excessive wage and price increases, by enforcing unemployment and excess-capacity penalties against these increases. Unfortunately, however:

> tight over-all monetary and fiscal policy in the face of wage and price increases in inelastic demand industries A, B, C, . . . can reduce output and employment in innocent industries D, E, F., . . ., while leaving A, B, C. . . . almost unaffected. The orthodox policy may be to some extent self-contradictory if it reduces demand and raises average cost in decreasing-cost or capital-intensive industries G, H, I, . . . by raising taxes and interest rates. Business and labor pressures for monetary and fiscal ease in validation of wage and price increases can therefore be supported by *prima facie* arguments.[25]

[24] For a development of the floating-rate solution, see Sohmen, Flexible Exchange Rates, Theory and Controversy (1961), preceded in some respects by Friedman, The Case for Flexible Exchange Rates, in Essays in Positive Economics 157 (1953).

[25] Bronfenbrenner and Holzman, *op. cit. supra* note 11 at 635, note 70.

Whatever its effect on justice and resource allocation, the rule would insure against accelerating the pace of American inflation relative to the rates of America's international competitors, and indirectly help bring the dollar glut to a natural and automatic (but not necessarily painless) end. A second ground for optimism should also be noted, in the opportunity provided by the breathing spell of continued fixed parities, for a gradual and phased withdrawal of at least official foreign Treasury and Central Bank deposits from the United States in a panic-free atmosphere. This would free America from any special policy hobbles imposed by its key-currency position.

IX

A legal and administrative issue, frequently avoided in discussions of monetary rules, is the problem of sanctions. If the monetary authority cannot or will not adhere to the monetary rule, what then? Should its leading lights be liable to immediate dismissal, and if so by whom? Should they be disbarred from reappointment, when their terms expire? Should they be paroled with warnings, wrist-slaps, or votes of censure? Can any impersonal sanctions be invoked against the authority as an organization?

The issue is most serious on the inflationary side. In the event of a natural disaster or a war, relief and armament expenditures must be financed here and now, just as in 1941-42 or 1950-51. They cannot wait for appropriate money, credit, or fiscal controls to be enacted. No monetary authority, however unsullied its purism, will stand in the way of relief or war financing in a disaster or defense emergency.

Under these circumstances, and as an inducement to shorten the resulting period of monetary and fiscal instability, we might consider the automatic transformation of all outstanding Federal Government securities to a purchasing-power basis, both as to principal and interest. This should come about under the rule itself, and not require new legislation. It means that in periods of legislative suspension of the monetary rule (but not otherwise) the entire body of Federal indebtedness is escalated automatically, imposing additional burdens proximately on the Treasury and ultimately upon the taxpayers. Escalation would end when the monetary rule is reimposed. Some, but perhaps not all,[26] Social Security obligations should be escalated in the same way.

It is difficult to conceive as of the 1960's the opposite condition, where a

[26] Escalation of unemployment compensation payments represents a problem. Wars and disasters are often periods of labor shortage, when one might wish the purchasing power of compensation payments reduced for the sake of increased labor supply. On the other hand, these are sometimes periods of structural unemployment following destruction of specialized capital instruments. Do we really want to cut down unemployment compensation to induce skilled people to abandon their skills?

monetary authority is helpless to check a decline in the money supply, but it may have obtained in the early 1930's. To visualize a powerless monetary authority faced with a shrinking money supply, let us conjure up a situation where the entire Federal debt has been paid off, while interest rates are too low and risk premia too high to justify even the maintenance of the existing volume of bank loans. Let us, in other words, combine the "lack of confidence" of the 1930's with the debt-free economy of the 1840's. In such a situation, the role of open market operations in expanding the circulating money supply would be minimal. Supplementary powers of a quasi-fiscal character would be required, for example, to put an increased money supply into direct circulation through wage subsidies, consumer subsidies, negative income taxes, negative sales taxes, or similar devices, over and above any scheduled budgetary deficit.[27] Lacking these powers, the monetary authority could be required only to hand over to the Treasury appropriate additions to the money supply. It could not prevent their foundering in the Treasury cash balance.

Under all presently realistic conditions, however, failure to follow the mandatory rule over any considerable period should be stated grounds for impeachment or dismissal of the individuals responsible. We cannot, however, automate the impeachement or dismissal procedures. As with war crimes, there will always remain difficult questions of allocating responsibility between higher and lower ranks of the administrative hierarchy.

X

We have postponed any discussion of the economic theory (other than the equation of exchange) underlying monetary rules. This discussion should also involve the relation of the proposal to at least two additional areas of economic policy, namely (1) fiscal policy as related to aggregate public receipts and expenditures, and (2) hortatory guide-lines for economic pressure groups, such as have been proclaimed by the Council of Economic Advisers, particularly since 1962.

1. Perhaps the major issue of any monetary theory (in its policy applications) is the power of changes in the money supply to accomplish any result of substance, and more particularly to reverse a recession or depression. The phrase "pushing on a string" expresses skeptical doubts on this score, based on one interpretation of American experience in the 1930's. The theory back

[27] Negative taxes or social-dividend payments played important roles in academic proposals for policy during the generation before 1945. Interest disappeared in the subsequent inflation; it is beginning to revive (1963-64) in the context of the automation controversy. The writer once proposed a general Federal sales tax at variable rates and exemptions, which might become negative *in extremis*. Bronfenbrenner, Sales Taxation and the Mints Plan, 29 Rev. Econ. and Stat. 39 (1947).

of the phrase is that monetary expansion can be effective only when coupled with fiscal measures to inject the new money directly into the income stream. In extreme form, the argument is that fiscal measures operate regardless of their effects upon the money supply.

An older position with similar implications rests on the quantity theory of money. We might call this view the "dichotomy" theory. In this skeptical view, monetary policy operates only on the price level, but something else is required to change real output and employment. If this dichotomy between monetary and real quantities is taken seriously, it seems to imply that the real money supply, corrected for price-level changes, cannot be altered significantly by monetary management. This position seems anomalous at first glance; statistical evidence indicates that the real monetary stock varies over time, so why not as a consequence of policy changes?

A second theoretical issue is related more closely to the "rules versus authorities" aspect of the debate. How practical is reliance upon discretion and judgment to improve on a monetary rule, and how frequently can intuitional Supermen be anticipated, in a world where "inside" lags exist between the need for policy changes and the execution of such changes, where "outside" lags exist between policy changes and their economic effects, and where both sets of lags may be too variable for explicit inclusion in economic calculations?

2. Let us first rebut the conventional wisdom about "pushing on a string," which may be no newer than Alvin Hansen's *Fiscal Policy and Business Cycles* (1941).[28] Hansen's book included a summary of American experience in the preceding decade, in which monetary expansion allegedly failed to bring about recovery from the Great Depression. A number of later writers have shown, none more forcefully than Friedman, that, far from expanding, the money supply was permitted to contract by over one-third between July, 1929, and March, 1933, "with over two-thirds of the decline coming after England's departure from the gold standard and the accompanying deflationary action by the [Federal Reserve] system."[29] The string-pushing hypothesis should at least be revised, to refer not to the ability of money to expand the economy but to the ability of the monetary *authority* to expand the money supply. Its grain of truth is suggested by the fact that the fall in the money supply occurred despite a rise in the total reserve base of "money in circulation plus member-bank reserves," sometimes called high-powered money.[30] One might make a case that, given the international gold standard,

[28] Hansen, Fiscal Policy and Business Cycles (1941).

[29] Friedman, *op. cit. supra* note 4 at 19. For fuller detail, see Friedman and Schwartz, *op. cit. supra* note 3, ch. 7, especially 407-419.

[30] For the period 1930-33, Tolley has estimated that a 17 per cent rise in the total reserve base failed to prevent a 23 or 25 per cent fall in the total money supply. 100 Per Cent Reserve Banking, in Monetary Constitution, *op. cit. supra* note 8, at 277.

and the size of the Federal debt, reserves could not have been expanded quickly enough to check the decline in the total money supply. We have indicated in the last section conditions in which this might be true, but there is no reason to feel that these conditions apply today.

Further refuting the happy phrase about string-pushing, a body of evidence has accumulated from statistical tests of the comparative efficiencies of the quantity theory of money and the Keynesian income-expenditure theory in explaining the movements of the national income and output. Controversy dates from the Friedman-Becker essay of 1957. Friedman and his followers maintain that the quantity of money is so much more efficient as an indicator that the Keynesian apparatus represents a backward step.[31] The opposition maintains that, with appropriate lags and more elaborate definitions of what one calls the autonomous or causative factors in the Keynesian system, it is the Keynesian model which yields the better results, or at the very least, there is little to choose between the two.[32] We need not enter into this dispute, except to emphasize the conclusion common to both sides, that money *does* effect the economic system. Whether its effect is more or less effective and regular than the Keynesian multiplier is a secondary consideration, if not a false issue.

3. By the same token, our purpose in this paper is not to disparage the fiscal-policy approach to economic stabilization. To reaffirm the "rediscovery of money," alias the "anemic counter-revolution," of the 1950's, is not to discard the tax and expenditure systems as engines of public policy. Monetary and fiscal policies, both automatic and discretionary, should work together rather than independently or at cross purposes.[33] If there is any conflict

[31] Friedman and Becker, A Statistical Illusion in Judging Keynesian Models, 65 J. Pol. Econ. 64 (1957). The fullest statement of the anti-Keynesian position is in Friedman and Meiselman, The Relative Stability of Monetary Velocity and the Investment Multiplier in the United States, 1897-1958, in Stabilization Policies 165 (1963). The early 1930's are a recognized exception to Friedman and Meiselman's conclusion. *Id.* at 186. Friedman and Meiselman consider (but reject) alternative explanations for high correlations involving money, namely causation from income to money and from some *tertium quid* to both money and income at 179.

[32] See Ando and Modigliani, Velocity and the Investment Multiplier, 55 Amer. Econ. Rev. 693 (1965), and Hester, Keynes and the Quantity Theory: Comment on Friedman and Meiselman CMC Paper, 46 Rev. Econ. Stat. 364 (1964), attacking specifically the Friedman-Meiselman results. Compare the last sentence of the present paragraph with a parallel passage from the Ando-Modigliani paper: "There is absolutely no justification for treating autonomous expenditures and money supply as mutually exclusive stabilization devices. . . . It is well known that, if broadly understood as a theory of the demand for money, the quantity theory, far from being inconsistent, is actually an important part of the mechanism in the Keynesian framework as generally understood." *Supra* at 715.

[33] It is difficult to resist the impulse to protest against the occasional interpretation of Jan Tinbergen's economic-policy writings as implying that, even in theory, policy *a* can be adjusted to affect only variable 1, and policy *b* to affect only variable 2 (leaving variable 1 unaffected), and so on to Utopia.

between them, it results from the tendency of expansionary fiscal policy to raise interest rates while expansionary monetary policy lowers them, and *vice versa.*

It is administratively more difficult to order fiscal than monetary changes by rules of any kind, although limited "formula flexibility" tax proposals have been advocated by the Commission on Money and Credit and the Council of Economic Advisers.[34] This consideration should not in itself relegate the fiscal system to any passive limbo. What is important, in the compromise position of this essay, is to prevent fiscal sabotage of monetary policy, in the name of either the annually balanced budget or of employment and growth at any cost. Unity of purpose is achievable most easily by using the best econometric forecasting models available in assisting the Administration (proximately, the Treasury, Budget Bureau, and Council of Economic Advisers, ultimately the president and Congress) to frame fiscal measures with an eye to maintaining a real growth rate equal to the sum of the growth rates of the labor force and labor productivity, while the monetary authorities finance resulting deficits and surpluses in stride, while following the monetary rule. In algebraic terms, the fiscal target should be:

$$\left(\frac{dY}{Y}\right)_t = \left(\frac{dN}{N} + \frac{d\pi}{\pi}\right)_t$$

without regard to V and dV. In practice, all elements of the fiscal target must be forecast, with the forecasts including both monetary policy and its repercussions on interest rates. As in the monetary—policy case, fiscal policy may be thwarted, or diverted into unemployment or inflation, by the wage, price, and profit decisions of private pressure groups. The writer does not believe that this diversion problem is a long-term one, provided only that fiscal and monetary authorities stand by their guns and explain their positions in plausible fashion. This, however, is merely a conjecture; it cannot be presented as anything more.[35]

4. In relating monetary rules, or other monetary and fiscal policies, to private bargains and decisions, what is the role of direct intervention, either in strategic industries or the economy as a whole? What can be said of "income policies," "guide-posts for collective bargaining," "moral suasion," "jawbone control"? They cannot serve as substitutes for monetary and fiscal

[34] Commission on Money and Credit, Money and Credit 129-30 (1961); U.S. President, Economic Report of the President 4, 18-19, 70-75 (1962).

[35] Compare the analysis of the so-called Phillips curves (relating rates of wage increase to rates of unemployment) under different monetary and fiscal climates, as presented in Bronfenbrenner and Holzman, *op. cit. supra* note 11 at 631-35.

controls against inflation, except in short-run or emergency situations. On the other hand, they have two functions within a system of monetary and fiscal controls in being.

The first and temporary function of direct controls is to hold a line, or serve as a stopgap, until effective rules are devised and implemented, or while "bugs" in the rules are being corrected. Their second and longer-term function is to translate aggregative policies for the economy as a whole into specific situations for specific industries or firms, and in this way to prevent or contain episodes of sectoral inflationary unemployment.

Why then is intervention, even the hortatory variety, so disdained by most advocates of monetary or fiscal rules? The explanation is largely historical. Intervention has been applied too often, and maintained too long after some initial success, as a toothless substitute for effective anti-inflation policies, or even a mask for actively inflationary ones. It has been applied too often discriminatorily, against prices but not wages, or wages but not prices, or "basic" industries but not others, or in some lock-step fashion which checks re-allocation of resources between industries. Inclusion of "guide-posts" in a package of reform proposals may be a kiss of death, and assure the whole package being laughed out of court. The writer sees no reason for continuance of this checkered history, and hopes rather that guide-posts can come into their own (belatedly) from association with rational monetary policy, just as they assist in the enforcement, maintenance, and rationalizing of whatever rules are enacted.

5. A *prima facie*, or practical man's case, for discretion as against rules can be paraphrased as follows: A discretionary authority need only do "better than chance" (in some sense) to improve on the situation without discretion. No Superman is required, to do better than chance; any competent expert or specialist should be able to do so most of the time. Therefore, why not leave the experts and specialists free to exercise and sharpen their judgments?

It is the merit of a Friedman paper[36] to have pulled the teeth of this plausible argument. To improve on the situation without discretion, meaning to perform in a stabilizing rather than a destabilizing manner, the authority must not only better chance, but better it by a substantial margin, whose size increases with the degree of discretion exercised by the authority.

The formal analysis is set out in the appendix. It indicates that the degree of judgmental acumen required for discretionary policies to stabilize, in fact as well as in intent, is significantly greater in absolute value than some number which is itself significantly greater than the value suggested by pure

[36] Friedman, The Effects of a Full-Employment Policy on Economic Stability: A Formal Analysis, in Essays in Positive Economics 117 (1953). (This essay appeared originally in French.)

chance. It does not purport to prove that this degree of acumen may not be available ever, normally, or even invariably, although the writer is among the skeptics as regards "normality and above." The algebra merely shows the magnitude of the discretionary authority's task to be greater than is plausibly imagined by advocates of the discretionary *status quo*, and to that extent enhances our basic case for a shift in the direction of a monetary rule—specifically, the "lag rule" outlined in Sections V-VI of the present paper.

APPENDIX

Denote by X_t the national income at time t in the absence of discretionary monetary or fiscal policy, and by Y_t the amount added to or subtracted from X_t by discretionary policy. Then $Z_t = (X_t + Y_t)$ represents the observed national income at time t. Under what conditions will the variance of the sum Z about its mean (or about its time trend) be less than the variance of X? Under what conditions will Y have compensated for the variability of X so that, in the conventional symbols, $\sigma_z^2 < \sigma_x^2$? The intuitive answer is, if policy is significantly "anti-cyclical," meaning, if Y rises as X falls or Y is negatively correlated with X. This answer is, however, wrong, and the correct answer imposes more arduous requirements upon judgement or discretion. (The symbol σ_x^2 means "the variance of x".)

Let r be the coefficient of correlation between X and Y; it takes on values between -1 and $+1$. Interpret "better than chance" as implying that its value is less than zero (negative correlation between X and Y), and interpret a value of -1 (perfect negative correlation between X and Y) as implying perfection in the exercise of discretion, or the judgement of Superman. What Friedman showed was that, for discretion to act as a net stabilizer ($\sigma_z^2 < \sigma_x^2$), r must not only be negative (better than chance), but more strongly negative than $(-\sigma_y/2\sigma_x)$.

By an elementary statistical theorem, when $Z = X + Y$:

$$\sigma_z^2 = \sigma_x^2 + \sigma_y^2 + 2r\sigma_x\sigma_y \qquad \text{(i)}$$

Dividing through by (σ_x^2):

$$(\sigma_z^2/\sigma_x^2) = 1 + (\sigma_y^2/\sigma_x^2) + 2r(\sigma_y/\sigma_x) \qquad \text{(ii)}$$

This must be less than unity for discretion to have operated in a stabilizing manner. This implies from the right side of (ii):

$$(\sigma_y^2/\sigma_x^2) + 2r(\sigma_y/\sigma_x) < 0, \quad \text{or} \quad r < -\frac{1}{2}(\sigma_y/\sigma_x) \qquad \text{(iii)}$$

Inequality (iii) yields the expression which closes the second paragraph of this Appendix. An implication of equality (ii) is that, for completely successful establization ($\sigma_z = 0$) we must have not only perfect discretion ($r = -1$) but also equality between the variances of Y and X.

Differentiating (i) with respect to σ_y, and setting the result equal to zero for a minimum, we obtain:

$$\sigma_y = -r\sigma_x \qquad \text{(iv)}$$

Rewriting (i) with σ_y defined as $k\sigma_x$;

$$\sigma_z^2 = \sigma_x^2(1 + k^2 + 2kr)$$

Minimizing this last expression with respect to k, we have:

$$k = -r \qquad \text{(v)}$$

If the attempt were made to insure complete stability, with each fluctuation in X matched by an equal and opposite fluctuation in Y and with $(\sigma_y = \sigma_x)$, discretionary actions would stabilize the economy only if r were smaller than $-.50$. If the aim of the authorities were somewhat less ambitious, so that σ_y were only some proper fraction k of σ_x, discretionary action could be stabilizing with r smaller than $-.50\,k$. (These requirements are obviously more stringent than the common-sense one that the correlation be significantly negative. Yet, unless they are satisfied, discretion will destabilize the economy.) Furthermore, $(-r\sigma_x)$ is an optimum value for the discretionary variance σ_y and $-r$ is an optimum value for the "modesty coefficient" k when σ_y is known, if we define optimum values as those σ_x which reduce the variance σ_y^2 to its minimum for a given r. (See equations (iv) and (v) above).

From these results, we can see that (in a world of fallible mortals, at least) discriminatory policy can be too strong as well as too weak, and also that the maximum achievable increase in stability is a function of r as well as of σ_y. In fact, substituting $(-r\sigma_x)$ for σ_y in (i), the result is not zero but $\sigma_x^2(1 - r^2)$. This clearly depends on r, and vanishes only in the Superman case of complete perspicacity, that is, perfect (negative) correlation between X and Y.

APPENDIX II

Materials in this appendix were selected by the Joint Economic Committee staff.

SUMMARY

MARTIN R. GAINSBRUGH: Sometimes I take comfort in the fact that at least the stenotypist must remain until the summary is heard.

I do want to thank all of you bitter-enders for staying on, as you have. No matter how much time we allot to those discussants who precede the summarizer, he once again finds himself with too little for that essential purpose. As in past years, then, all I can hope to do is to highlight briefly some of the major points advanced in this, the longest discussion of the Economic Forum in the 23 years it has met to appraise the outlook.

Let's begin by examining briefly the accuracy of the record for last year; then second, move on to our consensus for the key economic indicators for 1969; third, sum up the various sector accounts for 1969, as best I could detect them from the discussion, and contrast the sum of the parts with the GNP the group projected; and fourth, let's examine the yield of the projected level of employment and output per man-hour—surprisingly the most accurate of our projections for '68—and see what this produces in the way of aggregate GNP. In closing, I shall list some of the problem areas that becloud the outlook for 1969, providing thereby the Forum's qualitative rather than quantitative judgment about business trends in the year ahead.

Past Performance

Turning first to the Forum's record for 1968, we as a group definitely undershot. There was a divergence of viewpoint last year and clearly the optimists were proved right. Unfortunately, they were in the minority.

Two members of the Forum, praises be, came very close to the actual figures for the fourth quarter of 1968.[1] One daring individual had the GNP for the current quarter at $875 billion; another, at $871 billion. Allow about $5 billion for the upping of the GNP at the annual midyear revision, and they were virtually on target.

For the Forum as a whole, however, the anticipation was a GNP that by fourth quarter '68 would average around $860 billion. Instead, it will be at least $880 billion. The Forum looked for a rise of 7% in the GNP during 1968; it's actually up nearly 9%.

One of the reasons why we understated the GNP was that we failed to recognize how high it was for the quarter in which we were forecasting the outlook for the year ahead. The highest estimate then submitted was $3 billion below the subsequent official figure for GNP in the fourth quarter. That official figure was later revised upward by another $4 billion. I hope we're not guilty again of underestimating national output for the present fourth quarter. Once this happens, it's bound to infect all subsequent estimates.

As for the increase in real output, we thought that would move up by about 4%; instead, it's risen by a bit above 5%. The shortfall, then, stemmed from an underestimate of volume as well as of the degree of inflation.

[1] See "Business Outlook, 1968," *Studies in Business Economics* No. 99, National Industrial Conference Board, p. 118.

Where did we miss out in appraising the four major sector accounts? We placed the governmental sector at $198 billion, fourth quarter '68. The actual figure will be around $200 billion by yearend, perhaps a little bit above it. That's a most satisfactory record. We can take some pride and save some face in having placed defense expenditures at $80 billion, almost the figure that does prevail. When you are dealing with an uncertainty as great as that one, there's considerable comfort in recalling that projection.

Our estimate of $5 billion of net foreign exports may prove higher than the actual yearend figure. It's currently running around $3.5 billion.

We missed most in projecting gross private domestic investment. This is still the most intractable area to project, despite all the tools that we have developed for this purpose. Our estimate of plant and equipment fell short by at least $5 billion, we understated the accumulation of inventory figure, and we were low on housing.

As I indicated earlier, George Hitchings was most accurate in his projection of services and Ira Ellis did almost as well on nondurables. But we were overly conservative in our estimate for durables by about another $5 billion.

In summary, then, the explanation for the larger inaccuracy than usual in our projections stemmed largely from an understatement of investment and consumer durables, together with inadequate allowance for price increases in 1968, although we warned against the menace of mounting inflation.

In terms of direction, I think we had the profile of the year well sketched. We thought the year would open strong, but that business would tend to moderate as the year ran its course, as it has. We banked heavily upon strength of end-product demand throughout the year, so much so that I closed by describing 1968 as another year of worrisome, uneasy prosperity—and that it certainly has been.

Consensus on Aggregates

So much for the past. What of the future, particularly for the key economic indicators for 1969? We're in fairly close agreement over the position of that measure currently. The lowest estimate submitted is $882 billion; the highest $886 billion; the average $883.5 billion. Even so, wouldn't it help if we had monthly measures of national output, so that we'd have a better base on which to build our quarterly estimates!

As for the year ahead, the prospect of recession is not evident in any of the various models this group has built, nor even of any sharp but short contraction in 1969. That ought to help allay the fears that have arisen from the confusion of a slowing down or moderation in the rate of growth as being synonymous with recession or with mass unemployment. Sustained economic growth and high level employment throughout 1969 are anticipated by every member of the Forum.

While we agree that the economy will move up during 1969, we differ over the rate of growth in 1969, and markedly so over its profile, second half compared with first half. Indeed, three different models emerged for 1969, and the differences do not arise primarily from assumptions regarding either a

Table 11: Forum Outlook Expectations, 1969

Gross National Product[1]

Surtax Charge Assumed: Personal	Corporate	1968 IV Q	Year 1968	1969 I Q	II Q	III Q	IV Q	Year 1969
10%	10%	883.0	859.5	892.0	901.0	918.0	932.0	910.8
10%	10%	883.0	859.5	894.0	907.0	923.0	939.0	915.8
5%	5%	885.0	860.0	895.0	905.0	920.0	940.0	915.0
10%	10%	886.0	860.3	896.0	908.0	918.0	929.0	912.8
10%	10%	884.3	859.9	896.7	910.5	928.4	943.7	919.8
0	0	883.0	859.5	895.0	905.0	920.0	935.0	913.8
10%	10%	882.0	859.3	892.0	902.0	917.0	935.0	911.5
10%	10%	880.0	858.8	...	900.0	...	920.0-930.0	910.0-915.0
10%	10%	882.0	859.3	896.0	910.0	928.0	948.0	920.5
10%	10%	885.0	860.0	900.0	915.0	930.0	945.0	922.5
0	0	884.0	859.8	890.0	902.0	917.0	940.0	912.3
High...............		886.0	860.3	900.0	915.0	930.0	948.0	922.5
Low...............		880.0	858.8	890.0	900.0	917.0	920.0	910.0
Average............		883.4	859.6	894.7	906.0	921.9	937.0-937.9	915.0-915.4

Index of Industrial Production[2]

Surtax Charge Assumed: Personal	Corporate	1968 IV Q	Year 1968	1969 I Q	II Q	III Q	IV Q	Year 1969
10%	10%	165.0	164.5	163.0	162.0	164.0	166.0	163.8
10%	10%	164.0	164.2	165.0	167.0	169.0	172.0	168.3
5%	5%	165.0	164.5	166.0	166.0	168.0	170.0	167.5
10%	10%	166.0	164.7	167.0	168.0	169.0	170.0	168.5
10%	10%	165.5	164.6	166.0	167.0	169.0	170.5	168.1
0	0	163.0	164.0	162.0	164.0	166.0	169.0	165.3
10%	10%	165.5	164.6	165.0	164.0	166.0	168.0	165.8
10%	10%	...	...	...	...	...	...	...
10%	10%	...	...	...	...	...	...	...
10%	10%	165.0	164.5	...	167.0	...	169.0	168.0
0	0	165.0	164.5	167.0	168.0	169.0	170.0	168.5
High...............		166.0	164.7	167.0	168.0	169.0	172.0	168.5
Low...............		163.0	164.0	162.0	162.0	164.0	166.0	163.8
Average............		164.9	164.5	165.1	165.9	167.5	169.4	167.1

[1]Billions of dollars; seasonally adjusted annual rate.
[2]1957-1959 = 100; seasonally adjusted.

Table 11: Forum Outlook Expectations, 1969 (Continued)

Consumer Price Index[3]

Surtax Charge Assumed: Personal	Corporate	1968 IV Q	Year 1968	1969 I Q	II Q	III Q	IV Q	Year 1969
10%	10%	123.1	121.4	123.9	124.7	125.3	126.0	125.0
10%	10%	123.4	121.5	124.4	125.5	126.7	128.0	126.2
5%	5%	123.0	121.4	124.0	125.0	125.5	126.0	125.1
10%	10%	123.0	121.4	123.5	124.0	124.5	125.0	124.3
10%	10%	122.9	121.4	123.5	125.0	126.0	127.2	125.4
0	0	123.2	121.5	124.1	125.0	125.8	126.5	125.4
10%	10%	123.2	121.5	124.2	125.2	126.4	127.5	125.8
10%	10%	123.3	121.5	...	125.2	...	127.0	126.1
10%	10%	123.1	121.4	124.0	124.6	125.2	125.5	124.8
10%	10%	124.0	121.7	...	126.0	...	128.0	127.0
0	0	123.2	121.5	124.3	125.2	126.1	127.0	125.7
High		124.0	121.7	124.4	126.0	126.7	128.0	127.0
Low		122.9	121.4	123.5	124.0	124.5	125.0	124.3
Average		123.2	121.5	124.0	125.0	125.7	126.7	125.5

Wholesale Price Index[3]

Surtax Charge Assumed: Personal	Corporate	1968 IV Q	Year 1968	1969 I Q	II Q	III Q	IV Q	Year 1969
10%	10%	109.4	108.9	109.4	109.2	109.7	110.2	109.6
10%	10%	109.4	108.9	110.2	110.8	111.4	112.0	111.1
5%	5%	109.5	108.9	110.0	110.5	111.0	111.5	110.8
10%	10%	110.5	109.1	111.0	111.5	112.0	112.5	111.8
10%	10%	109.5	108.9	110.0	110.5	111.0	111.5	110.8
0	0	109.2	108.8	109.2	109.2	109.3	109.4	109.3
10%	10%	109.4	108.9	109.6	109.8	110.3	111.0	110.2
10%	10%	109.4	108.9	...	110.4	...	111.5	111.0
10%	10%	...	...	...	...	...	...	...
10%	10%	109.5	108.9	...	110.0	...	111.0	110.5
0	0	109.2	108.8	109.3	109.4	109.5	109.6	109.5
High		110.5	109.1	111.0	111.5	112.0	112.5	111.8
Low		109.2	108.8	109.2	109.2	109.3	109.4	109.3
Average		109.5	108.9	109.8	110.1	110.5	111.0	110.5

[3]1957-1959 = 100.

Table 11: Forum Outlook Expectations, 1969 (Continued)

Implicit Price Index[4]

Surtax Charge Assumed: Personal	Corporate	1968 IV Q	Year 1968	1969 I Q	II Q	III Q	IV Q	Year 1969
10%	10%	123.4	121.7	124.3	125.2	126.0	126.8	125.6
10%	10%	123.7	121.8	125.0	126.0	127.0	128.0	126.5
5%	5%	123.0	121.6	124.0	125.0	125.5	126.5	125.3
10%	10%	123.5	121.8	124.5	125.5	126.3	127.0	125.8
10%	10%	123.4	121.7	124.4	125.5	126.5	127.5	126.0
0	0	123.3	121.7	124.2	125.2	126.0	126.5	125.5
10%	10%	123.4	121.7	124.4	125.3	126.3	127.5	125.9
10%	10%	...	...	...	...	...	...	...
10%	10%	...	...	...	...	...	...	...
10%	10%	124.0	121.9	...	126.0	...	128.0	127.0
0	0	123.2	121.7	124.2	125.1	126.0	126.8	125.5
High		124.0	121.9	125.0	126.0	127.0	128.0	127.0
Low		123.0	121.6	124.0	125.0	125.5	126.5	125.3
Average		123.4	121.7	124.4	125.4	126.2	127.2	125.9

Unemployment Rate[5]

Surtax Charge Assumed: Personal	Corporate	1968 IV Q	Year 1968	1969 I Q	II Q	III Q	IV Q	Year 1969
10%	10%	3.8	3.7	4.0	4.1	3.8	3.7	3.9
10%	10%	3.7	3.7	3.8	4.2	4.0	4.0	4.0
5%	5%	3.7	3.7	4.0	4.5	4.5	4.0	4.3
10%	10%	3.6	3.7	3.6	3.6	3.7	3.8	3.7
10%	10%	4.0	3.8	4.3	4.5	4.5	4.6	4.5
0	0	3.8	3.7	4.2	4.5	4.4	4.3	4.4
10%	10%	3.7	3.7	3.9	4.1	4.1	4.0	4.0
10%	10%	3.8	3.7	...	4.0	...	4.2	4.1
10%	10%	3.6	3.7	3.8	4.0	4.0	4.0	4.0
10%	10%	3.6	3.7	3.7	3.8	3.8	3.8	3.8
0	0	3.6	3.7	3.7	3.8	3.8	3.7	3.8
High		4.0	3.8	4.3	4.5	4.5	4.6	4.5
Low		3.6	3.7	3.6	3.6	3.7	3.7	3.7
Average		3.7	3.7	3.9	4.1	4.1	4.0	4.0

[4]1958 = 100.
[5]Per cent; seasonally adjusted.

Table 11: Forum Outlook Expectations, 1969 (Continued)

Defense Expenditures[1]

Surtax Charge Assumed: Personal	Corporate	1968 IV Q	Year 1968	1969 I Q	II Q	III Q	IV Q	Year 1969
10%	10%	79.6	78.8	79.6	79.6	83.1	84.6	81.7
10%	10%	80.5	79.0	81.5	82.0	82.0	82.0	81.9
5%	5%	80.0	78.9	80.0	79.0	77.0	76.0	78.0
10%	10%	80.0	78.9	80.0	80.0	80.0	80.0	80.0
10%	10%	80.5	79.0	81.0	81.5	83.0	83.5	82.3
0	0	81.0	79.1	82.0	81.0	80.0	78.0	80.3
10%	10%	79.5	78.7	79.5	79.5	80.8	81.4	80.3
10%	10%	...	...	...	...	...	...	...
10%	10%	79.7	...	...	...	...	...	...
10%	10%	79.0	78.6	...	80.0	...	81.0	80.5
0	0	79.0	78.6	79.0	78.0	76.0	74.0	76.8
High		81.0	79.1	82.0	82.0	83.1	84.6	82.3
Low		79.0	78.6	79.0	78.0	76.0	74.0	76.8
Average		79.9	78.8	80.3	80.1	80.2	80.1	80.2

[1]Billions of dollars; seasonally adjusted annual rate.

cease-fire or a termination of the surtax. Only two individuals, I believe, have the surtax expiring, while a third has it halved at midyear. As for the impact of a truce on the economy, only a minority expect defense spending to be lower than it is currently. The lowest figure for defense spending by yearend '69 is $74 billion, or about $5 billion less than the prevailing rate. Where we differ significantly is over the profile of private investment as the year matures.

The first, and by far the most popular, model is saucer shaped, with some decline in the rate of growth in the first half and then a sharp step up in the rate of growth in the second half. Well over half the participants foresaw this trend. The gross national product on this basis would be about $900-$910 billion at midyear, equivalent to a rise of about 6%, on an annual basis. It would then accelerate to an annual rate of about 8% to reach $935-945 billion by yearend.

The second model is an inverted saucer with a bit more rapid growth rate in the first than in the second half. One such model submitted has the GNP up to $908 billion by midyear but only $929 billion by yearend.

The third model displays a straight line growth throughout the year, or something resembling it. This model, too, at yearend hits $940 billion—but with little, if any, quarterly change.

The range highlights the disparities in models. The lowest estimate for mid-'69 is $901 billion; the highest, $915 billion. By yearend the lowest is $929 billion; the highest, $948 billion. Even so, the bulk of the projections tend to cluster around the average of $906 billion for midyear and about $936 billion for the fourth quarter. On this basis, the collective expectation of the

Forum is for a rise of 6%-6½% in national output in 1969, with the rate of growth slowing to about 5% in the opening half and then speeding up to 7% as the year closes.

For the year 1969 as a whole, the gross national product is placed at $915 billion, as against $860 billion in 1968. The rate of increase in 1969 would average only about 6.5% compared with a rise of nearly 9% in 1968. In *real* terms the Forum anticipates an increase in the volume of national output of about 3.5%. Real GNP in 1968, in contrast, rose by about 5%.

Somewhat similar trends are evident in the other related measures. The FRB Index, which is put at around 166 currently, shows little, if any growth through mid-1969. The highest figure is 168. In fact, two measures have industrial production lower at that time than it is now. By yearend, however, the average approaches 170, ranging from 166 low to a high of 172. The majority have production in the second half in the 170-to-172 range, in conformity with the saucer model of sharper growth. In 1968, industrial production advanced by about 4%; for 1969, that growth rate is reduced to barely 1.5%.

The Forum is almost as one in anticipating less inflation in 1969 than in 1968. Consumer prices, for example, mounted by fully 4.5% this year but only a 3% rise may emerge next year.

Even more in point, the wholesale price index, which usually leads in reflecting change, is kept almost constant in most of the models submitted. The current quarterly average is about 109.5, and the mid-1969 average is only 110.1; the change over the year is little more than 1%, much less than in the consumer price index.

The implicit price index is perhaps the best measure of prices in general, emerging as it does from a comparison of national output in terms of current and constant dollars. It therefore reflects changes in prices paid not only by consumers but also by industry and government. That measure rose by about 3.8% in 1968. The Forum expects the rise to slow to about 3%-3.5% in 1969.

The unemployment rate anticipated by the Forum does not support the widely heralded conclusion that a slowing up in the rate of growth in 1969 will be accompanied by an alarming bulge in unemployment. The unemployment rate for the fourth quarter of '68 is put at about 3.7%. For the middle of 1969 the unemployment figures fall within the 3.5%-4.5% range. Seven of the eleven estimates submitted had mid-'69 unemployment at or below 4.1% (also the average for the group). By yearend the rate was lower than at midyear, the average being 4%.

I have already indicated the Forum's belief that defense expenditures would show little change in 1969. For the second quarter of 1969 the average still centers at $80 billion, the current rate. Indeed, nearly over half of those responding had defense expenditures higher in the second half of 1969. The highest estimate is nearly $85 billion, and eight participants anticipated the bill for defense by yearend '69 would still be at least $80 billion.

That then is the Forum's pattern for 1969—further economic expansion around a 6% to 6.5% rate, with the majority believing that growth will be less pronounced in the first half than in the second.

Sector Account Projections

Turning to the outlook for the major sectors of GNP, our consumption specialists had personal consumption outlays ascending throughout the year, in accord with GNP, to reach about $590 billion in the fourth quarter of '69. This is comprised of little improvement in durables expenditures from the recent third quarter outlays. Paul McCracken labeled those as artificially high and I have accepted his estimate of $86 billion for 1969. Ira Ellis had expenditures for nondurables rising by 6.6% to $252 billion by yearend. Finally, George Hitchings expected at least another 8% burst in service spending and that brings us within hailing distance of the $590 billion total for individual purchases of goods and services.

It's far more difficult to fill in the blanks for gross private domestic investment because of differing views, but the total that I would suggest as a first approximation is $135 billion. This incorporates an extremely good housing year, marking the onset of the housing boom we've all awaited but which never came thus far in the 1960's. I pushed Walter Hoadley hard and I think I have his agreement for posting an annual rate of $33 billion for the housing component of GNP.

The estimate for plant and equipment is necessarily a compromise. It's an average of the lower figures Lou Paradiso offered us and the higher figures from our survey of capital appropriations and the McGraw-Hill and other recent surveys. Somewhat reluctantly, I've entered $95 billion for plant and equipment outlays, or only a 6% increase over the capital spending currently.

On inventories, there's little reservation about Lou Paradiso's projections. I've entered $6 billion to $7 billion of inventory accumulation for fourth quarter '69; that, when added to housing and plant and equipment, gives us an aggregate of $135 billion for private investment.

On net foreign exports, Roy Reierson anticipated little, if any, improvement in our trade balance in 1969. Lacking any foreshadowing series for this sector, I entered the $3.5 billion surplus which we still managed to show in the third quarter of 1968.

Finally, the trend of the governmental sector is not as readily grasped for 1969 as in past years. Jim Knowles and Louis Paradiso, for example, believed defense expenditures would be higher at yearend '69 than now. Only two members of this Forum thought they would be lower. I accept Louis' figure with some reservation. I hope a ceasefire or truce may be reached in 1969, and if it is I believe that it will lead to a significant cut in defense expenditures before the year is out. That, however, is a personal reservation. I've incorporated the total of $108 billion, suggested by Jim and Lou, for Federal purchases of goods and services. To this is then added $110 billion of state and local. That yields $218 billion, a bit higher, for example, than George Hitchings' public component of about $215 billon.

Adding up the sectors produces gross national expenditures by yearend 1969 of $945 billion. What this suggests is that demand pressures may be greater than is implied in our earlier consensus in which the GNP was placed at only $938 billion.

Projected Sector Accounts, 4th Quarter, 1969
(Billions of Dollars*)

Personal consumption expenditures	588.0	
Services		250.0
Nondurables		252.0
Durables		86.0
Gross private domestic investment	134.5	
Housing		33.0
Plant and equipment		95.0
Inventories		6.5
Net foreign exports, goods and services	3.5	
Government	218.0	
Federal		108.0
Defense		84.0
State and local		110.0
Total gross national product	944.0	

* Seasonally adjusted annual rate

Certainly, the two approaches support the conclusion of an economy still operating in high gear when next we meet.

Another check on our 1969 projections can be attempted by cross-multiplying our employment and productivity assumptions. We have, for example, assumed that the rate of unemployment in 1969 will average 4%. We know, too, that the labor force will increase by 1.5 million or so in 1969. Let's assume, too, no change in the length of the work week, although there may be a tendency for the overtime to diminish as the year runs its course. That enables us to derive national man-hour input. Next assume around a 3% increase in output per man-hour. That's about the figure that some of you have suggested during our discussion. Finally, let's crank in a 3.5% price factor, in keeping with our expectations. This I did prior to our meeting and came up with a total of about $950 billion, again well above the Forum's consensus of $938 billion.

It may be that once more we collectively haven't given sufficient consideration to either the impact of price throughout the year upon the monetary aggregate of demand or the volume of production or both. The two optimists who submitted estimates of $945-$948 billion may yet be proved right.

MR. ELLIS: I think, also, Martin, we ought to give effect to the unfilled job opportunities. The first people released from employment by any slowdown could move into some of these unfilled job opportunities. It would be a changing job situation but it would still be production in the gross national product.

CHAIRMAN GAINSBRUGH: But there might conceivably be a lag between their departure from their present jobs and the time they move into their new jobs.

That, then, completes the comments on our formal model and the underlying quantities. Let's close, as in the past, with some qualitative observations the Forum has voiced about the year as a whole. It's always helpful to have some qualitative capsule phrases descriptive of the year. What you have said leads me to label 1969 as a bridge year, and as a year of a trying yet effective and constructive transition.

...Transition from an economy stimulated by war to one successfully deriving its growth increasingly from private stimuli.

...Transition from the present inadequate international monetary mechanism to a more efficient system of adjusting world trade and capital balances.

...Transition from the hyperstimulation of inflation to a slower but more sustainable rate of expansion with less rapid price increases.

...Transition from the soaring '60s into the socially sensitive '70s, with greater reliance upon industry to help resolve hard-core unemployment, the urban crisis, and the further alleviation of poverty.

Of all those unresolved problems, the Forum again singles out price inflation for special attention. We promise some relief on this score in '69, but price increases will still be eroding the long-term health of the U.S.A. And we are even more concerned about our balance of payments problems than when we met a year ago. Many of us thought that we had begun to build a firmer base for international exchange relations in 1968, only to discover last weekend that we were again on the very lip of an international monetary crisis.

As for the surtax, despite the early pledge of the incoming Administration, the Forum believes the fate of the surtax will be largely a function of the phase of the economic cycle as of midyear. If we're still in expansion then, it's likely that the surtax will be continued. Conversely, if there is a softening in the economy, the surtax may very well be allowed to terminate as a countercyclical measure.

But I close by re-emphasizing the major longer-term problem, the need to find constructive approaches to the social problems that were mentioned earlier. Business is being looked to far more receptively by government and the public alike for solutions to our problems of housing and of environmental control. If we can find an effective mechanism for stimulating the private sector—for properly rewarding the private sector through the process of sharing the social costs entailed in resolving such problems—this may indeed provide us with very effective and recurring additions to aggregate demand throughout the 1970's.

Again, may I proceed to extend to this hardy band of economic philosophers, not only those still present but also those who departed earlier, the heartfelt thanks of all of us at THE CONFERENCE BOARD for yet another major contribution to the hazardous art of business forecasting. I know that the Trustees and all of the Associates of THE CONFERENCE BOARD and the many readers of our *Outlook* over the years join in extending our deepest appreciation to the Forum, singly and collectively.

It is now 4:10 a.m. in London. Once again we have demonstrated that whatever time is alloted to economists, all of it—and more—will be used productively. This meeting is adjourned.

[The foregoing summary was excerpted from Business Outlooks 1969, Studies in Business Economics, No. 104, *A Research Report From the Conference Board,* a discussion by the Conference Board Economic Forum and guests, held at the Waldorf-Astoria, New York City, Nov. 26, 1968.]

APPENDIX

[From the New York (N.Y.) Times, Feb. 25, 1969]

Capital Spending Rise Predicted; Car Sales Up in Mid-February—Rinfret Sees 13.8 Percent Gain

(By Herbert Koshetz)

An unexpected surge in capital spending by private industry will push expenditures for plant and equipment to $73.3-billion this year, 13.8 per cent above the spending level in 1968, Pierre Rinfret, the economist, predicted yesterday.

The "surprising" development, he said, means that estimates of economic activity in 1969 are "pitifully low." It also indicates, he said, that interest rates are going much higher, that bond prices will fall further, and that the Admininstration must intensify its fight against inflation by increasing personal and corporate income taxes.

At a news conference announcing the preliminary results of a resurvey of capital expenditures, Dr. Rinfret, president of Rinfret-Boston Associates, Inc., economic and financial counselors, pointed out that in the fall of 1968 private industry indicated it would spend only 7 per cent more than the actual expenditure of $64.5-billion in 1968.

The survey, based on returns from corporations that account for more than 50 per cent of all capital spending, shows that in nonmanufacturing areas—including mining, railroads, other transportation, publications, communications and merchandising enterprises—expenditures this year will rise by 15.1 per cent. In the manufacturing, covering all durable and nondurable goods, spending will rise by 11.4 per cent.

It would be logical to expect, Dr. Rinfret said, that the discount rate will go considerably higher than the present 5½ per cent, and that the prime rate (the rate banks charge their best coustomers) will rise to much more than 7 per cent.

The yield on Triple A corporate bonds, he said, could reach 8 to 8½ per cent before the end of the year.

The high interest rates do not scare big corporations, according to Dr. Rinfret. Under the corporate tax set up more than half of interest expense is borne by the Government so that, in effect, corporations are getting their money for a net rate of about 3½ per cent.

The higher estimates of capital expenditure, Dr. Rinfret said, means that predictions of gross national product (the sum of all goods and services) which now are about $920-billion for 1969, are $15-billion too low.

The resurvey shows that durable-goods industries, which spent $13.6-billion in 1968, have raised their sights to $15.6-billion for 1969, an increase of 14.5 per cent.

In this category of production, while iron and steel companies have lowered their estimates by 0.7 per cent to $2.3-billion, nonferrous producers will spend $1-billion, or 8.9 per cent more electrical machinery, $1.4-billion, a gain of 7.9 per cent and automobile manufacturers, $1.7-billion, up 11.3 per cent.

The nondurable-goods category will, as a group spend a total of $14.3-billion, or 8.3 per cent more.

In the manufacturing field, while mining expenditures at $1.1-billion indicate a reduction of 25.5 per cent, spending by railroads at $1.7-billion will increase by 12.6 per cent, transportation other than rail spending at $5.4-billion will be up 21 per cent, public utilities, spending $13.2-billion will rise 16.2 per cent, and lumping of communications and commercal organizations (wholesalers and retailers), will rise by 16.4 per cent.

[From the Washington (D.C.) Post, Feb. 25, 1969]

Machine Tool Orders Leap 31 Percent in January

Their order books tell the Nation's machine tool manufacturers the economy is still running strong despite Government efforts to slow the growth rate.

New orders for January were 31 per cent above January 1968 at $127.8 million, the National Machine Tool Builders' Association reported.

"None of the studies available to us indicates any slowdown, or even a plateau," a spokesman for the industry association said.

"Those January order figures are fantastic."

While January volume was down substantially from $149.7 million in bookings in December, both months were extremely strong.

Manufacturers of metal-cutting tools reported $92.2 million in new orders in January; makers of presses and other metal-forming tools, $35.6 million. Compared with year-earlier activities the figures were up 22 per cent and 63 per cent respectively.

At month's end, the backlog of orders for metal-cutting tools had risen from $809.6 million to $814.9 million, the first increase in six months. Orders awaiting execution at plants of metal-forming tool manufacturers rose from $254.5 million to $264.3 million.

The following excerpt from "The Economy: Where Are We?" by Tilford Gaines, vice president and economist, Manufacturers Hanover Trust, New York, appeared in their Economic Report, November 1968:

THE OUTLOOK

One of the less productive exercises economists indulge in is the forecasting in precise detail of changes in the Gross National Product and its components, but there really is no acceptable way to avoid using some numbers. Consequently, the arithmetic details of the following forecast are intended more as a quantifying of the premises of the argument rather than as precise predictions.

The slowing of the economic growth rate, which was the objective of both the June tax bill and persistently tight monetary policy this year, has begun and may be expected to continue through most of next year. In terms of changes in the GNP, the increase in the fourth quarter this year may be expected to be in the neighborhood of $12 to $13 billion, sharply lower than the $18 billion growth in the third quarter; during the first half of 1969 the quarterly increases in GNP may average about $10 billion. The very slow growth rate in the first half of next year will reflect the impact on consumer incomes of the retroactive portion of the tax surcharge and the increase in the Social Security tax rate scheduled for January 1. The forecast assumes that additions to business inventories will ship to about $7 billion in the current quarter, down nearly $1 billion from the third quarter, and will average $4 to $5 billion annual rate in the first half of next year.

Translated to real growth rates, after removing the inflationary effect on GNP, the economy will be growing at a 2.5 per cent rate in the closing months of this year and at something like a 1.5 per cent annual rate in the first half of next year. Real economic growth was a 6 per cent annual rate in the first half of 1968 and 4.5 per cent in the third quarter. The predicted real growth rates imply that inflation in the GNP accounts is still running at something like 3.6 per cent in the current quarter but that it will have receded to a 3 per cent range by the second quarter of 1969. This measure of inflation was 4 per cent in the first half of 1968.

If this pattern of growth through the middle of next year proves to be correct, there will be some unfortunate corollaries; inflation can not be brought under control without some cost.

1. Corporate profit margins will be squeezed and total profits, both before and after taxes, will recede from their current high levels.

* * * * * * *

2. Another unfortunate corollary will be a higher rate of unemployment.

* * * * * * *

THE LAST HALF OF 1969

Attempting to develop a usable forecast for more than six or nine months ahead is always difficult, but attempting to forecast the last half of 1969 has more than the usual number of uncertainties. A new President and a new Administration will take office in January, so that predicting economic developments in the last half of next year also involves a forecast of the economic policies Mr. Nixon and his Administration will pursue.

A critical economic decision that the new Administration and the Congress will have to reach before mid-year is whether or not the 10 per cent tax surcharge should be extended beyond its scheduled expiration on June 30, 1969. Mr. Nixon has indicated he hopes it will be possible to permit the surcharge to expire, but economic circumstances next spring will suggest its extension. There are a number of possible variations, including retaining the full surcharge on corporations but reducing the personal surcharge by some amount. For purposes of this analysis, therefore, it has been assumed that Mr. Nixon will request and that Congress will approve an extension of the full 10 per cent surcharge on both individual and corporate income.

It also has been assumed that the new Administration will make every effort to limit or reduce non-essential government spending. Certain unavoidable expenditure increases will occur in fiscal 1970 under existing programs that would be difficult to alter or amend during the first year of the new Administration. However, if the tax surcharge is extended and if a serious effort is made to restrain spending, the outlook would be for a moderate budgetary surplus in fiscal 1970, following the anticipated budget deficit of about $3 billion in the current fiscal year.

On these assumptions, the lull in economic activity expected for the first half of 1969 could extend well into the second half. Quarterly increases in GNP would be larger than in the first half year, perhaps averaging $13 to $15 billion, if for no other reason than the fact that the restraining effects of the Social Security tax increase and the retroactive feature of the tax surcharge would have had their full impact during the first half of the year. The largest part of the more rapid growth rate would be in consumer expenditures, although some improvement in business spending might be expected to supplement the stronger pattern of consumer spending. During this half of the year, residential construction should develop its greatest strength, accounting for part of the stronger advance.

Translated to real growth, this forecast suggests a growth rate for the last half of 1969 of about 4 per cent, with real growth in the final quarter of the year somewhat greater than a 4 per cent annual rate. This configuration assumes that continuing restraint from both fiscal and monetary policy will succeed in reducing the rate of price inflation in the GNP accounts to 2.5 per cent, with the inflation rate approaching 2 per cent by the fourth quarter.

While this forecast hopefully concludes that inflation could be brought within reasonable bounds by the latter part of next year and that, therefore, a more normal economic growth rate may be resumed, even this promising prospect would not restore full employment. The unemployment rate reached by the middle of next year, perhaps something under 4.5 per cent, will probably be maintained throughout the year. However, the solid rate of growth foreseen for late 1969, with inflation a much less pressing problem would indicate that unemployment might be steadily reduced during 1970. Improvement in corporate profits also may lag behind the broad pick-up in business activity, but here, too, the outlook for 1970 should be excellent.

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The following is from "Business and Government Review," University of Missouri, November-December 1968:

The U.S. Economy in 1969

ROBERT W. PATERSON
Director of the Research Center
And Professor of Economics

Economic prediction is an art practiced only with varying degrees of success. This is my eighth annual forecast appearing in the *Business and Government Review* and, in retrospect, the results have been better than expected.

Nevertheless, the feeling of anxiety that comes after one makes judgments about the movement of the economy is heightened when the unexpected happens. For it is the unanticipated or ill-timed event or sequence of events that modifies quantitative measures. Data trends may easily be detected by school children as well as computer programmers (the latter on a somewhat more sophisticated basis). But there is more to forecasting than knowledge of data manipulation.

Tomorrow is a *new* day and 365 new days astronomically multiply the difficulties confronting the short-term forecaster. Trends form a base for determining where the economy is, but what we want to know is where it's going. Thus, the behavior of people (groups and individuals) reflected in new legislation, programs, plans and assessment of market conditions, forms an unknown quantity which is the overlay used in judging the future.

CHOOSING A PRESIDENT

In January the U.S. will have a new President. Quite probably there will be a host of new faces running federal agencies and departments. But, even more important, there will be new concepts of goals and criteria for determining objectives—as well as a new ledger for choosing national priorities. No one would be justified in claiming that all this will suddenly produce a sense of unity among Americans. It will not. But it is just possible that, during the transition of political management throughout the federal government, a growing awareness of the nature of our conflicts will be perceived by U.S. citizens.

The state of economic stability in 1969 hinges largely on the good sense of the individual citizen. If he acts stupidly, fearfully or aggressively in his commitments to himself (others), it may be a year he will later choose to forget. Yet, if he acts to breach the nonsense strewn along the pathways society is taking through the present social revolution, 1969 will be another year in which many economic records are broken.

Possible programs for 1969

As of October 14, when this article went to press, it appeared that Richard Nixon would be selected on November 5 as the next President. This may have considerable bearing on the short—and intermediate—term outlook for the economy. It has been said that Nixon favors maximum use of the private sector in producing jobs and relieving pockets of poverty. Thus, presumably he would rely heavily upon the kinds of government programs allied closely with firms located in areas where these problems are most severe. The kinds of things done would be geared to the growth of aggregate demand. Thus, over time, grants, payments and aid would be channeled to

REVIEW OF 1968 FORECASTS

Forecaster	Gross Nat'l. Product (Bil.)	Industrial Production (57-59=100)
Actual Value (Preliminary)	$854	164
1968 Business Forecasts Consensus	840-845	163-166
Survey of Nat'l. Assoc. of Business Economists	835	163
Nat'l. Assoc. of Home Builders News	833	—
Gerhard Colm Economic Outlook for 1968, NPA	844.5	—
Prudential Insurance Co. Economic Forecast	848	—
Survey of Nat'l. Industrial Conference Board	845*	163*
Nat'l, Securities and Research Corp., Forecast	839	163
Faculty Forecast UCLA	843	170
United Business Services Forecast	845	166
Standard and Poor's Annual Forecast	840	166
Robert Paterson Business and Government Review	850	160
J. A. Livingston Questionnaire of 59 Economists	848*	164*
U.S. News and World Report	850*	166
Wharton School Econometric Forecast	843	—
Walter W. Heller Economic Outlook	848	—
Council of Economic Advisers	846	—

Source: 1968 Business Forecasts, Federal Reserve Bank of Richmond, February 1968.
*Estimated from an original forecast for the 4th quarter.

the individuals or groups for whom specific personal goals are to be achieved. For example, in education subsidies would be granted to students, not mainly to institutions which are suppliers of educational services.

The Humphrey position, if one views his statements as extensions of Democratic Party policy since the 1930's, would be to rely upon the supply side of the marketplace to equate social and individual needs. This means that individuals would be benefited through grants or payments to existing institutions and would have little leeway for exercising preferences. Thus, any difference between the Nixon-Humphrey positions, while not entirely clear-cut, is that Nixon appears more sensitive to consumer interests while Humphrey is more agreeable to producer support programs,[1] such as direct payments to farmers.

[1] For an extended discussion of demand v. supply as means for distributing education benefits, see Orace Johnson, "Tax Credits and Scholarships for Education," Business and Government Review, September-October 1968.

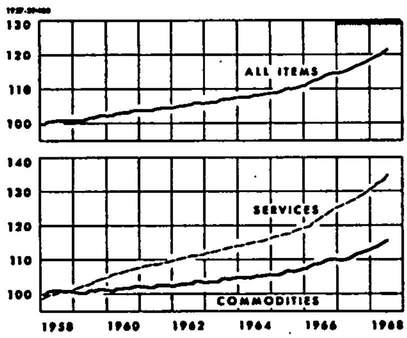
Market evaluation of candidates

These comments require a word of caution. We are trying to assess how *the market* evaluates two candidates. The fact that, no matter who is elected, there will be a mixture of approaches needed and used for existing problems, is pretty well recognized in the marketplace. But the market searches for differences or preferences between the candidates and, when found, these variations become the hallmarks of the candidates themselves.

The present mood of producers, distributors and financial managers is not favorable to policies that represent a continuation of those generated 35 years ago under a different core of influences. This mood seems to be carried over to the electorate generally.

Assuming a Nixon victory at the polls, what can be said about the prospects for the economy in 1969? On the technical side no major and few minor changes can be expected in the 1969 Federal Budget. It is passed and in effect until next June 30. Much of what goes into the 1970 Budget will have been specified, reviewed and tallied by next January. It will require feverish activity on the part of a new administration to reorganize and reorient the pattern of operations of government agencies before July 1969, when the 1970 Budget becomes effective. Certainly, it will begin to reflect the Nixon preferences and priorities, and it is this feature which makes it important.

Figure 1
CONSUMER PRICES
B.L.S. Monthly Indexes

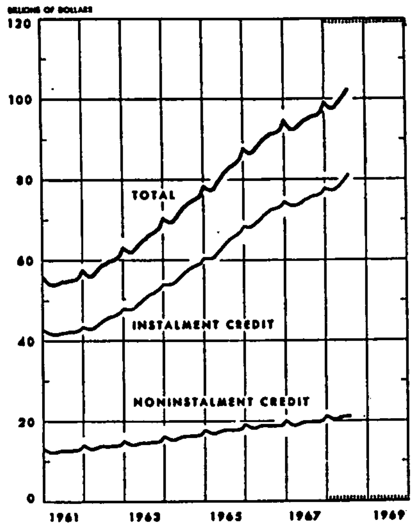


Source of figure: Federal Reserve Monthly Chart Book, September 1968, p. 72.

If Nixon—what about 1969?

As has been mentioned, we may expect no major changes in the current Budget. And, given the surtax and reduction in expenditures now in effect, it is probable that the federal deficit will decline from $25 billion in 1968 to about $8 billion in calendar 1969. This possibility suggests a reduction in the need for additional federal financing in 1969. This lessened demand for funds should ease the burden on financial markets and, assuming no greatly increased borrowing at state and local levels, cause a decline in interest rates.

Figure 2
CONSUMER CREDIT
Total Outstanding By Types



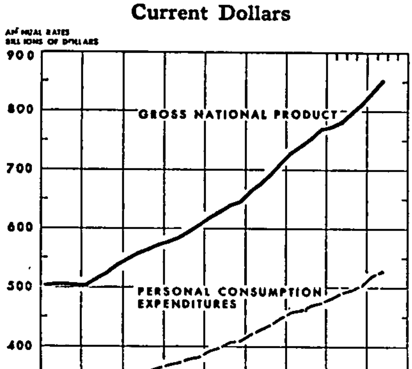
Source of figure: Federal Reserve Monthly Chart Book, September 1968, p. 48.

The Republican candidate has declared his opposition to the rapid inflation of recent years (2.9 per cent in 1967, 3.4 per cent in 1968). It is reasonable to expect that, if elected, Mr. Nixon would attempt to hold down expenditures and taxes (possibly let the surtax expire on June 30, 1969). This expectation on the part of consumers and suppliers would, if translated into market action, serve to cool the economy in the first 6 months of 1969 and cause the rate of inflation to slide below an annual 3.4 per cent rate. The expectation is for about a 3 per cent annual rate in 1969.

At the moment, data on consumer spending shows no indication that the surtax has lessened economic buoyancy. Consumers spent income and engaged in additional borrowing in July and August at levels suggesting they were unaware of any decline in their take home pay. Perhaps this kind of action may be attributed more to psychological-social events which occurred during the summer than to rational economic behavior.

It seems unlikely that the consumption levels of July and August continued into the last quarter of 1968. If this judgment is correct, demand will fall off, inventories will build up, and we will have a higher level of unemployment in 1969. From the standpoint of economic traditionalists, such a situation would be preferable to the conditions of the last 18 months to 2 years when the economy was overheating. This is not indicative of any serious dislocations in the system. It does mean that the current dollar rate of growth in GNP will decline from 8 per cent in 1968 to 6 per cent in 1969.

Figure 3
GNP and EXPENDITURES
Dept. of Commerce Data—
Current Dollars

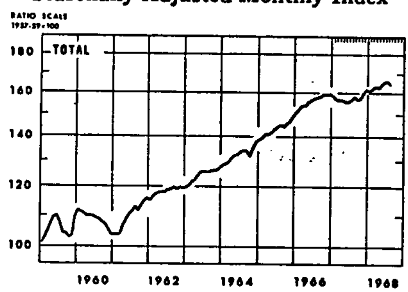


Source of figure: Federal Reserve Monthly Chart Book, September 1968, p. 51.

THE LONG UPSWING

January 1969 marks the 95th month of the current period of prosperity. Since March 1961, the economy has moved to higher peaks each year for the longest "peace-time" advance in U.S. history. It represents 8 years of unprecedented growth. During this time, pessimists have continually been looking over their shoulders to see whether a depression is about to overtake them. The optimists among us point with glee to each new month added to the advance saying, "See, we have learned how to manage the economy and have done away with major recessions."

Figure 4
INDUSTRIAL PRODUCTION
Seasonally Adjusted Monthly Index



Source of figure: Federal Reserve Monthly Chart Book, September 1968, p. 58.

That both may be wrong seems to escape attention. Some manipulative skills have been acquired by governmental economic operatives. They have been able to push against the surface of the economy at one place while reducing frictions at another. But, it is not likely that such manipulation is in fact more than the tidying up of frayed edges—certainly it is not the achievement of a unified, coordinated coalition of public and private policy objectives. Thus, in periods of tension the system is subject to failure. An example is the collapse of "guidelines" on wage-price questions.

Historic parallels?

Nor can it be said that historical cyclical periods need necessarily to recur. Unquestionably, no one presumes to discount depressions for all time. This, however, is no reason to predict, without substantive evidence, that a depression will occur next year or the year after. What we have today is a situation with sufficient checks and balances to prevent massive blunders from occurring, provided reasonably prudent economic policy decisions are made in at least one of three areas:

- **the Administration—particularly Treasury Department, Council of Economic Advisers, and Bureau of the Budget**
- **the Congress, mainly in the Appropriations Committee of the House**
- **the Federal Reserve Board of Governors.**

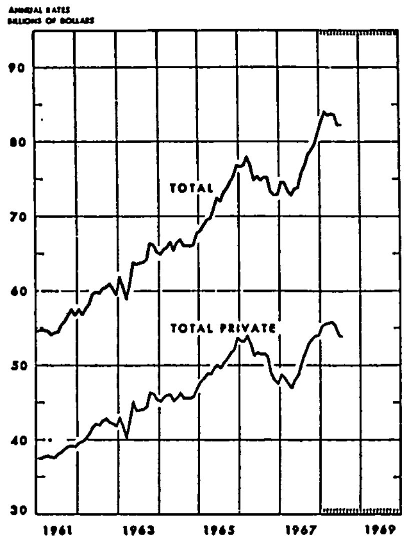
The amplitude of swings in economic fluctuations has been considerably shortened, if post-World War II conditions may be cited as evidence. The Board of Governors of the Federal Reserve System is in no small measure responsible for this signal achievement.

THE OUTLOOK IN 1969

The forecasts for 1969 (see two-page table) hinge on some *important assumptions*. These are:

- **The conflict in Vietnam will continue well into 1969.** It is estimated that war related expenditures in Vietnam are currently running at about $30 billion per annum. The assumption is that this figure will decline to a level of about $25 billion in 1969. Furthermore, it is assumed that a massive effort will be made to transfer a sizable share of the burden of the war to the South Vietnamese government.
- **The level of Great Society programs will remain at last-half 1968 levels throughout 1969.** Thus, in 1969 there will be a decline, the first such setback in the 1960's, in the support of the federal government for social projects.
- **Automobile manufacturers' unit sales will be about the same or slightly lower than in 1968.**

Figure 5
VALUE OF NEW CONSTRUCTION
Bureau of Census Data



Source of figure: Federal Reserve Monthly Chart Book, September 1968, p. 46.

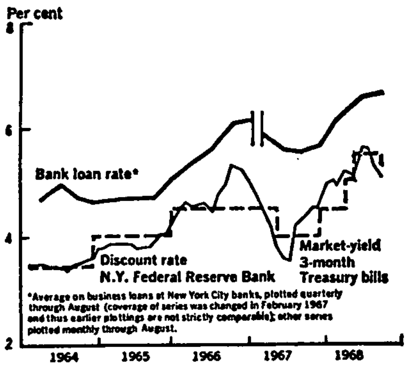
- **The probable expiration of the surtax on** June 30, 1969 will not have much effect in terms of expanding the level of demand during the year.
- **An upsurge in residential construction will** provide a source for investment expansion that would otherwise be weak.
- **A victory by Richard Nixon in the presidential election.**

If the assumptions prove accurate, the economy in 1969 will continue its upward course of the past few years but the rate of increase will be slowed.

Changes from 1968

The reduction in growth should ease the demand for loanable funds, and interest rates should be lower in 1969 than

Figure 6
SHORT TERM INT. RATES



Source: The Morgan Guaranty Survey, New York, September 1968, p. 11.

they were in 1968. The rate of increase in consumer prices should be slowed and unemployment will very likely rise from 2.8 million in 1968 to 3.5 million in 1969. The impact of the surtax may soften the demand for consumer goods in the early part of 1969, but even this will not cause a significant change in the general vitality of the economy. Gross national product will rise from the indicated 1968 level of $854 billion to $912 billion in 1969. Thus, the near term outlook under a Nixon presidency appears little different than under the present administration. There will, in the next 12 months, be a strong upward force in the economy, but the rate of buoyancy will not be as marked.

The longer term outlook for the next 18 to 24 months may be something else.

The material which follows is reprinted from Newsweek, January 13, 1969:

THE NEW YEAR FORECAST

It was a year to leave economists gasping—the most turbulent year in a long generation. The booming U.S. economy, a juggernaut seemingly out of control, took a 10 per cent tax boost in its stride and roared to new heights of inflation. The international monetary system rocked under the worst set of crises since the Great Depression. As 1968 ended, nearly all the forecasts of a year ago seemed best forgotten. But it was forecasting time again last week, and so the experts went gingerly back to their Ouija boards—this time with fingers crossed tighter than ever.

The uncertainties of 1969 seemed oddly unchanged from those of a year ago. Because of the domestic inflation, no one could be sure what the new Administration's tax policy would be—and once again, moneymen were worried that the Federal Reserve Board would clamp down on the supply of credit. Because of inflation, the nation's balance of payments was under strain, and the dollar, the underpinning of the world's monetary system, was still shaky.

Minds Open: But precisely because there had been no decisive remedy in 1968, the problems looked bigger this year, and the price of mistakes seemed higher. The price of a boom, historians warned dourly, is always a bust—and the bigger and longer the boom, the harder the ensuing thud. Could inflation be stopped now without touching off an outright recession? The incoming Nixon Administration seemed determined to try, and economists of all persuasions were cheering them on. "People are being genuinely open-minded about it," said a former Democratic Administration official. "Nobody's sitting back and waiting for a chance to crow about how they've mismanaged it."

Certainly, the outgoing managers of the economy had little reason to crow. Faced with the same problem to an earlier stage a year ago, the Administration battled Congress for a 10 per cent tax boost to cool the economy and take the fire out of inflation. Even then, some experts worried that the result would be "economic overkill." But when the battle was over and the tax boost passed, the result was a thundering anticlimax: almost nothing happened. The gross national product, which had been rising at an annual rate of $21 billion in each of the first two quarters of the year, slowed only to an estimated $18 billion gain in the fourth quarter. Consumer prices continued to soar; during the year, the index rose by an estimated 4.6 per cent. And the rising prices were creating inflationary psychology across the country.

All this was enough to give pause to the most fearless forecaster looking ahead to 1969. To make matters worse, some experts were beginning to suspect that the basic rules of the game were changing. "We're getting into a new kind of uncertainty," said Walter W. Heller, former chairman of the Council of Economic Advisers. "We don't yet know whether moving into the narrow band around full employment, and removing the gnawing fear of recession, will change people's basic behavior responses." Formerly, businessmen could be counted on to respond to a downtown by laying off workers and canceling capital spending plans. But in the new atmosphere, some economists suggested, business might try to hoard skilled workers and keep right on building in an effort to increase efficiency and cut costs. If this happened, it would throw all the assumptions out of kilter.

Despite these problems, the nation's economists in recent weeks have produced their usual "standard forecast"—a broad consensus predicting a year of solid growth for the economy. Gross national product, this consensus holds, will rise to about $920 billion in 1969, up 7 per cent from 1968, with unemployment rising slightly and the rate of inflation slowing down a bit. But such numbers clearly depend on a broad range of assumptions about the forces at work and the actions the new Administration may take. To explore these assumptions, NEWSWEEK correspondents interviewed twelve leading economists * of all schools of thought last week—and found an unusually wide diversity of opinion (table):

*Walter Heller, of the University of Minnesota; Gottfried Haberler, Harvard; Louis Paradiso, U.S. Commerce Department; Paul Samuelson, Massachusetts Institute of Technology; William Butler, Chase Manhattan Bank; Eliot Janeway, consulting economist; Beryl Sprinkel, Harris Trust and Savings Bank; Charles Schultze, Brookings Institution; Leif Olsen, First National City Bank; Otto Eckstein, Harvard; Pierre Rinfret, consulting economist; Tilford Gaines, Manufacturers Hanover Trust.

The shape of 1969

[What's ahead for the economy? Twelve leading economists polled by Newsweek, reflected the year s uncertainties by disagreeing sharply in their reading of the major factors that will shape the year, and some declined to answer particularly iffy questions. The box score:]

How hard will the Fed squeeze the money market?
Only a little: 3.
Fairly hard: 7.
A real crunch: 1.
Will the income surtax be repealed?
Highly unlikely: 6.
If the war ends: 3.
Yes, in part: 1.
Will there be another international money crisis?
Probably: 3.
Quite likely: 6.
No: 1.
Will there be an economic slowdown?
Possible recession: 2.
Slower growth rate: 8.
No, a boom: 2.

Split View: In one crucial area there was remarkably little disagreement. Despite the conventional doctrine that an ongoing inflation can be checked only by a dose of recession, nearly all the economists sampled approved the new Administration's intention to try milder medicine. "The big hope is to get a more moderate rate of increase," said the Commerce Department's Louis Paradiso. "If we can achieve that, it will be more realistic even though it may take us longer to get where we want." New York consultant Pierre Rinfret agreed: "You don't create a depression to stop inflation. The cure is worse than the disease."

Nonetheless, there is a growing split in the economic fraternity over the basic issue of what sort of curbs are truly effective. The Keynesian New Economists, who have been in the saddle since 1960, bank heavily on fiscal policy—changes in tax and spending patterns—to stimulate or slow down the economy. But the apparent impotence of last year's tax increase has weakened their position and boosted the stock of the newer monetarist school, led by the University of Chicago's Milton Friedman. Friedman (who was vacationing last week) was among the few economists whose 1968 forecast hit the target: he predicted that the surtax would prove ineffective, since changes in money supply are far more important than fiscal policy in determining what happens. The Federal Reserve Board provided a test case by rapidly increasing the money supply after the tax bill went into effect, and the result swung many to Friedman's position.

Pinch Watchers: Most of the economists who expect a slowdown next year explain their forecast on the Keynesian ground that the tax bill is finally beginning to bite, and that paychecks will be nipped again by social-security withholding starting this month. This group expects a lower rate of growth for the first half of the year, followed by a spurt in the second half. The monetarists arrive at about the same figures for the year, but in reverse: Fed policy has taken a turn toward tighter money recently, and this should start to curb the economy after a lag of four to six months. "My guess is," says Beryl Sprinkel of Chicago's Harris Trust, "that the Fed is going to gradually tighten up, and this will slow the rate of rise in the second half."

Will the money markets be put through another crunch on the order of the 1966 squeeze, when conditions verged on panic? Answering this, all hands agreed, is a matter of reading the Fed's tea leaves—but the great majority doubted that the pinch would be that severe. "I don't rule out a squeeze but I can't see a crunch that would bring things to a grinding halt. It won't be teeth-rattling," said Walter Heller.

What role will the new Administration play? Paul McCracken, the incoming CEA chairman, has acknowledged that he is paying increasing attention to the effects of monetary policy. But McCracken, most economists believe, is not likely to ignore the effects of tax and spending policies. Thus, most of the economists surveyed believe that the new Administration will make genuine efforts to hold the increase in Federal spending to $15 billion or less, achieving a budget near balance. By this same token, most doubt the income surtax will be allowed to expire on schedule June 30, despite the President-elect's campaign promises.

Danger Flag: There is still the risk of economic overkill, and a minority of the experts surveyed saw a real danger that the economy could tip into recession. Tilford Gaines of Manufacturers Hanover Trust noted that retail sales seem recently to have lost their zip, but manufacturers are still turning out goods at full speed. "Business behavior and consumer behavior are on a collision course," Gaines said. "I am simply raising the storm signal."

Beyond such purely domestic issues, the dollar's weakened international position poses the threat of renewed crisis that might force the U.S. to new economic curbs aimed at improving the balance of payments. Though most of the NEWSWEEK sampling expected that slower growth would cut into imports and improve the basic trade balance in 1969, none saw the trade position as particularly cheery—and nearly all warned that events beyond U.S. control might trigger another monetary crisis.

How could another world crisis erupt? Pierre Rinfret and consultant Eliot Janeway—whose dour if accurate predictions have won him the sobriquet of "Calamity Janeway"—both expect a renewed attack on the French franc, followed by a French devaluation big enough to put all the Western currencies in jeopardy. It's a question of when the franc snaps," Janeway said, "and I put that at March or April at the outside."

For most Americans, all these warnings and uncertainties seem as insubstantial as shadows flitting across the ceiling—and oddly enough, even if the dangers materialized they would have remarkably little short-range effect. Any recession this year would almost surely be short and mild; even a doubled rate of inflation would not be immediately crippling. And international storms would take months or years to have visible effects on the U.S. economy. It was a time when those expecting strong growth were the real pessimists, and the true bulls were the relative bears. But by anyone's standard, the outlook was for prosperity. And however it worked out, 1969 was not going to be boring.

STOCK MARKET: BACK TO 5 DAYS

After nearly seven months of four-day trading—designed to leave one day, usually a Wednesday, free for the back rooms of brokerage houses to clean up the paper work clogging the entire securities industry—the nation's stock exchanges last week embarked on a new timetable. With the turn of the year, they went back to their old five-day week—but with hours shortened to four (10 a.m. to 2 p.m. in New York) instead of the normal five and a half. The leftover hour and a half presumably will be devoted to the paper-work pile-up.

The action, spearheaded by the New York and American Stock Exchanges and reluctantly accepted by the over-the-counter market, was taken in the teeth of stern disapproval by the Securities and Exchange Commission.

The SEC's position is that one uninterrupted day permits more paper work to be dealt with than 90 minutes at the end of each trading day. But exchange chiefs say the free Wednesdays often developed into a back-office holiday.

Actually, the SEC could have laid down the law and simply ordered the exchanges to stick to the four-day timetable. Instead, it has evidently decided to give the industry its head for a period of at least several weeks, meanwhile stepping up its spot inspection of brokerage-house bookkeeping. But competition may do more to spur the New York exchanges than the SEC's surveillance. The ambitious Pacific Coast Stock Exchange decided to stay open two hours a day longer (7 a.m. to 1 p.m., local time) than its Eastern rivals. "For those two hours," says a PCSE official, "we will have an unparalleled opportunity to become a major national exchange."

The material below was issued as a press release from the American Statistical Association, Washington, D.C., and the National Bureau of Economic Research, New York, March 2, 1969:

Gross national product is expected to increase by about 7 per cent in 1969, according to 63 economists in business, government, and academic institutions who regularly prepare detailed forecasts of the course of the economy. A little less than half (3.3 per cent) of this rise will be due to price increase, the same rate of inflation as predicted by these forecasters in the December 1968 survey.

The economists anticipate that growth in constant dollar GNP will average about 3.6 per cent in 1969, slightly higher than they expected three months earlier.

These are some of the results of a nationwide quarterly survey conducted by the American Statistical Association among members of its Business and Economic Statistics Section. Analysis of the survey is done for the ASA as part of an ongoing study of economic forecasting being conducted by the National Bureau of Economic Research, an independent nonprofit research organization.

The survey, instituted last year, is designed to collect forecasts on a continuing basis. It is hoped that examination of the methods and performance of economic forecasters will contribute to improvements in such predictions. A more complete evaluation of the entire set of forecasts will eventually be issued by the National Bureau.

EXPECTED PATTERN OF CHANGE IN GNP

The results of the new survey anticipate that rates of growth will be considerably lower in the first three quarters of 1969 than in the last quarter. This development differs somewhat from that expected at the end of 1968, when the survey group, like most economists, predicted more of a slowdown in the first half of 1969 and an earlier (mid-year) upturn in the rate of growth. The change, which may be symptomatic of trends in forecasters' thinking, is probably due to the impact of new information: the group's fourth quarter 1968 predictions proved somewhat low in the light of actual events, and there may be increasing recognition of the extent of lags in effects of current economic policies.

The chance of a decline in GNP in constant dollars, that is, of a general business recession, is regarded as very small in the first half of 1969 and a little higher in the second half. In December 1968, the probabilities were just about as low on the average (not exceeding 15 per cent), but they were seen as higher in the first half than in the second of 1969.

FORECASTS OF OTHER ECONOMIC INDICATORS

Output of manufacturing, mining, and public utilities, as covered in the FRB production index, is expected to increase by 2.4 per cent, while the unemployment rate is expected to rise to nearly 4 per cent. Both predictions are unchanged from the previous survey. Also, corporate profits are anticipated to be steady or moderately lower, with a pick-up in the latter part of the year. Bcsiness outlays on plant and equipment are forecast to reach $68.2 billion in 1969 (up $3.6 billion from their 1968 level and slightly more than was predicted in December). Modest increases relative to 1968 are seen for private housing starts and consumer expenditures for durable goods, but these forecasts are somewhat lower now than three months ago. Businessmen are still expected to add less to their inventories in 1969 than they did in 1968; at less than $7 billion, inventory investment would not be a strong source of change in GNP. Defense spending is viewed is rising slowly from $79 to $81 billion between 1968 and 1969.

The participants in this survey are well differentiated in terms of industry affiliation and geographic location, although most are associated with manufacturing companies and most come from New York. The sample, therefore, may be broadly representative of the current views of all forecasters. Full evaluation of the results will consider the individual forecasts and their distribution as well as the average forecasts for the group as a whole.

TABLE 1.—PROJECTIONS OF GNP AND OTHER ECONOMIC INDICATORS, 1968-69

Indicator	Number of forecasters	1968 actual				1969 forecast (median)				Annual	
		1st quarter	2nd quarter	3rd Quarter	4th quarter	1st quarter	2nd quarter	3rd quarter	4th quarter	1968	1969
1. Gross national product (in billions of dollars)	63	831	853	871	888	901	913	926	943	860	920
2. GNP implicit price deflator (1958:100)	61	120	121	122	124	125	126	127	127	122	126
3. GNP in constant dollars (billions of 1958 dollars)		693	703	712	[1] 716	[1] 721	[1] 725	[1] 729	[1] 743	[1] 705	[1] 730
4. Industrial production (1957-59:100)	59	162	164	165	167	168	168	170	171	165	169
5. Unemployment rate (percent)	61	3.6	3.5	3.6	3.5	3.5	3.8	3.8	3.9	3.6	3.8
6. Corporate profits after taxes (in billions of dollars)	60	49.1	50.7	51.0	51.9	51.2	50.8	51.4	52.3	50.7	51.6
7. Plant and equipment expenditures, OBE-SEC (in billions of dollars)	60	64.9	62.8	63.5	67.3	68.2	68.2	68.2	68.2	64.6	68.2
8. Private nonfarm housing starts (annual rate, millions)	61	1.47	1.42	1.52	1.56	1.55	1.58	1.61	1.63	1.49	1.60
9. Change in business inventories, GNP accounts (in billions of dollars)	62	2.1	10.8	7.6	10.0	7.8	6.5	6.0	6.2	7.6	6.8
10. Consumer expenditures for durable goods (in billions of dollars)	62	79.0	81.0	85.1	84.8	84.7	84.9	86.0	87.1	82.5	85.9
11. National defense purchases, GNP accounts (in billions of dollars)	63	76.8	79.0	79.6	80.0	80.4	80.5	81.2	81.3	78.9	81.0

[1] Line 1 divided by line 2, times 100.

Source: American Statistical Association and National Bureau of Economic Research, Business Outlook Survey, February 1969.

TABLE 2.—ESTIMATED PROBABILITY OF DECLINE IN GNP IN CONSTANT DOLLARS

[In number of forecasters]

	4th quarter 1968 to 1st quarter 1969	1st quarter 1969 to 2d quarter 1969	2d quarter 1969 to 3d quarter 1969	3d quarter 1969 to 4th quarter 1969
Estimated probability (chances in 100):				
Less than 1	36	13	14	19
1 to 10	14	20	15	18
11 to 20	10	11	16	17
21 to 30	0	10	12	7
31 to 40	1	3	2	0
41 to 50	1	4	4	0
51 and over	1	2	0	2
Total number of forecasters	63	63	63	63
Median probability (chances in 100)	0	10	12	8
Mean probability (chances in 100)	7	18	16	12

Source: American Statistical Association and National Bureau of Economic Research, Business Outlook Survey February 1969.

TABLE 3.—MEAN PROBABILITY DISTRIBUTION OF CHANGES IN GNP AND PRICES, 1968-69

Percent change	Mean probabilities attached to possible percent changes, 1968 to 1969, in— GNP in current dollars	Implicit price deflator
+10.0 or more	0.6	0
+9.0 to +9.9	3.8	.1
+8.0 to +8.9	8.4	.2
+7.0 to +7.9	28.4	.4
+6.0 to +6.9	30.9	1.5
+5.0 to +5.9	14.7	5.1
+4.0 to +4.9	6.0	22.5
+3.0 to +3.9	3.4	46.4
+2.0 to +2.9	1.9	18.6
+1.0 to +1.9	1.1	4.1
0 to +0.9	.6	.8
−0.1 to −1.0	.2	.2
−1.1 to −2.0	.1	.1
−2.1 to −3.0	.1	.0
−3.1 or less	.1	.0
Total	100.1	100.0

Note: The total number of forecasters included is 60. Percentages may not total 100 due to rounding.

Source: American Statistical Association and National Bureau of Economic Research, Business Outlook Survey, February 1969.

TABLE 4.—FORECASTING METHODS USED

	Number of forecasters		Number of forecasters using each method who ranked it				
	Using	Not using	Most important	2d most important	3d most important	4th most important	5th most important
Informal GNP model	50	13	42	4	2	1	1
Lead indicators	44	19	5	20	14	4	1
Anticipations surveys	43	20	0	13	21	7	2
Econometric model (outside)	32	31	6	8	6	11	1
Econometric model (own)	14	49	3	5	1	3	2
Other methods	11	52	7	2	0	2	0

Source: American Statistical Association and National Bureau of Economic Research, Business Outlook Survey, February 1969.

TABLE 5.—FORECASTERS' AFFILIATION

Primary affiliation	Number of forecasters	Primary affiliation	Number of forecasters
Manufacturing	23	Academic	6
Commercial banking	9	Government	5
Other financial institutions	6	Labor union	0
Consulting or research	7	Other	6
Merchandising	0		
Trade association	1	Total	6

Source: American Statistical Association and National Bureau of Economic Research, Business Outlook Survey, February 1969.

TABLE 6.—PROJECTED PERCENTAGE CHANGES IN GNP AND OTHER ECONOMIC INDICATORS, 1968-69

Indicator	Number of forecasters	Actual		Forecast					
		2d to 3d quarter, 1968	3d to 4th quarter, 1968	4th quarter 1968 to 1st quarter 1969	1st to 2d quarter, 1969	2d to 3d quarter, 1969	3d to 4th quarter, 1969	4th quarter 1968 to 4th quarter 1969	1968 to 1969
1. Gross national product (dollars in billions)	63	+2.1	+2.0	+1.5	+1.3	+1.4	+1.8	+6.2	+7.0
2. GNP implicit price deflator (1958 equals 100)	61	+.8	+1.6	+.8	+.8	+.8	0	+2.4	+3.3
3. GNP in constant dollars (billions of 1958 dollars) [1]		+1.3	+.6	+.7	+.6	+.6	+1.9	+3.8	+3.6
4. Industrial production (1957-59 equals 100)	59	+.6	+1.2	+.6	0	+1.2	+.6	+2.4	+2.4
5. Unemployment rate (percent) [2]	61	+.1	−.1	0	−.3	0	+.1	+.4	+.2
6. Corporate profits after taxes (dollars in billions)	60	+.6	+1.8	−1.3	−.8	+1.2	+1.8	+.8	+1.8
7. Plant and equipment expenditures, OBE-SEC (dollars in billions)	60	+1.1	+6.0	+1.3	0	0	0	1.3	+5.6
8. Private nonfarm housing starts (annual rate, millions)	61	+7.0	+2.6	−.6	+5.5	+1.9	+1.2	+4.5	+7.4
9. Change in business inventories, GNP accounts (dollars in billions) [3]	62	−3.2	+2.4	−2.2	−1.3	−.5	+.2	−3.8	−.8
10. Consumer expenditures for durable goods (dollars in billions)	62	+5.1	−.4	−.1	+.2	+1.3	+1.3	+2.7	+4.1
11. National defense purchases, GNP accounts (dollars in billions)	63	+.8	+.5	+.5	+.1	+.9	+.1	+1.6	+2.7

[1] See table 1.
[2] Change in rate, in percentage points.
[3] Change in billions of dollars.

Source: Computed from table 1.

TABLE 7.—KEY ASSUMPTIONS UNDERLYING FORECASTS

Tax policy: Surtax:	
Extended	55
Reduced	6
Eliminated	2
No explicit assumption	0
Monetary policy:	
Unchanged	9
Tighter	7
Easier	4
First tight, then easier (2d half)	17
Tight, but no crunch	9
No explicit assumption	17
Level of hostilities in Vietnam:	
Increased	0
No change	17
Reduced	10
No explicit assumption	36

The following is from Business Economics, Dun & Bradstreet, Inc., New York, N.Y., V–10, No. 1, Dec. 3, 1968:

BUSINESSMEN'S EXPECTATIONS, FIRST QUARTER 1969

With a new Administration on the way and the peace talks in Paris entering a new and perhaps even more difficult stage, what do the nation's businessmen think of the outlook for the first quarter of 1969? Despite all the political and economic uncertainties, they firmly predict that business will improve. As a group, the 1,554 corporate executives interviewed in the latest quarterly Dun & Bradstreet survey have regained much of the ebullience they showed in the spring of 1968. By generous majorities, they look for increases in sales and profits in the coming quarter.

Their confidence shows up most tangibly in the Profits Optimism Index (the percentage of businessmen expecting year-to-year gains in earnings minus the percentage expecting declines). For first quarter 1969, the index shows an impressive rise of nine points, which nearly offsets its eleven-point slide to a five-year low in the previous quarterly survey.

Earlier fears about the impact on business of the long-debated surtax are now considerably allayed. Corporate profits in the third quarter rose at an annual rate of 12 per cent. Buoyed by that good news, more than three out of every five executives interviewed look for further gains as 1969 begins. The most optimistic group is the manufacturers, of whom 67 per cent expect earnings to outstrip those of the first quarter of 1968. (In the previous survey, 60 per cent foresaw such year-to-year gains.) Wholesalers and retailers for the most part still cling to their predictions of the previous quarter, with 56 per cent and 64 per cent respectively looking for a happier result on the bottom line.

On the sales front, the business executives are obviously cheered by the continued high rate of consumer spending. Thus the Sales Optimism Index has staged its own partial recovery after the previous quarter's dip, climbing to within one point of the peak it reached in the spring of 1968. Across the board, fewer firms than in September now look for a decline in sales, while three out of four count on an increase. One exception: the retailers, facing comparisons with their record first quarter in 1968, are less confident about further gains at the cash register than they were three months ago (75 per cent versus 81 per cent).

As for prices, most executives take a somewhat more conservative view than they did last quarter. The number of businessmen expecting a further rise is off slightly, while a larger percentage expects prices to stay on an even keel. Retailers, as they did earlier, top the list in predicting higher prices, although the percentage offering this verdict is off in the latest survey from 75 per cent to 69 per cent.

On another front, a large number of those interviewed believe that inventories will continue to just about match levels of a year ago. Only the manufacturers of durable goods predict a rise—presumably because of the huge steel hedge inventories that still remain to be worked off.

Finally, the much-discussed outlook for employment also has brightened. Every group but the retailers, in fact, is more confident of a rise in payrolls than it was in the previous quarterly survey.

WHAT BUSINESSMEN EXPECT FOR THE 1ST QUARTER OF 1969 COMPARED WITH THE 1ST QUARTER OF 1968

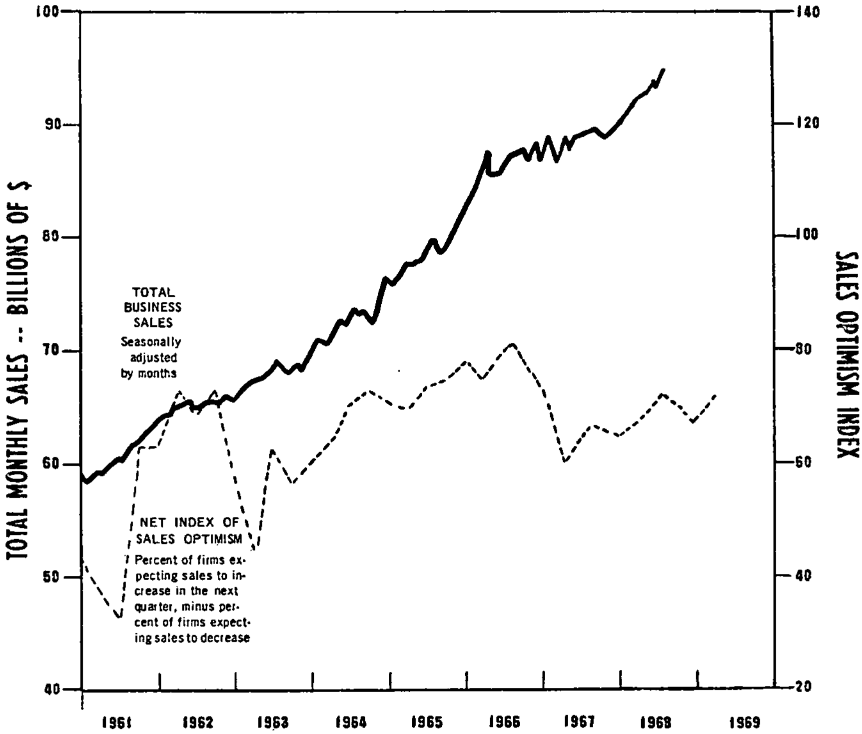
[Interview period: Oct. 14-25, 1968]

	All concerns	Total manufacturers	Manufacturers: Durables	Manufacturers: Nondurables	Wholesalers	Retailers
Net sales:						
Number reporting	1,554	792	455	337	493	269
Percent expecting:						
Increase	75	76	76	77	73	75
No change	21	19	18	20	23	22
Decrease	4	5	6	3	4	3
Net profits:						
Number reporting	1,519	774	449	325	481	264
Percent expecting:						
Increase	63	67	65	69	56	64
No change	29	25	26	24	36	30
Decrease	8	8	9	7	8	6
Selling prices:						
Number reporting	1,547	785	453	332	494	268
Percent expecting:						
Increase	57	51	52	50	59	69
No change	42	48	47	48	40	30
Decrease	1	1	1	2	1	1
Level of inventories: [1]						
Number reporting	1,546	787	455	332	490	269
Percent expecting:						
Increase	42	43	46	41	41	42
No change	48	47	44	50	47	51
Decrease	10	10	10	9	12	7
Number of employees: [1]						
Number reporting	1,556	794	459	335	494	268
Percent expecting:						
Increase	25	30	32	27	19	19
No change	71	65	63	68	78	78
Decrease	4	5	5	5	3	3
New orders:						
Number reporting		755	441	314		
Percent expecting:						
Increase		69	69	68		
No change		27	25	29		
Decrease		4	6	3		

[1] End of quarter.

BUSINESSMEN'S EXPECTATIONS

SALES OPTIMISM: ON THE RISE AGAIN



SOURCES: United States Department of Commerce
Industry Studies Department, Dun & Bradstreet, Inc.

The material which follows appears in "Consumer Buying Prospects," Winter 1968–69, vol. II, No. 2, a quarterly report published by Commercial Credit Company, Baltimore, Md.:

Has the Tax Increase Reached Consumers?

(By John Chapman, F. Thomas Juster and Rudoff Modley)

Demand Growing Faster Than Capacity to Produce

It would seem to strain credulity that "failure" of the economy to slow down would ever be disappointing for a nation understandably committed to vigorous growth and full employment. Yet there are those who remain mystified and not a little taken aback that the economy has kept rolling along. With policies this year coming into sharp focus with the midyear tax increase, we were supposed to have a slower pace for the economy.

Actually we may now be seeing some of the early effects of "cooling off" policies initiated this year. While the evidence is inconclusive, the pace of the business advance has seemed to lose momentum as we have moved into the winter months.

ANNUAL RATE OF INCREASE OF SELECTED INDICATORS

[In percent]

Period	Civilian employment	Industrial production	Personal income
June-December 1967	3.8	8.4	8.8
December 1967-June 1968	1.3	4.1	9.8
June-September 1968	−.5	−2.4	9.7
September-October 1968	−.1	4.5	4.4

Source: Federal Reserve Bank of St. Louis.

The importance of a little economic cooling has been obvious enough. In an economy whose capacity to produce is enlarging 4–4½ per cent per year, the demand for output has been allowed to gallop ahead at more than double that rate. Indeed, in 1968 so-called final demand for output has been rising at the rate of 10.2 per cent per year, and in the third quarter the pace moved up to a 10.6 per cent annual rate.

ANNUAL RATE OF INCREASE OF THE CONSUMER PRICE INDEX

Period:	Percent
June-December 1967	3.8
December 1967-June 1968	4.6
June-October 1968	5.1
September-October 1968	7.1

Source: Based on data from the Bureau of Labor Statistics.

This inevitably produced severe and growing pressure on the price level. During the final half of 1967 the consumer price index rose at the rate of 3.8 per cent per year. From June to October this year the pace stepped up to a 5.1 per cent annual rate, and in October the rise was at a rate in excess of 7 per cent per year. October caught the full impact of shifting form discounted 1968 model new car prices to higher 1969 model prices (with smaller discounts); October price increases were pervasive and substantial.

Some Slow-Down In Consumer Buying Expectations

There is now some slight evidence that this year's measures to slow down the economy are beginning to have some effect. The evidence is to be found in the latest Survey of Consumer Buying Expectations by the Bureau of the Census. While there has been no sharp deterioration, there does seem to be some fraying around the edges. Most of the indexes did not hold their high readings of the previous quarter. The largest declines were in buying expectations for houses and cars, with a smaller decline registered for household durables. Moreover, income expectations were slightly less ebullient, and more cautious income prospects, as consumers see them, can have a pervasive and diffused adverse effect on subsequent spending.

INDEXES OF EXPECTED CONSUMER EXPENDITURES

[1st quarter, 1967=100; seasonally adjusted]

Year and quarter	New cars	Houses		Household durables
		Dollars	Units	
1967:				
1st	100.0	100.0	100.0	100.0
2d	99.2	101.2	100.2	99.8
3d	100.4	104.9	102.5	100.3
4th	99.6	105.0	101.4	99.7
1968:				
1st	100.5	103.4	99.3	99.9
2d	104.0	108.4	101.8	101.0
3d	105.1	113.8	105.4	101.5
4th	102.2	112.8	103.0	101.0

Source: Based on data from Survey of Consumer Buying Expectations, Bureau of the Census, U.S. Department of Commerce. The index of new car purchase expectations has been substantially altered. The previously published index would also have shown a decline in the 4th quarter of 1968—from a 1968 3d quarter figure of 102.2 to 100.7.

There was a clear regional pattern to changes in buying expectations. Expected purchases of cars in the north central states held up well. Expected purchases of houses, however, held their strength best in the West and were weakest in southern states. The deterioration in plans to buy a house was also particularly marked for families in the 35–55 age group. This may well reflect the cumulative effect of high mortgage rates, to which home buyers in this age group would be particularly sensitive because many already own homes with mortgages obtained at substantially lower rates.

This was, of course, the first survey conducted after the September 15 recomputation of tax liabilities, which must have been the source of dismay for many consumers. Indeed, this may have been the first time that many families became explicitly aware that the tax increase did have some unhappy implications for after-tax incomes.

Non-Consumer Demand Will Outpace Consumer Demand

Does this all portend a stalemated economic situation for 1969? Not necessarily. For one thing non-consumer demands for output will continue to rise. McGraw Hill's survey of business outlays on new facilities projects an 8 per cent increase from 1968 to 1969. Since these outlays have been quite flat through 1968, the rise through 1969 would have to be at the rate of roughly 10 per cent per year. These plans also indicate an expected sales increase of 6 per cent (in physical volume). Since this is probably overly optimistic, and there is already surplus capacity in many industries, an 8 per cent increase in capital outlays would seem to be on the high side of what is reasonable to expect, but a good gain still remains a good bet.

PLANT AND EQUIPMENT EXPENDITURES

[Seasonally adjusted annual rate in billions]

Year and quarter:	Amount
1968:	
1st	$64.90
2d	62.75
3d	64.90
4th	65.15
1969:	
1st	66.50
2d	68.00
3d	69.75
4th	72.00

Source: 1968—SEC and Department of Commerce.
1969—a quarterly pattern consistent with McGraw-Hill's projected increase from 1968 to 1969.

Second, government at all levels will increase purchases of output another $10–12 billion next year, even if Federal expenditures were to show little increase. Even Federal outlays in calendar 1969 are apt to show a modest further rise over 1968 levels—this because of increases baked into existing programs.

Third, credit conditions continue to be conducive to financing. While rates are high, the supply being made available continues to enlarge rapidly—too rapidly for an orderly domestic economy or renewed strength in our external payments. Indeed, since mid-year the rate of increase in bank credit has actually been accelerating.

ANNUAL RATE OF INCREASE IN BANK CREDIT (SEASONALLY ADJUSTED)

Period:	Rate
June–December 1967	11.4
December 1967–June 1968	8.3
June–September 1968	14.9
September–October 1968	17.0

Source: Federal Reserve Bank of St. Louis.

Finally, the evidence suggests a continued further rise in consumer capital formation if past relationships between these outlays and after-tax incomes and buying expectations continue to prevail.

CONSUMER CAPITAL FORMATION

[Seasonally adjusted annual rates in billions of dollars]

Year and quarter	Total	Houses	Total durables	Autos and parts	Furniture and appliances	All other
1968:						
1st	98.9	19.9	79.0	34.6	33.3	11.1
2d	100.8	19.8	81.0	35.4	33.9	11.7
3d	106.5	21.4	85.1	38.1	35.4	11.5
4th [1]	106.1	22.6	83.5	35.9	35.6	12.0
1969:						
1st [1]	106.4	22.4	84.0	35.9	36.0	12.1
2d [1]	107.7	22.7	85.0	36.4	36.2	12.4
3d [1]	109.3	23.0	86.3	36.9	37.0	12.4

[1] Projected on the basis of income, income change, population change, and consumer buying expectations.

Source: Basic data from U.S. Department of Commerce.

If these projections are roughly indicative, consumer capital outlays seem to be on about a 3 per cent rising trend well into 1969. The rise will be somewhat greater for durable goods than for house purchases.

The projections imply that new car sales will be on a 9.2 million sales rate plateau in 1969. If realized, sales would therefore, be slightly below the 9½ million for 1968, and perhaps 10 per cent below the exceptionally high third-quarter pace for this year.

Cross Currents in the Economic Outlook

As we approach 1969 there are cross-currents in the economic outlook. Steps taken in 1968 to cool down the economy were all along apt to exert their major effects on the economy in 1969. Consumer capital outlays are apt to move forward a bit sluggishly in 1969. The evidence still, however, points to further increases in these outlays. These together with increases in non-consumer demands for output should keep the economy expanding at close to a 6½ per cent per year pace as we move through 1969.

Remarks by William H. Chartener, Assistant Secretary of Commerce for Economic Affairs, January 14, 1969

THE U.S. ECONOMY—RECENT TRENDS AND OUTLOOK

The income tax surcharge enacted last summer may have begun to bite, though with a very soft mouth. And the teeth marks are still not distinct.

Preliminary estimates of gross national product being released today by the Office of Business Economics of the Department of Commerce show a slightly smaller rise in the nation's output of goods and services in the fourth quarter of 1968 than in the third quarter. The increases ran just under $17 billion in the fourth quarter compared with just over $18 billion in the third quarter. The rise had been slightly over $20 billion in each of the first two quarters of 1968, before passage of the tax bill. The new estimates show a GNP of $887.8 billion (annual rate) in the fourth quarter and $861 billion for the year 1968.

The significant changes between the third and fourth quarter results are in the composition of demand for current production, rather than in the total volume of economic activity. The principal items worthy of note are:

—signs of some weakening in consumer spending

—a leveling off in Federal government purchases

—an evident surge of strength in business investment activity.

Before commenting on some of these components of the GNP accounts, I would caution you that these are preliminary estimates. Large revisions of the total figure or of the major components are unlikely. However, we have only two months' data on such small but sensitive items as the change in business inventories and net exports of goods and services. Firm data on business expenditures for plant and equipment and on profits for the fourth quarter likewise are not yet available.

I call your attention to these items in particular because of their key roles in any interpretation of both current economic trends and the near-term outlook. However, I shall not use the imprecision of last quarter's figures as an excuse for leading you through a labyrinthine hedge in comments on the outlook.

With employment and incomes continuing to rise and with the fundamental forces that determine consumer demand running strong, the U.S. economy should score another solid advance in 1969. As I indicated earlier this month, I expect GNP to rise about $65 billion this year to about $925 billion. This would be not much under the $71 billion increase achieved in 1968 and would be in line with the economy's basic potential for growth in output.

Now, a few brief comments on important implications of the new GNP estimates for the fourth quarter of 1968:

(1) The rise in final sales—or current demand exclusive of the changing amount going into inventory—was appreciably less than in the third quarter. The fourth quarter increase was only $14 billion, compared with a rise of over $21 billion in the third quarter.

(2) Consumer spending was up very little—only $5 billion, after a $13 billion spurt in the third quarter. If the effect of price increases is taken into account, there was actually a very small *decline* of ⅕ of 1 percent in personal consumption expenditures in the fourth quarter. Auto sales slipped from the exceptionally high level reached in the third quarter. New car sales were at an annual rate of 10.1 million units, including imports, in September; they have run about 9.6 million the last two months. Purchases of other consumer durable goods also were down slightly, as were apparel sales. The Hong Kong flu epidemic which kept a good many of us out of the stores just before Christmas has been given some of the credit for the disappointment in retail trade figures. However, there had been some signs of softening in auto and other retail sales beginning in November without any obvious natural, medical, or sociological explanation.

(3) There was some offset to the weakness in consumer spending on goods and services in the strong rise in expenditures on residential construction. After two quarters at $29.5 billion, this figure spurted $2.3 billion in the fourth quarter, as housing starts moved back toward a 1.7 million annual rate.

(4) The rise in Federal government spending—less than a half billion dollars—was the smallest since 1965, when defense spending began its sharp climb. The expenditure control part of last summer's tax bill is clearly biting as intended. State and local expenditures continued about on trend, rising $2½ billion.

(5) Meanwhile, business investment activity was accelerating, both in current spending and in plans for future spending. Business outlays for new structures and equipment moved up $4 billion, after a $3 billion rise in the third quarter. Surveys conducted both by private firms and by the OBE and SEC in the fall point toward a further substantial rise in capital spending this year. This trend is confirmed by the strong showing of new orders for durable equipment and construction contracts in recent months. No doubt, it also helps explain the strength in prices—a euphemism for price increases—running broadly through the metals industries lately.

(6) The smaller rise in final sales noted earlier had its counterpart in a somewhat larger rise in business inventories. These had increased only $7½ billion in the third quarter. The estimated rise in the fourth quarter was $10 billion, or almost up to the second quarter figure of $10.8 billion. This rate of accumulation of inventory cannot be sustained very long without prompting efforts to slow down further accumulation—namely, through reduced orders or curtailed production schedules. However, note that we are still far short of the 1966 rate of inventory build-up of $15 billion which set off the mini-recession of early 1967.

(7) December figures on foreign trade are not yet in, and the dock strike that began on December 20 undoubtedly distorted any semblance of normal performance. Data for the first two months, though, indicate no appreciable change from the $3 billion net export figure in the third quarter.

(8) Price increases—where we would have welcomed some slowdown in the final months of the year—continued at a rate of about 1 percent a quarter. Overall, prices rose about 3¾ percent in 1968, the largest increase since 1951.

The composition of the changes in demand during the second half of 1968 should make us alert to the possible emergence of an imbalance in the nation's economy—production of goods and the building of new facilities increasing faster than consumers are prepared to buy these goods and absorb the expanding output. In the past, this sort of imbalance has typically set off a general business recession or, at least, a pause in economic advance.

Some economic analysts have expressed concern over the potential impact on consumer spending power of two new tax developments coming on top of last summer's rise in withholding taxes.

—The January 1 increase in OASDI employment taxes from 8.8 percent to 9.6 percent. The effect is estimated at an annual rate of $3 billion, about half of which will be deducted from the take-home pay of employees.

—Year-end settlements of individual tax liabilities, which will run heavier than usual because the rise in withholdings covered only two-thirds of the tax surcharge liability. Here the estimated effect is an increase in tax payments running at an annual rate of $3 billion in each of the first two quarters.

Both these items should, however, be considered in conjunction with the continuing rise in personal incomes. Combined, the two bites come to about $4½ billion as they affect individuals. Most of last year, personal income was rising at a rate of over $5 billion a month. Thus, the combined effect of these two nips out of spending power can be offset by a few weeks' rise in incomes. Moreover, the larger of the two—the make-up payments on the tax surcharge—will be a one-shot proposition. Unless something happens to interrupt the generation of personal income, consumers—and the economy—should be able to take these small additional tax payments in stride.

Do the figures for the fourth quarter suggest any retreat in consumers' mood to spend what they are earning? Spending did increase somewhat less than the rise in disposable income. This meant that the savings rate—which had dropped from over 7 percent in early 1968 to 6¼ percent in the third quarter—moved back up to almost 7 percent. However, even this rate is rather high by recent historical standards. If anything, we should expect consumers to spend a slightly *higher*—rather than lower— proportion of their rising incomes in 1969.

Consumer spending has moved up on an erratic, zig-zag path through the past year—advancing sharply one quarter, slowly the next. I am inclined to view the small fourth quarter advance as having some of this character, not as being the indicator of a new and more sluggish trend.

1969 Forecast of Gross National Product, Consumer Spending, Saving, and Housing

(By Irving Schweiger*)

In 1969, I expect the U.S. economy to advance strongly with one of the largest increases in real growth in its history. It will continue the striking recovery from the enforced slowdown of the economy in 1966 and 1967. No end to the expansion is in sight. The performance will be marred by continued price inflation, although prices will rise a little less rapidly than in 1968 and will decelerate slowly during the year.

All sectors of the economy will show substantial increases in investment or spending; no major areas of weakness are discernible. Moderately restrictive fiscal and monetary policies are anticipated. Housing will continue to be disproportionately affected by the credit restraint. Interest rates will continue at high levels except for short-term rates which are expected to decline briefly in early 1969. Employment will increase steadily, and there should be no undue increases in unemployment if monetary policy does not become severely restrictive.

My estimate is that the Gross National Product will total $933 billion in 1969, about $73 billion or 8.5 per cent more than in 1968. A rise of 3.6 per cent in prices will account for a little more than two-fifths of the apparent gain in GNP. In 1968, prices rose 3.8 per cent. The advance in real goods and services in 1969, adjusted for price change, will total about 4.8 per cent.

This is a relatively optimistic forecast. Most other published forecasts expect growth of real GNP at 1.5 to 3 per cent for the year, which is one-third to two-thirds less than my estimate of 4.8 per cent.

Why do I expect so much greater growth? Very briefly, I anticipate growth

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*Professor of marketing, Graduate School of Business, University of Chicago; and editor, *Journal of Business*.

in demand to be so strong and pervasive as to be only slightly affected by the present schedule of tax increases or by anticipated moderate tightening on the monetary side. Unless there are heavier tax levies or much more restrictive monetary policies than are presently visualized, I foresee a larger volume of spending or investing in all major sectors of the economy with no important areas of weakness. Without moderate fiscal and/or monetary restraints, economic growth would be even larger but at the cost of dangerously accelerating price rises. The economy is in such a resilient and expansive condition that ending of the fighting in Vietnam would free resources for other uses with a bare minimum of dislocation.

Let me spell out my assumptions and reasoning regarding the public sector before turning to the private sector.

My forecast assumes that government spending for goods and services (federal, state and local) will be nearly $19 billion larger in 1969 than this year. This compares with a rise of not quite $11 billion in the past year. The added spending is primarily for non-defense or civilian activities. It reflects a belated catching up with non-governmental pay scales, increased militancy among civil service workers—teachers, policemen, firemen, clerical personnel, and others—and a continued enlargement of the demands for more and better governmental services. A truce in Vietnam is not assumed, although it could come at any time. If peace does come, the economic effects in 1969 are likely to be moderate.

With respect to federal tax policy, most attention has been directed to the possible fate of the "temporary" income tax surcharge in mid-1969. My opinion is that the surcharge will be extended in some form through calendar 1969. Both the economy and the price level will be advancing at such a rate in mid-1969 that the mild restraint of the surcharge will be welcome. Federal tax revenues will grow so rapidly that it is likely to show a significant surplus in 1969 on a national income accounts basis.

I will advance one basic reason for my belief that neither fiscal nor monetary policy is likely to be overly restrictive in 1969. The new Republican administration, the first in eight years, is likely to look with strong disfavor on policies, whatever their desirable objectives, that lead to an early recession or a substantial rise in unemployment with its disproportionate impact upon minority groups. Policies that reduce inflationary pressures slowly while maintaining high employment and vigorous expansion are likely to be preferred over those that reduce inflation quickly at the cost of slow growth, rising unrest, and a re-enforced association of recession with Republican rule.

Monetary policy is likely to have at least two phases in 1969. In the early part of the year, some easing of credit is a good possibility because of policy uncertainty concerning the effects of higher social security taxes and final 1968 surcharge payments as well as fear of tight money choking off the flow of urgently needed housing. Also in point will be a marked reduction in federal claims upon capital markets in early 1969.

In the latter part of 1969, monetary policy is likely to reverse any easing and turn more restrictive in recognition of the strong expansive drive of economy and continued rapid rises in prices. During the year, only small changes from current high levels are anticipated for long-term interest rates, while short-term rates are expected to fall and then rise again. As already indicated, the new administration is likely to argue against a monetary policy so restrictive that it results in considerable unemployment even to reduce inflationary pressures more quickly. Monetary authorities are likely to be troubled by rising prices and in their efforts to counter them will tend to keep credit as tight as possible without large increases in unemployment. The authorities may err and go too far as in 1966. Their task is not an easy one.

Let us turn now to prospects for the private sector. As in recent years, opinions vary concerning the outlook for business investment in plant and equipment. At present the consensus of analysts seems to be that businessmen will not carry out their stated intentions to increase investment spending by 5–8 per cent. Skepticism is based on anticipated slow growth of the economy and the low current utilization (83 per cent) of manufacturing capacity. My estimate is that plant and equipment spending intentions will be more than fully realized and will advance about 9 per cent over the 1968 figure.

Contributing to this step-up in investment are a change in economic outlook by businessmen as well as greater opportunities and need for investment. There appears to be a growing conviction by many business executives, strengthened in the past year, that any business recession will be brief and shallow and that future expansion of the economy will occur at a faster pace than in earlier periods. This fundamental change in outlook is highly conducive to increased investment. This more favorable view of the future is joined with a rising flood of investment opportunities for new and improved products and more advanced and efficient technologies stemming from an unprecedented volume of expenditures for industrial research and development. In addition, inflation itself—recent and prospective—enhances the desirability of substituting capital for labor, particularly with an inadequate and inelastic supply of essential skilled workers. Need for cost reduction through investment is underscored by more intensive competition from foreign and domestic sources. Ability to pay for the investment program is aided by a more liquid corporate position based on better profits, larger depreciation allowances, and lowered requirements for accelerated tax payments. All told, these factors tend to raise the level of business investment and render their execution less sensitive to transitory developments.

Because I anticipate that the economy (GNP) will expand by close to 5 per cent in real terms and well over 8 per cent in current dollars—advances larger than are expected by most executives—my belief is that businessmen will fulfil their investment intentions with a little to spare. Total investment in plant and equipment in 1969 is estimated at about $98 billion compared with a little under $90 billion in 1968.

Before leaving the subject of investment, one note on capacity utilization rates. The most authoritative and widely quoted series prepared by the Federal Reserve System deals with manufacturing capacity, and only manufacturing capacity. This series is frequently considered to be the bellwether for all private industry. I have used this series myself in the past and can report that it is not a reliable guide to the total. This is pertinent because manufacturing accounts for only about two-fifths of business investment in plant and equipment. Investors in other sectors of the economy can and do march to different drums. Investment by manufacturing companies as a group declined in both 1967 and 1968 to date from 1966 peak levels, while increased investment in other industries (utilities, commercial facilities, etc.) more than offset the reduction in manufacturing investment.

Now to discuss the household sector. The reduced rate of personal saving predicted for 1968 did occur. It was reflected in a greater rate of spending for durable goods, especially automobiles. Factors curtailing the rate of saving are expected to continue in 1969, resulting in another small reduction in the saving rate. These factors include a further substantial increase in number of young adults, greater familiarity with and psychological acceptance of higher prices, and increased credit capacity, based in part on a reduced ratio of debt-to-income. A greater rate of household spending out of income in combination with larger expenditures of business and government will provide substantial support for expansion of the economy.

Disposable personal income will total about $635 billion, a gain of nearly 7.6 per cent. Consumers are expected to increase total spending for goods and services by 7.8 per cent.

Unlike 1968, expenditures for automobiles are not expected to show a large percentage gain. In view of the large 1968 rise—close to one-fifth on the basis of government data—it is noteworthy that some further gain is expected. Dollar expenditures will rise because of significantly higher average expenditure per car and some increase in unit sales.

The gains in total new car sales will not be large, with sales in 1969 approximating 9.5–9.6 million units compared with 9.25 million in 1968. Some of the strength of the new car market may be attributed to inflationary factors. Consumer incomes in current dollars, assisted by inflation, have risen relative to the effective prices of new cars also stated in current dollars. As a result, new cars are cheaper relative to average consumer income than they have been for some years. This has tended to enlarge the total car market. At the same time, small foreign cars have risen less in price than U.S. manufactured cars, a factor which has contributed to a substantial increase in share of market of the imports. With the introduction of new, smaller, and less costly cars beginning in spring, 1969, U.S. manufacturers should be able to compete more effectively in this sector. In time, imported cars may again be held to less than 10 per cent of the market.

The underlying demand for housing continues to grow strongly and will do so for a number of years. But tight credit continues to restrict housing output as it has in greater or lesser degree since 1966. For the full year 1969, total private residential construction expenditure is estimated at $32 billion, about 8.5 per cent above 1968.

However, demand for housing has been so strong that consumers, frustrated by tight credit and disproportionate price rises for conventional housing, have turned increasingly to a substitute form. This is the so-called "mobile home." In 1968, approximately 300,000 mobile homes were shipped, of which the great majority are intended for permanent housing. These will add nearly 20 per cent to the total of new conventionally constructed units. In 1969, this new type of housing unit, which is not included in the official U.S. government series of housing or construction statistics, will probably augment the supply of new conventional housing by 350,000–375,000 units or more than 20 per cent.

Purchases of consumer durable goods other than automobiles (furniture, household appliances, television sets, etc.) will reach a record total of a little more than $50 billion in 1969. The gain over 1968 expenditure will be about $4 billion or 8.7 per cent, moderately more than the 7.6 per cent increase in disposable income.

Spending for non-durable goods and services, including clothing, food, recreation, and medical service, will total about $487 billion for a gain of $35 billion over 1968.

Personal saving is expected to contract further from the unusually high rate of 7.4 per cent in 1967 and 6.9 per cent in 1968 suggested by current U.S. Commerce Department statistics. A decline to 6.7 per cent in 1969 will reflect, in part, a substantial increase in household formation (including families living in mobile homes). As to disposition of saving, continued inflation and well-sustained corporate profits may result in some shift to equity-type investments, such as real estate and mutual funds from fixed claims such as savings deposits.

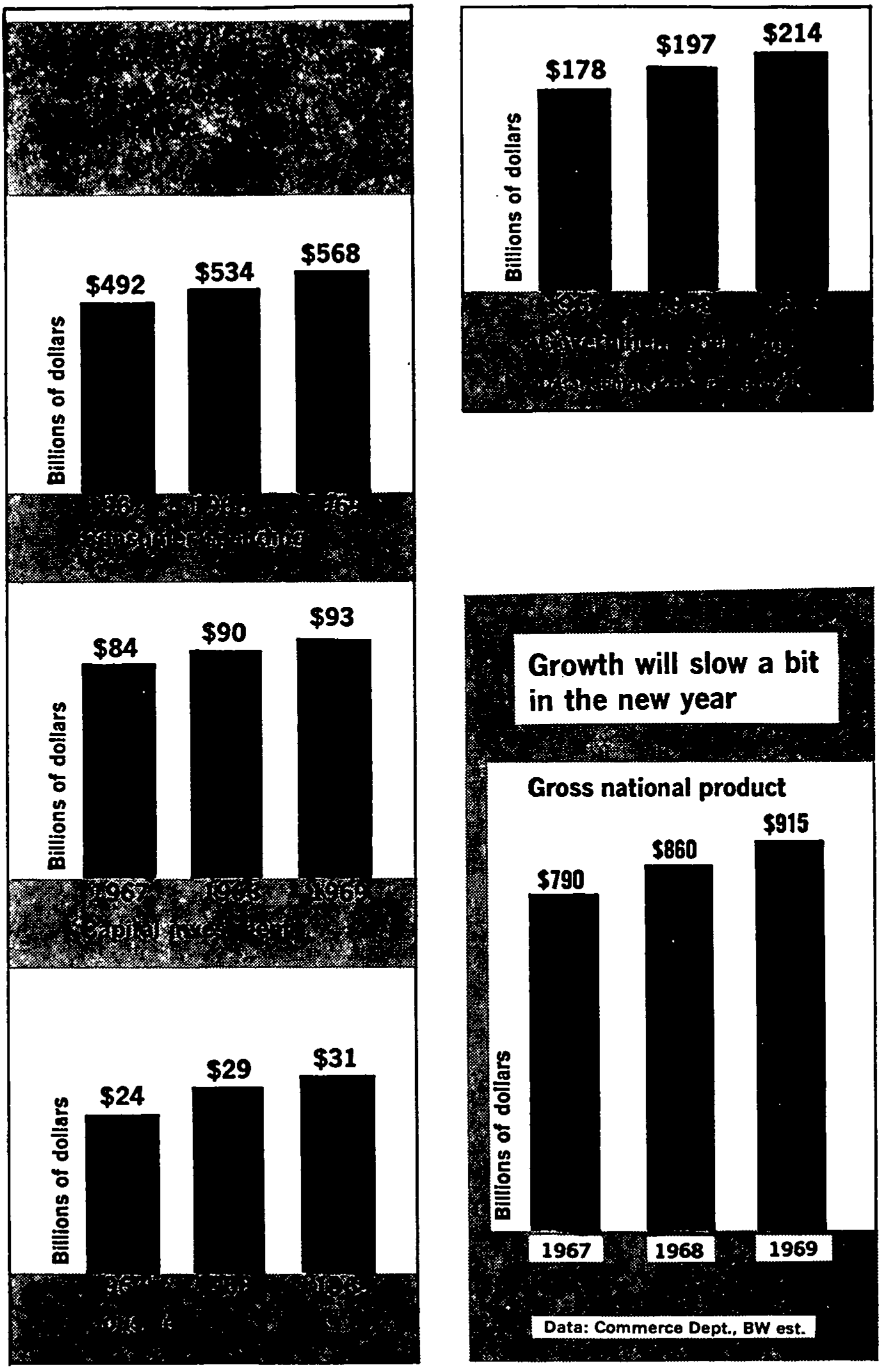
In summary, I expect the economy to make a substantial advance in real terms in 1969. Prices will continue upward at a rapid rate, although somewhat less than in 1968. Short-term interest rates are expected to fall and then rise, while only small changes are anticipated in long-term rates.

All major sectors will step up spending; no important weaknesses in demand are foreseen. Unemployment will continue at relatively low rates.

The economy will be relieved of some of the strains and distortions caused by past errors in fiscal and monetary policy IF further errors are not committed. Lessons furnished by recent experience should help in adjusting toward a balanced, expanding economy, with tolerable rates of price change. The full process of adjustment will not be accomplished quickly or easily.

In 1969, it seems both possible and probable that the economy will enjoy a near-record increase in real output with a diminishing rate of inflation. It will be a forceful performance by an economy with vitality, resilience, and staying power. No end to the vigorous expansion is in sight.

(The following is from Business Week, Dec. 28, 1968:)



SLOWING DOWN TO A FAST RUN

Economists are at odds over the shape of next year's curve, and expect a real growth to slacken. But the consensus is that 1969 will still be a good year for American business.

It is an understatement to say that the U.S. is moving into 1969 in the midst of a strong boom. Yet, with prices rising too fast, interest rates too high, international money too shaky, and the Paris peace talks too uncertain, it is an uncomfortable boom. It gives many economists and businessmen a distinct feeling that things could easily come unstuck.

These uncertainties—particularly the threat of a new money crunch—make it a tougher job than ever to sketch a business curve for the year ahead. Quarter-by-quarter projections are just too wobbly for businessmen to lean on.

Reassurance. Nonetheless, there are two reassuring signposts:

What economists are saying. Disagreement may be rife, but no one is talking recession. The main argument is about the shape of 1969.

What the new Administration is saying. President-elect Nixon and his advisers have already gone on record against a meat-ax approach to ending inflation.

Disagreement among economists over the shape of next year conceals a fairly broad consensus on the overall gain from 1968. Gross national product projections for 1969 seem to average about $915-billion—a gain of $55-billion, or 6.4%, over this year.

It is significant, moreover, that both Republican and Democratic economists are comfortable with the $915-billion figure. Before being designated Council of Economic Advisers chairman, Paul W. McCracken made a projection that was in line with it. And the same figure is likely to be the choice of the outgoing Administration's top forecasters, including present CEA Chairman Arthur M. Okun.

Improvement. If the $915-billion forecast proves out, 1969 will be a good year for business. Over-all growth will trail this year's 9%, but too much of the gain to suit economists will be in higher prices. Still, most economists expect a slowing of the price climb to less than 3½% from this year's 4%.

Less comforting is the outlook that real growth will also slow—from 5% to 3%. This 3% figure is below the average of 4% for the 1960s to date. But it should be enough to keep unemployment from rising much above 4% and profits from deteriorating much from this year's high level.

BANNING THE MEAT AX

Not surprising in this period of economic controversy, the major argument over the shape of next year is between the fiscal school, which holds that budget swings are what really count for business, and the monetarists, who put their faith in changes in the supply of money.

Although burned on this year's forecast of a slowdown that never came, the fiscal school sticks to the expectation of an early flattening. But it still feels it will be short and quite mild, with the economy again moving ahead quite strongly in the second half.

The monetary school, which has its successful no-slowdown forecast for 1968 going for it, sees a reverse pattern: a fairly strong first half, with a mild slowdown after midyear.

The new Administration's economists are determined to steer a middle course between the monetary and fiscal schools, and are not yet talking about the shape of next year's business curve. They clearly want to stop inflation—but in a way that would avoid a repetition of the unemployment-breeding mistakes made by the Eisenhower Administration in the late 1950s. "Some people say you always have to use meat axes," says Treasury Secretary-designate David M. Kennedy "I don't."

Built-in spending. The budget that the new Administration will inherit would, by itself, be enough to prevent a meat-ax strategy. Spending will rise by at least $7-billion, because of rises set for such so-called uncontrollables as military and civilian federal pay and Social Security. Moreover, many economists feel that spending, for military hardware will climb unless there is a significant deescalation in the Vietnam war.

"We will be spending much more next year for sophisticated weapons systems," says Harvard economist and ex-CEA member Otto Eckstein. "So you would have to have a sizable slowdown in the war to avoid another increase in defense spending."

PRUNING THE MONEY TREE

If four years of inflation had not bred a feeling that further inflation was in the cards, a budget outlook like this would go a long way toward insuring a strong 1969. But inflationary expectations are unquestionably widespread, and all economists recognize that 1969 may be a year in which normal forecasting methods—both monetary and fiscal—may paint too optimistic a picture.

Indeed, there are three threats to prosperity that can't be shrugged off: a new money crunch; another international monetary crisis; and the building up of excesses that could lead to an old-fashioned bust.

Getting rough. The present money squeeze is in danger of becoming a genuine crunch. "To get the economy out of its present inflationary orbit, the Federal Reserve will have to get pretty rough," says Sam I. Nakagama, vice-president or Argus Research, who expects a fairly sharp slowdown in 1969's first half.

The Fed is already acting rough. It called last week's hike in the discount rate an action "in furtherance of a policy of restraint." And in private conversations later in the week, Fed officials visiting New York said they weren't kidding.

The money markets got the message. In just two days last week, the price of the bellwether 1987–92 U.S. Treasury bonds dropped nearly two full points.

Relief. Still, economists hope that any squeeze will be short-lived. "Any crunch will be brief," says Tilford C. Gaines, vice-president and economist for Manufacturers Hanover Trust. "The Treasury is moving into a surplus position."

The important point about Gaines' thinking is that it appears to reflect the echoes that bounce off the marble walls on Constitution Avenue in Washington when Fed officials talk to each other—in spite of what they may say when they visit Wall Street.

Fed officials know there is a crucial difference between what is happening now and the 1966 money crunch. Two years ago, the budget deficit was high and rising; now it is small and swinging toward surplus. As a result, the Treasury will provide at least $8-billion in new funds to the market in the next six months. This makes the Fed hope that interest rates will back down soon enough to prevent the kind of flight of funds out of banks and savings and loan associations that squeezed both capital spending and housing in the 1966–67 slowdown.

SMOOTHING OUT THE CYCLE

Even if this money crunch can be skirted, there is still a worry that the economy might move into a classic boom-bust cycle. A mild form of this worry is over inventories—particularly in retailing.

"The question is whether the Christmas season was good enough to bite into the big buildup in retail stocks that took place earlier this year," says Harvard's Eckstein. "If it wasn't, and retailers try to work off these excess inventories, the first quarter could well be very slow, indeed." In any event, Eckstein expects strong growth to resume by late spring.

Deeper worries. For some economists, cyclical worries go deeper than imbalances between inventories and sales. They are concerned over potentially more serious imbalances between a turned-on business community and a turned-off consumer. They question whether the 10% rise in capital spending for next year now projected by the Commerce Dept. and the Securities & Exchange Commission is justified by current operating rates or by any realistic projections of long-run growth in demand.

Other economists, however, think this an antediluvian concern, and cite a host of new trends in the economy that justify high capital outlays. For one thing, 13% of industry's equipment is obsolete, according to a recent McGraw-Hill survey, an oppressive figure in the light of skilled labor shortages. At the same time, rising wage rates mean that equipment is cheaper now relative to labor costs than at any time in the past 20 years, according to a recent study by the Machinery & Allied Products Institute.

Most economists feel that the rate of inflation will slow next year. They recognize more clearly than ever that economic problems are never solved—they only change. But most would say they have changed for the better.

Challenges. The challenge of the immediate postwar years and the 1950s was to show that another Great Depression could be avoided. And so it was, although there were four recessions.

The challenge of the 1960s was to show that even recessions could be eliminated. The boom that started in February, 1961, is still going on—eight years later, but now at the expense of inflation.

The current challenge, which is likely to last into the 1970's, is to show that sustained prosperity can be combined with reasonable price stability. This is a problem that economics has not yet solved—even in theory—and that makes it the greatest challenge of all.

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 26, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room 1114, New Senate Office Building, Hon. Wright Patman (chairman of the joint committee) presiding.

Present: Representatives Patman, Bolling, Reuss, Widnall, Brock, and Conable; and Senators Proxmire, Sparkman, and Percy.

Also present: John R. Stark, executive director; and Douglas C. Frechtling, minority economist.

Chairman PATMAN. The committee will please come to order.

Today we continue our hearings on the state of the economy and the administration's economic program. In the course of this annual inquiry, the committee is always delighted to hear from Chairman Martin. The Federal Reserve Board has a most powerful role in economic policy. No one denies that. Some of us have strong differences with Mr. Martin on policy matters which no doubt will be voiced here today. At the moment, however, we shall not go into that. Instead, we would like to hear from Mr. Martin.

Mr. Martin, will you proceed in your own way? And if you want to summarize your statement and put it all in the record at this point, so as to give the members an opportunity to question you, it would be appreciated, too, with the understanding that in addition to what you say you may extend your remarks when you receive the transcript.

We are delighted to have you, sir.

STATEMENT OF HON. WILLIAM McCHESNEY MARTIN, JR., CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ACCOMPANIED BY DANIEL H. BRILL, SENIOR ADVISER TO THE BOARD, AND ROBERT SOLOMON, ADVISER TO THE BOARD

Mr. MARTIN. Thank you, Mr. Chairman.

Once again I welcome the opportunity of meeting with this committee to discuss some of the key economic problems facing the Nation. We are, at long last, beginning to make some headway in dealing with a major economic problem that has plagued us for over 3 years—inflation. Progress has been slow, but that is understandable after so much inflationary momentum has been generated by the delay in getting the Nation's finances in order. I am optimistic, however, that the forces of fiscal and monetary restraint set in motion last year will gradually bring us back to reasonable price stability.

Optimism about the ultimate success in containing inflationary pressures should not, however, blind us to the difficulty of the task in the months immediately ahead. We must deal with a heritage of cost and price increases that is continuing to generate further cost and price increases, and—importantly—has become deeply embedded in business and consumer expectations. After several years of rapidly rising prices, it is only natural that many spending decisions are motivated now by the fear that prices will be even higher next year, or by the conviction that inflation will bail out even the most marginal speculation. The price component of our national product has advanced with increasing rapidity, from an average increase of less than 1½ percent a year in the early 1960's, to 2 percent in 1965, 2½ percent in 1966, 3 percent in 1967, and close to 4 percent last year. Public skepticism about the Government's ability to "do something" about prices has its roots in this history of ever-quickening inflation.

This skepticism has been reinforced by the initially inauspicious results of fiscal restraint. The immediate response to enactment of the tax and expenditure control legislation last June was, admittedly, disappointing. For a month or two after withholding taxes were raised, consumers continued to increase their outlays at a rapid rate, drawing on their savings and borrowing heavily to finance both higher taxes and higher spending. The ebullient behavior of consumers infected the business community. With retail sales booming, business plans for adding to inventories and plant capacity were revised upward sharply, and in this heady atmosphere, cost increases were rapidly passed on in the form of higher prices. The pause in the spiral of prices last summer lasted only briefly; by early fall, the price indexes were headed up again at an accelerating pace.

Our foreign trade balance, too, has shown the effects of the last 4 years' spiraling rise in prices and costs in this country. In 1968, the U.S. merchandise trade surplus virtually disappeared. Exports increased fairly well, at least until the port shutdowns near the end of the year. But imports increased substantially, as aggregate demand in the United States expanded excessively and as our prices rose.

In retrospect, I believe that the Federal Reserve was overly hasty last summer in expecting an immediate impact from fiscal restraint. As the published record of Board and Federal Open Market Committee deliberations indicates, monetary policy moved promptly to an accommodative stance at midyear, anticipating that an easing of demands and of financial market pressures would ensue with little delay after the enactment of the fiscal restraint legislation. The easing in financial markets that did occur in early summer enabled the banking system to rebuild its liquidity rapidly. Inflows to banks of time and savings deposits, which had contracted during the spring, expanded rapidly during the summer, permitting a resurgence in bank credit expansion to finance both Federal and private borrowing. Federal Reserve open market operations provided the reserve base to support this expansion; while deposits expanded rapidly, banks were able to reduce their borrowings at the discount window.

The business statistics that emerged over the summer and early fall indicated far less of an impact of fiscal restraint on aggregate demands than had earlier been anticipated, and as the pace of inflation quickened, monetary policy moved back toward a posture of restraint.

The intensification of this restraint has been gradual, rather than abrupt, in keeping with our assessment of the economy's needs over the longer term.

It takes some time for such a change in monetary policy to have its full effect on financial markets and financial flows, and as the policy is working through there are likely to be disparate movements in key financial indicators. Interest rates often tend to react most quickly, because they reflect market participants' assessment of the future of policy and its interactions with the economy.

The effects of policy changes on the general availability of money and credit, however, typically take more time to work through. The very flexibility that is a key attribute of our financial system over the longer run allows some short-run crosscurrents in financial flows to occur. At times of policy tightening, institutional lenders typically have some cushion of liquidity that they can utilize, at a cost, to maintain loans. Borrowers, too, have liquid resources at their disposal and can take advantage of past arrangements to command additional funds, at least for a time. Individual and business holdings of money balances are importantly influenced over the short run by such technical factors as fluctuating transfers in and out of U.S. Government deposits, as well as by the play of market uncertainties and pressures on investors' decisions, and by underlying forces stemming from changes in monetary policy.

Nonetheless, the effects of a policy of restraint become more and more evident as these liquidity cushions are worked off and the effects of temporary aberrations and transitional adjustments fade. As was pointed out in our staff's report on financial developments during the fourth quarter of 1968, submitted to this committee earlier in the month, the developing monetary restraint last autumn was first indicated by a considerable slowing in the growth of the volume of reserves supplied to banks through open market operations. As a consequence, banks were forced to increase their borrowings from the Federal Reserve, and to bid more aggressively for certificates of deposit in order to maintain expansion in their loans and investments. Banks with branches abroad had to pay relatively high interest rates even to retain Eurodollar deposits. With the passage of time, these adjustments of bank sources of funds had to be supplemented by modifications of bank lending and investing policies; banks generally began to withdraw from active participation in the markets for United States and State and local government securities, while also stiffening lending terms to businesses and consumers.

By late November and early December, the developing pressures on the banking system had pushed the effective offering rates on large negotiable time certificates of deposit to regulation Q ceiling limits. Shortly thereafter, interest rates on competitive market instruments, such as on Treasury bills and commercial and finance company paper, moved above the Q ceilings.

The result has been a steady reduction in outstanding large-denomination time certificates of deposit at banks, particularly at large banks which account for the bulk of such deposits. From the first week in December through the first half of February, these deposits declined by almost $4 billion, or about 15 percent of the total outstanding. In addition, there has been a slowdown in net inflows of other time and savings deposits to banks during this period. Although banks with branches abroad built up Eurodollar borrowings sharply in January, aided by a heavy outflow of funds from Germany, outstanding bank credit has, on balance, shown little growth over the past several weeks.

Under these conditions, banks have had to turn increasingly to liquidation of short-term securities to accommodate loan demands. They have also had to cut back sharply their net purchases of other securities. While the liquidity position of banks as a group is not quite as strapped as it was in the spring of 1968, or in the fall of 1966, the ability and willingness of banks to help finance credit-based spending is clearly becoming more and more limited.

Outside the banking sector, evidences of the effect of monetary restraint are also becoming somewhat more widespread. Interest rates on high-grade corporate and State and local government bonds have edged up further from the advanced levels reached in December of last year. These high yield levels have been maintained even though the prospective volume of bond offerings has not tended to build up, and there is evidence that some potential borrowers have postponed bond issues in view of tight current market conditions.

In mortgage markets, interest rates rose during the fourth quarter of last year and have moved steadily higher in recent weeks. Demands for mortgage credit have remained strong while the availability of new funds has become increasingly constrained. Net inflows of savings to thrift institutions tapered off in December, as market interest rates rose further, and preliminary data suggest a further tapering in January. Net savings withdrawals at these institutions during the reinvestment period of late December and early January were somewhat larger than a year earlier, and it appears that the subsequent deposit buildup was less than usual.

Currently, the mortgage market does not seem to be quite as dependent on thrift institutions as in earlier years, nor do these institutions themselves seem to be quite as sensitive to monetary restraint as in, say, 1966. The existing structure of ceiling rates on deposits at bank and thrift institutions has contributed to a more evenhanded slowing of consumer deposit flows among the major savings institutions. Thus, monetary restraint has developed so far without an excessive burden falling on the homebuilding industry, although new supplies of funds for the housing market are becoming increasingly restricted.

Even while credit markets were in the process of tightening during the fourth quarter, expansion in the privately held money supply accelerated, to a 7½-percent annual rate. A principal cause was the larger than seasonal rundown in U.S. Treasury balances at commercial banks during the fall. A little later, around yearend, deposit balances were swollen by the combination of seasonal money market pressures, large yearend international and domestic flows of money, and market uncertainties about the intensity and course of monetary restraint. In the ensuing weeks of 1969, however, the money supply contracted, while U.S. Government deposits were being rebuilt more than seasonally.

In my judgment, monetary restraint is now fully reinforcing fiscal restraint. And fiscal restraint is becoming increasingly effective. In retrospect, it appears that while the Federal Reserve was overly optimistic in anticipating immediate benefits from fiscal restraint, the business community may have been overly hasty, last fall, in writing it off as a complete failure. For just about the time that business spending plans were being enlarged, consumers' spending enthusiasm began to wane. Retail sales reached a peak in August, but have remained below that level since then. The consequence was a rapid rise in business inventories in the fourth quarter; for some types of merchandise, the buildup of stocks in distributors' hands became excessive before yearend, and production of these goods has begun to be curtailed. Moreover, the impetus provided to consumer incomes and business activity by rising Government spending also began to moderate after midyear. In the second half of last year, the rate of Government purchasing of goods and services rose by less than $2 billion, compared with a rise of $6½ billion in the first half of the year.

Federal spending is scheduled to flatten out further during the winter and spring months, and the full impact on consumer spending of the higher taxes legislated last June is now only coming to be felt, as retroactive personal income tax payments are made to cover surcharge liabilities for the period before increased tax withholdings began. Over the next few months, therefore, the economy's advance should be at a more moderate pace, and that should provide a start on alleviating some of the demand pressures underlying the advance in price levels.

Expectations of inflation are deeply embedded, however, and speculative fervor is still strong. A slowing in expansion that is widely expected to be temporary is not likely to be enough to eradicate such expectations. The experience of early 1967 is a lesson in point. Moderation in economic activity at that time did indeed produce a significant slowing in the rate at which prices advanced. But the moderation was short lived. As economic activity accelerated after midyear, so did prices. The rate of increase in the GNP deflator, which had slowed to about 2 percent by the spring of 1967, almost doubled by the end of that year.

The critical test for stabilization policies in 1969 will be their ability to keep such a rebound in activity and prices from developing. If we were to dissipate again the benefits derived from a reduction in excessive demands, the credibility—at home and abroad—of Government economic policies would be severely strained.

We have been fortunate this past year that the poor results in the U.S. trade balance have not damaged the international standing of the dollar. In fact, we had a surplus in the overall balance of payments, both on the so-called liquidity basis of calculation and as measured by official reserve transactions. The surplus was the result of favorable flows of capital; greatly enlarged foreign purchases of U.S. equities at the same time as foreigners were acquiring a substantial volume of securities that U.S. companies were issuing abroad in compliance with the compulsory direct investment controls: repayments by foreigners of U.S. bank loans, in accordance with the Federal Reserve voluntary foreign credit restraint program; and, large flows of foreign liquid funds out of other currencies into the Eurodollar market where they were borrowed by U.S. banks.

This year a slowing of the excessive expansion of domestic demand should bring with it a slowing in the growth of U.S. imports, and an improvement in the trade balance. On the other hand, capital flows are not likely to be as favorable as in 1968, even with relatively taut credit conditions here.

The problems of restoring international payments equilibrium are truly international problems. It has been recognized more and more widely that better international balance requires positive actions by countries in surplus as well as by those in deficit. For our part, whatever else we or any other country may be doing, one absolute essential is to check the inflation in this country and to make a start in restoring a healthy and lasting surplus in our trade with the rest of the world.

Much of the burden of accomplishing the containment of domestic demand pressures this year will rest on monetary policy, for even with continuation of the 10-percent surcharge into fiscal year 1970, fiscal policy is scheduled to become less restrictive after midyear. Completion of the retroactive tax payments on 1968 liabilities, the increase in pay scheduled for Federal workers, and the rise indicated in the January budget for other Federal expenditure programs will reduce the budget surplus substantially in the second half of the year, and at the same time increase the flow of incomes available for spending. A sharp upturn in consumer spending would be likely to rekindle business incentives to acquire additional inventories and to add further to plant capacity. With pressures for additional housing still strong, and the spending requirements of State and local governments continuing to mount, the stage would be set for a strong resurgence in overall demand.

Whether such a surge in demand will in fact occur cannot be predicted with any assurance, but it would be foolhardly to increase the risk by adding the fuel of easy credit. In the hope that it will be useful to your committee, I am attaching to my statement a projection, prepared by the Board's staff, of the monetary and credit conditions that would be consistent with progress toward achieving the objective of reducing inflationary pressures. The progress envisioned would necessarily be gradual, for an effort to disinflate abruptly, after so extended a period of cumulating inflationary pressures, would risk wrenching the economy sharply, with major dislocations in employment and in the structure of production. The state of the economic art does not, of course, permit precision—or too much confidence—in such projection exercises, but they are useful in describing the general financial environment that would be appropriate in light of prospective private and public resource demands.

As I noted in my opening remarks, I am optimistic about the prospects for gradual success of the stabilization policies now in force, if we have the fortitude and patience to give them time to work. It is essential for us to do so; at stake is not only the opportunity of restoring a stronger base for equilibrium in our international payments situation, but also of restoring a sound base for continued domestic growth.

Mr. Chairman, I have attached the staff projections.

Chairman Patman. It may be inserted here, Mr. Chairman.

(The document referred to follows:)

STAFF PROJECTION OF ECONOMIC AND FINANCIAL DEVELOPMENTS IN 1969

DIVISION OF RESEARCH AND STATISTICS, DIVISION OF INTERNATIONAL FINANCE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

February 25, 1969.

ECONOMIC BACKGROUND

A moderation in the pace of economic expansion began to be evident late in 1968, and has continued into 1969, largely as a result of the fiscal restraint measures adopted in the middle of last year. In real terms, economic growth diminished to less than a 4 per cent annual rate in the fourth quarter, compared with 5 per cent in the third and 6 per cent or more in the first half. In current dollars the diminution in the growth rate of Gross National Product was not as large, however, as average prices rose somewhat faster late in the year.

The slower pace of economic expansion late in 1968 was accompanied by a change in the structure of GNP growth. The rise in final sales (GNP expenditures other than for inventories) dropped from an annual rate of 10 per cent in the third quarter to just over 6 per cent in the fourth, and inventory investment contributed substantially more to the GNP increase in the 4th quarter than in the third.

In retrospect, it appears that failure of the economy to respond more promptly to the enactment of the Revenue and Expenditure Control Act reflected a temporary willingness of consumers to maintain unusually high rates of spending in the face of markedly reduced growth of disposable income during the summer. As a consequence, while the effects of cutbacks in some categories of Federal expenditures began to be felt shortly after midyear, the effect of the tax increase was blunted by one of the sharpest quarterly increases of recent years in consumer spending relative to disposable income. Total consumer purchases in the third quarter rose at a 10 per cent annual rate, and this spurt appears to have been a significant factor in the subsequent upward revision of planned expenditures by business for plant capacity and inventories.

It is now clear that the rate of growth in consumer spending in the fourth quarter dropped abruptly to just over a 4 per cent annual rate. Retail sales, in fact, began to drift downward after reaching a peak in August of last year. January sales picked up from the sluggish December pace, but not quite enough to regain the November level. Among the major elements of consumer spending, unit auto purchases have shown the most significant weakness, with the annual sales rate for domestically produced cars, including Canadian imports, dropping from a high of 9 million units in October to about 8¼ million in January. Moreover, sales of nondurable goods have also eased somewhat since last August.

Business investment in inventories, however, advanced considerably in the fourth quarter, to a $10½ billion annual rate, partly reflecting this distinct slowdown in the growth of consumer purchases. There is no clear evidence that businesses, in the aggregate, regard themselves as heavily burdened with excessive stocks. But it does appear that some downward adjustments have occurred in production schedules for autos and other consumer lines in response to recent inventory-sales developments.

An economic projection for 1969 must take into account, therefore, the increasing evidence that fiscal restraint is working, though with a somewhat longer lag than the Board staff and most economists elsewhere had assumed. Moreover, the pressure of fiscal restraint will be intensified in the period just ahead. Federal purchases of goods and services are projected in the January Budget document to show no further advance in the first half of this calendar year, and the total of all Federal expenditures included in the national income accounts should register only very modest increases during this period. Federal receipts, meanwhile, will be increased sharply further by the rise in social security taxes in the first quarter and by retroactive payments on 1968 income tax liabilities in both the first and second quarters. The Federal budget on a national income accounts basis will thus be moving to a significant surplus in the months immediately ahead.

With Federal purchases leveling out and the growth of disposable income and consumer spending tempered by increased tax payments, a further slowing in the overall pace of economic expansion seems highly probable in the first half of 1969. The rate of business inventory accumulation may well taper off in the months ahead. Some recovery in consumer spending from the sluggish pace of the fourth quarter is to be expected, and the momentum of rising housing starts and increasing business expenditures for plant and equipment during the last half of 1968 is likely to carry forward into the opening months of this year. But our assessment of the economic climate on which our staff projection for 1969 is based starts with the premise that the fiscal restraints adopted last summer are working and, together with the intensification of monetary restraint since last fall, will slow the pace of expansion further in the first half of this year.

A second major element of the economic environment to be taken into account in developing a projection for 1969 is the climate of inflationary expectations that has developed over the past 3½ years. This long period of predominantly overheated conditions has quite clearly begun to affect private spending decisions. Since about the middle of last year, for example, plans for business fixed investment have strengthened measurably, despite relatively low rates of capacity utilization in manufacturing, as businesses have sought to find ways to hold down the pressure of rising costs on prices and profits. Housing starts, especially multi-family units, have also shown exceptional buoyancy. Interest rates as high as 7 per cent and over have not been enough to cause deferral of investment intentions in the climate of strongly inflationary expectations that has prevailed.

Excess demand in the domestic economy during this period has also spilled over into world markets. U.S. imports have risen very rapidly, and our trade surplus last year almost disappeared. Thus, balance of payments considerations reinforce the need to persevere with policies to combat domestic inflation.

As noted earlier, the expectation of a slowdown in the domestic economy during the current half year is predicated mainly on the belief that fiscal measures already adopted will become increasingly effective in restraining spending. After midyear, Federal expenditures—assuming they follow the path laid out in the January Budget—will be rising more briskly, and the completion of retroactive tax payments by individuals will give rise to more rapid growth in disposable income. Fiscal policy will become less restrictive in the second half of 1969. therefore, even if the tax surcharge is extended. The strength in markets for goods and services that could result, in an atmosphere of protracted inflation, could touch off a new spurt of business and consumer spending, with its inevitable effects on prices and costs. Should the surcharge be allowed to lapse, inflationary pressures could break out even more strongly in the latter half of this year.

It would seem apparent that the principal task of stabilization policies this year will be to ensure that significant progress is made in curbing the rate of inflation in the domestic economy, and that the initial steps are taken towards restoration of our traditional trade surplus. It will be especially important, if these results are to be accomplished, to adopt policies that prevent resumption of an excessively rapid pace of spending in the second half of the year, following the slower pace of advance expected in the first six months.

In our projection, therefore, we assume the surcharge will be extended, as recommended in the January Budget document, since without that extension the prospects of cooling off the economy appear dim indeed. We are also assuming that the projected pattern of Federal expenditures outlined in the January Budget will be realized. Of course, unforeseen developments in Vietnam or elsewhere could alter the outlook for defense spending radically, and stabilization policies will have to stand ready to alter course with any marked change in those outlays.

Policy Assumptions

The projections also assume a monetary policy of substantial—but not severe—restraint, dictated by the need for a steady pressure of stabilization policies to contain the strong inflationary pressures in the economy. The shift toward greater monetary restraint initiated last fall has already begun to have noticeable effects in financial markets. Growth rates of money and bank credit have declined from the rapid pace of the second half of 1968, while interest rates have risen well above their average 4th quarter levels. As the year progresses, credit restraint should become increasingly effective in moderating the pace of private spending.

The staff projection assumes that the growth rate of bank credit will be reduced from the 11 per cent rate of 1968 to a rate in the range of 4 to 7 per cent in 1969. The decline in credit expansion rates would reflect reduced growth in bank deposits, particularly a turnaround in large-denomination negotiable CD's, from a rapid expansion during 1968 to significant reduction in 1969. A decline in the growth rate of the narrowly-defined money stock (currency plus demand deposits) should also occur, in the financial market conditions arising from bank credit expansion at such a rate and the projected slower growth in GNP. We project a reduction in the growth rate of the money stock from the 6½ per cent rate of 1968 to a rate in the range of 3 to 6 per cent during 1969. The stance of policy assumed implies a somewhat higher growth rate of bank credit (on an end-of-month basis) than that which occurred in January and currently seems in prospect for February.

GNP Projection

Based on these fiscal and monetary policy assumptions, as Table 1 indicates. current dollar GNP for the year as a whole is projected to be in a range of $918 billion to $920 billion, which would mean an increase from 1968 of about $60 billion, or a little less, compared with a gain of $71 billion from 1967 to 1968.

Following the moderation that began in the latter half of last year, the reduced growth rate foreseen in this projection should be increasingly apparent in the first half of 1969. The most important factors in the anticipated cooling off during the first half are an expected leveling out and then a decline in inventory accumulation, and a marked shift of the Federal Budget into substantial surplus. Final sales during the first half of the year should continue to expand at about the reduced $14 billion rate of the fourth quarter of 1968, reflecting some increase in the growth of consumer spending from the exceptionally low fourth-quarter rate, continued though diminishing strength in business investment, and a topping out of housing starts in the first quarter. Real growth in the economy during the first six months is expected to drop a little more sharply than dollar expenditures, given the prospects for continued sizable price increases, and might average near a 2 per cent annual growth rate if our current dollar GNP projection is realized.

For the last half of the year, the course of GNP depends importantly on the assumption of continuing and increasingly effective monetary restraint. Although fiscal policy is scheduled in the Budget to become more stimulative around mid-year—even with continuation of the surcharge—we believe that quarterly GNP increases in current dollars during the second half might be held down to an average only a little higher than projected for the first half, given sufficint monetary restraint and continuation of the surcharge. Real growth in GNP also would be a little larger in the second half, as inflationary pressures diminish.

FEDERAL BUDGET OUTLOOK

The surplus in the Federal Budget, as measured in the national income accounts, should reach an annual rate of around $6 billion during the first half of 1969. But as expenditures increase and receipts level out after mid-year, this surplus may well disappear. Thus, the surplus for the calendar year as a whole is projected at around $2 billion to $3 billion.

A significant part of the projected growth of Federal expenditures is due to the rise in military and civilian pay on July 1, with the net increase estimated at $2.8 billion (annual rate). The January Budget calls for defense outlays, excluding the pay raise, to continue on a plateau, with reduction in Vietnam spending offset by increases on other military programs. Nondefense expenditures are scheduled in the Budget to rise somewhat in the last half of the year.

In contrast to the somewhat faster rise in Federal expenditures after mid-year, receipts are likely to rise sharply in the first half and then stay on a plateau during the last half, even though the surcharge is maintained. This reflects the completion of retroactive tax payments, together with the effect on tax receipts of the projected slowdown in the growth of personal income and some weakness in corporate profits.

DISPOSABLE INCOME AND CONSUMER SPENDING

The impact of the surtax on disposable income was appreciable in the last half of 1968, and gains in after-tax income should continue to be limited in the first half of this year as a result of the retroactive portion of the higher tax payments and the anticipated slowing in economic expansion. Therefore, we expect that growth in consumer expenditures will continue relatively moderate, despite the prospect of some acceleration from the small rise of $6 billion in the fourth quarter of 1968. Such an acceleration would require a decline in the rate of personal savings during the first half. That pattern does not seem unreasonable, assuming that the fourth quarter rise in the saving rate was due in part to special factors—such as the flu epidemic—and given the fact that the saving rate typically falls when a temporary slowdown occurs in the growth of disposable income.

In the second half of 1969, faster expansion in disposable income could again provide the potential for a renewed strong consumer buying. At that time, too, the effects in consumer markets of an abrupt change in income growth should be cushioned to a degree by a change in the saving rate. To hold expansion within bounds, however, we are depending importantly on continuation of the tax surcharge and the success of restrictive monetary policy in altering business expectations and spending decisions. If this restraint can be accomplished, slower growth of nonconsumption demands should act to offset the latent strength in consumer markets and to dampen aggregate demands.

HOUSING

Higher mortgage interest rates, a slackening in the flow of loanable funds through banks and other depositary institutions, and an anticipated curtailment in the volume of new mortgage commitments should limit housing starts this year. The drop in starts in December was followed by a large rise in January, as this series continues to display large erratic movements. As the year progresses, however, we expect the policies of monetary restraint in train since late last year to begin registering their effects on housing starts and residential construction expenditures. By the second half, the annual rate of housing starts may drop somewhat from recent high levels, but the monetary policy assumptions underlying the projection suggest a much more moderate decline than in 1966, when the financial crunch reduced housing starts by a third. For the year as a whole, therefore, housing starts are projected to average around 1.5 million units, and the dollar volume of residential construction is expected to register a small rise from the 1968 level.

BUSINESS INVESTMENT

The current surge of investment in plant and equipment in the face of a relatively low rate of capacity utilization would appear to reflect considerable business optimism about the course of the economy in the near term. Expectations of future growth in sales, a concern about rapidly rising prices and the need to offset some of the increasing pressures from labor costs are likely to produce a continued uptrend in investment outlays. Considerable business optimism also is reflected in recent surveys of business plans to spend for new plant and equipment. Quarterly increases in business fixed investment are therefore expected to average somewhere around $2 billion during the first half—and would be larger but for an anticipated sharp decline in commercial construction and in investment by aircraft manufacturers. However, once manufacturing production begins to level off, declining capacity utilization rates and lower profit margins—together with credit restraint—should tend to dampen optimism. Although plant and equipment expenditures are projected to rise by roughly 10 per cent for the year as a whole, we anticipate a marked slowing in these expenditures as the year progresses, with little further dollar growth—and perhaps some decline in real terms—after midyear.

The staff's projection also takes an optimistic view about the prospects for cooling off investment in inventories, given our assumption that final demands will be held in check. Some dampening influence should result from the imbalances which already have developed between output and consumption. Exactly when the accumulation of stocks will begin to outrun businessmen's confidence in the prospects for higher sales and prices is problematical. By early spring, however, we think that downward production adjustments to temper the inventory buildup should become more general, so that, on average, the rate of inventory investment would decline in the first half. If growth in final demands is kept to a moderate pace in the second half, the rate of inventory accumulation may decline somewhat further, especially in view of the greater cost and difficulty of holding large stocks when funds are tight.

RESOURCE UTILIZATION

If growth of real output moderates in line with the projection to a range of 2 to 3 per cent in 1969, pressures on both physical and manpower resources should gradually abate. As Table 2 shows, the rate of capacity utilization in manufacturing is expected to fall from 84.5 per cent in 1968 to a range around 82 per cent in 1969, reflecting both the slowing of growth in industrial production and continuing large additions to manufacturing capacity. At the same time, employment gains are likely to fall short of prospective net additions to the labor force. The adjustment is expected to occur mainly in manufacturing, where cutbacks in the length of the workweek may be followed by effects on employment once it becomes clear that prospects for further growth in product demand are less ebullient. The uptrend in employment in nonindustrial sectors will undoubtedly continue, but probably at a slower pace than in the last several years. As a result, the unemployment rate is projected to rise somewhat from the exceptionally low rate of 3.3 per cent in recent months, but the average is projected to stay under 4 per cent for the year as a whole.

Upward pressures on wage levels should abate somewhat in 1969 if the GNP projection is realized. Key factors here include a sharp reduction in the number of workers covered under collective bargaining agreements up for renegotiation this year, the smaller second- and third-year wage increases under earlier settlements, and the smaller and less pervasive increase in the minimum wage scheduled for this year. However, the effect on costs is likely to be offset in large part by a slowing in productivity gains as the rise in output moderates. As a consequence, the increase in unit labor costs could continue at close to the recent 4 per cent rate during the first half of 1969, and then edge down somewhat in the latter months of the year.

PRICES

With labor and other costs continuing to climb and business demands very strong, industrial prices recently have been moving up at a very fast pace. But if the slowing in growth in the economy indicated in our projections is achieved, the rise in industrial prices should moderate, especially in the latter part of the year after upward wage pressures ease and business expectations and spending plans have lost their steam. The sharp consumer price gains witnessed during most of last year also seem likely to moderate in 1969. Prospects are for some slowing in consumer products prices in response to smaller increases in industrial prices, although service prices seem certain to continue climbing at a fast pace—perhaps around a 6 per cent annual rate—for some time to come.

On balance, if we can continue to make headway in avoiding excessive rates of expansion in GNP, the rise in average prices should diminish as the year progresses. The projection implies a steady downward drift in the GNP implicit price deflator, adjusted for the third quarter Federal pay raise, towards something around a 3 per cent annual rate of increase in the closing months of 1969.

FINANCIAL PROJECTION

The GNP projection just described, together with the assumptions about fiscal and monetary policies on which it rests, imply a significant reduction in the rate of total credit expansion this year, with the total volume of funds raised declining from about $100 billion in 1968 to a range of $75 to $80 billion in 1969, as Table 3 indicates. We are in the process of experiencing a substantial swing in Federal borrowing requirements, from an annual borrowing rate of over $15 billion in the last half of '68 to debt repayment at around a $2 billion annual rate this half year.s Federal borrowing—measured to include the borrowing of Federal agencies as well as the Treasury—should pick up again in the second half, however, to register an annual total in the $2 billion to $3 billion range, substantially less than in 1968.

PRIVATE BORROWING

Borrowing by the private domestic nonfinancial sectors (business, consumers, and State and local governments) is also expected to recede a little in 1969. This is a reflection partly of the assumed effects of monetary restraint in reducing the degree to which expenditures are financed by credit, but the projected slower pace of economic activity resulting from both monetary and fiscal restraints will also help to reduce private credit expansion.

The projected effects of monetary restraint on private credit expansion are perhaps best illustrated by considering the volume of borrowing by consumers and businesses, and the relation of borrowing to projected net investment in these two sectors (shown at the bottom of Table 3). Total borrowing by these two sectors together is projected to decline in 1969, despite continued high demands for credit. For example, even though the rate of inventory investment is projected to drop, business needs for external financing will be sustained in the first half by large tax payments and further growth in plant outlays, at a time when profits are projected to be squeezed.

But the very essence of monetary restraint is to prevent some credit demands from being satisfied. Given the degree of restraint assumed, businesses and consumers should have to dig further into their liquid assets to realize spending plans, and—more importantly—to trim these plans in areas heavily dependent on credit availability. The ratio of borrowing to net investment is projected to fall below 90 percent, compared with 96 percent for 1968.

BANK CREDIT EXPANSION

This decline in private credit expansion, like the maintenance of a more moderate pace of GNP growth during the latter half of 1969, is predicated on the assumption that monetary restraint is maintained during most of 1969. Based on our judgments of the relations between financial variables and rates of GNP expenditure, we believe the GNP projection—and its financial counterpart in terms of total funds raised—could be realized if bank credit growth were limited to an annual rate in the 4 to 7 percent range. At this projected growth rate, the banking system would be supplying from about one-fifth to about one-third of total funds raised during 1969, compared with two-fifths or more during each of the past two years.

TIME AND SAVINGS DEPOSITS

In the banking system, the effect of restraint on the growth of deposits seems to us likely to show up mainly in time and savings accounts, rather than in demand balances and the money stock, as Table 4 indicates. Much of the expected reduction in growth rates of time deposits relates to the projected outlook for large-denomination negotiable CD's. The rise in rates of interest on competing short-term money market instruments late last year, together with the existing Regulation Q ceiling rates that banks may offer to attract time deposits, have made it very difficult for banks to roll over maturing CD's since early December 1968. Consequently, the total volume of large CD's issued began to decline after mid-December, and fell $2.3 billion in the first six weeks of the year.

Our projection assumes that monetary conditions will remain taut enough to keep large banks under pressure in the CD market. It also assumes, however, that attrition of CD's will diminish from the very high rates of January and February; rates of decline that large would not be consistent with growth rates of bank credit in the 4 to 7 per cent range projected for the year as a whole.

The projection also implies some reduction in growth rates of time and savings deposits held by households. Given prospective interest rate relationships, we are projecting that households will divert a larger share of their savings flows into market securities. The annual growth rate of household time and savings deposits at commercial banks is projected to decline to a range of about 8 to 10 per cent—less than the rate in the latter half of 1968.

NONBANK SAVINGS ACCOUNTS

This divergence of household savings flows from depositary claims to market securities is likely to affect nonbank intermediaries also. Inflows to these institutions were curbed in December and January, and we project them to stay at a reduced pace of about 5 per cent, only a little above the amounts that would result from interest crediting. The reduction in flows projected, however, is much less severe than in 1966.

MONEY STOCK

We do expect that, in addition to affecting time and savings deposits at banks and nonbank intermediaries, the tighter monetary conditions assumed in this projection will produce some slowing in the rate of expansion of the narrowly defined money stock (currency and demand deposits). Interest rates are high enough now to induce some further economization of cash; additionally, the moderation of GNP growth is projected to hold down the rise in transactions demand for money. The overall monetary policy projected seems consistent with an annual rate of expansion in the money stock in the 3 to 6 per cent range.

EFFECTS ON CREDIT MARKETS

At the reduced growth rates of deposits projected, both banks and nonbank intermediaries will find themselves under pressure to reduce the availability of credit to private borrowers.

This restraint on funds flowing through the major depositary institutions is the principal factor underlying the projected decline in the rate of private credit expansion relative to spending mentioned earlier, and the trimming of expenditures on goods and services that is essential to moderate the rate of expansion in GNP during the second half.

While some of the impact of reduced credit availability will inevitably be felt by the mortgage market, and consequently by the residential building sector, other markets for loanable funds would also likely be affected by the restrictive credit policy assumed here. With limited supplies of funds available because of the reduced rate of growth in their time and savings deposits, banks would presumably cut back on new investment in municipal securities; last year they took roughly 80 per cent of the net increase in such debt. The projected diversion of household savings flows into market securities will help to fill the gap left by the banking system's reduced purchases, but we also are projecting some moderation in the total of new issues during 1969, in response to the reduced availability of funds. More importantly, the posture of monetary policy assumed in this projection implies that banks will have to intensify significantly further their rationing of credit to businesses and other customers as the year proceeds. This is expected to impel businesses to turn increasingly to market financing, and we are projecting a rise in corporate security issues to about one-fifth to one-fourth above the 1968 level. Such an increase in the supply of new issues would presumably raise the cost of capital financing to large businesses which, together with the intensified rationing by banks, would help to moderate the course of business spending for fixed investment and inventories.

Balance of Payments

The gradual cooling off of demand pressures projected for the domestic economy should have helpful implications for the external balance of payments, since it would be accompanied by changes in the structure of receipts and payments in the right direction for getting nearer to a sustainable equilibrium. Last year some of the capital inflows that contributed to our overall balance-of-payments surplus were clearly at unsustainable rates. While net capital inflows in the year ahead will probably not be as large as last year's, the slowdown in the pace of domestic expansion should bring some improvement in the goods and services account.

Statistical indexes of export unit values for the United States, Germany, and Japan clearly illustrate the need for a persistent effort to check the deterioration that has been going on since 1965 in our costs and prices compared with those of some of our dynamic rivals in world trade. But positive benefits for the balance of trade from improvement in price relationships cannot be quickly achieved. The significance for the 1969 balance of payments of the assumption of a gradual slowing of price inflation lies mainly in the assurance it provides against a further worsening of the trade balance and against any general weakening of confidence in the dollar as a key currency and reserve currency.

Improvement in the trade balance in 1969 would result from continuing export expansion and a slowing of the rise in U.S. demand for imports. On the export side, it seems likely that continental European economic activity will continue to rise strongly this year, so that growth of world demand may bring an advance in the value of U.S. merchandise exports by 9 or 10 per cent ($3 billion annual rate in round terms). Over the past several years U.S. nonagricultural exports have risen about in line with total world exports of manufacturers, and our percentage share has not changed significantly. This performance is creditable so far as it goes, though in the light of apparent U.S. propensities to import goods and invest abroad it seems to be inadequate.

While the strongly rising trend in U.S. imports—a major element in the world payments disequilibrium—cannot be quickly modified by cost and price developments, last year's import swing above trend should be followed by a dip below trend this year, as happened in the first three quarters of 1967 when growth of domestic demand slowed that year. The rise in merchandise imports in 1969 will probably be somewhat more than $1 billion. Taking exports and imports together, the merchandise trade surplus for the year 1969 might approach $2 billion, compared with about $100 million last year.

When we add in flows of services, investment income, and military expenditures abroad, net exports of goods and services may be around $4 billion this year, about double last year's net exports. While growth in payments for transportation may be below normal in a year of slow import expansion, and while a renewed acceleration in receipts from foreign travel in the United States may occur, these and other services will not contribute much on balance to the improvement. Interest payments to foreigners will be larger, offsetting much of the gain in investment income receipts. As for military expenditures abroad, they are projected as leveling off now, and then dipping slightly later this year, but on the other side of the account military export sales also are passing their peak.

Outflows of U.S. private capital last year were apparently near $5 billion, including the investment abroad of funds obtained through long-term borrowings abroad by U.S.-based companies. The net outflow of U.S. funds after deducting such borrowings was perhaps not much over $2 billion in 1968. This net outflow is projected to be greater in 1969, despite the assumed continuance of credit restraint in the United States and the probability that financial conditions abroad will not restrict seriously the ability of U.S. businesses to sell securities abroad or to obtain credit from banks in Europe. The main reason for expecting a larger net outflow is that last year's heavy borrowings abroad by U.S. companies built up a large target leeway under the direct investment controls, and it is assumed that some of this leeway will now be used. Furthermore, there will probably not be the net reflow of bank credit we saw in 1968.

We assume, however, that the domestic credit restraint that is needed to bring inflation under control will help to prevent a resumption of the trends shown in earlier years toward much greater outflows of U.S. private capital. For example, corporations will still be encouraged to do some borrowing abroad.

For foreign private capital, exclusive of the flow of liquid funds to the United States through commercial banks abroad, the inflow last year apparently amounted to about $6 billion if bond issues sold in Europe and bank loans obtained in Europe by U.S. companies for direct investment financing are included, and about $3½ billion if these are netted out against U.S. capital outflows. In 1969 the corresponding net inflow could be smaller, but any projection would be subject to much uncertainty. While inflows are influenced by relative financial market conditions, they also depend very heavily on factors other than interest rates. First, over $2 billion of last year's inflow was to acquire U.S. stocks and to make direct investments here. A large inflow into U.S. equities is expected again in 1969, but its magnitude is uncertain. Second, something like $1 billion of last year's private capital inflow was apparently in such miscellaneous accounts as commercial credit, advance payments for aircraft, and foreign working balances in the United States.

After taking account of transactions in goods and services, Government loans and grants, other unilateral transfers, and all private capital flows other than flows of liquid funds to the United States through commercial banks abroad, there was a negative balance last year of somewhat under $2 billion. That was more than covered by about $3½ billion of liquid funds from U.S. bank branches and other commercial banks abroad, so that on the official settlements basis the balance of payments showed a surplus of $1.7 billion.

It is difficult to foresee at present whether the adverse balance in the accounts mentioned above will be larger or smaller than $2 billion in 1969. The projected improvement on current account would make it smaller, while the probable shifts in flows of private capital (apart from liquid funds through banks) would make it larger. But in any event the inflow of funds through U.S. bank branches and foreign banks is not likely to be as large as last year's $3½ billion, in view of the very high interest rates U.S. banks are now having to pay to attract fresh funds into the Euro-dollar market out of assets in other currencies. Thus a surplus on the official settlements basis is rather unlikely in 1969. It is quite possible, however, that the over-all deficit to be settled by using U.S. reserve assets or by increasing U.S. liabilities to foreign monetary authorities may be small.

Given the assumptions we are making about the U.S. economy and conditions abroad, the U.S. balance of payments in 1969 is not likely to give rise to acute difficulties. As noted earlier, the prospective improvement in the goods and services account is a change in the right direction. But we have a long way to go, since this year our net exports get the benefit of a favorable cyclical conjuncture here and abroad; because capital controls, hoped to be temporary, are still in force; and because interest rate relationships are more favorable now for the U.S. balance of payments than they may become later.

Policy Problems in 1969

From a purely technical viewpoint, the monetary policy assumed in this projection could be difficult to achieve. The projection of bank deposit and credit growth depends importantly on the maintenance of the appropriate degree of restraint exerted on the larger banks in the banking system, a restraint consistent with a continued gradual decline in outstanding CD's as 1969 progresses, but at rate more moderate than the steep descent of January and early February. This will not be easy to accomplish. The response of banks and potential holders of CD's to fluctuations in the spread between market rates and CD ceilings is neither smooth nor easily predictable; at times a shade of difference can trigger large inflows to or outflows from banks. It may be necessary to vary the intensity of restraint on bank reserve positions from time to time in order to keep the degree of tautness needed, if this projection is to be realized.

Given the high degree of sensitivity that exists among banks and depositors to changing differential rates of return on market securities and bank deposits, there may well be periods of time in which actual rates of growth of bank credit, time deposits, and the money stock are outside their projected ranges. Nonetheless, if the general direction of policy is maintained along the course outlined, its effect should be increasingly observed in all credit markets.

The more important substantive issue to which we must be alert in 1969 is the possibility that the course of credit restraint projected here, even if realized, may not produce the GNP expenditure patterns that we presently are projecting. The relationships between financial variables and GNP expenditures are not fixed; our economic and financial history indicates very clearly that there are wide variations in relative rates of growth of GNP and money or bank credit, and in the relationship of GNP expenditures to interest rates. Our judgmental projections could well have overestimated the potency of monetary factors in slowing down the rate of expansion in GNP—especially at the present time, when inflationary expectations are strong. On the other hand, the course of monetary policy assumed here could entail greater effects on GNP growth than envisaged in the staff projection. Monetary policy must remain flexible, and policy makers alert to the actual course of developments as the year progresses.

Finally, it seem appropriate to note that the staff GNP projection, if realized, would result in economic conditions that are still a long way from being fully satisfactory. For example, it seems quite clear that we cannot, and should not, hope to restore fully our traditional trade surplus in one year. The costs both at home and abroad of such an abrupt change in our international trade position would be too great. Also, price inflation seems likely to plague us for quite some time, even if the real economic growth rate is reduced during 1969 in line with the projection, and some slack begins to develop in markets for resources. Yet, the declining rates of resource utilization projected for 1969 are evidence that even this modest step in the movement toward a noninflationary economy will not be without its costs. The momentum of inflationary pressures is so great that efforts to accomplish a more rapid return to reasonable price stability could result in a much heavier toll in real output and employment. The gradual cooling off of demand pressures embodied in the projection, however, is an essential first step in the longer-term task of halting inflation and assuring a sustainable rate of economic expansion.

TABLE 1.—1969 PROJECTION OF GNP AND RELATED ITEMS

[In billions of dollars]

	Annual totals		Annual changes	
	1968	Projected, 1969	1968	Projected, 1969
GNP, current dollar	860.6	918–920	70.9	58–60
Personal construction expenses	533.8	567–569	41.6	33–39
Gross private domestic investment	127.7	135–137	13.4	7–5
Residential construction	29.9	30–32	5.3	1–2
Business fixed inventory	90.0	98–100	6.4	8–10
Inventories	7.7	5–7	1.6	−3–−1
Net exports	2.0	3.5–4.5	−2.8	1–2
Government purchases	197.2	210–212	18.8	13–15
Federal	100.0	103	9.4	3
State and local	97.2	107–109	9.4	10–12
Personal income	685.8	735–737	57.0	49–51
Disposable personal income	589.0	622–624	42.7	33–35
Corporate profits before tax	[1] 92.3	89–92	[1] 10.7	−3–0
Total Federal expenses, NIA basis	182.2	192	18.6	10
Total Federal receipts, NIA basis	176.9	194–195	25.7	17–18
Surplus (+) or deficit (−)	−5.3	2–3	7.1	7–8

[1] Based on estimate for the 4th quarter of 1968.

TABLE 2.—REAL GROWTH, RESOURCE USE, AND PRICES

	1968	Projected 1969
Percentage growth of GNP in constant (1958) dollars	5.0	2.0–3.0
GNP implicit price deflator, annual percentage change	3.8	[1] 3.1–3.5
Total labor force	82.3	83.5–84.0
Armed Forces	3.5	3.5
Civilian labor force	78.7	80.0–80.5
Unemployment rate	3.6	3.8–4.0
Capacity utilization in manufacturing	84.5	81.5–82.5

[1] Excluding effects of the Federal pay raise in the 3d quarter.

TABLE 3.—FUNDS RAISED IN CREDIT MARKETS

[In billions of dollars]

	1968	Projected 1969
Total, all nonfinancial borrowers	97.5	75–80
Federal Government [1]	16.9	3–4
Foreign borrowers	3.0	2–3
Private domestic nonfinancial sectors	77.7	70–75
Loans	29.7	24–27
Consumer credit	11.0	6–8
Bank loans	12.7	9–12
Other loans	6.0	7–9
Securities	22.7	23–26
State and local	10.0	8–10
Corporate	12.7	15–17
Mortgages	25.3	22–24
Consumer and business borrowing included in private domestic nonfinancial sectors:		
Total	67.4	62–65
Percent of net investment	96.0	86–90

[1] Includes agency issues and participation certificates. Home loan banks, land banks, and FNMA are consolidated with other Government agencies in this table, which departs in this respect from new budget concepts. Table includes net issues by these agencies but excludes interagency transactions.

TABLE 4.—BANKING AND MONETARY VARIABLES—ANNUAL PERCENTAGE RATES OF CHANGE

	1968	Projected, 1969
Total reserves [1]	7.2	3.0–5.0
Money supply	6.5	3.0–6.0
Currency	7.4	5.0–6.0
Demand deposits	6.2	3.0–6.0
Time deposits at commercial banks	11.3	1.0–5.0
Total bank credit	11.0	4.0–7.0
Nonbank savings accounts	6.4	4.5–5.5

[1] Adjusted for reserve requirement changes.

Note: Data for reserves, money supply, and time deposits at commercial banks are on a daily average basis. Bank credit and nonbank savings accounts are on an end-of-month basis.

Mr. MARTIN. I would like to add that I think we are engaged in a very exciting and very constructive effort to disinflate without deflating. There are a great many pessimists who think that this can't be done. And we certainly have had what I call a heritage of error over the last 3 years, so that it is going to be difficult to damped down these fires of inflationary psychology that have developed. But I for one am not a pessimist who thinks that the only way this can end is in a bust.

I think if we move intelligently and constructively as we are trying to do, recognizing that we have made some mistakes, then we can disinflate without deflating. And this is our purpose in our program. And I for one am hopeful that it can be achieved.

Chairman PATMAN. Thank you very much, Mr. Martin. Your statement was very interesting, as always.

Senator Sparkman?

Senator SPARKMAN. I am going to have to leave to go to the Banking and Currency Committee to confirm two appointees at 10:30. I want to express my appreciation to Mr. Martin for his very clear and succinct statement.

I am glad to hear you end on that note—I don't know whether I should say optimism or antipessimism. You think we can work it out with the tools that we have?

Mr. MARTIN. If we have the patience and use our tools I think we can disinflate without deflating. This has never been done before too successfully. So I think we are in pioneer territory in one sense. But I am optimistic that it can be achieved.

Senator SPARKMAN. I certainly hope it can.

There is just one question that I want to ask, if the chairman will permit.

Chairman PATMAN. Go ahead.

Senator SPARKMAN. Over in the staff projection I notice that it is stated that housing starts will top out—I think that is the expression used—in the first quarter of 1969. I am just curious to know, why do you predict a time after the first quarter? If they can stand the gaff that the first quarter directs, why can't they do it after?

Mr. MARTIN. Would you mind if I asked Mr. Brill, who worked on this projection, to give you his thinking on this?

Senator SPARKMAN. I shall be glad to hear Mr. Brill.

Mr. BRILL. Senator, these are projections, and as such have to be regarded as simply judgments of what might be occurring. I think the anticipation we had of an acceleration in housing starts earlier in the year has been confirmed so far by the January figures, which moved up very sharply. This might well be a result of anticipation by builders that housing funds might get less ample later in the year, and therefore would attempt to move in rapidly while the funds are available. But given the flow of funds to the major housing financing institutions, it would seem likely that inflows of funds would get somewhat less ample as the year went on, and that the rate of house starts might decline from what is an exceptionally high level earlier in the year. That is the thinking that lay behind the estimates.

Senator SPARKMAN. Of course, they were unusually high at the beginning of the year, there is no question about that. But it has been pretty freely predicted that we would have an increase in housing starts this year by probably 100,000 units, from 1,500,000 to 1,600,000. Does that go along with your projection?

Mr. BRILL. For the year as a whole, sir, I think we are estimating that the level of starts would be roughly about the same as last year under the general fiscal and monetary conditions that underlie the projection.

There would be about 1,500,000 for the year.

Senator SPARKMAN. I just want to throw in this thought. I hope the matter will be more fully developed in the hearings this morning, because I consider the housing industry to be one of the most important in this country, not only because we need the homes, and we need them badly, but also because of the economic impact that it has. And I want to express the hope that the housing will not be caught in the crunch this year as it has been, as it was in 1966, for instance, and as it has been at various times in the past. It seems always that it and small business together take an unjust share of the adverse impact.

Thank you very much.

Thank you, Mr. Chairman.

Mr. MARTIN. Before you leave, Senator, let me just say that the construction costs, of course, bear very heavily on housing, and that is one of the reasons why we have got to stop this inflation.

Senator SPARKMAN. That is one of the problems we are studying in our committee right now.

Thank you.

Chairman PATMAN. Mr. Martin, how long have you been Chairman of the Federal Reserve Board?

Mr. MARTIN. It will be 18 years on the 1st of April, if I survive that long.

Chairman PATMAN. That is longer than any other Chairman has served, is it not?

Mr. MARTIN. That is longer than any other Chairman.

Chairman PATMAN. Well, we have some good documented evidence of how your administration compares with the administration before, which I want to present.

Now, I know the newspapers and the bankers' lobby and many others insist that there is a vendetta, that I am after you.

Mr. MARTIN. I have never accepted that thesis.

Chairman PATMAN. I know you have not said that. And it is not true. I have no personal interest in this at all regarding you or any member of the Board. I don't charge any of you with dishonesty or corruption or anything that is bad. You have a right to your opinion and I have a right to mine. What I do charge the Board with is that it has been guilty of nonfeasance, misfeasance, and malfeasance.

Now, the question is: What is best for the public interest? And that is what I have tried to serve. Maybe I haven't served it as well as other people could have in the same position that I have been in, but I have done my very best to serve the public interest with no selfish motive at all. And I feel that you intend to do the same thing.

Now, we have an illustration here that I want to invite your attention to, Mr. Martin. And if I fail to get through the questioning—it will come back to me as we go around a second time—of course, you will be given plenty of opportunity to answer. But in the event that you don't answer fully you may enlarge upon your remarks, expand upon them to insert any germane material that you desire to, sir.

Mr. MARTIN. Thank you.

Chairman PATMAN. Now, from the years 1939 just approaching World War II, when we were getting ready in our preparedness program, from 1939 to 1952, in fact up into 1953, the Government never paid more than 2½ percent interest on long-term Government bonds. And that was done at a time that was the worst time in history, and sometimes the most inflationary time in history. We had tens of millions of people in the breadlines and unemployed part of the time. We had the stress of hunger, and even starvation during that time. Other times we had so much money in circulation, so much money chasing so few goods, that inflation was considered a problem that would be ruinous unless we were able to counter it. And part of that time we were shooting away on the battlefield, $250 million a day.

So you couldn't have a rougher time in history than in those 14 years. Yet with the Federal Reserve Board working with the administration in power in the public interest, just the public interest alone, interest rates on long-term bonds were kept down to 2½ percent and below.

Now, of course that enabled all other interest rates to be held down. By financing the interest rate on the large national debt you can fix all interest rates clear across the board.

Now, let's take the next 14 years after Mr. William McChesney Martin came in in 1951—I believe it was about March 1, wasn't it, Mr. Martin?

Mr. MARTIN. That is correct.

Chairman PATMAN. Now, let's take the next 14 years, from 1953 to 1966 inclusive—the 1967 and 1968 years are even worse, of course. I am not charging that this is political, in that both major parties were guilty of not doing what I consider to be in the public interest during this time. Now, from 1953 to 1966 the interest rates commenced jumping up. When Mr. Eisenhower first came in the first bond issue was 2⅜ percent long term. It went over with a bang. The next was 2½ percent. It went over, no question. Then Mr. Humphrey, Secretary of the Treasury, I well remember, issued a sale of bonds at an arbitrary rate of 3 percent.

I accused him of doing it solely for the purpose of raising interest rates. He never did deny that in the committee that I was on. So that started increased interest rates.

It got so bad in May that you had a reaction, and we had to go back some. We almost had a depression right there in good times.

The average rate during those years was 4.65, as contrasted with an average rate under two and a half, an average rate of 2.36 in the first 14 years. During the second 14 years the average rate was 3.65. So that was a substantial increase.

The bill rates, of course, are more sensational. In the first 14 years the yield was an average of 0.6, whereas the average during the last 14 years was 2.7. It comes to about five times as much.

Now, the fact is that during those 14 years, Mr. Martin, the increase in interest rates compared with the 14 years before that was so high that the public and private debt both—not one, but both—had an increase of over $14 billion a year every year. The total is well over $200 million.

Now, if those interest rates had not been increased, our national debt today would probably be insignificant. We should have some national debt for many purposes, as you know. But it would be insignificant in comparison to our present debt. And the truth is that we are paying this year $16 billion interest on our national debt—just the interest, none of the principal.

Now, if we were paying according to that first 14 years instead of the last 14 years, we would only be paying $8 billion. So we can point out an $8 billion saving right there. My point is, if you can do it the first 14 years, you could have done it the last 14 years.

The truth is, whether you intended to do it or not, Mr. Chairman—I am not impugning your motives, your honesty or anything else, but you have been the most costly public official in the history of the world. I consider those billions and billions of dollars to be excessive interest charges, exorbitant charges, because they could have been less if the Board during the last 14 years had been working in the public interest just like the Board was working in the public interest during the first 14 years.

I want you to consider those figures and consider the fact that this country must be saved from high interest rates. You know, every year—I don't really know, possibly some time you have raised interest rates not because you wanted to fight inflation, but it seems to me that every year you raised interest rates you gave "fighting inflation" as your reason. Well, of course, while you are fighting inflation all these years, Mr. Martin, our interest rate has gone up on long-term bonds as much as 250 percent. And we are paying twice as much interest now on the national debt as we would have been paying.

The net result, regardless of your intention, has been disastrous to the people. And today we don't have enough housing. We have a program goal of 26 million houses in the next 10 years, and we can't even get started on it because of excessive, extortionate rates, and I hope that the Board under your leadership will take remedial action. When do you expect to go out?

Mr. MARTIN. I can assure you I will leave on February 1, 1970.

Chairman PATMAN. Of course, I am not saying anything about that, except that the 14-year term is supposed to be a life term—considered as a life term, when it was instituted.

Mr. MARTIN. I have thought of that.

Chairman PATMAN. A member serving his whole term can't be reappointed, and he can't go in the banking business for 2 years after that.

Of course, there are some gimmicks that have changed this somewhat. We have had members serving 30 years. You have served 18 years, yet the term is supposed to be 14 years. There is one way that you could continue to serve. If some member were to resign, or there should be a vacancy, or an unexpired term, and you could resign your present position and take the vacancy.

You wouldn't have anything like that in mind, would you?

Mr. MARTIN. I have been sitting up nights thinking about it.

Chairman PATMAN. That is the only way that you could stay on, Mr. Martin.

And without questioning your motives or anything else, I say that your record is terrible. And I expect to get back to it when time permits me to do it.

Mr. Brock?

Representative BROCK. Thank you, Mr. Chairman.

Mr. Martin, I think—in order to assure a bipartisan flavor to the meeting—that you have been the finest Federal Reserve Chairman that this country has ever had. And I am delighted with your record and sense of integrity and responsibility.

I would like to talk in specific terms a little bit about the ramifications of monetary policy, or at least ramifications of the projection you make in terms of monetary policy. You mentioned that after the tax increase, the surcharge, was proposed, the Fed acted perhaps overly hasty in relieving monetary pressure and restraint. First, I would like your comment on whether or not you think this relaxation delayed the impact of fiscal restraint which was then proposed for a period of 2 or 3 months beyond what it would have normally taken, or whether the situation would have occurred under any circumstances, and we would have the continuation of consumer demand through August and the reaction on the part of the business community in the sense of developing inventory accumulation and capital expenditures.

Mr. MARTIN. That is a very difficult question to answer categorically. It might have occurred anyhow. But I think the accommodating stance of the Federal Reserve did make it easier for consumers and business to continue. And I think in retrospect there is no question that we would have been wiser not to make the discount rate adjustment and not have been as accommodating as we were during that period.

Let me just develop that a little bit, if I may, by saying that I mentioned earlier that we were dealing with what I call the heritage of errors. And we were at least 18 months late in our tax increase. And during the period when I was up here and other places trying to bring to the attention of everyone the seriousness of the budgetary deficit that had developed, we perhaps pursued an easier monetary policy than was warranted in the hope that at any point we were going to get less stimulative fiscal policy to supplement it. Early in September of 1967 we seriously considered shifting toward monetary restraint. But we were before the Ways and Means Committee—Mr. Conable will remember that very well—on the tax question at the time, and we were hopeful that we were going to get some tax increase, some fiscal restraint as a supplement, so that we delayed. If we had known that the surtax would not take effect until late in 1968 we would have moved considerably earlier.

So we had a long period of waiting. Now, during this period this momentum of inflation built up in such a way that when we finally got the bill—and it was signed on June 28 of last year—the pressures on the money market didn't diminish as we had expected because consumers were willing to draw on their savings with the expectation that if they didn't buy something today it would cost more tomorrow.

Representative BROCK. I think you know that I felt very strongly in 1966 that we needed the fiscal restraint of a surcharge at that time. We didn't achieve it. And we did go through the chaos. But what worries me now is that it seems like most action is taken by the Government, with the possible exception of some current expenditures in public works, perhaps most actions that we take at the policy level in fiscal monetary policy have a lag time before application.

The economy—I am not sure that we are being very accurate when we think that the economy takes that long. I am not so sure that the economy doesn't react a whole lot faster than the Government does.

Now, what concerns me at this particular time was your comment where you say "whether such a surge in demand will in fact occur cannot be predicted with any assurance, but it would be foolhardy to increase the risk by adding the fuel of easy credit." By no definition can we call the present situation an easy credit situation.

Mr. MARTIN. That is correct.

Representative BROCK. With interest rates 8 to 9 percent it is not easy, it is fairly painful.

It seems to me that we may be again getting into a situation where we are behind the economy. I think the economy is already slowing measurably. I think we can already see significant signs of a good deal more general public restraint than we have at the Federal level. I wonder really, if we are going to talk about continuing the surtax—and all the testimony that we have had indicates support for that premise or position—if we are going to talk about continuation of the surcharge—and I am not sure that it would be necessary myself a couple of months down the road; it may be at this date, but I am not sure how I will feel in 60 days—then I question whether or not a continuation of real restraint is warranted in monetary policy. And I would like your comment on that. Because it seems to me that we may again be just over the hump, and additional pressures on both fiscal and monetary policy might upset the situation into something we wouldn't like.

Mr. MARTIN. Well, you have posed the problem that the Board is wrestling with. And it is a very difficult one for us to know how to solve, except to move with it. But we have to recognize the fact that a credibility gap has developed over our capacity and willingness to maintain restraint. Starting in 1967, when we were trying hard to get some tax retraint, we did ease money, and we did help pump the economy up shortly thereafter. Now we have been wrestling with this problem of overkill and underkill, and we have developed a lot of new words in this process. And I think all the dangers that you suggest are there, and we are very aware of it, having had the 1966 so-called money crunch and the Board, perhaps unwisely, at the time said we don't want a recurrence of that crunch.

We don't in that form. But we do want to stop the inflation and the difficult thing we have to deal with is psychology. This is the one thing that doesn't seem to be measurable in any way or form. And if you don't take some risk in policy you never get any result.

Over the last few years we have been unwilling to take any real risks at any time of any additional restraint. We have raised what I call in many instances the ghost of overkill at the first sign of a few clouds in the sky.

Representative BROCK. What worries me, though, is that so many of our policies taken at the Federal level can have selective impacts. For example, the 1966 impact on the credit sensitive industries, and particularly on homebuilding, of monetary policy exceeding the high restraint, and no fiscal response.

Mr. MARTIN. Right

Representative BROCK. Here we have a different situation. There is a great concern here, at least in the Congress, with the policy of restraint and its impact on jobs. We are talking—I think we have had projections of as much as 4½ percent, and some people are even predicting more. I am not sure that many people would like to tolerate that degree of unemployment. We are in a situation where we have passed the investment tax credit, so that you can have a real incentive for capital expansion when we are already down to 83 or 84 percent of productive capacity in terms of sales.

We really need to have additional encouragement for expansion of productive capacity. And high interest rates curtail the greater social and economic need in the area of homebuilding. For example, can't we balance our policies a little bit more? Wouldn't it be at least worthy of consideration to talk about the investment tax credit in this one area and couple it with a little bit more ease in the monetary area of specifically the degree of input into the money supply?

Mr. MARTIN. I don't want to be ducking your question, but you could almost write a book on that subject, because we are dealing with the technological advances that are being made. And when we talk about capacity we have to think about capacity that isn't obsolete or becoming obsolete very rapidly. And the moves in the last few years in this field have been very dramatic, as is evidenced by the issuance of an electronics stock at 10 and having it sell at 90 three months later.

Representative BROCK. I think we have been on the outside looking at that.

Mr. MARTIN. Yes. There have been some people on the inside looking at it.

Representative BROCK. If we were there maybe we would have a different attitude.

Mr. MARTIN. But I think we are in a period of transition; and we can't put hard and fast rules down, as much as we would like to do it.

But basically, we ought not to be talking about levels. One of the bad things about this discussion of unemployment is that everybody has gotten to talk about it as three and a half, four, four and a half, or five percent, without any reference to the people and the hard-core unemployed and the training they need. People begin to fix on these levels.

I happen to believe that if we follow a sound policy here, with the increase in the service industries, that you can dampen this inflation without increasing unemployment substantially. But what the level is I don't know. Or if you are talking about a situation where for 1 or 2 months the level is up, and then 3 months later it levels out, you are talking about another situation.

Representative BROCK. I fully agree. I think the reason we have any increase in unemployment would primarily fall under this policy in the manufacturing areas as opposed to other areas, because when you are talking about a 1-percent increase in national employment you may be talking about a 10-percent increase in manufacturing employment, which is a significant increase.

My time has expired. I thank you very much.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. Governor Martin, I want to thank you very much and congratulate you on your responsiveness to the questions of the committee of last June. These were very tough questions. And I think you have complied extremely well and have been very cooperative. I think that we are going to have the best relationship now between the Federal Reserve and the Congress that we have had ever, and a better understanding on our part of what you are doing, and a better appreciation perhaps on the part of the Federal Reserve on what Congress intends and what they do. I am referring in the first place to the response that you have given us in every quarter now on the relationship to our request that when the money supply increases at a rate of less than 2 percent, or more than 6 percent of the annual rate each quarter, you explain why.

You went much further than that, and I am glad you did. Our request was probably too limited. You go into other areas to explain the significance of the change. And it was very helpful. And these responses, while we have been critical of the substance of then, I think have helped us greatly.

Then in the second place we requested something that you were reluctant to provide, and very understandably. We pointed out that we had the President's Economic Report on Fiscal Policy and on many other economic policies, but no really authoritative monetary report from the monetary authority of our Government. And we thought that something of that kind would be useful to give us an understanding of what the financial world is likely to look like in the coming year, and what perhaps ought to be done about it.

Now, you have gone part way, and I think the way you have gone is very useful. The staff report you have appended to your report I think is an extremely useful and helpful analysis. It is specific, it is definite. You don't hide behind generalities, you tell us exactly what you expect.

However, I think it would be most helpful if you could consider—and I know you want to take some time to discuss this with other members of the board—making this the expression of the board and not just a staff study which seems to be an orphan, having no real support, but tossed out as something that we can look at. I think the sponsorship by the board of this study would give it an authority and force that it deserves.

You have fine economists there, and I think they are the experts that we must look to for advice on monetary policy.

Mr. MARTIN. We will consider that, Senator.

Senator PROXMIRE. I do hope you will. I think it would improve the situation.

Mr. MARTIN. Let me say for my part that your queries and your interest in this have been helpful to us in trying to examine this matter of the money supply and its relationship to the overall problem.

We have found it stimulating, and at times exasperating, because we don't have the answers. But I think that this is something that we must explore to the best of our ability in the academic area, and in the practical area, and see if we can't develop answers. And we will have to do some experimenting from time to time in this area.

Senator PROXMIRE. You indicated at the beginning of your statement that we are making progress in combating inflation. We may be making progress, but I feel to some extent that it is like the reports that we get from Vietnam every year, that we can see the light is at the end of the tunnel and we are about to win, and things like that. The most recent reports, I must say, on prices, interest rates, and balance of payments are very, very discouraging. We just got yesterday a report from the Commerce Department on what has happened to prices. As you know, in January the consumer prices went up 0.3, less than 3 percent. And that isn't so bad. But wholesale prices, the prices of the future, went up eight-tenths of 1 percent, the sharpest rise in 3 years, the sharpest rise in manufacturing prices since 1956, a rise that I think is most disturbing, and which suggests that we are going to be plagued with rising retail prices and consumer prices for some time.

Mr. MARTIN. I agree. And I think this is the major problem. I come back to the phrase that I like, the heritage of error. We have been involved in this.

Mr. Patman in his earlier rehearsal went back to the days of the pegged bond market. I remember them very well—I was Assistant Secretary of the Treasury at the time. There is very little question in retrospect that we continued to peg the Government bond market probably a year to a year and a half longer than we should.

And when we finally unpegged it, a great deal of damage had been done. And immediately, when I took over at the Fed, we had the problem of unraveling a Government bond market that was in a state of disarray.

And we had to sit down with the insurance companies and make an arrangement with them to put out a 2¾-percent convertible—and they converted in the neighborhood of $10 to $15 billion of them—or we wouldn't have been able to handle the market at all. And this was because of the pentup pressures resulting from the fact that we had delayed all during this period in letting the forces of the market operate. They finally became too big for us to continue the peg.

Now we have somewhat the same situation with respect to the delay in getting a tax increase, and the problems that you rightly stressed about Vietnam. Vietnam came in as a small cloud on the horizon, and became a storm before we were able to pull things into perspective. And we never did get the American people involved in the war in Vietnam—I am talking about it financially—in the way that I think they should be. We drafted men, but we didn't draft capital. And this has been the financial problem that has caused us our biggest problem.

Chairman PATMAN. Will the gentleman yield?

Senator PROXMIRE. Yes.

Chairman PATMAN. The 2¾-percent bonds you mentioned, Mr. Martin, they were nonnegotiable bonds, and in order to get your money on them you had to trade them for short-term securities and take a loss on both transactions. The meaningful rate of interest was less than 2½ percent.

Mr. MARTIN. Mr. Patman, that was—call it a device or whatever you want, but we were right up against the wall, and this was a means of saving face with respect to the 2½-percent rate. We gave 2¾ for it. It was a device—I called them for some time the "Rieflers," because the idea was developed by one of my associates, Win Reifler.

Chairman PATMAN. I know, but they were not negotiable bonds.

Mr. MARTIN. They were negotiable in the sense of anything else, they were convertible. And they were accepted by the insurance companies, who came in—if they hadn't been willing to take them we would really have had a holocaust.

Senator PROXMIRE. The point I was making is that it seems to me right now that it would be very hard to say that we are getting inflation under control. Or that we are getting them under control, or are making progress, when wholesale prices are acting as they are.

But in addition to that we had yesterday a report from a very reliable economist, B. R. Rinfret, who has made some studies of what the intentions are of industry to invest in plant and equipment the coming year. He says that the estimates have been far too low. The investments will be not a 7-percent increase, but a 13.8-percent increase, a fantastic increase on top of what we have already had.

And this, of course, will also be highly inflationary, and is the kind of thing that will have inflationary consequences for some period of time.

I notice that your own staff study indicates a 10-percent increase, which is more than we estimated to begin with. Putting those things together, it seems to me that it is hard for us to conclude that we are now making the kind of progress that we had hoped to make in the past.

Mr. MARTIN. I didn't intend to suggest that we had licked inflation——

Senator PROXMIRE. I know you didn't.

Mr. MARTIN. But I did say I think we are making progress. One evidence of it is that gradually there has been—Mr. Brock here, for example, took an opposite position from Mr. Rinfret in his estimate of what was going on.

Senator PROXMIRE. May I say that I am very skeptical about estimates, as I am sure you are, and as your economists have to be, in view of the experience they have had and all of us have had. But Mr. Rinfret's is based on getting in touch with the top executives of the big manufacturing companies around the country, who make a large share of investments, and in many cases he had to change his previous estimates.

I would like to ask you about this fact. In December of 1967 virtually all economists were saying that our real problem is to slow down the economy, to slow down the expansion. Now, since then it seems to me that the Federal Reserve Board has followed a policy of monetary expansion, not monetary restraint. And I base that on the analysis of a number of people. Roy Reierson, who we all recognize as a competent economist, a financial conservative, senior vice president and chief economist of the Bankers Trust Co., said that the Federal Reserve policy last year "had permitted record rates of expansion of bank credit."

The First National City Bank of New York said the same kind of thing, that they were strongly expansive throughout 1967.

The Federal Reserve Bank of St. Louis concluded that the money managers tended to push the economy ahead through 1968 or most of 1968.

The Federal Reserve Bank of New York—which rarely agrees, incidentally, I understand, with the St. Louis Federal Reserve Bank—said that "over the whole year the money supply and bank credit grew faster than it was desirable in the inflationary environment."

Isn't this a pretty solid and comprehensive indictment of the policies of your Board that they were too expansionary last year?

Mr. MARTIN. I have accepted that, Senator. I think that in retrospect there is no question that we were too expansive in the fall months of the year. And we gradually came to this conviction unanimously. We reversed ourselves. And we are doing our best to mop up. But we were too expansive. I don't think it was entirely due to that, however. I think again——

Senator PROXMIRE. Of course not. I wouldn't say that, and they don't either.

Mr. MARTIN. I wouldn't mean to suggest that.

Senator PROXMIRE. You apparently take the same position that Secretary of the Treasury Kennedy took, that we are going to have to persist in a policy of restraint throughout 1969, that we made a mistake in 1967—you seem to agree—in letting up when the economy slowed in the first half, and we shouldn't make that mistake again. Is that your view?

Mr. MARTIN. Yes. I think that persistent steady pressure is what is called for here, and that we must not relax prematurely. We must get this thing under control before relaxing.

Senator PROXMIRE. My time is up. I just want to say that, as I understand it, the real cutting test is likely to be in the third quarter of this year. There may be some slowdown, your staff analysis indicates, in the first half. In the third quarter for a number of reasons there is likely to be some little fiscal stimulus, and another stimulus to the economy which will put a burden on monetary restraint, and we have to be particularly careful then, is that correct?

Mr. MARTIN. It may be. But let me just emphasize this one thing that runs through all of my thinking at the present time, and that is that the most difficult thing for us to gage is psychology. It swings from one extreme to another. Here we have gone through this credibility gap experience, and you can turn the other way and have that swing to the point where people think that stabilization policies are just going to grind everybody to pulp. I have spent most of my life in this area, and I have gotten more and more humble about it as I have worked on it, because we do not have any means of gaging psychology, or what the forces are. It comes in waves at times. And it is generated by factors like war and threats of war. The reason I have frequently said that this can never be a coldly analytical science is that you are dealing with human choice. And human choice is awfully hard to measure. But leaving that out, I think your projection is all right.

Chairman PATMAN. Mr. Conable?

Representative CONABLE. Mr. Chairman, I would like to express great confidence in your service to this country as well.

I would like to ask you—I don't in any way want to exacerbate the longstanding mutual friendships that you and Chairman Patman have had, but I wonder if you would like to comment on the proposal to raise the ceiling on U.S. bond interest.

Mr. MARTIN. I think it is very important to raise the ceiling above the 4¼-percent level. I think it has cost the Government a great deal in recent years. A year ago when I was up before this committee I pointed out that the bill rate was something like 6.04 or 6.10, and in my judgment it would have been substantially lower if the Treasury had not been compelled to finance at the short end of the market. I think this is an outdated and outmoded problem for the Treasury. I think with current interest levels any sensible management of the Federal debt requires that the Treasury have more latitude than it presently has.

Representative CONABLE. Your situation on the monetary side is at least in part responsive to what happens on the fiscal side. And I am sure you agree that we have tended to emphasize on the fiscal side the necessity for the surtax and the question of whether or not it should be extended. Do you have any feelings about the 1970 budget in terms of the other aspects of fiscal restraint that will influence your actions as the chief monetary official of the Government?

Mr. MARTIN. The fiscal 1970 budget is what we are basing monetary policy on at the present time. And that includes a continuation of the 10-percent surtax.

Representative CONABLE. You are a member of the Quadriad—is that what it is called?

Mr. MARTIN. That is right.

Representative CONABLE. Are you taking any position there relative to action with respect to Government spending as it is represented in the 1970 budget?

Mr. MARTIN. Well, let me say for the Quadriad that it does not have an agenda. It meets with the President and discusses the problems generally, and doesn't cover the specific conclusions. I talk about monetary policy and its implications there, and the Director of the Budget talks about the budget and the problems that he has, to inform the President of what the general situation is. And we do not try to hammer out there a policy, but to keep the President informed of the way things are going, because it has to be kept fluid. We have only had one meeting with President Nixon, the new Quadriad, and it is far too early to do more than say that we are embarked on this program, which I find quite constructive, of trying to disinflate without deflating.

Representative CONABLE. You have expressed dismay with the length of time that it took to accomplish the fiscal restraints implicit in the passage of the surtax. But for the record, sir, I believe you were consistently during that entire period indicating a desire also that there be fiscal restraint on the spending side, is that not correct?

Mr. MARTIN. That is correct.

Representative CONABLE. And is it not true that this type of fiscal restraint has had a more direct and more obvious impact on the direction of the economy than the surtax has had?

Mr. MARTIN. Yes, I think that is probably true. The spending restraint that came in came in more rapidly than the tax. The full impact of the tax restraint is just beginning to be felt now. And the spending restraint, I think, was felt to some extent early in the third quarter and the fourth quarter more so than the tax.

Representative CONABLE. I have asked several people who appeared before this committee about capital spending projections. Whether you accept the figures that Senator Proxmire was quoting from the New York Times of 2 days ago, or whether you accept the general assessment that capital expenditures are going to be up perhaps 8 percent as opposed to 4.7 last year, how do you account for such growth when there seems to be elements in the economy that would indicate the kind of uncertainty that might not be expected to generate an accelerating capital expenditure.

Mr. MARTIN. I think it is entirely due to the pervasive inflationary psychology and the extent to which it has become embedded in people's thinking. I talked to a group of treasurers of medium sized companies not long ago. It seemed to me from their inventory position that they were not warranted in any additional plant expenditures. But almost to a man in this group I found that they were talking along these lines:

> There will be no halt in inflation. The new administration will come in, and they won't do anything about it. And it is perfectly obvious that the Fed is not going to permit money to get too tight, therefore, even though our inventories are backing up on us we had better get some additional plant here to take advantage of the inflation that is inevitable.

Now, under those circumstances I think, if that judgment were correct, why they were warranted in going ahead and spending it. But I think they will have a rude awakening if the inflation doesn't develop.

Representative CONABLE. Obviously psychology is a very large factor in the difficulties any government is going to have in fine tuning the economy, is it not?

Mr. MARTIN. That is right.

Representative CONABLE. Not just political psychology, but the psychology of the marketplace looms quite large in plans relating to capital expenditure and other items having a substantial impact on the money market and the economy in general.

Mr. MARTIN. That is right, there is no question about that.

Representative CONABLE. That is all, Mr. Chairman.

Chairman PATMAN. Mr. Bolling?

Representative BOLLING. Thank you, Mr. Chairman.

You, Mr. Chairman, said that Mr. Martin had been the most expensive public official I believe in the history of man.

Chairman PATMAN. The most costly.

Representative BOLLING. The most costly. And I would merely like to comment on it.

Putting in a little history, I became a member of this committee at about the same time that Mr. Martin became a member of the Federal Reserve Board. And I remember that my first active duty was as a member of the five-man subcommittee—the Patman subcommittee—which was reviewing the activity of the five-man subcommittee—the Douglas subcommittee—which had something to do with the accord that was mentioned earlier. And I had the rather unique opportunity of being the swing man on that subcommittee. Now, Mr. Patman and Ralph Flanders were on one side—Senator Flanders—and the unlikely combination of Senator Douglas and Jesse Wolcott were on the other.

And the result was that I had a rather major responsibility, because as a swing man I had something to say about what was in the report. And I came to a conclusion then that I have never had any reason to regret. And that was that while the system of the Federal Reserve might be a little expensive, it was in the long run very well worth it, because it was the only system that we had in our Government that gave at least a somewhat objective and neutral entity a right to have something to say about the quality of our money.

And you may have been expensive, sir, as a symbol of the Board, but I think you have been well worth the cost in the 18 years, and I think the system has been well worth the cost over the years.

That doesn't mean that I think you are perfect.

Mr. MARTIN. I understand, sir.

Representative BOLLING. But I think the proof of the efficacy of your efforts since you have been there for 18 years has been the fact that although we do have a serious inflation, and have had a serious inflation for some time, that we still remain the most remarkably affluent society in the history of man, with more of the good things of life going to more people than ever in any society in the history of man. And we have had a unique period, not of 18 years, but of all the postwar period from 1946 to date.

So I think that the gentleman deserves a compliment, and not the suggestion that he is the most expensive, or most costly, public servant of all time.

But the chairman and I have disagreed on this for almost 18 years.

Now, my own judgment is that the responsibility for the inflation is very clear. I think that the administration had some responsibility, because I favored publicly a tax increase in January of 1966. I think very clearly from about January of 1967 the Congress took over the full responsibility for the inflation. And I think our failure to function either on a tax increase or expenditure cuts—and I very much favor the tax increase as opposed to the expenditure cuts, because I think they would affect the programs that I think we are still going to have to expand if we are going to do anything about our social problem—I think the Congress clearly is responsible more than the Fed and more than the administraiton for the inflation we now experience. And I don't expect the gentleman to necessarily comment on that.

But I would like to ask some questions which imply some criticism, perhaps, of the composition of the Board. The Board has changed considerably, at least I read in the papers that it has, over the last 10 years. There have been a larger number of members whose background was economics, academic economics, or at least the field of economics, and a smaller number of members, if I understand it correctly, of people whose background was finance.

Would that be a fair statement? Or have I been misreading the papers?

Mr. MARTIN. Well, we have four professional economists of the seven now. And I think that is the largest number of professional economists the Board has had in modern times.

Representative BOLLING. The only question that is bothering me—and another one was raised yesterday that is bothering me—I don't know whether you care to comment, but it occurred to me 18 years ago, and it has occurred to me on occasion since, that it might not be a bad idea to have an even broader mix in the Board, that it might not be a bad idea to have people who were other than either people with fianancial backgrounds or backgrounds as professional economists, people who came from entirely different backgrounds.

Mr. MARTIN. Well, I think there is a lot to that. But you must remember, we have 262 directors at the 12 Reserve Banks and the 24 branches. If you look at our 262 directors, you will find that we have a good many college presidents and a good many people that have no real direct connection with money and finance. So we do get the benefit of their participation in the System.

Now, the problem in the Board is size. You know, the Commission on Money and Credit—and others have made studies on this—recommended five men rather than seven, and deletion of the statutory requirement of geographic distribution. And I believe that over a period of time we are going to have to take a good look at the Federal Reserve System, the 12 Reserve banks and the 24 branches, and their relationship to the Board, and whether we are getting the right mix. But it is a very long and prolonged and difficult study, Mr. Bolling, as you well know.

Representative BOLLING. I do know.

Yesterday, one of our witnesses, I believe it was Mr. Culbertson, indicated that he felt that we ought to eliminate the regional aspect of the Board. I didn't ask him to expand on it, and, frankly, I was confused on it. Would you comment on that?

Mr. MARTIN. The regional aspect is not the same as it was when the System started, because at that time you didn't have communications and transportation as we now have, and you could have a different discount rate in a different area, and have it prevail. Today, you can't have different discount rates very long. You can have it for a week or 10 days or so, in any one district. But I still think that there is an advantage in having regional Reserve banks, because each regional bank, its staff and its board of directors are concentrating on the problems of its particular area of the country, and particularly on economic development in that area of the country. And I think it is better to be decentralized rather than to have it centralized here in Washington.

Representative BOLLING. How does the interaction between the Board and the regions and the branches work, in a very oversimplified way?

Mr. MARTIN. Well, the Board has the authority today over virtually all aspects of the System. But the boards of the 12 Reserve banks can recommend a discount rate change to the Board. They join with us in selecting the president and the first vice president of each Reserve bank; they recommend them, and we have authority to approve or not. This is the interrelationship between us, you see.

We have a Federal Open Market Committee which meets every 3 or 4 weeks which consists of five of the 12 presidents of the Reserve banks, and the seven Board members. And there we discuss all aspects of System policy. It may be reserve requirements, where the authority belongs entirely with the Board, but, nevertheless, we ask the presidents of the Reserve banks for their views on it. And we discuss the sort of study that Governor Mitchell has made on the discount mechanism which he has unveiled for the Congress here, in which Senator Proxmire has taken an interest. We try to pull the System together in the Federal Open Market Committee.

Now, Mr. Patman has felt for some time that we ought not to have all of the 12 presidents there.

Chairman PATMAN. You ought not to have any of them.

Mr. MARTIN. He thinks we ought not to have any. But I have felt that there are great advantages in the regional system in getting this outside view. And also I think it is of value to have St. Louis and Kansas City, and the other districts, through their presidents, come in and give us their views, so that we may try to draw from those communities what the thinking is.

We have the authority to override them. But I have tried not to override them.

Representative BOLLING. You get a flow of information.

Mr. MARTIN. That we wouldn't have otherwise.

Representative BOLLING. Thank you, Mr. Chairman.

Thank you.

Chairman PATMAN. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Martin, I, too, welcome you before the committee. We always appreciate your testimony and strength and forthrightness, and it adds a lot to the record we are trying to compile.

It was just said and quoted that "your policy has made possible during the recent period a record rate of expansion of bank credit." If that were so, where did that bank credit go? It certainly didn't go to the homebuilding industry.

Mr. MARTIN. Some of it did.

Representative WIDNALL. It is not reflected in what you hear from the field. It is an availability of credit, where it is becoming tighter and tighter all the time. And many who have been in the mortgage business are out of it completely today. Don't you get records indicating that?

Mr. MARTIN. I have had relatively few reports as compared to the 1966 period of the nature that you are stating. But we are watching the availability and the cost of money very carefully here. We did have more bank credit expansion than I would have liked to see in the last 3 or 4 months of 1968. And that is why we turned around in December on our policy. We were up to a 12-percent increase in bank credit last year, and we are trying now to get down to the neighborhood of 5 to 7 percent.

Representative WIDNALL. I have heard of a memorandum being circulated among some banks saying no more credit for homebuilders, too risky today. Have you heard anything of this?

Mr. MARTIN. No, I haven't heard that. But that may be based on the cost escalation.

Representative WIDNALL. And too long term.

Mr. MARTIN. Too long term; yes.

Representative WIDNALL. I find an increasing problem as far as the homebuilders are concerned, particularly in my area, in getting any commitments with stability. And they don't know whether to go out of business completely or just what to do during this period. And some of these people have been in the business for 20 or 25 years, and they have had excellent credit all the way through.

And I am terribly bothered by the increase in inflated cost in that industry. Today, what has happened with lumber, plywood, and some other supplies—it is as though the Mafia has taken over and is extorting blackmail out of people, when prices go up 100 percent in 1 year. And I am sure you must be quite cognizant of what has been taking place. Congress is certainly going to get into this and do a job. And I hope it will be done on our side as well as the Senate, where they are starting an investigation at the present time. But we are just not going to be able to build the homes that are required for America with material costs going up and labor costs going up very materially, and everybody taking along the line. I would say that everybody is now building into their bids, or into their prices, a hedge against inflation of 15 to 20 percent, which is adding to and pyramiding the costs all the way through. And it is going to be a very serious strain on the economy. Do you get much of this?

Mr. MARTIN. Yes; we get quite a bit of this. And I am interested in one little project in which the builder told me he was figuring 1 percent a month increase during the life of the building in prices, in cost. And this is terrible.

Representative WIDNALL. If he has a stoppage in his credit, or any stoppages as far as labor is concerned, it adds up to more than 1 percent a month when he tries to get going again.

Mr. MARTIN. That is right; he is really caught.

Representative WIDNALL. Mr. Martin, there seems to be several factors, such as heavy loan demands, higher Eurodollar and Fed fund rates, and time deposit money, which could lead banks to raise their prime interest rate in the near future. The indications are, however, that they probably won't do it unless the Fed further restricts the credit market through a higher discount rate, higher reserve requirements, or the imposition of severe requirements for the Eurodollar. Do you anticipate employing any of these devices?

Mr. MARTIN. I can't predict on credit policy, Mr. Widnall. But what we have been doing since the new policy went into effect in December is letting the certificates of deposit run off. And as I indicated in my statement, with the six and a quarter ceiling being reached, they have run off to the extent of nearly $4 billion. I for one would have been a little bit frightened about such a large runoff so rapidly unless there was a safety valve. The safety valve has been the Eurodollar market. And about 50 percent of this runoff has been replaced by drawing funds out of the Eurodollar market at a price. Now, it is getting more and more difficult to get money out of the Eurodollar market, because the rates there are up 8¼ percent, and it is a pretty costly operation, and the funds are drying up. But this has been, from my point of view, a sort of Rube Goldberg device that has worked with the market operation.

As some of you may know, I have never been terribly enthusiastic about this ceiling operation as a means of keeping the savings and loans and the banks and others in a competitive relationship.

I think it breaks out at the seams from time to time. And this is one of the periods. But we have had the legislation, and we have worked effectively under it.

Now, I am avoiding your questions, because all of the things you are talking about we are considering constantly.

Representative WIDNALL. It was noticeably being avoided.

Mr. MARTIN. So I am telling you what we are doing at the present time. But we are very aware of the risk and the problems here. And the risks are always great in monetary policy. We don't want—and I think we have been criticized in some quarters for saying that we don't want—another money crunch such as we had in 1966. And some people said, if you don't want a money crunch, that means you don't mean business. Well, this is again that psychological point that I have been stressing here this morning, and what the market expectations are. We do mean business.

And the Board is unanimous today in meaning business. We don't think the sort of inflationary prices that Senator Proxmire has so well pointed out here—which certainly makes it look like we have some more to do before we really get this under control—we just don't think this can be tolerated. And we don't think that we can expect the dollar to have the position that it has in the world unless we get our house in better order than it is today.

For three and a half years we have been wrestling with this problem. Since the summer of 1965 we have been in trouble on this front.

Representative WIDNALL. The Federal Reserve Board announced in January that it planned to continue in 1969 the guidelines established in 1968 regarding foreign claims held by financial institutions in an effort to reduce the balance-of-payments deficit. Was the original target of the $500 million reduction reached?

Mr. MARTIN. Yes, it was reached, and a little more. We have been fairly successful on that program. I think we all hope that sometime we can dismantle some of these controls and depend more on fiscal and monetary policy to do it.

Representative WIDNALL. What is the target for 1969?

Mr. MARTIN. The ceiling remains where it was. And there is a little leeway left over from last year. So it is just the same at the moment. I am sure the administration has all of these programs under review.

Representative WIDNALL. What impact do you expect the guidelines to have on a long range basis?

Mr. MARTIN. Well, the guidelines are just designed to try to contain the deficit that we have had. And on a long range basis I think that what we are trying to do is to restore the trade balance that makes our dollar viable. You see, Mr. Widnall, last year or right now, the dollar is strong. It is strong for three reasons. It is strong because we got the tax increase and the expenditure reduction which the President signed on June 28, which is a prerequisite. If that hadn't been passed I think we would be in serious trouble, regardless of how effective it has been in the early stages. But this renewed faith in a good part of the Western World that the United States was going to be responsible.

And then we had two untoward incidents that have caused the flow of credit to this country. This started in the summer, but I think it accelerated from this. One was the problem that the French got into. And the other was the invasion of Czechoslovakia. As I have said on several occasions, a very outstanding investment counselor in Europe not long ago told me that every client he has, from the time of the invasion of Czechoslovakia, has been liquidating securities abroad and investing over here. And this was not hot money in the ordinary sense of the word, this was coming over here partly for a long-term haven, not only because of what they thought they would do in this market, but because it was a haven. Once Czechoslovakia was invaded the whole purview of Western Europe as far as investment was concerned was changed.

And with the problem that the French were in, we have had a pretty steady inflow of funds which have made our balance of payments at the end of the year look pretty good.

But this has nothing to do with our trade surplus. Our trade surplus has virtually disappeared. And this is the critical thing. And until we get this inflation under control I don't believe we are going to get the trade surplus rejuvenated.

Representative WIDNALL. What you are saying in effect is that we are really not complete masters of our own fate, and that outside influences such as European influences and their investments can have a marked effect on our own economy.

Mr. MARTIN. There is no question about it. We can't, any of us, be complete isolationists any more in the investment area.

Representative WIDNALL. Thank you, Mr. Chairman. My time is up.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Chairman Martin, I too have to sympathize with you. For years, particularly in the first half of this decade, you were excoriated by this committee for not creating enough money. And now you are criticized for creating too much. It is very difficult to win. But I know you are trying.

One of the reasons suggested for your admittedly poor performance in the last year or two, creating too much money——

Mr. MARTIN. I wouldn't say the last year or two; the last 6 months, let's say.

Representative REUSS. One of the reasons attributed for the over-creation of money and credit is the fact that the Fed has tried to be helpful to the Treasury; and when the Treasury is attempting a financing, the Fed creates new reserves, more than in its sound judgment it would otherwise have created, and thus ends up creating too great additions to the money supply. At least this was the point advanced by the Treasury. And I take it that you would agree that your kindliness toward the Treasury has deflected you from what you would otherwise have wanted to do as masters of our money.

Mr. MARTIN. Well, I wouldn't think that was an important factor, Mr. Reuss. I think that it has been a factor, of course. When you run a deficit of $25 billion on an administrative basis, there is constant pressure on the capital market. With a capital market of $70 billion, on the flow of funds basis, between the third quarter of 1966 and the third quarter of 1968 the amount taken by the Treasury rose from something like 10 percent to 25 percent of that market.

I have been amazed that interest rates haven't gone higher than they have.

Representative REUSS. Then you disagree with the criticism of Federal Open Market Committee policy made by President Darryl Francis of the Federal Reserve Bank of St. Louis in which he says "undue concern for the well-being of the Government securities market and the concept of even keel during Treasury financing are impediments to rational monetary management. For example, during the last 9 months of 1967 the Federal Open Market Committee imposed the even keel constraint more than half the time. In those periods the money stuck, grew at a 12-percent rate during Treasury financing, and at a 4-percent rate the remainder of the period. The result was an overall increase in money at a 7-percent rate, an excessive rate of increase in view of the mounting inflationary pressures."

Let me ask a couple of questions. I take it you agree that that 7-percent rate in the face of those inflationary pressures was not good performance by the Fed. But I can't understand your rejecting this excuse or explanation tendered by Mr. Francis. Didn't that have something to do with your excessive creation of money?

Mr. MARTIN. I have been trying to keep it on the broader perspective, Mr. Reuss, of the Treasury deficit. And this is the basic problem, the fact that in a period of affluence in this country—not that everybody is affluent, but there was great affluence—we had our budget deficit start at a relatively low figure and end up at $25.2 billion. And this is what created the pressure that made the Treasury come into the market. In the third quarter of last year, the Treasury took 8.4 billion out of that market. It is only now that the Treasury is getting to the point where it wants.

I agree with Darryl Francis' general point, if the Treasury hadn't had this deficit, we would have been in a much sounder position.

But I can't blame all of it on the even keel policy we have had in the Fed. We have had periods in between when we could operate and we have operated. And during even keel periods we haven't been just supporting the market ad infinitum, we have been trying during the period of Treasury financing to facilitate their efforts. But we haven't been creating money directly during that period for the Treasury.

Representative REUSS. Haven't you babied the Treasury a little too much? Suppose you told them that you weren't going to distort your monetary policy to accommodate them, and that they had better get busy and have a more rational debt management policy, not come to the market in such bunches, but instead try to even it out so that they didn't need your help. Wouldn't that give you an opportunity to avoid the creation of excessive money and credit?

Mr. MARTIN. This is a judgmental factor. And some people might think we have babied the Treasury too much. We have worked very closely with the Treasury, and I think we should.

Representative REUSS. Mr. Francis, the vice president for St. Louis thinks that you have babied the Treasury too much. I am persuaded by him. I don't know why the Treasury can't use less bunching. It is somewhat ironic that you, the negotiator of the "Great Accord" of 1951, designed to make the Fed independent of the Treasury, is resisting the suggestion that you should be independent and tend to your monetary business and not create inflationary amounts of new money, and that it is up to the Treasury to arrange its financing in a way that will require the least possible amount of intervention.

Mr. MARTIN. We keep the Treasury right on edge on this. I am not defending the Treasury, I am not defending the Fed, I am just enunciating the broad principle that the big culprit here is the size of the budget deficit that has had to be financed. And when you run up, in the period from 1965 through fiscal 1968, a period of prosperity, a budget deficit of $25 billion, you are making Government finances very, very difficult indeed.

Representative REUSS. Then for the period ahead, when large budget deficits and huge borrowings do not appear imminent, you would not anticipate that your Federal Reserve monetary policy would be hampered or hamstrung by Treasury refinancing?

Mr. MARTIN. No, I think it is going to be much easier from here on.

Representative REUSS. Let me now turn to the point you made about the extraordinary inflation in capital goods and equipment, which you attributed to inflationary psychology. There are no psychologists on the board, are there? There are four economists? Are there any graduate psychologists?

Mr. MARTIN. I don't believe we have a graduate psychologist on our staff.

Representative REUSS. Then this committee can approach you on an even keel.

I wonder if, in addition to psychology, a lot of the trouble in our capital goods overhead boom is not due to the 7-percent investment tax credit which works with the business cycle and causes inflation just when the boom gets moving, and whether that provision of our tax laws doesn't also absorb an awful lot of the Nation's savings and credit, and thus partially at least accounts for the terrible shortage of credit in the housing industry, and finally, if we shouldn't forthwith get rid of this incubus from our tax books. How do you feel about that?

Mr. MARTIN. Well, I think you know my view on this. I am sorry to have to disagree with you on that. I was one of those who believed that the investment tax credit should be a permanent part of our arsenal of incentives during a period when technological advance was as rapid as it is presently.

Because I think we have to modernize everything constantly—this is not my field, this is a matter for the Treasury—but you have asked me a question, and so I answer it on a personal basis, not any other. When the tax credit went in, I told Secretary Dillon that I thought it was a good provision, but it ought to be permanent, until we get to a period where it is clear that you are not having the technological advances that I think we are having at the present time.

Now, that is purely a matter of judgment, Mr. Reuss.

Representative REUSS. Thank you.

Chairman PATMAN. Senator Percy?

Senator PERCY. Mr. Martin, there probably isn't a voice in America that international bankers listen to more closely than yours. I wonder if I could ask you two questions—and I hope our friends abroad are listening to your answers. The first relates to your comment that our imports have increased substantially, and that our trade surplus virtually disappeared in 1968. I understand that Mr. Nixon had on his agenda in Brussels to discuss the proposed EEC internal tax on soybeans. Illinois is the largest exporter of soybean meal and oil.

I have heard discussions already that if the EEC tax goes into effect it would be equivalent to a tariff of up to 50 percent. It would severely hurt our exports at a time when we are trying to increase exports. The United States then would probably retaliate by slapping a quota on steel, or maybe shoes and other products, and I am sure that the EEC would retaliate by putting quotas on other items. Would you have a word of advice for this country as well as for our friends abroad on the consequence of now starting to talk seriously about imposing restrictions on trade after agonizing for 25 years on how to bring tariffs down?

Mr. MARTIN. I think it is the road backward. I am essentially a free trader. I believe in the long run that we will all be better off by a constant reduction of tariffs. And I think that both in Europe and here that any tariff—any quotas or anything of that sort—is a step backward, and will end in a lower standard of living for all of us before we get through.

Senator PERCY. I agree wholeheartedly, and I am sure that many members of this committee do.

In your testimony you mention that "it has been recognized more and more widely that better international balance requires positive action by countries in surplus as well as those in deficit." I went over to represent the Senate in November as an alternate delegate to NATO in Brussels. I was on the economic committee. I proposed to them there that this system that we now have where there are large deficit countries in terms of NATO expenditures, and also large surplus countries—Germany, Belgium and Italy are surplus, the United Kingdom, Canada, and the United States are deficit countries—the United States to the extent of three-quarters of a billion dollars a year—imperils our mutual security if we continue to have this kind of an imbalance.

And to expect us to go hat in hand every year to the Germans after begging them to buy bonds—which I thought were fairly long term bonds, but I am horrified to find that they are 4½-year bonds, which will all become due in this administration—is a very short term solution. And it is politically infeasible for the German Government to continue to do it. I proposed the creation of a central bank where expenditures for mutual defense would not create deficit or surplus. The bank would buy long term and sell long term bonds each year automatically and we wouldn't have to go through this negotiating process. This proposal was adopted by the parliamentary conference. The NATO ministers adopted the principle in their report. I wonder if this would be something that you would feel should have a high priority to be worked out this year as a means of moving ahead in a very large area of balance of the payments which finds us in a deficit position on that one account.

Mr. MARTIN. I would have to study the specific proposal. But I am in complete agreement with you that we can't have a persistent surplus on one side and a persistent deficit on the other. But we have got to have a better adjustment process to level this out. And the problems have changed since the Marshall plan came into being, when we did such an amazing job of making it possible for Europe to recoup its reserve position, as well as its ability to earn its own way. That time is long past, and now there is an equal responsibility on the part of the surplus countries to do their share of pulling this together.

Now, the hope, I think, of our international payments mechanism and our international financial community is that we will build up enlightened cooperation between all of these parties to see that this adjustment process works.

Take the gold exchange standard. The gold exchange standard can't survive if the people who are using it assume no responsibility for it whatever, and just take whatever they think they need without any responsibility for the system as a whole.

One thing that has developed in recent years which is, I think, worthwhile, has been the cooperation between the central banks. And gradually now we are getting to the point where I can call my counterparts and they can call me, and we are getting so that we have a rapport that when anybody is in trouble we are all moving on it right away. They may be in trouble because of their own fault, and that they must correct. But they must get help during the time they are correcting it. This is the only way that this system can work.

Senator PERCY. It is my observation that there are a lot of loopholes that can be plugged in this balance-of-payments problem, and we ought to go after those vigorously now.

Mr. MARTIN. There is no question of it.

Senator PERCY. I would like to ask you about inflation. Your statement had a note of optimism that we are starting to see a solution. And yet 2 days ago a group of academic economists forecast an inflation ranging from 3½ to 4 percent this year, and unemployment anywhere from 3.6 to 4.5 percent. Do you essentially disagree with these forecasts?

Mr. MARTIN. Well, I have avoided making any forecasts per se. But I think that if we move intelligently and persistently along the course we are pursuing, we can, to use the phrase I have repeated over and over here, disinflate without deflating. Now that is something that hasn't been achieved to date. But it is a worthwhile opportunity for us to put our heads together and see if we can't make it work. And I have referred here to what I call the heritage of error since the summer of 1965—not that the economy has collapsed, but that inflation has gotten an overall toehold on everything. In the light of that, we are not going to be able to eliminate inflation overnight. And we have got to be very careful to not overreact or underreact. It is a balancing problem for those of us who are in responsible positions. And it is very difficult in this psychological field where, as I mentioned earlier, we have had quite a credibility gap as to whether we meant business at the Federal Reserve.

Now suddenly if people would turn around and say not only do they mean business but they are going to grind us to pulp, you have got a psychology problem the other way. This is one of the major difficulties that we face and we have got to be very careful about this. In correcting what has happened over the last few years we must not get carried away with suddenly overreacting. And at the same time we have got to take some risk if the policy is going to work. If we were to assume automatically that restraint is overkill, and so we were not going to do anything, we wouldn't make any progress.

When you have had a budget deficit of this size and you get the turnaround that we now have, you have set in motion forces that have to be very carefully weighed and evaluated.

Senator PERCY. One problem of overreacting or underreacting is that we have an inertia here in Congress that prevents us from acting sometimes.

Mr. MARTIN. From acting at all.

Senator PERCY. A lot of us felt strongly that we ought to have a tax increase long before it finally came, and budget cuts long before they finally came. Yesterday it was suggested by several academic economists that the Congress give the President authority to raise or lower taxes within certain limits, subject to congressional veto. Would you favor this, as enabling us to act more swiftly?

Mr. MARTIN. Well, after the experience of the last couple of years I have been attracted to the idea, but I am not sure I want to espouse it.

Senator PERCY. Is that a yes or a no?

Mr. MARTIN. That is a roll. I can see the desire of the Congress to retain this authority, and it might be a good thing if they could speed up their ability to act. But in the absence of their speeding up their ability to act, if we are going to use fiscal policy, something like that has got to occur.

For years taxation was looked on as something for revenue only. And then we suddenly turned around now, and you don't think about revenue as paying your bills at all, you only think about when you are retarding or expanding your economy. And there must be some middle ground.

Senator PERCY. Thank you, Mr. Chairman.

Chairman PATMAN. Mr. Martin, you said something about the Federal Reserve means business; in other words, you are playing for keeps about disinflating without deflating—is that your phrase?

Mr. MARTIN. That is right.

Chairman PATMAN. That sounds like a good phrase, but unless you can document it some way, saying how you are going to do it, it seems you are just going off on another chase, a wild goose chase maybe. I hope you are not. But we are spending now from $14 to $20 billion in interest. In other words, that much money is being siphoned off from the middle-income group principally and the poor people. Now if that keeps on going on—that is excessive, extortionate, in many instances usurious interest—we are going to have the kind of depression that Mr. Humphrey, Secretary of the Treasury under Mr. Eisenhower in his first administration, predicted.

He said we had to raise interest rates higher and higher, otherwise we would have a depression that would curl your hair. Of course, I didn't agree with Mr. Humphrey. But I do agree with those who say that if you don't change your course and make interest rates lower and lower, we are going to have a real depression in this country.

We can't avoid it. People can't pay these bills, they just can't do it. They can't buy homes. They can't pay their installment purchases. And there is where the pinch comes first, when the interest rate is so high that the people who owe so much in installment purchases have to elect whether they are going to feed their children or pay the excessive exorbitant interest charges.

Of course, they are going to feed their children. And that means they are going to have bankruptcies, and they are going to have everything that comes along when the depression hits them. And it hits the poorest people first.

So I hope you are really considering that. Because this is a serious matter, I think, in our country.

The question was mentioned about the Open Market Committee. I think it is the most important part of the Federal Reserve System. Don't you agree with that?

Mr. MARTIN. Yes; I think it is very important.

Chairman PATMAN. It is the most important part. You know, we had an ad hoc report that we put in the record in 1954 when Mr. Flanders was chairman of the subcommittee that I am normally chairman of. That ad hoc report was an investigation by the members of the Federal Reserve Board themselves on what the Open Market Committee could do. And in that ad hoc report it was decided that a member of the Open Market Committee had no obligation except to himself and to God. He owed no obligation to the country or anybody else. He could act independently of everybody.

And that was the feeling. Now, of course, if you are going to have that, you have five people on that Open Market Committee that represent the banks of this country—like in New York, where the president of the bank, the president of the Federal Reserve Bank in New York is selected by the nine directors. Of those nine directors, six are selected by the private banks themselves, two of them by the big banks, and three of them selected by the Board. But in the law they must be men of tested banking experience. So you have nine bankers on that board in New York. And they select their president to represent them. And he comes down here and is a permanent member of the Open Market Committee. He is the only one except the seven members of the Board. He is a permanent member. The others alternate. Five bankers are in those secret sessions you have down there in that Federal Reserve Board, with all the windows and doors barred, and no way for anybody to know anything about what is going on, or why you make those decisions, just those seven and five. And five of them have a rusty ax to grind. They are representing the biggest bankers of this Nation. I don't see how you could insist that people that are obligated to the banks themselves, and are responsible to nobody but themselves and God, should have that kind of power to influence the interest rates in this country.

But that is going on, and it is secretly done. And we don't know anything about it. We don't know a lot of things about it. But that is one thing we ought to know something about.

Now, I got from your office the other day a report that the amount of interest collected by the Federal Reserve last year was $2.2 billion. Is that about correct, to your knowledge?

Mr. MARTIN. That is about right.

Chairman PATMAN. That is $53 billion, or $51½ billion now, of U.S. Government bonds, that you bought. The Federal Reserve doesn't want to go to Congress to get its money to operate—all the other more Government agencies do, and that is the only way that the people's representatives, representatives who are elected by the people, have any voice in such organization. You were determined not to go there, and you didn't go. But you began to acquire bonds, a million or 2 million worth, by taking Federal Reserve notes from the Bureau of Engraving and Printing and trading for those bonds, which in effect cancelled the bonds, because you are paying them off. In theory the fiscal agent of the Government is supposed to look after the interest of the Government. Therefore you shouldn't take a Government obligation that is money, currency, and trade it for an interest bearing obligation and not cancel the interest bearing obligation. That is having two obligations out on one debt. That would be inflationary to the amount of $51½ billion. That would be terrible. But on that you are getting $2.2 billion. You can spend that money any way you want to, can't you?

The rest of it goes back into the Treasury, isn't that correct?

Mr. MARTIN. That is right; it goes back to the Treasury.

Chairman PATMAN. That is right. You can spend it for any purpose you want to. I don't know of any place in the world where any agency had a $2 billion budget without restrictions or limitations of any kind, and no audits—you have refused to let the General Accounting Office audit your books. And normally you think that somebody has something to hide when they don't submit to an audit. But you have refused to do that. There is much confusion in Congress as to whether or not you should have had an audit—it has never been passed on directly. But Mr. Mills said last year that he would be glad to vote for it, because he said your budget ought to be audited.

And I think people generally feel that way about it.

Now, $2.2 billion, that is a big budget. No restrictions, no limitations. And you can pay any debt you want to with it, do anything with it you want to.

Now, I have asked you about this, and I have got your thoughts on this. You spend your money for different things—and some of them are ridiculous—but most ridiculous it seems to me is paying dues to the American Bankers Association, the biggest lobby in the United States, which has the most money, and is the most effective—they brag about this. The ABA is quoted as saying that they didn't used to have the power, but now members are afraid of them.

And you contribute to that lobby, $100,000 a year of taxpayers' money that would go into the Treasury were it not intercepted by you and paid as dues to the American Bankers Association lobby.

Now, that makes you a dues-paying, card-carrying member of a vicious lobby that you are supposed to supervise and do something about, and make sure that it is not dishonest.

Now, among the things that you paid part of this money for are employees parties and recreational activities, and employee magazine, annual dances, retirement dinners and gifts, fees for use of recreational facilities, baseball games, et cetera, miscellaneous luncheons and dinners, employees, directors, guests, open house, registration fees for conventions, conferences, employee educational benefits, courses at the American Institute of Banking, attendance at school of banking evening classes and nonbanking related subjects, costs of textbooks, tuition, transportation, cafeteria subsidies, retirement systems, membership dues in various banking and nonbanking associations, the American Institute of Banking, the ABA, and Chambers of Commerce all over the Nation. You are making generous contributions to Chambers of Commerce all over the Nation, travel expenses to conventions and conferences—you are spending money for anything in the world. And it is about a quarter of a billion dollars a year. That's the best estimate I have; it is more than that, isn't it? How much is it that you spend before it is turned over to the Treasury?

Mr. MARTIN. I haven't got the exact figure—$242 million current expenses.

Chairman PATMAN. I will place in the record these tables that I have here.

(The documents referred to follow:)

Comparison of interest rates—14-year period from 1939 to 1952, compared with 14-year period from 1953 to 1966

I. YIELDS ON LONG-TERM GOVERNMENT BONDS, 1939 TO PRESENT

[Percent per annum]

Years	Yield	Years	Yield
1939	2.36	1957	3.47
1940	2.21	1958	3.43
1941	1.95	1959	4.08
1942	2.46	1960	4.02
1943	2.47	1961	3.90
1944	2.48	1962	3.95
1945	2.37	1963	4.00
1946	2.19	1964	4.15
1947	2.25	1965	4.12
1948	2.44	1966	4.65
1949	2.31	1967	4.85
1950	2.32	1968	5.26
1951	2.57		
1952	2.68		
1953	2.94	Average for 14-year period (1939–52)	2.36
1954	2.56		
1955	2.84	Average for 14-year period (1953–66)	3.65
1956	3.08		

II. AVERAGE ANNUAL YIELD ON 91-DAY TREASURY BILLS, 1939–60

Year	Yield	Year	Yield
1939	0.023	1953	1.931
1940	.014	1954	.953
1941	.103	1955	1.753
1942	.326	1956	2.658
1943	.373	1957	3.267
1944	.375	1958	1.839
1945	.375	1959	3.405
1946	.375	1960	2.928
1947	.594	1961	2.378
1948	1.040	1962	2.778
1949	1.102	1963	3.157
1950	1.218	1964	3.549
1951	1.552	1965	3.954
1952	1.766	1966	4.811
Average yield (14-year period)	.645	Average yield (14-year period)	2.797

EXCESS INTEREST ON PRIVATE AND PUBLIC DEBT, 1951–66: $211,700,000,000

TABLE I.—NET PUBLIC AND PRIVATE DEBT, TOTAL INTEREST PAID, AND AVERAGE RATE OF INTEREST IN THE UNITED STATES, 1951–66

Year 1	Total debt (billions) 2	Interest paid (billions) 3	Computed average interest paid (3÷2) 4	Interest costs figured at 1951 computed rate 5
1951	$524.0	$17.0	3.397	$17.8
1952	555.2	19.7	3.548	18.9
1953	586.5	21.9	3.734	19.9
1954	612.0	23.7	3.873	20.8
1955	672.3	26.0	3.867	22.8
1956	707.5	29.8	4.212	24.0
1957	738.9	34.0	4.601	25.1
1958	782.6	36.0	4.600	26.6
1959	846.2	40.8	4.821	28.7
1960	890.2	45.7	4.134	30.2
1961	947.7	48.4	5.107	32.2
1962	1,019.3	53.4	5.238	34.6
1963	1,096.9	59.8	5.452	37.3
1964	1,174.3	66.5	5,663	39.9
1965	1,270.3	74.0	5.825	43.2
1966 (estimated)	1,368.3	82.7	6.044	46.5
Total		680.2		468.5

Note.—See the following table:

	Billions
Total col. 3	$680.2
Less total col. 5	—468.5
Excess cost	211.7

Source: Economic Report of the President, 1967.

Note: These figures through 1966. Obviously excess interest is well over the $211,700,000,000 listed here.

FEDERAL RESERVE CONTRIBUTIONS TO BANKING ASSOCIATIONS

1966—$94,000 contributed to American Bankers Association and various state and local banking associations.

Complete figures not available for 1967, but estimates indicate the total contributions were about $98,000.

The Federal Reserve has not furnished any figures for 1968.

(Summary of dues and contributions follows:)

SUMMARY OF MEMBERSHIP DUES AND CONTRIBUTIONS PAID TO BANKING ORGANIZATIONS BY THE FEDERAL RESERVE BANKS AND BRANCHES, JAN. 1, 1961, THROUGH DEC. 31, 1967

Banking organization	Year 1961	1962	1963	1964	1965	1966	1967 [1] (estimated)
American Bankers Association	$13,713	$17,892	$18,246	$18,246	$18,246	$13,246	$19,112
American Institute of Banking, including local chapters (the educational section of the American Bankers Association)	42,262	44,189	43,148	42,083	42,566	41,121	43,045
State bankers associations (all States except Delaware, Hawaii, and Mississippi)	20,734	21,159	21,997	21,208	21,792	22,227	23,265
Local bankers associations, clubs, groups, and conferences	490	670	655	665	605	430	453
Independent Bankers Association	50	125	75		75	75	79
Association of Agricultural Bankers	10	10		5	5	15	16
National Association of Bank Women, including local groups	191	191	183	203	200	226	236
Association of Chicago Bank Women	20	20	20	20	20	20	20
Houston Bank Women's Club	5						
NABAC, the Association for Bank Audit, Control & Operation, including local chapters and conferences	9,585	5,371	5,383	6,510	6,451	6,480	6,781
Chicago Bank Auditors Conference	25						
Robert Morris Associates, including local chapters (association of commercial bank credit men and loan officers)	4,409	4,401	4,865	4,879	4,891	4,870	5,098
Bank Credit Associates of New York (association of credit men representing about 60 banks in the New York area)	14	12	12	12	12	12	13
Bank Public Relations & Marketing Association (formerly Financial Public Relations Association)	400	300	300	200	200	284	295
San Francisco Clearing House Association (for expense of 1961 American Bankers Association Convention in San Francisco)		200					
Total, 12 Federal Reserve banks (including branches)	91,909	94,540	94,884	94,031	95,063	94,006	98,412

[1] The breakdown of individual amounts for 1967 is based upon the actual 1967 "membership dues and contributions" total expenses apportioned in the ratio of category expenses to total expenses for 1966.

Mr. MARTIN. I can respond to all this in a written answer.

Chairman PATMAN. Yes, sir; you may do that. When you look at your transcript you can add to it.

Mr. MARTIN. I would like to respond to all of this.

(Mr. Martin subsequently supplied the following for the record:)

As has been true often in the past, Mr. Patman and I agree on goals, but disagree as to how they can best be attained. I think recent events show that interest rates rise, just as prices rise, when inflation gets out of hand. Interest rates have risen recently at a time when money supply, bank reserves, and bank credit were also rising sharply. We cannot expect to drive down interest rates under present conditions by increasing the supply of money and credit still faster.

Regarding expenditures by the Federal Reserve System, it should be understood that while the System has an income of more than $2 billion (roughly $2.8 billion in 1968), its "budget" is about one-tenth that size (expenditures were $242 million in 1968; the System paid roughly $2.6 billion into the Treasury as interest on Federal Reserve notes). The System cannot, of course, spend money for anything it wants to, as has been charged. Expenditures may be made only as an incident to the performance of functions vested in the System by statute. Subject to overall standards laid down by the Board of Governors, the Reserve Banks have a considerable measure of discretion in determining what expenditures are appropriate. Expenditures for membership dues are among those as to which the Reserve Banks exercise this discretionary authority. The Federal Reserve Bank of Cleveland has outlined the reasons it authorizes certain expenditures for membership dues as follows:

"Memberships provide the opportunity for bank personnel to meet formally and informally with the business and banking leaders within the area, enabling the bank's staff to arrive at a more comprehensive understanding of business and economic conditions within the district. Memberships are the basis for relationships which permit a free flow of information and data. No payments are made for dues in social organizations or organizations whose activities are not related to the bank's activities or which do not supply the bank with information useful to the bank.

"In addition to its monetary responsibilities as the central bank, the bank provides numerous services for the commercial banks and the U.S. Treasury. In this capacity, the bank is constantly seeking better and more efficient methods for providing the varied services. Memberships are a means of keeping current with technological changes in all phases of the bank's operations. They provide a vehicle in the form of meetings, seminars, workshops, and conventions for keeping personnel alert to new techniques and procedures. The memberships range from professional organizations for economists to the more technical associations for persons working with high-speed data processing equipment."

As to GAO audit, the Congress in 1933 terminated such audit for the Board of Governors; the Reserve Banks have never been audited by the GAO. Rather, they are subject to examination by the Board's examiners, and these examination procedures are reviewed and observed by outside commercial auditors of national repute. In addition, each Reserve Bank has an internal audit program conducted by personnel who are directly responsible to the board of directors and independent of management.

Finally, I see no evidence to support the assertion that the Reserve Bank presidents represent commercial banks at meetings of the Federal Open Market Committee. On the contrary, the voting records show that neither the presidents nor the Board members vote as a bloc. All members of the FOMC are dedicated, in accordance with the oath they take as members, to the service of the whole American public.

Chairman PATMAN. May I just mention one thing, and that is about housing. We understood, at hearings held before the Banking and Currency Committee of the House, that if we approved it you would invest in housing paper, so as to relieve the housing market. That is, if we put it in the law you would do it. We first put it in and you didn't do it. And then you said if we would put it in directly the Board would do it.

Well, we put it in there. And you have refused to do it. Now, there is where we say you are guilty of malfeasance in office. The Congress told you Congress intent. And you are the servant of Congress.

Mr. MARTIN. You used the phrase nonfeasance and not malfeasance.

Chairman PATMAN. No; I would make that malfeasance now, because you led us to believe, in the printed testimony, that you would act.

Mr. MARTIN. No. The record is very clear on this. We are given the authority, we are not directed to.

Chairman PATMAN. But you told us that you would do it if Congress said so. And Congress said so in a law approved by the President. This is where it is malfeasance instead of nonfeasance.

Representative BROCK. It is my recollection that the Congress did not direct the Federal Reserve to do this; the Congress gave the Federal Reserve the authority to do this. There is a great deal of difference.

Chairman PATMAN. We were led to believe that they would do it if we gave them authority.

Representative BROCK. I think the chairman is exceeding his authority when he says malfeasance.

Chairman PATMAN. The Congress said that he wanted that done. The President approved the law.You had told us in testimony that you would do it if Congress said so, that you wanted to carry out the will of Congress. You are the servant of Congress, you have admitted that a number of times.

Mr. MARTIN. I am.

Chairman PATMAN. And here is Congress telling you what we want done. You said you would do it if Congress said so. We didn't direct you—we didn't think it would be very respectful to direct you.

Mr. MARTIN. That is the first time you showed any respect of us.

Chairman PATMAN. As a humble, loyal servant of the people we thought you had carried it out.

Representative WIDNALL. Will the chairman yield?

Chairman PATMAN. My time has expired.

Representative WIDNALL. You have made a very, very serious accusation against the Chairman of the Federal Reserve Board. I think he should have the opportunity right now for a full answer without interruption, and not a prepared statement submitted after the committee has gone out of session.

Chairman PATMAN. I ask unanimous consent that he answer it right now if he wants to, say 5 minutes would be long enough.

Representative WIDNALL. I don't think there should be any limitation.

Chairman PATMAN. No limitation. Go ahead, without objection.

Mr. MARTIN. Do you want me to start at the beginning?

Chairman PATMAN. About the housing loans and why you don't make them. You make loans for everything else, but you don't make any for housing, and you could do it under the law if you wanted to.

Mr. MARTIN. We have authority to buy Federal Home Loan Agency issues, Export-Import Bank issues——

Chairman PATMAN. I am talking about housing.

Mr. MARTIN. All right, we have the authority. If it fits in with open market operations, we are prepared to do it. The question is whether it does. This is a matter of judgment. We have never given the slightest indication that we would use this authority to support the mortgage market. And I have pointed out the dangers that I think there are in this, to have the Central Bank committed to any one independent industry. If housing, why not something else? If you want to do it by subsidy, you can do it directly. There is no reason why you shouldn't. There has never been any commitment. In fact, I think some of you know that I opposed very vigorously the bill that, I think you, Senator Proxmire, sponsored last year. I opposed it to the best of my ability, sincerely.

I think it would be wrong and unwise for the Fed, and I said so.

Senator PROXMIRE. You lost by one vote.

Mr. MARTIN. The proposal lost by one vote.

Chairman PATMAN. You could buy housing paper if you wanted to?

Mr. MARTIN. We have the authority; yes.

Chairman PATMAN. You have the authority, and you won't do it. You let housing go to where we don't have housing action except for people who feel they are threatened. They feel that if they don't buy under these high prices and interest rates now, they will have to pay more, because Mr. Martin, the Chairman of the Federal Reserve Board, says that it is going to get tighter and tighter and higher and higher. And therefore they are persuaded to buy at these high prices.

Mr. MARTIN. I don't think so, Mr. Patman. It is a matter of judgment.

Chairman PATMAN. All right.

Mr. Widnall?

Representative WIDNALL. There are people ahead of me.

Chairman PATMAN. Mr. Brock?

Representative BROCK. Mr. Chairman, you exercised a great deal of discretion today. You intended to do so. I will take the time if you want me to.

I am somewhat distracted by the recent colloquy. I had a couple of of questions that I did want to get in.

In your testimony, Mr. Chairman—to get back to the Economic Report of the President, which is the relevant matter under discussion today, I think we should try to maintain some germaneness—you made a statement that I would like to have you elaborate on either today or at your leisure. You may prefer to do it in written form. You said:

> The mortgage market does not seem to be quite as dependent on thrift institutions as in earlier years, nor do these institutions themselves seem to be quite as sensitive to monetary restraint as in say, 1966. The existing structure of ceiling rates on deposits at bank and thrift institutions has contributed to a more evenhanded slowing of consumer deposit flows among major savings institutions.

I would like your comment in this regard. I would like a more thorough analysis, if you would, of how regulation Q has affected the rapid shift between types of monetary institutions, banks, savings and loans, and so forth, and whether or not you think in the long term regulation Q should be used in this sense of controlling the allocation of the monetary resources between various types of institutions, or whether it should be primarily an instrument of monetary policy overall in terms of the security deposits, which was the original premise of regulation Q, as I recall.

You may respond to that now or later if you wish to.

Mr. MARTIN. I would be glad to give you a paper on that. But in essence the real problem here is the extent to which we have gotten into the mobility of funds between these institutions on a competitive basis. I have visited with the mutual savings banks in New York, and with other groups here. And in the period of stress that we came into in 1966, after the raising of the discount rate in December of 1965, there was an outflow there in the early part of 1966 that could have endangered quite a number of these institutions.

And as a result of that, we took measures that resulted in this ceiling operation. Now they are better prepared this time than they were previously because of what happened. But nevertheless the flows and the real role of these institutions, and where their future lies, is being examined now by all of them in a more careful way than it has been for a long time. I am personally really dubious about the effectiveness or the usefulness of regulation Q as a device of this sort. But we would not want to do anything to upset regulation Q at a time of stress. We want to try to remove regulation Q, assuming that we gave it up, in a period of relative stability.

Representative BROCK. I fully concur. But I think my earlier questions illustrated that coupled with this my concern— I think so often we talk about a specific tool, a fiscal or monetary policy, as if it were an entity into itself without interrelationships. We are a house of cards in this economy. Every action we take affects some other agency or group or segment of the economy. I am not sure that we have become sophisticated enough in our economic policy to really analyze the relative impact of open market operations, for example, as opposed to tax policy as opposed to expenditure policy as opposed to monetary policy as opposed to selective monetary policy with regulation Q, or the discount rate—these can have an effect on one or another of the existing economic units when it comes to a segment of the monetary system—for example, savings and loans as opposed to banks.

And I am concerned that I don't see enough work being done to try to tie together these relationships and to be sure that we are using a broad brush and not creating dislocations, that concerns me a great deal, and that we talk about inflation as a problem, and we want to cure it with an X or a combination of X and Y. Inflation may be a product of the Nation's economy, but it may not be a problem for a certain segment of the economy.

I think we have got to be a little more cautious in the application of these tools, and not so far as the dislocation that it might create within a certain segment of the industry.

Mr. MARTIN. I think that is a valid point. And I think that we have to do more work on the restrictive side of the operation. I think we we have spent a great deal of time and effort, and that is perfectly natural, on how we expand. But when it comes to the restrictive side, we have neglected it.

Representative BROCK. That will conclude my questions for the day. I want to thank you very much for your excellent testimony and for your responsiveness before the committee.

Mr. MARTIN. Thank you.

Chairman PATMAN. Next I will yield to Senator Proxmire. But with his permission I would like to ask you one or two questions.

We did make permanent that authority for you to buy housing paper, didn't we? That was in the law of 1968, if you recall that. It is permanent authority, you can do it, there is no question about it. I call your attention to the following language on page 15 of the 1968 report of the Joint Economic Committee on the Economic Report of the President dated March 15, 1968:

> The Federal Reserve under legislation enacted in last year's crisis is now empowered to purchase obligations of the Federal National Mortgage Association and the Federal Home Loan Bank to bring about a reduction of interest rates on home mortgages. Report of both of the House and the Senate on this legislation contains clear expressions of legislative intent that the Federal Reserve Board should assist the housing market by making such purchases in meaningful amounts whenever home building is unduly retarded, retarded by overall monetary stringency. In spite of this directive, the Board has thus far seen fit not to take action designed to stem the diversion of funds from the housing sector.

And so I repeat, Mr. Martin, you and the Board are doing the housing industry and the entire Nation a great disfavor so long as you fail and refuse to carry out the known will of Congress in this regard.

Mr. MARTIN. Mr. Chairman, I just want to say that I would like to review the record. And I think you are putting an improper construction on it. I have here just some notes on this, that the Senate committee report warned against use of this authority to peg rates on any agency issues. Governor Robertson in his testimony in 1966 said we would use repurchase agreements under this authority.

Chairman PATMAN. That is only sort of interim financing, isn't it? It amounts to practically nothing. It does not carry the spirit of the economic law.

Mr. MARTIN. That is the judgment you are making. And you in 1966 said there was no mandate to support housing in the bill that was passed; that is, the Stephens bill. I would like to review the entire record on this.

But I do not think you are correct in asserting either malfeasance or nonfeasance with respect to our activities in this matter.

(Mr. Martin subsequently supplied the following for the record:)

The Joint Economic Committee's report of March 15, 1968, contains the following statement regarding the 1966 legislation authorizing purchases of agency obligations by the Federal Reserve: "Reports of both the House of Representatives and the Senate on this legislation contain clear expressions of legislative intent that the Federal Reserve Board should assist the housing market by making such purchases in meaningful amounts whenever homebuilding is unduly retarded by overall monetary stringency." But as I pointed out to your Committee last year (Hearings on the 1968 Economic Report, February 1968, pp. 171–173) there is no basis in fact for such a statement. The House committee majority report (H. Rept. 1777, 89th Cong., 2d sess.) said nothing about using the authority to assist housing (although the minority report challenged the "erroneous assumption" that purchases of FHLB and FNMA issues would expand funds available for housing); neither did the Senate committee report (S. Rept. 1601, 89th Cong., 2d sess.). On the contrary, the Senate report stated that it is important "to avoid any semblance of 'rigging' he markets or 'pegging' the interest rates for any particular issues."

The pertinent portions of the Senate committee report are reproduced below:

"Making all agency issues eligible for System purchase or sale would increase the potential flexibility of open market transactions and could also serve to make these securities somewhat more attractive to investors. While public acceptance and understanding of these issues has grown, there may still be a lingering public hesitation in some cases to acquire and hold some of these issues because of diverse and complex legal and administrative factors. If all the issues were eligible for System operations, this could act as something of a common denominator of market acceptability and would tend to establish a more uniform market background for the various agency issues.

"By authorizing System transactions in agency issues, the bill would place them on the same footing as direct obligations of the U.S. Government so far as System open market operations are concerned. As with direct Treasury debt, System decisions as to whether, when, and how much to buy or sell of agency issues would have to be made with a view to the need for supplying or absorbing reserves as indicated by the stance of monetary policy and in light of developments in the markets, including the need to cope with disorderly market conditions, should they emerge. In any event, it would be important, as at present, to avoid any semblance of 'rigging' the markets or 'pegging' the interest rates for any particular issues, for such actions would give rise to official dominance of the markets that would run counter to many of the broader objectives of Federal financial policies and might in fact harm rather than aid the propitious functioning of the market for such securities."

These two paragraphs of the Committee report were consistent with Vice Chairman Robertson's testimony before the Committee regarding the proposal. In addition, Mr. Robertson testified as follows regarding repurchase agreements (Hearings, "Interest Rates and Mortgage Credit," Senate Banking and Currency Committee, August 4, 1966, p. 18):

"If and as the market conditions surrounding Agency issues develop to the point where Federal Reserve operations would be appropriate it might prove desirable for the System to conduct such operations in the form of repurchase agreements rather than or in addition to outright purchases and sales. The authority to undertake outright transactions in an issue is required in order for that issue to be eligible for repurchase agreements. The use of such agreements would tend to reduce the risk of undesired System market dominance associated with sizable outright transactions by the System while at the same time it would enhance the development of markets in Agency issues by making it more attractive for dealers to position the securities."

There is nothing in the House Banking and Currency Committee's report in conflict with the quoted material; the bill reported by the House Committee included a provision to authorize purchase of obligations issued by the Federal National Mortgage Association and the Federal Home Loan Banks if requested by the Secretary of the Treasury. The discussion of this provision in the Committee report was brief adding nothing to the langauge of the provision itself except to stress that purchases and sales of the two issues could be undertaken only at the request of the Secretary of the Treasury "but such a request would not require that they be made." (H. Rept. 1777, 89th Congress, 2d session, July 28, 1966, pp. 3 and 11). The House voted instead, to accept the Stephens amendment, which incorporated the language of section 6 as it now reads; and that is the version to which the Senate Committee report was addressed.

Mr. Patman, himself, told the House that the Stephens amendment (the language finally enacted) did not constitute a directive to support the housing market. In comparing the Committee bill with the Stephens amendment, Mr. Patman made the following remarks on the House floor:

"The homebuilders are opposed to the Stephens amendment for an additional reason. That reason is that the committee bill asks the Federal Reserve to give particular attention to the mortgage market in its open market operations, while the Stephens language confuses the issue by making all Government obligations eligible for Federal Reserve open market purchase. Not that this is necessarily bad, but as a legal matter it destroys the expression of congressional intent that special consideration be given to housing and the mortgage market." (Congressional Record, Vol. 112, part 16, p. 21962, September 7, 1966.)

Chairman PATMAN. I told you the reason I said it.

(The following material was placed in the record by Chairman Patman:)

FED SETS INTEREST RATES

Mr. MONRONEY. Do you mean to say that with your present Open Market Committee, and the operation of the Federal Reserve, as it now stands, that, regardless of what the national income is, or other economic factors, that you can guarantee to us that our interest rate will remain around 2.06 per cent?

Mr. ECCLES (Marriner S. Eccles, then Chairman of the Board of Governors of the Federal Reserve System). We certainly can. We can guarantee that the interest rate, so far as the public debt is concerned, is where the Open Market Committee of the Federal Reserve desires to put it.

(Hearings before the House Banking and Currency Committee, March. 1947, on Direct Purchases of Government Securities by Federal Reserve Banks, Page 85.)

FED SETS THE INTEREST RATES

". . . public debt has become the dog, and private debt the tail. That is, public debt has become the dominant factor in our economy, and this in turn makes inevitable the conscious control and management of the money market."

(Quote from *Beckoning Frontiers*, by Marriner S. Eccles: New York, Alfred A. Knopf, 1951, Page 345.)

THEORY OF FREE MARKETS

"So far as 'free markets' are concerned, I think we are all attracted by the phrase. It suits our habit of mind. But we haven't had a free market in money and credit, at least since the Federal Reserve System was established, and we haven't had a free market in Government securities, and therefore a wholly free securities market, since the Government debt climbed to the higher magnitudes, and open market operations by the Federal Reserve System came to be used as a principal instrument of credit policy."

(Allan Sproul, then president of the New York Federal Reserve Bank, as quoted in the *American Banker* of May 7, 1954.)

FEDERAL RESERVE "INDEPENDENCE"

Chairman Martin told the Joint Economic Committee on March 26, 1965: ". . . the Federal Reserve Board has the authority to act independently of the President . . . even despite the President."

BONDS HELD BY THE FED

"Mr. MARTIN. The bonds were paid for in the normal course of business.
"The CHAIRMAN (Mr. Patman). That is right.
"Mr. MARTIN. And that is the only time they were paid for.
"The CHAIRMAN. Just like we pay debts with checks and credits.
"Mr. MARTIN. Exactly.
"The CHAIRMAN. In the normal course they were paid for once, you will admit that, will you not?
"Mr. MARTIN. They were paid for once, and that is all.
"The CHAIRMAN. That is right."

(Excerpt from colloquy between William McChesney Martin and Chairman Wright Patman on H.R. 7601, July 7, 1965, Page 45)

BONDS HELD BY FED

As of February 20, the Federal Reserve had $52,167,000,000 worth of government bonds in its portfolio.

Interest paid by the Treasury to Fed on Federal Reserve portfolio in 1967—$2.2 billion.

[H. Rept. No. 1814, 90th Cong., second sess.]

EXTENSION OF INTEREST RATE CONTROLS

The Committee on Banking and Currency, to whom was referred the bill (H.R. 16092) to extend for 1 year the authority for more flexible regulation of maximum rates of interest or dividends, higher reserve requirements, and open market operations in agency issues, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike all after the enacting clause and insert in lieu thereof the following:

SECTION 1. Section 7 of the Act of September 21, 1966 (Public Law 89-597; 80 Stat. 823) is amended to read:

" 'SEC. 7. Effective September 22, 1969—

" '(1) section 19(j) of the Federal Reserve Act (12 U.S.C. 371b) is amended to read as it would without the amendment made by section 2(c) of this Act:

" '(2) the second and third sentences of section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) are amended to read as they would without the amendment made by section 3 of this Act; and

" '(3) section 5B of the Federal Home Loan Bank Act (12 U.S.C. 1425b) is repealed.' "

GENERAL STATEMENT

The act of September 21, 1966 (80 Stat. 823) gave the financial regulatory agencies flexible authority to set interest rate ceilings on savings accounts, authorized higher reserve requirements for member banks, and permitted open market operations in direct or fully guaranteed obligations of any agency of the United States. The legislation was to be effective for a period of 1 year. By the act of September 21, 1967 (81 Stat. 266) the authority was extended for an additional year. Thus, the legislation will expire on September 21 of this year.

This bill would provide an additional 1-year extension. Your committee has consulted with affected industry groups and no objection has been filed. The regulatory agencies—the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board—have recommended that the extension be authorized.

Temporary extension of this authority appears clearly to be in the public interest. It would permit the regulatory agencies to act in a timely fashion if necessary in light of developments in the financial markets. This authority has contributed significantly to a moderation in the excessive competition for consumer savings, has facilitated an increased flow of funds into thrift institutions, and has improved the mortgage market. In view of the continued uncertainty as to conditions in the financial market, it seems clearly desirable to extend the authority of the financial supervisory agencies to regulate time and savings deposit interest rates in a coordinated manner.

In addition to the interest-ceiling authority, this bill would also extend the authority of the Federal Reserve to vary reserve requirements on time and savings deposits between 3 and 10 percent, and conduct open market operations in securities issued or guaranteed by any agency of the United States. Both are valuable potential tools to promote financial stability and the efficient function of our financial markets.

While reserve requirements on time and savings deposits have not been raised beyond the 3 to 6 percent range permitted under earlier legislation, the reserve required on time deposits in excess of $5 million is presently at 6 percent. The broader latitude inherent in the 3 to 10 percent range is clearly desirable.

Federal Reserve open market operations can contribute gradually to the improvement of the market for agencies securities. In time, the yield-spread between agency and Treasury securities should narrow as the agency market becomes broader and more responsive. The legislation authority for Federal Reserve operations in agency markets was originally granted, and has since been used in a minor way for this purpose.

COMMITTEE AMENDMENTS

Your committee adopted two amendments which make permanent provisions of this statute which under existing law are temporary.

Both of these amendments affect the Federal Reserve Board and System. Both amendments have the full support of the Federal Reserve Board as testified to by Chairman Wm. McC. Martin.

One amendment would make permanent section 2(b)(3) of Public Law 89–597 which provides for member bank reserves for other than demand deposits shall be not less than 3 percent and not more than 10 percent.

Chairman Martin best described the desire for making this provision of the law permanent when he said, "Statutory expiration dates confront the Board with the prospect that if they should raise reserve requirements on time deposits about 6 percent, the action might be automatically reversed, thereby reducing reserve requirements, at a time when such a reduction would have undesirable consequences.

The other Committee amendment makes permanent section 6(2) of Public Law 89–597 which allows the Federal Open Market Committee to buy and sell in the open market any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States.

The purpose of this section of the law is to increase the flexibility of open market operations and transactions in an effort to make such securities more attractive to private investors. Since this objective is both long range and in order to be effective must be permanent.

CHANGES IN TEXT OF EXISTING STATUTES

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, the text of existing Federal statutes or parts thereof which the bill, as reported, would amend or repeal is printed below, with the proposed changes shown (*a*) by enclosing in black brackets material to be omitted, and (*b*) by printing the new matter in italic type.

SECTION 7 OF THE ACT OF SEPTEMBER 21, 1966

(Public Law 89–597; 80 Stat. 823)

[SEC. 7. The provisions of the preceding sections of this Act shall be effective only during the two year period which begins on the date of enactment of this Act. Upon the expiration of such period, each provision of law amended by this Act is further amended to read as it did immediately prior to the enactment of this Act.]

SEC. 7. *Effective September 22, 1969—*

(1) section 19(j) of the Federal Reserve Act (12 U.S.C. 371b) is amended to read as it would without the amendment made by section 2(c) of this Act;

(2) the second and third sentences of section 18(g) of the Federal Deposit Insurance Act (12 U.S.C. 1828(g)) are amended to read as they would without the amendment made by section 3 of this Act; and

(3) section 5B of the Federal Home Loan Bank Act (12 U.S.C. 1425b) is repealed.

Senator PROXMIRE (now presiding). Governor Martin, the study which you have appended to your statement indicates that the expansion in the money supply next year will be between 3 to 6 percent, or it could be between 3 and 6 percent, this would be an aim or policy. I wonder, in view of the fact that the range, the long-term range we suggested was 2 to 6 percent, the expectation of the healthy growth in the economy would be around 4 percent or 5—if 3 to 6 percent is really an indication of restraint in this kind of an atmosphere should not the aim be to reduce the growth in money supply to around 2 to 3 percent, rather than in the upper range?

Mr. MARTIN. We have tried to do this on the basis of not contracting too rapidly. And you have pointed out quite rightly that we have not had the even flow in this that we would like. We have been trying to get into a more even flow. This projection is based on the assumption that we would do a better job and not have a bulge and then a decline which, as you so rightly pointed out, is a destabilizing factor. That is what this projection is based on.

Senator PROXMIRE. But the message, it seems to me, that goes out to the country with this kind of a statement is that while there will be restraint as compared to what happened last year, that it is going to be moderate—certainly, it should be—but it is going to be almost neutral When you have an expansion of the money supply that exceeds the real growth of the economy, is it really a restraint of any kind?

Mr. MARTIN. Yes, I think it is. I think in this setting, when we are coming down from this budgetary deficit of $25 billion to a surplus in our overall budget, I believe this is a restrictive set of circumstances. But we cannot be sure until we have gotten further along on the path. It is a very difficult thing when you are wound up this way to unwind. And we want to unwind in the most sensible way we can.

Senator PROXMIRE. Apparently part of the problem, too, as indicated in the last few pages of the staff study, page 25, is that the slowdown in money supply, is very very hard to achieve. I would like to quote briefly:

"From a purely technical viewpoint the monetary policy assumed in this projection should be difficult to achieve. The projection of bank deposits and credit growth depends importantly on the maintenance of an appropriate degree of restraint exerted on the larger banks in the banking system which are consistent with a continued gradual decline in outstanding"—and so on. "This will not be easy to accomplish."

And then you go on to say that "there may well be periods of time in which actual rates of growth of bank credit, time deposits, and money stock are outside the projected ranges."

So when that happens of course it is not always easy to end up with even the 6 percent that you liked.

Mr. MARTIN. That is right.

Mr. PROXMIRE. And then you finally conclude that "our judgmental"—and this is very important to me—"our judgmental projections could well have overestimated the potency of monetary factors in slowing down the rate of expansion in the GNP."

So even if you achieve it you may not be able to have the kind of cutting, biting, decisive effect on the rise in price levels that you would like to?

Mr. MARTIN. That is right. And also, you see, this could be under this level as well as over it. You mentioned over. It could be under also, and probably should be at some points.

Senator PROXMIRE. Now, there was a fascinating analysis of this that I just read in the last few days. Partly quoting Professor Friedman—who admits, I understand, in a recent statement that he has been wrong in part, which is always a wholesome reaction—he indicates "that the problem of interpreting what has been going on in monetary policy is complicated by shifts in checking account balances—the principal component of the narrow money supply—from private accounts to the Treasury."

You don't measure, apparently, the Treasury deposits, but you do measure the private deposits. When the Treasury deposits go up the private deposits tend to go down, and therefore you get a drop in the money supply—which some people feel is an indication of restraint, and it might not be anything of the kind. He indicates that a better measure is the base, the monetary base, as he puts it, bank reserves and currency held by the public.

Now, when he goes into that he indicates that whereas there has been some drop in the rate of increase in last couple of months in the money supply, or—I guess there has been an actual decline—that the monetary base has been expanding. And he says that this suggests a very serious potential problem which the Fed may not be able to control. He says, "The trouble is that I do not believe the Fed has been doing this deliberately"—that is, moving back and forth in this area—"It rather has been something of an accident."

And then he goes on to point out that "if the Federal Reserve should continue to increase the monetary base,"—that is, current and the bank reserve—"at the recent rate, this would produce a very rapid increase in the narrow money supply and perhaps even in the broad money supply at a later date. And he finally says this, "Since I believe if the Federal instruments are not well adopted to correct this method of operation, I am inclined to predict that the present restraint will prove a temporary interruption in unduly expansive monetary policy." He said, "Myself I am expressing the view that the Fed has been restraining a little too much, but I am wrong. Upon reexamining the evidence, particularly on the face of the Treasury deposits, I believe I have been wrong, and that the odds are much better than 50–50 that we shall see a renewal of monetary ease."

Now, this is all very complicated for all of us up here in the Congress, and I am sure for the public, and even for some of the economic experts, perhaps. But would you say that it is possible that under these circumstances, because of the expansion of the monetary base, that you will try your best to pursue a policy of moderation and restraint, that we may well have an expansion of monetary supply, and expansion of the availability of credit that is going to be very hard to control, and you cannot really predict with certainty that you are going to get the restraint that you would like to achieve?

Mr. MARTIN. We cannot predict with certainty on it. I think we are getting better on it. I have confessed up here a number of times—and the people on the Board are tired of hearing me say this—that I have great difficulty in understanding the way the money supply works, because there is quite a difference between the short run and the long run. My favorite illustration of this is the long period when eleemosynary institutions like churches would never dream of putting their idle balances into bills. And then all of a sudden when the bill rate went up you found that a little church that had a small balance was rushing to the bank to invest it in Treasury bills. That changed the composition of the money supply temporarily. Now you can be fairly accurate in regulating the money supply over a period of time. But over the short swings it is very difficult.

You might like Mr. Brill, who has worked on this problem, to make a few comments on this.

Senator PROXMIRE. I would like you to comment on this conclusion of Mr. Friedman, Mr. Brill, that the odds are much more than 50–50 that we shall see a renewal of monetary ease.

Mr. BRILL. Senator, that I cannot comment on, because the answer to that is really a question of policy. There is nothing mechanical——

Senator PROXMIRE. I think he is talking about some of the technical aspects here, that you have a rapidly growing monetary base.

Mr. BRILL. I might say in connection with just the technical aspect of what Professor Friedman may have been looking at—some of the recent figures on changes in reserves, which is the largest component of the monetary base—one must keep in mind in looking at the figures that as a result of the new technique for reserve accounting introduced last fall that the figures at any point in time on bank reserve changes reflect in essence the changes in deposits roughly 2 weeks earlier. Now in the month of December deposits were growing rapidly. That did show up in a change in the bank reserve figures for January. But if one looks at the figure for February on reserves, one sees a reflection, to some extent, of the smaller growth of deposits in January. And this may be what is disturbing Professor Friedman. I have not communicated with him on this particular point on the very current situation. But I see nothing mechanical, in the interrelationships involved between reserve base of deposits and total credit expansion, that would suggest a likelihood, let alone such a high probability as he suggests, that monetary policy will ease in the future. That still remains a policy decision by the Board.

Senator PROXMIRE. You think, then, that it is within the grasp of the Federal Reserve Board to act in the way described by the chairman this morning to restrain the use of credit, without any serious technical problem, that would make it possible to achieve it?

Mr. BRILL. It would not be of the technical nature that I think is alluded to.

Senator PROXMIRE. They have the discretion, they can do what they want to do, they have the tools to achieve it.

Mr. BRILL. I believe so, sir, all the way.

Mr. MARTIN. I believe, sir, that Professor Friedman has been very generous with his time. And I have been in communication with him and investigating the variables that he is talking about. And we may be able to benefit from some of those comments.

Senator PROXMIRE. I do have a couple of more questions, but my time is up.

I will defer to Mr. Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Martin, the February statistics show that, while consumer spending is increasing rapidly, retail sales have remained steady for the past several months, indicating that much of the increased spending is going for services. Now, shouldn't corporate treasurers take this into account when they are talking about the expansion of plant facilities in order to take care of consumer demand? I think that is a pretty unhealthy thing as far as the sale of their future inventories are concerned.

Mr. MARTIN. I could not agree with you more. But I mentioned earlier that I met a group of treasurers of medium-sized companies not long ago in New York, and I found them so imbued with the conviction that inflation was not going to be halted that it was almost like talking to a stone wall to persuade them that they should not have additional plant and equipment on the prospect that inflation would bail them out. I think you are putting your finger right on it. If they were not expecting inflation they would be cutting back rather than increasing their expenditures. But at the moment they were not convinced that inflation had not become a permanent way of life here.

Representative WIDNALL. I think they are making a horrible mistake at this time.

Mr. MARTIN. I hope so.

Representative WIDNALL. Mr. Patman made a little speech about the public inability to pay the installment credit. It is very true that the public could cut back on its installment buying and not be subject to some of the charges and the problems they have when it comes to the use of installment credit. Isn't that so?

Mr. MARTIN. That is true.

Representative WIDNALL. This too is a matter of psychology. Some of the public are probably buying again as a hedge against inflation, if they think that inflation is taking place—and they have seen it rapidly taking place in many areas, with the cost of some products in the grocery store and on the shelves going up very markedly in the last few months.

I think that possibly, Senator Proxmire, you are right as far as the composition of the Board is concerned. I think you are the one that raised the question—or was it Mr. Bolling?

Senator PROXMIRE. Mr. Bolling.

Representative WIDNALL. Maybe there ought to be someone taking a look at it from the standpoint of the consumer as to what is happening outside in the market and report it first hand. I am not advocating bringing in an expert that we brought into the administration before. But somebody who is not related actually to the banking fraternity, or possibly the economic area, but who is competent in this field, who is more of a what we call the average consumer, as a representative on the Board. I think it might be healthy.

The records of policy action taken by the Federal Market Committee in February of last year and released yesterday by the Federal Reserve indicate that the Board considered increasing bank reserve requirements on escalation, in its fight against inflation. What would be the effect of a one-half percent increase in reserve requirements on inflation, the money supply, and interest rates at this time?

Mr. MARTIN. Well, one-half percent increase on time and savings deposits amounts to—what is it, $450 million, or $500 million?

About $800 million, Mr. Brill tells me, would be the impact of it. And I think it would cause interest rates probably to rise further than they are at the present time. And it would have some restrictive effect, because unquestionably banks would be harder pressed for funds. And since they have losses in their bond accounts now, they do not want to meet their present commitments or make new loans by selling treasury securities at a loss.

Representative WIDNALL. Those are paper losses in their bond accounts.

Mr. MARTIN. No, if they have to sell them, they become real losses.

Representative WIDNALL. I think all of us who have any investments today, unless they are in land, are suffering some paper losses, unless we have been in some highly speculative electronic issues and other issues. But I do not personally consider these as losses until they are realized as losses, because these things go up and down very quickly.

Toward the end of last year a moderate rate of inventory accumulation, combined with a slowdown in sales, pushed the inventory sales ratio of durable finished goods to 2.06, compared with the year's low of 1.96 for October. Do you believe this sudden unexpectedly large shift will have a destabilizing effect on the economy of this year?

Mr. MARTIN. If it continues there is no question that the accumulation of inventories will change market sentiment generally. But there is no indication yet that it will continue.

Representative WIDNALL. I realize that this is a little bit in conflict with my previous question about inventories, but would not manufacturers, then, attempt to substantially trim inventories in a way that would significantly slow the economy?

Mr. MARTIN. Yes, I think they would. Senator Proxmire, of course, earlier referred to Rinfret's analysis. But it is still anybody's guess as to what really is going on in the economy. Automobile sales in the second ten days of the month were very good. For the last three or four months, we have been thinking of the inventory accumulation gradually reaching the point where it will cause a slowing down. But there has been very little real evidence of it as yet. This is one of the factors, however, that makes us say that we think we are now beginning to get inflation under control. We hope that these price upsweeps that Senator Proxmire is referring to are perhaps the tail end of the upswing on that side.

Representative WIDNALL. How far can we go in this country with the extension of credit-card credit in practically every area without running into a very dangerous situation at the end? I can see a buildup of liability of 1 percent and one family unit after another today with the unlimited use of credit cards, and the juggling of credit cards from one place to another. You get an unrealistic view of the economy, where so much credit is involved. Don't you think there is a true danger in that?

Mr. MARTIN. Yes, I think there is a real danger in that. But we have got to realize that we are in a transitional period. And we are in a computerized economy. I think the stock exchange has just done a very significant thing in setting up this central clearing device, where you can clear securities. It has been needed for a long time. Well, in the credit field perhaps the small consumer has needed additional ways of getting credit, particularly as the prices get higher. I do not have any credit cards, and I find sometimes I have to borrow money to pay the bill to get out of a restaurant. I wish I could establish some credit.

This is a new transition period that you are in.

Senator PROXMIRE. If the Congressman would yield at that time, it is fascinating that the number one financial leader in this country cannot establish credit to get a credit card. This is an example of why we need the kind of legislation we are working with with credit bureaus and also with credit cards that you may know about.

Mr. MARTIN. No, I do not know about credit cards. But I have not tried to get one.

Senator PROXMIRE. I am sure. You can get plenty of references from this committee, though it may not be unanimous.

Representative WIDNALL. It is certainly true that the person who has not owed money to an institution or to a department store or something like that has the greatest difficulty in getting any major credit, because they have had no experience with them.

Mr. MARTIN. That is right.

Representative WIDNALL. And yet you see the unlimited credit sometimes is being extended to people who have no background or substance at all. So there is a penalty for paying cash. The same thing is true in going to the restaurant. You are paying for the Diner's Club users and the American Express card users. The restaurant is paying for that service. And the customer who should get a discount for paying cash has to carry the credit-card customer.

Mr. MARTIN. That is absolutely right.

Representative WIDNALL. This is absolutely unfair in our system today.

Mr. MARTIN. It certainly is.

Representative WIDNALL. I think we ought to move to try to change things.

Thank you.

Senator PROXMIRE. This request which I referred to earlier for a report from the Federal Reserve Board on the monetary outlook includes the following statement in the report:

> That such a projection would present a picture of what the financial world money supply, flows to financial intermediaries, the appropriate course of interest rates, would look like.

Now, this staff study—which I think the world of, it is very good, it is one of the best I have seen of any kind—shows the range of estimates for 1969 on prices, GNP, money supply, growth, unemployment, rate of capacity utilization, labor costs, and so forth, but not interest rates. And it is important, it seems, for us to know in determining congressional policy what the best authority on this particular measure of monetary policy is, what your estimates are, what your goals are, not what you are commited to at all, but what you expect to develop. Perhaps I missed that in the report. But I have asked the staff to check for it, and they could not find any precise number which you have been able to give us.

Mr. MARTIN. We did not put that in, you are quite correct, Senator. We did not think it was appropriate to give any precise levels of interest rates.

Senator PROXMIRE. You mean whether it would be a good policy for the Reserve Board to say that they expect interest rates to be at a particular level during the year?

Mr. MARTIN. That is right.

Senator PROXMIRE. I see that there is a problem. It might be helpful if we could do this.

Mr. MARTIN. Mr. Brill says we have a discussion of this problem on page 19. But you can see the basic problem for us. And we are the agency in this area, and if we start putting out projections on interest rates, why it has an impact on the market.

Senator PROXMIRE. Certainly, one of our goals, we would all agree on, is to reduce interest rates. And it would be very helpful if we had some kind of a target figure in mind. Perhaps you have it, but you think if you released it publicly it might be adverse?

Mr. MARTIN. I think probably each member of the Board has his own target on all of this. But I could not agree with you more that we want to see interest rates reduced.

I did not make a speech on Mr. Patman's colloquy there. Because one thing we have been testifying to for a good many years here, and you have taken an active part in it, is that the only real way to get moderate interest rates is to have fiscal responsibility and monetary responsibility. If you do not have those two, you get the sort of interest rates that we have at the present time. We have the highest interest rates in our history today. And this has been the history of practically everybody who has been through the same thing.

Senator PROXMIRE. Let me ask this. Perhaps you would have Mr. Brill reply, or perhaps you could reply. Can you give us any notion of whether you expect interest rates to be lower, or the same level, or perhaps unfortunately a little higher this year, on the basis of your total analysis?

Mr. MARTIN. On the basis of this model, I would say they would be fairly neutral on the projection, as I see it.

Senator PROXMIRE. You are saying they would be about the same level they are now, you do not expect them to either go up or down?

Mr. MARTIN. That would be my personal analysis, that is right.

Mr. BRILL. I think there would be fluctuations over the course of the year, Senator, as the economy changes as indicated in the projection. If we get the slowing-up in demand that is pictured, I think there would be ultimately a movement in the direction that you indicated. We much desire to see them come down. But whether that would be possible by the end of the year or, say, later in the year is a kid of a difficult thing to pinpoint. Much depends upon whether the real projection, the projection of the real economy, is realized within the course of the year.

Senator PROXMIRE. That is what I am asking, on the assumption that you achieve your projection, you expect the GNP to be at about that rate—would you agree that interest rates will remain about the same level for the year?

Mr. BRILL. But tending to move down, possibly with some lag, as demands begin to show the easing that the projection implies.

Senator PROXMIRE. Along the same line you indicated in your statement that you are hopeful, or you expect, that the price increases may moderate toward the end of 1969, to a rate of 3 percent per year increase. But that does not tell us what you expect prices to increase over the years—in other words, there might be a very sharp increase during the year, maybe in November or December it might cool off somewhat, but perhaps that is my interpretation, perhaps during the year you expect to have about 3-percent increase in prices?

Mr. BRILL. In our own thinking we were hoping that it would be consistent with the economic picture to see a gradual moving down in prices over the course of the year, rather than a further increase.

Senator PROXMIRE. Can you give me a specific percentage increase that you estimate prices in 1969 compared with 1968?

Mr. BRILL. In one of the tables, sir, we give a range, a figure of the average for the year, as falling between 3.1 and 3.5 of the GNP deflator, but making allowance for the impact on this deflator of the Federal pay raise schedule for the third quarter. If one took the midpoint of that range, roughly a 3¼ percent increase in that measure. But it would be a gradual decline.

Senator PROXMIRE. In your statement you indicate what you expect to have in the housing, you say you expect to have a million and a half housing starts, about the same this year as last year. Have you broken this down so that you could tell us what low and moderate income housing starts are likely to develop, or is this just an overall estimate?

Mr. BRILL. It is an overall estimate.

Senator PROXMIRE. You have no estimate for——

Mr. BRILL. We have not made any.

Senator PROXMIRE. This picture is very discouraging for us on the Banking Committee. Senator Sparkman, Mr. Patman, and many others think that this is the real weakness in the economy. Housing did not share in the boom of the sixties at all. It is very disappointing. And the administration set housing goals that we would very much like to start realizing. What can we do?

Mr. BRILL. I would point out one thing, Senator—and it is small comfort—I am sure that the picture is certainly a better one than what was realized in the period of monetary restraint in 1966.

Senator PROXMIRE. You say it is probably not going to get into such catastrophic levels as when it went down to 850,000 starts a year as it did in 1966. But that is cold comfort when most people consider the housing industry depressed now. Is there anything you think, Governor Martin, that we could or should do to get more activity in this area that is so important for our economy?

Mr. MARTIN. I think we will get the activity in this area very quickly, and very promptly, when inflation gets more under control than it is today. I think it is the cost escalation that is causing a slowdown—it is not the demand side at all. We know that demographically we have got a strong picture in housing for quite a while to come. But I think that the cost side—which is a part of this inflation picture—is a very serious thing.

Senator PROXMIRE. The cost side being number one. And the biggest restraint on this is the cost of money.

Mr. MARTIN. That is right.

Senator PROXMIRE. In addition you have the cost of lumber, the cost of labor, and so forth.

Mr. MARTIN. That is right. You have got to get all these cost factors under better control.

Senator PROXMIRE. I do hope that you will consider some special way that we can help this industry, because it has borne the brunt, as everybody has said, of our attempts to combat inflation. It was the first victim, and it has difficulty in recovering, and it has a long way to go.

I would just like to ask about one other point. On page 17 the staff study indicates that bank credit control could be slowed so that in 1969 instead of two-fifths, only one-fifth to one-third of the total funds raised would be by the banking system. Is this a goal or a policy that you expect to achieve, or is this something that you think is going to result without the conscious effort to achieve this?

Mr. BRILL. I think this would be the result of the policy, not specified as a goal, the result of a policy which would change incentives to the private economy as to how they want to hold their assets. In that process the changing relationship between market interest rates and the rates available at financial institutions would result in a larger supply of funds being channeled from savers through financial markets to borrowers, rather going through institutions such as the banking system.

Senator PROXMIRE. Did you work up this graph considering what has happened to the stock market in the last couple of weeks? I would think if I were a corporate treasurer I would be very reluctant about going into a market which is deteriorating as badly as the stock market is. It is almost down to 900 on the Dow-Jones.

Mr. BRILL. Of course, corporate treasurers have not been going to the stock market, they have been going to the bond market.

Senator PROXMIRE. But for long-term money it seems to me it would be.

But all this is good, because it restrains business economic activity, and right now we would like to see restraint.

Thank you very much, Governor Martin, you have done a marvelous job. You have been extremely responsive and helpful.

The committee will stand in recess until 10 a.m. in room 1114, the same room, to hear the Secretary of Commerce.

(Whereupon, at 1 p.m. the committee was recessed, to reconvene at 10 a.m., Thursday, February 27, 1969.)

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 27, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room 1114, New Senate Office Building, Hon. Henry S. Reuss (member of the Joint Committee) presiding.

Present: Representative Reuss; Senators Percy and Javits.

Also present: John R. Stark, executive director; James W. Knowles, director of research, and John R. Karlik, economist, and Douglas C. Frechtling, minority economist.

Representative REUSS (presiding). Good morning. The Joint Economic Committee will be in order for today's discussion of international economic issues.

We have with us this morning Mr. William M. Roth, until recently the Special Representative for Trade Negotiations. Last January 14 he submitted a report to President Johnson outlining his recommendations for a future U.S. foreign trade policy. We are delighted to have Mr. Roth with us today and hope that he will summarize the recommendations made in his report.

Later on this morning, we expect Secretary of Commerce Stans and Under Secretary of the Treasury Volcker to outline the new administration's position toward balance-of-payments matters, foreign investment controls, and possible reforms in the international monetary system. They will arrive in half an hour or so. Therefore, I would like to proceed with Mr. Roth.

Mr. Roth, you are very welcome. Your statement has been received into the record. Would you proceed now in your own way to read or summarize your statement.

STATEMENT OF HON. WILLIAM M. ROTH, FORMER SPECIAL REPRESENTATIVE FOR TRADE NEGOTIATIONS

Mr. ROTH. Mr. Chairman, thank you. I would like to read my statement. I wonder, too, if I could have our report of January 14 as part of the record?

Representative REUSS. Without objection, the report [1] is made a part of the record in these proceedings. (See appendix, this day's proceedings.)

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[1] "Future U.S. Foreign Trade Policy," report to the President submitted by the Special Representative for Trade Negotiations, Jan. 14, 1969. Available from Superintendent of Documents, U.S. Government Printing Office, Washington, D.C.

24-833—69—pt. 3——12

Mr. ROTH. Mr. Chairman, I deeply appreciate the opportunity to appear before you today.

My report on future U.S. trade policy, which was submitted to President Johnson in January, sets out the various aspects of that policy that I believe to be of particular importance. This report attempts to take note of the sweeping changes that have taken place in world commerce over the last decade and to suggest modifications in our own policy—in techniques if not in objectives—to meet the challenge of those changes.

I feel most strongly that U.S. trade policy, and therefore the trading structure of the entire world, is at a crossroads. The problems that the new administration and the Congress are facing now, today, entail choices that are not—as they have been in the past—choices of degree but rather choices of alternate routes that are fundamentally divergent.

Our choice lies between a world trading system of shared markets restricted by import and export quotas and a system of competition based upon a further liberalization of impediments to trade. These are the alternatives that I want to emphasize this morning.

Let me be specific. President Nixon, at his second press conference made a fine and forthright statement on the necessity for the continuation of a policy of liberal trade. He said he did not believe in quotas, but rather in the expansion of world trade. He added, however, that textiles were a special problem and that exploratory discussions will be taking place with the major countries involved to see if we can handle this on a volunteer basis rather than through legislated quotas. Former Vice President Humphrey during the electoral campaign made a similar pledge to the textile industry. This is not, therefore, a partisan issue. Rather, it relates to an industry—with plants in many States employing a large number of workers—that has the political power to make itself heard. But does it also have a sound economic case in asking for what amounts to a substantial subsidy from the American people?

To my knowledge the U.S. textile industry has not made an economic case for overall protection. In fact, investment analyses over the past few years by respected Wall Street firms suggest that this industry is properous and growing.

True, there are parts of the industry where heavy import penetration has raised the possibility of economic hardship—knitted woolen outerwear is an example. But the important point to emphasize—and one repeatedly made by former Representative Tom Curtis, who was a member of this committee—is that protection should not be afforded to an entire industry, involving billions of dollars, to take care of the problems of individual segments. And yet this is exactly what the textile industry, as a totality, is asking from the American people today.

In terms of other U.S. foreign trade goals, additional quota protection for the textile industry would be very costly. The foreign cost to the United States of the international arrangement in cotton textiles was minimal because—let us be honest—it primarily affected less developed countries with relatively little ability for effective retaliation. An extension of this arrangement to include man-made and woolen textiles would affect important trade of developed countries and would invite overt retaliation in the form of restrictions against

U.S. exports and/or lack of cooperation in achieving major U.S. trade objectives.

These trade objectives—of vital importance to our agricultural and industrial exports—require cooperative international effort. For example, a major U.S. goal is the reduction of the adverse effects on U.S. exports of the common agricultural policy of the European Economic Community. Soybeans is a case in point. Because of the huge surplus of dairy products that the common agricultural policy has artificially stimulated, the EEC is now considering levying a very high tax on soybeans and other vegetable oil products. This tax would affect close to $500 million of U.S. exports. We have urged the Community not to levy it. We are also urging restraint in the common agricultural policy for tobacco, which has yet to be decided and which could be very restrictive.

The subsidization by European countries of exports of poultry and other products has already injured our exports to third markets and is another issue that must be settled. We are also engaged in international discussions on border taxes and are trying to eliminate the trade distortions arising from the tax systems of several European countries. But Europe is not the only area where important U.S. trade objectives could be frustrated. We have a number of outstanding problems with Japan, for example, which are of both a trade and investment nature. All these efforts would be endangered if the United States demanded an expanded textile arrangement.

During the last session of the Congress, the House-Senate conferees considered the Hollings textile quota amendment to the surtax bill. Congressman Byrnes and other Members consistently made the point that if there was to be protection for the textile industry it should also be extended to other industries equally pressed by import competition. Why, they asked, should one segment of American business and not others have this kind of Government assistance? Chairman Mills also pointed out that a similar discussion must have been held many years before during consideration of the Smoot-Hawley tariff bill when individual Congressmen traded high protection in one industry for protection in another. In other words, it was clear to the conferees, and I believe it must be clear to you that once we go down the road of market sharing, there will be no place to stop.

Last month, Japanese and European steel producers announced their intention to voluntarily limit their exports to the United States during the last 3 years. When in Government, I did not oppose this arrangement because of problems peculiar to the domestic steel industry. However, I have become increasingly concerned about the precedent established by this and other voluntary agreements that restrain trade. Not only do such voluntary agreements have the same economic objections as mandatory quotas, but they are concluded without a demonstration of serious injury in accordance with the rules of the GATT. Furthermore, they circumvent legislative and administrative procedures and preclude both public and congressional consideration. We must be terribly careful lest this precedent become a prelude to a general market-sharing or quota approach to U.S. trade policy.

The cost of such a general approach—whether achieved through voluntary agreements or by mandatory legislation—would be enormous. Domestically, the cost would be higher prices and less variety for the consumer, higher raw material and intermediate costs for producers, and inflation for the economy as a whole. Furthermore, the nature of the U.S. economic system would be changed. Government—not the marketplace—would decide the level of imports and to whom they were allocated. Indeed, in order to look after the interests of consumers and of unprotected producers, I believe it would become necessary for a Government agency to review price and investment decisions.

But U.S. adoption of the quota approach would have worldwide effects. It would undermine the General Agreement on Tariffs and Trade (GATT), which prohibits the use of quotas for protective purposes. The postwar multilateral trading system that has been so painstakingly constructed would be seriously weakened.

The alternative to market sharing and quotas is the continued expansion of world trade. In my judgment, the goal of U.S. foreign trade policy should be to make America more—not less—competitive and to strengthen—not weaken—the multilateral institutions concerned with international trade and monetary affairs.

As my report points out, however, this will require that we deal effectively with new and changing conditions in world trade—including the inflationary pressures in this country, the growing competitiveness of European and Japanese industry, the increasing importance of nontariff barriers to trade, and the effects of an inadequately flexible international monetary system.

I firmly believe that a nation that uses its managerial, educational, and research abilities to maximum advantage need not fear that it will become noncompetitive in world markets. Indeed, one of the most important competitive advantages this country has is a demanding and increasingly sophisticated consumer market—a market that generously awards innovation and technical advance. With innovation and technical advance, our position in international trade will grow.

In making America more competitive in world markets, the U.S. Government must play a significant role. On the broadest front, the rate of inflation must be slowed down. Domestic policies providing for growth with price stability are now a prerequisite to our ability to compete at home and abroad and to improve our trade balance. More specifically, the Government should go considerably further in assisting our exporters, through stepped-up export promotion and more extensive and readily available export financing.

At the same time, changes and growth in trade can cause hardship, and particularly to individual firms or groups of workers. This I believe is a legitimate concern of government and society. There must be adequate adjustment assistance to firms and workers adversely affected by increased imports. Moreover, temporary import protection—or escape-clause relief—should be available more broadly to industries that can show serious injury from imports.

My report makes recommendations for liberalizing the present rigid statutory criteria for adjustment assistance and escape-clause relief. In both cases, it is proposed to drop tariff concessions as the first cause of injury and deal solely with the relationship between increased imports and injury.

In addition, the President should be empowered to reduce U.S. duties so that compensation can be given to foreign countries that may be affected by escape-clause actions that impair previously granted trade concessions. The President now has no such authority and the United States would in such cases be subject to foreign retaliation.

Moreover, the supplemental agreement on chemicals negotiated during the Kennedy round should be approved by the Congress. Under this agreement, the necessary and unjustifiable American selling price—ASP—basis of customs valuation for benzenoid chemicals would be eliminated in exchange for valuable tariff and other concessions by other countries. In the eyes of other countries, ASP has become symbolic of U.S. intentions in the nontariff barrier field. Its elimination would put the United States in a position to seriously consider with other countries the worldwide problem of nontariff barriers.

But, if further negotiations on nontariff barriers are to be conducted, more than congressional approval of the supplemental agreement on chemicals is needed. An indication of congressional intent is required, since in most cases it will be necessary to negotiate an agreement first and then return to the Congress for necessary action. Yet, this is the very procedure that a number of Senators have strongly opposed in the past. This serious problem must be solved if we are to make headway in the field of nontariff barriers.

I would here like to emphasize how vital it is that trade legislation giving the executive branch new authorities of the kind I have discussed in the report be enacted this year. It is already almost 2 years since the tariff-reducing authority of the Trade Expansion Act of 1962 lapsed. A continuation of this gap in statutory authority—the longest since the original 1934 Trade Agreements Act—would be very dangerous. There is no such thing as standing still in trade. We must go forward or we will go backward.

Internationally, a continuation of a liberal trade policy requires, above all else, a recognition by our trading partners that they, too, must share the burden of further progress. The United States is no longer—as it was in the decade after World War II—the only great economic power. The Western European countries and Japan are now healthy competitors. We must insist that their markets be as open to American products as our markets is to theirs. We must insist that illegal trade barriers that they now maintain—both in industry and agriculture—be done away with and that any proposals to impose such barriers be abandoned. Otherwise, we should not hesitate to take action under the GATT to protect our interests.

In particular, foreign countries must not embark upon new trade arrangements that discriminate against U.S. exports. The United States strongly supported creation of the EEC and has continually supported expansion of its membership to include the United Kingdom and other countries. We did this for political reasons and because a full customs union or free trade area was likely to lead to greater trade creation than trade diversion—with consequent favorable effects upon U.S. exports. However, we should oppose any kind of preferential commercial arrangements between the EEC and the United Kingdom, as has been recently proposed by France and Germany, unless it were clearly part of an ultimate customs union.

Turning to the prospects for negotiation on trade barriers, we should give full support to the GATT committees now compiling and analyzing the protective devices used in agricultural and industrial trade. If these committees do their job well, a sound basis will be established for the next major round of trade negotiations.

In the field of nontariff barriers, two in particular are now under active discussion. For almost a year, in a series of GATT meetings, we have been emphasizing the need to revise the GATT rules concerning adjustments made at the border—on both imports and exports—for internal indirect taxes. The United States should now submit a concrete proposal for eliminating the trade-distorting effects of these border adjustments, with a view to reaching multilateral agreement in 1969. In addition, for several years the OECD countries have been discussing restrictive government procurement practices and exploring the possibility of an international code governing such practices. Similar agreements on other nontariff restrictions should be pursued whenever possible, though what we do about ASP will significantly affect all these efforts.

One of the major objectives of U.S. trade policy over the next few years should be the liberalization of agricultural trade. As a huge net exporter of agricultural products this would be very much in our interest. I have already mentioned some of our agricultural problems with the EEC. But the problem of agricultural protection is worldwide. It is also one in which restrictions at the border are necessitated by domestic agricultural price support and similar programs. To deal effectively with agricultural trade restrictions it will also become necessary to negotiate on these domestic agricultural programs and policies.

In recent years the United States has moved somewhat away from price supports to direct payments to farmers as a means of supporting agricultural income. Such direct payments result in much less interference with international trade. We should continue moving in this direction and urge other countries to do likewise.

International supervision of trade measures taken for balance-of-payments reasons is becoming increasingly important. Because of the rigidity of GATT rules governing such trade measures, countries have recently tended to ignore them.

International consideration has been after-the-fact and on an ad hoc basis. The GATT rules should be revised so that trade measures taken for balance-of-payments purposes can again be brought under international control. Any such revision should also place increased responsibilities on surplus countries.

I would not want to end this statement without making two more pleas: One parochial and one more general. The first has to do with the institutional arrangements in the U.S. Government for the formulation of trade policy and the conduct of negotiations. I would hope to see a continuation—and indeed an expansion—of the authority and responsibility of my former office. Trade has become sufficiently important, both in terms of our economy and our balance of payments, to require a small, independent agency within the Executive Office of the President to coordinate trade policy and to aggressively pursue our commercial interests. Trade policy should not be permitted to dissolve in the pool of larger institutional interests.

More generally, I hope this committee will continue to concern itself with the interrelationship between trade and other aspects of our economic policy, both domestic and international. The balance-of-payments crisis has brought out clearly the close connection between domestic economic policies and trade and between international monetary policy and trade. This connection must be reflected not only in the policies but also in the organization of the U.S. Government.

In closing, let me again thank you for the opportunity of appearing before you. I have a great and abiding faith in the ability of American business and agriculture to compete in this market and abroad—if the markets of other countries are reasonably open and if we do not lose the confidence in our capabilities that our past performance has so amply justified.

Thank you, Mr. Chairman.

Representative REUSS. Thank you very much, Mr. Roth. We appreciate the valiant services you have given to this Nation in recent years. I personally hope that a successor will be found who can fill the large shoes you leave.

Mr. ROTH. Quickly, I hope.

Representative REUSS. In that connection, you ask, and I think it would be a good idea, that there be established somewhere in the Executive Offices of the President a doctor for trade matters. Do you envisage that as something in addition to the special representatives for trade negotiations or as a successor to your office?

Mr. ROTH. No, I see it as a continuation of the office with some expansion, some clarification. As you know, when we worked on the trade policy study, I had the benefit of working with a distinguished committee of about 35 industrialists and agricultural and labor leaders. This was one of the areas that concerned us the most. There was a group of business leaders who felt there should be an independent agency, a board of trade or some type of agency having to do with trade. My own recommendation, however, was that because trade related to many aspects of Government policy, it was better to have a small unit in the President's Office that coordinated total policy.

Representative REUSS. And you would not envisage the appointment of a successor to the statutory office you held as Special Representative for Trade Negotiation? The Kennedy round negotiations have been substantially but not entirely concluded.

Mr. ROTH. No; they have not.

Representative REUSS. I should think that under the statute, the President could, if he wanted to, appoint a successor to you.

Mr. ROTH. Yes.

I would hope he would do this.

Representative REUSS. And in addition, set up another office—make the same man possibly a two-hat man for a while.

Mr. ROTH. Well, actually, my office has two responsibilities under the law—the Trade Expansion Act of 1962—and by Executive order after that. One is: the negotiation of multilateral trade agreements, bilateral on occasion, but also the coordination of trade policy within the Government.

Representative REUSS. So when you talk about the setting up of an office in the executive branch, you are talking about a continuation of the Office of Special Representative for Trade Negotiations?

Mr. ROTH. That is correct.

Representative REUSS. It ought to have a better title and frame of reference, ought it not?

Mr. ROTH. I think so.

Representative REUSS. I think so, too.

Should not the duties of this trade man include, in addition to promoting U.S. exports, also include a broad look at helping U.S. industry aid our balance of payments by practicing, whenever it can be done in a nonautarchic way, import substitution. Specifically, shouldn't we encourage American Motors car manufacturers to get into the compact market, American electronics people to recapture some of the market they have lost to the Japanese, American shoe manufacturers to take a lead from the Italians and so on? It seems to me there are two sides to the balance-of-payments trade equation, and I do not see why all our attention should be given to the export side, why there is not a perfectly legitimate case to be made for import satisfaction.

Mr. ROTH. I think, Mr. Reuss, you are very right. I see a distinction in the work of the office between negotiation and policy and operations. For instance, one of my concerns, which ties in exactly with what you have been saying, is that the office should be represented on all interagency committees that have to do with trade, either in your sense or in an export sense. The operations, let us say, of an export program or the operations of a program having to do with substitution should be in the Commerce Department. But the policy should be worked out in a coordinated fashion, in which the trade policy office should be represented. This relates very strongly, too, to not only areas of domestic economic policy, but to monetary policy as well.

Representative REUSS. You mentioned the American selling price of benzenoid chemical as a very important American nontariff barrier, which must be attended to as a part of the Kennedy round package. Would you say that elimination of American selling price valuation is essential to the whole program of getting on with expanded world trade?

Mr. ROTH. Yes, I do. First, I think the American selling price type of protection is outmoded, is no longer required. It is the same kind of protection that the Common Market uses for agriculture—in effect, the variable levy type of approach—and therefore is not required on its own merits. But beyond that, beyond the fact that in the Kennedy round, we negotiated a package in which other countries, on a reciprocal basis, gave us something—beyond that, it is, as you know, the bête noir of Europeans. They feel that it symbolizes American protectionism in the nontariff barrier area. Now, certainly, if we want to negotiate in the nontariff barrier area in other countries, it will be very difficult to do so if we ourselves, in effect, come into the negotiation with ASP still around our necks. Also, there is the secondary problem that if the Congress refuses to approve of the ASP package, our credibility in negotiations will be damaged. Our partners will say, if you agree to something, can you deliver?

This, by the way, is a problem we try to consider in the trade policy study. It is a very difficult one. You cannot, in the nontariff barrier area, which is so complex, ask for prior congressional authority, because you would not know what to ask for. Yet if you negotiate and then on an ad referendum basis—if it needs a change in the law—come back to the Congress, it is of concern, particularly in the Senate, that the Executive has exceeded his authority. This creates a problem. I do not know how to get at this particular problem. We suggest that a possibility might be a sense of the Congress resolution that will give the

President some sense of support in going into these complex negotiations.

Representative REUSS. You mention in your statement that close to $500 million of U.S. agricultural exports would be affected if the Common Market follows its apparent present intention to levy a high import tax on soybean and similar vegetable oil products. Is it not a fact that this kind of action by the Common Market is initiated by obscure technocrats operating at a subterranean level who do their deviltry and without the issue ever coming to the attention of the political authorities?

Mr. ROTH. No, I would not entirely say that. As you know, the common agricultural policy is really the brain child of Mr. Mansholdt, the vice president of the Community. The extension of the common agricultural policy to more and more products, is partly the result of political pressures at a very high level from the member governments—from France, for instance, which again is in response to strong political pressures from the farming community. So I think it does come to the attention of the people at the top, and most certainly, when the soybean problem started last fall, we brought it to the attention of Jean Reys and at the highest level, both in the member countries and in Brussels.

Representative REUSS. Aha! You say this body blow to expanded world trade occurs at the highest level of the Common Market countries and we brought it to their attention. Who is the "we?" President Lyndon B. Johnson? President Richard M. Nixon?

Mr. ROTH. We have over a period of time a number of these problems. Sometimes it was my office; it was myself. Sometimes it was the Secretary of State. Sometimes it was the President. It varied. Certainly, also, looking back over 4 or 5 years, President Johnson had many conversations with the heads of government from other countries. If at that point, there was one of these problems of serious concern, they were brought up, just as other heads of government most certainly brought them up with President Johnson.

Representative REUSS. Well, did our President bring the matter of their proposed tax on soybeans up with the Europeans, and if so, with what countries?

Mr. ROTH. Soybeans, as I said, came up at the end of last year. I am not aware of any conversations he had. We did have, from myself and from Secretary Rusk, messages to the Commission, to Jean Rey. Our Embassy, also, at all levels there, was very active.

But I think the Community knows our attitude well enough on this that they are not ignorant as to what might happen.

Representative REUSS. What might happen?

Mr. ROTH. Well, first, the soya bean problem is complicated in that what they are suggesting is not just an import tax, because we have a zero binding which would make this very difficult for them to do. But in effect, a tax which would be both domestic and international the effect of which would be to shift consumption away from soya beans to dairy products. I think out of this could come a really major confrontation between the United States and the Community. But let me say soya beans are only one example. We had throughout last year the continuing problem of poultry. We have the problem still coming up of tobacco. And always, Mr. Congressman, in the background is the fact that the common agricultural policy has not worked, even in terms of Europe. Increasingly, as we thought, it is becoming a very, very expensive program and the finance ministers, particularly in Germany, who bear the greatest cost, are becoming increasingly concerned.

Representative REUSS. Your report, basically recommends that this issue ought to be the subject of a high-level meeting and that domestic agricultural policies should stress income support for farmers rather than price supports; is that correct?

Mr. ROTH. That is right.

Representative REUSS. I think that is exactly it.

Mr. ROTH. And getting all countries away from subsidies. Last year, we found that we were losing, as an example, our poultry market in Switzerland. Our sales went down from 65 percent, as I remember, of their total imports to 4 or 5 percent because the European Community, and the Danes, were subsidizing poultry. We decided then to subsidize poultry into that market—not as a matter of policy but as a negotiating tool to regain the market. We said, in effect, we can play battle of treasuries, too. But at the same time, we pressed them to come to Geneva to talk about the subsidy problem. Now, to date, this has not been successful because their own internal pressures are so great in the opposite direction. But here they are now building these tremendous surpluses in butter and other commodities and they are up against a serious financing problem.

Representative REUSS. Senator Javits?

Senator JAVITS. Thank you.

Mr. Roth, first, let me apologize for not being here for your opening statement, but we are rather engaged upstairs in coal mine hearings where we have basic problems. But I have gone through the statement, and I would like to ask you a few questions about the general policy of the United States to which you contributed so much in the Kennedy Round of negotiations.

Now, you wrote a piece for the New York Times on February 23, 1969. The heading which the paper gave it is "Nixon Urged To Pursue Strong Liberal Trade Policy."

That is a piece written by you?

Mr. ROTH. That is correct.

Senator JAVITS. Mr. Chairman, I ask unanimous consent that this newspaper article be made part of the record.

Representative REUSS. Without objection, so ordered.

(Article referred to follows:)

VIEWPOINT: NIXON URGED TO PURSUE STRONG LIBERAL TRADE POLICY

(By William M. Roth)

President Nixon has lost no time in making his position on trade policy clear. In his Inaugural Address he called for "a world . . . open to the exchange of goods" and at his second press conference he said:

"I believe that the interests of the United States and the interests of the whole world will best be served by moving toward freer trade rather than toward protection."

My own views on future trade policy are set forth in detail in a report submitted to President Johnson last month. This report is the first comprehensive review of United States trade policy in more than a decade. It was based on the work of a number of task forces within the Government, as well as intensive discussions with a distinguished public advisory committee appointed by President Johnson.

The report concludes that our policy of trade liberalization and expansion has contributed importantly to the achievement of such major national goals as economic growth, full employment and higher real incomes, and that it should be continued and strengthened.

There have, of course, been changes in world trade in recent years. Because of the dramatic postwar economic growth of Western Europe and Japan, competition is keener than ever before. The patterns of trade have also been profoundly affected by the creation of regional trading blocs, notably the European Common Market and EFTA, and by the spectacular growth of great multinational corporations.

There are some who, citing these changes, maintain that our liberal trade policy has outlived its usefulness. They would have us take refuge in a commercial "Fortress America." The typical form that this economic neo-isolationism has taken is the advocacy of restrictive import quotas. The professed objective is "orderly marketing"—a euphemism for restraining competition through market sharing. This is in fact the goal of the old-style cartels, which Americans have traditionally rejected as the antithesis of our system of free competition and individual enterprises.

For consumers, import quotas would mean higher prices and less freedom of choice. For producers, they would mean higher costs and impairment of their ability to meet foreign competition at home and abroad. For the economy as a whole, they would mean a further push toward inflation.

Therefore, I welcome the President's statement that he takes "a dim view" of quotas, though I wish he had expressed the same opinion of voluntary quotas which in most cases are as unjustifiable as mandatory quotas. This is certainly true of those currently being suggested for woolen and synthetic textiles.

Trade expansion, with all its benefits, does result in occasional hardships. Our means of alleviating them can and must be significantly improved. My report recommends the liberalization of the present unduly strict criteria for obtaining "escape-clause" relief in the form of quotas or higher tariffs. It would be advisable, of course, for us to be in a position to provide compensation to those of our trading partners whose interests may be adversely affected—and for this purpose the President should be given authority by the Congress to make limited tariff adjustments.

Similarly, the report recommends the liberalization of the criteria for adjustment assistance to individual firms and groups of workers—and for individual establishments within a firm, even when the firm itself may not be eligible for assistance.

The criteria suggested for the granting of "escape-clause" relief to industries are stricter than those for adjustment assistance. It is frequently the case that the weaker firms in an industry—those already falling behind their domestic competitors—are the ones that are most affected by imports. In such cases, across-the-board relief amounts, for the stronger firms, to a needless and unjustifiable windfall.

Our over-all objective must be to help industries and firms adjust to competition—not to shelter them from it indefinitely. It is therefore essential that "escape-clause" tariffs or quotas be regularly reviewed and that the firms concerned be required to report periodically on their progress toward meeting import competition.

Internationally, the United States must continue to insist upon the principle of reciprocity. We can offer others access to our market only to the extent that they offer us access to theirs. We should continue to uphold the rules of international trade embodied in the General Agreement on Tariffs and Trade (GATT), particularly the rule of non-discrimination in trade policy, but we must insist that others abide by them as well.

The United States must take full advantage of the remedies available to it under the GATT whenever its interests are jeopardized by the actions of others. Indeed, we should put ourselves in an even stronger position to do so. We should amend our trade legislation to enable us to retaliate against illegal restrictions on our industrial exports as forcefully as we are already able to do in the case of agricultural products.

There are many nontariff barriers that are not illegal. Together with its trading partners, the United States must work within GATT and bilaterally to reduce and eventually eliminate them. We should begin by abolishing the American selling price system of customs valuation, an obsolete form of protection—which will enable us to realize the significant tariff and nontariff benefits embodied in a special agreement negotiated concurrently with the Kennedy Round.

Action against nontariff barriers is particularly important for our farm exports. They are increasingly threatened by agricultural protectionism abroad, especially in the Common Market. High price supports are protected by high and variable duties against efficient outside suppliers, including the United States. The excess production they generate is being marketed on a subsidized basis in third countries, undercutting our own sales. Surpluses of dairy products in the Common Market have recently inspired a proposal to levy a heavy tax on oilseed products, menacing our very substantial soybean exports.

SPECIFIC TALKS URGED

The current preparations for another general round of trade negotiations should be pressed vigorously. Meanwhile, the United States should seek negotiations on specific nontariff barriers wherever progress is possible, as well as negotiations aimed at the elimination of tariff and nontariff barriers in particular industrial sectors. It is especially urgent that the nations take agricultural protectionism in hand before it provokes a major confrontation—and to do so they must be prepared to place their own domestic agricultural systems on the bargaining table.

One important respect in which the present GATT rules should be changed is in the field of border tax adjustments. They now permit export rebates and levies on imports to compensate in full for domestic taxes on products, such as business sales taxes, based on the very dubious assumption that all such indirect taxes are passed on fully to the consumer. To the extent that such taxes are not passed on, these border adjustments are protective and hurt our trade. We are seeking a satisfactory revision of the GATT rules and should continue to press hard for it in 1969.

The United States must take account, in its trade policy, of the interests of the less-developed countries and give serious consideration to generalized preferences for them. We must consider means of extending selective most-favored-nation treatment to the Communist countries of Eastern Europe, in return for equivalent commercial benefits.

ACTIONS EXPLAINED

During the last year and a half, balance-of-payments difficulties have repeatedly induced nations to take or contemplate restrictive trade measures. It is clear that the maintenance of an open trading world requires the strengthening of the world monetary system. Trade measures should be taken only under international supervision and as a temporary and supplementary means of easing balance-of-payments strains while more basic remedies are put into effect. And countries in surplus have an obligation to help in the adjustment process as well as the country that is in deficit.

Finally, trade policy must be developed in full recognition of its close relationship with other economic policies, domestic and international. I believe that the Office of the Special Representative for Trade Negotiations in the Executive Office of the President is well situated to fulfill this responsibility. During its six years of existence it has gained the confidence and cooperation of important sectors of American business, agriculture, labor and consumers. It seems to me urgent that the President appoint as special representative a businessman of stature and that the status, budget and staff of his office be strengthened to measure up to its mission.

As the world becomes more complex and interdependent, so do the problems of domestic and international economic policy. We must remember, however, how successful the basic thrust of American trade policy has been over the years. We must not risk all the gains we have made—rather, we should build upon them for the future.

Senator JAVITS. In this piece, you take a position which I think is critically important to our country, because you position it from the fact that we have suffered a very material erosion in the export surplus of the United States. Is that your central thought?

Mr. ROTH. That is correct.

Senator JAVITS. And it is attributable to that erosion which, many say, after you stop tricking up the figures, represents a deficit from what was traditionally a $5- to $6-billion surplus, that this is now the nubbin of the adverse status of our balance of payments, is that not correct?

Mr. ROTH. True.

Senator JAVITS. In other words, we could be doing everything we are doing in the world, including fighting the Vietnam war, and if we had maintained our export surplus, we would have an affirmative balance, in effect, of international payments.

Mr. ROTH. And expanded travel.

Senator JAVITS. And expanded travel, exactly.

I gather you attribute the main cause of our balance-of-payments problems not alone to inflation but also to certain other policies. One is that American trade has not expanded as you had hoped it would and could with more liberal trading policies pursued by us and the world. Is that correct?

Mr. ROTH. That is right.

Senator JAVITS. And secondly, that our exports have been cut by added restrictions now imposed by the world, including nontariff barriers to border taxes, value added taxes?

Mr. ROTH. That is correct.

Senator JAVITS. As well as bulging imports from other countries.

Mr. ROTH. That is right.

Senator JAVITS. Now, one of the things I did not get clear from your statement was what should be the foreign trade policy of the United States, what changes specifically do you recommend in the foreign trade policy of the United States to deal with the three points which I have just made and just restated to you, or any other points which you feel are germane?

Mr. ROTH. In our trade policy study, I went into our answers to this question in considerable detail. One fundamental problem I did not go into and did not put forward solutions because I am not competent to is in the area of inflation. The most fundamental need is to control our price structure.

Secondly, we go in some detail into the possibilities of further help by the Government in export promotion, in export financing, although there is a lot more study that has to be done in this area. Third, a central point is that if our market is going to be open, other markets must be equally open. And I think in the last year of the Johnson administration there was a note of increased toughness in our insistence that particularly illegal barriers in other countries be done away with.

Actually, you mentioned, Senator, that nontariff barriers to trade had increased recently. This is really only in two areas—one is agriculture, where the common agricultural policy has been extended over additional products, and the other is in this very complicated area of border taxes, which we have been negotiating on now for some months.

I would like to say about border taxes—and we have a long analysis in here—that there is no question in my mind that because of them there is a distortion in trade. On the other hand, the distortion is nothing like that claimed by certain industries.

I would like just parenthetically at this point to say that to work out a method that is technically feasible to do away with this trade distortion is very difficult. I would hope, as I could not say in the report but I can now, I would hope that at least some consideration by the administration and Congress would be given to the use of an added value tax of some sort in this country. This is beyond my field, but I think at least it should not be swept under the rug, it should be examined.

Senator JAVITS. One question on that, Mr. Roth. Is it not a fact that this is an indirect tax, very much like an excise? And it will therefore preempt something of the policy of the United States which is heavily based upon direct taxes, like the progressive income tax, with the expectation that it does not enter as much into the cost base and therefore, as you feel very strongly an increase in the cost base because of inflation has caused greater imports, won't the value added tax work exactly in reverse in this country, because it represents a change? The European countries are heavily indirect taxation countries. We are a heavily direct taxation country. Therefore, because of the change, if we follow what you have said, would we not just be adding fuel to the fires of inflation?

Mr. ROTH. This could be true. I think what is true is it is not precisely known what the effect of one system of taxation or another is on price. As you know, Senator Javits, when the GATT was founded 20 years ago, it was felt by the economists that a direct tax went almost 100 percent into price and indirect tax none. This absolute dichotomy has not worked out. You have to look at the elasticity of the product, at the economy at that point and so forth. Very little—because it is a difficult analytical job—very little work has been done on this. One chemical company that I know of looked at this problem in terms of some of its own products under the German tax and found that the amount of absorption was about 50 percent, as I recall. But this might be, Senator, one of the problems. I think it is a valid one, but I think it has to be analyzed.

Senator JAVITS. In other words, I make a valid argument, but you are not prepared to say that that is an absolute answer to what you have in mind? But I am correct in that assumption?

Mr. ROTH. Correct.

Senator JAVITS. You spoke rather feelingly in your piece about an amendment which Congressman Reuss—I will withdraw that.

I do want to ask a question about it. I will ask this frontally. Do you think that the foreign trade policy of the United States should now ascend another plateau, should adopt a totally different principle than reciprocity, which resulted in your historic service to our country, which I might add was classic, and your associates in the Kennedy Round, and commit the United States to a willingness or to give the President authority, subject to ratification by the Senate, to enter into a free trade area and Common Market agreements?

Do you think the United States has now gotten to the point where, in order to really put itself in a position to deal with the modern world—knowing as well as I do that inflation is not going to be controlled in 6 months or in a year sufficiently to redress the balance, and being faced, as we are, with aggravated trade problems in Latin America, which feels very much discriminated against compared with the so-called associated African territories—that we now ought to free our hands, go to the policy that Congressman Reuss, Senator Douglas, and I supported some years ago, and give ourselves the opportunity, at least the authority, to negotiate with respect to common markets and free trade areas?

Mr. ROTH. I do still believe that the principle of reciprocity is a critical one. I am not convinced that at this point, pursuit of the possibility of a multination trade area, either NAFTA or MAUTA, is realistic or perhaps desirable. On the other hand, as we say in our report, the world of economic matters is changing rapidly. It could be that a time might come when this is desirable. And this, Senator, by the way, ties into something else you spoke of—the relationship we have with Latin America and the whole preference issue. The way in which our current negotiations on preferences goes could be an important factor in the kinds of problems you raise. As you know, President Johnson decided to attempt to negotiate a generalized scheme. I myself do not think that preferences are that important, but I agree they are of some importance to the developing country. A generalized preference scheme would take the place of the special preferences that the African countries have with Europe, and would be extended across all products, with some exceptions, to all countries by all developed countries.

Senator JAVITS. That is the LDC's?

Mr. ROTH. The LDC's.

Senator JAVITS. That is the less developed countries?

Mr. ROTH. Right.

This, it seems to me, if you are going to have preferences, is the most reasonable way to proceed. What worries me about this country—as a reaction to the European situation—giving special preferences to Latin America, just as it worries me when Europe gives them to Africa, is that then economic policy, trade policy, gets closely intertwined with foreign policy. To a certain extent, I think this problem of separation between trade policy and political policy was in the minds of the Congress when they took the negotiating function, the trade function, out of the State Department and set it up as a separate entity.

Senator JAVITS. Incidentally, do you strongly believe that we should continue that framework of operation? That is, that we should have a separate Representative for Trade Negotiations outside of the State Department?

Mr. ROTH. Very strongly. The chairman, however, made a good point, and that is maybe the title is wrong. I think perhaps it is. Because it is not just a negotiating function, it is a trade policy function.

Senator JAVITS. But nevertheless, you want it kept separate?

Mr. ROTH. Yes, I think that is right.

Senator JAVITS. In the White House, under the President?

Mr. ROTH. Yes.

Senator JAVITS. Coming back to the main thesis, what do you say to the fact that we have tried operating with liberal trade policies such as you describe for a very long time—indeed, I think in all fairness, since the end of the war. Now, we find that with an inflationary bulge in our country, which is very small considering other countries' level of inflation—British, French, Latin American, Brazilian, et cetera—

but it is big for us, although relatively speaking very small, but our whole export surplus, for all practical purposes, has been eroded.

Does that not indicate that although we may not like it and though it may not be optimum, we have to move to some other posture? We can't continue to beat the same old horse, which is that we are the optimums, we are the idealists, we will remain on this level even if everybody else departs from it completely, and there is very little chance of bringing it back? You have the Common Market in Europe. We are trying very hard for a common market in Latin America to change the Latin American free trade association with its present built-in rigidity into a common market.

There are free trade areas—of course, you have your common market in Central America—being discussed all over the world in a very active way. Aren't we just King Canute in trade policy, even though you are right and I agree with you, we are running a government and a world and not an academic class at one of the universities? What do you say to that? I am making it intentionally provocative, because I think it is very rare that we have this opportunity to be with you, and we want to get the best of your thinking.

Mr. ROTH. Let me give you an example. First, let me say that I think progress that has been made in trade, in an international institutional sense, among other things, has been important and good, and there are some clear areas which I would like to come back to where we have to continue making progress. But for instance, should anything like the Brandt-Debre plan, and De Gaulle's most recent suggestions relate to that earlier plan, it seems to me——

Senator JAVITS. You said Debre. Whose was the first name you mentioned?

Mr. ROTH. Willy Brandt.

The possibility of a looser free trade area than the Common Market, including the United Kingdom and perhaps other countries in Europe, if something like this ultimately came into being—I would assume it probably would not, but if it did, it would seem to me this would have very serious implications for American trade policy and what our attitude should be. I think, as I understand your question, it is a kind of flexibility that the U.S. Government should have in being able to meet new circumstances such as this when they come along. And I think that is right.

Representative REUSS. Could I just interrupt you, Senator Javits, long enough to ask one question?

Senator JAVITS. Surely.

Representative REUSS. You have said that the Brandt-Debre proposal for a free trade area of Europe rather than a common market could have serious consequences for the United States. Might it also not provide a genuine opportunity, namely, to join the free trade area ourselves and thus move toward a worldwide free trade area which eliminates the autarchic barriers that our child, the Common Market, has constructed? Would that not be a happy state of affairs?

Mr. ROTH. Well, if in effect what proposed is really, really just the continuation of expanding the areas of free trade, certainly. But it is a question of how you get there. I am inclined to feel, given the pressures of the problems, that you get there by a continuation of rather difficult, hard-nosed, lengthy negotiations on particular problems.

Could I just, Senator, come back to one thing you said apropos of our declining surplus and trade problems? One thing that I have been convinced of in the last year and a half, particularly after the balance-of-payments prices a year ago last fall, was the close interrelationship between trade policy and monetary policy, and the tendency, given certain rigidity in the monetary system, for governments such as the United Kingdom, France, others, to look to trade measures in order to take care of the adjustment process. It seems to me that the kind of movement toward greater liquidity, greater flexibility in the monetary system has to be pressed terribly hard as a major part of U.S. policy in order to take care of the trade problems. There are trade measures for adjustment permitted in the GATT, and I think they should be further examined. They can be used under certain circumstances to help the adjustment process. But it always seems to me that they should be secondary, very secondary, to improvement in the monetary field.

Senator JAVITS. Mr. Roth, is it not a fact that the modern tendency is toward the so-called range of weapons theory and that, therefore, we should vest the President with the necessary authority beyond the authority which we have traditionally given him of reciprocal negotiations? Indeed, I feel so strongly about it that perhaps the alliance with Mr. Reuss may be revived with me instead of Senator Douglas as the protagonist here in the Senate. Therefore, I would like very much to get your views.

Mr. ROTH. Senator, I think you are correct. I would like, Mr. Chairman, if I may, to repeat myself. We were talking earlier about the fact that Congress agrees, American industry agrees, that the major area we should be concentrating on in trade is the nontariff barrier area. Yet this is an area where the Executive cannot come to the Congress and ask for specific advance authority because they do not know what authority to ask for. It is too complicated, too complex. You have to negotiate before you know what authority you need. Therefore, we suggest that perhaps it might be desirable to have a sense of the Congress resolution. At least, it would give the President some backing. Because as you know, in the ASP situation, and really to a certain extent, in our dumping negotiations—where we felt we did not have to come back to the Congress—in both these instances, a number of Senators felt that the President acted without proper congressional authority. So this raises this difficult problem: If you cannot ask for specific authority beforehand, and yet if you come back on an ad referendum basis and there is resentment that you acted beyond your authority, how do you get out of this difficult hole in what is generally acknowledged to be the most important trade area? I think this comes right back to what you said.

Senator JAVITS. My assistant reminds me that in 1963 I sponsored exactly such a "sense of the Congress" resolution for the minority on the Joint Economic Committee, since I am the ranking member. But I will say this and then I will be through, in order not to detain the proceedings. I understand my good friend, the Secretary of Commerce, is waiting.

There is a middle ground that we will be considering in the Foreign Relations Committee, this and many others. The middle ground will be that the sense resolution we are afraid of. We have had it in Vietnam on the sense resolution and the dog-eared copy that the President is said to have carried around in his pocket for months. And also, of course, there is the treaty ratification which the executive branch finds sometimes too difficult to accept, and the built-in veto in the Senate by filibuster and so on. Therefore, it seems to me that the reorganization procedure may be the suitable way, because it is often forgotten that you have a cloture provision built in to the reorganization law by law, so that it can't be filibustered, and the time limits are narrow so you cannot destroy the effect of the negotiation by just delay. I only throw that out as a possibility. Perhaps the Congressman and I will collaborate in some other way to work out a definitive means. But that may be the reasonable constitutional way to deal with the situation.

Mr. ROTH. I have not suggested that the sense of the Congress is the right way to go. I have problems with it, too. But we wanted to dramatize the issue which, as you say, is a terribly important one.

Senator JAVITS. We have no trade legislation now.

Mr. ROTH. That is right.

Senator JAVITS. So if we do a new one, we could conceivably give that authority, with the check and balance of the veto, which is contained in the Reorganization Act.

Mr. ROTH. It is absolutely critical that you have trade legislation this year, I feel.

Senator JAVITS. Mr. Chairman, may I express to Ambassador Roth my appreciation for his expertise and I hope if anything I said was abrasive, you will forgive it, because it was solely designed to elucidate your response.

Mr. ROTH. Thank you. I appreciate this opportunity.

Representative REUSS. Thank you very much, Mr. Roth. You go with our deep gratitude for a wonderful job you have done. Good luck.

Mr. ROTH. Thank you, Mr. Chairman.

Representative REUSS (presiding). Having rung out the old, we will now ring in the new with Commerce Secretary Stans and Treasury Under Secretary Volcker.

Gentlemen, let me say that we thank you for coming up this morning. Let me also say that we have read your testimony. It is very responsive to this committee's inquiry and it will be most helpful. Both statements will be, without objection, included in the record. May I ask you, Secretary Stans, if you will proceed to read your statement or summarize in whatever form you prefer.

STATEMENT OF HON. MAURICE H. STANS, SECRETARY OF COMMERCE; ACCOMPANIED BY WILLIAM H. CHARTENER, ASSISTANT SECRETARY OF COMMERCE FOR ECONOMIC AFFAIRS

Mr. STANS. Mr. Chairman, Senator Javits, gentlemen, I want to say first that I appreciate the opportunity to appear before this distinguished committee. The last time I was here was a little over 8 years ago when I was Director of the Budget, so it gives me particularly great pleasure to testify again, this time as Secretary of Commerce.

Having said that, Mr. Chairman, I would appreciate it if you would permit me to have the rest of my statement read by my associate, Assistant Secretary Chartener. It happens I have been ill the last 2 days and I would like to conserve whatever strength I can for your questions, if I may.

Senator JAVITS. Mr. Stans, if you do not feel well enough to be with us this morning, the Chair will understand.

Mr. STANS. I think I will be all right so long as I do not have to spend 15 minutes reading the paper. I will be delighted to stay.

Representative REUSS. You will certainly be able to do that and I will ask our old friend, Mr. Chartener, to perhaps set forth the highlights of the Secretary's statement. I have a few questions to ask him and I know Senator Javits has.

(The Secretary's statement was read by Mr. Chartener as follows:)

Mr. CHARTENER. I will proceed with the statement set forth by the Secretary.

Your committee has already received the testimony of other administration witnesses. Rather than duplicate their review of the general economic situation, I should like to devote most of my statement to particular items of economic policy of direct concern to the Commerce Department. I note also that your chairman asked me in his letter of invitation to appraise some specific issues of international economic policy.

For that purpose, I shall begin by reviewing recent developments in the U.S. balance of payments and discussing the immediate outlook. I shall then relate this to policy issues and to administration programs, especially for trade and foreign investment. And I shall conclude my remarks by references to one or two departmental matters that seem to be of great importance to the Joint Economic Committee.

I do not wish, however, to minimize the importance that I attach to general economic policies. I feel as strongly as my Cabinet colleagues about the importance of these policies for the national well-being. In particular, successful control of inflation in a way that does not jeopardize the sustained growth of the economy is our prime need. In our external economic affairs also, it is imperative that the U.S. position should be buttressed by a more stable price level.

U.S. BALANCE OF PAYMENTS

The 1968 balance-of-payments accounts showed a surplus of $190 million on the liquidity basis, and $1,660 million on the official settlements basis. Both of these figures were correctly described as "soft" by the Republican members of your committee in their statement at the opening of this set of hearings.

The 1968 liquidity surplus was the first since 1957. But it occurred despite a deterioration of the merchandise trade surplus to the lowest level since the year 1937. This trade decline is a matter of very great concern. The 1968 trade surplus, on the balance-of-payments basis, was only $90 million, compared with $3.5 billion in 1967.

The largest single influence on this change was the vigorous inflationary expansion in the U.S. economy. True, actual or threatened strikes in domestic metals industries and by longshoremen at east and gulf coast ports distorted monthly trade patterns throughout the year. However, only about one-fifth of the trade deterioration could be attributed to this source.

Most of the remaining four-fifths was brought about by the acceleration of import demand. Imports as a percentage of GNP reached 3.8 percent. While all major categories of imports shared the increase, the most noteworthy feature was the 40-percent rise in imports of consumer goods over 1967.

There were very substantial shifts in the movements of both private and official capital to offset the deterioration in our trade accounts. Some of these movements occurred during the last few weeks of 1968. The statistical detail for the whole year is not yet complete.

The apparent dramatic improvement in the overall balance resulted in part from private capital movements that were in some degree affected by the tightening in U.S. credit.

These private capital movements were reinforced by special financial transactions arranged between the U.S. Government and foreign governments. The primary effect of these special transactions was to reduce foreign official holdings of liquid dollars and increase foreign official holdings of nonliquid dollars. These conversions improve the overall U.S. balance on the liquidity basis, because nonliquid dollar assets are regarded as a foreign official investment in the United States.

The immediate outlook for the U.S. balance of payments will be affected by two principal influences:

The manner in which domestic policies contribute to the improvement of the competitiveness of U.S. producers in foreign and domestic markets, and to the reduction of the pressure of demand for imports.

The relative stringency of credit conditions here and abroad.

As to the first, we can hope for a modest improvement in 1969 in the trade balance. We can and ought to sustain our export growth. But we also must create domestic conditions that will slow down last year's abnormal growth of imports.

As to the second, foreign capital was flowing into the United States in 1968 at a rate that may not be sustained. To be sure, foreigners have discovered new opportunities for investment in the United States. Not all the flow is unstable. But some of the 1968 inflow appeared to be borrowed from the future and therefore could be reversed later.

These conditions are not durable enough to allow us to regard the improvement in the overall balance as a full recovery. On the contrary, we have to assume that 1969, in the absence of special transactions, will again show a deficit that could be significant.

EXPORT EXPANSION

The drastic decline in the net export balance in the past year must be altered on two fronts—export expansion, and improvement in productivity at home in order to compete with imported goods. The Commerce Department has laid out a 5-year export expansion plan to which it is giving high priority, and it is working closely with Amercan businessmen as well as other Government agencies such as the Export-Import Bank to help us achieve our goals.

Business, not Government, must do the exporting. The National Export Expansion Council, which is supported by a group of regional export expansion councils, advises me as Secretary of Commerce on the export expansion program. The national council last December presented a report entitled "Policies and Actions To Improve the U.S. Balance of Trade and Balance of Payments."

I am studying the recommendations of that report. Its range includes not only the promotion and financing of U.S. exports, but questions of taxation and transportation as affecting trade, and even the encouragement of U.S. investment in developing countries.

On Monday of this week I called together the Cabinet Committee on Export Expansion, in which all the agencies of the executive branch concerned with foreign trade, as well as the Federal Reserve Board, are represented. We are proceeding on a high priority basis to develop the necessary measures to step up our exports materially. You will be interested to know that we have tentatively set an export goal of $50 billion to be achieved by 1973. This compares with 1968 exports of $33.8 billion.

Trade Policy

I cannot do better than quote President Nixon's statement at his February 6 news conference on the subject of trade policy.

"I believe that the interests of the United States and the interests of the whole world will be best served by moving toward freer trade rather than protection. I take a dim view of this tendency to move toward quotas and other methods that may become permanent, whether they are applied here or by nations abroad."

The difficult problems, however, are not those of general principles but of particular cases. The quick growth of imports has presented a severe challenge to a number of domestic industries. The right first response of a business system that is based on competition is to compete more effectively. We should do all we can to increase productivity in our factories and in our distributive system.

Our trade policy, however, if it is to be successful, must take into account those industries which suffer acute distress from import competition. We must make much more effective use of the unused provision in the Trade Expansion Act of 1962 for giving adjustment assistance to injured firms. This will require amending legislation. It is wise that, in a period when we are fighting inflation, we should not invite price increases by erecting barriers to imports. Rather, we should think of adjustment assistance as a means of aiding U.S. industry.

There are, of course, difficult problems associated with certain industry situations, particularly textiles and steel, for which import relief is being sought urgently. But these must be tackled with a full recognition that assistance must be needed and merited, and that trade is a cooperative process as well as a competitive process. We should be equally sensitive to the legitimate interests of our exporters who might be the targets of foreign retaliation. We should also take into account the interests of friendly foreign countries which would like to maintain a healthy and growing two-way trade with us.

Most of all, we should fight foreign as well as domestic tendencies to restrictionism, whether occurring by nontariff barriers or by tariffs, and in agriculture—which is a vital U.S. export interest—as well as industry.

Control of Foreign Direct Investment

The Department of Commerce has had responsibility for administering both the voluntary foreign investment restraint program introduced in 1965, and the mandatory foreign direct investment program which was introduced in January 1968. Both programs were announced as "temporary." This administration hopes to phase out these controls as quickly as possible.

Government controls over investment are distasteful and, although they produced results helpful to the 1968 balance of payments, their long-range effects are not advantageous. The controls are a stopgap; basic actions to control inflation at home and to negotiate with our trading partners to remove inequitable trade barriers, should make possible steady phasing out of the controls.

The very high interest rate pattern in the United States was an important inducement to foreign capital inflows which contributed to the balance-of-payments surplus in 1968. The basic need to control inflation will probably keep rates here high for the time being, which will somewhat reduce any risk in relaxing the investment controls program. Further, returns to the United States from foreign investment have steadily increased and are projected to climb again substantially in 1969. These factors, taken together with the basic fiscal and monetary actions we will be implementing, suggest that we start phasing out these stopgap controls.

Already the Office of Foreign Direct Investment has relaxed in some degree the application of the controls. Smaller firms have been relieved of the burden of filing detailed reports, and allowances have been made for the problems of the construction industry. In the administration of the controls every effort has been made to permit investment in the developing countries. Also, to provide more equity in the assessment of investment quotas, the Office has introduced as an alternative to the original base-period investment, an option of using earnings as the determining principle. This is an important conceptual change. We have utilized the rising trend of earnings on overseas investment as a way of providing more headroom for new investment within our overall balance-of-payments objectives.

In our consultations with leading business and banking leaders, there has been general agreement that the abrupt removal of the controls could be severely disturbing both at home and abroad and would involve too big a risk. The balance of payments must be kept under control, and the dollar must be a trusted currency. Therefore, the administration has been reviewing a number of ways to relax the investment controls in the context of its general balance-of-payments review.

Other Matters

With your permission, I wish to outline two matters of policy which come within the range of interest of your committee and which are of great concern to the Department of Commerce.

The first is the preparation for the Nineteenth Decennial Census in 1970. An issue has been raised as to whether the census questions constitute an invasion of the people's entitlement to privacy. The contrafactor is modern Government's needs for accurate information as a basis for reaching economic and social judgments.

The second is the development of minority business enterprise, with both the Government and the business community providing assistance. The President has asked the Commerce Department to take a leading role in this area.

THE 1970 CENSUS

The Joint Economic Committee has for many years shown close interest in the statistical activities of the Bureau of the Census, the Office of Business Economics, and other Government agencies, and has made constructive suggestions for their improvement.

Consequently, I feel sure that this committee will share my concern over the growing support for proposals that threaten to do serious damage to the quality of some of our most basic demographic and economic statistics. I refer to proposals that would sharply limit the number and nature of questions people would be required to answer in the 1970 Decennial Census.

It is easy to understand why there should be a certain amount of annoyance over being asked to fill out questionnaires. Nevertheless, it is both inappropriate and unfortunate that this is contended to be an invasion of privacy.

Actually, the 1970 census will be, for most people, less burdensome and no more invasive of privacy than previous decennial censuses. For the first time, about three out of five families will receive and be able to return their questionnaires by mail without ever seeing a census enumerator. Most families will be able to fill out their questionnaires in about 15 minutes. The total number of questions will be about the same as in 1960 and *less* than were asked in 1950 or 1940. A limited number of questions will be asked of every household. Most of the questions, however, will be asked of only one househould in four, selected on a random basis. As has always been the case, answers given the Census Bureau will be strictly confidential and cannot be published or given to any other Government agency except in the form of statistical totals.

The decennial census is the one occasion when we try to get complete information on certain key characteristics of our population and the homes our people live in. This is vital information for all levels of government, down to local school districts, if they are to carry out their responsibilities intelligently.

The American people have always regarded the decennial census as one of the least onerous obligations of citizenship. They have cooperated willingly and taken great interest in the results. I believe it would be an extremely disturbing development if this spirit of cooperation should be undermined.

MINORITY BUSINESS ENTERPRISE

In regard to the development of minority business enterprise, President Nixon stated in his inauguaral address that we must draw into the solution of our socioeconomic problems all the strength of our Nation. Government and private enterprise will need to act together in dealing with these problems. Capitalism and private enterprise must present challenging opportunities for minority groups as well as for those who are in the mainstream of our national economic life.

One aspect of our urban problem is the separation of those in our minority groups from involvement in the country's principal economic activities. There are many different ways of tackling this problem but one of the most promising is to assist them in setting up their own business enterprises.

The difficulties of making these programs effective are great. The number of people whose experience enables them to create new business enterprises without considerable training is relatively small. But we are aware of these difficulties and will try to surmount them. In fostering minority enterprise, we intend to help not only the black people, but also Spanish-Americans and American Indians. And we shall be careful to avoid the development of new barriers between the poorer areas and those areas surrounding them.

The Involvement of the Business Community

There are a great many people in the business community who want to take a larger part in dealing with the problems that plague us today. This administration is solid in its determination to marshal the resources of the business community for solving social problems.

Too often people think that the sole means of inducing business participation is the offer of favors. We do not take that view. The function of government is to provide the environment in which business, under the profit system, can develop its best efforts in producing the goods and services that we need. Beyond that, tax incentives may be useful in some cases, in order to direct special efforts toward solving critical social problems. But I believe it is possible in many instances to induce American business, in its own self-interest, to contribute time, money and skills to the redressing of society's imbalances. This will be a major objective of this administration.

This completes our presentation, Mr. Chairman.

Representative Reuss. Secretary Stans, your excellent report is indeed a cogent contribution to our hearing.

Mr. Stans. Thank you, Mr. Chairman.

Representative Reuss (proceeding). Under Secretary Volcker, because your statement interlocks with Secretary Stans', I will ask that you proceed with your statement now.

STATEMENT OF HON. PAUL A. VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. Volcker. If you would prefer to go ahead with your questions for Secretary Stans——

Representative Reuss. If the Secretary can wait, Senator Javits will be back.

Mr. Volcker. I will read my statement, then, Mr. Chairman.

Representative Reuss. Fine. The whole statement is before us, and if you will hit the high spots, I think we will proceed as rapidly as possible.

Mr. Volcker. Mr. Chairman, this committee has come to play a special role in stimulating congressional thinking and public discussion in the complex area of international finance, and I particularly look forward to the opportunity of working with you in the future. As you will understand, I will not at this stage attempt to lay out the specific ingredients of our approach toward the balance of payments or a precise agenda for improvements in our international monetary arrangements. Rather, I would like to appraise where we now stand and to suggest a general framework for approaching the future.

Certainly, there can be no shrinking from the fact that serious problems exist in the areas you are reviewing today. Secretary Stans has already covered our balance-of-payments results for last year.

I will not go over that ground again in detail. However, I would reiterate the plain fact of the matter. The overall balance in our external payments last year on the liquidity basis, welcome as it is, was achieved only as a result of an unprecedented swing in the capital accounts. The United States, for the first time in the postwar period, became a large net importer of capital. This is an extraordinary position for the world's richest economy. It is a position that we should neither expect nor want to sustain for long.

Meanwhile, the international competitive position of our industry is feeling the effects of several years of accelerating price inflation and overheating at home. The impact on our trade balance has been aggravated by slower growth and excess capacity in some other leading industrialized countries.

The behavior of our price indices helps tell the story. Consumer prices in this country rose by only a little over 1 percent a year from 1958 to 1964, and export prices were nearly flat. From 1964 through 1968, in contrast, consumer prices rose by over 14 percent, and the latest available data show export prices up by about 9 percent from 1964. A composite index of export prices for the industrial countries of Europe rose by only 2 percent over the latter period; and, in Japan, the rise was only 1 percent.

While movements in relative prices are certainly not the only factor responsible, we are faced today with a situation in which our once healthy trade surplus has entirely disappeared. The most recent data, while difficult to interpret because of the dock strike, show no clear evidence that the turning point has yet been reached. In these circumstances, there is no room for complacency with respect to our competitive position.

I have no wish to minimize the constructive and longer term elements in the large capital inflow last year. Given the fact of the deterioration in the trade balance, these flows did serve an equilibrating function and, in part, reflect some desirable longer run structural changes in financial markets. For instance, the foreign net purchases of U.S. stocks, which jumped to $1.9 billion last year from an average of only $200 million over the previous 5 years, may stem, in part, from a basic shift in the investment patterns of many European investors, attracted by the liquidity and growth potential of the American market. The expanded promotional activities of the American financial community—backstopped by action the Government itself has taken to rationalize the tax treatment of foreign portfolio investment—has certainly played a part.

Similarly, the rapid development of the Euro-bond market—and the Euro-dollar market more generally—has provided both United States and foreign businesses with an alternative source of funds in financing overseas expansion, reducing the drains on the American market. The result was that U.S. firms could raise some $2 billion in the European bond markets at interest costs only marginally higher than they might otherwise have paid in the United States.

Nevertheless, more transient factors also played a major role in the swing in the capital accounts. The main impetus to foreign borrowing by the U.S. companies came from the mandatory controls on direct investment outflows from the United States commercial banks, faced with tighter guidelines on their foreign lending, cut their overseas credits in 1968, in contrast to a sizable increase the year before. These particular sources of improvement will not be operative in the future. Indeed, instead of relying on controls to achieve short-run improvement, we want to move in the direction of relaxation just as quickly as circumstances permit.

The increasingly tight money conditions in the U.S. market also pulled large amounts of capital to this country. This was most visible in the form of an increase of about $2 billion in borrowing of American banks from their own overseas branches. Those branches, in turn, were bidding for funds in the Euro-dollar market.

The pull of tight money, which has continued into the early weeks of the new year, helped to account for the sizable surplus of $1.7 billion achieved on the official settlements basis in 1968. Essentially, dollars that might have become foreign official claims on the United States were, instead, diverted into the Euro-dollar market and returned for use in this country through the private market. In the short run, this inflow was helpful. But short-term borrowing in this amount can hardly be considered a part of a long-term solution to our balance-of-payments problem.

A variety of so-called special transactions arranged with foreign official institutions were also an important element in last year's results, and an element that should not be relied upon year after year. Here, I would draw a distinction between those special transactions that represent an offsetting or neutralization of our military expenditures abroad and those designed simply to change the maturity of some of the dollars held by foreign central banks. The former reflect an effort to come to grips with the continuing problem of evening out balance-of-payments burdens arising out of the mutual defense effort. We cannot be entirely satisfied with the form of many of these offset transactions, but the basic principle that no country should suffer balance-of-payments disadvantage through its contribution to the NATO defense structure is sound.

Turning from our own balance of payments to the international financial scene generally, signs of tension and strain have been evident over the past year or more. I need not review the series of so-called crises, beginning with the devaluation of sterling in late 1967, that have attracted so much attention. Nor will I maintain that the period of relative calm that has been restored to the markets since the Bonn Conference last November is an indication that the problems are now behind us. But I would urge that, in approaching these problems and finding durable solutions, we not be beguiled by the thought that a full answer can be found merely by a change in some of the technical international monetary arrangements.

The problems are deeper. In part, they are a symptom of inflation, not only in some countries abroad, but in recent years in the United States as well. The result has been a sense of lack of control—of drift—which, if long continued, could undermine the sense of confidence in the monetary system. Without confidence, any monetary mechanism will work poorly—and orderly change becomes more difficult.

That is one reason why a first priority for the United States must be to regain control over its own inflation. We do not have the option of achieving that result in an abrupt way that would lead to a contradiction in trade abroad as well as excessive unemployment at home. Even looking at the balance of payments in isolation, there would be little or nothing to be gained from a sharp recession that drives too much money abroad in search of more profitable employment. But steady restraint, applied as long as necessary, is the basic ingredient upon which American leadership in the international monetary area must rest.

Apart from the current inflationary problem in the United States, developments in recent years have brought into fresh focus some old—but still unsolved—problems of international adjustment. Nations give heavy weight to domestic objectives, and it is natural for differing emphases to emerge with respect to employment, growth, productivity, and price stability. The result is a tendency to push balance of payments out of equilibrium, with resultant strains on the monetary mechanism.

Even considering balance-of-payments objectives themselves, the evidence seems to be accumulating that nearly all countries feel more comfortable with—and aim for—surpluses (or at least increases in international reserves) over a period of time. Yet, unless new reserves are being created in sufficient volume to support these aims, they turn out to be mutually (and arithmetically) incompatible and thus impede adjustment.

As a practical matter, the United States, because of its size and the widespread use of its currency, is in an essentially different position from most other countries in this respect. A small country is able to make adjustments in its economic policies within some range upon the assumption that the rest of the world will "stand still;" the adjustments can, therefore, be expected to be effective in terms of its balance of payments. The United States often cannot make the same assumption. The policies we adopt have a pervasive influence on the rest of the world, and other countries may thus react to our moves by changes on their part to maintain their external balance. In this situation, so long as other countries collectively want, over time, to run a surplus—and essentially achieve this surplus by adjusting to the position of the United States—the ability of this country to restore a durable equilibrium is closely circumscribed.

I would go further and put the point more positively. Surplus countries must themselves recognize they share the responsibility for undertaking the adjustments, in current as well as capital accounts, necessary to achieve a healthier international monetary system.

Another problem area is the strains on the monetary mechanisms that have developed from structural changes in international payments. One aspect of this change, referred to earlier, is the large and sustained burden of defense expenditures abroad. These expenditures obey no economic law; yet they do permeate the economic and payments structure of the United States and other countries in a way that cannot easily, if at all, be absorbed by the traditional adjustment policies.

At least as important over time is the increasing volume of capital flows that have accompanied the growing integration of the international economy, particularly in the highly developed part of the world. This movement of capital brings great gains in the rapid dispersion of technology and managerial techniques, in the potential for efficient large-scale production, and in the better allocation of scarce capital worldwide. But it also brings the potential for a great volatility of funds and essentially speculative flows that do not reflect lasting economic advantage and can be an added source of strain to the financial mechanism.

These comments can, of course, do nothing more than touch lightly upon some of the underlying problems that lie behind the international financial difficulties of the past year or more. Moreover, in citing these problems, I do not want to lose sight of the very real economic achievements of the postwar period for which the international monetary system can certainly take a large share of the credit. For instance, in terms of the acid test of expanding trade, increases have averaged 7 percent a year since 1950, and that upward trend continued through the crises of last year. Capital flows have expanded enormously within the industrial world, and gains in productivity and income have been both relatively steady and large by historic standards. International cooperation has, in the pressure of events, proved up to the task of containing and defusing the crises that have developed, without lasting damage to trade.

These are substantial achievements, not to be jeopardized lightly in a search for the will-of-the-wisp of some simple, sweeping reform that will easily solve all our problems. In this complex world, such a simple one-dimension solution does not exist. We cannot escape from the problems of achieving a better adjustment process, or orderly growth in liquidity, or sustaining confidence in the dollar by increasing the monetary price of gold. Secretary Kennedy has pointed out we will not seek an answer to our problems by such a change. Nor should we be under any illusion that the opposite extreme of freely fluctuating exchange rates, in theory bringing a quick and automatic adjustment process, would necessarily be less painful or less disturbing.

But, as this committee has itself emphasized, neither can we stand aside, unwilling to examine responsible proposals for change that deal with important parts of the evident problem. We will not drift into a morass of controls, whether on capital or trade, in a misguided effort to avoid changes in financial arrangements, where change is needed.

We do not seek change for the sake of change. We want to test our ideas and plans with our friends abroad to make sure that they are responsive to the common interest in a strong and durable international monetary system. But where change is demonstrably needed and responsive to the nature of problems before us, we will be prepared to move ahead.

Some items are already on the agenda. Prompt ratification of the Special Drawing Rights—SDR's—and then their early activation, are high on the list. This is the method of supplementing world liquidity agreed in the framework of the International Monetary Fund after years of patient negotiation. It is aimed at only a part—but an important part—of the problem before us. Special Drawing

Rights will not cure our own balance-of-payments problem. But they can make a vital contribution in further undergirding the stability of the system, even in the shorter run, by providing concrete evidence of the capacity of the world community to manage consciously the supply of international liquidity in the common interest.

Progress in achieving a more equitable distribution of the balance-of-payments consequences of the military effort is another area in which we need now to build more permanent arrangements, learning from the experience of the past. Nontariff barriers to trade in general, and border taxes in particular, deserve—and are receiving—our close attention to see whether changes in these areas might contribute to facilitating the adjustment process.

Our already strong defense against speculation—the network of swaps and other facilities for marshaling funds quickly at the point of need—will be maintained and adapted to changing circumstances, as necessary.

Our horizons must extend further. Discussions in this committee and elsewhere have proposed means for introducing an element of greater flexibility into exchange rates. Careful evaluation is needed of the possible contribution such changes might make to dampening speculation by increasing its costs, and to easing the longer range problems of adjustment. Your committee and others have also proposed new means of better assuring stability in the composition of reserves, and these proposals, too, need to be explored.

But I would conclude by repeating again what must be the sine qua non of lasting progress—a strong and respected dollar rooted in healthy, noninflationary growth at home. Without this, no monetary device can assure stability and an international financial framework conducive to economic progress. But, with inflation under control, I am confident that we can attack, forcefully and intelligently, the remaining causes of strain and tension with every prospect of success.

This concludes my statement, Mr. Chairman.

Representative REUSS (presiding). Thanks to both Under Secretary Volcker and Secretary Stans. It is very gratifying to this committee to have Secretary Stans' firm vote in favor of freer trade as the general direction of national policy and also Under Secretary Volcker's agreement with this committee that very serious exploration needs to be given to both the idea of somewhat greater flexibility in exchange rates and to new means of assuring stability in the composition of world international reserves. Those are views with which I think the Joint Economic Committee fully agrees.

Secretary Stans, do you have a timetable for the relaxation and removal of our present controls on capital direct investment and portfolio investment abroad and bank lending to foreigners?

Mr. STANS. Mr. Chairman, I would say that we are hopeful that somewhere in the next 30 or 60 days we would make the first step toward some type of relaxation. I do not believe we can tie it into a timetable for total elimination, for the simple reason that that judgment is so much influenced by the other factors in the balance of payments and other elements in the economy that any time estimate now would be too risky. We do hope, however, to make some moves in the very near future.

Representative REUSS. On a similar aspect, Secretary Volcker, given the high level of interest rates in the United States and given the very considerable influence of foreign capital into this country in the last year, could not the interest equalization tax be allowed to expire this year?

Mr. VOLCKER. We certainly have that under review, Mr. Chairman. The question of the interest equalization tax is being considered parallel with the consideration of the direct investment program and for that matter, the Federal Reserve program, and what changes seem appropriate there. We would certainly like to make a reduction in the rate, at least, if that seems possible. It will be considered and announced along with the elements that Secretary Stans referred to.

Representative REUSS. A question for both gentlemen, I think. Professor Machlup of Princeton has been making some interesting studies recently on the relation between our capital investment abroad and trade abroad. His studies, published last September in the *Quarterly Review* of the Banca Nozionale del Lavoro, indicates that there is a very close correlation between the amount of American capital investment abroad and the amount of our net real exports—almost a one-for-one correlation. To the extent that these studies are correct, it would seem as if controls over capital investment abroad are a self-defeating, kill-the-goose-that-laid-the-golden-egg proposition, or at least are becoming so. Is either of you familiar with either Professor Machlup's study or with the general proposition of correlation between investment abroad and our exports?

Mr. STANS. I have not read his specific studies, but I have read about them. We have also had some discussion about them in the Department of Commerce. No one knows for sure what the correlation is, but there certainly is a degree of relationship between our foreign investment and our ability to export. It may very well be that if we could pin down the facts, we would find that some part of our deterioration in the trade balance last year, some part of the failure of our exports to match the growth in imports, was the result of the fact that we held back as tightly as we did on capital investment overseas. I would hope that if we can come up with the first moves toward relaxation of the export of the investment controls, this might produce an added gain that we would secure by reason of the fact that it might free up the opportunities for exports as well.

Representative REUSS. Secretary Volcker, has the Treasury put its mind on the problem of this correlation?

Mr. VOLCKER. The Treasury does have its mind on matters of this kind and I think the general proposition that trade often follows capital has a degree of validity, certainly in the longer run. I think we cannot feel that this is our whole current problem with the trade balance.

Without in any way conflicting with anything Secretary Stans just said, but in order to put the thing in some perspective, I would just mention that the big problem last year, in particular, was the increase in imports rather than a slower growth in exports, although clearly, we want to be more competitive in the export area. The really dramatic change last year was a 23-or-so-percent increase in our import bill. While our exports, of course, did not do as well as we would have liked, they did continue on an uptrend.

Representative REUSS. Here, I would like to say, Secretary Stans, that I applaud your $50 billion 5-year export goal. I know it is easier to set goals than to fulfill them, but in my judgment, you are on the right track in your goal setting.

Mr. STANS. The first thing to do in trying to achieve a result in our exports is to set a goal like that and then bring to bear all the tools and mechanisms we have in the Government and private industry to try to reach it. That goal will be subject to adjustment from time to time as the international developments and other circumstances suggest. But there is no reason why, under the present state of facts, we should not be able, with all of the effort that can be applied, to achieve that kind of goal.

Representative REUSS. I would like to ask both the Treasury and the Department of Commerce to file with us for inclusion in the record your observations on the Machlup correlation. I know they cannot be final, but I would like to have the benefit of whatever research was done on this so that, even in the half-finished state it may be in, we can appreciate it.

(Material received by the committee from the Commerce Department follows:)

DEPARTMENT OF COMMERCE COMMENTARY

Professor Machlup's Views on the U.S. Payments Balance, "The Transfer Gap of the United States," *Banca Nazionale del Lavoro Quarterly Review*, No. 86, September 1968, reprinted by the International Finance Section, Department of Economics, Princeton University as Reprint in International Finance, No. 11, October 1968.

Professor Machlup's theme is that the U.S. international accounts are in chronic deficit because there are no acceptable ways to raise the export surplus to match the large scale of U.S. financial transfers. Consequently, there is a "transfer gap" measured by *net financial transfers* less *not real transfers*. Professor Machlup's definition of these terms is discussed below.

The theory of transfer is that autonomous financial movements induce and ultimately require a similar movement of real resources. If real resources move at a different rate, the gap is necessarily filled by movement of reserves, that is, in the U.S. case a deficit.

Mr. Reuss's question at the hearing was on the casual connection between U.S. investment and U.S. trade. U.S. direct investment outflows, according to the transfer theory, generate directly or indirectly a demand for U.S. exports. To restrain direct investment would thus result in a comparable reduction of U.S. exports. There would be no reduction in the U.S. over-all deficit, or perhaps a relatively small reduction. But there would also be lasting damage from the longer-run effects of the restraint.

The voluntary and mandatory controls of foreign direct investment have not operated as sharp restraints on the rate of balance-of-payments outflow of U.S. direct investment. In each of the years 1965 through 1967 and in no year before 1965, this capital outflow has exceeded $3 billion. The principal effects of the controls have been to divert the source of financing through an increase in foreign borrowing and to speed up the repatriation of earnings. Both of these have caused a reduction in net financial transfers, as Professor Machlup defines them. However, as Mr. Charles E. Fiero testified before your Subcommittee on International Exchange and Payments on January 15, 1969:

"Certain other critics charge that the program has adversely affected U.S. exports. There are, of course, many factors affecting U.S. export performance, and any influence of the conrtols cannot easily be isolated. However, there is no indication of any significant export offset. The fact that U.S. direct investors borrowed more abroad has not caused them to buy less goods from home except in a few isolated cases. On a seasonally adjusted basis, U.S. non-military merchandise exports for the first three quarters of 1968 rose 9 percent over the same period of 1967. To put this increase in perspective, non-military exports for 1967 rose by only 4 percent over 1966."

However, Professor Machlup's argument is plausible in particular cases. It is conceivable that a restraint of capital outflow can be reflected in real transfers. If so, there would be some offsetting of the desired reduction in the transfer gap or the liquidity deficit. It is also clear that "temporary" restrictions can have unassignable permanent effects, and that prolonged restriction creates distortions of trade and payments. It is even possible to agree that some measures of restriction are not assuredly measures of adjustment, and that "at best (they) suppress the imbalance, but cannot move it."

However, in the opinion of the Commerce Department, the Machlup article does not firmly establish the causal relation between investment and trade. The statistical correlation is high, but would naturally be so. Moreover, it would be higher still if the adjustment process were faster and less imperfect.

The article, moreover, is a study of the persistence of the transfer gap or liquidity deficit and not, except in a brief epilogue, of the actual policies that would be required for its elimination.

Observations on Professor Machlup's article are made under three headings:

(1) Rearrangement of statistics;
(2) Theoretical inferences; and
(3) Implications for policy.

(1) The statistical rearrangement of the balance-of-payments tables is illuminating.

To measure net real transfers, it removes from the net balance on current account—

(a) Receipts and payments of income from investments (which are regarded as financial transfers),

(b) Military expenditures abroad (which are with less justification likewise regarded),

(c) Government nonmilitary grants, and

(d) Both Government and private remittances and pensions. (Government military grants and the associated commodity exports which offset each other are excluded.)

To measure net financial transfers, the rearrangement includes (a), (b), (c), and (d) above as financial transfers. It includes all types of private U.S. capital movements. But it rejects the differentiation of short-term and long-term banking and U.S. Government obligations to foreigners. Instead, the types of foreign capital included in net financial transfers are direct investment in the United States, changes in foreigners' holdings of American securities other than Treasury issues and other long-term liabilities to foreigners of private nonbank U.S. residents.

The resulting calculation of the transfer gap is differentiated from the liquidity deficit by three items:

(a) errors and omissions. (This balancing item in the official tables can be regarded as the unexplained variation in reserve assets and liquid liabilities.)

(b) changes in foreign long-term liabilities of American banks and in short-term liabilities of nonbank residents. (The former are now with very minor exceptions reported as "special transactions," though they are not included in the category of "liquid" capital. The latter have been rather small until 1968 when they were raised through foreign borrowings by U.S. corporations.)

(c) changes in the foreign liabilities of the U.S. Government other than marketable or convertible Treasury obligations. (Most of these are likewise the subject of "special transactions" in nonliquid capital.)

The usefulness of this presentation is that it seeks once again to differentiate autonomous capital movements from accommodating capital movements. The former generate spending flows and hence, by income and substitution effects, real flows of goods and services. The latter are responses of varying kinds, and with varying time-lags, to the imperfection of adjustment between autonomous financial flows and real flows.

But the principal criticism of the presentation is also an admission of a general fault of many statistical reports: there is no satisfactory way of imputing intent to any particular financial movement, especially when the statistics are collected by type of financial transaction.

On narrower grounds, however, there should be little surprise that there is a high correlation between the transfer gap as defined and the liquidity deficit particularly if it is adjusted for "special financial transactions" by U.S. and foreign official agencies. These figures are published regularly in the *Survey of Current*

Business so that the adjustments can easily be made. When the liquidity deficit is adjusted in that manner the differentiating items—consisting of the balancing figure of errors and omissions, plus certain types of formally "nonliquid" capital—are likely to be relatively small.

(2) There is a much more serious objection to the regression analysis by which net real transfers are related to net financial transfers as the explanatory variable. The "explanation" is statistical, but the inference that it is causal goes too far.

First, if the transfer gap, like the liquidity deficit, has been a consistent and not wildly variable feature of the past 18 years, there will be a consistent and not wildly variable difference between net real transfers and net autonomous financial transfers, no matter how the various types of transactions are divided among these categories. This is not to assert that there is no causal linkage. But the variety and time-lags of the causation and the feed-back process all go beyond the range of a linear estimate.

As Professor Machlup himself admits, there is an element in the increase of foreign liquid dollar holdings, both private and official, that could qualify for inclusion in autonomous financial transfers as long as confidence in the unrestricted convertibility of the dollar into foreign currencies at stable rates can be maintained. Nobody knows what part of the transfer gap would be eliminated by making such a change. But even if it were made, there would be no firm assurance that the acquired level of liquid dollar holdings would remain the desired level. It may be that the balance-of-payments accounts remain the principal statistical check on the U.S. position. But there is some need to keep watch on the net investment position too, especially in regard to the total of "liquid, near-liquid and pseudo-nonliquid liabilities"—whether or not there is supposed to be a disequilibrium because of the size of the deficit.

Secondly, there is a vast variety of responses to different capital flows. Even within the category of direct investment, there is a very great difference between the acquisition of an existing firm as a foreign affiliate and the construction of an entirely new overseas unit. Investment in Europe creates a different response from investment in a small developing country, particularly one with which we have strong trade ties. The trade-inducing effects include the stimulus to immediate associated U.S. exports of equipment and the development of new outlets, through the subsidiary, for U.S. exports. The trade-displacing effects include the development of a new source of supply of U.S. imports and of competition with existing U.S. exports in foreign markets. Only a few of the trade effects are prompt. Ultimately the effects are dispersed through the whole system, and are unidentifiable.

If there were a consistent composition of capital flows, there might be better hope of identifying the induced real flows. But it is, at present, true to say that no analysis, official or academic, has satisfactorily demonstrated in predictable quantitative terms the process by which autonomous financial flows generate real flows.

Thus, the transfer gap is a useful schematic demonstration of imperfection, friction or time-lag in the adjustment process. But it is not possible to prescribe from a theoretical model of the transfer process any assured measure for the reduction or elimination of the transfer gap.

What Professor Machlup eventually prescribes is a real adjustment which "requires raising the level of Real Net Transfers of the United States to 1.5 percent of GNP, and perhaps higher."

(3) The question that policy makers have to answer is not whether Professor Machlup's theory is right or whether his policy prescription is attainable within the existing structure of incomes, prices and exchange rates. In fact, the article gives no basis for confidence that, in the existing structure, the removal of direct investment controls would promptly improve exports.

The problem is more immediate, and is also wider than the range of the balance-of-payments accounts. It is to maintain a viable process of internationl exchange and the continued confidence of the international community in the quality of the dollars. This brings into the forefront the significance of the large total of outstanding U.S. quick (or liquid) liabilities to foreigners. These could conceivably be used to purchase U.S. exports and increase the level of net real transfers, or to purchase U.S. longer-term securities or other capital and decrease the net autonomous financial transfers. Both types of action would tend to close the transfer gap. However, the very existence of the gap and the overhang of quick liabilities creates the risk of alarm in the exchange markets. The first response of the authorities to a full-blown crisis has to be a prompt cutback of expenditures and especially of those expenditures whose reduction would be least damaging to the national interest in the short run. The other response, to induce an increase of receipts, is less likely to yield prompt results but is equally necessary.

The restrictions in capital flows can be justified as an offset to large military expenditures both at home and abroad. It is true, however, that the effect of the restrictions on capital outflows hinges on measures to prevent domestic investment from raising domestic expenditures. Present monetary and fiscal policy is designed to do that. If the restrictions were removed, the tight fiscal and monetary policies would probably have to be made even tighter.

Thus, the Administration's approach to the removal of the controls on capital flows has to be cautious. The policy has to be a phasing-out and not an abrupt termination. Even a high degree of confidence that the removal of controls would not increase but would somewhat decrease the transfer gap does not suffice. There are potential disturbances to both official and private financial flows that have to be reckoned with.

(The Treasury Department's response follows:)

MARCH 3, 1969.

Professor Machlup has argued that a very sizeable part of the changes in our net exports during the period, 1950–1967, can be accounted for by changes in our net financial transfers abroad. He explains this as a result of several factors, mainly related to the transfer adjustment mechanism operating through incomes and prices, here and abroad. For example, if we *reduce* our capital outflow or military expenditures abroad, Professor Machlup argues, U.S. domestic expenditures would presumably be higher than they otherwise would be. In that event, U.S. incomes and prices will be higher, and these changes will tend to discourage exports and encourage imports—in short, reduce our export surplus. Similarly, in the country or countries which are receiving less U.S. capital than before, there will be a restraining impact on incomes and prices, with a consequent beneficial effect on their export surpluses.

Professor Machlup considers the chances of reducing our financial outflows without causing an approximately equal decline in our export surplus to be small. Consequently, he considers that Government measures to improve the balance of payments by curtailing such outflows are futile over any period of years, although they may be effective for a short time.

The following points raise questions about this analysis:

(1) Professor Machlup implies much more precision and automatism in the adjustment process than most economists. Shifts of capital may often set in motion forces affecting the trade balance; but the effects will vary from time to time depending on such factors as the degree of plant capacity and labor force utilization at the time, import propensities of the sectors that are affected, relative price changes, and, perhaps, most important, the nature of domestic policies here and abroad.

It is interesting that application of Professor Machlup's analysis to another major industrialized country—whose external transactions are much larger relative to its domestic transactions than in the case of the U.S.—gives a markedly lower correlation than for the U.S.

(2) A large part of the dollars transferred by the U.S. to certain foreign countries may return to the U.S. not for purchase of U.S. goods and services, even indirectly—as Professor Machlup's analysis would suggest—but for long- and short-term investment in the U.S., including accumulation of dollar reserves by foreign governments. This would be particularly true of a country in a strong international competitive position and with a policy of giving very high priority to domestic price stability. In short, when one is considering the potential effect of U.S. financial transfers on U.S. net exports, it makes a great deal of difference which foreign countries are acquiring these transfers from the U.S.

(3) The statistical categories of balance-of-payments data, as Professor Machlup realizes, are not sufficiently refined to permit a careful testing of his thesis. In particular, he hypothesizes that non-accommodating financial flows determine real flows, rather than the reverse; and he includes government grants, direct investment and portfolio investment as non-accommodating financial flows. But the cause and effect relationship is difficult to isolate and many of his results would be consistent with a view that capital tended to follow trade, rather than the reverse.

Representative REUSS. I have one more question before I call on Senator Javits and Senator Percy.

Secretary Volcker, you referred to the need for picking up the balance-of-payments cost of our troop commitment in Europe. You referred to this in your statement as the basic principle that no country should suffer balance-of-payments disadvantage through its contribution to the NATO defense structure. Of course, we have been suffering about a billion and a half dollars a year balance-of-payments disadvantage because of our commitment to the NATO structure. Is that not so?

Mr. VOLCKER. As I recall it, something like $1.6 billion is the gross fiscal year 1968 balance-of-payments cost in the Western European area. But this has in part been neutralized or offset.

Representative REUSS. These offsets bother me a bit. To have our friends in the Federal Republic of Germany buy a billion and a half dollars worth of American military hardware that happen to be the least expensive in the world does not seem to be much of an answer. When it ceases to be the least expensive, they do not buy it anymore, as has been true in the last couple of years. On the other hand, if our friends lend us money at the going interest rate for 3 or 4 years we still do not really solve our problems. They merely compound and will come home to roost in 3 or 4 years. It has been the view of this committee that the only meaningful way in which our NATO friends can pick up our balance-of-payments cost is to write us a check. Yet we were not, I regret to say, successful in convincing the previous administration that they ought boldly and forthrightly to ask our NATO friends to do that. Do you think this committee is going to have any better luck with the current administration?

Mr. VOLCKER. As I suggested in my statement, while I recognize that the offsets and neutralization efforts that have been made are not valueless in the short term, I am not satisfied with the form that they have taken. I think this is an area where we need to do some fresh thinking and I am very glad to have the reiteration of your judgment on this matter in that connection.

Representative REUSS. Senator Javits?

Senator JAVITS. Just to take up where the chairman left off, though I have no questions and I would like to relieve the Secretary of Commerce promptly, is it not a fact that the most effective thing the Europeans can do would be to see a great deal more to their own defense? There is plenty of manpower in Europe. The tripwire effect of American troops in Europe can be attained with one-half or less of the troop deployment that we have there.

You would agree with that, would you not, Mr. Secretary, or Secretary Volcker? The only way is not to write us a check?

Mr. VOLCKER. It is clearly not the only way, but I am not going to pronounce, myself, any judgment on the strategic elements here. I would say if the decision is made to maintain troops there, a more effective way should be found of distributing the balance-of-payments cost.

Senator JAVITS. Secretary Stans, you indicated, or at least there was indicated in the press just this week, that you are going to Western Europe to discuss monetary trade issues with European leaders and that you are also planning a new export drive. This is what I would like to ask you about. There is a piece in the Journal of Commerce that says you are making a bid to take over the functions of the office of Special Representative for Trade Negotiations. Would you care to make any comment at this time on that?

Mr. STANS. On that latter point, I think the press is way ahead of me. I have thought of it. The matter has not been studied. It may well be that the Department of Commerce is the best place for it, but I have no prejudgment on it and I have not made a bid for it up to this time.

Senator JAVITS. This piece would have us believe that it has some relation to an announcement made by the President in London, that you are going to Western Europe. But you say it has no relation to it whatsoever?

Mr. STANS. No relation to taking over that agency.

Senator JAVITS. Would you wish to give us any opinion now? I do not ask you to, because I think it is too important to press you about. But would you wish to give us any impression on former Ambassador Roth's feeling that this ought to be retained as a special negotiating agency in the Office of the President?

Mr. STANS. Senator, I am not prepared to express that opinion yet. I do not know enough about it. In another 3 or 4 months, as events evolve and relationships develop, I will be happy to make that expression.

Senator JAVITS. In your statement, you indicated that you are studying a report by the National Export Expansion Council which will encourage U.S. private investment in developing countries. We have just been discussing that in connection with the balance of payments. Are you aware of the report of the International Private Investment Advisory Council which, pursuant to an amendment of my own to the Foreign Assistance Act of 1968, has proposed the establishment of federally chartered corporations to take over the governmental functions of the United States respecting overseas private investment?

Mr. STANS. I am not, personally.

Senator JAVITS. I would strongly commend it to you, Mr. Secretary, that you acquaint yourself with this matter personally. I propose to introduce legislation on it, though I am hopeful that the administration will do it itself. It is a critically important matter, reflecting upon the very thing which we have just been talking about with Mr. Volcker.

Mr. STANS. I assure you we are interested in all possible solutions to improve this overall situation, because it is in the nature of being quite critical at the present time.

Senator JAVITS. The idea would be to establish a Government corporation which could carry on with much greater flexibility and with much greater hope of success the question of stimulating private investment, and we do not believe that it has anything but advantage to the United States and does not have any material balance-of-payments difficulty.

May I ask you, Mr. Volcker, if the Treasury is aware of this activity?

Mr. VOLCKER. I am not personally familiar with this, but I have already made a note, Senator, to become so.

Senator JAVITS. I would greatly welcome it, gentlemen, because it is, I might say, without being unduly partisan about it, very much of a character which the new administration has set of desires to look into that as the corporate form for carrying on highly desirable governmental activities, with the promise of great improvement in respect of its usefulness because it is a corporate form.

Mr. Secretary, one or two other questions. I notice there is nothing in your statement about travel. Now, it is a new administration and I am not attacking it at all, but I do think this is a time when we can enlighten each other. That is a big item in our balance of payments. It is adverse by about $2 billion a year. Senator Magnuson and I sponsored the U.S. Travel Service, which is now an established part of the Government.

In 1968, I introduced the International and Domestic Travel Act, which was cosponsored by a number of other Members, including Senator Percy who is here today. It is my intention to reintroduce this bill in this Congress.

I ask unanimous consent that a brief digest of that bill may be made part of my remarks, Mr. Chairman.

Representative REUSS. Without objection, it is so ordered.

(Excerpts from a statement made by Senator Javits upon introduction of S. 2907 follow. These appeared in the Congressional Record of February 1, 1968:)

INTERNATIONAL AND DOMESTIC TRAVEL ACT OF 1968

* * * * * * *

The proposal made in this bill is a positive approach to a solution of the U.S. travel deficit problem. Positive measures suggested to the administration for the last several years should, in your judgment, be given an opportunity to operate before Congress enacts any measures to restrict travel abroad by U.S. citizens. Travel restrictions as proposed by the administration would be self-defeating, difficult to administer, and would invoke retaliation by countries which depend on income received from Americans tourists.

Let us emphasize the positive before we go for the negative and restrict the freedom of our people to travel.

This bill, bipartisan in sponsorship, is designed to strengthen the capabilities of the U.S. Travel Service to reduce our balance-of-payments deficit. It would increase foreign travel to the United States and assist private industry and official travel organizations to encourage increased domestic travel by Americans.

Specifically, the bill provides:

First. New responsibilities for the U.S. Travel Service. These include development of a coherent national travel policy, coordination of present travel activities of various Federal agencies, encouragement and improvement of domestic travel facilities, and coordination of and acting as the Federal Government's liaison with State and private tourist organizations.

Mr. President, at the present time the United States Travel Service operates exclusively abroad and it has no domestic functions.

The proposed legislation further provides:

Second. A budget of $15 million to finance the Service's new activities and to strengthen its present activities abroad. Of this, $5 million would be used to start the proposed domestic travel program and $10 million would be used to promote foreign travel to the United States.

Third. A national inventory of our travel resources to lay the groundwork for a long-term national travel program. The bill calls for the establishment of a 15-member National Tourism Resources Review Commission, to be appointed by the Secretary of Commerce from among private citizens knowledgeable and experienced in the travel field.

* * * * * * *

Senator JAVITS. Would you be kind enough to give us your views and comments on what, if anything, the Department thinks can and should be done about a new escalation of the American effort to stimulate travel in the United States from other countries as one of the means of very materially redressing our balance-of-payments deficit?

Representative REUSS. Would the gentleman yield at that point?

Senator JAVITS. I will be glad to.

Representative REUSS. I would hope, Mr. Secretary, your response could include a reference to the use of a travel stamp plan or some packaging of discounts by airlines, hotels and motels, carriers, and so on, as a method of greatly accelerating tourism in the country. I know that is in the Javits-Percy bill.

Senator JAVITS. Yes.

Mr. STANS. May I say I will be very happy to do that. I have had some discussions about the travel agency. As you know, there has been only an acting Director of the U.S. Travel Service for some time. A new Director has been nominated by the President. We hope he will be able to take office within a few days. It is quite apparent that we do need a great deal more action in that area than has existed in the past. I think budgetary problems have intervened to some degree, but perhaps we have to do a better selling job in order to surmount the budgetary problem. In any event, we are very anxious in this area also to find new approaches, and certainly we will give full consideration to those you two gentlemen have suggested.

Senator JAVITS. Mr. Stans—I am saying this only by way of buttressing the Department's argument—when you compare the leverage of what we are seeking, which is $15 million more a year, with what's at stake, it almost becomes ridiculous. It is hard to see how it can be resisted provided the Department will really use the money effectively. That is the important thing.

Mr. STANS. I agree.

(The Department later supplied the following:)

INCREASING THE FLOW OF FOREIGN VISITORS TO THE UNITED STATES

The United States Travel Service serves as the focal point around which the United States travel industry and other government agencies involved in international travel cooperate in shaping policies and programs to increase the flow of foreign visitors to the United States.

The United States Travel Service has recently undergone some significant changes. Internally, it has been reorganized to strengthen the control of the Director's office over the operation of the staff divisions and, most particularly, the overseas offices. In addition, the qualifications of all USTS personnel were reviewed and appropriate changes were made. The primary objectives of the reorganization are to allow the Department of Commerce, through the Travel Service to accomplish three main objectives, which are as follows:

(1) To increase the demand of foreign citizens to travel to the United States.

(2) Expand the capability of the United States travel industry to sell travel to and in the United States to the foreign visitor.

(3) To aid industry and government to improve their services to foreign visitors in order to stimulate return visits.

The new emphasis placed on working with the travel industry can be seen in the following examples:

(1) The seven USTS offices abroad are emphasizing service to the foreign travel industry. These prime promoters of travel are being encouraged to sell actively the U.S. as a travel destination. Through an orientation process, these sellers of travel abroad are learning more about the marketing of travel to and within the United States. USTS is sponsoring familiarization tours to the U.S. for over 1200 of these foreign travel agents, tour operators, and travel writers.

(2) USTS is conducting a $1.2 million trade and consumer advertising campaign in 18 major overseas markets. This campaign's development and scheduling has been coordinated with the travel industry. All major carriers

both U.S. and foreign have designed advertising campaigns complementing the VISIT USA program. Two major foreign airlines, SAS and Alitalia, are participating by direct financial support with USTS in the campaigns in Scandinavia and Italy.

(3) USTS is working with International Airports to facilitate reception and flow of foreign visitors and with hotels and motels to improve their visitor services.

(4) USTS is working closely with state and local governments in each of the 50 states and the territories in promoting their specific attractions.

(5) USTS is constantly working with the travel industry in developing pricing patterns and discount programs that have appeal to the foreign visitor while at the same time offer profit to the industry.

(6) USTS, in conjunction with industry, is establishing a capability to collect, collate and disseminate data in a form and content immediately applicable to trade and government use.

(7) USTS has revised the 1968 hospitality discount program which originated with the Presidential Task Force and was promoted abroad by USTS. While this program can be said to have been generally effective, problems did exist in its implementation. USTS still believes in the overall purpose of providing incentives to travelers.

In 1969 the special VISIT USA travel bargains to be promoted overseas will be confined to those host services which can offer a substantially attractive discount, can be available from all members of an affinitive group, and which can be implemented on a nation-wide basis. These criteria were developed as a result of USTS's experience with the Hospitality Card program conducted last Spring and Summer. In addition, further possible incentive measures might be taken such as visa waiver legislation for foreign travelers, and/or a waiver of overseas visitors on the automobile excise tax.

Without question, international travel is a growth market. One of the most understated of current economic facts is that international tourism is the most important element of world trade today. More than 138 million foreign tourist arrivals were recorded in 1967 in the countries of the world, representing a growth of more than 7% over the tourist arrivals recorded in 1966. This tourist traffic generated $14 billion worth of international tourist receipts—a sum of 8% higher than in 1966. This sum is greater than that spent for any other single internationally traded commodity.

We cannot afford to stand still. The competition for the tourist and his money is world-wide and is growing in intensity. Every major and minor nation in the world has seen the potential and will be competing for this sector of world trade with all the resources at their disposal, both public and private. We must be continually adaptive and innovative to stay abreast of this rapidly changing and growing international market.

Senator Javits. In addition, I would strongly urge that you give attention to our ideas for matching projects with the travel industry—not only the national travel industry, but State by State travel industries which are very large, in many cases. New York State, my own State, is one of the greatest recipients of travel there is in the whole country. There is a great mutuality of interest in New York and the Federal Government to stimulate more travel in the United States. It has many connotations, including jet ports. I hope very, very much you will give it early attention.

Now, the last thing, Mr. Secretary, the International Chamber of Commerce thinks that you can lift all controls over private investment abroad this year. Would you care to give us now, or could you give us in the approximate future, some target date on which the American business community could look when, hopefully, the controls on overseas private investment will be lifted?

Mr. Stans. I have seen that report which, incidentally, is a good one, but I think the idea of eliminating all the controls by the end of this year is overly optimistic. It depends entirely on the extent to which we can increase net foreign trade, and to which we can relieve other elements of the balance of payments. I think we have to talk about this in terms of years rather than a year. Beyond that, I would have no estimate at this time. I hope that events will transpire so that later this year, I can give a more definite estimate. But as of today, all we can do is move toward relaxation step by step.

Senator JAVITS. Mr. Secretary, you heard the testimony of Mr. Roth with respect to what might be a new plateau for foreign trade policy of the United States in giving us, giving the President a greater negotiating range. Would you, if we gave you the opportunity in the record, be able to give us the Department's views on this whole question?

Mr. STANS. I will be very happy to.

Senator JAVITS. Mr. Chairman, I ask unanimous consent to include the views of the Department in a considered way. I think the Secretary ought to have the opportunity to do it in a considered way.

Representative REUSS. Without objection, it is so ordered.

(The views of the Department, referred to, follow:)

BROADER TRADE NEGOTIATING AUTHORITY FOR THE PRESIDENT

The question of broader trade negotiating authority for the President relates primarily to what our foreign trade policy should be in the 1970's when the Kennedy Round tariff reductions have been fully implemented. That policy is now only in the planning phase, and its form and content should and will be influenced by developments occurring over the next year or two.

Under GATT auspices, an analysis is being made of the tariff levels in each major country when the final stage of the Kennedy Round concessions goes into effect on January 1, 1972. GATT's Committee on Trade in Industrial Products is conducting a detailed examaination of non-tariff barriers to determine their trade effects and negotiability. GATT's Committee on Agriculture is examining all relevant elements of agricultural trade and production policies to explore possibilities for removing barriers to agricultural trade. Another GATT committee is making a study of the trade distortion caused by border tax adjustments. In the OECD, the issues of government procurement practices and tariff preferences for developing countries are being examined. The results of these and other studies, which should be available within the next year or so, will have an important bearing on the content of the trade policy that is formulated in the 1970's, and on the authority needed by the President to implement that policy.

Meanwhile, there are a number of shortcomings in existing legislation. To cite a few, the provisions in the Trade Expansion Act of 1962 for adjustment assistance for firms and workers and for the escape clause for industries have proved unworkable; Section 252 of the same Act which enables us to retaliate against unjustifiable foreign import restrictions imposed on our exports does not give us the same leverage for industrial products as it does for agricultural products; the President now has no authority to reduce tariffs to provide compensation to affected countries when the United States might have to take action to protect a domestic industry; and the Senate, in approving S. Con. Res. 100 in 1966, raised questions which affect our ability to negotiate on non-tariff barriers.

These and other problem areas are being studied for a possible legislative proposal to provide the necessary tools to enable us to deal with current issues pending the development of a program for the 1970's.

(Senator Javits subsequently submitted four questions to the Department of Commerce. The Department responded as follows:)

ANSWERS BY COMMERCE DEPARTMENT TO QUESTIONS REQUESTED BY SENATOR JAVITS IN A MEMORANDUM OF FEBRUARY 28, 1969

For the record of the February 27, 1969 hearing of the Joint Economic Committee, the Committee asked that Secretary Stans answer four questions by Senator Javits on the relationship between the objectives of the Office of Foreign Direct Investments and United States taxation of earnings of foreign affiliates of United States persons. The answers follow:

Question 1: One of the objectives of the program administered by the Office of Foreign Direct Investments in the Commerce Department has been to force the repatriation of earnings of foreign affiliates to direct investors in the United States by way of dividends. Is it not true that experience with this program has indicated that federal income tax considerations severely inhibit such remittance?

Answer: The experience of the Office of Foreign Direct Investments ("OFDI") has been that federal income tax considerations do not severely inhibit remittance of dividends from foreign affiliates to their parents within the United States. OFDI data indicate that dividends paid by foreign affiliates (excluding Canada which is exempt) have increased over the past four years (in billions of dollars) as follows: 1965—$1.297; 1966—$1.336; 1967—$1.456; and estimated for 1968 at about $1.7 billion.

The Foreign Direct Investment Regulations (the "Regulations"), as amended during 1968, do not require the declaration and payment of dividends, as such, in order for United States persons to stay within their direct investment quotas since a "negative net transfer of capital" (i.e., inflow to the United States) as well as a dividend serves to reduce direct investment. One of the most common forms of a negative transfer of capital is repayment by a foreign affiliate of loans from its parent. Accordingly, direct investors are free to offset retained earnings by making transfers of capital to the United States to stay within their schedular direct investment allowables.

It is important to note, moreover, that the Regulations apply to all affiliates in a Scheduled Area, not to individual foreign affiliates. Accordingly, direct investors may offset retained earnings where tax consequences of the payment of dividends may be the most adverse.

Prior to November 9, 1968, United States direct investors were required, under the Regulations, to stay within allowable limits of direct investment in Schedule C countries (primarily Western Europe) solely through the declaration and payment of dividends. From January 2 until November 9, 1968, only a few companies applied for specific authorizations under the Regulations requesting permission to substitute transfers of capital from Schedule C for the payment of dividends. The basis for these requests was that both United States income taxes and foreign withholding taxes would be payable on dividends, while those taxes would not be payable when transfers of capital were made, for example, by foreign affiliates repaying long-term debt to United States parent companies.

Following the amendment of the Regulations on November 9, 1968, which authorized the substitution of transfers of capital from Schedule C affiliated foreign nationals for the payment of dividends, the basis of applications for relief from the repatriation requirements of the Regulations changed. Such applications from all Scheduled Areas involved companies whose affiliates could not make transfers of capital in lieu of dividends and situations in which dividend payments would cause a hardship, most often in tax cost. One category of cases involved individuals who owned direct interests in foreign corporations and who were not entitled to the "deemed-paid" foreign tax credit available to corporations in the United States. A second category involved United States corporations which owned interests in foreign corporations involved in the shipping business or which had received tax deductions or other incentives from host countries. In cases of proven hardship, OFDI allowed the direct investor to comply with the requirements of the Regulations by bringing back funds borrowed abroad to the United States in lieu of having affiliated foreign nationals pay dividends.

It should be noted, in addition to the cases described above, that other cases involving foreign government restrictions on declaration of dividends, foreign exchange controls, and minority positions of U.S. investors were processed in 1968. In these cases, free and clear relief was given for 1968.

Question 2: As to the United States balance of payments, would it not be desirable to adopt legislation which would (a) mitigate the income tax burden on forced dividend repatriations under the OFDI Program and (b) encourage voluntary repatriation in excess of such requirements? In other words, should we not consider some sort of tax exemption for voluntary dividend repatriations as an incentive to business to bring back to the United States amounts which they might otherwise more profitably reinvest in their foreign businesses?

Answer: We have no direct evidence that the Foreign Direct Investment Program is causing significant United States income tax hardship to direct investors. The Regulations can be satisfied without foreign affiliates' declaring dividends, and OFDI has developed procedures to grant relief in appropriate cases as outlined above. The experience gained in the Program does not by itself indicate that new income tax legislation is needed.

Question 3: Referring to that part of Subpart F of the 1962 Revenue Act which causes certain investments in United States property by controlled foreign corporations to be taxed as constructive dividends to the United States shareholders: Is not this provision inconsistent with the objectives of our balance of payments programs? An amendment to the Code lifting this restriction would permit foreign affiliates to make direct investments of their earnings here in the United States instead of forcing reinvestment abroad.

Answer: The small number of direct investors applying for relief from the Regulations on the grounds of tax hardship during 1968 would indicate that the existence of Section 956 of the Internal Revenue Code of 1954 has not been generally troublesome. Section 956 applies, of course, only to certain transfers of capital made by controlled foreign corporations to the United States. Transfers of capital from other than controlled foreign corporations are not affected. Without more evidence of hardship resulting from the impact of Section 956 than has been brought to the attention of OFDI by direct investors, I would be reluctant to recommend its elimination on this basis. To the extent that inconsistency, as a practical matter, between Section 956 and the OFDI balance of payments program does exist, a desire to relieve tax hardship may not outweigh the value of the Section to the Internal Revenue Service in preventing avoidance of other Sections of the Internal Revenue Code.

Question 4: As part of any general tax revision, should we not consider some less restrictive and less complicated treatment of controlled foreign corporations and their relationships with United States owners and affiliates than has existed since 1962?

Answer: While Subpart F may be a complicated portion of the Internal Revenue Code, the Department of Commerce does not have specific information as to the efficiency or success of Subpart F, as administered, in achieving the purposes of the Revenue Act of 1962. Consequently, I am unable to make recommendations with regard to amendments.

Senator JAVITS. Mr. Volcker, I just had a question or two of you, sir; although you understand, of course, that anything you wish to comment upon that the Secretary of Commerce has said, you will be more than welcome to. I am deeply interested in any progress you can report with respect to the international monetary system and the activities of the Group of Ten, and perhaps a generic question on that would be the best.

What do you consider the outlook for the international monetary system in 1969 in view of the three monetary crises of 1968, which were pretty much handled on an ad hoc emergency basis, after rather than before the fact?

Mr. VOLCKER. Well, as I indicated, I think there are some problems in the monetary area that are beneath the surface of the calm that has been prevailing. Naturally, I hope the calm is maintained and I have no projection or expectation otherwise. But we want to do all we can to assure that result by working as hard as we can as quickly as we can on some of these underlying problems to which I pointed. I do not think I can give you any specific progress report at this stage. We are still in a very early stage of looking at this problem and beginning to talk with our friends abroad and I will be in a much better position to tell you the status and prognosis for changes in a few months, I suspect.

Senator JAVITS. Well, now, what's holding up the implementation of the special drawing rights program?

Mr. VOLCKER. It is in the stage of ratification by the great many countries that are involved. The only thing that is holding it up so far as I know is the normal—what appear to be normal, unfortunately—parliamentary delays in the great number of countries that are involved. At present, something like 36 countries, if I recall correctly, accounting for about 50 percent of the quotas, have completed the ratification process. We have to get up to 67 countries, with 80 percent of the quotas, to complete that process. Obviously, we cannot go on to the next stage until the ratification is completed. I would look to this being completed in the spring, and I would hope early in the spring.

Senator JAVITS. Does the Department still stand pat on Secretary Kennedy's statement regarding the price of gold?

Mr. VOLCKER. Yes, sir.

Senator JAVITS. No change in that situation?

Mr. VOLCKER. No change at all in that situation.

Senator JAVITS. As the chairman says, which statement.

Well, his position that we will stay with the present situation, with $35 plus a two-tier system, one for the private and one for the public market.

Mr. VOLCKER. He said just the other day, there is no change in the offing there, sir.

Senator JAVITS. Nor does the administration at the time—I am not pressing you, because I realize you are all very new—contemplate any international monetary conference or new Bretton Woods Conference?

Mr. VOLCKER. We do not.

Senator JAVITS. We may be alone at the moment but we detect an element of difference between the Treasury and the Chairman of the Council of Economic Advisers on the issue of the fixed exchange rate system, whether to confine it to 1 percent or to "consider"—and I quote that word and emphasize it—the possibility of some greater flexibility. Is there any difference?

Mr. VOLCKER. I am not aware of any difference, Senator. This is a difficult problem and I would be less than frank if I did not say that I have not detected any overwhelming enthusiasm for this idea among our European friends at this stage. I think this is a process that we have to work through. It does take a lot of careful consideration and study, not only within governments, but outside government, so we get a clearer view of where our own interests lie and where the interests of the system lie. I do not think any of us are prepared to make that judgment at this point.

Senator JAVITS. Do I gather that you, like Dr. McCracken, are willing to consider it, willing to examine it?

Mr. VOLCKER. I certainly think this is something that falls within the range of the responsible kinds of proposals that we will certainly want to look at and see whether this is something that would be good for the system or good for the United States or not. We do not have that judgment at this point, one way or the other.

Senator JAVITS. Thank you very much. Just one question of Secretary Stans.

I notice that you dealt in your statement, Mr. Secretary, with a question which comes under the generic heading of black capitalism. There are quite a few of us here sponsoring—Senator Percy has done that himself—the Community Self-Determination Act and other similar measures. Is there any discussion within the administration as to the prime responsibility for this question of local entrepreneurship, financing, all that goes with business establishment and seed money, which can include seed money for housing and many other things to end slums and ghettos? Is there any discussion in the administration about whether to leave the present system, which essentially vests this whole idea in the SBA, charging it to coordinate with Commerce, or the possibility that there may be some organizational change and that it may go to Commerce?

Mr. STANS. Senator, the first thing I would like to say is that we are no longer using the term "black capitalism" because we have expanded the concept of the program to include other minorities as well—the Spanish Americans, Mexican Americans and Puerto Ricans, and American Indians.

Senator JAVITS. I think that is an extremely important and satisfactory development.

Mr. STANS. Secondly, we have made a study of the number of loan and grant programs in the U.S. Government that might, in one way or another, help in the development of minority enterprise and we find 114 specific programs scattered across 21 agencies of the Government. Now, some of them are doing a good job in the area of helping minority entrepreneurs, some are doing practically nothing, some are not directing any effort in that respect. The President, as one of the first steps in the Urban Affairs Council, appointed a Subcommittee on Minority Enterprise, of which I am chairman. Our subcommittee has had three or four meetings and has reviewed various proposals as to how to do a more effective job within the Government. There is no present plan to change the funding of the various programs that exist, but there is a strong feeling that a great deal needs to be done to increase the effectiveness of the use of those funds, to increase the coordination among the various agencies of the Government with programs of this type, to prevent overlap on the one hand and the great gaps that exist on the other. Out of it has come a program which, hopefully, can be announced within a few weeks, to concentrate the coordination of these activities within the Department of Commerce, but are to change the funding of the programs from where they are now.

This particular program will also include a number of steps to draw upon the private community, the corporations and the nonprofit enterprises as well, to coordinate their activities among the private sector in the area of minority enterprise, so that we can have an overall view, at all times, of what's being done to help minority entrepreneurs, what's being done effectively and what's being done poorly, and out of it, to help this program very substantially in the next few years. It is not a program out of which we can expect instant miracles. It is one that will take a considerable period of time to develop. But those of us who have studied it, and I have spent a considerable amount of time on it, believe that it can be greatly improved and that its results can be amplified manifold by more effective administration and by better management of the whole activity.

Senator JAVITS. Nor, like so many of its detractors would have people believe that we think, can it cover the whole antipoverty field, Mr. Secretary?

Mr. STANS. Of course not.

Senator JAVITS. In other words, it can only affect probably a minority of that field, but an important part.

Mr. STANS. It is just one element of dealing with the whole antipoverty program.

Senator JAVITS. I thank the Secretary very much and hope that we have not taxed him.

Mr. STANS. Thank you.

Representative REUSS (presiding). Senator Percy?

Senator PERCY. Mr. Chairman, first I would like to say how disappointed I was that I was in a Government Operations hearing while the committee had, I understand, a stimulating discussion on the soybean problem. I would have rushed out to come down and talk about soybeans as I represent the largest soybean exporting State. I understand the question came up as to whether or not the President was to discuss this subject in Brussels with the EEC. I was wondering whether he would also, and after I discovered who was making up the agenda I wrote a letter to Mr. Helmut Sonnenfeldt of the National Security Council. Here is an unclassified reply in which he says he is grateful for the letter suggesting that this be put on the President's agenda. He says the subject is being included in the material and preparation for the President's discussion in Brussels and that a copy of his letter was being sent to the Department of State.

So I assume that it was discussed, although some would say that soybeans are not the most worldshaking issue today. To farmers in Illinois, they are. I think the whole point was that if the EEC implemented its proposed tax this would start a round of retaliation that would open the door and provide an excuse for textile, steel, clothespin, and shoe quotas over here. The only response we would get is more retaliation on the other side and reverse a trend of 35 years standing. So I think this is an important subject.

I would like to ask a question of Secretary Stans.

I think very wisely, you have pointed to the problem of inflation and also set a goal of $50 billion in exports by 1973. I think it is a good idea to have a goal. You may not, as they say, when you reach for a star, get one, but you do not end up with a handful of mud, either. We all know where we want to go and should try to go. How important will inflation be, however, this year and next year, in our attempt to achieve a goal of this type?

We have had estimates before this committee that we expect inflation of 3½ to 4½ percent again in 1969, despite expenditure cuts and the tax increase. How high a priority must we place on fighting inflation? What will be a significant cutback in inflation this year and next year that could favorably affect our exports?

Mr. STANS. Well, it is very difficult to know how much we can achieve in a short period of time in reducing inflation, because it must be done so delicately as not to disturb other important elements of the economy, as you know. I think the main objective of the administration must be this year to turn the direction of inflation downward so that we do not have as much as we had last year and, hopefully, to reduce the amount of inflation thereafter. The illustration that you make is an important one. Obviously, if we had very high inflation in the next few years, we could have $50 billion in exports before 1973. It certainly would be a very poor outcome for the country to achieve that goal in that manner. We are hoping that we can achieve that goal with a minimum of inflation over the next 5 years. I do not think anyone can name at this date the precise point that we hope inflation will be down to 3 percent a year or down to 2 percent a year, but we have to maintain the effort and keep the pressure on as much as we can, without seeing unemployment increase unduly or seeing other elements of the equation get out of balance.

Senator PERCY. The balance of payments picture in 1968 looked on the surface to be good and we have discussed it at some detail in the committee. We feel it looked good primarily due to high U.S. interest rates that have attracted foreign capital, to U.S. direct investment restriction programs which we want to get rid of, and special official transactions of large foreign purchases of U.S. bonds. What do you anticipate or what does the Treasury estimate will be the capital movement picture in 1969?

Mr. VOLCKER. That is an area in which I think it is just impossible to make anything like a precise projection. I think that tight money has been an important element in this, as you suggested. Obviously, tight money is continuing. At present, if anything, it has intensified. I think this provides a substantial element of protection in terms of the total picture this year. But in saying that, I think clearly one is not happy in having to rely upon this degree of tight money for a variety of reasons. So in shaping our longer run program, I certainly think we have to consider this particular support for the balance of payments, valuable as it is in the short run, valuable as it is continuing to be, it is something we have to work our way out of.

In general terms and without trying to predict the timing of the thing, what we want to see over a longer period of time is a recovery in trade balance which will, at least in a rough way, be synchronized with the relaxation of pressures in the money market as we return to a more balanced domestic economy. This timing will permit a reduction in capital inflow without throwing us entirely off course in the balance of payments as a whole. There is many a possible slip in the timing when one is talking in these terms. But as a general strategy for the balance of payments, I think this is the way we would like to see it go.

Senator PERCY. This is going to be a shared responsibility. I think the Secretary of Commerce's goal to increase exports and trade will, in the long run, do more to do this on a really sound basis than anything I know of. But I think there are other loopholes that can be plugged in the meantime. One of the loopholes is NATO expenditures. We have a balance-of-payments deficit of three-quarters of a billion dollars on our NATO expenditures for mutual defense. Canada has and the United Kingdom has an unfavorable deficit. Germany, Italy, and Belgium all have surpluses every year as a result of our expenditures for mutual defense. I went to Brussels in November and attended the parliamentary sessions there. I proposed the creation of something like an international settlements bank among NATO countries where automatically, every year, we settle these accounts multilaterally. Such settlements would not be subject to the political whims or political problems faced in Germany and it would not have short-term, 4½-year bonds that they are now buying, but it would have long-term bonds.

Will the Treasury place high priority upon this, now that we have the approval of 16 countries in the parliamentary session and the NATO ministers have written it into their communique from Brussels, also in November. I think it is up to us to devise the mechanism. Nobody else is going to do it. We have all the incentive. No one else really has it to that extent. How high an importance can we place on it?

I am supposed to report back in May to NATO on what action we have taken. With the change in administrations, I recognize the problem of deciding on this quickly.

Mr. VOLCKER. That is right, Senator. I think we do attach the highest kind of priority to this military deficit problem in our balance-of-payments effort. We fully sympathize with your view that we should aim at a more permanent kind of arrangement here and get away from the kind of stopgaps that have been used. I do not think there is anything in your views to which I would take exception. I think we do also face the practical problem of assuring progress in the shorter run, so that while working toward the multilateral framework, which I think would be certainly desirable, and while thinking about what mechanism might be most appropriate there, I am not ready to suspend the bilateral effort. I think it will be necessary to push vigorously bilaterally.

I think in principle, we have made an important step in getting a NATO consensus that this is a problem requiring cooperative effort. I think we want to build upon that general principle into some practical arrangements. But for the immediate problem, I think we have to go to work also on a bilateral basis and do that promptly and effectively and as quickly as we can.

Senator PERCY. I would like to say that working in Brussels, I had the full support of the Treasury Department. Your Mr. Albright was exceedingly helpful. We took fully into account the fact that we did not want to in looking at the short run picture, interfere with the long run. We wrote right into the council document that we should continue those bilateral arrangements. I think we strengthened your hand and put the force of NATO behind those negotiations and, hopefully, removed from them some of the political problems that are always present in Germany, particularly in an election year.

Mr. VOLCKER. Precisely. I think we should be working in both directions simultaneously.

Senator PERCY. Lastly, I would like to make a comment to Secretary Stans. I do not know what the administration has in mind for organization of our trade agreements program. I would just like to say for the record that many of us have enjoyed a fine relationship with Ambassador Roth. We feel that he carried the torch and he fought the good battle. I think his testimony today is an exceedingly enlightened statement. I really agree with him on his analysis of the textile situation. Everyone thinks they have a special case. All of my compatriots for 25 years in the photographic business used to think we had a really special case and I did not find in all my years there that their case was any different than that of a hundred other industries, even though Japanese and the Germans developed a little interest in our business. But I think we just have to put the country's interest ahead of company interest. I think Ambassador Roth has done that, and I hope however we organize our trade program, we will strengthen the office of special trade representative rather than weaken it. We need a voice looking out to the future, not just to be on the defensive, but rather offensively to broaden and strengthen trade.

I wonder if you would mind commenting on some of the ways we might have in mind to reduce nontariff barriers and to extend the authority to negotiate additional agreements? Or if it is a little early in the administration to talk about that, I will certainly abstain and wait until such time as you care to discuss it with us.

Mr. STANS. It is quite early in the administration to say very much in terms of details. I have called, as I said in my statement, the first meeting of the Cabinet Committee on Export Expansion that has been held for 5 years. I think perhaps the Committee was inactive during the time because our trade balance was in a range of $5 billion and it may have been justified in not working to increase it. But now that our trade balance has practically expired in 1968, it seems as though we really have to go to work on this and consider all of the alternatives. We are considering recommendations of the National Export Expansion Council, the International Chamber of Commerce, and other bodies. The Department of Commerce itself has just completed a 5-year study of the potentials for export trade with somewhat gloomy predictions as to where we will come out unless we take specific, positive steps. And through these reports there are some 75 or 100 recommendations that have been made as to things that can be done.

We may find it possible to increase very materially the opportunities for extending credit in export trade. We are certainly going to take a look through a task force headed by Treasury, at the possibilities of tax benefits of some kind or other. We have to take a look at the questions of the value added tax, even though it may be a very difficult matter to get the American public and the Congress to accept the idea of the value added tax because it is so new. But there are, as I said, many items of approach to this problem that are now being studied. I have asked each of the task forces working on these matters to deal with them in terms of a crisis basis, with the objectives that we will get some conclusions in the next 60 or 90 days and others may take longer. We are going to do everything we can to analyze this problem to the fullest and determine what steps might be taken.

Beyond that, Senator, it is a little difficult for me to make any prognosis indications or promises. I hope that we can, the next time I come back here, point to results that we have secured in this area.

Senator PERCY. Well, I sense a new feeling of activism in the Department of Commerce under your leadership. I think many of us will welcome this. I do not think it should be a statistical department that analyzes figures and says what has happened in the past, as a historian does. I think it has a really creative role, because if American enterprise can't continue the leadership that it has, if we have to as a Government impose our official restraints on investment abroad, it will take the best ambassadors we have ever had away from their work abroad. It will place restrictions on us that will do irreparable damage to carrying on an effective foreign policy. Foreign aid programs will go by the boards, overseas military programs will go by the boards if we cannot solve the problems. I just can't imagine, Mr. Chairman, anybody I would rather see in this role than my former neighbor and longtime friend, and a very knowledgeable friend who enjoys the confidence of the President, Mr. Stans.

Representative REUSS. Activism in the Department of Commerce and passivism in the Department of Defense—that would be a good combination.

Mr. Stans, you mentioned now to Senator Percy the study made of export expansion by the Department of Commerce. Does that have a name?

Mr. STANS. I do not know the precise name, but it is a 5-year study of foreign trade prospects.

Representative REUSS. Would you file that study with us for our general education?

Mr. STANS. Yes, we have no objection to that.*

Representative REUSS. Do you have any further questions?

Senator PERCY. No.

Representative REUSS. I want to express my gratitude to Mr. Volcker, Mr. Stans, Mr. Chartener, for their excellent testimony. You are off to a fine start. We wish you well. Take care of your health.

We will now stand in adjournment until next Wednesday morning in this place at 11 o'clock, where we shall have Mr. George Meany of the AFL-CIO.

(Whereupon, at 12:20 p.m., the committee adjourned until Wednesday, March 5, 1969, at 11 a.m.)

*"U.S. Foreign Trade—A 5-Year Outlook With Recommendations for Action," a report to the Secretary of Commerce by the Bureau of International Commerce, U.S. Department of Commerce, December 1968. Copy retained in committee files.

APPENDIX

FUTURE UNITED STATES FOREIGN TRADE POLICY

REPORT TO THE PRESIDENT

submitted by the

Special Representative for Trade Negotiations

Washington, D.C. January 14, 1969

CONTENTS

PREFACE

In March of 1967, as the Kennedy Round was drawing to a yet uncertain conclusion, President Johnson instructed the Special Representative for Trade Negotiations to initiate a study of future U.S. foreign trade policy. The President said at that time "successful conclusion of the Kennedy Round will not mark the end of the drive toward trade liberalization."

Since the spring of 1967, many events have altered the course of trade. The Kennedy Round was successfully concluded in June of that year. In the United States, as in other countries, forces in both industry and agriculture seeking protection against imports became more insistent. In the fall of 1967, a series of monetary crises began to develop, with attendant effects on world commerce. Finally, this country's own trade surplus declined sharply.

It was obvious that a study of future trade policy must take into consideration these changes and problems -- both domestic and international. This report, therefore, attempts to consider with an open mind the whole sweep of our foreign trade policy. In the following Introduction some of the major problems in international commerce are noted, and in the recommendations that follow we attempt to take these into account. Although these recommendations deal with most of the problems and related issues, they do not deal with all of them or with those of particular industries.

While the report is concerned primarily with trade, it is impossible, under today's conditions, to consider this subject by itself. Other aspects of domestic and international economic policy are closely related. We have tried to take all that are relevant into consideration.

This report has been prepared with the assistance of other government agencies. Although it does not necessarily have their approval, we have tried to take into account the thinking of those most concerned with the issues.

The President also appointed a Public Advisory Committee on Trade Policy. The discussions with the members of this Committee and their alternates were most helpful and were taken into consideration in preparing the recommendations. In addition, the members were given the opportunity to record their comments on any aspect of the report. Comments on specific passages appear at the end of the relevant chapters; general comments appear at the end of the report. The absence of any comment, however, should not necessarily be considered as agreement with our recommendations.

Views were also expressed in public hearings held by the Trade Information Committee of this Office, and these were analyzed and extensively used. Equally important were the public hearings of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Economic Committee. In addition, individual Members of the Congress made suggestions on the study. A number of outside specialists were also consulted. We are very grateful for all the assistance we received from these sources.

Finally, although the responsibility for this report is mine, it represents a collaborative effort with the senior officials of my Office.

William Roth
William M. Roth
Special Representative
for Trade Negotiations

January 14, 1969

MEMBERSHIP OF THE PUBLIC ADVISORY COMMITTEE
ON TRADE POLICY

This report was prepared with the advice of the Public Advisory Committee on Trade Policy, which was established by Executive Order No. 11425 and consisted of the following members:

I. W. Abel	President United Steelworkers of America
William M. Allen	Chairman of the Board and Chief Executive Officer The Boeing Company
Mrs. Bruce B. Benson	President League of Women Voters of the United States
Arch N. Booth	Executive Vice President Chamber of Commerce of the United States of America
Fred J. Borch	Chairman General Electric Company
David M. Corcoran	President Sterling Products International
Tony T. Dechant	President National Farmers Union
Woodrow W. Farha	President Hereford Heaven Brands, Inc.
William H. Franklin	President Caterpillar Tractor Co.
Carl J. Gilbert	Chairman of the Executive Committee The Gillette Company
Patrick E. Haggerty	Chairman Texas Instruments Incorporated
Armand Hammer	Chairman of the Board Occidental Petroleum Corporation
George M. Harrison*	Chief Executive Officer Brotherhood of Railway and Steamship Clerks, AFL-CIO
Halbert M. Jones	President Waverly Mills, Incorporated
R. Heath Larry	Executive Vice President United States Steel Corporation
Charles Y. Lazarus	President The F. & R. Lazarus & Co.
Ian MacGregor	President American Metal Climax, Inc.
George Meany	President American Federation of Labor and Congress of Industrial Organizations

Arjay Miller	Vice Chairman of the Board Ford Motor Company
William B. Murphy	President Campbell Soup Company
Herschel Newsom**	Grand Master The National Grange
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Charles B. Shuman	President American Farm Bureau Federation
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Arthur K. Watson	Vice Chairman of the Board International Business Machines Corporation
Sidney J. Weinberg	Senior Partner Goldman, Sachs & Co.

Certain members of the Committee have commented on various parts of the report. The absence of any comment, however, should not necessarily be considered as agreement with it. Participation in its preparation by the members of the Committee is not intended to constitute endorsement of the report, in part or in whole.

* Deceased
** Resigned

INTRODUCTION

A. NATIONAL GOALS AND TRADE POLICY

Trade policy makes an important contribution to our fundamental national goals -- economic growth, full employment, and higher per capita real income. Its objective is not trade expansion for its own sake. Rather, it is to facilitate the more efficient use of our resources and the attainment of a free and dynamic economy.

Although trade itself represents a relatively small share of our gross national product, its significance to our economy is far larger. Trade has played and can continue to play an important part in improving the well-being of American industry, agriculture, and labor. Exports enable U.S. producers to take maximum advantage of their competitive ability. Consumers and retailers benefit from imports in terms of style, quality, and price.[1, 2] Producers benefit from access to needed supplies at competitive prices. Wider competition brings about the continual improvement of products and, through the encouragement of technological innovation, increases the productivity and real wages of labor.

Trade policy also creates problems and sometimes hardships, domestic and international. These must be faced realistically. New tactics, even new policies, must be devised without losing sight of our fundamental goals.

This is the purpose of this report: to consider foreign trade policy as a flexible, changing instrument in the service of a continuing national objective -- the vitality of the U.S. economy and the world economy of which it is an integral part.

B. TRADE PROBLEMS IN A CHANGING WORLD

For the past 34 years the trading nations of the world, under U.S. leadership, have pursued a policy of trade liberalization on a reciprocal basis. That policy has, on the whole, served our country well -- and it has served the world well. In the United States, it has been pressed forward under Administrations of both parties, with support from both sides of the aisle in the Congress. Its most recent achievement was the successful conclusion of the Kennedy Round in June of 1967.

At the same time that these long and arduous negotiations were being pursued, new forces were already affecting the currents of world trade. Indeed, in the latter part of 1967, concern was growing throughout the world over problems in domestic economies and in changing international commercial relationships -- including the declining U.S. trade surplus.

Both at home and abroad, these problems raised the specter of economic nationalism and a return to the divisive trade policies of the past.

1. The Problems of Success

When World War II ended, the economies of Europe and Japan were paralyzed, and the international trading system had broken down. Two actions were urgently necessary. First, national economies had to be made viable. Second, new international institutions had to be created to facilitate an increasing exchange of goods. Only one country was in a position to take the initiative -- the United States.

Through the Marshall Plan and other aid programs, the United States assisted in the rebirth of European and Japanese industry and agriculture. It also initiated

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[1] See comment by Mr. Jones.
[2] See comment by Mr. Larry.

negotiations leading to the establishment of the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF), and the International Bank for Reconstruction and Development (World Bank).

Underlying these actions was the belief that a strong international trading community was not possible without strong national economies. On the other hand, without the existence of strong international institutions to assure the freer flow of trade and a viable international monetary system, strong national economies could not be attained. The requirements of nations and the requirements of an international order were inextricably linked. They are today.

American initiatives and the responses of its trading partners were successful. World trade increased from less than $60 billion in 1948 to more than $200 billion in 1967. The institutions that established the rules of international trade and payments became accepted instruments for furthering national interests.

But success itself, of necessity, creates change and thereby problems. The very fact that our foreign economic policy succeeded made it inevitable that Europe and Japan would regain their competitive strength. Today, they offer the United States a serious challenge in world markets.

In the same manner, the dynamic economic progress throughout the world, made possible in part by the GATT and the IMF, began to press upon the institutions themselves. Rigidities in some of the international rules led major trading nations to resort to ad hoc trade measures to cope with balance-of-payments problems. It is ironic that governments leaned heavily on trade measures to shore up a monetary system created primarily to further a smooth and expanding flow of trade.

The problems that both this country and others face today in trade and monetary policy are the result, in part, of expanding international economic activity and changed competitive relationships. Improvements are needed -- both domestically and internationally -- but they are refinements, not new directions.

2. Regional Trading Blocs

In Europe, success had another dimension. The GATT was written to exempt customs unions and free trade areas from the rule of nondiscrimination. This was a logical extension of one of the central themes of U.S. policy after the war -- that the economic strength and political unity of Europe were essential to world peace.

In the years following, the European Economic Community (EEC) and the European Free Trade Association (EFTA) were formed. Each has resulted in a substantial increase in trade, not only among its members but also with other countries. But, because the EEC was under the necessity of adopting a common external commercial policy, the need to compromise conflicting national interests made it difficult to give full weight to the international repercussions of some of its policies.

This has been particularly true in agriculture. Under its common agricultural policy, which is being progressively extended over wider areas of products, the EEC uses high support prices to maintain farm incomes. In order to make this policy effective, the EEC has adopted variable import levies and export subsidies, which restrict imports and compete unfairly with foreign exports in third markets. The danger of a major confrontation between agricultural exporters and the EEC is very real.

The impetus toward regional trading has not been limited to Europe. Regional African and Latin American associations have also been formed, designed to evolve into customs unions or free trade areas. They are far from reaching that goal. Their impact on world trade is not yet serious, but they too pose problems for our future trade policy.

3. Multinational Corporations

The growth of regional trading blocs has provided one of the incentives for the development of yet another important agent of change -- the multinational corporation. Challenged by growing markets abroad, particularly in Europe, American companies have become international. Europeans welcome the benefits that well-capitalized, highly efficient, and technologically equipped enterprises bring to their economies.[3] They worry, however, about a possible American take-over in important industrial sectors. Some Americans, on the other hand, fear that U.S. manufacture abroad is displacing domestic employment by decreasing exports and increasing imports.[4]

In principle, an expanding world economy requires the freest possible movement not only of trade but also of capital and technical and managerial resources. In practice, however, the specific effects of the multinational corporation on employment and trade are unclear. Such considerations as the balance of payments and the relative immobility of labor can raise problems that require solutions. These must be solved without unnecessarily restricting the most efficient allocation of resources.

4. Less-Developed Countries

One of the most difficult problems in trade policy is the need of the less-developed countries to expand their foreign commerce. Most of them have not shared fully in the general increase in international trade that has taken place since the end of the war. Most of them are dependent for export earnings on a narrow range of primary products, which, in many cases, are characterized by inelastic demand and unpredictable price fluctuations.

The primary responsibility for economic development and diversification rests with the less-developed countries themselves. However, the United States and other developed countries cannot ignore the need of the less-developed countries to increase their export earnings as an essential part of their development.

C. CONCLUSIONS

The increasing competitive strength of foreign countries, the strains on the international monetary system, the benefits and dangers of regional trading blocs, the growth of multinational corporations, and the needs of less-developed countries -- these are some of the major international problems of both immediate and long-term concern that we must face. The very fact that some of them are so new means that we are not yet equipped to propose definitive answers. For these, their recognition and definition must suffice for the time being.

The objectives of our trade policy as developed over three decades continue to serve the national interest. There is no reason to conclude that the United States, or indeed any other country, could gain by a retreat from world competition. What must be reviewed, and where necessary revised, are the methods to be used in expanding foreign trade and in adjusting to any domestic dislocation that may result.

The recommendations that follow look to the immediate future -- and especially the legislative proposals, which should for the most part be acted upon in 1969. They also look to the longer term and to areas where we will have to develop more data and further analysis before specific courses of action can be proposed. All of our recommendations necessarily assume a workable international monetary system.

One major theme runs throughout these recommendations -- that trade policy must be pursued in full recognition of its relationship with all U.S. economic policies, particularly the continuing struggle against inflation. Coordination and consistency

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[3] See comment by Mr. Parker.

[4] See comment by Mr. Borch.

among such policies become even more essential as the United States faces increasing world competition. Coordination and consistency must also extend to the organization and operation of our governmental institutions.

Similarly, international trade, monetary, and development policies must be viewed and pursued together. The organizations that play a role in the flow of international trade and payments and that assist the developing countries must more closely coordinate their activities -- especially the GATT, the IMF, and the World Bank.[5]

There are great dangers ahead -- dangers of serious international confrontation among the major trading nations and of widespread protectionism as well. However, there are also great and exciting opportunities to build even further toward a freer world market -- a market that will be increasingly open to American exports.

We will lose these opportunities if we abandon our faith in the benefits of competition and replace it with a philosophy of market sharing. We must not adopt import quotas as a major instrument of our trade policy.

As the world grows in complexity, so do the problems of foreign and domestic economic policy. It should not be forgotten, however, how successful the basic thrust of American trade policy had been for over 30 years. The gains should not be lost. They can and should be increased.

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[5] See comment by Mr. MacGregor.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON THE INTRODUCTION

[1] Mr. Jones

In several places this report contains strong implications that the best interest of the American consumer is served automatically by a high level of imports. The position of the consumer, who must first be a producer before he has the means to consume, is protected and served in only minor degree by the relatively small volume of imports and in major degree by the overwhelmingly large production of the U.S. economy, by the research and development of its industries, by the keen competition of those industries, and by the earning power that those industries permit him to achieve.

[2] Mr. Larry (Mr. Murphy has asked to be associated with this comment)

No one doubts the validity of the proposition that competition is useful in restraining the tendency of prices to inflate, but two points should be made: 1) as noted elsewhere in the report, much of the competition faced by American manufacturers at the moment is unfair; and 2) the effect of foreign competition upon the price level in the United States, and hence upon inflation, seems at times to be subject to overstatement. Price levels are compounded of two basic factors. One concerns demand and is related to competition, including that from abroad. The other is related to costs, which, if we look at the economy as a whole, are principally labor costs. A vast portion of what goes into the American cost of living is now in the service areas, which are largely unaffected by foreign competition, but in which labor cost increases and hence price increases have been well beyond those reflected in manufacturing. These labor cost increases tend to spread throughout the economy, putting pressure even on the areas most heavily influenced by foreign competition. Unrestrained foreign competition will not solve this problem of price inflation.

[3] Mr. Parker (Mr. Rockefeller has asked to be associated with this comment)

In addition to the points made in the text, I believe a strong case can be made that the multinational corporation is a new and more effective mechanism for the working out of comparative cost effects, and for the most efficient allocation of production functions among nations.

[4] Mr. Borch (Mr. Murphy has asked to be associated with this comment)

The concern that U.S. manufacture abroad is displacing domestic employment must be regarded in the context that U.S. manufacturers would generally prefer exporting to offshore manufacturing. But, when U.S. exporters are disadvantaged by the creation of trading blocs and other government policies such as the closing of borders, the U.S. manufacturer has only two choices, (1) give up the market, (2) enter local manufacture.

[5] Mr. MacGregor (Mr. Borch, Mr. Larry, and Mr. Peterson have asked to be associated with this comment)

I welcome the emphasis in the report on the necessity of viewing the international adjustment process in its entirety. A major new effort is needed to overcome the institutional tendencies in the postwar era that kept international trade and international monetary policy in separate compartments and, especially within the United States, permitted domestic economic policies to be considered in isolation from their international consequences.

CHAPTER I

NEW CHALLENGE OF WORLD COMPETITION

Since the Trade Expansion Act was passed in 1962, the nature of world competition has fundamentally changed. The tempo of rivalry has quickened across a broad range of products.

The major sources of U.S. economic strength in the earlier postwar years were our existing plants, our skills, and our technological advantage. Today, foreign competitors can produce and sell at competitive prices, and they too have learned to innovate, to promote, and to market. The lead the United States once possessed in many industrial and agricultural products has clearly been narrowed. As a result, the pressure on the United States for more rapid innovation, more advanced technology, and more rapid adaptation to change has intensified, and its response to this pressure has become more critical.

Other sources of U.S. economic strength have similarly been challenged. The vast American market, long free of internal barriers to trade and specialization, is being matched in Western Europe. U.S. productivity, incomes, and standard of living -- while growing -- no longer exceed those abroad by as much as they once did. The same is true of our educational system and technical skills. Our technological advantage has disappeared in some sectors, though increasing in others. Economic power and potential have become more evenly distributed among the industrialized countries. The impact of these changes has necessarily varied between products and industries.

Over the years, the U.S. trade balance has fluctuated widely. In 1950 the trade surplus dropped to a low of $1.1 billion and, after rising, fell again to $1.4 billion in 1953. It improved, rising to $6.5 billion in 1957, but dropped back in 1959 to $1.2 billion. By 1964 it climbed to $7 billion.

Since 1964, however, the margin of exports over imports has clearly not been enough to meet our commitments abroad. From its 1964 peak, the U.S. trade surplus, including government-financed shipments, has fallen off. It steadied in 1967, but in 1968 approached another low.

Through the 1960's, total exports have held to their long-term trend, rising nearly 7 percent on the average in every year -- a good record, but not as good as that of some countries. The growth rate in exports of U.S. manufactures has been even better -- 7.4 percent. Total exports grew more rapidly between 1960 and 1964, when our prices and costs were relatively stable and foreign demand was growing rapidly.

Since 1964, domestic prices have been rising, and the rate of growth in important overseas markets, a major determinant of exports, has decreased. At the same time, rapid economic growth and higher prices at home have reduced both the incentive and the ability to export. Although, as a result, the rate of export growth fell off slightly, during 1968 it returned to its long-term trend. Throughout this period, the proportion of domestic output shipped abroad remained virtually unchanged.

The volatile factor in the U.S. trade balance has clearly been imports. In the earlier years of this decade, they grew at an annual rate of about 5.5 percent. Between 1964 and 1967, this rate accelerated to 12.8 percent a year. In 1968 the rate exceeded 20 percent. With imports rising at such a pace, the U.S. trade surplus fell rapidly.

Temporary influences can explain some of this recent import performance. Rising prices, costs, and incomes at home, together with full employment and near-full capacity, sharply increased the demand for imports. Indeed, during this period many imports fulfilled an essential role by meeting shortages and retarding price rises. In addition, major labor disputes interrupted production and led to anticipatory stockpiling of imports.[1]

This record clearly demonstrates that, when our domestic economy grows rapidly and prices and costs are rising, imports rise even more rapidly -- faster, in fact, than the increase in domestic demand. When growth is more normal and prices are stable, the increase of imports falls off quickly. As Paul McCracken, newly-designated Chairman of the Council of Economic Advisers, has pointed out:

> "For the U.S. economy imports tend to grow at about the same percentage rate as GNP if the latter is growing about 5-6 percent per year. When GNP begins to race ahead more rapidly, the rise in imports quickly starts to become close to 2 percent for each 1 percent rise in the domestic economy. This is to be expected. When the domestic economy becomes overheated, delivery schedules at home stretch out, and increasingly demand spills over to foreign markets."*

Our gross national product, for example, increased by an average of 8.4 percent during 1965-66. The growth in imports, however, averaged 16.5 percent during this same period. The same pattern was repeated in late 1967 and again in 1968.

Imports during such periods, particularly imports of consumer goods and industrial materials, respond sharply to the pace of business activity and to higher incomes. Because the United States has become a country with a high tendency to import during prosperous times, there is a vital national need to achieve as much stability as possible within an expanding economy.

<u>The United States must avoid excessive growth and cost-price increases. Domestic policies providing for growth with price stability are now a prerequisite to the ability to compete at home and abroad and to improve our foreign trade balance</u>.

The United States depends upon imports for many essential products -- some not produced here, others available only in insufficient amounts or at prohibitive costs. For these reasons, two-fifths of U.S. imports now enter duty-free -- for example, coffee, cocoa, bauxite, newsprint, and nickel. A large fraction of our imports complements rather than competes with U.S. production. The arithmetic of our trade balance alone cannot provide any clear measure of competitive performance.

Nevertheless, certain important industries argue that imports competing with their products are already excessive and are growing at an alarming rate. These industries therefore urge that quotas be imposed in order to keep imports within bounds and to achieve what they call "orderly marketing" of the products concerned. While professing belief in the merits of competition, they would predetermine its extent and its influence -- if it originates abroad.[2] Their demands, moreover, have grown in volume during a period of full employment and increasing profits.

This is a fundamental challenge to U.S. trade policy. It would abandon the concept of serious injury as an essential criterion for import relief. It has been established U.S. policy that protective devices, such as quotas, should be resorted to only when serious injury or the threat of injury from imported products is clearly established, and then only for limited periods of time, sufficient to permit adjustment to import competition.

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[1] See comment by Mr. Larry.

* Address presented to the Annual International Conference, National Association of Accountants, New Orleans, Louisiana, June 17, 1968.

[2] See comment by Mr. Larry.

Even in such circumstances, quotas are the negation of the market mechanism. The absolute limitations they impose are a far more drastic interference with market forces than even high tariffs. This is true even of quotas that permit a limited growth in imports related to the growth in domestic consumption.[3] Unless prohibitively high, tariffs can be overcome by such competitive responses as increasing efficiency and reducing costs. But no amount of efficiency can overcome a quota. Moreover, the sheltered position granted the domestic industry necessarily lessens the incentive for efficiency, the motivation to innovate, and the need to change.[4]

The cost of quotas to the rest of the economy will be equally high. For other industries, it will be higher prices for the things they must buy, domestic or imported, and, in turn, a reduced ability to compete in world markets. For retailers and consumers, it will be not only higher prices but, equally significant, less freedom of choice and greater hardship for those with limited purchasing power. For all, it will be the irreparable cost of less restraint on the inflationary forces with which this nation must come to grips -- and must overcome.

The widespread use of quotas would also create a new relationship between government and industry. If the U.S. Government is called upon to shield particular industries from competition, the public interest will require that it assume responsibility for the effects of that action. It will be forced to develop new means of ensuring that a protected industry be competitive in price, quality, and service, that the management be aggressive and imaginative, and that the interests of consumers and other producers are served.[5]

The answer for industries that face severe import competition lies in other directions. In the short run, it lies in the use of existing remedies, and particularly in the escape-clause provision of the Trade Expansion Act of 1962.[6] Under this provision, as Chapter V recommends it be amended, there may be cases where quotas would be the most suitable form of relief. However, they should be used only after a careful consideration of their costs to the economy as a whole. Moreover, they should be allowed only on a temporary basis in order to provide time to adjust to competition. In addition, they should be subject to periodic review to ensure that they are liberalized or eliminated at the earliest possible time.

In the longer run, the answer lies elsewhere. For an industry, the ability to improve, innovate, adapt, and change affords the best means of dealing with import competition.[7, 8] On the national level, the answer is ultimately to be found in policies that promote economic growth with stable prices. Only in this environment can the forces of competition most effectively play their role in promoting the efficiency of American industry, agriculture, and labor.[9, 10, 11]

<u>The United States must reject the quota or market-sharing approach as a general response to the pressures of world competition. However, it must also improve the</u>

3 See comment by Mr. Larry.
4 See comment by Mr. Larry.
5 See comment by Mr. Larry.
6 See comment by Mr. Borch.
7 See comment by Mr. Jones.
8 See comment by Mr. Murphy.
9 See comment by Mr. MacGregor
10 See comment by Mr. Meany
11 See comment by Mr. Abel

<u>adequacy and flexibility of mechanisms to facilitate adjustment to such competition, including those that now provide for temporary import restrictions.</u>[12, 13, 14, 15]

The reduction in the U.S. trade surplus and other changes in the world economy have led some to ask whether the United States can continue to compete both here and abroad. Much needs to be done to strengthen our competitive ability and to assure an adequate adjustment to foreign competition. Many of the recommendations in this report are directed to this major objective.

But fundamentally, the basic economic, social, and political sources of strength of the United States -- its large market, its single political system without internal barriers, its high standard of living, its educational system, its technological skills, and its traditional flexibility and adaptability to change -- should enable it to continue to meet the increased challenge of world competition.

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12 See comment by Mr. Booth.
13 See comment by Mr. Jones.
14 See comment by Mr. Rush.
15 See comment by Mr. Sobin.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER I

1 Mr. Larry

It should be more sharply emphasized that, in addition to imports growing faster than exports, manufactures and semimanufactures are contributing an increasing share of the persistent long-term decline in the U.S. balance of trade.

2 Mr. Larry

An advocate of a legislated quota is scarcely seeking to predetermine its competitive impact if he seeks a judgment from the Congress as to the extent of the problem and requests the Congress to review the situation from time to time.

3 Mr. Larry

It has not been proven that the absolute limitations imposed by quotas are a "far more drastic interference with market forces than even high tariffs."

4 Mr. Larry

It is dangerous to conclude that quotas lessen the incentive for efficiency, the motivation to innovate, and the need to change. In some circumstances, in the absence of a quota, injury may be such that there will be no ability to pursue efficiency and innovation and the capital investment needed for responding to technological change. The statement presumes a lack of competitiveness between the material that is the subject of the quota and other comparable materials in our domestic market. In steel, for example, there is ample competition from other materials, including aluminum, glass, copper, wood, cement, and plastics, to keep steel prices in an appropriate competitive relationship with potential substitute materials.

5 Mr. Larry

The reasons some form of market limitation may sometimes be needed are based not on a failure of the industry involved to maintain its technological competitiveness, but are related rather to the variance in labor standards between competing economies, to unfair barriers that other nations have established, or to the involvement of government in the industry of other countries (as in the case of steel). Thus, the fault may not lie with the industry. In such case, there would seem to be no equity in subjecting an industry to a utility-type supervision during the time that some protection is afforded. Legislation dealing with quotas for any particular industry should provide for review, revisions, or removal. Were Congress to endorse quotas for any particular industry, it has it within its power to remove such quotas or to qualify them if, in its judgment, the results of their continued imposition would be inimical to the public interest.

6 Mr. Borch

Escape-clause proceedings and adjustment assistance should not be used when the competitive problem results from illegal foreign trade practices or legal practices that are discriminatory, such as subsidies, quotas, border taxes, etc. Instead, steps should be taken to eliminate these unfair foreign practices or to offset them with unilateral countervailing action on the part of the United States.

7 Mr. Jones (Mr. Farha and Mr. Larry have asked to be associated with this comment)

A major defect of the report is its failure to take adequate cognizance of the fact that for many industries it has become impossible to compensate for the international wage-cost differentials by greater productivity in the United States. In fact, productivity differences are waning fast as technology moves freely between countries.

8 Mr. Murphy

There is no question that tremendous differences in wages have an effect on a country's ability to compete. This needs a thorough investigation and airing.

9 Mr. MacGregor

I strongly support the report's conclusion that "quotas are the negation of the market mechanism." They are the antithesis of the basic concepts on which a free enterprise system should be based. This is why I view with alarm the growing wave of protectionism in the United States. However, in considering the range of possible answers for those industries which face severe import competition, it seems to me that government also has innovation to do, and that government must assist the adjustment process by recognizing that the power of organized labor in the United States has produced dislocations of costs that are difficult to rectify so long as labor enjoys a disproportionate protection under our laws. We must restore the American principle of checks and balances as between management and labor and provide some guaranties for industry to protect its role as the mainspring of economic activity and growth, both in the domestic economy and in our international relationships.

10 Mr. Meany (Mr. Abel has asked to be associated with this comment)

In international trade as well as in domestic affairs, market forces, alone, cannot assure continued social and economic progress. When necessary, the United States should negotiate international agreements to prevent market disruption from sharply rising imports. Such international agreements should be viewed as part of a liberal trade policy in a world of international technology, international corporations, and managed economies.

11 Mr. Abel

I feel impelled to add that during the last five years steel imports have skyrocketed from 3 percent of total domestic consumption to 16 percent. Moreover, this trend is expected to continue since it is abetted by foreign government export subsidies and by a rising world surplus of steel-making capacity.

In the face of the job attrition American steelworkers are suffering because of automation, additional losses due to unfair import competition are intolerable. While I fully appreciate the value of expanding world trade when the rules are fair, a further destruction of jobs because of unbalanced import competition, based on subsidies and dumping, cannot be endured. Legislation to establish a reasonable system of steel import quotas is now necessary.

12 Mr. Booth

We strongly concur in the rejection of the market-sharing concept, believing that reliance on the competitive enterprise system and adjustment to competition from any source should be the keynote.

13 Mr. Jones

The rejection of market sharing -- quantitative control of imports -- as a significant tool of trade policy is unfortunate. The arguments employed in opposition to market sharing are largely doctrinaire. In fact, both U.S. law and policy authorize the use of the market-sharing technique in appropriate trade situations, and its use has proved to be both practical and constructive. For some essential industries, it may be the only effective means of avoiding substantial injury and of reconciling trade objectives with domestic needs and policy.

14 Mr. Rush (Mr. Farha and Mr. Larry have asked to be associated with this comment)

With reference to the statement in the report that the United States must reject the quota or market-sharing approach as a general response to the pressures of world competition, we submit that in certain instances some form of temporary quantitative restriction of imports may be necessary and justified to protect industries that for reasons beyond their control are at a disadvantage with respect to foreign competitors and as a result are inequitably treated. It is, of course, impossible to generalize in this area since justification for such action depends upon the situation of each affected U.S. industry. For example, with reference to nationalized or subsidized foreign industry, or in cases of certain natural resources that cannot be produced competitively against similar resources from outside this country, U.S. companies often find themselves in a position of being unable to combat what amounts to unfair international competition. Accordingly, in certain cases there may be no alternative but to adopt measures that at least prevent the growth of import competition at a rate that endangers the stability of U.S. industry.

15 Mr. Sobin (Mrs. Benson has asked to be associated with this comment)

I strongly endorse this rejection of the quota or market-sharing approach to meeting world competition. The basic strengths of the United States combined with adjustment assistance will enable us to meet world competition; and the overall result of trade liberalization will be a higher standard of living in the United States.

CHAPTER II

MOST-FAVORED-NATION POLICY

A. CONTINUATION OF MOST-FAVORED-NATION POLICY

A basic tenet of U.S. policy since the early 1920's has been to follow, and to insist that other countries follow, a policy of unconditional most-favored-nation (MFN) treatment* -- that is, nondiscrimination in international trade.

There have been sound reasons for this policy. In the first place, as the world's greatest trading nation, the United States has much to gain from the assurance that its own exports will be permitted to compete in foreign markets on equal terms with those of any third country. To be assured of this treatment, it must guarantee MFN treatment to others.

The alternative policy of trading a preferential position in the U.S. market for a similar advantage in another market is almost certain to be self-defeating. Bilateral arrangements in the 1930's led to bilateral balancing of trade and contributed to a drastic reduction in world commerce.

Discriminatory arrangements reduce not only the volume of trade but also its economic benefits. Purchasers can no longer buy from the lowest-cost sources. Sellers are restricted in their outlets. Thus, trade no longer promotes the most efficient use of world resources or the maximization of real incomes.

These reasons entered into the decision by the United States and its allies at the end of World War II to re-establish a multilateral trading system, of which MFN treatment was an essential ingredient. Under this system world commerce has attained record heights, and real income in most of the world has reached higher levels than ever before. The benefits that the United States has obtained, and continues to obtain, justify our retention of the MFN principle as a keystone of U.S. foreign trade policy.

<u>U.S. trade policy should continue to be guided by the unconditional most-favored-nation principle</u>.

B. CUSTOMS UNIONS AND FREE TRADE AREAS

The GATT makes a clear distinction between (a) a customs union or free trade area that frees substantially all trade among its members and does not increase tariffs against third countries, and (b) a system of preferential tariffs that does not result in such free trade. The former are permitted. The latter are prohibited except for preferential systems that were already in existence in 1947, but members of those systems are not permitted to increase any margin of preference.

There was a valid economic reason for distinguishing between areas designed to result in free trade and systems that merely reduce tariffs between partners. Under either system, two economic effects are possible. On the one hand, relatively efficient producers in one member country are able to develop new exports to another member country and to replace less efficient production that had previously been protected by

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*Unlike "conditional" most-favored-nation treatment, the unconditional form requires that any privilege granted to one country must be extended automatically to, and without requiring special compensation from, others entitled to MFN. When the term MFN is used in this report, the reference is to the unconditional form.

a tariff. This is "trade creation." On the other hand, such producers may simply replace, in the territory of another member, sales that had previously been made by more efficient nonmember producers -- i.e., "trade diversion."

In a customs union or free trade area, however, the likelihood that trade creation will outweigh trade diversion is greater than in the case of a selective preferential arrangement. Because preferences are not exchanged selectively, there is a much greater chance that competition will be increased among the members and will lead to increased efficiency in the area as a whole. Thus, the longer-term effect is more apt to be an increase in economic growth and real income and improved markets for exports of third countries.

This expectation appears to have been borne out in the development of the EEC and the EFTA. Their member states have enjoyed rapid economic growth and, despite the preferences granted to each other, they have increased their purchases from the rest of the world. From 1960 to 1967, world exports to the EEC rose by two-thirds and to the EFTA countries by almost one-half.

There are, however, circumstances under which a customs union or free trade area can prove disadvantageous to the trade of third countries. The higher the external protection, the more likely the area will result in trade diversion and the less likely it will produce longer-term benefits to third countries. This was recognized in the terms of the GATT exception itself. One of the principal reasons for U.S. support of the Kennedy Round was to reduce the common external tariff of the EEC. Although its common external tariff has been substantially reduced, some import restrictions remain high enough to create the likelihood of serious trade diversion. This is especially true of certain nontariff barriers and of restrictions on agricultural imports.

<u>In order to minimize any adverse effects on its trade arising out of customs unions and free trade areas of other countries that are maintained in conformity with GATT rules, the United States should direct its efforts towards obtaining further reduction in the existing external trade barriers of such areas</u>.

C. ENFORCEMENT OF MOST-FAVORED-NATION TREATMENT

As this report is written, a proposal for linking the EEC and some other Western European countries by an exchange of preferences is under serious consideration in European capitals and by the EEC Commission. If this proposal were implemented, it would represent a serious breach of GATT obligations and could create significant difficulties for U.S. exports. It represents an attempt to compromise the differences between France and other EEC members over the accession of Great Britain to the Common Market. Under it, the EEC and other countries would grant each other tariff preferences on an agreed list of products. Although it has been said that this system would pave the way to eventual British entry into the Common Market, the proposal does not involve such a commitment by the member countries. It would therefore not be in conformity with GATT provisions. The proposal would put U.S. exports to Europe at a competitive disadvantage without any assurance that economic integration, with its potential economic and political benefits, would be attained.

The U.S. Government has formally objected to the plan. If the countries involved should nevertheless put it into effect, the new situation that would be created would justify a re-examination of the present MFN policy. But this does not necessarily mean that it would be in the U.S. interest to abandon that policy. The cost of doing so would still be heavy and should not be incurred unless the other methods provided by the GATT for re-establishing the balance of advantages should prove inadequate.

Another category of preferences not in accordance with GATT rules is that between certain developed countries and certain less-developed countries, especially the preferences between the former African colonies of European countries and the EEC. Those granted by less-developed countries to the EEC not only place U.S. exports at a disadvantage but have none of the economic justification that can be found for generalized preferences toward less-developed countries, discussed in Chapter VII. The United States has opposed, and should continue to oppose, these "reverse preferences." As recommended in Chapter VII, their removal should be made a condition of the application to the countries concerned of any system of generalized preferences for the benefit of less-developed countries.

The United States should continue to oppose the creation of regional or other preferential arrangements among developed countries that do not comply with the GATT rules governing customs unions and free trade areas. It should continue to insist on the elimination of preferences enjoyed by developed countries that are contrary to GATT obligations.* [1]

D. U.S. PARTICIPATION IN FREE TRADE AREAS

A number of businessmen, academicians, and members of Congress have suggested that, acting under the GATT exception to the MFN rule, the United States should seriously consider exploration of membership in a free trade area as an approach to the further liberalization of its trade with other major trading countries. [2] One proposal is that the United States, Canada, and the EFTA countries enter into a multilateral free trade area. The agreement would be open to accession by the EEC and Japan, as well as Australia and New Zealand, when they are willing and able to accept its obligations. [3] Such an agreement would provide for the staged elimination of tariffs within the area and would establish a framework within which the abolition of non-tariff barriers could be more easily accomplished.

Proposals for such a multilateral free trade area do not usually provide for full membership by the less-developed countries, but they do assume free entry for their exports. That being the case, an open-ended free trade area, if all the proposed members should join, would result in the virtual elimination of tariffs, at least among non-Communist countries.

The proponents of such a free trade area do not suggest that it is likely to be achieved within the next few years. Nor do they suggest an immediate attempt to negotiate an international agreement. They visualize a period of intensive international discussion that would convince the rest of the world that this country is determined to maintain the momentum generated by the Kennedy Round. They believe that such a discussion would not interfere with, and might even support, other trade negotiations on an MFN basis that might take place before a free trade area could be established.

An important question is whether such an initiative would have any chance of acceptance in the near future. Canada and the United Kingdom, which have most frequently been mentioned as charter members of a new free trade area, would not soon be likely to contemplate unrestrained competition with American industry. There is also little reason to believe that either the EEC or Japan would seriously consider early membership, even if it is assumed that the United States itself would welcome free trade

* The subject of preferences, customs unions, and free trade areas among less-developed countries is discussed in Chapter VII.

1 See comment by Mr. MacGregor.

2 See comment by Mr. Rockefeller and Mr. Straus.

3 See comment by Mr. Farha.

with them. Japan, in spite of its industrial power, has shown no inclination to run the risk of unsheltered competition with American industry in its domestic market. Nor would the EEC be likely to contemplate free trade with the United States until it has had more time to adjust to the formation of its own common market.

It can also be taken almost for granted that the EEC would consider such an area to be intended as a counterweight to the Common Market and inimical to its interests. Therefore, so long as the United Kingdom wishes to obtain entry to the Common Market, it could not be expected to enter into serious discussion of such a proposal even to gain bargaining power for that purpose. To do so would probably not be an entirely credible threat and could jeopardize its chances of accession. [4]

If these judgments are correct, it seems unnecessary to examine whether, under present conditions, a multilateral free trade area would be in the U.S. interest. For the costs of an unsuccessful U.S. initiative would outweigh the apparently slight chance that an international exploration of the idea would meet with a favorable response. At worst, it could exacerbate trading and other economic relations with the EEC. At best, it would divert attention and efforts from the accomplishment of more modest objectives that have some chance of being attained in the foreseeable future. [5]

There are, however, circumstances that could change this conclusion. This might be the case if the efforts of the United States to bring about a further substantial reduction in world trade barriers through multilateral negotiations on an MFN basis should encounter obstacles that cannot be overcome. For example, if the EEC should permanently exclude Great Britain from membership and should itself be unwilling to participate in multilateral efforts to reduce trade barriers, it is possible that both the United States and the other developed countries outside the EEC would see more to gain from a new and enlarged free trade area than from a continuation of present policies.

<u>The United States should not jeopardize the chance of a further reduction of trade barriers on an MFN basis by proposing or encouraging plans for participation in a new free trade area. It should be prepared to re-examine this position, however, if circumstances should change so as to make it unlikely that a liberal trade policy based on MFN can succeed</u>. [6]

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[4] See comment by Mr. Straus.
[5] See comment by Mr. Larry.
[6] See comment by Mr. Sobin.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER II

1 Mr. MacGregor (Mr. Borch, Mr. Franklin, and Mr. Larry have asked to be associated with this comment)

I believe it is too weak to advocate, as the report does, that the United States should "continue to insist" on the termination of preferences that are contrary to GATT obligations but are still maintained by some developed countries. In my view, if our insistence does not result in the termination of these infractions of GATT obligations, the United States should serve notice of its intention to consider what protective measures it should take on its own behalf.

2 Mr. Rockefeller and Mr. Straus (Mr. Lazarus, Mr. Parker, Mr. Peterson, and Mr. Shuman have asked to be associated with this comment)

Now that the Kennedy Round negotiations have been completed and further progress along these lines is uncertain, the United States should consider the feasibility of a broad-based free trade association as part of its long-run policy to reduce trade barriers. Participation in a free trade association does not violate formal adherence by the United States to the MFN principle. Under Article XXIV of the GATT, a general waiver is accorded to customs unions and free trade areas provided that duties and other regulations maintained by the members shall not be higher or more restrictive than those existing prior to their formation. A majority of industrialized countries are already either members of free trade associations or customs unions, as are many of the developing countries.

A multilateral free trade association is an alternative means of further liberalization of world trade. The removal of nontariff barriers, in particular, might be more readily negotiated among the members of the proposed multilateral free trade association in which the participating nations have committed themselves by agreement or treaty to the mutual removal of these trade barriers. Indeed, the very prospect that the United States is considering a multilateral free trade association as a serious option might well encourage other countries, especially those that belong to narrower trade groupings, to accelerate the lowering of their external trade barriers. Moreover, it should be an open-ended association, and not be considered as in competition with such existing regional groupings as the European Common Market and the European Free Trade Association; rather, it would try to incorporate these arrangements within its multilateral context.

The time appears ripe for serious consideration of such a multilateral free trade proposal. It would reinforce U.S. Atlantic ties to Europe as well as our Pacific ties to Japan and Asia, and to Australia and New Zealand. Moreover, if the EEC should decide to join, because of the attractions of close association with a large and technologically sophisticated market, a multilateral free trade association would have helped overcome the present economic dislocation of Europe caused by its two regional groups. Even if the time were not yet ripe, however, it would be preferable to have available a thought-out plan of action, rather than groping for new arrangements later on.

To be sure, the United States alone cannot undertake a free trade association. Other countries must believe that it is in their own interests to cooperate with us in this joint effort for reducing trade barriers. At the moment, Canada, Britain, the European Community, and Japan may not be ready to join such a multilateral undertaking, although there has been a growing interest in this proposal very recently. The long-term policies of all these countries might well turn in the direction of a free trade area and the United States should be prepared to react positively to such initiatives. This is why the United States should take the diplomatic lead in exploring the feasibility of a multilateral free trade association, provided the approaches to other countries are made with due appreciation of their self-interests as well as of our own.

3 Mr. Farha

I urge that the United States join Canada and the EFTA countries in a free trade area and keep it open for accession by the EEC and Japan. Meanwhile, Japan should be strongly encouraged to fulfill its trade obligations to the United States.

4 Mr. Straus (Mr. Rockefeller has asked to be associated with this comment)

Great Britain is now in a relatively weak bargaining position with the EEC. If it had an alternative course of action, such as possible membership in a multilateral free trade association, its bargaining position would be considerably strengthened.

5 Mr. Larry

An additional drawback to U.S. participation in a free trade area is that it could mean there would be a substantial increase in imports of semi-processed and processed manufactures, which would jeopardize the position of a number of basic U.S. industries now encountering difficult import adjustment problems.

6 Mr. Sobin

I see no reason why the United States should not explore tentatively the idea of a new free trade area with other governments in order to determine their possible interest in such an area. Such an exploration could take place concurrently with other negotiations leading to reductions in trade barriers on an MFN basis.

CHAPTER III

TARIFF AND NONTARIFF BARRIERS

In spite of the accomplishments of the Kennedy Round, world trade is still restricted in many cases by tariffs and by a variety of nontariff barriers. Their further reduction or removal, particularly in Europe and Japan, is central to U.S. export prospects.

In some cases the elimination of existing barriers can be achieved by strict enforcement of GATT rules. But, like tariffs, many nontariff barriers -- our own as well as those of others -- are permitted under those rules and can only be reduced or removed by negotiation. In the shorter term, the United States should negotiate limited agreements concerning particular categories of nontariff barriers or involving both tariff and nontariff barriers in certain industrial sectors that lend themselves to this approach. The reduction or removal of other barriers, however, will have to await another general round of trade negotiations. Planning for this should begin promptly.

A. CONTINUING REQUIREMENTS

The recommendations that follow in this section point to the need for protecting U.S. interests under the GATT and for completing the implementation of the Kennedy Round.

1. Enforcement of U.S. Interests in GATT

Most tariff and nontariff barriers consist of practices that do not violate existing GATT obligations. In fact, the only important category of a clearly illegal barrier still maintained by developed countries is that of import quotas that were originally adopted because of balance-of-payments difficulties but are no longer justified on those grounds. While most of these quotas have been eliminated on industrial products, there remain important ones, especially in the field of agricultural products and processed foods.

The GATT provides a mechanism for dealing with illegal and other restrictions that nullify or impair the value of a country's benefits under the GATT. In such a case, the country imposing the restriction can be required (under Article XXII) to consult with the injured party or with the Contracting Parties.* Alternatively, it can be required (under Article XXIII) to negotiate a satisfactory settlement. If a settlement is not forthcoming, the Contracting Parties may authorize the injured party to withdraw equivalent benefits from the offending party.

It has often been possible to persuade countries voluntarily to bring their practices into conformity with their obligations. But, where this has failed, the United States has invoked these GATT provisions -- for example, against countries that maintained quantitative restrictions that could not be justified on balance-of-payments grounds. The use of these GATT provisions to enforce contractual rights should be continued and intensified until our major trading partners are convinced that compliance with the GATT is their most profitable policy.

Where U.S. interests under the GATT are injured significantly by other countries' actions and where a settlement under Article XXII of the GATT does not prove possible,

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* The term "Contracting Parties" refers to the GATT countries acting jointly.

the United States should invoke the remedial provisions of Article XXIII of the GATT.[1]

At the present time, the President's authority to retaliate against illegal foreign restrictions -- once approval of the Contracting Parties is obtained under Article XXIII -- is not balanced. The sanctions that can be used against imports from countries maintaining illegal restrictions on our agricultural exports are more extensive than those available to defend our industrial exports. Under several provisions of the Trade Expansion Act of 1962, the high rates of duty of the Smoot-Hawley Tariff Act of 1930 could be imposed in retaliation against illegal import restrictions impeding either class of U.S. exports. However, under section 252(a)(3) of the Trade Expansion Act of 1962, the President may impose higher rates of duty -- or even quotas -- but only in cases where our agricultural exports are being injured through illegal action. In order to put the United States in a position to protect all its export interests as effectively as possible, this arbitrary distinction in the law should be eliminated.

Section 252(a)(3) of the Trade Expansion Act of 1962 should be amended to permit the full range of retaliatory powers to be available, in accordance with the GATT, against illegal foreign import restrictions imposed on either industrial or agricultural exports of the United States.[2]

2. Compensatory Tariff Concessions

As the result of reciprocal tariff negotiations conducted over more than three decades, almost all the dutiable items in the U.S. tariff have been bound in the GATT against increases in rates of duty. But occasions can arise when it is necessary to increase a rate of duty: in order to prevent injury to a domestic industry pursuant to an escape-clause action under the Trade Expansion Act of 1962; incidental to the elimination of tariff anomalies; or as the result of a reclassification of a product by the courts. When any GATT country increases a bound rate, it must be prepared to grant compensation to countries that have a contractual right to that rate. If it is not able to offer reasonable compensation, it must face a retaliatory withdrawal of benefits enjoyed by its exports.

Since June 30, 1967, when the tariff negotiating authority in the Trade Expansion Act of 1962 expired, the President has had no authority to reduce tariffs for any purpose. It is essential that the President be given this flexibility. Some of the authority in the Trade Expansion Act remained unused upon its expiration on July 1, 1967. But, even if that authority were now restored, much of it would be unavailable because its use might threaten injury to certain domestic industries, or because the principal beneficiary of a reduction would be a non-GATT country.

In order to provide the needed flexibility over the next several years, the President should be given the authority to reduce any tariff by as much as 20 percent of its post-Kennedy Round rate, subject to the safeguards in the Trade Expansion Act of 1962. Any such reduction should become effective no earlier than one year after the final reduction agreed to in the Kennedy Round becomes effective. The proposed authority should not be sought, however, for the purpose of conducting a new general round of trade negotiations but rather to meet needs, as they arise, for negotiating compensatory tariff reductions on individual products.

The President should be given the authority to reduce any tariff by up to 20 percent of the post-Kennedy Round rate. The legislative record should make it clear that

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[1] See comment by Mr. MacGregor.

[2] See comment by Mr. Booth.

the authority is requested for use in compensatory negotiations and not in a general round of trade negotiations.[3]

3. Supplementary Agreement on Chemicals

During the Kennedy Round the United States negotiated a Supplementary Agreement on Chemicals, subject to enactment of implementing legislation. This agreement traded substantial tariff benefits to the American chemical industry for the elimination by the United States of the American selling price system of customs valuation -- a system that gives extraordinary protection to a small segment of domestic chemical production, as well as the production of a few other goods, including rubber-soled footwear. The Congress has not yet taken action to permit implementation of the agreement.

The American selling price system has become, for some foreign countries, the prime example of an unjustified nontariff barrier. As such, it has a significant bearing on the effort to eliminate nontariff barriers. It poses the issue of whether the United States is willing to remove one of its most restrictive nontariff barriers to the trade of others, while still providing substantial and adequate protection for a domestic industry.

The Agreement would remove the American selling price system not unilaterally, but in exchange for fair and adequate new opportunities for growth in chemical exports, as well as for significant liberalization of nontariff trade barriers on certain other U.S. exports. The action that is taken on this Agreement will be regarded by other nations as an indication of our determination -- or lack of determination -- to move forward in the difficult task of freeing world trade from nontariff barriers.

The President should be given the authority to abolish the American selling price system of customs valuation in order to permit, in particular, the implementation of the Supplementary Agreement on Chemicals, negotiated during the Kennedy Round.[4,5,6,7]

B. INTERNATIONAL NEGOTIATIONS IN SPECIFIC AREAS

Neither the United States nor any other country is likely to be in a position to enter into a general round of tariff and nontariff barrier negotiations until the tariff reductions negotiated in the Kennedy Round have been completely implemented. The final stage of those reductions will become effective on January 1, 1972. In the meantime, there are certain areas -- relating to specific nontariff barriers or industrial sectors -- in which there is a possibility of reaching agreements benefiting U.S. exports if the President were in a position to negotiate effectively.

However, the prospect of such negotiations in the near future poses a fundamental dilemma. Ever since the first Trade Agreements Act in 1934, tariff reductions have been negotiated and implemented under prior authority delegated to the President. This time-tested method has proven its worth and should form the basis for any future general round of negotiations dealing with tariffs.

But prior delegations of authority are probably not feasible for negotiations concerning particular nontariff barriers or industrial sectors recommended below for the

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[3] See comment by Mr. Larry.
[4] See comment by Dr. Hammer.
[5] See comment by Mr. Meany.
[6] See comment by Mr. Rush.
[7] See comment by Mr. Sobin.

nearer term. Because of the variety and complexity of nontariff barriers, there is no common standard applicable to such barriers that would lend itself to a general and meaningful grant of authority. Furthermore, in the case of an industrial sector, the scope of the tariff and nontariff negotiations involved could probably not be forecast with precision. In these cases, therefore, any necessary Congressional action would, in all likelihood, have to take place after the agreement has been negotiated.

The question of the necessary legal authority breaks down into two subsidiary questions -- the authority to negotiate an international agreement and the authority to implement it. So far as the act of negotiation is concerned, Presidents have from the beginning taken the view that they have an inherent constitutional power to negotiate agreements with other countries and do not need any prior Congressional authority or license to do so.

However, as a practical matter, it may no longer suffice to rely on inherent authority alone. The negotiation of three agreements in recent years without advance authorization has led some members of the Senate to oppose this sort of negotiation in principle. The negotiation of the U.S.-Canadian Automotive Agreement was the first of the three. It provoked charges that the Executive Branch was presenting the Congress with a _fait accompli_ in seeking the necessary implementing legislation.

During the Kennedy Round, both the American selling price agreement and the International Antidumping Code were negotiated notwithstanding Senate Concurrent Resolution 100. This resolution, which was passed by the Senate in 1966, but not by the House, declared that it was the sense of the Congress that the President should negotiate no agreement in the Kennedy Round outside the authority granted by the Trade Expansion Act of 1962. The negotiation and conclusion of these two agreements have aroused misgivings among certain members of the Senate.

Because of this problem, it would seem advisable for the Executive Branch to seek an expression of the sense of the Congress favoring the negotiation of trade agreements that might require the subsequent enactment of implementing legislation. If such an expression could be obtained, it would facilitate the negotiation of agreements dealing with particular nontariff barriers and individual industrial sectors. But it would not, of course, avoid the need, where relevant, to obtain implementing legislation after an agreement had been concluded.

In order to facilitate the negotiation of agreements for which a prior delegation of authority is not feasible, the Congress should be asked to pass a resolution expressing its general intent that the President negotiate agreements concerning both nontariff barriers and industrial sectors. Any agreement requiring implementing legislation would not enter into force until such legislation were enacted. [8]

In order to make sure that any such agreement is in the U.S. interest and in order to determine the probable economic effect on U.S. firms and workers of any increased imports that might result, the Executive Branch should conduct public hearings and obtain the advice of the Tariff Commission before entering into negotiations.

Before the negotiation of any trade agreement dealing with particular nontariff barriers or individual industrial sectors, the Executive Branch should conduct public hearings and obtain the advice of the Tariff Commission on the probable domestic economic effect of such agreement.

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[8] See comment by Mr. Booth.

1. Nontariff Barrier Negotiations

Nontariff barriers include such disparate devices as quantitative restrictions, arbitrary customs practices, restrictive government procurement policies, and unreasonable application of health and safety standards. They even include such nongovernmental practices as industrial standards and specifications that can make the use of imported products more difficult.

Of the many measures other than tariffs that have the effect of restricting trade and protecting domestic producers, some have been instituted for reasons unrelated to their effect on trade, such as the protection of public health and safety. This adds greatly to the difficulty both of determining their effects on trade and of negotiating their modification or removal.

The nature of nontariff barriers and the wide differences in the practices of different countries are such that an overall nontariff barrier negotiation, conducted independently of a general round of trade negotiations, is probably impracticable. Nevertheless, there is a possibility -- and this possibility should be thoroughly explored -- of negotiating international agreements, including codes of uniform practices, concerning certain categories of nontariff barriers.

In exploring this possibility, consultations should be held with representatives of industry, labor, and other affected domestic interests. After such consultations and after discussions with other countries, it should be possible to determine those cases in which an international agreement on particular nontariff barriers would be both feasible and in the national interest. The object of such an agreement would be to ensure that U.S. exports receive in foreign markets treatment no less favorable than that accorded to imports into the United States.

When further exploration shows that agreements limiting or eliminating nontariff barriers, including codes of uniform practices regarding particular nontariff barriers, are feasible and in the national interest, the United States should initiate negotiation of such agreements in the GATT. [9]

Certain areas in which the negotiation of international codes should be pursued -- subsidies and countervailing duties, border tax adjustments, government procurement, and restrictive business practices -- are discussed in section D of this chapter.

2. Industrial Sector Negotiations

Another possibility of improving U.S. export prospects before countries are ready for another general round of trade negotiations lies in negotiations within individual industrial sectors. This technique would make it possible to deal both with tariffs and with other matters affecting trade within a sector. This was attempted on a limited basis during the Kennedy Round. For example, an effort was made to reach a special agreement in one sector that would have recognized the multinational nature of the industry concerned. Primarily because of the opposition of a single foreign producer, an agreement was not achieved. The possibilities of similar negotiations in other industrial sectors have not been exhausted, however, especially those in which the industry is organized on multinational lines and where competitive strength is comparable.

A sector negotiation should deal with all impediments to market access, including tariff and nontariff barriers, investment restrictions, and restrictive business

[9] See comment by Dr. Hammer.

practices. After consultations with representatives of industry, labor, and other domestic interests concerned, and after discussions with other countries, it should be possible to identify individual industrial sectors in which negotiations would be both feasible and in the national interest. The object of a sector negotiation should be to establish equality of opportunity for the industry concerned in all major markets.

When further exploration shows that agreements in individual industrial sectors are feasible and in the national interest, the United States should initiate negotiation of such agreements in the GATT. [10]

C. A GENERAL ROUND OF TRADE NEGOTIATIONS

However successful negotiations in individual sectors or on specific nontariff barriers may prove, substantial impediments to trade will remain. After the Kennedy Round is fully implemented, many tariffs will still be high. Moreover, a preliminary inventory of nontariff barriers recently compiled by the GATT reveals many barriers that are of such limited application or so specialized that they cannot be adequately dealt with in the kinds of negotiations recommended above.

Another general round of trade negotiations is unlikely until the Kennedy Round tariff concessions are fully put into effect. However, the complexity of a future general trade negotiation requires that serious preparatory study begin now.

The form that such negotiations should take will depend upon a variety of circumstances. The discussions now under way in the GATT in relation to specific nontariff barriers and certain agricultural problems will lay the groundwork for, and influence, the final form of a general round of trade negotiations. Domestic considerations within the United States and in the other participating countries will be another important determinant. Before that form is decided and before the nature of the required tariff-reducing authority can be determined, there should be intensive discussion both within the United States and with the other countries concerned, bilaterally and in the GATT.

In preparing for another major round of trade negotiations, much additional work is needed in the collection, automation, and analysis of relevant data. In particular, appropriate weight should be given to the level and characteristics of the post-Kennedy Round tariffs of the prospective participants. Moreover, possible methods of reducing tariffs should be considered in the light of what can be learned of effective, as opposed to nominal, tariffs of the United States and the other participants.*

The GATT study now underway concerning nontariff barriers and their protective effects is an essential part of the preparation. This should be complemented by considerably more information than the U.S. Government now has on the impact of foreign nontariff barriers on U.S. exports, both agricultural and industrial.

The experience of previous negotiations should also be taken into account. The item-by-item approach, used in all negotiations before the Kennedy Round, presents serious difficulties, especially in dealing with the EEC. The linear approach used in the Kennedy Round was more successful, but variations would be required, both in order to take account of some of the problems that developed in those negotiations and to ensure that greater emphasis is given to the inclusion of nontariff barriers.

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[10] See comment by Dr. Hammer.

* A brief discussion of effective tariff rates is contained in Chapter VII.

Following further study within the U.S. Government, the United States should initiate an exploration in the GATT to determine the approach in a general trade negotiation that is most likely to accomplish U.S. trade objectives in both industry and agriculture.

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D. SPECIAL PROBLEMS

A number of special problems in the field of nontariff barriers merit more detailed treatment than that given above generally to nontariff barriers. In the following cases, the problem has already been introduced by the United States in the GATT or the Organization for Economic Cooperation and Development (OECD), and discussions preparing the way for future negotiations are already in progress.

1. Export Subsidies

The use of export subsidies and the imposition of countervailing duties as a protection against subsidized imports are rapidly becoming a major issue in international trading relations. Differences of view as to what constitutes a subsidy in terms of GATT rules may, if allowed to persist, lead to a destructive dispute between the United States and the EEC. Inconsistencies between the U.S. countervailing duty law and the provisions of the GATT also create opportunities for disagreement.

In seeking to amend the GATT or develop a supplementary code of behavior under the GATT concerning export subsidies, the present prohibition against subsidies on industrial exports should be retained.* However, in the first instance, a reasonably clear and workable definition of industrial subsidies is needed. At present, the GATT lacks a definition of a subsidy, and it is only by virtue of a GATT working party report that there is any guidance as to what constitutes a subsidy.

In addition, the effectiveness of countervailing duties in discouraging industrial export subsidies should be strengthened. Countervailing duties protect only against those subsidized exports that compete with producers in the importing country. When unsubsidized exporters encounter subsidized competition in third markets, the only redress available at present is retaliation against the subsidizing country. But this will not, of course, assist the producers who have been deprived of their export markets. This problem could be met if the GATT were to include a provision requiring importing countries to apply countervailing duties against subsidized industrial exports if the GATT Contracting Parties find that they materially injure a competing export industry in the territory of another GATT country.

If sufficient improvements can be obtained in the provisions of the GATT, the United States should consider changing several features of its countervailing-duty law. First, countervailing duties are now available only in the case of dutiable products. American producers competing with nondutiable imports are thus deprived of protection against subsidized competition.

Second, because the U.S. law was enacted before the United States adhered to the GATT, this country is not bound by the GATT requirement that countervailing duties be

11 See general comment on sections A, B, and C of this chapter by Mr. Gilbert.

* The GATT contains no prohibition against subsidies on agricultural exports. Recommendations relating to agricultural export subsidies are contained in Chapter IV.

applied only against subsidized imports that materially injure a domestic industry. Adoption of this requirement would significantly assist the United States in obtaining the needed improvements in the GATT to protect its exporters and would not harm any domestic industry.

Third, the U.S. law does not permit the President to waive a countervailing duty even if he should find that such waiver is required by the national interest. Thus, he lacks an authority that could enable him through negotiations to accomplish the purpose of defending American interests more effectively than by the imposition of a countervailing duty.

Finally, if the GATT should be amended to deal with the effect on exporters of subsidized exports in a third market, the U.S. law should be amended to permit the imposition of countervailing duties in such cases.

The United States should initiate negotiations in the GATT with the objective of strengthening the present prohibition against subsidies on industrial exports with a clear definition of industrial subsidies.

The United States should consider seeking the inclusion in the GATT of a provision under which importing countries would be required to apply countervailing duties against subsidized industrial exports if the GATT Contracting Parties find that they materially injure a competing export industry in another GATT country.

If sufficient improvements can be obtained in the provisions of the GATT, the United States should be prepared to amend its countervailing duty law so that (a) duty-free as well as dutiable imports would be subject to countervailing duties; (b) countervailing duties could be imposed only if material injury were established;[12] (c) the President would be empowered to waive the imposition of countervailing duties if he should find that such a waiver is required by the national interest; and (d) countervailing duties could be applied to subsidized imports that materially injure an export industry of a third country.[13, 14]

2. Border Tax Adjustments

There is growing concern in the United States with the trade-distorting effects of internal taxes charged on imports and rebated on exports, as well as with the GATT trading rules relating to these border tax adjustments. As a result, the United States has taken the lead in the GATT to reexamine these rules.

At present, these adjustments at the border are permitted under the GATT in order to compensate for taxes on domestic products, that is, so-called "indirect" taxes. To

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12 See comment by Mr. Borch.

13 See comment by Mr. Farha.

14 See comment by Mr. Larry.

take an example from U.S. practice, when whisky is imported, the federal excise tax is collected at the border; when it is exported, the excise tax is not paid, or is rebated. Furthermore, when imported whisky is sold in the United States, it is also subject to any state and local excise or sales taxes. This compensation for indirect taxes is the general practice of GATT countries. On the other hand, GATT rules do not allow for border adjustment of direct taxes, such as the corporate income tax.

This difference in treatment between direct and indirect taxes has a long history. When the GATT was drafted more than two decades ago, it reflected normal practice. The distinction can be found in the U.S.-Canadian bilateral trade agreement of the 1930's and in the earlier British-Canadian bilaterals. It was, at the time, considered the obvious and expedient way of dealing with sales and excise taxes in international trade. The United States itself at that time wished to continue to impose on imported products taxes equal to those borne by similar domestic products.

Especially in the last two or three years, however, there have been important changes in tax rates and in the nature of the basic tax systems in a number of countries. These have raised a serious question as to the trade effects of the present rules. Two changes have pointed up the need for a reexamination of those rules. Both have been stimulated in the first instance by the movement to harmonize internal tax levels and systems within the EEC, but their effect has been multiplied as other countries have taken or are preparing to take similar action.

The first of these changes is the abandonment of a system under which domestic taxes were only partially compensated at the border and the adoption of a system under which full border compensation automatically occurs. As compared with the previous situation, this change must necessarily result in restricting the imports and stimulating the exports of the country concerned.

The second change has been the tendency to increase the rate of the indirect taxes charged on the domestic product and consequently the rate of the border tax adjustments. These increases have raised the question of whether full border compensation for indirect taxes is trade-neutral or, in fact, is trade-distorting. Finally, both these changes have emphasized the trade disadvantage that may be suffered by a country like the United States that relies primarily on direct taxes and makes relatively small use of indirect taxes.

In order to understand the effect of the tax changes being made, primarily in Europe, it is necessary to examine them and their underlying reasons in some detail. Until recently, most European countries employed a business turnover (or cascade) tax. Simply put, this is a tax representing a uniform percentage of the value of each sale from raw material to final consumption. It creates economic distortions, since it results in a high tax burden on the products of non-integrated firms, which change hands often before the final sale, and a lesser tax burden on integrated firms. Also, because the total burden varies from enterprise to enterprise, adjustment at the border is a matter of guesswork.

Most countries that have employed the cascade tax, including all the members of the EEC, have changed or are changing to the "tax on value added" (TVA). The TVA, first used extensively by France, avoids the ambiguities and domestic distortions of the cascade tax. The tax is usually collected at all stages in the distribution chain from raw-material producer to final consumer. It is assessed only on the value added at each stage, so that the amount finally collected is the same as if it had been imposed as a single-stage tax at the final point of sale. The businessman periodically reports all the taxes collected on his sales and deducts from them all the taxes he paid on his purchases. He turns the difference over to the government.

Under the TVA system -- in the absence of false invoicing to the final consumer -- the full tax is certain to be collected on the final value of the product. Because the amount actually paid at any stage is always the tax due less taxes previously paid, a lower tax at one stage will automatically result in a higher tax at the next stage.

Imported products under the TVA system are subject to the same tax rates and procedures as domestic products. Since there are no domestic TVA taxes previously paid to be deducted, the whole tax is levied. For exports, the taxes previously paid are rebated or credited.

One consequence of the way in which the TVA is collected is that it would make little difference whether or not it was collected at the border. Technically, no border tax adjustment at all is needed for imports, except in the case of direct importation by the final consumer. The TVA could be collected on the first or second domestic transaction after import and the effect would be virtually the same, except that the importer's tax burden would be postponed.

The changeover from cascade tax to TVA has already involved a change from undercompensation to full compensation at the border. Germany, for example, previously had a cascade system that provided for an average, estimated border adjustment that was less than could have been justified by the actual tax paid on the domestic product. This undercompensation was automatically eliminated when the TVA was introduced on January 1, 1968. The result was equivalent to a devaluation in the trade account of the Deutsche Mark by about two percent.

The Netherlands has just completed its arrangements for a changeover from a cascade tax to the TVA, and again the apparent result is a modest trade devaluation of the guilder. Belgium recently raised its estimated border adjustment rates in order to make a transitional step towards an ultimate changeover.

It is clear that a change from previous undercompensation to full compensation at the border must have a trade effect similar to that of a currency devaluation, since it increases the price of imports and decreases the price of exports. Because most of the countries making or planning these changes presently have a balance-of-payments surplus, the change to full border compensation has come at a particularly unfortunate time from the point of view of the international adjustment process. [15]

As already indicated, the effect of the harmonization of tax rates within the EEC has been not only to introduce full border compensation in the case of some countries but also to raise the level of indirect taxes collected domestically and adjusted at the border. One theory, widely held in Europe, is that these increases will not affect trade because full border compensation for indirect taxes is itself trade-neutral. According to this theory, a businessman in the country levying the tax adds it to the price of the product and does not absorb any of it as a cost.

In reality, however, such indirect taxes are often partially or even wholly absorbed by the manufacturer, depending upon the degree of competition in his markets and in the markets for his materials. Thus, the price effect at any stage is likely to be less than the full tax rate. If it is less, the exporter receives a special bonus and the importer is disadvantaged.

Similarly, some economists believe that a part of direct taxes, such as profits taxes, are passed forward into the price charged to buyers. The simple, black-and-white distinction between direct and indirect taxes in the GATT is therefore questionable.

In the absence of some international agreement to eliminate or reduce the resulting inequities, the problems ahead in the border-tax field are likely to increase. Countries may, as France recently did, seek opportunities to sweep other taxes into the TVA framework. This would further curb imports and stimulate exports without any significant impact on the domestic tax burden or the domestic price structure. Since further changes are already contemplated in connection with the harmonization of taxes within the EEC, the need for intensified work in the GATT on this problem assumes considerable urgency.

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[15] See comment by Mr. Borch.

Because of the impossibility of determining the precise trade effects of border tax adjustments, it is difficult to formulate a solution that fully meets the problem. Nevertheless, there are a number of approaches that have been suggested.

First, the inclusion in the TVA system of taxes not previously compensated at the border, or a change from undercompensation to full compensation, could be formally recognized by the GATT Contracting Parties as having the effect of a devaluation on trade account and as impairing the trade position of other countries. If so, it would be necessary to place countries under an obligation to offer compensation.

Second, the Europeans could agree to make a less-than-full adjustment under the TVA. However, it would not be enough merely to set a lower tax on imports. Under the TVA system, a lower tax on the import as it enters the country would simply result in a smaller credit at the next stage. The full tax will be collected in the next transaction. Thus, less-than-full adjustment would require: (a) a credit for a tax not paid, but that would have been paid if the product had been produced domestically, or (b) an outright tax refund or subsidy for imports such as those recently adopted by Germany in an effort to curtail its balance-of-payments surplus.

Third, an adjustment for direct taxes at the border could be allowed. However, since there is no way of arriving at the tax rate that would reflect the tax incidence on an individual product, this uncertainty could be abused by other countries. Moreover, some of the countries that use indirect taxes extensively also have substantial direct taxes of their own. A number have nominal direct tax rates as high as, or higher than, those in the United States, but direct comparisons are difficult because of differences in the earnings base used and in permitted accounting practices. A rule that would permit border adjustments for direct taxes would increase the total adjustments by all countries and could greatly increase incentives to obtain an unfair trading advantage.

A possible way to cope with this danger would be an overall limit of a fixed percentage of the value of the product for indirect and direct taxes together, with a lower percentage limit for direct taxes alone. Then countries already at the outer limit could make no further adjustments for direct taxes but countries within the limit might increase their border adjustments. This would not provide an answer to the extremely complex problem of how fairly to allocate direct tax burdens to individual products, nor how to treat products that are subject to luxury or other sumptuary taxes. But it might be possible to devise outside limits to all border tax adjustments that would represent a fair compromise.

Fourth, the United States could average its own indirect taxes, including such taxes as those on gasoline consumed in the production of goods, and adjust at the border for them. Such an adjustment would amount to about 2 to 2.5 percent. This, however, would involve compensation for some taxes that are not imposed on the product as such -- so-called "taxes occultes," or hidden taxes -- and would open the way for countries that do not now adjust for these taxes to do so. In some countries, such an adjustment would run between 5 and 10 percent, and the net effect might very well be to worsen the U.S. position.

Fifth, border adjustments could be related to a nation's balance-of-payments position. New GATT rules could be devised providing for the undercompensation of border taxes by countries in surplus position. Countries in balance-of-payments difficulties and facing border taxes or export tax rebates in third countries might, with IMF and GATT approval, be allowed special border tax adjustments during these periods of difficulty.

The recent German action taken in response to the monetary crisis of November 1968 demonstrates how the TVA can be adjusted at the border to favor imports and discourage exports. On the export side, a tax is now charged so that the export does not go out entirely free of tax. On the import side, the importer is given a tax refund of a specified percentage of his assessment base.

__Sixth__, the United States could impose countervailing duties against exports from countries rebating indirect taxes, though this might require new legislation. In addition, with the necessary grant of authority from the Congress, it could use the proceeds from these countervailing duties to subsidize U.S. exports. But the affected countries would then be likely to apply countervailing duties against U.S. exports and thus nullify whatever advantages we might initially gain.

__Seventh__, it has been suggested that the United States should replace all or part of the corporate income tax with a single-stage or multi-stage manufacturers' tax, which could then be compensated at the border under the present GATT rules. This would tend to offset the relative trade advantage now enjoyed by countries using the TVA system. However, to do so would be to subordinate the domestic and social considerations underlying our present tax system in favor of foreign-trade considerations.[16, 17]

Whichever of these various approaches -- or possibly others -- should prove to be both negotiable and desirable, three key considerations should be emphasized. First, the United States cannot continue to tolerate the trade disadvantages arising out of the GATT rules. Second, other countries must be prepared to work actively towards a fair settlement of the problem. Third, this settlement should aim at a means of substantially neutralizing the trade distortions caused by border tax adjustments.

__The United States should press its present initiative in the GATT with the objective of negotiating in 1969 a solution that would substantially neutralize the trade distortion caused by border tax adjustments.__

18, 19, 20

3. __Government Procurement__

Government procurement, including direct purchases and those by state-owned companies and quasi-autonomous entities, has a substantial impact on international trade. As the scope and volume of these purchases have increased in recent years, the disparities in practice among the major trading nations have created an increasingly serious distortion of trade.

In the United States, government procurement for use in the United States is governed by the Buy American Act and implementing regulations. The margin of preference is a clearly stated percentage difference between foreign and domestic bids. Except for certain contracts involving goods and services essential to the national security, foreign suppliers are regularly afforded a clear opportunity to bid on government projects and are awarded contracts on the basis of their bids.

In most other countries, by contrast, government procurement is usually carried out under a very high degree of administrative discretion, unquestionably favoring domestic suppliers even where there are published standards and procedures. As a result, U.S. and other foreign suppliers frequently have no established means of competing for contracts or sometimes even of learning of the existence of a government project. Moreover, some foreign governments consistently invite bids only from domestic firms and thus exclude foreign suppliers entirely. This is especially true in the field of heavy electrical equipment.[21]

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[16] See comment by Mr. Borch.

[17] See comment by Mr. Parker.

[18] See general comment on this subsection of this chapter by Dr. Hammer.

[19] See general comment on this subsection of this chapter by Mr. Rush.

[20] See general comment on this subsection of this chapter by Mr. Shorenstein.

[21] See comment by Mr. Borch.

At present, non-defense U.S. procurement is subject to a preference of 6 percent of the price including duties, with an additional 6 percent preference when the goods are supplied from depressed areas or by a small business. Defense procurement is subject to this same preference or to a preference of 50 percent excluding duties, whichever is higher. This is designed to alleviate the impact of Defense Department expenditures on the U.S. balance of payments. The Defense Department has stated that it does not expect to use the 50 percent factor beyond the time when the U.S. balance-of-payments deficit is corrected.

The precise manner in which foreign countries administer their preferences is often difficult to determine. Disappointed U.S. and other foreign bidders are reluctant to complain about specific cases of abritrary procurement for fear that the complaint might become known and be held against them in future bidding. The difficulty of obtaining detailed information is compounded by the fact that, after repeated disappointments, exporters may be discouraged entirely from bidding on foreign government contracts.

During the past five years the Trade Committee of the OECD has been examining government procurement practices and attempting to obtain international agreement on guidelines for such practices. The consultations in the OECD have been useful in pointing out the universality of buy-national practices and the openness of U.S. procedures as contrasted with those of some other countries. Only minor progress, however, has yet been made toward fair international rules in this area.

One of the major impediments to progress is that certain countries maintain that their nationalized industries and quasi-autonomous entities are not subject to government direction in their procurement. Another important problem is the constitutional inability of national governments, including the United States, to direct the procurement practices of their political subdivisions.

In spite of the admitted difficulties in this field, there is a clear need to develop a common set of standards for government procurement. If substantial progress is not soon made, there is considerable risk that whatever open government procurement now exists will be abandoned and an important area of international trade will be closed off.

<u>The United States should continue to press the international effort to achieve a code on government procurement practices, including those of state-owned companies and quasi-autonomous entities, that would ensure foreign procurement practices no more restrictive than those of the United States.</u> [22, 23]

4. <u>Restrictive Business Practices</u>

In public hearings of the Trade Information Committee related to this report, a number of spokesmen referred to the trade effects of foreign restrictive business practices. The specific cases cited generally related to export cartels formed for the purpose either of increasing the ability of a foreign industry to penetrate the U.S. market or of reducing competition among exporters to this market so as to increase profits. While it is difficult, if not impossible, to estimate the harm done to domestic industries by such practices, it is clear that action should be taken against them when their existence can be established.

U.S. law presently affords a variety of remedies against such practices. First, there are the antitrust laws administered by the Department of Justice and the Federal

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22 See comment by Mr. Borch.

23 See comment by Mr. Larry.

Trade Commission. These provide a basis of action against many restrictive practices that originate abroad and that have an impact on the U.S. market or our international trade.

Second, our present trade and tariff legislation is available in such cases. The Antidumping Act of 1921, with its counterpart under the GATT, permits the United States to offset injurious pricing practices of foreign cartels. In addition, section 337 of the Tariff Act of 1930, which concerns unfair and injurious methods of competition generally, may be used. This would not violate our GATT obligations because its enactment antedated our adherence to the GATT.

Finally, section 252 of the Trade Expansion Act of 1962 provides another tool. This section provides that where a foreign country "engages in discriminatory or other acts (including tolerance of international cartels) or policies unjustifiably restricting United States commerce," the United States may take remedial tariff action. It should be noted, however, that this provision could not be invoked consistent with our GATT obligations unless the United States obtained the necessary authority to do so under Article XXIII of the GATT.

The provisions in U.S. law permitting action against foreign restrictive business practices that injure U.S. trade should be utilized more extensively. If further experience indicates that they are not adequate, appropriate amendments should be proposed to the Congress. [24]

After World War II, many of the leading industrial countries adopted the general proposition that restrictive business practices were incompatible with maximizing economic growth. The result was a spurt in domestic legislation that was addressed to the whole spectrum of restrictive business practices, including price fixing, discrimination among customers, and abuses of patents, trademarks, and other industrial property rights. Today, the EEC countries, the United Kingdom and most of the other EFTA countries, Canada, and Japan impose legislative restrictions of one kind or another on anti-competitive behavior.

However, not only do the national laws differ in detail and in application, but they also differ widely in philosophy. Unlike U.S. and Canadian law, European law is concerned principally with the abuse of economic power, not its use; the cartel is told to behave properly but not to dissolve. Moreover, in order to permit competition with American firms, European countries and Japan have in recent years encouraged mergers, joint ventures, and other forms of intercorporate cooperation. The United States, on the other hand, tends to look at such cooperation suspiciously. Finally, while some countries prohibit price fixing domestically, they specifically permit, and even encourage, such behavior in international trade. Export cartels and similar arrangements in foreign operations are generally exempted from the domestic prohibition of restrictive business practice laws.

International efforts to place restrictive business practices under international controls have met with little success thus far. This has been due in large part to the conflicting approaches taken by the United States and other countries, as well as to the difficulty of proving causal relationships between specific restrictive business practices and injury to trade.

The most recent of these international efforts is that of the OECD Committee of Experts on Restrictive Business Practices. The OECD Council late last year adopted a recommendation of this Committee that contains four provisions: first, notification

[24] See comment by Dr. Hammer.

by a member of its antitrust proceedings involving the important interests of any other member; second, coordination of actions when two or more members proceed against the same practice; third, exchange of information on restrictive business practices in international trade; and, fourth, cooperation in developing or applying mutually beneficial methods of dealing with such practices in international trade.

In order to promote a fuller exchange of information and a better understanding of the problem, which could eventually provide a basis for an international agreement prohibiting the use of restrictive business practices in international trade, the United States should continue to give full support to the OECD effort in this field.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER III

[1] Mr. MacGregor (Mr. Larry has asked to be associated with this comment)

I believe that a stronger sense of urgency should be introduced into this recommendation of the report. Just as the later recommendation on border tax adjustments takes as its objective the negotiation of a solution in 1969, I believe that the United States should invoke the remedial provisions of Article XXIII if a settlement of infractions of the GATT does not prove possible to obtain during 1969.

[2] Mr. Booth (Mr. Borch and Dr. Hammer have asked to be associated with this comment)

A more vigorous enforcement of the provisions of the GATT dealing with unfair trade practices is necessary. Moreover, provisions of existing U.S. law for suspensions, withdrawal, or prevention of the application of benefits of trade agreement concessions to products of a country that maintains import restrictions against U.S. agricultural products should, as recommended here, be extended to cover restrictions against U.S. industrial products as well.

[3] Mr. Larry (Mr. Rush has asked to be associated with this comment)

If Congress should grant the President authority to adjust tariffs after the Kennedy Round reductions are completed, it is felt that the President should not use that authority until significant nontariff barriers to trade are removed.

[4] Dr. Hammer

The Supplementary Agreement on Chemicals negotiated in the GATT has been placed before the Congress for decision. I do not think it appropriate to include in a report on future United States trade policy a recommendation on a controversial subject already well known to the Congress and on which it must yet make its decision.

The whole issue of American selling price has been exaggerated far out of proportion to its total significance in trade terms at the same time that probable effects on segments of the chemical industry have not received adequate consideration. Studies prepared by companies in the benzenoid segment of the chemical industry raise substantive questions on the reciprocal effect of the concessions agreed to in the Supplementary Agreement. For many competitive benzenoid chemicals, U.S. tariff reductions under the Supplementary Agreement would amount to considerably more than the 50 percent authorized by the Trade Expansion Act. This results because of the manner in which rates were converted from the American selling price valuation base to the ad valorem valuation base, and also because of new ceiling rates established in the Agreement. Therefore, before any implementing legislative action is considered, the method of conversion and the new ceiling rates proposed should be reexamined by a government-industry task force.

Industry and company studies of the economic effect of these additional tariff reductions show that serious injury will result to many American producers of benzenoid chemicals with injury falling especially on smaller companies. The studies also indicate that on a national accounts basis the export opportunities resulting from the concessions made by other countries in the Supplementary Agreement will fall short of compensation for the injury to U.S. firms. For these reasons, positions in opposition to the Supplementary Agreement have been taken by the Manufacturing Chemists Association, Dry Colors Manufacturers Association, Synthetic Organic Chemical Manufacturers Association, Drug Chemical & Allied Trades Association, International Chemical Workers Union, District 50 of the United Mine Workers Union, and a number of individual chemical companies.

5 Mr. Meany (Mr. Abel has asked to be associated with this comment)

In the AFL-CIO view, no tariff-cutting authority, beyond the authorization of the Trade Expansion Act of 1962, should be approved if there is any change of the methods of valuation of imports, such as the American selling price.

6 Mr. Rush

The American selling price (ASP) system of customs valuation, and the question of whether it should be retained or repealed, is a very complex issue that has been subjected to wide debate and testimony before government agencies and committees. However, there is little doubt that some companies within the chemical industry would be adversely affected by the abolition of ASP in varying degrees of severity -- from moderate to serious. A substantial segment of the chemical industry believes that both the tariff reductions on chemicals negotiated during the Kennedy Round and the "Supplementary Agreement" as it relates to the U.S. chemical industry do not represent a fully reciprocal trading arrangement, and accordingly feel that implementation of this contingent Agreement as presently constituted would subject them to inequitable treatment in contrast with their European competitors.

7 Mr. Sobin (Mrs. Benson has asked to be associated with this comment)

I strongly endorse this recommendation to ask Congress to abolish the American selling price (ASP) system of customs valuation in order to permit the implementation of the Supplementary Agreement on Chemicals. This endorsement is based on my belief that adopting the Supplementary Agreement on Chemicals would result in a favorable net trade balance to the United States, because the lower EEC and United Kingdom tariffs would result in an important increase in United States chemical exports on a wide variety of chemicals made by a large number of chemical companies. On the other hand, the ASP method of valuation gives protection to a very small segment of the United States chemical industry.

The major effect that adopting the Supplementary Agreement on Chemicals would have on U.S. imports would be the removal of uncertainty in the valuation process. Although in some few products excessively high tariffs, some in excess of 50 percent, would be reduced, the average change in tariff levels would be insignificant. In fact, adopting this Supplementary Agreement on Chemicals would have a relatively minor effect on the U.S. benzenoid industry, the segment of the chemical industry most affected by the Agreement. Even if the Agreement is adopted, total imports of benzenoid chemicals into the United States are estimated to be less than 3 percent of U.S. production of benzenoid chemicals and continued growth in output is expected in all segments of the U.S. benzenoid industry. The average growth in production of benzenoid chemicals is expected to be 45 percent between 1965 and 1972.

8 Mr. Booth

The Congress should be prepared to delegate to the President, prior to their negotiation, adequate authority to implement trade agreements within specified limits, as well as to grant him the authority to implement agreements involving nontariff barriers concluded subject to subsequent Congressional action.

9 Dr. Hammer

A more appropriate objective for the negotiation of nontariff barriers in most instances would be the elimination of present inequities. This pragmatic approach is generally preferable to the negotiation of international codes of uniform practices.

10 Dr. Hammer

We agree with the recommendation that the United States initiate sector negotiations. Until the Kennedy Round, all bargaining was on an item-by-item basis without overall regard for the resulting trade effect on the total industry structure.

During the Kennedy Round, sector studies and discussions in steel, aluminum, textiles, pulp and paper, and chemicals helped to clarify the competitive relationships in these industries among the producing countries. However, except as noted in the report, these discussions did not develop into negotiations nor did they proceed far enough to provide adequate understanding for the negotiators of the competitive impact of proposed concessions.

The sector approach appears promising if the goal of such sector negotiations is the negotiation of all barriers to trade with the aim of establishing equivalently free access to world markets for all producers. Our experience in the past has been that trade negotiations have generally led to reduction and elimination of tariffs only while substantial barriers to our trade, which are less obvious and less amenable to change than tariffs -- such as taxation systems, business practices, state trading, differential freight rates, and government procurement -- remain, to the relative disadvantage of our exports.

In pursuing the sector approach, special effort must be made to avoid discrimination among sectors of U.S. industry. The five sectors discussed in the Kennedy Round cover only a small fraction of total U.S. industry. To provide equal treatment for all sectors, industry sector definitions should be developed to cover all of U.S. industry for which the sector approach to negotiation might be helpful.

11 Mr. Gilbert

Of utmost importance will be the formulation of the specific legislative program to be proposed to provide the flexible and productive negotiating authority the President will need if he is to cope effectively with the host of trade barriers and trade policy issues that pose significant problems in the years ahead. Absent a coherent "package" of negotiating authority, it is unlikely that the Executive will be successful in getting Congressional approval for many of the individual negotiating proposals made in this report or pursuant to this report.

12 Mr. Borch

The recommendation that the United States should amend its countervailing duty law so that a countervailing duty could be imposed only if material injury were established would be ineffective in the case of long-cycle capital goods. The actual injury could only be established years after the business was placed.

13 Mr. Farha

We should consider providing an income tax credit on net profits for all exporting domestic manufacturers, based on the percentage of increase in export sales over their present export sales. This would require a GATT waiver in our behalf. A subsidy is different in that it is a grant before any profit is realized and before the endeavor and expertise of marketing produces a profit. Therefore, it is my desire to place the emphasis on exports and profits. If a company's gross profits on exports are now marginal, this would be an encouragement necessary for them to pursue additional export sales. If a particular industry's sales are substantial the tax credit would be a further impetus for expanding sales.

It may be commented at this time that the tax credits would be a public expense. However, the balance-of-payments loss is likewise a public expense. It really makes no difference if we have a deficit because of our export position, domestic spending, war expenditures, or Public Law 480. They are all adding to the deficit and are borne by the public. Therefore, if we can increase income through a diversity of methods (or through the prudence of spending), then it is to our benefit.

It is true a tax credit is partisan to export industries. Therefore, it is recommended that the tax credit should be gradually decreased after the third year until it is eliminated in approximately the sixth year. By this time, additional export markets will have been established and industries will have been rewarded for their expansion. (An export tax rebate may be a substitute for the above plan.) Additional study must be made to find if the above plan may be adapted to agriculture.

14 Mr. Larry

Although we subscribe to the proposition that the United States take the initiative in eliminating export subsidies by all nations in international trade, we do not concur in the proposal that an international countervailing agreement contain a requirement that an industry be injured before countervailing duties may be assessed. Since subsidized exports have a trade-distorting pattern, it seems a basic premise that all nations should be discouraged from providing illegal subsidies in their export trade. In order to effectively implement this desirable concept, there should not be the cumbersome procedure of requiring an importing nation to show damage to an industry before it can assess countervailing duties for illegal subsidies. The history of the antidumping statute in this country would surely indicate that introduction of a standard of injury in our countervailing duty statute would severely restrict its efficacious enforcement.

15 Mr. Borch

Since undercompensation existed in these countries before they switched to the TVA system, it should have been continued, or conscious measures to offset the overt devaluation effect of the changeover should have been taken in the interest of world monetary and trade stability.

16 Mr. Borch (Mr. Franklin has asked to be associated with this comment)

Recognizing that negotiating a solution within the organization of GATT is a long process and not certain to produce results, the United States should prepare to take unilateral action to replace a portion of our direct tax structure with an indirect tax such as the TVA. Since this will require legislation, which is also a long process, we recommend that the government anticipate such a tax and put in indirect border tax adjustments during 1969. Recommended action of the type suggested would make this section of the report more consistent with the pragmatic approach taken in the paper on agricultural programs.

17 Mr. Parker

The TVA has much to recommend it as a form of taxation -- aside from its relevancy to the border tax question. The TVA should be studied as a possible national instrument of taxation.

18 Dr. Hammer

The President's Special Representative for Trade Negotiations is to be commended for his perceptive recognition of the trade effects of border tax adjustments. Too often the border tax problem has been considered only in relation to its effect on U.S. exports to countries making such adjustments. Border tax adjustments, however, also give products from these countries a competitive advantage in the U.S. market and in third country markets where U.S. products compete with products from countries using this system of taxation.

For many U.S. products, third countries rather than the other major producing countries offer the greatest opportunity for growth in exports. Yet, it is the adverse impact of border tax adjustments on our exports to these important third country markets that is most often overlooked in discussions of the issue.

I endorse the recommendation of this report that the United States pursue the border tax issue as a matter of highest priority. The potential impact on trade of border tax adjustments has recently been demonstrated by changes made in these taxes by major nations to accommodate their trade objectives.

Neutralizing the trade distortions caused by border tax adjustments should be negotiated through the GATT in 1969, as proposed. Failing any real progress in these negotiations, unilateral action should be taken that would be objectively calculated to provide U.S. products equivalent compensation for the disadvantage to them of border tax adjustments. Such actions might include, as appropriate at that time, the adoption of a value added tax by the United States, use of countervailing duties, or special tariff surcharges and the adoption of export rebates.

19 Mr. Rush (Mr. Larry has asked to be associated with this comment)

Ambassador Roth and his organization are to be commended for the forthright and perceptive statement on the implications of border tax adjustments as covered in his report. However, as a supplement to his recommendation that the United States should press negotiations within the GATT toward neutralization of the trade distortions caused by border tax adjustments, we would like to urge that failing tangible progress the United States should promptly take unilateral action to correct for these inequities that disadvantage U.S. trade. In this direction, consideration might be given to more extensive utilization of countervailing duties, import surcharges, and export rebates.

20 Mr. Shorenstein

I agree with the recommendation but wish to emphasize that the United States should negotiate with foreign nations in the framework of the GATT to remove or at least mitigate trade distortions caused by border taxes and their administration. If this approach does not succeed, we should examine the imposition of unilateral countervailing measures in the United States, but only as a last resort. Under no circumstances should the Public Advisory Committee, even implicitly, recommend for foreign trade reasons a shift from our present system of taxation, which has contributed to economic growth and greater equality of distribution, to a system of heavier reliance on indirect taxes that might be rebatable under GATT but injurious to domestic economic objectives.

21 Mr. Borch

The statement that some foreign governments consistently invite bids only from domestic concerns and exclude foreign suppliers entirely is unfortunately only too true. It is not generally recognized, however, that this practice results in a dual pricing system under which the foreign governments pay their domestic suppliers a much higher price for the equipment than those suppliers quote in other countries, therefore, in effect, subsidizing exports of such equipment.

22 Mr. Borch (Mr. Larry has asked to be associated with this comment)

Should the United States fail to obtain agreement on an international code on government procurement practices within a specified period of time, consideration should be given to taking predetermined unilateral action that would match the foreign restrictions. Also, this code should apply to both government agencies and companies owned or controlled, in whole or in part, directly or indirectly, by government.

23 Mr. Larry

The Federal Government should refrain from interfering with state and local "Buy American" policies, until such time as local procurement practices in foreign countries are regulated by international agreement.

24 <u>Dr. Hammer</u>

Existing remedies in U.S. law should be used more extensively to offset foreign restrictive business practices that affect U.S. trade. In many cases, however, existing laws and procedures are not adequate to obtain corrective action or they do not cover the restrictive practice at all. Some examples include foreign governments directly encouraging or engaging in restrictive trade practices, export combinations of producers in competing countries, public ownership of production resources, and cartel combinations designed to rationalize production and marketing.

Responsibility for solving the problems of foreign restrictive business practices limiting U.S. trade should be centralized at the highest level of the U.S. Government, such as a strengthened Office of the Special Representative for Trade Negotiations, which would be attuned to all implications of these complex matters and would have the negotiating authority to pursue them through diplomatic channels.

CHAPTER IV

AGRICULTURAL PROBLEMS

The United States is both a major exporter and a major importer of farm products. It ranks first in exports and third in imports.

Exports account for one-sixth of U.S. farmers' total cash marketings and provide employment for one of every eight farm workers. Without exports, the well-being of the nation's farmers and related sectors of the economy would suffer.

Imports provide about 10 percent of our food supply, but half of them are not directly competitive with U.S. production. Without food imports, our diet would be more costly and would be deficient in many items that Americans consider essential. Imports of agricultural products other than food are also important, particularly to the many manufacturing industries that use them as raw materials.

U.S. agriculture is increasingly export-oriented. Exports grew rapidly in the 1960's -- from $3.7 billion in 1959 to a record $6.8 billion in 1967. Most of this increase was in commercial exports, which rose from $2.5 billion in 1959 to $5.2 billion in 1967. Since then exports have declined somewhat, due in part to lower prices and larger world supplies of grain.

The major exports of farm commodities are wheat, feed grains, soybeans, fruits and vegetables, tobacco, and hides and skins. The bulk of these represent commercial sales to industrially advanced countries, primarily European countries and Japan. Only in the case of wheat are large quantities exported as non-commercial sales under the Food for Freedom Program -- Public Law 480.

Several less-developed countries are also emerging as important commercial buyers. Despite rapid technological advances in recent years and increased attention to agricultural development, it is unlikely in the longer run that these countries will be able to supply their increasing food needs. As economic development progresses, imports of agricultural products tend to rise.

Most developed countries pursue international trade policies for agricultural products that are more restrictive than those for industrial products. This reflects the differences in their domestic policies affecting the two sectors, which arise, at least in part, from the structural differences between agriculture and industry. Agricultural products are exempted from some of the basic international trading rules that apply to industrial products. Thus, agricultural trade is characterized by extensive subsidization and by special trade restrictions, such as minimum import-price schemes, variable levies, quotas, and other nontariff barriers. Their effect on world trade has been intensified by the technological revolution in agriculture and the resulting rapid growth of agricultural productivity.

Most of the major trading nations use some method of support to maintain domestic prices above world prices. The use of price supports arises primarily out of the disparity between incomes of farmers and those of industrial workers, and the fact that adjustment of agricultural production responds only slowly to economic pressures, with a tendency for short-run adjustments to overcompensate or undercompensate. When imports threaten, restrictions often become necessary to protect the domestic price-support level from foreign supplies and to ensure the market for domestic producers, lest government support costs rise substantially. On the other hand, surpluses often result and, when they do, lead to export subsidies, depressed world prices, and pressures for adoption of protective systems by those who are affected. These actions and counteractions cause further distortions of world agricultural trade.

The use of price supports alone tends to worsen the economic situation of the country employing them, as well as that of other countries. To avoid trade distortions,

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price supports must be brought more closely into line with world market prices and must be accompanied by production controls and incentives to move resources out of agriculture. The resultant decrease in prices received by producers can be offset by direct income support. There has been a trend in this direction in the United States. Price supports are increasingly being used here as a stabilization measure by relating them to world market prices and supplementing them with income support in the form of direct payments to farmers.

Domestic prices for several of our major export commodities, such as wheat, feed grains, and cotton, are now supported near world levels and supplemented with payments to producers to support their incomes. In return, producers agree to limit the acreage planted in supported crops.[1]

However, many other countries have continued to utilize price supports alone without accompanying production controls. The EEC, in particular, has increasingly relied on high price supports protected by variable levies on imports and subsidies on exports.

A. LONG-TERM POLICIES

In the long run, the objective of the United States should be to achieve liberal agricultural trade throughout the world. We should recognize, however, that the developed countries will not soon end their price-support programs. A complete and sudden shift to a system that directly supplements incomes of noncompetitive producers, coupled with strong incentives to move out of farming, would be extremely costly, politically difficult, and likely to lead to a painful period of instability in world prices and production.

Thus we must recognize that only gradually will countries bring their domestic agricultural policies into closer conformity with the principles of liberal trade. The United States must therefore continue to deal directly with agricultural systems as they exist, and be prepared to negotiate changes in such systems as opportunities arise.[2]

In short, there is a need to find ways to provide for improved access to importing countries, ways to achieve more rational export policies among exporters, and ways to obtain reasonable and more stable world prices. These ways will be found through the modification of domestic and foreign trade programs of importing and exporting countries. The techniques of achieving such modification will, of course, vary from commodity to commodity.

<u>The United States should begin to explore in the GATT the possibility of negotiating adjustments in domestic agricultural policies and related trade barriers in order to further the objectives of fair and equitable farm income and expanding agricultural trade</u>.

In particular, we should seek understandings that in the long run price supports should be used primarily for stabilization purposes rather than as income guarantees. Trade negotiations based on this principle might include negotiations on the nature and level of price supports and on other measures that stimulate inefficient production. In addition, based on the technique of direct income maintenance, negotiations might be undertaken on the quantities of production for which a producer receives payments. In dealing with price supports and income maintenance, the concept of "market access," which was explored in previous negotiations, might be further examined.

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[1] See comment by Mr. Shuman.
[2] See comment by Mr. Shuman.

In some countries, variable levies or other special import charges are used to prevent world market prices from influencing domestic prices, by raising import prices up to or above domestic support levels. Negotiations on price support policies should aim at the elimination of all such special charges.

The United States should attempt to obtain acceptance of the principle that price regulation should be aimed at price stabilization alone and that import charges, other than moderate tariffs, should be limited in their application to offsetting subsidization and other measures that artificially interfere with world market prices.[3]

In order to negotiate changes in domestic agricultural policies and trade policies related to them, the United States must be prepared to consider changes in its own policies. If we are to reduce restrictions on our exports and gain improved access to foreign markets, we will have to offer improved access to our own market.

Foreign countries are dissatisfied with the special right the United States has under the GATT to use import quotas and special fees in circumstances in which Article XI of that agreement does not permit their use. Under that article, quotas are permitted for the purpose of protecting domestic farm programs, provided that such programs restrict production or marketing. But to enable it to take actions that might be required under section 22 of the Agricultural Adjustment Act in cases in which acreage controls were impracticable, the United States in the early 1950's asked for and obtained a waiver from the GATT. A careful study is needed in order to determine whether the remaining section 22 quotas and the GATT waiver are still needed.

The President should request the Tariff Commission to undertake a complete review of existing import quotas under section 22 of the Agricultural Adjustment Act to determine under what circumstances these quotas might be expanded or terminated. The United States should also examine whether it is any longer necessary to maintain our GATT waiver, which permits such actions under section 22 as would otherwise be inconsistent with the GATT.[4]

B. SHORTER-TERM MEASURES

General negotiations involving domestic agricultural policies and related trade restrictions will require careful and lengthy preparation. Shorter-term measures will therefore be needed in working toward more fundamental liberalization and rationalization of world agricultural trade.

The use of export subsidies is growing. They create problems for importing countries by abnormally depressing import prices, thus endangering their own agricultural programs. Competition among exporters becomes competition among national treasuries with little relevance to efficiency. Market uncertainty, together with unecessarily low and unstable world prices, results in major distortions of world production and trade. Unfortunately, the GATT provisions on subsidies have proven inadequate in dealing with agricultural commodities.

3 See comment by Mr. Shuman.
4 See comment by Mr. Dechant.

The United States should take the initiative and actively seek multilateral agreements or understandings that would reduce the use of agricultural export subsidies and other forms of export incentives, place carefully defined limits upon their use, and eventually prohibit them. Meanwhile, as the export subsidies of other countries are eliminated or meaningfully limited, the United States should be prepared to phase out its own subsidies. [5]

Efforts to reduce or prohibit subsidies and other aids to exports will take time, and progress may be possible in the short run only in certain areas. While pursuing this objective, the United States should itself use subsidies whenever the subsidy practices of other countries are unreasonable and threaten our competitive position. However, such subsidies should be employed for tactical reasons and should be used only to preserve export markets in the short run. In the long run, this tactic should improve the possibility of reaching multilateral agreement to reduce or prohibit the use of costly export subsidies, particularly as the aids of others lose their real effectiveness.

Whenever the agricultural export subsidies of other countries are unreasonable and result in the loss of the U.S. position in specific markets, the United States should use agricultural export subsidies in order to offset them in those markets and in order to improve the possibility of obtaining multilateral agreement reducing or prohibiting the use of agricultural export subsidies.

In liberalizing agricultural trade over the shorter term, it will be necessary to consider a number of approaches. In some cases, negotiation on a sector or commodity basis might lead to meaningful results. In specific commodity areas, alleviation of the pressures of some of the disruptive trade practices could help avoid dangerous trade conflicts in the interim and might help pave the way for more fundamental liberalization of trade in the longer run.

The United States should be ready, together with other countries, to explore the possibility of international arrangements concerning particular product areas that would expand U.S. agricultural exports.

As pointed out above, one of the serious and immediate problems in the field of agricultural trade arises out of the operation of minimum import prices and variable or flexible levies. Over the short run, the United States must make greater efforts to reduce the trade distortions of such devices. In addition, the United States should not fail to take advantage of opportunities to press for the adoption of policies more consistent with freer access and expanding trade. For example, there is growing evidence that the high and increasing costs of the EEC's agricultural policy will eventually compel it to make significant changes in its system of price supports and variable levies.

The U.S. Government, as a whole, should intensify its efforts to obtain relief from such trade restrictive measures as minimum import prices and variable or

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[5] See comment by Mr. Dechant.

<u>flexible levies. In particular, when other trading nations consider significant changes in their existing agricultural policies, the United States should exert pressure to achieve freer access and expanded world trade opportunities.</u> [6]

Most developed countries engage in a variety of programs to promote and develop their agricultural exports. The United States should expand its efforts to increase exports of agricultural products. Specific recommendations are included in Chapter IX.

East-West trade is another topic of interest to U.S. agriculture because of the potential market in Eastern Europe for U.S. agricultural products, such as feed grains, cotton, and tobacco. Specific recommendations are included in Chapter X.

6 See comment by Mr. Dechant.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER IV

[1] Mr. Shuman

It is impossible to reconcile the goal of expanding agricultural trade with either government price supports or direct payments to farmers. Both are, in effect, export subsidy devices and invite retaliation. Direct financial assistance to low-income and part-time farmers may be desirable but the solution of these social problems should be separated from the market expansion goals for commercial agriculture.

[2] Mr. Shuman

In considering future U.S. trade policy -- and in carrying out trade and tariff negotiations -- it is essential that the United States aggressively implement the policy clearly expressed by the Congress in the Trade Expansion Act that agriculture be considered a full participant with other export industries in benefits of trade negotiations.

The United States should oppose vigorously any attempt to set agricultural trade apart from industrial trade and to allocate international agricultural markets through the use of international commodity agreements.

[3] Mr. Shuman

This recommendation and the preceding discussion evidence a "soft" approach and a tendency to accept domestic intervention as permanent. The United States should evidence sincere interest in expanding foreign trade by taking the lead in phasing out price supports and direct payments. We would then be in a strong position to insist that other nations reciprocate. The U.S. objective should be to expand trade -- not to "obtain reasonable and more stable world prices." These results will come as markets are opened and expanded and not through international agreement on prices, income payment levels, or the division of markets between countries.

[4] Mr. Dechant

A review would be in order but included in it should be a full review of whether it provides adequate protection to U.S. producers and to their farm programs.

[5] Mr. Dechant

Any phasing out of U.S. subsidies should be consistent with the need to increase farm income.

[6] Mr. Dechant

Competitive opportunities for trade cannot be isolated from the need to improve farm prices and income -- nor from a desired national policy of promoting a strong family farm agriculture.

CHAPTER V

DOMESTIC ADJUSTMENT

The U.S. Government has evolved the principle that the nation's economy as a whole should share the cost of any injury resulting from our trade policy. The principal form of domestic adjustment has been escape-clause relief in the form of higher tariffs or quotas for entire industries. The Trade Expansion Act of 1962 added a new dimension to domestic adjustment by also providing for financial and other assistance to groups of workers and individual firms injured by imports.

Since 1962, however, the nature of world competition has undergone fundamental change. As this report notes in Chapter I, competition has intensified across a broad range of products. In particular, an increasing share of imports has consisted of semifinished or finished manufactures that are competitive with goods made here. With these changing circumstances has come a more rigorous test of a basic premise of U.S. trade policy -- that satisfactory means for adjustment can be provided when injury from imports occurs or is threatened.

Import competition may cause injury to an entire industry. It is more apt, however, to have an impact within an industry on certain groups of workers or individual firms. Moreover, import competition may also affect communities, and especially those that are dependent upon single plants for a major source of employment and income.

The problems of adjustment to import competition -- and therefore the policies that are needed -- necessarily vary, depending upon who is affected and how. The following recommendations deal separately with workers, industries, firms, establishments, and communities.

A. ASSISTANCE TO GROUPS OF WORKERS

Concern with any adverse impact of imports upon American workers should begin in the first instance with the greater immobility of labor compared with other major productive resources.[1] It must also reflect the fact that our wage and living standards are the highest in the world, reflecting our generally higher skills and greater productivity. Moreover, this concern must recognize that we have adopted a variety of programs that, in effect, place a floor under wages as well as other elements of cost. Consequently, the United States must offset the lower standards of others by higher productivity and by other cost advantages -- by innovation, style and design, and better distribution and marketing.

Although most American workers -- as consumers of imported products and as producers of exported products -- have undoubtedly gained from the growth of world trade and from price restraints resulting from import competition, some workers have been hurt. Imports can cause dislocation and hardship by displacing American products. Even in years of full employment, imports can create short-run problems for workers -- problems of seeking another job, moving to another location, or learning a new skill. In doing so, they may risk the loss of seniority or other employment rights. The problems of adjustment to import competition become social problems when trade adversely affects jobs.

Thus, the challenge of imports to a high-wage, high-living-standard country is not only to find satisfactory means of adjustment, but also to provide new opportunities for the increased productivity of its citizens. The U.S. Government can help ensure that the benefits of trade are not gained at the cost of unemployment for some, and that workers are trained in skills that are in demand.

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[1] See comment by Mr. Larry.

The adjustment assistance provisions of the Trade Expansion Act of 1962 were designed to provide various forms of assistance to workers dislocated by imports -- readjustment allowances, relocation expenses, and retraining opportunities. Unfortunately, the statutory criteria for adjustment assistance proved to be too strict, and no petition for assistance was approved.

These criteria for adjustment assistance to workers require the Tariff Commission to determine: first, whether tariff concessions are <u>the major cause</u> of increased imports and, second, whether such increased imports are <u>the major cause</u> of unemployment or underemployment of a significant number or proportion of the workers in the firm or subdivision concerned.* In no case since the Act was passed has the Tariff Commission found that the first requirement -- that tariff concessions should be the major cause of increased imports -- was satisfied.

This record raises a serious doubt whether it is possible to segregate tariff concessions, many of which go back for 30 years or more, as the major cause -- that is, the cause greater than all other causes combined -- of increased imports. The one test relating tariff concessions to increased imports that was successfully applied by the Tariff Commission was included in the original escape-clause provision in 1951. This required that tariff concessions should be responsible <u>in whole or in part</u> for the increased imports. In practice, the Tariff Commission assumed in every case that tariff concessions played at least some part in bringing about increased imports.

This experience under the two escape-clause tests strongly suggests that, if a viable program of adjustment assistance to workers and firms -- as well as relief for industries -- is to be established, there is little point in retaining any statutory requirement that increased imports be causally linked to past tariff concessions. At the same time, since any increase in imports is attributable in part to the trade policy of the U.S. Government, it is appropriate that the U.S. Government assume an obligation to render assistance when increased imports cause economic injury. Moreover, in terms of the individuals involved, the more important issue is not the cause but the effects of increased imports.

<u>The criteria in the Trade Expansion Act of 1962 for adjustment assistance to workers should be amended to eliminate the requirement that increased imports be causally linked to past tariff concessions.</u>

The criteria for adjustment assistance to workers -- as well as to firms -- should instead be based solely upon the relationship between increased imports and the economic injury in question. The need under the present law to establish that increased imports are the major cause -- that is, the cause greater than all other causes combined -- of economic injury presents formidable problems of evidence as well as of analysis. In particular, it is very difficult to isolate one cause from all other causes.

Instead, it should be sufficient to require that increased imports are <u>a substantial cause</u> of economic injury. This would require that a petition by workers demonstrate that increased imports have an actual and considerable bearing upon the unemployment or underemployment that is alleged. The petition would not need to show, however, that increased imports are greater than all other causes of the injury combined, nor even greater than any other single significant cause.

In addition, an interagency board within the Executive Branch, rather than the Tariff Commission, should be responsible for applying the new test for adjustment assistance to workers -- as well as to firms. The successful administration of the

* The causal criteria underlined in this sentence are the same in the case of adjustment assistance to firms and of escape-clause relief to industries.

special adjustment assistance program under the Automotive Products Trade Act of 1965 indicates that this would be an effective mechanism. In addition, it would permit the Departments of Labor and Commerce, which would presumably be represented on the board, to bring to bear their special expertise in the local problems of workers -- as well as firms -- affected by imports. The Tariff Commission should, however, carry out the fact-finding function, as it now does under the automotive adjustment assistance program.

The criteria in the Trade Expansion Act of 1962 for adjustment assistance to workers should be amended to require only that increased imports are a substantial cause of unemployment or underemployment. In addition, an interagency board of the Executive Branch should determine whether the criteria for adjustment assistance are satisfied.

After adequate experience has been acquired under the new test and the changed administrative procedure, a careful review should be made to determine if the assistance has proven to be sufficient. If eligible workers still encounter difficulties, either in regaining employment or adapting to more productive activities, other forms of adjustment assistance should be devised. This is fundamentally a sound approach to the problems of import competition and one that is vital to a realistic policy of expanding trade and to the national interest.

It is not enough, however, to offer help to those already displaced. The United States can and should devise better means of averting dislocation and unemployment before they occur. For example, improved data and more detailed and faster reporting of conditions at the plant and community levels are essential. Further, retraining programs should not be confined to the already unemployed, but should also be designed to assist those in need of greater skills and those whose jobs may be threatened by import competition.

This is not a new concept. The Manpower Development and Training Act of 1962, as amended in 1968, already requires that techniques and procedures be established to detect in advance the potential impact on workers of changes in the structure of domestic production and to develop solutions to the problems they create. Foreign competition is but one of the causal factors specified in the Act for which advance-warning techniques will be devised.

The provisions of the Manpower Development and Training Act of 1962, as amended in 1968, relating to a system of advance warning of the potential impact on workers of changes in the structure of domestic production, should be implemented as soon as possible. Particular emphasis should be given to the potential impact of imports.[2]

The adjustment assistance for workers provided in the Trade Expansion Act of 1962 should be but one of the forms of assistance available to those affected by import competition. Among other forms of adjustment, labor must be helped to move when capital moves in response to foreign competitive pressures, lest workers unnecessarily bear the brunt of the adjustment.

After sufficient experience under the adjustment assistance program, the concept of domestic adjustment should be examined with a view to the feasibility and desirability of broadening it to meet dislocation arising from any source. Consideration

[2] See comment by Dr. Hammer.

should also be given either to maintaining adjustment assistance as a separate program, or to integrating it into a coordinated effort encompassing all federal manpower and development efforts.

U.S. manpower policies should be reexamined in order to improve the adaptability and mobility of labor. The short-run goal should be effective adjustment assistance to import competition. The long-run goal should be a more flexible manpower program, including better solutions to such problems as the potential loss of pension and seniority rights that now reduces the mobility of workers.[3]

As capital, technology, and managerial skills become increasingly international, differences in labor standards that affect unit labor costs will play a greater role in determining the flow of trade. For domestic producers, both state and federal agencies now establish and enforce certain minimum labor standards. By contrast, the United States has no means of compelling its foreign competitors to abide by comparable labor standards.

The world trading community, acting through international institutions, must attempt to ensure that goods that move abroad are produced under satisfactory labor standards. If other nations are to have equal access to world markets, they must assume responsibility for reasonable labor standards in their own countries. The United States should neither use its fair labor standards as a protective device nor require that others match ours in absolute terms. Other governments should, however, observe and improve the standards prevailing in their own countries.

As one means of trying to enforce the concept of fair labor standards, the United States should use the dispute-settling provisions of the GATT. If goods exported to this country are produced in a foreign country under labor standards that the United States considers to be clearly unfair, the United States should bring the case for consultation under Article XXII. If such consultation does not bring about a solution, then the case might be brought before the Contracting Parties under Article XXIII.

This use of the GATT would, however, be only a first step toward an enforceable concept of fair labor standards. Accordingly, the United States should also seek to develop international agreement upon a workable definition of fair labor standards and upon realistic means for their enforcement. This effort should be made through the GATT and the International Labor Organization (ILO) and possibly other international organizations as well.

The United States should bring for review and resolution under appropriate provisions of the GATT cases of exports to this country produced under what it believes to be clearly unfair labor standards. The United States should also seek, through the GATT and the ILO and possibly other international organizations, to develop international agreement upon a workable definition of fair labor standards and upon realistic means for their enforcement.[4, 5]

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[3] See comment by Mr. Parker.
[4] See comment by Mr. MacGregor.
[5] See comment by Mr. Parker.

Finally, progress in appraising the impact of trade on labor and in maximizing opportunities for adjustment has been seriously hampered by lack of funds and personnel. Far too few resources have been devoted to this important area.

The United States should undertake a systematic and comprehensive program of research into the impact of both exports and imports on labor. The goal should be policies to make U.S. exports more competitive and to shift men and other resources into more efficient industries.[6, 7, 8]

B. ASSISTANCE TO INDUSTRIES

Assistance to industries to permit them to adjust to import competition has long been available under the escape clause in the form of higher tariffs or quotas. Such relief has been granted only after careful investigation by the Tariff Commission and a clear demonstration of serious injury or the threat of serious injury from increased imports. Under Article XIX of the GATT, escape-clause action by the United States requires it to pay compensation in the form of reduced tariffs on other imports or to accept retaliation by the imposition of increased barriers to its exports.

In none of the requests for escape-clause relief under the Trade Expansion Act of 1962 has the Tariff Commission been able to satisfy the new criteria for such relief. In light of this record and for the reasons given in section A of this chapter, it seems clear that tariff concessions should be eliminated from the criteria for escape-clause action as well as from the criteria for adjustment assistance.

The criteria in the Trade Expansion Act of 1962 for escape-clause relief for industries should be amended to eliminate the requirement that increased imports be causally linked to past tariff concessions.[9]

Further, as already noted, there is a serious question whether it is possible to determine the single cause of serious injury -- whether it be increased imports or any other single factor -- that is greater than all other causes combined. However, because of the economic consequences of escape-clause relief in the form of higher tariffs or quotas, a fairly rigorous test should be substituted requiring that increased imports should be the primary cause of serious injury.

This test should prove workable. It does not demand that increased imports be the major cause of serious injury, that is, the cause greater than all other causes combined. It does require, however, that increased imports be greater than any other single significant cause. This test for escape-clause relief is more demanding than the recommended test for adjustment assistance.[10]

The present escape-clause criteria should be amended to require only that increased imports be the primary cause of serious injury to an industry.

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[6] See comment by Mr. Larry.
[7] See comment by Mr. Sobin.
[8] See comment by Mr. Gilbert.
[9] See comment by Mr. Gilbert.
[10] See comment by Dr. Hammer.

While there is an established need to change the criteria for escape-clause relief, no case has been made for altering the concepts of "serious injury" and "industry" now embodied in the Trade Expansion Act of 1962 and its legislative history. In the first place, serious injury, and not simply injury, must be found, as indicated by such factors as idling of productive facilities, inability to operate at a level of reasonable profit, and unemployment or underemployment. In the second place, serious injury must be widespread throughout the establishments in the industry in which the product is made.* Finally, because of the expertise that the Tariff Commission has developed over a number of years in investigating the economic condition of particular industries, it should continue to apply the criteria for escape-clause relief.

<u>The concepts in the present escape-clause criteria concerning "serious injury" and "industry" should be retained, and the role of the Tariff Commission with respect to escape-clause petitions should remain the same.</u>

If the U.S. Government has a responsibility for granting temporary import relief to an industry seriously injured by imports, the firms in that industry should also bear the responsibility for taking prompt and effective action to improve their ability to meet competition at home and from abroad. Present policy provides them with an opportunity to adjust, but places no responsibility upon them to do so.[11]

Accordingly, if escape-clause relief is granted to a particular industry, the Tariff Commission should be required to seek from the firms in that industry annual reports on the specific efforts they are making to adjust to import competition. These efforts would be designed either to increase the efficiency of their present activities or to provide other adjustment to such competition. The Tariff Commission should take these efforts into account in its annual report to the President concerning the escape-clause action involved.

In addition, midway in the period for which the escape-clause relief is granted, the Tariff Commission should be required to report to the President on the probable economic effect of reducing or terminating such relief. This report should include the Commission's judgment of the progress being made by the firms in adjusting to import competition. It should also include an analysis of price and other policies adopted during the duration of the escape-clause action and their effects on the adjustment process. All of these factors should be considered by the President in deciding whether to reduce or terminate that action.

<u>The Tariff Commission should be required to seek annual reports from the firms in an industry granted escape-clause relief on the specific efforts they are making to adjust to import competition, and the Tariff Commission should take these efforts into account in its annual report to the President on the escape-clause action. In addition, midway in the period for which the relief is granted, the Tariff Commission should be required to report to the President on the probable economic effect of</u>

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* An establishment, in Tariff Commission usage, is a factory, plant, farm, mine, or fishery, including any necessary auxiliary facilities, producing the article or articles subject to the escape-clause investigation.

[11] See comment by Mr. Larry.

reducing or terminating such relief, and to include in that report its judgment of the progress being made by the firms in adjusting to import competition.

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C. ASSISTANCE TO INDIVIDUAL FIRMS AND ESTABLISHMENTS

A balanced and adequate program of assistance in adjusting to import competition must also include workable provisions designed to help individual firms. At present, firms can join together on an industry basis to seek escape-clause relief. The effects of import competition, however, are seldom uniform across a given industry, and special assistance may be necessary for those firms whose smaller size, lesser product diversification, and more limited financial resources make them more vulnerable than the stronger firms in the same industry.

The adjustment assistance provisions of the Trade Expansion Act of 1962 provide for assistance to firms in the form of technical assistance, financial assistance, and tax relief. The criteria for such assistance are the same as those for adjustment assistance to workers and have proved to be equally unworkable. Accordingly, the same changes in the statutory criteria are needed.

The criteria in the Trade Expansion Act of 1962 for adjustment assistance to firms should be amended to eliminate the requirement that increased imports be causally linked to past tariff concessions. They should also be amended to require only that increased imports be a substantial cause of serious injury.

The recommended modification of the criteria for adjustment assistance should provide an adequate basis for testing the various forms of assistance to firms. If these forms should prove to be insufficient and if eligible firms are still experiencing difficulties, either in regaining their competitive posture or in adapting to more productive activities, other forms of assistance should be developed.

The Trade Expansion Act of 1962 contains an anomaly with respect to domestic adjustment. Under the escape-clause provision, injury is determined on the basis of the economic condition of the establishments rather than the firms within the industry. However, under the provision for adjustment assistance to an individual firm, injury is determined not on the basis of the establishments in the firm but the entire firm itself. In other words, the escape-clause provision recognizes an important economic fact, which the provision for firms does not -- that separate establishments may be seriously injured by imports while the firms containing those establishments are not as a whole so injured. Accordingly, consistent with the concept of making assistance available directly to those adversely affected, individual establishments should be made eligible to petition for adjustment assistance under the same criteria as are recommended for firms.

The Trade Expansion Act of 1962 should be amended so that individual establishments may be eligible to apply separately for adjustment assistance.[13]

[12] See general comment on this section by Mr. Larry.
[13] See comment by Dr. Hammer.

D. ASSISTANCE TO COMMUNITIES

In some cases a program of assistance to groups of workers, industries, firms, or establishments may not be enough. A community-wide problem can arise, for example, when firms or industries adjust by relocating or by consolidating plant operations. This problem can be particularly critical in a community heavily dependent upon a single plant.

It is government policy to assist community and regional development in areas suffering from economic distress. Such assistance is particularly appropriate when imports resulting from government trade policy are the cause of this distress.

There is a need, therefore, when dislocation occurs in a community because of imports, to find better means of coordinating the many already existing community programs, to stimulate further community-wide development efforts, and to provide constructive new solutions. The existing programs of community assistance cover many possible approaches -- such as rural renewal loans, technical assistance in the development of local economic plans, loans to development companies and private firms, vocational education, relocation financing, and management counseling.

This abundance of separate programs, each operating under separate authorization, often by separate funds, presents a serious problem of implementation, more so because in many cases the enabling legislation also requires that there be an organized local or community initiative before any federal participation can be brought to bear. This type of assistance, moreover, is not directly available to individual firms or groups of workers in a community.

Upon approval of either an escape-clause or an adjustment-assistance petition, the Executive Branch should undertake a coordinated examination of the present and prospective implications for the communities where the workers, industry, firm, or establishment are located, particularly when the enterprise is a dominant employer in the community.

To make this effort effective, responsibility for coordination and supervision should be assigned to a single federal agency and clear channels should be established to all other agencies with related responsibilities. Community efforts should not be hampered by the difficulties of dealing with many separate federal agencies on separate programs.

E. NATIONAL SECURITY PROVISION

In addition to other provisions of law designed for the relief of private interests injured by imports, the Trade Expansion Act of 1962 provides for the use of import restrictions to protect the national security of the United States. The Act authorizes the President, following an investigation by the Office of Emergency Planning (now called the Office of Emergency Preparedness), to impose restrictions on imports that are threatening to impair the national security. The international counterpart is found in Article XXI of the GATT, which recognizes the right of any country to suspend its obligations -- including the obligation to maintain rates of duty at agreed levels -- in order to protect its national security.[14]

The U.S. national-security provision as now written contains several deficiencies that should be corrected in order to make it a workable provision from the point of view of both the private petitioner and the U.S. Government. For example, no time

14 See comment by Mr. Larry.

limitation is imposed upon the investigation that the Office of Emergency Preparedness is required to carry out. As in the case of the escape clause, a petitioner should be entitled to a determination by the investigating agency within a given period of time. Recognizing the complexities of an investigation into the alleged threat posed by certain imports to the national security, nine months would be a reasonable period for the investigation. Upon completion of its investigation within this period, the agency would be required, as the law now provides, to publish its findings.

In addition, the present provision lacks a requirement for the periodic review of any outstanding national-security action. It is in the national interest to have any extraordinary action of this kind evaluated after a certain period of time to determine whether it is still needed or, if it is, whether it is accomplishing its objective. Such a review at least once every three years would seem reasonable and would assure that the action is not perpetuated indefinitely.

Still another deficiency in the national-security provision is that it does not clearly authorize the President to reduce or eliminate duties or other import restrictions if he determines, after an appropriate finding by the investigating agency, that increased imports are needed to avoid a threat to the national security. In recent years, there have been cases where there was general agreement on the critical need to increase the importation of certain products, and the Congress eventually suspended the applicable duties. But the President should be able to respond to situations of this kind more quickly. It makes little sense to relate imports to the national security only in negative terms.

<u>The national-security provision of the Trade Expansion Act of 1962 should be amended (a) to fix a limit of nine months on the investigation by the Office of Emergency Preparedness, (b) to require a review by the Office of Emergency Preparedness of any existing national-security action at least once every three years, and (c) to give the President the authority to reduce or eliminate duties or other import restrictions if he determines that increased imports are needed to avoid a threat to the national security.</u>

Only one action has ever been taken under the national security provision -- the oil import quota program. This was established in order to protect the national security of the United States during a period when world petroleum markets were disrupted by surpluses. During the latter years of World War II and in the immediate postwar period, petroleum had been in short supply throughout the world. By the mid-1950's, however, excess producing capacity developed with the entry into the market of new producing areas in the Middle East and Venezuela. This situation continues to the present day.

The program has now been in effect for almost ten years. There have been a number of changes in its structure over that period, some basic and some ancillary, designed to meet changing conditions. Nevertheless, several of the major issues relating to the program continue to be a subject of controversy today, as they were at the program's inception. In addition, problems with regard to the administration of the program have arisen, and especially as circumstances of the petroleum and petrochemical industries have changed. Of these problems, the following four are perhaps the most significant.

The first problem involves the basis for allocating quotas of crude petroleum and petroleum products among individual companies. In its initial stages, the program gave weight both to historical imports and to refinery runs as the basis for allocations. In 1962, the program was changed to provide for a phasing-out of allocations of crude petroleum based on historical imports and increasing reliance on refinery runs as the criterion for granting these allocations. This shift has taken place slowly for allocations of crude petroleum, while the basis for allocations of petroleum products remains unchanged.

The second problem relates to the equities involved in allocations of crude petroleum as between large and small refiners. Firms earning quotas on the basis of refinery runs receive allocations on the basis of a sliding scale. The smallest firms can receive allocations equivalent to as much as 20 percent of their refinery runs, while the largest firms can receive allocations as low as 6 percent of their runs.

The third problem involves petroleum imports into foreign trade zones. Currently, several refiners and petrochemical manufacturers are seeking to establish operations in foreign trade zones. These operations would involve the importation of low-priced, ex-quota crude petroleum and conversion of that crude into higher value products with a liberal entry provision under the program, or conversion into petrochemicals that are not controlled under the program.

The fourth problem concerns the accommodation to be made in the program for the increasing feedstock needs of the petrochemical producers. The program was changed in 1965 to permit petrochemical producers to earn allocations on the basis of their runs within the overall quantitative limitations of the program. This is a prime example of a need that was not anticipated at the time of the program's establishment but that must now be accommodated.

Each of these and other related problems should be studied to determine the separate equities and the program changes needed to satisfy such equities. Against this background, two fundamental questions should be explored: whether there is a need to protect the national security through an oil import quota program and, if so, whether such changes in the program would meet this objective.

<u>The Executive Branch should undertake a thorough review of the oil import quota program and the effectiveness of the governmental machinery by which it is regulated. This review should, in particular, determine whether the program fully answers the needs for which it was created and whether it is responsive to national interests.</u>[15, 16]

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[15] See comment by Mr. Nickerson.
[16] See comment by Mr. Rush.
[17] See general comment on this chapter by Mr. Booth.
[18] See general comment on this chapter by Mr. Borch.
[19] See general comment on this chapter by Mr. Lazarus.
[20] See general comment on this chapter by Mr. Meany.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER V

1 Mr. Larry (Mr. Murphy has asked to be associated with this comment)

The report implies in several places that labor has substantially greater immobility than "other major productive resources." Labor may not be as mobile as new investment capital, but certainly a major part of the capital of our country is represented by important facilities of great investment value that have been created by prior investment of capital. The steel industry is an example. The over $20 billion of assets currently in the steel industry are not very mobile.

2 Dr. Hammer

The advance warning system authorized in the Manpower Development and Training Act typifies the type of approach that should be followed in all key areas of trade policy, namely the prevention of problems by timely action before a crisis situation develops.

With respect to manpower, the key is continuing education. Change is now occurring at such a rapid rate that a person just entering the labor force today can expect several separate and different kinds of employment over his working lifetime. Education and training must not stop with high school or with college. Education systems and incentives for employers should be developed to assure that the continuing education needed to keep the United States competitive will be broadly provided.

3 Mr. Parker

Labor mobility, as one of many fundamental freedoms, is unassailably desirable. So also is the right for employers and employees to negotiate mutually advantageous arrangements, including pensions and seniority. Care should be taken that, in efforts to improve mobility for a relatively few, other rights, meaningful to all, are not restricted.

Specifically, the majority of employers are willing to negotiate pension and seniority arrangements providing more than minimal benefits in order to induce the retention of valued employees.

4 Mr. MacGregor (Mr. Farha has asked to be associated with this comment)

I welcome and heartily concur in the recommendation that the U.S. Government should seek in all relevant forums to develop international agreement on fair labor standards. On the one hand, we must avoid giving way to the old protectionist dogma that any foreign wage rate that is lower than its U.S. equivalent is *ipso facto* cause for tariff protection. On the other hand, the developed nations of the Western community must begin to recognize an obligation to harmonize their social objectives. When international commerce exceeds $400 billion per year, it is essential that profound new consideration be given to the rules of the game of world commerce.

5 Mr. Parker (Mr. Shuman and Mr. Straus have asked to be associated with this comment)

I fear that attempts to reach agreement internationally on "fair labor standards" are both impractical and potentially disruptive. The details of wages, fringe benefits, and working conditions in any nation depend first, on the nation's productivity and second, on local customs, traditions, and preferences. Both productivity and custom differ widely among the nations. Because of the non-comparability of standards internationally, attempts at detailed conformity could impair productive efficiencies and injure worker well-being.

[6] Mr. Larry

Shifting capital and workers into other avenues of economic activity can often be a misdirected remedy. Thus, in the face of significant unfairness in the trade practices of other nations (viz., nontariff barriers, discriminatory tax systems, subsidies, cartels, etc.), surely no one would want the industries most adversely affected by these elements of unfairness, which elements admittedly must be eliminated in time, to be given financial incentives to shift into other industries pending the ripening of a fair climate of trade.

In a similar vein, surely no one would want to cause the spending of large sums from public -- or private -- sources in an attempt to produce a technological lead for an industry that was not in fact technologically behind, but rather was suffering in large measure the consequences of these unfair trade practices, or suffering from the disparity in levels of labor standards as between our own markets and those of other world competitors, the adjustment of which is inevitable, but again will take time. Thus, from time to time, there may arise situations where it may be in the U.S. interest to consider temporary market-sharing as a possible strategy.

[7] Mr. Sobin

I endorse this concept, especially since statistics show that the average compensation per U.S. export job is higher than the average compensation per import-competing job in the United States. Therefore, increased trade enables U.S. workers to shift from low-paid to high-paid jobs.

[8] Mr. Gilbert

The report proposes that government concern itself with the evolving effects of international trade on American labor. This is sound, but a similar proposal should also apply to the evolving competitive situation of American industry and agriculture in a rapidly changing world economy. This should in fact be a major focus of the President's Annual Report to the Congress in this field of public policy, consistent with the recommendation made in Chapter XI.

[9] Mr. Gilbert (Mr. Straus has asked to be associated with this comment)

Although I support in general the proposed changes in the adjustment-assistance criteria, as well as the proposed adoption of "the primary cause" as the test of injury in escape-clause proceedings, I do not support severing the causation link, as far as the escape clause is concerned, between a trade-agreement concession and the expansion of imports that is alleged to be the primary factor in causing the injury claimed in the petition. To remove this causation link appears to change the basic concept of the escape clause. The escape clause, with tariff increases and import quotas the major remedies (or among the major remedies), has always been and should continue to be related to trade agreements, particularly since withdrawal of a trade-agreement concession would be a permitted remedy in such cases.

I fully recognize that in some cases a trade-agreement concession is so distant as to be a minor or negligible factor contributing to the expansion of imports; and that government attention to the particular industry's problem may be necessary. I believe, however, that where a trade-agreement concession has become only a remotely contributing factor, government remedies should be concentrated on domestic economic policies and might include, but only in emergency cases and as temporary measures of last resort, the negotiation of international trade-restrictive agreements (or the advocacy of voluntary export restrictions of a temporary character).

As long as tariff increases or import quotas are to be available as remedies, the requirement of a causal relationship between import expansion and a trade-agreement concession should be maintained. If "the major cause" proves to be an unworkable criterion for such purposes, then something like "the primary cause" might be substituted.

10 Dr. Hammer

This report proposes tighter criteria for escape-clause action than for adjustment assistance. The intent is to rely primarily on adjustment assistance as the remedy for industries injured by import competition. Yet, because of the rigid criteria established in the 1962 Trade Expansion Act, the adjustment assistance provisions of that Act have never been tested in practice as to their effectiveness.

As tariffs and other trade barriers are reduced, it is quite probable that instances of injury to some industries will develop. Since escape-clause relief has been demonstrated in practice while adjustment assistance has not, we strongly urge that the criterion of "a substantial cause" be established both for adjustment assistance and for escape-clause relief.

11 Mr. Larry

The question as to whether any part of the problem of meeting import competition lies in the industry's hands or whether it stems from governmental policies is given insufficient emphasis.

12 Mr. Larry

Past experience with adjustment by industry to import injury shows emergency relief difficult to obtain and investigations long drawn out. As a general rule, provisions are needed that will speed up review and facilitate granting relief in emergency situations.

13 Dr. Hammer

This proposed amendment is essential in order to provide assistance needed by workers, by communities, and by the productive facilities -- the individual establishments -- providing them income. The proposed amendment would make available both a local and an industry sector approach to adjustment assistance, thus broadening the range of options available. As individual firms increase in both size and diversity, it becomes essential to provide for adjustment assistance on the basis of establishments.

14 Mr. Larry

Several basic industries, including steel, which are essential to the national security, have already been adversely affected by developments in international trade. It is imperative that existing threats to the national security be recognized early.

15 Mr. Nickerson

While I agree that a review of the mandatory oil import program might usefully be undertaken, including a redetermination as to whether the program is essential to the national security, I believe there is no question whatsoever that this is the case. Such a review should also consider whether changes in the program, both those already adopted and those proposed, are consistent with its original national-security objective. For example, changes in quota allocation intended to contribute to control of air pollution or to improvement in the balance of payments must be examined both as to whether they are really effective in these regards and also as to whether or not they are authorized by the statute that provides the legislative basis of the program.

16 Mr. Rush

With reference to the oil import program, I not only endorse the recommendation but strongly concur in the statement to the effect that the requirements of the petrochemical industry for imported petroleum feedstocks represent a prime example of a need that was not anticipated at the time of the program's establishment, but that must now be accommodated. Without in any way questioning the basic objective of the program to protect the energy sector of the U.S. petroleum industry as essential to national security, it should be emphasized that the program should not be allowed to impair the competitive position of the U.S. petrochemical industry in domestic and world markets with respect to foreign producers that may have access to lower-cost feedstocks. Our petrochemical industry is a major foreign-exchange earner. The program should be reappraised to assure that it does not adversely affect this industry, which presently contributes so favorably to the U.S. balance of payments. The original intention of the oil import control program was certainly not to deny raw materials to the petrochemical industry at competitive cost with respect to foreign producers. Therefore, it should be amended so that it relates only to petroleum importation for energy uses.

[17] Mr. Booth

We agree that trade adjustment assistance and escape-clause provisions of existing law should be changed to make them operable for the benefit of domestic industries seriously injured by reason of imports. However, existing programs operating under separate authorizations to aid companies, workers, and communities should be coordinated to avoid the proliferation of additional programs of assistance.

[18] Mr. Borch (Mr. Franklin, Mr. Murphy, and Mr. Shuman have asked to be associated with this comment)

I am concerned with the underlying philosophy reflected in this chapter and feel that it detracts from the main thrust of the overall report. Extreme caution should be exercised in implementing the approach recommended. Where injury is created by imports benefiting from discriminatory practices (excessive border taxes; subsidies, both direct and indirect; and other nontariff barriers reflected in this report), the American taxpayer should not be asked to bear this burden. Instead, efforts should be made to eliminate the discriminatory practices at their source. In other instances of injury through imports, we do not feel that domestic assistance should be provided unless sudden, abrupt, or other serious action on the part of our government is the causative factor. The broad sweep of recommendations in this chapter, if followed, could well constitute a "welfare program" for industry with all the disincentives for efficiency associated therewith.

[19] Mr. Lazarus (Mrs. Benson has asked to be associated with this comment)

With respect to adjustment assistance for workers, firms, and communities injured as a result of imports, I strongly agree with the recommendations that present assistance programs should be strengthened. We must provide meaningful assistance, but on a temporary basis. In addition, in line with our national goals, we must learn how to adapt, more effectively, the mobility of both capital and labor to tackle successfully the problems of free world trade.

[20] Mr. Meany (Mr. Abel has asked to be associated with this comment)

The U.S. Government's liberal trade policy should include an arsenal of measures that can be used to cushion adverse impacts, to prevent disruption of domestic markets, and to avoid undermining domestic social and economic progress. Effective trade adjustment assistance machinery is one essential part of such an arsenal of measures, which should also include a workable escape-clause mechanism, international agreements to prevent market disruption, and the early development of international fair labor standards machinery.

CHAPTER VI

INTERNATIONAL ADJUSTMENT PROCESS

The recommendations of this report rest on the basic assumption that the international monetary system will be improved and strengthened so that countries will be able to adjust effectively to fluctuations in their balance of payments.

The primary remedy for the causes of balance-of-payments difficulties lies in appropriate domestic monetary and fiscal policies. Drawings from the IMF, as well as other international financial measures, can help bridge the gap until domestic policies become effective. If the balance-of-payments problem is of a long-range structural nature, adjustments in exchange rates by deficit or by surplus countries may be in order.

However, changes in domestic monetary and fiscal policies may work quite slowly, and international borrowings and other financial measures may be inadequate to meet recurring crises. Under such circumstances, countries have tended in recent years to rely on restrictive trade measures. But such measures cannot be a cure for the causes of balance-of-payments deficits or for malfunctions in the international monetary system. On the contrary, one of the primary purposes of an effective international payments system is to facilitate international trade.

It is not within the province of this report to recommend specific improvements that should be made in the international monetary system. However, it is appropriate to emphasize that it is in the monetary system -- and not in the trading system -- that the primary and fundamental international adjustments must be made.

<u>Countries' balance-of-payments difficulties should be remedied primarily by domestic monetary and fiscal policies. In addition, the international monetary system must be strengthened and improved in order to permit successful adjustments to balance-of-payments difficulties. Trade measures should be used only as a supplementary and temporary means of alleviating such difficulties</u>.

Article XII of the GATT permits countries in balance-of-payments difficulties recognized by the IMF to impose quotas on imports. Although the use of import surcharges, export subsidies, and other trade measures for balance-of-payments purposes is not consistent with the GATT rules, they have nevertheless been used in recent years by Canada and the United Kingdom, and more recently by France. One of the reasons for their use is that they avoid the cumbersome administrative machinery and other undesirable features of quotas. Because of these features, none of the developed countries that dismantled their post-World War II regimes of quotas for balance-of-payments purposes has chosen to reinstate them.

Since the GATT has exercised no effective control over recent trade measures taken by developed countries for balance-of-payments reasons, the Contracting Parties should reexamine Article XII of the GATT. One major objective of this reexamination should be to permit countries in balance-of-payments difficulties to take measures other than quotas that will result in less trade distortion. [1]

It is difficult to devise a system of import quotas that does not seriously distort the existing pattern of trade. The absolute nature of quotas prohibits all

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[1] See comment by Mr. Larry.

imports once they are filled. Moreover, quotas must usually be allocated among foreign countries and among domestic importers. They thereby freeze shares of the market. Furthermore, quotas apply only to the import side of the trade account.

Import surcharges can be less trade-distorting than quotas, because they do not set an absolute limit on imports and do not necessitate allocations among importers or sources of supply. However, they too affect only the import side of the trade account, with resulting trade distortions.

Import surcharges combined with export subsidies of the same amount applicable to all products could avoid the distortions resulting from the use of surcharges alone. They would have an effect on trade similar to an exchange rate devaluation. Imports would be discouraged and exports would be stimulated. But so long as the surcharges and subsidies were applied to all products, there would be no distorting shifts of resources among different domestic producers. Moreover, the use of export subsidies together with import surcharges would tend to offset the revenue effects of surcharges and thereby eliminate an incentive for their retention for a longer period than necessary. For these reasons, particular consideration should be given to this method in the reexamination of Article XII of the GATT.

Another major objective of the reexamination should be to ensure that any trade measures taken for balance-of-payments purposes are subjected to careful scrutiny by the IMF and the GATT Contracting Parties. No trade measure should be used unless the IMF determines that a country's balance-of-payments difficulties require it. This determination should be based upon an examination of the domestic monetary and fiscal measures and international financial arrangements that are being undertaken by the country concerned. Moreover, the nature, level, and duration of any trade measures should be approved by the GATT Contracting Parties in consultation with the IMF, so as to ensure that they are the most appropriate for the purpose and no more restrictive than necessary.

The determination by the IMF and the approval by the GATT Contracting Parties should be made simultaneously and, if possible, prior to the implementation of the trade measures involved. In practice, however, there may be emergencies in which countries believe they must institute trade measures before the GATT and IMF can act. Nevertheless, this practice should be avoided except in the most urgent and unusual cases. In those cases, emergency measures should be promptly brought to the IMF and the GATT Contracting Parties for the requisite action.

Whatever form of trade measure is used, less trade distortion will result if it is applied equally to all products. However, for political, social, or other reasons, countries may feel it necessary or desirable to exempt certain products. But these exemptions should be carefully examined by, and should be subject to the approval of, the GATT Contracting Parties in consultation with the IMF.

<u>The United States, together with other countries, should reexamine Article XII of the GATT. The purpose of this reexamination should be to consider the trade measures that might appropriately be available to countries in balance-of-payments difficulties. Whatever trade measures are permitted should avoid trade distortion to the maximum extent possible and should also be subject to stronger surveillance and control procedures by the GATT Contracting Parties in collaboration with the IMF.</u> [2, 3]

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[2] See comment by Mr. Sobin.

[3] See comment by Mr. Watson.

Another deficiency in the present GATT rules is the lack of any mention of the responsibility of surplus countries to help bring about payments equilibrium. It is probably unrealistic to impose any specific obligations on surplus countries. However, any revision of the GATT rules should recognize the desirability of having surplus countries suspend or reduce tariffs, border taxes, and other charges on imports and make similar reductions in tax rebates and other export incentives.

The likelihood that surplus countries will take such action would be enhanced if consideration were given to the use of Article VII of the IMF agreement, which permits countries to impose exchange controls on any currency declared to be scarce by the IMF. If the IMF were to authorize the use of this provision, Article XIV of the GATT would permit the imposition of corresponding quotas on the imports from such a scarce currency country.

As part of the recommended exploration of Article XII, the GATT Contracting Parties should recognize the responsibility of surplus countries to encourage imports and discourage exports. Before, or immediately after, a GATT member takes trade measures for balance-of-payments purposes, the GATT Contracting Parties in consultation with the IMF should ascertain what contributions surplus countries are prepared to make and, in the light of these, whether the trade measures proposed or taken by the deficit country are appropriate or should be modified.

Finally, it must be emphasized that any changes in Article XII of the GATT to make it more consistent with current practice and more in line with the rationale of the adjustment process cannot and should not take the place of a fundamental strengthening of the international monetary system itself.

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[4] See general comment on this chapter by Mr. Booth.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER VI

1 Mr. Larry

Any trade restriction, if improperly conceived, can result in trade distortion. Tariffs or import surcharges, if set high enough, can act as an effective embargo. If competing countries sell similar commodities at different levels below domestic prices, then a tariff can be set so as to price some countries out of the market, leaving all imports to those remaining. Distortions can result from tariffs as well as quotas.

Voluntary restraints or world trade agreements also cause distortions, but have been condoned and encouraged by many in the past.

The distortion of the U.S. industry affected by imports should not be overlooked and may, in fact, be the factor most urgently in need of recognition and assistance. If quotas -- whether they be dollar quotas, tariff quotas, absolute quotas with built-in allowance for growth, market-sharing quotas or voluntary quotas -- are what is required to reach this end, then they should be applied as the best alternative.

2 Mr. Sobin (Mr. Miller and Mr. Rockefeller have asked to be associated with this comment)

From the point of view of the businessman, this concept of adjusting to balance-of-payments difficulties by changing tariffs or imposing quotas is a very poor substitute for adjustments carried out within the international monetary system. The international monetary system should be able to cope with short-term needs by the extension of temporary loans and with long-term needs by exchange rate adjustments. This same principle applies to the use of tax adjustments mentioned in Chapter III, in that international monetary system adjustments are much preferred to tax adjustments. If only the exchange rate can be changed, the businessman can study this one uncertainty and make estimates of possible changes in it. Also, there are existing institutions in the form of foreign-exchange markets that enable him to protect himself against changes in exchange rates by buying or selling foreign currencies for delivery at a future date. If the businessman in the future is going to be faced with negotiating to cover possible changes in tariffs, quotas, and border taxes as well as possible changes in currency values, then negotiations will be more time-consuming than at present and the net effect of the increased uncertainties and extra negotiations will reduce world trade.

3 Mr. Watson (Mr. Peterson has asked to be associated with this comment)

Our goal must continue to be an international financial system sufficiently flexible so that balance-of-payments problems can be met through monetary adjustments rather than through the creation of fresh trade barriers.

Any such barriers should be kept as low as possible and in force no longer than absolutely necessary. Any change in Article XII of the GATT must strongly emphasize these limitations.

It should be emphasized that any broadening of the authority to use trade measures for balance-of-payments reasons -- however justified as actions supplementary to other balance-of-payments measures -- carries with it very real dangers. Domestic pressures in the country concerned may make it difficult to limit the nature, level, and duration of the trade measures to those authorized internationally.

In brief, I would hope that restrictive trade measures will not be found necessary and that solutions to balance-of-payments difficulties will be found in the monetary field.

4 Mr. Booth (Mrs. Benson has asked to be associated with this comment)

We applaud the emphasis in this chapter on the interrelationship of trade and monetary policy and the need to correlate the international machinery dealing with problems in these fields.

CHAPTER VII

LESS-DEVELOPED COUNTRIES

There is no universally accepted definition of a less-developed country but, except for a few borderline cases, there is little question as to what countries fall into that category. Their per-capita income is very low, averaging less than $200 annually, or about one-twentieth of that of the United States. They are generally dependent upon the exportation of primary products for most of their foreign-exchange earnings, and all are deficient in capital, technology, and managerial skills.

These generalities conceal wide differences among the less-developed countries. They differ in climate, natural resources, and stage of development. A prescription for economic development appropriate to Chad, for example, has little relevance to India or to Brazil.

The stake of the United States in helping the less-developed countries to improve their position is a compound of humanitarianism, economic self-interest, and the need to prevent world disorder. The gap between their economic status and that of the rest of the world creates serious international tensions. The United States has much to gain both commercially and politically from any improvement in the prosperity of some 1.8 billion people, whose potential demand for the output of American farms and factories is limited only by their inadequate purchasing power.

Most less-developed countries are dependent upon imports for the capital equipment needed for their economic development. At present, around 85 percent of the foreign exchange used to pay for these imports is derived from export earnings. Thus, an increase in exports can provide far more foreign exchange than a proportionate increase of receipts from all other sources, including foreign aid and transfers of private capital.

Aid and trade alone will not be sufficient to launch the less-developed countries on the course to self-sustained economic growth. They can only be effective in conjunction with sound domestic policies by the less-developed countries themselves. But an expansion of export earnings is one of the essential ingredients in any economic development program.

A. EXPORTS OF PRIMARY PRODUCTS

What are the prospects for increased export earnings? The most obvious place to look first is an increase in earnings from traditional exports. For most less-developed countries, this means the exportation of primary products, and usually a very narrow range of such products. Sixty-six less-developed countries depend upon from one to three primary products for more than 50 percent of their total export earnings.

In many cases, however, opportunities for increased export earnings are severely limited because of the low response of demand to changes in consumer income and strong competition from substitutable products in developed countries. Almost the only important raw materials in which the less-developed countries can look forward, with any assurance, to increasing demand are petroleum and metallic minerals. But in these products prospects for continued growth in demand are not matched by a comparable prospect for increased production in the less-developed countries.

The contribution made by exports of primary materials to economic development would be greater, however, if it were not for the characteristic instability of the prices of those materials. One source of potential instability in the prices for primary materials is the existence in the United States and other countries of stocks of strategic raw materials and accumulated agricultural surpluses. The United States has exercised, and should continue to exercise, great care in the disposal of surplus stocks so as to minimize the likelihood of disrupting world price structures.

International commodity arrangements have been given a great deal of attention as a means of dealing with the problem of commodity prices. However, such arrangements can help the situation only in a very limited number of cases. The purpose of international commodity arrangements, if they are to avoid the stimulation of uneconomic production, should be to smooth out cyclical price changes. They should not be designed to support prices at an artificially high level. Other measures must be taken -- such as diversification, cost reduction, and research into new uses -- to achieve the goal of bringing long-term supply and demand into balance. Commodity arrangements themselves should be so drawn up as to further this goal, for example, by channeling a part of the proceeds of export sales into diversification funds.

<u>The United States should carefully consider proposals for price-stabilization arrangements for those few commodities where they can work effectively without stimulating uneconomic production, without encouraging the development of substitutes, or without having other results that would defeat their purpose. Such arrangements should also be designed to reduce the dependence of less-developed countries on the export of primary products -- by the establishment of diversification funds</u>.

B. EXPORTS OF INDUSTRIAL PRODUCTS

If an increase in export earnings is to play an important role in economic development, diversification of the production of less-developed countries is essential. For most of them, given the limitation of their natural resources, this can only mean the development of processing industries to utilize their own raw materials and ultimately the development of more sophisticated manufacturing. This, in most cases, will require the development of export markets.

Various obstacles stand in the way of an expansion of exports by less-developed countries. Some of these can be removed only by the less-developed countries themselves, but some are the result of policies and practices of developed countries. Within the less-developed countries, diversification of production for export is impeded by the lack of adequately-educated labor and management and by a lack of capital. To some extent, these deficiencies can be overcome by economic and technical aid. But any substantial improvement will come only gradually, as incentives to produce for export stimulate diversification and help create the savings that can be translated into capital investment.

1. <u>Effective Tariff Rates</u>

One obstacle to the diversification of export production in less-developed countries arises from the tariff structure of most developed countries. These countries, including the United States, impose low or zero tariffs on many imported raw materials and higher rates on the same materials in processed form. The effect is often that a seemingly moderate rate of duty on the processed product provides a level of effective protection for the domestic processor that prevents the exporting country from processing its raw material for export.

The simplest example is that of a single duty-free raw material processed in the importing country into a final product that is protected by an import duty. To illustrate -- a duty-free raw material, costing a domestic processor $1.00, is processed into a final product selling for $1.50. If the final product were protected by a duty of 20 percent ad valorem and if it had been imported at $1.50, the duty would have been $.30. But of the total value of the domestic product ($1.50), the processor added only $.50, or one-third. Thus, the protection afforded his production is not 20 percent -- the nominal rate -- but $.30/$.50, or 60 percent.

The potential export earnings of less-developed countries are clearly limited by high effective rates applicable to those products resulting from the processing or simple manufacture of raw materials and foodstuffs. Typically, the exporting countries have demonstrated their ability to produce and sell these primary materials in the world market. And, for many of these countries, the early stages of processing or manufacturing such primary materials are within their capabilities.

There are not as yet any sufficiently reliable estimates of the actual effective rates of duty on individual items in the tariff schedules of the United States or other developed countries. There is therefore a need to develop the necessary data on effective rates of duty -- both within the U.S. Government and in collaboration with other GATT countries. Once this is done, consideration could be given to seeking the necessary statutory authority to reduce effective rates, not only in the United States but among developed countries generally. Careful account would have to be taken of the domestic economic impact of such reductions.

<u>The United States should take the initiative in developing with other countries the information required to permit a calculation of the effective level of protection now afforded to products processed from primary materials exported by less-developed countries. On the basis of this information, the Executive Branch should consider the desirability of a request to the Congress in advance for authority to act, in concert with other developed countries, to reduce that protection to a level that would help the less-developed countries to export their primary materials in processed form</u>.

2. <u>Generalized Tariff Preferences</u>

The United States, along with other developed countries, has agreed in international organizations to attempt to work out a generalized system under which all developed countries will grant temporary preferential tariff treatment to all less-developed countries. In the OECD, developed countries are considering the various ways of establishing such a system. But differences of view among them are such that there can be no certainty that agreement will be reached.

A system of generalized preferences is likely to be of less value to the export trade of less-developed countries in general than is suggested by the emphasis they have placed on it. In fact, many of the smaller countries that are unable to compete with the larger less-developed countries may obtain little benefit. [1]

Moreover, it is unlikely that most developed countries will include in a preferential scheme the products in which the less-developed countries have the greatest competitive advantage -- namely, those which, because of their labor-intensiveness, are presently protected by high tariffs. [2]

Even if some of the more important of the products presently manufactured by the less-developed countries should be excluded from the scheme, however, there are potential benefits to them from preferences in other products. Companies seeking to

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[1] See comment by Mr. Sobin.

[2] See comment by Mr. Sobin.

manufacture components abroad could be influenced in their choice of location. In addition, developed countries, including the United States, may be able to make tariff reductions that would not be feasible if such reductions were extended to exports from other developed countries, including the reduction of high effective rates of protection on the processing of primary materials.

Such a system would also have some substantial advantages from the point of view of the United States. It is probably the most effective way to eliminate the selective preferences now in existence between certain developed and certain less-developed countries. Those now accorded by the EEC to some African countries and by the United Kingdom and other developed Commonwealth countries to less-developed countries within the Commonwealth result in discrimination against Latin American and other countries. These preferential systems are not only economically disadvantageous to many less-developed countries, but tend to divide the world into potentially disruptive political spheres of influence. [3]

The "reverse preferences" granted to developed countries by less-developed countries in exchange for selective preferences have even less economic justification. The adoption of a generalized system of preferences would facilitate the elimination of these special arrangements, which distort the flow of world trade and, in the case of preferences granted by less-developed countries, place U.S. exports at a disadvantage.

The increased export earnings that might result from a system of generalized preferences must be channeled into productive investment if they are to make a substantial contribution to sound economic development. In order to bring this about, there is a particular need for professional assistance in the fields of education, training, organization, and motivation. [4] The Agency for International Development, the Peace Corps, and the International Executive Service Corps conduct programs designed to meet this need. These and similar efforts to help the less-developed countries are essential to the improvement of trade opportunities.

But the less-developed countries themselves must adopt appropriate policies if these various forms of assistance, including generalized preferences, are to bear fruit. In particular, they must create a receptive climate for private investment, domestic and foreign; they must take positive steps to ensure that the benefits of increased exports are translated into higher living standards and better working conditions; and they must increasingly liberalize their own import restrictions in order to improve their ability to compete in export markets. The willingness of developed countries to grant generalized preferences should be used to influence the policies of the less-developed countries in these directions.

<u>The United States should continue to participate with other developed countries in the formulation of a system of temporary, generalized tariff preferences for the benefit of less-developed countries, subject to the subsequent enactment of implementing legislation. It should continue to insist that any such system supersede existing selective preferences and that "reverse preferences" enjoyed by developed countries be eliminated. If agreement on the latter point is not reached, the United States should make it clear that it will extend preferences only to those less-developed countries that do not discriminate against U.S. goods in favor of other developed countries</u>.

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[3] See comment by Mr. Parker.

[4] See comment by Dr. Hammer.

3. Nontariff Barriers

In a number of products in which less-developed countries have demonstrated that they have a competitive advantage, the effective barriers to the maximization of their export earnings are not tariffs but nontariff barriers, particularly quotas.

In the field of agricultural products, for example, most developed countries use nontariff barriers to protect relatively high-cost producers of beet sugar against imports of cane sugar from less-developed countries. In the United States, as a consequence of sugar legislation, prices have usually been well above the world level and have thus resulted in some transfer of income from American consumers to those less-developed countries that receive import quotas. But, fundamentally, this system of quotas has not operated to encourage the expansion of production of sugar by the most efficient producers.

As part of any overall negotiation on agricultural policies, the sugar-quota system could appropriately be reexamined. If it should prove feasible to restore competitive prices in that sector and to replace the present program with income payments to American sugar producers, both the American consumer and efficient producers in less-developed countries would benefit.

In the field of industrial products, the principal sector in which exports of less-developed countries are restricted by nontariff barriers is that of cotton textiles. Because of the relatively simple technology involved, a number of less-developed countries are able to produce cotton textiles at prices that make them highly competitive with established industries in industrialized countries.

The Long-Term Cotton Textile Arrangement (LTA), negotiated in the framework of the GATT, permits the United States and other importing countries to restrict imports by the use of quotas under certain circumstances. The LTA provides a formula for establishing the minimum levels at which imports that disrupt markets in the importing country may be restrained; this minimum is increased each year in accordance with a standard growth factor.

When first entered into, the LTA was intended to be temporary and to deal primarily with the problem of "market disruption" arising out of sharp increases in imports. Quotas were permitted in such circumstances in order to provide time for domestic producers to adjust to increased competition.

The United States and other major importers have negotiated many bilateral supplementary agreements incorporating quotas higher than those that would result from application of the growth factor alone. In addition, imports by the signatories of the LTA, including the United States, have increased as a result of quotas allotted to new exporters.

Nevertheless, imports of cotton textiles from less-developed countries have been restrained from growing at the rate that would have been possible in the absence of quotas. Moreover, since the distribution of imports from various sources has been determined through negotiation instead of competition, the LTA has prevented the maximum growth of production in countries with the lowest costs.

When the LTA was drawn up, it was expected that its adverse effects would be minimized by the concept of "market disruption." But this concept has been largely replaced in practice by the virtually automatic application of restraints at the minimum levels permitted by the LTA or at the levels negotiated in the bilateral agreements.[5]

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[5] See comment by Mr. Jones.

It would be difficult for the United States or any other importing country alone to limit the application of quotas under the LTA to cases in which imports actually disrupt the market. But, if all the major importers were to agree on an equitable distribution of the quotas permitted by the LTA and were to agree to restrain imports only in cases of market disruption, it should be possible to minimize their restrictive and trade-distorting effects.

The United States should seek agreement with other developed countries to ensure that the share of world exports of cotton textiles subject to the Long-Term Cotton Textile Arrangement is equitably distributed among importing countries. Such an agreement should include meaningful criteria for market disruption and an undertaking by all importing countries that they will refrain from the imposition of quotas except against imports that disrupt the domestic market.

C. REGIONAL ECONOMIC INTEGRATION

It is clearly in the interest of the economic development of the less-developed countries that they should increase their own trade with each other, since this will enlarge the markets available to them and improve their opportunities to effect economies of scale. It is for this reason that the United States has given its support to movements towards regional economic integration, especially in Latin America.

These regional movements, however, are not without danger to the economic health of the less-developed countries concerned. If they do not extend beyond the exchange of selective preferences among less-developed countries, they are most likely to lead to the development of uneconomic industries. These will need permanently high protection, and member countries will be deprived of the freedom to purchase in the most advantageous markets and at the most advantageous prices.

With the exception of the Central American Common Market, which has already achieved a large measure of internal free trade, none of the many so-called "customs unions" or "free trade areas" among less-developed countries presently seems assured of arriving at the goal of complete trade integration. It will be in the longer-run interest of the less-developed countries themselves if these arrangements should lead to genuine economic integration instead of permanent selective preferential areas. It will be equally in their interest if they progressively reduce their external trade barriers as rapidly as circumstances permit. [6]

The United States should support the development of regional trade arrangements among less-developed countries that contain provisions for achieving virtually complete free trade within a reasonable length of time. Where the United States has already encouraged the formation of regional arrangements, it should make continued progress towards internal free trade a condition of its continued encouragement and of any financial or other assistance it might provide. [7]

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[6] See comment by Mr. Murphy.

[7] See comment by Mr. Larry.

D. COORDINATING TRADE, AID, AND ECONOMIC DEVELOPMENT

The relationships among trade, aid, and economic development are of paramount importance. But the actions of governments and international organizations in these fields remain largely uncoordinated.

The GATT has made an effort to inject trade more explicitly into the development plans of less-developed countries. With their cooperation and that of experts from the World Bank and the IMF, the GATT Secretariat has prepared studies of individual development plans. These studies, with particular emphasis on the trade aspects of these plans, have been made available to the GATT Contracting Parties.

However, those developed countries whose trade policies can be most helpful in the realization of development objectives have not been directly involved in the basic studies and consultations that have taken place. There has also been inadequate implementation of the trade recommendations that have emerged, especially since governments rarely attempt to work out in advance a particular form of trade liberalization designed to fit the development program of an individual less-developed country.

The difficulty of achieving adequate coordination is complicated by the number of channels through which aid is provided, including individual governments, multilateral organizations, and regional institutions such as development banks. Thus, there is no single aid organization with which decisions in the trade field can be harmonized, in spite of the arrangements that have been devised to reduce inconsistencies in aid policies.

The World Bank, the IMF, and donor countries have joined in consortia to work out with particular less-developed countries the best combination of actions by all of them, including the less-developed countries themselves. The Development Assistance Committee of the OECD undertakes a general coordination of the aid activities of its members. Consultative and coordinating agencies have been established in such regional organizations as the Organization of American States. But these efforts have generally either had to ignore the special role of exports and imports in economic development or have had to assume that the trade barriers that exports will encounter will be those currently in effect.

There is also a need for governments and international organizations to take into account in a more systematic way the role that can be played by private investment in the formation of development plans. In particular, the less-developed countries themselves need to give greater attention to the impact on their economic development of their policies concerning private investment.

It will not be easy to establish the necessary coordination of trade, aid, and economic development plans. Nevertheless, any mechanism that helps achieve this objective should be actively explored. For example, it might be desirable to combine the GATT reviews of the development plans of individual less-developed countries with the annual consultations conducted with them by the IMF.

The United States should propose an international arrangement through which the examination of the development plans of individual less-developed countries can be conducted jointly with them, with the principal donor and trading countries, and with the international organizations concerned, including the GATT, the World Bank, and the IMF. The purpose of this examination should be to bring about a better coordination of (a) the development plans and policies of the less-developed countries, including their policies concerning private investment, (b) the trade measures of the importing countries, and (c) the aid programs in the less-developed countries.

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[8] See general comment on this chapter by Mrs. Benson.
[9] See general comment on this chapter by Mr. Jones.

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COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER VII

1 Mr. Sobin

I know of no study that would support this statement concerning the minimal value of generalized preferences. Furthermore, many of the smaller less-developed countries might actually obtain more benefit than the larger ones because their small internal market means they are more dependent on exports to support industrialization programs.

2 Mr. Sobin (Mrs. Benson has asked to be associated with this comment)

In order to improve our standard of living, I feel that we must make the necessary domestic adjustments as discussed in Chapter V in order to enable us to take advantage of the standardized labor-intensive products that could be made competitively in the less-developed countries. We must use our ability to shift our manpower into the manufacture of products in which we have the greatest competitive advantage. Some of these are capital intensive and some are labor intensive, but those that are labor intensive utilize highly skilled manpower rather than the relatively unskilled manpower found in the manufacture of products in which the less-developed countries have a comparative advantage.

3 Mr. Parker

I am in accord with the report in decrying the existence of selective preferences offered by the industrial countries to only a selected group of less-developed countries. As long as the present situation exists, however, I would favor a more sympathetic approach on the part of the United States to the less-developed countries that are left out of such arrangements. Perhaps a practical program would be to offer U.S. preferences, not to Latin America specifically but to all less-developed countries that do not have, or are willing to surrender, selective reciprocal preferential arrangements in other quarters.

4 Dr. Hammer

These forms of assistance -- education, training in skills, organizational assistance, and motivation development -- should become key elements in the aid programs provided by the United States and other developed countries. The economic growth of poor countries is accomplished primarily by their energetic, entrepreneurial citizens whose strong drive for achievement creates growth. Aid can, therefore, be most effective by providing assistance and resources to help encourage and develop the productive enterprise of such individuals.

5 Mr. Jones

The United States has administered the LTA generously. While the LTA provides for 5 percent growth in imports annually, U.S. cotton textile imports have grown overall by 10 percent per annum and at an even higher rate from the less-developed countries, and the United States now absorbs much more than half of all cotton textile exports from the less-developed countries.

6 Mr. Murphy

While regional economic integration and regional common markets may have long-term trade benefits for both member and non-member countries, the practice has developed of using the region's external tariff to systematically exclude imports from non-member countries. This practice results in trade diversion, not trade expansion, and should be discouraged if we are to provide financial and other assistance to such associations.

[7] Mr. Larry (Mr. Rush has asked to be associated with this comment)

The United States should be sympathetic to the formation of regional trading arrangements among less-developed countries that have an objective of internal free trade in the short run; but the United States should also encourage the reduction of external trade barriers of such economic unions over the long run.

[8] Mrs. Benson

We regret that no analysis or recommendations have been included on an issue of clear relevance and importance to this chapter, namely "tied aid" to the less-developed countries. The practice of donor countries requiring that all their aid funds be spent on purchases of their own commodities (including the United States whose "tied loan" policy was begun in 1959 because of its balance-of-payments deficit) has clearly depreciated the economic benefits of development aid. Cost estimates for "tied aid", in contrast to untied procurement, run from 15 percent to 20 percent higher. Such an uneconomic use of funds is all the more serious during a period when development aid levels are dropping and prospects for increased aid are dim. Although it is probably not feasible for this country to untie all of its aid as long as its balance-of-payments deficit continues, untied aid should be enunciated as an important long-range foreign economic policy goal. In the interim, the United States should seek with other donor nations ways of obtaining the maximum value of development aid through arrangements that would provide at least a partial freeing of aid from purchase requirements.

[9] Mr. Jones

If used imaginatively, the market-sharing or LTA-type approach has much to offer in terms of assisting the trade of the less-developed countries.

CHAPTER VIII

FOREIGN INVESTMENT

Foreign trade and foreign investment are becoming increasingly interwoven in the conduct of world business. In recent years, this interrelationship has been emphasized by the dynamic growth of multinational corporations. It is therefore clearly necessary for the United States to achieve a more effective coordination of trade and investment policies and a greater understanding of the specific effects of foreign investment.

U.S. investments overseas, especially those in manufacturing, are influenced by the trade policies of other countries. At the same time, U.S. exports are affected by the investment policies of others. U.S. investments also affect our own trade. A significant portion of our exports and a growing share of our imports, for example, consist of capital equipment, basic materials, parts, and even finished products that are, in fact, shipments between U.S. firms and their affiliates abroad.

The rapid growth and increasing diversity of U.S. foreign investments have injected new considerations into trade policy. In some cases, U.S. investment is undertaken abroad because foreign tariff and nontariff barriers make it the more profitable -- and sometimes the only feasible -- alternative. In other cases, U.S. exports have not been able to benefit fully from the removal of trade barriers because of foreign restrictions on investment. This is particularly true where investment is the necessary complement to exports, in order, for example, to permit the assembly of exported components into a finished product abroad.

<u>The United States should insist on the inclusion in future trade negotiations of foreign barriers to U.S. investments that hinder the development and expansion of export markets. In evaluating tariff and other concessions offered to it, the United States should take into account the extent to which other countries are willing to liberalize such barriers.</u>

Because of balance-of-payments difficulties, the U.S. Government has imposed temporary controls on capital outflows. When the United States regains a healthy payments position, these controls should be terminated. For the mobility of American capital on a world-wide basis has on balance had beneficial results.

It has generated exports from the United States that might not otherwise have been possible, as well as a rising volume of repatriated earnings. Moreover, the internationalization of American firms has contributed to the more rapid pace of world growth and economic development. American investment abroad has also been a means of helping less-developed countries to strengthen and diversify their economies.

<u>The U.S. Government should remove the temporary controls on capital exports when balance-of-payments considerations permit.</u>[1, 2]

The return to unrestricted capital flows will increase the importance of a better coordination of investment and trade policies and a better understanding of their interrelationships. Coordinated policy-making and the necessary institutional arrangements for it have lagged behind the rapid growth of U.S. investment abroad. Meanwhile, U.S. overseas production has grown faster than U.S. exports, and sales of overseas

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[1] See comment by Mr. Booth.
[2] See comment by Mr. Larry.

subsidiaries are today several times larger than U.S. exports. Consistent with the additional responsibilities recommended for it in Chapter XI, the Trade Expansion Act Advisory Committee would be an appropriate body to coordinate foreign investment and trade policies.

The Trade Expansion Act Advisory Committee should, in carrying out its additional responsibilities recommended in Chapter XI, coordinate foreign investment policy with trade policy and make recommendations to the President on those aspects of foreign investment policy that affect U.S. trade.[3]

The effective operation of the Trade Expansion Act Advisory Committee will require more data, in particular, on the specific effects of investment on U.S. trade and employment. In the area of trade, for example, not enough is known of the extent to which investments abroad have generated exports that would not otherwise have been made. Moreover, little is known of the extent to which sales from U.S. foreign subsidiaries displace U.S. exports or generate additional imports.

Another important question concerns the specific impact of U.S. foreign investment upon domestic employment. Such investment can facilitate the rapid transfer of production, technology, and managerial skills abroad. In contrast, labor typically has little if any mobility across national borders. This creates the possibility that, whatever its value to the U.S. economy as a whole, investment abroad may displace individual workers -- either by replacing exports or by generating additional imports. To the extent that this displacement may occur, it will have a direct bearing on the need for a more adequate adjustment-assistance program.

The U.S. Government should develop more data on the specific effects of American investment abroad, particularly on U.S. trade and employment.[4]

American and other companies making foreign investments are often subject to the laws of more than one country that are not only different but may be in conflict. As business firms become increasingly international, such conflicts in the regulatory and other policies of countries affecting foreign investment will tend to increase. Efforts will be needed to establish an international institutional framework for settling the conflicts that may result. The first step in this direction should be to begin to explore with other countries the problems arising from the internationalization of business activity, particularly where they have implications for international trade.

With other industrialized countries, the United States should begin an exploration of the problems arising from the internationalization of business activity, particularly where they have implications for trade.[5]

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[3] See comment by Mr. MacGregor.
[4] See comment by Mr. Meany.
[5] See comment by Dr. Hammer.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER VIII

1 Mr. Booth (Mr. Farha has asked to be associated with this comment)

The free movement of capital across borders is a vital means of gaining and preserving access to overseas markets that otherwise would be lost to the United States. In dividends it earns abroad and in U.S. exports it generates, direct overseas private investment is one of the most important sources of payments received in the U.S. international accounts.

2 Mr. Larry (Mr. Rush has asked to be associated with this comment)

Although there is no disagreement that mandatory controls should be removed, it is not necessary to wait for an improvement in the balance of payments, especially if alternatives can be substituted. One reason to drop mandatory controls immediately is to minimize the size of the pent-up demand awaiting liberalization, which would then have an immediate unstabilizing effect. The longer the controls are maintained, the larger the pent-up demand becomes and the greater the reason for continuing the mandatory control program. Thus, the program becomes self-perpetuating and alternative solutions are not sought.

3 Mr. MacGregor

The development of an integrated foreign trade and investment policy is of great importance. For example, it would be interesting to consider whether the wave of U.S. investment in EEC countries in the past decade would have been of the same extent if it had not been for the common tariff wall that was planned around the Common Market area. In effect, Le Défi Américain may have been Une Réponse Américaine.

4 Mr. Meany (Mr. Abel has asked to be associated with this comment)

The skyrocketing rise in the export of U.S. private capital and the operations of international corporations, in the past dozen years, have contributed to balance-of-payments difficulties, the loss of American jobs, reduced exports, and added imports. The U.S. Government should be equipped with a variety of measures that can be imposed, when necessary, to supervise, regulate, or control private capital outflows. Until the balance-of-payments problem improves significantly, the current mandatory controls on private investment in developed countries should be maintained. The U.S. Government should also require detailed reporting on foreign investments and the operations of foreign subsidiaries and should provide for regular publication of such information.

5 Dr. Hammer

Trade policy concerns itself with the relationship of the U.S. economy to the world economy. This report proposes, and I endorse, the sector approach to negotiations as a way of segmenting the total economy into more understandable and more manageable parts. This sector approach will also provide the framework for the analysis and the understanding of the internationalization of business activity. Problems will then become identified, defined, and more amenable to solutions. There will also develop a better understanding of opportunities for growth and the improvement of real incomes through all means available -- an important one of these being the international business firm.

CHAPTER IX

EXPORT PROMOTION

A basic premise of U.S. trade policy is that the reduction of trade barriers abroad will expand our export opportunities in step with the reciprocal opportunities we grant others to sell in our market. Most of the recommendations of this report are addressed to implementing this goal -- to ensuring that the opportunities will indeed be reciprocal, and that the results will be in our national interest. A successful trade policy, however, should not only create opportunities for traders but should also help traders to take advantage of such opportunities through various programs of export promotion. In the final analysis, of course, only U.S. exporters themselves can ensure that greater trade will in fact result.

Much has been done in recent years to promote the expansion of U.S. exports. The Export-Import Bank, for example, has established a $500 million Export Expansion Facility. It has also provided a rediscount facility for export paper. The Departments of Commerce and Agriculture have recently reinforced and expanded their trade-promotion activities and services. The tax treatment of corporate income from intra-company overseas sales and from Export Trade Corporations has been liberalized.

These efforts, however, have not been sufficient, and greater priority must be given to our export trade. In contrast with other industrialized countries, such as Japan and Germany, our export markets have too long been considered marginal to our own large internal market. The United States can no longer afford this attitude.

Government policies affect export performance in many specific ways -- through promotional efforts and assistance, through credit and financing, through specific tax policies, and through transportation and a variety of other programs.* Looking to the future, if new opportunities in world markets are to result in new exports, at least three major courses of action must be pursued. These are a closer, more effective partnership between the private sector and government, improved government export-promotion facilities, and a better organization within the Executive Branch in support of the export efforts of private enterprise.

The Departments of Agriculture and Commerce participate in a variety of joint promotional programs with private enterprise, including trade fairs, trade centers, trade missions, and market research. The Department of Commerce has recently begun a program of Joint Export Associations and is now developing a long-range strategy for export expansion in cooperation with industry, which involves a five-year program with specific commodity and industry targets. The Department of Agriculture also engages in similar joint efforts with farm groups and provides financial assistance as well.

However, an even more effective partnership between the private sector and government must be created to deal with the complex problems of world competition. Success will often require changes in attitude -- by the private sector and by the U.S. Government -- toward exporting.

<u>The private sector and the U.S. Government should place greater emphasis upon joint consultation on the problems of exporting and on coordinated programs for the expansion of exports.</u>

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* The National Export Expansion Council, a group of 72 business and professional leaders serving in an advisory capacity to the Secretary of Commerce and other government agencies, has been actively studying these areas since 1960. It recently submitted a comprehensive report, which contains a number of recommendations on export promotion. Some of these are similar to the recommendations made in this chapter.

Even with a closer and more effective partnership, there is much more that the Executive Branch itself can do to assist U.S. exporters. While appropriations have at times been inadequate, the Executive Branch has not fully devoted its available resources to the promotion of exports.

<u>The United States Government should expand its export-promotion efforts, including the dissemination of information on export opportunities for industrial and agricultural products through regional offices throughout the country.</u>

In particular, the United States must ensure that its exporters are able to compete on a fair basis with other exporters and are not handicapped by any shortcomings of their own government in this field. Governments throughout the world, for example, have long played an important role in providing export credit and finance. The major U.S. instrument in this field is the Export-Import Bank. However, both budgetary and policy considerations have restrained any further liberalization of the terms on which export credits may be obtained from the Bank. Moreover, its principal facilities are located in Washington, in contrast to the nation-wide credit facilities that are available for domestic transactions.

<u>The policies of the Export-Import Bank should be revised to make export credits more quickly available and on more competitive terms. It should give special attention to credit facilities for U.S. products in those foreign markets where competitive credit terms are crucial to export expansion. It should also develop regional facilities that will be readily available to potential exporters.</u>[1]

The foreign credits extended by private U.S. banks and other financial institutions, including credits for exports, have been subject since 1965 to restraints on balance-of-payments grounds by the Federal Reserve Board. Since an increase in exports is clearly a positive factor in the balance of payments, the restraint program should not operate so as to adversely affect our export sales. Export credits have been included under the restraints thus far, however -- primarily because their exemption, it has been claimed, would be difficult to administer and would risk widespread evasion of the overall restraint program.

<u>If the Federal Reserve Board, in cooperation with commercial banks, can formulate the necessary safeguards to prevent evasion of the overall credit restraints, it should develop a program exempting export credits from these restraints.</u>

In addition, the modification of certain domestic tax policies could also stimulate exports. For example, U.S. foreign subsidiaries established as Export Trade Corporations are now provided with a limited deferment of corporate tax on income earned from their sales of U.S. exports. Removal of some of the present limitations would not fundamentally change the nature of the tax incentive, which would continue to be only a deferment of liability, but should stimulate the formation and expansion of Export Trade Corporations.[2]

A final, vital requirement for a successful export program is the improved organization of the Executive Branch in the field of trade, a subject discussed in greater detail in Chapter XI. The present statutory authorities and administrative

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[1] See comment by Mr. Peterson.
[2] See comment by Mr. Larry.

responsibilities for credit and finance, for insurance and guarantee services, as well as for trade and other policies that bear on our export program, are now distributed among a variety of agencies.

A standing committee, such as the Trade Expansion Act Advisory Committee discussed in Chapter XI, should review the various export promotion programs and should coordinate such programs with our overall foreign trade policy.

[3], [4], [5]

3 See general comment on this chapter by Mr. Miller.
4 See general comment on this chapter by Dr. Hammer.
5 See general comment on this chapter by Mr. Farha.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER IX

[1] Mr. Peterson (Mr. Rockefeller has asked to be associated with this comment)

It is doubtful that the revision of Export-Import Bank policies would be sufficient to raise the export credit discount program to desirable effectiveness. The efforts of the Export-Import Bank should be supplemented in this area by increased responsibilities of the Federal Reserve System. Should the Federal Reserve System be unable or unwilling to accept these responsibilities, the Export-Import Bank might consider making use of the offices of selected commercial banks knowledgeable and experienced in the field of export credit.

[2] Mr. Larry

A review of U.S. tax measures affecting all foreign-source income, whether income from foreign corporations controlled by U.S. interests, or foreign-source income received by a domestic U.S. company, should be undertaken to determine their impact on U.S. export competition. Recommendations should be included to remove those taxes on any foreign-source income that hinder U.S. export competitiveness.

[3] Mr. Miller (Mr. Borch, Mr. Lazarus, Mr. Murphy, and Mr. Rockefeller have asked to be associated with this comment)

While I believe this chapter is sound in its recommendations for improved government export financing and expansion of export-promotion efforts, I feel that the chapter would be considerably strengthened if it went on to recommend an upgrading of the commercial function of the Foreign Service. While recognizing that this function has been improved in recent years, the American business community does not generally receive the vigorous support abroad that its competitors do through their diplomatic establishments.

Specifically, I recommend that within the Foreign Service there be created the posts of commercial ministers or commercial counselors in U.S. embassies in those countries where the United States has a significant trade and investment interest. I understand that within the whole U.S. Foreign Service there now are but three or four commercial counselors.

I would hope that all U.S. ambassadors would devote their personal interests and efforts to promoting U.S. commercial interests in their host countries. Without this active interest, it is unlikely that export and investment promotion activities and programs can be truly successful.

With our balance of payments in such a precarious state, I believe it essential that our trade account be strengthened, and that the above steps would greatly assist toward this purpose.

[4] Dr. Hammer (Mr. Murphy, Mr. Rockefeller, and Mr. Rush have asked to be associated with this comment)

We agree with the general tenor of this chapter but feel that it does not go far enough in recommending specific actions to be taken. In addition to the constructive steps recommended in this report, we urge that immediate attention be given to the additional recommendations of the National Export Expansion Council, which are briefly referred to in this chapter.

The United States has lagged behind other governments in helping provide equivalent competitiveness for its exports. Action on the recommendations of the National Export Expansion Council must now be taken to provide U.S. goods a more equal opportunity to compete in world markets. The recommendations on export expansion made in this report, plus those made by the Council, must become a priority action program for 1969.

[5] Mr. Farha

In regard to export promotion, see my comments concerning export subsidies in Chapter III. I would like to add that all nations cannot have a balance-of-payments surplus. Someone has to be in a deficit position. The United States is in an entirely different position from the other countries of the free world. We must continue to have a trade surplus simply to finance the humanitarian policies we have adopted in defending democracy in the free world and in aiding the less-developed countries of the world.

CHAPTER X

EAST-WEST TRADE

Trade between the Communist countries of Eastern Europe (including the Soviet Union) and the Western developed countries is small compared with world trade as a whole, but it is growing rapidly. The share of the United States in that trade and in its growth is minuscule. In 1967, Eastern Europe imported about $6.3 billion of goods from the Western developed countries, of which the United States supplied only $291 million. If its relative share of exports to Eastern Europe had been the same as its share of exports to the world as a whole, the United States would have supplied several times that amount.

The small participation of the United States in this growing trade is due to a number of causes. One of the most important is the effort of Eastern European countries to achieve a degree of bilateral balance in their trade with individual countries. This has not prevented the United States from selling to them substantially more than it buys, but it has undoubtedly limited its sales to them. In addition, a large part of the exports of Eastern Europe to the West consists of foodstuffs and raw materials that find a more ready market in Western Europe than in the United States. But these limitations on U.S. trade with Eastern Europe are compounded by policies that have been followed by the United States and other Western countries.

U.S. exports to Eastern Europe are limited by strategic export controls that are not confined to products of military significance. Even in the case of products for which export licenses are freely granted, the requirement to obtain a license can act as a disincentive to the exporter. Similar controls on the exportation of technology restrict the ability of American concerns to compete for the sale of capital equipment or for the construction of complete industrial plants. Finally, a provision of the 1968 legislation that renewed the authority of the Export-Import Bank prohibited the Bank, in effect, from participating in the financing of exports to countries aiding North Vietnam. The legislative history of this provision makes it clear that this prohibition applies to exports to all Eastern European countries except Yugoslavia.

The President is also restrained by law from granting most-favored-nation (MFN) treatment to imports from any of the Eastern European countries except Poland and Yugoslavia. This has meant that imports from them have been subject to the usually very high, so-called "statutory" duties based on the 1930 Tariff Act. As a result, exports from the United States pay the higher rates of duty that the Eastern European countries generally impose against imports from countries that deny them MFN treatment.

The restrictive effect of these policies on U.S. trade with Eastern European countries is accentuated by the existence of bilateral trading agreements between all of them and most Western countries except the United States. Although these agreements do not usually contain firm purchase commitments on the part of Eastern European countries, they do set import targets. If these targets are not met, the Western European countries reduce their own import targets in subsequent renewals. Thus, the agreements tend to reinforce the tendency toward bilateral trade-balancing.

For the United States to obtain its competitive share of the growing imports of Eastern Europe is not simple. One prerequisite is to end the present bilateral trading systems of those countries. A commitment by any one of them to grant the United States MFN treatment would, in theory, result in the termination of any discriminatory treatment accorded as a result of a bilateral agreement. In most Communist countries, however, trading decisions do not result automatically from competitive forces but are made by government fiat. Both their sales and purchase prices are largely arbitrary. As a result, it is difficult for their trading partners to determine whether discrimination is practiced and difficult also for the economic authorities of the

Communist states themselves to be sure they are basing their decisions solely on commercial considerations. Poland recognized this fact when, as part of the price for its accession to the GATT, it offered to guarantee a minimum value of imports from GATT countries, with an annual allowance for growth.

Together with the benefits of increased trade, which will probably come slowly, there are important political gains to be had from establishing closer trade relations with individual countries of Eastern Europe. So long as these countries are largely dependent on trade with each other and remain outside such international institutions as the GATT, their attitudes of opposition toward normal contacts with the West will be reinforced, and the likelihood of establishing peaceful relations with them will be diminished.

There has recently been a movement in several of the Eastern European countries to modify their economic systems so that competition will play a much larger role than in the past. This movement has been carried in Yugoslavia to a point at which the GATT Contracting Parties were able to exchange MFN obligations with that country. The movement was growing in strength in other countries, especially Poland and Rumania, at least until the 1968 Soviet intervention in Czechoslovakia.

In order for the United States to be in a position to take advantage of this trend, if it continues, it will be necessary for the President to be empowered to grant MFN treatment to Eastern European countries when he determines that it is possible to obtain equivalent benefits for U.S. trade. It would be desirable that any commitment made under this authority be subject to termination in order to put the Eastern European country concerned on notice that it must carry out its obligations.

If the President is given this authority, it would also be possible for the United States, where desirable, to support the accession of any Eastern European country to the GATT and to enter into GATT relations with it, subject to a similar provision for termination.

Even after an exchange of MFN commitments with these countries, however, U.S. exports are not likely to increase substantially so long as Export-Import Bank credits are unavailable.[1] But an improvement in trading relations through the extension of MFN treatment may help create better political relations and eventually permit the United States to relax both its export and credit controls.

<u>The President should be given the authority to enter into agreements with Communist countries of Eastern Europe that he determines would be likely to result in commercial benefits to the United States equivalent to those extended to them. While such agreements will have a political value, they should be negotiated primarily in terms of commercial considerations.</u>

<u>In particular, the President should be authorized to apply MFN rates of duty, or rates of duty between the MFN and "statutory" rates, to some or all of the imports of any such country. In return, the President would obtain commitments designed to secure equivalent commercial benefits. Any commercial agreement should be limited to three years, subject to renewal upon the President's determination that the extension</u>

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[1] See comment by Mr. Sobin.

would also be likely to result in equivalent commercial benefits for both parties. It should be terminable whenever the President determines that it is no longer in the national interest.

[2]

[2] See general comment on this chapter by Mr. Meany.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER X

[1] Mr. Sobin

If trade between the United States and the Eastern European countries is to be increased, then the United States must make arrangements to finance U.S. exports to such countries.

[2] Mr. Meany (Mr. Abel has asked to be associated with this comment)

East-West trade should be viewed as a tool of our nation's foreign policy, not as a mere commercial issue. Appropriate precautions against exporting advanced U.S. technology and prohibitions against exporting strategic items are essential. Considerations of national security and international policy objectives should have top priority in evaluating East-West trade issues, over any temporary or marginal commercial advantages that may exist.

CHAPTER XI

ADMINISTRATION OF TRADE POLICY

A. ADMINISTRATION OF TRADE AND RELATED POLICIES WITHIN U.S. GOVERNMENT

In urging the continuation of a liberal trade policy, this report attempts to answer a number of substantive questions raised by changed circumstances and new problems in international commerce. But an equally important question is how trade policy and related matters should be administered within the U.S. Government. The answer to this question will have a large bearing on the degree of effectiveness of our policy in this important field.

1. Administration of Trade Policy

From 1934 until 1963, the responsibility for the administration of foreign trade policy was vested in an interdepartmental committee chaired by the Department of State. However, in the early 1960's there was a concern that under this arrangement full weight was not given to U.S. trade interests. To meet this concern, the Trade Expansion Act of 1962 provided for the appointment of a Special Representative for Trade Negotiations, reporting directly to the President. He was not only given responsibility for trade negotiations but was also made chairman of a new Cabinet-level trade policy committee known as the Trade Expansion Act Advisory Committee.

In a 1963 Executive Order, President Kennedy established the Office of the Special Representative for Trade Negotiations as a separate agency within the Executive Office of the President. STR, as this Office became known, has never exceeded 35 individuals, including secretaries. During the Kennedy Round, there were two Deputy Special Representatives, both ambassadors -- one in Washington and one in Geneva. The Deputy in Geneva was in charge of the day-to-day negotiations over the four-year period. He was supported by 30 to 50 people -- most of them loaned to STR by other departments for the duration of the negotiations. In Washington, policy for the Kennedy Round as well as for other trade matters was largely decided by the interagency committees chaired by STR.

The shift of responsibility to STR has generally been considered successful. Most departments feel that their views are given more weight than before in the process of interdepartmental discussion. Important segments of American industry, labor, and agriculture have also expressed satisfaction with this new arrangement. STR has brought together different points of view and has been able to work out courses of action reconciling the diverse interests that bear upon most trade policy and negotiating issues.

There are three possibilities for dealing with the question of where the trade policy and negotiating functions should reside: (a) they could be placed in a new department that would cover all foreign trade matters, along the lines of the U.K. Board of Trade; (b) they could be given to an existing department (e.g., the Department of State or Department of Commerce); or (c) they could be continued as the responsibility of a small office located in the Executive Office of the President.

The main argument for the creation of a department of foreign trade rests on the importance of international commerce to the United States and to the rest of the world. Although our trade amounts to a small part of the gross national product, it has a growing significance. Trade is clearly a major factor in our balance of payments, which has become a critical issue. The recent increase in worldwide competition has further emphasized the importance of the trade policies we adopt, both for imports and for exports, to a widening area of American industry and agriculture. In short, trade has come to warrant a much greater priority among our national goals. Therefore, a good argument can be made for a Cabinet-level department that would coordinate and administer all aspects of trade policy. [1, 2]

On the other hand, there are strong arguments against a department of foreign trade. First, it would be difficult to separate the domestic and international functions of existing departments. For example, the Department of Agriculture's domestic price-support programs are intimately related to its export programs. Second, the departments now with specific responsibilities in the field of foreign trade would be reluctant to give them up. The establishment of a new department might therefore result in a Parkinsonian expansion of government. Finally, even if these serious obstacles could be overcome, the removal of any responsibility for foreign trade policy from such departments as Agriculture, Commerce, and Labor would tend to give them an essentially domestic orientation. Thus, issues related to foreign trade would become polarized within the U.S. Government to a far greater extent than they are today. This would make it much more difficult to develop a balanced foreign trade policy responsive to the national interest.

Nor does it seem desirable, on the other hand, to place the trade policy and negotiating functions in one of the existing departments, such as Commerce or State. The diversity of considerations that must be taken into account in promoting the commercial interests of the United States makes no one existing department appropriate for this important task. Moreover, depending upon the department that might be suggested, influential and vocal private groups would be likely to object on the ground that this department would not be sympathetic to their positions.

On balance, therefore, a separation of the trade policy and negotiating functions from the regular departments is desirable. The best solution appears to be the one that has already worked effectively -- STR. This Office can meet the need for the centralized formulation and coordination of U.S. trade policies. STR should, however, be established by law rather than by Executive Order, in order to give it permanence and the other attributes of a statutory agency. Moreover, to properly discharge its responsibilities, the staff of STR should be moderately expanded, with a corresponding increase in appropriations.

<u>Legislation should be enacted establishing the Office of the Special Representative for Trade Negotiations (STR) as a statutory agency located within the Executive Office of the President and reporting directly to the President. Beginning with the fiscal year 1971 budget, if not earlier, provision should be made for an expanded professional staff in STR and an increased appropriation adequate to permit STR to discharge its responsibilities effectively</u>.

STR should continue to bear the primary responsibility for the formulation and coordination of U.S. trade policy under the direction of the President. In addition, STR should continue to have the primary responsibility for the negotiation of most agreements that involve the movement of goods between countries -- irrespective of the international organization involved.

There may, however, be a few areas of substantial commercial significance that should be assigned elsewhere because of overriding considerations. For example, the foreign policy aspects of East-West trade may initially be of greater importance than

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1 See comment by Mr. Shuman.

2 See comment by Mr. Sobin.

the commercial aspects. Certain commodity agreements with less-developed countries are perhaps more political than commercial. But even in these areas, STR should be fully informed and continuously represented.

In carrying out its responsibilities, STR should rely heavily on the expertise and resources of the other departments and agencies. Especially in the formulation of basic trade policy, STR should take maximum advantage of the knowledge and experience elsewhere in the U.S. Government concerning specific issues. This should extend not only to agencies of the Executive Branch but to the Tariff Commission as well. In preparation for, and during the conduct of, the Kennedy Round, the Tariff Commission played an important role. Its resources are considerable, and they should be used more often and more effectively.

STR should not be responsible for the detailed administration of trade programs or policies, such as the implementation of the wheat or cotton textile arrangements. Once a policy has been established or an agreement negotiated, the day-to-day operations should be left to the departments concerned. Even here, however, there must be some surveillance by STR, since the administration of programs or agreements can sometimes raise significant policy issues. Moreover, it need not necessarily follow that STR should actually staff and conduct every negotiation. In some cases, the authority can and should be delegated to another agency.

Legislation should be enacted giving STR the primary responsibility for the formulation and coordination of trade policy and for the negotiation of most international agreements involving the movement of goods. In carrying out its responsibilities, STR should draw upon the advice and use the resources of other agencies. [3, 4, 5, 6]

2. Coordination of Trade and Related Policies

There is a clear requirement to bring about a closer and more effective coordination between our foreign trade policy and our other economic policies, both domestic and international, that have an effect on trade. This need not involve the establishment of new bureaucracies or the reassignment of existing responsibilities. But it does require a single individual, with a competent staff, to exercise a clear coordinating function. This function should be carried out through the use of interagency committees chaired by STR -- the system that worked successfully during the Kennedy Round in the more limited field of trade negotiations. It must be further extended to encompass the coordination of other policies that significantly affect trade.

The obvious mechanism to accomplish this is the Trade Expansion Act Advisory Committee -- the existing Cabinet-level committee chaired by the Special Representative for Trade Negotiations. This Committee should be given the additional responsibility of reviewing all economic policies -- foreign and domestic -- that have a bearing on U.S. trade. In some cases the requirements of trade will not have priority, and inconsistencies will continue to exist, but these inconsistencies will at least be recognized and considered. To the maximum extent possible, however, the Committee should seek to develop a consistent and coordinated program to strengthen our trade position.

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[3] See comment by Dr. Hammer.

[4] See comment by Mr. Lazarus.

[5] See comment by Mr. MacGregor.

[6] See comment by Mr. Meany.

The Trade Expansion Act Advisory Committee should be given the additional functions of reviewing periodically the interrelationship between our foreign trade policy and our other economic policies -- both domestic and international -- and of recommending to the President ways of making them more consistent and more effective in order to strengthen our trade position. [7, 8, 9, 10, 11]

Within the U.S. Government there are a number of important committees that attempt to coordinate other important areas of economic policy, both domestic and international. In recent years, for instance, the Balance of Payments Committee, chaired by the Secretary of the Treasury, has performed this function in that particular field. STR is represented on this Committee, but it is not always a member of other committees that deal with matters having an impact on trade, such as oil import quotas, stockpiling, export promotion, and price stabilization. Sometimes these committees are established on a standing basis; sometimes they are concerned only with a single situation. In either case, however, STR should be a full member if the economic issues affect the trade position of the United States.

In the case of the Balance of Payments Committee, in particular, there should be a standing subcommittee chaired by STR to deal with the trade aspects of the balance of payments. This subcommittee should meet on a regular basis and should maintain the maximum possible interchange of information with other subcommittees that might be established in related fields. Thus, the Balance of Payments Committee, supported by the more specialized subcommittees, could undertake to develop and oversee a long-range blueprint for a coordinated program of monetary, trade, and other policies to improve the U.S. balance of payments.

In the Balance of Payments Committee, a standing subcommittee, chaired by STR, should be established to deal with the trade aspects of the balance of payments. In addition, STR should be made a formal participant in interagency committees dealing with other matters related to trade policy, such as oil import quotas, stockpiling, export promotion, and price stabilization.

3. Congressional Participation

An important innovation of the Trade Expansion Act of 1962 was to provide for the selection of two members from each House of the Congress (not of the same political party) to be accredited as members of the U.S. delegation to each negotiation under that Act. Two members of the House Ways and Means Committee and four members (including two alternates) of the Senate Finance Committee served in this capacity during the Kennedy Round. They were briefed regularly by STR and most of them traveled at least once to Geneva to confer with the U.S. negotiators. The value of this arrangement was limited by the schedules of the Senators and Congressmen concerned, but it proved helpful, especially as a means of obtaining Congressional views on current issues. The arrangement should be continued in any significant trade negotiation in the future.

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7 See comment by Mr. Booth.

8 See comment by Mr. Murphy.

9 See comment by Mr. Borch.

10 See comment by Mr. Rush.

11 See comment by Mr. Shorenstein.

<u>The practice of designating Congressional Delegates to trade negotiations, begun in the Kennedy Round, should be continued in any significant future trade negotiation</u>.

It is particularly important that the major committees of the Congress concerned with trade and related economic policies should be provided with full and current information concerning trade problems. Committee hearings on trade are one way of meeting this need, as are briefings of individual Senators and Congressmen. Another way would be to expand the scope of the President's annual report to the Congress on foreign trade.

Since 1966 the annual report has been amplified to cover most aspects of trade policy. It has not, however, been expanded to include the relationship, emphasized in this report, between trade and other related aspects of domestic and international economic policy. If the report were expanded to cover such matters, it could serve as the basis for an annual dialogue between the Congress and the Executive Branch on the full range of issues affecting trade policy.

<u>The President's annual report to the Congress on trade should be expanded to include other related aspects of domestic and international economic policy</u>.

4. <u>Relations Between Private Sector and Government</u>

Both the preparation for and the conduct of the Kennedy Round involved far closer cooperation between the private sector and government than in previous trade negotiations. The mandate of the Trade Expansion Act of 1962 was to "seek information and advice with respect to each negotiation from representatives of industry, agriculture, and labor." In compliance, new avenues of cooperation and collaboration were developed, both formal and informal.

The President appointed a 45-member Public Advisory Committee on Trade Negotiations, consisting of spokesmen for the public interest selected from business, labor, agriculture, and consumers. This group met regularly with the Special Representative for Trade Negotiations during the Kennedy Round.

Private groups designated about 250 members of a Roster of Technical Specialists, who served during the negotiations as the principal contact between STR and their groups for developing useful information to assist in making negotiating judgments. Liaison was maintained, moreover, not only with roster members but also with other specialists whom they designated within their industries. Other groups were also encouraged -- and were often sought out -- to provide additional information and experience.

The Trade Information Committee, an interagency group chaired by STR, afforded a continuing vehicle for the development and receipt of information, through formal public hearings, through numerous informal meetings, and through extensive correspondence initiated both by private parties and by the Committee itself.

In addition, STR staff members were in frequent contact with firms, trade associations, labor unions, farm groups, and individuals to obtain facts and opinions on trade policy issues. Ad hoc groups, consisting of both government and private citizens, were also formed and contributed significantly to such specialized phases of the negotiations as those relating to industrial sectors and agriculture.

Many of these arrangements were experimental, aimed at developing the closest possible collaboration in the interests of a sound negotiating position. In the complex problems of today's trade, such continuing collaboration is essential. The solution of trade problems, especially in the area of nontariff barriers, can no longer be solely a governmental responsibility. The operation of some nontariff barriers can be so intricate that only business experience and judgment can assess their impact or point to a solution. More must therefore be done to establish the frankest and fullest cooperation between government and industry.

Experience with the public advisory committees established for the Kennedy Round and for this report indicates the value of establishing a similar and permanent committee to advise the Special Representative for Trade Negotiations on trade policy issues. Men and women of high caliber, such as those who have served on these committees, can make an important contribution to the analysis and solution of current problems affecting the U.S. position in world trade.

<u>A new and permanent public advisory committee, broadly representative of the public interest, should be appointed to advise the Special Representative for Trade Negotiations on trade policy issues</u>.

In addition, a more successful collaboration will require senior staff officials from the private sector and government who would meet regularly on trade matters. The activities of this working-level group should be supplemented by a greater use of ad hoc working parties and informal, off-the-record discussions. In particular, better means will need to be devised to exchange and verify confidential business information, particularly that involving future objectives and plans.

<u>The Special Representative for Trade Negotiations should designate a working-level group of individuals, experienced in trade and representing such major domestic interests as industry, labor, agriculture, and consumers, to exchange information and views with the STR staff on current trade problems</u>. [12]

Neither of these two advisory groups, however, should participate either in policy formulation within the Executive Branch or in any international negotiations, as some industry spokesmen have urged. In particular, it has been suggested that representatives of private interests should be given access to confidential data and should participate in negotiations in order that their interests be fully considered. These steps are not recommended.

Public policy decisions must ultimately be made on the basis of a determination of the overall national interest. They should be made only by appointed officials who are accountable for their decisions. Moreover, any fuller participation by private citizens beyond that recommended here would necessarily involve the present conflict-of-interest statutes. Unless and until they are revised, no deeper involvement in trade policy decisions could be authorized nor, indeed, does it appear to be desirable.

5. <u>Trade Data and Analysis</u>

The underpinning of good trade policy is good trade data. During the Kennedy Round, all the traditional methods of compiling and analyzing information were used. In addition, for the first time trade and tariff data for the principal participants were automated, and the analysis of negotiating positions was facilitated by data-processing techniques.

But this was a modest beginning. Substantially greater priorities must be given, both in budgetary support and in manpower, to the establishment of a comprehensive data system for purposes of guiding our future trade policies and assessing the impact of such policies upon our domestic economy.

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[12] See comment by Dr. Hammer.

STR developed a foreign trade and tariff data bank, principally for use in the Kennedy Round, which can and should be kept current and indeed expanded. Other departments also have data banks concerned with foreign trade but designed for their specialized needs. The Bureau of the Census and the Tariff Commission, which originate the basic trade and tariff statistics, have developed automated data systems of their own.

As a result, these numerous programs for the collection, automation, and analysis of data on foreign trade create the danger of a duplication of effort and additional cost. If these programs were supervised by STR, in coordination with the Bureau of the Budget, the most current and complete trade and tariff data would be available to all the interested agencies on an economical basis.

STR should, in coordination with the Bureau of the Budget, be responsible for ensuring that the existing governmental programs for collecting, automating, and analyzing trade and tariff data are effectively conducted for the benefit of all the interested agencies.

STR should not, however, assume responsibility for overseeing the collection and analysis of more specialized data necessary for individual agency operations. Nor should STR assume the functions of collecting prime data now carried out by the Bureau of Labor Statistics and the Bureau of the Census.

The data requirements of good trade policy extend beyond trade and tariff statistics. Most other relevant data, such as production statistics, prices, and employment data, are collected primarily for other purposes, using systems of classification not directly compatible with trade and tariff information. Significant steps have been taken in establishing bridges between some of these systems, but many gaps remain. Such data are essential for assessing the probable impact of import competition and the prospects for U.S. exports.

The Executive Branch should develop an integrated system of trade and relevant domestic statistics under centralized direction and at the level of detail necessary for trade policy decisions. This system should be automated so that the relevant data can be quickly made available to interested agencies from a central computer source.[13]

With U.S. support, the GATT has begun to explore the feasibility of a central, standardized data bank that would maintain and provide comprehensive trade and tariff data for use in international discussions and negotiations. Each country would supply the GATT with its own data in agreed, standardized forms and would receive, in return, the comparable data for other countries.

The United States should support the establishment by the GATT of an international trade and tariff data bank, compatible with the U.S. data system.

B. ROLE OF INTERNATIONAL ORGANIZATIONS CONCERNED WITH TRADE

In an interdependent world, multilateral organizations are essential if the actions of governments are to be effectively coordinated. Nowhere is this more true than in the area of international trade and payments, where any agreements reached

[13] See comment by Dr Hammer.

among countries must inevitably affect and be affected by the rest of the world. The question remains, however, whether the existing organizations are effectively serving their purposes.

Except for those organizations that are only regional, the existing intergovernmental institutions that relate in an important way to trade are the GATT, the IMF, the OECD, and the United Nations Conference on Trade and Development (UNCTAD). The GATT and the UNCTAD are primarily concerned with trade matters. The IMF is responsible for maintaining order in international monetary relations, which have a critical bearing on the conduct of trade. The OECD deals with a range of economic matters of interest to the major developed countries, including trade.

1. General Agreement on Tariffs and Trade

In 1947 the United States, together with 22 other countries, including its principal wartime allies, negotiated a major multilateral trade agreement and prepared a draft charter for the International Trade Organization (ITO). The ITO was designed to be the trade counterpart of the IMF and World Bank and, with them, to bring order into postwar economic relations. Pending negotiation of the ITO charter with a much larger group of countries, the 1947 negotiators drew up and subscribed to a less ambitious agreement -- the GATT, which was originally designed to be an interim agreement. The ITO charter was adopted in a multilateral conference the following year but was not ratified and never came into being.

The GATT survived and developed into the principal international forum for the negotiation of tariff reductions, the enforcement of trading rules, and the settlement of trade disputes. It is, therefore, both a contract and an organization. As a contract, it incorporates most of the obligations by other countries that have been achieved for the benefit of U.S. exports. If the GATT as an organization were to fail, because of lack of support by the United States or for other reasons, these obligations would be destroyed and over 20 years of efforts to achieve an orderly trading system would be lost.

As a central feature of its trade policy, the United States should continue to support the GATT as the principal international instrument for the negotiation and enforcement of trade obligations.

However, in spite of its accomplishments and its value to the United States, the GATT has worked imperfectly. Weaknesses have developed that, if permitted to continue, could seriously damage its usefulness to the United States and other countries. For example, the GATT has not fulfilled its promise as an instrument for regulating trade measures taken during times of international monetary difficulties. In addition, while substantial reductions in tariffs have been negotiated in the GATT, the GATT Contracting Parties have not yet developed effective means for the reduction or elimination of many of the nontariff barriers that impede trade.

In these and other respects, the Contracting Parties must make greater efforts to enforce and improve the trading rules laid down by the GATT. In participating in these efforts, the United States should have one basic goal in mind: the establishment of fair and equivalent opportunities for competition in international trade. [14]

Perhaps the most concrete measure that could be taken to increase the effectiveness of the GATT would be to bring it definitively into force. From its inception in 1947, the Agreement has been made effective by GATT countries under the Protocol of Provisional Application. The signatories of this protocol have undertaken to apply most of the substantive obligations of the GATT only to the extent that they are not inconsistent with legislation existing at the time of their accession.

[14] See comment by Dr. Hammer.

For all GATT countries, including the United States, definitive acceptance would necessitate the amendment of some existing laws. No major country would be willing to take this step unless it were part of a simultaneous move by most of them. It is not likely that definitive acceptance can be accomplished quickly or easily. Nevertheless, the United States and other countries should make its eventual achievement a major trade policy objective.

<u>The United States should strengthen the role of the GATT by observing -- and insisting that others observe -- the obligations it now incorporates, and should propose necessary changes in the GATT in order to make further progress towards establishing fair and equivalent opportunities for competition. In particular, the United States and other countries should make definitive acceptance of the GATT a major trade policy objective.</u> [15, 16]

As the world's leading trading nation, it is especially important that the United States demonstrate its determination to support the GATT and its activities. Since 1947, its annual contributions to the GATT have been financed through general contingency funds instead of specific appropriations. Because of the importance of the GATT to the United States, it would be desirable for the United States to regularize its own contributions to the GATT budget.

<u>Legislation should be enacted authorizing specific annual appropriations for the U.S. share of the expenses of the GATT.</u>

2. <u>International Monetary Fund</u>

The IMF plays several essential roles in the field of trade. First, it is responsible for the maintenance of an effective international monetary system on which world trade critically depends. As this report emphasizes elsewhere, this system must be strengthened and improved if the world economic system established after World War II is to continue to prosper.

Second, the present rules of the GATT assign a key role to the IMF in the implementation of Articles XII and XV, dealing with balance-of-payments problems. In Chapter VI of this report recommendations are made concerning new GATT rules that would more effectively control the use of trade measures for balance-of-payments purposes. In the enforcement of these new rules, the IMF would provide an essential link between monetary policy and trade policy.

Third, the IMF has a significant influence on the development plans of the less-developed countries. In Chapter VII of this report a closer coordination of aid, trade, and economic development policies is recommended. The IMF together with the GATT and the World Bank would be the primary international organizations to participate in such coordination.

<u>The United States should seek to strengthen cooperation between the GATT and the IMF in dealing with the international adjustment process and coordination among</u>

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[15] See comment by Mr. MacGregor.

[16] See comment by Mr. Rush.

the GATT, the IMF, and other international organizations in promoting the economic development of the less-developed countries.

3. Organization for Economic Cooperation and Development

The two functions of the OECD that are most directly related to trade are: (a) to serve as a forum in which the developed countries can arrive at common understandings concerning trade problems of special concern to them, and (b) to serve as a counterpart of the caucus of the less-developed countries in the UNCTAD.

This first trade function of the OECD could, in theory, be transferred to the GATT. But the existence of an organization of developed countries, which has its principal justification outside the trade field, does present a convenient platform for at least a preliminary exploration of trade problems in which coordinated action by these countries is particularly important. By virtue of the second function, the OECD can be a means for rendering economic assistance to the less-developed countries. Many of the actions that can be taken by developed countries on behalf of the trade of less-developed countries will only be taken by one if others share the burden.

Tentative agreements reached in the OECD will normally need to be confirmed in the framework of the GATT, either because they could affect the interests of other GATT members or because less-developed countries may believe that their interests are adversely affected if final agreement is reached in an organization in which they are not represented.

The United States should use the OECD for the formulation of certain understandings among the major developed countries, which could then serve as the basis for the negotiation of contractual obligations in the GATT.

4. United Nations Conference on Trade and Development

The UNCTAD first met in 1964 as a result of the dissatisfaction of the less-developed countries with existing international institutions dealing with trade, in the formation of which they had played a minor role. The original conference led to the organization of a number of standing committees and to the appointment of a secretariat with some 400 employees and a budget much larger than that of the GATT.

The most important function of the UNCTAD has been to serve as a forum in which the less-developed countries, which constitute the overwhelming majority of its membership, can unite in their demands for trade help from the developed countries. In the GATT, important decisions are generally taken by consensus. In the UNCTAD, by contrast, the less-developed countries have presented their demands in formally approved resolutions, often passed over the objections of some or even all of the developed countries to which they are directed. In cases where the developed countries themselves have agreed with a resolution, it has generally been implemented only after having been accepted as a firm obligation within the framework of the GATT.

Although the UNCTAD does not have to its credit achievements of the sort that can be attributed to the GATT, it has served a useful purpose in exploring the possibilities for opening up export opportunities for the less-developed countries. It is in the interest of the United States to continue to support the UNCTAD as a forum in which the less-developed countries can propose and discuss their ideas for expanding their exports as a means of promoting their economic development.

The United States should continue to support the present division of functions between the UNCTAD and the GATT. The UNCTAD should serve as a forum in which the

<u>less-developed countries can propose measures to promote their economic development</u>. <u>The GATT should serve as the principal forum for the negotiation and enforcement of contractual commitments</u>.

COMMENTS BY MEMBERS OF THE PUBLIC ADVISORY COMMITTEE ON CHAPTER XI

[1] Mr. Shuman

A new Commission on trade and tariffs should be established with power to act against unfair trade practices. In view of agriculture's important role in foreign trade, it is imperative that it be represented on this Commission. Industries encountering expanding imports should have ready access to this Commission and assurance of prompt and appropriate action.

[2] Mr. Sobin

Study should be given to establishing one overall trade agency, with one group in this agency responsible for policy and another responsible for operations. The operations group would perform such functions as monitoring agreements and promoting exports. The personnel in these groups should have the ability and authority to talk with their counterparts in other countries such as officials of the Board of Trade in the United Kingdom and MITI in Japan.

[3] Dr. Hammer (Mr. Farha has asked to be associated with this comment)

We agree that the administration of trade policy should be vested in a strengthened STR having a leadership responsibility to coordinate the international trade activities of the various agencies and to harmonize these with Congressional committees whose activities affect U.S. international trade.

Other agencies importantly involved in trade matters include the Departments of Treasury, Interior, Commerce, Labor, and State, and the Tariff Commission. In the House of Representatives, the Ways and Means Committee, Foreign Affairs Committee, Banking and Currency Committee, Judiciary Committee, Interstate and Foreign Commerce Committee, Interior Committee, and the Armed Services Committee all have jurisdiction over matters significantly affecting U.S. international trade. In the Senate, important jurisdiction over trade matters is held by the Senate Finance Committee, Foreign Relations Committee, Banking and Currency Committee, Judiciary Committee, Commerce Committee, Interior and Insular Affairs Committee, and the Armed Services Committee.

By relying on the expertise of existing executive departments and agencies, by acting responsively to the Congressional committees involved in trade matters, and by encouraging an international perspective at all times, STR can succeed in projecting to the world a clear, coordinated American foreign economic policy, reflecting the full strength of this country's economic power.

[4] Mr. Lazarus

It would be my hope that a continuing coordinating office for trade matters within the Executive Branch would be established promptly to ensure consistency of trade policy and administration within all branches of government.

[5] Mr. MacGregor

It should now be clear to all concerned that our economic position in the world requires a new recognition within the Cabinet and throughout the government of the importance of foreign trade policy and a new priority for better coordination of national actions in this field. The present urgent need is for the United States to produce some new solutions in the field of foreign trade policy. We have to improve our trade balance, stimulate our exports, deal with imports in areas where U.S. production is finding it difficult to compete successfully, and dismantle the present restrictions on U.S. investment abroad. This does not seem to me to be the time to try a major governmental reorganization to create a new foreign trade agency, as some members are recommending. Thus I agree with the recommendation in the report to leave STR where it is in the Executive Office of the President but strengthened by being given a statutory base and with added personnel. The work of coordination so well initiated by Ambassador Roth needs only further support and continued strong leadership with the backing of the President and a new recognition of the country's needs. Such a strengthened STR should be able to assert the authority required for the formulation of a coordinated U.S. national policy on trade.

[6] Mr. Meany (Mr. Abel has asked to be associated with this comment)

The government's trade policy affects all Americans -- workers and consumers, as well as business, the banks, and agriculture. Workers, for example, have at least as much at stake in trade policy as any other group. Moreover, trade policy is related to the nation's foreign policy. The Office of the Special Representative for Trade Negotiations, within the Executive Office of the President, was created to provide the necessary coordinating focus in government, to assure that no interest be omitted or subordinated to others. Interagency coordination of trade policy is essential and cannot be provided effectively by any single Cabinet-level department. Therefore, the Office of the Special Trade Representative should continue to bear primary responsibility for the formulation and coordination of U.S. trade policy.

[7] Mr. Booth (Mrs. Benson has asked to be associated with this comment)

The President should provide a mechanism immediately accountable to him to assure effective coordination of U.S. foreign economic policy, including both development and implementation.

[8] Mr. Murphy (Mr. Farha, Mr. Franklin, Mr. Haggerty, Mr. Larry, Mr. Lazarus, Mr. Peterson, Mr. Rockefeller, Mr. Russell, Mr. Seymour, Mr. Shuman, and Mr. Sobin have asked to be associated with this comment)

There is pressing need for vastly improved coordination of government and industry efforts on foreign business matters by a Cabinet-level mechanism that has the intent and ability to achieve properly coordinated action.

[9] Mr. Borch

I thoroughly endorse Mr. Murphy's recommendation for the establishment of an agency at Cabinet level that would include the work done by STR but with broader responsibilities and capabilities. This agency should concern itself with both trade and investment because both are inexorably interwoven in the conduct of world business. Such an agency would give the business community one place to go on all matters affecting their ability to contribute to the country's foreign economic policy. We also endorse the concept of regular meetings of senior government officials and representatives of major domestic sectors to exchange views and advise on current trade matters.

[10] Mr. Rush

While I endorse Mr. Murphy's recommendation, I would like to suggest the following extension. One single agency should be responsible by law for developing and coordinating all aspects of U.S. foreign trade policy. It should be responsible for directing U.S. participation in both bilateral and multilateral trade discussions and negotiations in whatever forum these may take place.

This agency should have statutory responsibility for keeping under constant review at Cabinet level the relationships to our foreign trade policy of other U.S. economic policies as well as activities of other federal agencies. This responsibility should include continuous appraisal of the administration of existing policies and programs for which primary responsibility would appropriately remain with other departments, e.g., monetary policy, cotton and wheat agreements, etc.

11 Mr. Shorenstein (Mrs. Benson and Mr. Gilbert have asked to be associated with this comment)

I propose that STR be the agency that would be responsible for the formulation and coordination of all aspects of foreign trade policy and for directing U.S. participation in all negotiations that involve foreign trade. In addition, through the Trade Expansion Act Advisory Committee, STR would review and coordinate, with the other appropriate agencies, related aspects of our domestic and international economic policies and would recommend to the President those actions necessary to promote greater consistency and effectiveness.

Consistent with these functions, STR should be established by statute as an agency with the title of the Office of Foreign Trade Policy and with an explicit permanent authorization of appropriations. Experience to date has established the soundness of the concept of STR as an effective coordinating agency operating at a sufficiently high level within the Executive Office of the President, and it should therefore be strengthened as I propose.

12 Dr. Hammer

We enthusiastically endorse this proposal to designate a limited number of experienced officials who represent major sectors with interests in foreign trade to advise on trade problems and issues. The appointment of such advisors should be made official instead of unofficial as was the case with the Roster of Technical Specialists assembled during the Kennedy Round. Among other effects official appointment would give rise to obligations that would be helpful in creating an atmosphere that could lead to meaningful dialogue between the sector advisors and their counterparts in government, an objective never fully realized during the Kennedy Round.

The role of sector advisors could include counseling conferences with STR, on-the-scene advisory assistance to U.S. representatives in GATT negotiations, attendance at OECD Industry Committee meetings and meetings of other OECD committees, an advisory relationship to U.S. participants at UNCTAD conferences, and participation in or advisory service for regional trade organization conferences.

Such a system of sector advisors could provide a solution to one of the most critical problems of trade negotiations -- getting depth of knowledge at the point of decision at the time decisions are being made. It would also improve understanding of the negotiations among the various sectors affected and, therefore, provide a more favorable consensus for the results obtained.

13 Dr. Hammer

Sound trade policy administration requires a data system that enables a continuing analysis of economic change affecting trade so that potential problems and opportunities can be identified in advance and appropriate action initiated at an early stage. Trade data for 1964 were widely used during the Kennedy Round, but additional data and sophisticated evaluation were required for decisions affecting the trade relationships of 1972 -- the year Kennedy Round concessions will be fully in effect. Similarly, for future policy decisions and for future trade negotiations a capacity must be developed for identifying current trends and for evaluating the future impact on these trends of policy changes and of trade concessions.

Such a capacity must not be limited to the evaluation of broad economic indicators and non-homogeneous aggregates. The data must be highly specific, and the programs and systems developed must be highly sensitive to mix as well as to totals.

Inputs for some of the more specific programs may be sought from the sector advisors, for example, in addition to data available from official government sources.

The intent of this proposal, that trade policy decisions be based on a present evaluation of future competitive relationships, is highly recommended.

14 Dr. Hammer

This is a concise statement of the basic goal of trade policy -- the establishment of fair and equivalent opportunities for competition in international trade. If all discussions and all actions on trade matters are references to this stated goal, the national dialogue on trade policy can become much more productive.

15 Mr. MacGregor (Mr. Larry and Mr. Straus have asked to be associated with this comment)

In addition to observing and insisting that others observe the obligations incorporated in the GATT, the United States can strengthen the GATT by recognizing that the developed countries of today are far different from the contracting parties that created the GATT, and that today's trade patterns are similarly quite different. The United States should not take a defensive position in its approach to the GATT. The United States can no longer afford to overlook disappointing shortfalls in the actions of other nations and in their responses to our liberalizing measures.

16 Mr. Rush (Mr. Larry has asked to be associated with this comment)

The report emphasizes that the United States should support the GATT as the principal international instrument for negotiation and enforcement of trade obligations, and it goes on to state that the United States should propose changes in order to establish fair and equivalent conditions of competition. Obviously, world economic conditions and the international competitive posture of the United States have changed markedly since the consummation of the GATT. It seems essential that this agreement must be a flexible, living instrument. Unfortunately, renegotiation of important provisions has been extremely difficult, if not impossible. If the United States is ever to have equivalence of competitive opportunity, it must not leave itself in the position of being unilaterally bound by an agreement that was established to benefit the world community under conditions that no longer obtain today. In other words, the United States must leave itself free to undertake bilateral negotiations with major trading partners outside the GATT whenever efforts to amend GATT provisions turn out to be unsuccessful.

GENERAL COMMENTS BY MEMBERS OF THE
PUBLIC ADVISORY COMMITTEE ON THE REPORT

Mrs. Benson

We welcome this succinct appraisal of the major economic and political issues confronting U.S. trade policy-makers in the late 1960's. We regard the report as a strong vote of confidence for continuing the liberal trade policies that have served the nation and the world so well since the early 1930's. The document's major contribution is its affirmation of the validity of continuing the process of consultation and negotiation with our trading partners and its rejection of a unilateral, retaliatory approach to complex international economic problems.

In addition to commending the report's basic message, we also endorse what we consider to be its major recommendations. Our specific endorsements are indicated through association with comments made on separate chapters. As both an immediate and long-range blueprint for national action and international negotiations, these forward-looking proposals have been tempered by a recognition of political realities. We hope the report also conveys a sense of urgency for needed constructive action to head off negative action. In our judgment, the most pressing proposals for Congressional action call for Presidential negotiating authority sufficiently broad and flexible enough to meet current as well as future trade exigencies.

Mr. Booth

We are in accord with the premise and most of the conclusions set out in the report. We believe the report as a whole is well-balanced and should serve as an exceedingly useful guide for incoming policy-makers. The Special Representative for Trade Negotiations and his able staff are to be commended for preparing excellent materials for consideration by the Public Advisory Committee and for the diligent manner in which they have sought to give full consideration to all suggestions made by members of the Committee.

Mr. Gilbert

I enthusiastically support the overall thrust of this report even though there are various places where the meaning is not as clear as I would prefer, and other places where I might take some exception to the particular point being made.

Mr. Jones (Mr. Larry has indicated that he associates himself with many of the statements in this comment)

The report and its recommendations are based on two fundamental propositions:

1. That the United States should continue to be guided by the principles of a free trade philosophy and should move as rapidly as possible toward further trade liberalization.

2. That any injury to the industries or employees of the United States arising from imports will be remedied, not by policies to avoid or minimize the injury, but primarily by adjustment procedures designed to move productive resources out of the import-affected industries.

These propositions represent no essential change from those established in 1934 in the first instance and 1962 in the second. Continued adherence to these principles without reservation or qualification cannot be a realistic basis for an effective trade policy for the future. The United States is experiencing serious problems in its balance of trade reflecting changes in the composition of our trade and a sharp decline in our export surplus.

Whatever may be the merits of trade liberalization as the basic thrust of policy, that policy cannot be adequate if it does not take account of certain changes which have occurred recently in world trading and competitive positions. Some of the most crucial developments, several of which are noted in the report, are as follows:

1. The United States wage level, even after the most generous correction for productivity differences, is very much higher than in much of the rest of the world, with growing consequences for many segments of U.S. industry.

2. The rise of money wages in the United States has been accompanied in more recent years by a rapid decline in the relative advantages in technology, management, and market size formerly held by the United States.

3. The explosive growth of multinational companies during the 1960's has been accompanied by strong pressures to manufacture in the lowest cost areas of the world and to sell in the highest cost areas.

4. The formation and hardening of trade blocs, in Europe and Latin America particularly, will have an unknown impact on the future world trading position of the United States.

5. There is increasing evidence that the less-developed countries, because of capital shortage and limited technological skills, will concentrate their industrialization on a relatively small number of labor-intensive industries to provide export earnings.

6. The Kennedy Round agreements will have an impact on the U.S. trade position that will not be fully identifiable or measurable until well into the 1970's.

The report does not bring into proper focus, either in its analysis or policy recommendations, these changes which are taking place in the world trading situation and which, in all likelihood, will assume greater importance in the future and pose serious problems for the American economy and hence for public policy. Unlike other issues of trade policy, the implications of these developments are not examined in a detailed, coherent, and structured form. More importantly, the policy conclusions of the report largely fail to take account of these issues.

Perhaps the most fundamental issue, and one that is inadequately considered, is the wide wage differential (with its implications for costs and prices) between this country and others and the impact of this differential on the ability of many industries in the United States to effectively compete in both foreign and domestic markets. To suggest that increased productivity and further innovation can offset this differential is to ignore the very core of the problem. Similarly, to recommend, as does the report, the control and moderation of inflationary tendencies in the United States as a solution to the problem is unrealistic. At best, price inflation is only part of the problem, and it reflects certain institutional and structural rigidities in the domestic economy that are not susceptible of easy change.

The United States can hardly be faulted on its technological achievements. But the technology of other nations also has greatly improved in recent years; we retain no monopoly on innovative techniques. Moreover, in this era of almost instantaneous communication and rapid movement of capital internationally, the advantages of technological improvement remain the property of no one nation for very long.

At the same time, foreign wages have also risen, but they started from such a low base that comparisons of their percentage increases with our own can be highly misleading. The likelihood of the wage gap narrowing appreciably in the future appears extremely doubtful.

We are thus faced with a narrowing of the productivity lead once enjoyed by many of our basic industries without compensating adjustments in the wage-cost position. This poses a fundamental dilemma for our trade policy.

Another critical factor, among those enumerated above and to which trade policy must be responsive, is the growth of multinational corporations. The enormous investment abroad in manufacturing has created a foreign productive capacity which will increasingly seek outlets in the American market. For many years this investment by U.S. companies reflected a defensive strategy designed to protect their foreign market positions. In recent years there has been a growing tendency to invest abroad to take advantage of lower costs of manufacture, particularly lower wage costs, for exploitation of the American market.

The operations of multinational corporations have greatly enhanced this tendency, and the incentives for the growth of this trend are quite substantial. Technology and managerial skills are, in many areas of industry, being readily transferred abroad and in combination with low labor and other input costs, yield tremendous cost economies. The ability to exploit growing markets in the overseas country in which production takes place, together with increasing access to foreign markets, including those of the United States, are making it possible to sustain mass production on a scale similar to that which we in the United States enjoy, further reducing an advantage which in the past has accrued to domestic producers. Thus, the longer term effect of the multinational corporation on international trade, while not yet completely measurable, is clearly substantial and growing, with critical implications for the future.

The implications for trade policy of these new developments are many, but of particular concern is the impact on those United States industries that are especially vulnerable to the new import competition. These industries are characterized by a relatively high wage component of cost, keen price competition, and readily available technology. It is in these areas where strong incentives exist for the development of substitute sources of supply abroad with great potential for increasing foreign production quickly and for rapidly changing the product mix in response to market and policy developments in the United States.

The report does not adequately deal with the remedial measures to meet this new and growing form of import competition. Aside from the recommended changes in the escape-clause provision of existing law (which are sensible but are not adequate to the problems discussed here) the report has two things to say about remedies for injurious and disruptive import competition: (1) the principle which should govern the application of any remedy shall be designed to facilitate the movement of productive resources out of the import-affected activities into other forms of economic activity; and (2) the principle of "market sharing" (any form of quantitative restrictions on imports) has no significant role in American trade policy.

As to the question of market sharing, the report largely adopts an "either/or" posture, with the implication that support for market sharing must necessarily imply its enthronement as the guiding principle of U.S. trade policy. As a matter of fact, market sharing has proven to be a useful instrument of policy under selected circumstances and in response to special conditions. Indeed, for many essential industries and products it may be the only effective means of avoiding substantial injury and of providing for trade expansion by international agreement. This is not a novel idea. Existing law and practice countenance the use of such an approach, and in the substantive analytic chapters of the report, this is recognized. (For example: Section 22 of the Agricultural Adjustment Act; Section 352 of the Trade Expansion Act, which provides for orderly marketing agreements arrived at through international negotiation following an escape-clause recommendation; and the fact that the United States sought to achieve a market-sharing arrangement with the EEC on agricultural products in its pursuit of an "access" agreement in the Kennedy Round.)

The basic philosophy of adjustment is equally not applicable under all circumstances. The simple fact is that there are situations and industries in which it is neither feasible nor desirable to adjust to injurious or disruptive import competition by shifting productive resources. We already recognize in law that there are certain types of import competition that are unfair (e.g., dumping and government subvention) and that such competition requires correction rather than adjustment to

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it. There are other types of import competition where for one reason or another the competitive advantage of imports is of a temporary character which would not warrant the cost of resource adjustment.

But most important of all are the situations involving essential industries and large employment in which the social cost of adjustment of resources would be too great and outweigh the benefits of increased trade. This, too, is not a novel idea: our free enterprise market economy is punctuated with a number of important constraints designed to achieve desirable social and economic objectives. The character of the new competition which is unfolding in the international marketplace will increasingly give rise to cases in which adjustment of resources is not the indicated response. More sophisticated techniques may have to be applied, perhaps along the lines of the "market disruption" concept which was embodied in the GATT by decision of the Contracting Parties. What we must devise -- and what the report fails to do -- are measures to deal effectively and pragmatically with such situations and in a manner that does not do violence to international cooperation and the spirit of amity among nations.

In conclusion:

1. While the major thrust of U.S. trade policy is toward international cooperation and trade liberalization, the report is unnecessarily doctrinaire and ideological in its approach. It does not adequately and realistically deal with the implications for trade policy of certain new and important factors in the world trading environment.

2. These new factors require careful and pragmatic evaluation not presently possible on the basis of available information, and, therefore, trade liberalization should move with extreme caution.

3. By the same token, policy options and remedies, including market sharing where appropriate, should remain flexible and available to deal with problems which have developed and which are likely to continue to arise in our international trade.

Mr. Lazarus (Mrs. Benson has asked to be associated with this comment)

I am strongly in agreement with the major theme of this report prepared by the Special Representative for Trade Negotiations: namely, that trade policy must regulate and contribute to the achievement of our national goals.

This report is distinguished by its recognition of the critical stake of the American consumer in trade policy. Of primary concern in any definition of our national goals is the well-being of the individual American citizen, and the continued improvement in his standard of living must be paramount. Since the purchasing power of the American consumer represents over 60 percent of our gross national product, I feel that the report could have given the consumer's stake in trade policy more intensive treatment, especially the inflationary impact of trade restrictions, which decrease the real purchasing power of the consumer dollar.

Every American in his role as a consumer has an interest in what his well-earned dollar will buy in terms of fashion, assortment, and price. Consequently, the role of imports in helping to achieve this objective must be constantly under scrutiny.

Often overlooked in consumer prices, because it is buried deep in manufacturing and distribution costs, is the effect of tariff barriers on capital costs that go into final consumer prices.

Another factor on consumer prices is the effect through taxes of government procurement policies which have been largely formulated under the Buy American Act and similar legislation, at federal, state, and local levels. Defense procurement must recognize the need for domestic production of strategic defense materials. On the other hand the Buy American Act and similar legislation that seeks to accomplish this purpose should not operate as disguised protectionism or increase the cost of government unnecessarily and hence increase, through taxes, consumer prices.

I would strongly recommend continuing studies by government in line with our national goals that would measure the effect on both consumer prices and purchasing power resulting from the imposition of tariffs, quotas, and nontariff barriers, on (a) direct imports, (b) capital costs, and (c) government procurement.

Mr. Miller (Mr. Borch and Mr. MacGregor have asked to be associated with this comment)

I want to commend Ambassador Roth and his associates for a most balanced and thorough report on U.S. trade policy. It should be of very great usefulness to the incoming Administration and to all others with an interest in the future course of national trade policy.

I particularly welcome the recognition in the report of the close interrelationship of the trade, investment, and monetary aspects of U.S. international economic policy and would hope that future administration of policy would treat these matters as part of a whole.

It appears to me and to many of my business colleagues that these aspects of our foreign economic relations have in the past been treated separately and apart from each other. Bringing them together in a consistent manner should greatly assist the future conduct of international business operations.

Mr. Rush (Mr. Farha and Mr. MacGregor have asked to be associated with this comment)

The development of this type of report, as exhaustive and complete as it is, was indeed a sizeable task for the Special Representative for Trade Negotiations and his staff, particularly when it is realized that they painstakingly took into consideration the varying points of view, not only of the 35 members of the Public Advisory Committee, but also of many others, both within and outside the government. In my opinion, the report will be a highly useful document and of invaluable assistance to all branches of government concerned with the determination of future trade policy. The Special Representative and his staff are to be complimented for a noteworthy accomplishment.

Many of the members of the Public Advisory Committee, myself included, do not agree entirely with some of the specifics contained in this report. However, by taking an enlightened approach, the Special Representative has provided for the inclusion of footnote commentary by members of the Public Advisory Committee so that their different points of view might be included as an integral part of the report. The presence of these footnotes should not be misinterpreted or cause the reader to lose sight of the fine work done by the Special Representative and his staff. On the contrary, the footnotes really tend to make the basic report that much more meaningful and useful.

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, MARCH 5, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 11 a.m., in room 1114, New Senate Office Building, Hon. Wright Patman (chairman of the joint committee) presiding.

Present: Representatives Patman, Bolling, Reuss, Moorhead, Rumsfeld, and Brock; and, Senators Proxmire, Miller, and Percy.

Also present: John R. Starks, executive director; and James W. Knowles, director of research.

Chairman PATMAN. The committee will please come to order.

We continue our hearings on the state of the economy today. We are privileged to hear from one of the outstanding labor leaders of our time, Mr. George Meany.

Mr. Meany, it is no secret that over the year, I have found you and your organization to be a most positive and constructive force in our national economy.

You and your representatives have always been very happy to present us with your views of economic problems. We have been pleased to hear them testify on many occasions. At the present time, we are at a crossing over point in administration. It is most important that we have clearheaded statements on matters of basic economic policy. I think that it renders our hearing this year even more important than ever and we are pleased to have your views.

You may proceed, sir, in your own way, after which we will take up questioning under the 10-minute rule.

You have prepared statement, I notice. You may follow it if you desire or you may put it in the record and speak extemporaneously, whatever you do will be satisfactory to us.

STATEMENT OF GEORGE MEANY, PRESIDENT, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY NATHANIEL GOLDFINGER, DIRECTOR OF RESEARCH, AFL-CIO; AND ANDREW J. BIEMILLER, DIRECTOR, DEPARTMENT OF LEGISLATION, AFL-CIO

Mr. MEANY. Mr. Chairman, and members, I appear here today on behalf of the American Federation of Labor and Congress of Industrial Organizations.

As we in the AFL-CIO see it, the economic outlook for 1969 is clouded. It is difficult to make judgments when one is uncertain about the degree of slowdown during the course of the year and the policies that the new administration will pursue.

The pace of economic expansion is already slowing down—particularly retail sales—and the Government's brake on economic growth may be going too far. Moreover, the recent emphasis of Government policy on slowing residential construction, while maintaining special tax subsidies for business investment, is misguided. Interest rates have soared to unprecedented heights. There is danger of rising unemployment.

Some slower economic pace was to be expected this year, after the 5 percent real expansion of 1968, the seventh consecutive year of economic growth. By the beginning of 1969, several dampening developments were already in effect.

The temporary surtax, adopted in 1968, was withdrawing about $11 billion a year from consumers and business, to pay for part of the increase in military spending. The holddown on Government expenditures, ordered by Congress last year, had placed a lid on the amount of additional funds the Government can put into the economy's spending stream. The increase in social security taxes, effective January 1, was withdrawing about $1½ billion a year from employees and a similar amount from business, to pay for improved social security benefits. In addition, the buying power of the average worker's weekly take-home pay increased only slightly last year, after accounting for taxes and the 4.2 percent rise in living costs.

On top of these dampening developments, new restrictive Government measures were imposed in the early weeks of 1969—the commercial banks raised the prime interest rate to an unprecedented 7 percent—an effective prime rate of over 8 percent, because of the banks' requirement that such borrowers maintain an interest-free deposit. This boost in the prime rate is raising interest rates all along the line—to medium-sized and small businesses, to home buyers, farmers, consumers and the Government. Some new Federal securities have been floated, in recent weeks, at the highest interest rates in over 100 years. These high costs for borrowed money are being built into the price structure, from manufacturer to retailer and consumer—to the profit of the banks and other lenders. In addition, these high interest rates, accompanied by the Federal Reserve's squeeze on bank credit, threaten a sharp slowdown of economic activities.

The Government increased the interest rates on FHA and VA mortgages from the high 6¾-percent rate of early January to 7½ percent—an effective rate of 8 percent, when insurance is included. This peak rate on Government-backed mortgages, on top of the excessive rates for builders' loans, is boosting the cost of homes, which the home buyer is required to pay for the entire term of the mortgage. These costs are narrowing the home-buying market. A slowdown of residential construction is threatened, instead of the vast homebuilding expansion that is needed. Past experience teaches that high interest rates and tight money hit homebuilding fastest and hardest—the tight money high interest rate policy of 1966 threw residential construction into a deep recession.

The unprecedented interest rates of early 1969 are being built into the prices of almost everything we buy, as businessmen pass on these cost increases to the consumer. In addition, they are being built into the payments that consumers will make on installment and mortgage loans for years to come.

For example, if you buy a house now and get a 25-year mortgage at the very high rate of 7½ percent, you will have to pay that 7½-percent interest rate, every month for 25 years, even if interest rates decline—unless you are fortunate enough to refinance the mortgage at some point when interest rates are lower.

These developments and Government measures are dampening the rise of economic activities. They present the danger of a sharp economic slowdown and rising unemployment.

Moreover, there have been statements by some officials of the new administration—as well as by business spokesmen—that a rise of unemployment may be required to achieve greater price stability, although President Nixon has indicated a distinctly different viewpoint.

On February 19, President Nixon, in a letter of greeting to the AFL-CIO Executive Council, made his position clear when he said:

> We must find ways to curb inflation, which robs working men and women and their families of hard-earned gains. And we must do this without asking the wage-earners to pay for the cost of stability with their jobs.

The AFL-CIO welcomes President Nixon's viewpoint on this issue. It is timely and to the point.

The notion that there is an inevitable, mechanical trade off between inflation and unemployment is economically false and loaded with social dynamite.

Advocates of this Neanderthal view have never explained how a million additional unemployed can possibly reduce such price pressures as physicians' fees, hospital charges, auto and property insurance rates, which have risen sharply in the past decade—or how a million additional unemployed can halt the sharp increases of land costs, with their impact on rents and the price of homes.

Yet a rise in unemployment would hit the most vulnerable workers hardest—the most recently hired, the least skilled, particularly Negroes, other minorities and young workers. Working people generally—and the most vulnerable workers, in particular—would be forced to pay the price in unemployment and substantial losses of family incomes for such a policy.

Furthermore, relative price stability can—and must—be achieved without a growing army of unemployed. Expanded manpower training programs, an effective nationwide, public employment service and reduction of bottlenecks can help. But most essential to achievement of relative price stability is lower profit margins and reduced profit rates of return on investment.

A study by the staff of the outgoing Cabinet Committee on Price Stability, published last January, reported:

> . . . if the primary goal is a reduction of the rate of inflation, this can be done by increasing the unemployment rate, decreasing the profit rate, or both. Similarly, a low unemployment rate could be maintained with a smaller rate of inflation if profits were to fall.

A depression or deep recession could probably curb increases in the prices of many consumer goods—at the price of human misery for hundreds of thousands of families. Or a continuing, substantial rise of unemployment and economic stagnation over a period of years could possibly achieve similar results at a similar price.

However, the Cabinet Committee's staff study clearly indicates that there are other alternatives—"a low unemployment rate could be maintained with a smaller rate of inflation if profits were to fall."

Indeed, the inflation of recent years has been largely a profit inflation. Profits skyrocketed between 1960 and 1966, and after a dip in 1967, they moved up again last year. Business Week, February 8, reports:

> In 1968, U.S. corporations earned more money than they ever did before in a single year—thanks in good part to sharply rising prices.

Business profits moved up sharply after the early months of 1961, as the economy turned up from the recession of 1960–61. Profit margins on sales and profit rates of return on investment continued up sharply in the years that immediately followed. However, the usual pattern of economic recession about every 4 years—with a drop in profits—did not occur in the 1960's.

Profits continued to shoot up through 1966, as economic activities surged forward. The profit decline in 1967 was small, and in 1968 profits moved up again.

This sharp rise of profits during almost all of the past 8 years of sustained economic expansion has been shifting the Nation's income to profits.

Business profits have soared, far out of line with other major types of income. Between 1960 and 1968:

—After-tax profits skyrocketed 91 percent.

—Dividend payments to shockholders soared 84 percent.

—But the total after-tax personal income of all people in the country rose only 68 percent—reflecting increased employment, as well as the income-gains of individuals.

—And the weekly, after-tax take-home pay of the average non-supervisory worker, approximately 47 million wage and salary earners in private industry, increased only 31 percent and, in terms of buying power, merely 11 percent.

Thus, during the 1960's, after-tax profits rose one-third faster than the total after-tax personal income of all Americans and almost 200 percent faster than the weekly take-home pay of the average non-supervisory worker. A key cause of the price increases of recent years, therefore, is business profits—surely the record clearly indicates that profits have been the major beneficiary, by far, of these price increases.

For manufacturing corporations, after-tax profits rose from a 9.2 percent rate of return on investment in 1960 to an 11.8 percent rate of return on a much-greater investment in the first three quarters of 1968. At that rate of return—and with the addition of depreciation allowances that are almost as great as after-tax profits—manufacturing corporations can recoup the value of their investments in less than 5 years. Indeed, at the high rates of return and large depreciation allowances of the past 5 years, many manufacturing corporations, by 1968, had actually recovered the value of their 1963 investments.

As for the banks, in one year between 1966 and 1967, the after-tax profits of all member banks of the Federal Reserve System rose over 18 percent.

Complete reports for 1968 are not yet available. However, the Commercial and Financial Chronicle of January 16 reports that: "the past year was a good one with respect to bank earnings." Its 1968 profit report on a group of banks states that "the average increase for the group was 13.5 percent."

These trends are creating economic and social imbalances. An increased share of the Nation's income has been shifted to profits. Moreover, with their great profits and large depreciation allowances, most big corporations have created shelters for themselves against the early and full effects of tight money and unprecedented interest rates. In addition, the 7 percent tax credit on investment in new equipment and fast depreciation of new buildings offset part of the additional cost of high interest rates for these corporations.

Despite tight money and historic interest rates, the profit-laden corporations are continuing substantial increases in their investments in new and improved plants, machines and equipment—after a 100-percent rise between 1960 and 1963—although industry's operating rate is only about 84 percent of existing productive capacity.

This situation, which has been contributing to inflationary demand pressures in recent years, threatens to create a future gap between the economy's rapidly growing capacity to produce and demand for goods and services. It isn't necessary and it can—and should—be avoided.

We in the AFL–CIO have some suggestions along that line—suggestions unanimously adopted late last month by the AFL–CIO Executive Council. We suggest the following policies and measures:

1. Full employment must be the Nation's primary economic goal.

The Government's tax, expenditure, and monetary policies for an adequate rate of economic growth should be supplemented by manpower training measures and a Federal program, along the lines of the bill introduced by Representative James O'Hara, of Michigan, to create jobs for the remaining hard-core unemployed and seriously underemployed in providing needed public services.

2. Residential construction must be sheltered from the ravages of the credit squeeze and unprecedented interest rates.

The 7 percent investment tax credit should be repealed—to curb the flow of available funds into business investment and provide additional funds for homebuilding.

The provision of double depreciation should be repealed on all new construction, except low and moderate rental housing.

The Secretary of the Department of Housing and Urban Development should direct FNMA (Fannie Mae) to assist low- and moderate-income housing, at the lowest possible interest rate.

The development of the new form of Government security, authorized by the Housing Act of 1968—Government backed mortgage bonds—should be speeded up, to attract new investment funds into housing.

3. The Government's monetary policy should be eased at the first signs of a general economic softening and rising trend of unemployment.

Moreover, a thorough congressional review of monetary policy and the Government's monetary machinery is needed—for the development of a policy that is in the best interest of the Nation and the American people, rather than the banks and other lenders.

4. The trend of unemployment in the months ahead and the level of military expenditures should be key factors in deciding whether the temporary surtax should be terminated in midyear, phased out, or continued.

A rising trend of unemployment in the coming months would be a strong reason to terminate this temporary tax or to begin to phase it out.

If the surtax is continued for another 6 months or a year—or if part of it is maintained—the same rate as the surtax should be applied to income that is now excluded from Federal taxation, as a result of the major loopholes for capital gains, oil and mineral depletion allowances, and income from State and local bonds.

5. Reform of the tax structure is long overdue:

—to eliminate loopholes of special tax privileges for wealthy families and business;

—to establish a minimum tax that will end tax avoidance; and

—to reduce the relative tax burden on low- and moderate-income families.

6. A substantial rise in the buying power of wages, salaries, and fringe benefits is needed to provide wage and salary earners with a fair share of economic progress and to strengthen the consumer foundation of the national economy.

The lag of real wages and salaries must be ended. Rapidly rising productivity and increased business profits make possible substantial improvements in workers' earnings, within the context of a relatively stable price level.

7. Rising business profits should be based on narrow profit margins on each sales dollar and an expanding sales volume, rather than on swollen profit margins at the expense of consumers and workers—to curb pressures on the price level and to provide an improved economic balance between wages, profits, dividends, and other forms of income. This major economic policy issue requires careful and objective examination by the Congress.

8. The trade union movement is disturbed by the accelerated rate of economic concentration in the past few years—including conglomerate mergers and one-bank holding companies—and the impact of this trend on the national economy. The Congress and appropriate Government agencies should make the facts fully known to the public and curb the adverse impacts of this trend.

Mr. Chairman, I should like to submit for the record, with your permission, copies of four statements on major economic and social policy issues, adopted by the executive council at the meeting I referred to earlier.

Chairman PATMAN. Without objection, it is so ordered.

(The documents referred to follow:)

STATEMENT BY THE AFL–CIO EXECUTIVE COUNCIL AT BAL HARBOUR, FLA., FEBRUARY 21, 1969

TOWARD ELIMINATING POVERTY

Today, despite eight years of unparalleled national prosperity, 22 million individuals remain in the ruts of poverty. And at least 10 million others marginally exist near poverty's income rim of $3,500 a year for a family of four.

In the face of poverty's persistence, some single solutions have been offered as cures, such as the guaranteed annual income, the negative income tax and the family allowance plan.

The AFL–CIO is convinced no one program can eliminate poverty. There are no simple solutions. Indeed, a profile of poverty in America shows it has many and diverse origins and treatment of the malady requires not a nostrum, but specific remedies for specific causes.

It is especially noteworthy that the poor are not work-shy idlers. Indeed, three out of five poor people are in families headed by an employed person and if the involuntarily unemployed are added, the figure is probably as high as two-thirds.

Basic to solving the poverty problem is a national commitment to a full employment policy, with a firm undertaking to reduce unemployment to no more than two to two and one-half percent of the labor force. A large scale public service employment program will be needed, which will provide employment for those who can work but aren't working because of lack of education, training, job information, or other similar reasons.

The public service employment program could channel unemployed workers into existing and directly needed services in hospitals, schools, parks, recreation centers and libraries around the nation.

To prepare workers for available and socially desirable jobs, America needs a national, coordinated manpower program. The core of such a program must be job training and related services, designed to meet the specific needs of the "hard core" unemployed. This program must be designed to meet the actual needs of the present job market and it must consider the future job market. Training for non-existent jobs and "dead end" jobs offers no permanent solution to unemployment or poverty and adds nothing to the dignity of the worker.

For those who are working but do not receive incomes above the poverty line, we recommend a statutory minimum wage of $2 an hour and that minimum wage coverage be extended to millions of workers presently not covered.

Currently, full-time employment at a $2 minimum wage would produce a $4,000 annual income which would raise the average sized family above the government-defined poverty line. Even so, those working part-time would still be below the poverty level.

We are convinced that full employment, coupled with adequate Fair Labor Standards protection, is the best basic approach toward eliminating poverty for the greatest number of people.

We realize other programs will be necessary in order to reach into the crevices of poverty and assure decent incomes to those who, through no fault of their own, but because of peculiar and special circumstances, cannot be reached by this broad twin approach.

To eliminate poverty among the elderly, we recommend a minimum monthly Social Security benefit of $100 and a 50 percent increase in all benefits paid. These increased benefits would remove an estimated 4.5 million Americans from the rolls of poverty. Once benefits are increased, they must be kept in line with prices and incomes of those still in the labor force to avoid sinking below the poverty line again.

About 60 percent of non-working, head-of-household males, who are poverty stricken, are either chronically ill or suffer from physical disability. One way to raise these men and members of their families above the poverty line, is to increase payments and extend coverage under the disability insurance phase of the Social Security program.

Crevice-like poverty also stems from frictional unemployment. To cure this cause, we recommend broader coverage of the unemployment insurance system, at higher benefit levels and for an extended duration. We also urge elimination of harsh and unjust disqualification provisions.

We are convinced the best way to improve the workmen's compensation and the unemployment insurance system is to federalize them, or at the very least, establish adequate minimum federal standards for both programs.

But work and work-related social insurance would not help another segment of the poor, who cannot work or cannot be expected to work. Primarily, these are mothers and children in fatherless homes. To help them, the existing welfare program should be overhauled and strengthened. Welfare payments in most states are at sub-poverty levels and should be made adequate enough to provide decent living standards for those who must depend on them. Payments should be supplemented by social and rehabilitative supportive services which would permit recipients to make the best use of them. Eligibility should be based solely on need and families with unemployed fathers should be eligible for assistance on the basis of need, too.

To assure uniform treatment of recipients and adequate financing throughout the country, the welfare program should be administered and entirely or largely financed on a national basis.

As further steps toward the elimination of poverty, we strongly recommend other programs which are essential to the well-being of people, such as: a national Federal Employment Service with authority to grant relocation allowances; enforcement of anti-discrimination laws; full educational opportunities for all children at all levels of income; low-income housing; health care and other community services; comprehensive national health insurance program; day-care centers for working mothers; social services to meet family and personal problems.

We believe the above several and specific programs obviate the need for the single-shot solutions currently being discussed in some circles. The advertised attraction of the negative income tax of other general guaranteed income scheme is usually its seemingly mechanical and simple approach that is supposed to do away with all or most of the social insurance, minimum wage and other existing programs. At almost any conceivable level of guaranteed income, in the period immediately ahead, there would still be the need for individual programs, such as welfare assistance, to supplement guaranteed income receipts.

While a program of family allowances is another plan being discussed, this plan cannot be regarded as a panacea for poverty. In those industrial countries where the family allowance is used, the payments provide only a modest supplement to other forms of income. For larger than average families, however, the possibility that family allowances might be one effective way to meet the special needs faced by them should be explored.

We believe there is a discernible danger in the arguments of some of the proponents of these simplistic solutions and in simultaneous attacks on the Social Security, minimum wage, welfare and other social programs. It is a reactionary attack by opponents of all social welfare programs. These new proposals must not be permitted to serve as vehicles to depress wages and to abrogate the federal government's responsibilities in eradicating poverty.

To sum up, then, the AFL–CIO believes the many complex causes of poverty can best be attacked through reorganized and radically improved employment, wage, social insurance, welfare and supportive programs.

BACKGROUND STATEMENT

Eight years of prosperity under the Kennedy-Johnson Administrations have cut poverty almost in half. Yet, by government-defined standards, 22 million Americans are still poor—earning under $3,500 a year for a family of four—and at least 10 million are near-poor.

By definition, all poor are poor because they do not have sufficient income to obtain even the bare necessities of life. While the common characteristic of poverty is lack of income, the causes of poverty vary greatly. The latest detailed government figures available give this profile of poverty:

1. Contrary to a widely held misconception, the poor are not work-shy idlers; indeed, three out of five poor people are in families headed by an employed person and if the involuntarily unemployed are added, the figure is probably as high as two-thirds. Most shocking is the fact that one-third of the poor are in families where the breadwinner is employed throughout the year. Among heads of poor families under retirement age with children, 90 percent of the men and over half of the women work at least part of the year. Most of the men who do not work are disabled.

2. More than one-fourth of all poor families are headed by women, and of persons in families headed by women 43 percent are poor.

3. Three-fourths of the poor are white but proportionately far more Negroes are poor than whites—one household in three among Negroes compared to one in seven for whites.

4. Forty percent of the poor are children.

5. At the other end of the age span, 20 percent of the poor are 65 and over; of the elderly, fully 30 percent are poor.

6. Although we emphasize the problems of concentrated urban poverty, poverty hits rural areas, especially but not exclusively in the South, even harder. Only about 6 percent of the poor live on farms but the chances of being poor are twice

as great for people living on farms as for the non-farm population. Half of the nation's poor—urban and rural—are in the South.

Reactionaries claim, and many well meaning people believe, that most poor people are poor because they do not want to work. But the facts explode the myth. The most striking and least noted fact about poverty in America is that three out of every five poor people are in families headed by an employed person. These are the "working poor," who are poor because they cannot find all-year full-time jobs or because their employers do not pay them even subsistence level wages. In addition, many poor are in families whose head wants to work but cannot find a job. The remainder are too old, too young, disabled or otherwise unable to work. So the facts of poverty explode the myth of the cause of poverty.

In the face of the persistence of poverty, some well-intentioned individuals have offered single program solutions, such as the guaranteed annual income, the negative income tax or the family allowance plan. These single shot proposals are offered as a panacea to rid America of the scourge of poverty.

The AFL–CIO is convinced that no one program can wipe out poverty. America needs not one program but several, which will provide a concerted assault on poverty. This assault must take fully into account the many reasons why people are poor. The truth is: there are no simple solutions.

Basic to solving the poverty problem is a national commitment to a policy of full employment with a firm undertaking to reduce unemployment to no more than two to two and one-half percent of the labor force.

With an effective national commitment to full employment, most workers will be employed in the private economy or in regular Federal, State or local public employment. But for the remaining workers who, because of lack of education, skills, training or other similar reasons, cannot obtain regular private or public employment a large-scale public service employment program is needed.

This would not be a make-work program. To the contrary, workers now unemployed or working only part-time could be working in well-planned and useful public service jobs—in hospitals and other health facilities, in schools, parks, recreation centers, libraries and many other types of work—which could not only provide remunerative work for the poor but add to the health and well-being of the entire nation. Such employment should be linked with training and guidance so that these workers can move as rapidly as possible into regular employment.

In order to ensure adequate income for these public service workers and in order to avoid depressing the labor market, such workers should receive not less than the Federal statutory minimum wage.

The statutory minimum wage under the Fair Labor Standards Act should be raised immediately to at least $2 an hour. Minimum wage coverage should be extended to millions of workers presently not covered.

Currently, full-time employment at a $2 minimum wage would produce a $4,000 annual income which would raise the average-sized family above the poverty income level.

Full employment and an extended and increased minimum wage would directly benefit the millions of Americans who are in "working poor" families and also directly benefit those of the non-working poor who want to and could work but can't find a job.

Full employment, coupled with adequate Fair Labor Standards protection, is the best basic approach toward eliminating poverty for the greatest number of poor people.

To prepare workers for available and socially desirable jobs, America needs a national, coordinated job training program, designed to meet the specific needs of the "hard-core" unemployed. These training programs should be directed at skills geared to the actual needs of the job market and should include basic literacy, education, and supportive services. This program must also be designed to consider the future job market, for training for non-existent jobs and "dead end" jobs offers no permanent solution to unemployment or proverty.

In addition to measures directly aimed at assuring adequate incomes to workers in the labor force and their families, America needs effective supplementary measures such as:

1—A nationwide Federal employment service with authority to grant relocation allowances.

2—Enforcement of anti-discrimination laws.

3—Adequate educational opportunities for all children at every income level.

4—Housing for low income families.

5—Health care and other community services.

6—A comprehensive national health insurance program.

7—Adequate day care centers to enable mothers who are capable of work to do so to find employment.

8—Adequate social services to meet family and personal problems.

These measures would assist almost all of the poor, not only those in the labor market but also those who cannot now be expected to work, to begin to move out of poverty. They would also help the children of the poor lift themselves out of poverty through education, better health and eventually employment at decent wages.

Other programs will be necessary in order to reach into the crevices of poverty and assure recent incomes to those individuals who, through no fault of their own but because of peculiar and special circumstances, cannot be reached by the broad twin approach of full employment and minimum wage coverage. These are people who cannot be expected to work because of age, physical disabilities and infirmities, cultural and skill handicaps, frictional unemployment or because their family role dictates that they remain in the home with children and perhaps other dependents.

These supplementary programs must include:

1—A comprehensive and improved system of work-related social insurance including (a) old age, survivors and disability insurance, (b) unemployment insurance and (c) workmen's compensation.

2—A humane and improved welfare program.

Social insurance is the nation's most powerful bulwark against poverty for families who find it impossible to rely on work for income. A comprehensive and greatly improved system of work-related social insurance programs could contribute even more toward the elimination of poverty. Presently, most workers and their families have some, although inadequate, protection against loss of income brought about by unemployment, retirement, death or injury. The breadwinner's previous employment entitles him and his family to such protection as a matter of right and the benefits they receive are generally related to past earnings.

But far too many families dependent on social insurance payments are poor. The AFL–CIO believes millions of families could be removed from poverty by expanded social insurance coverage and higher social insurance payments.

Despite periodic updating of Social Security payments, the elderly are still the poorest people in our society. The rate of poverty among the elderly—30 percent—is almost twice their proportion of the total population in America.

By far, the most promising method to eliminate poverty among the elderly is to increase Social Security benefits. They should be raised as rapidly as possible by at least 50 percent and the minimum monthly benefit should be increased to $100. This will require a gradual introduction of contributions from general revenues, in addition to employer and employee contributions at scheduled levels. With Social Security payments as the floor, expansion and improvement of collectively bargained private pension plans will help to maintain the income of a growing number of the elderly.

The increased Social Security benefits we are urging would remove an estimated 4.5 million Americans from the rolls of poverty.

Once most Social Security benefits are raised to an above poverty level, they must be kept in line with prices and incomes of those still in the labor force, in order to make certain the recipients do not fall back into poverty.

About 60 percent of non-working, head-of-household males, who are poverty stricken, are either chronically ill or suffer from physical disability. These men form another large group of poor people who cannot be expected to work.

There are two immediate ways to raise these men and the members of their families above the poverty line. One is to increase payments and extend coverage under the disability insurance phase of the Social Security program. Another is to federalize the workmen's compensation programs and, at least, establish Federal minimum standards for the workmen's compensation program.

Crevice-like poverty may also exist for many of those who are jobless because of frictional unemployment. In order to cure this cause, the unemployment insurance system must be improved substantially. This will require broader coverage, higher benefit levels, extended duration of benefits and elimination of harsh and unjust disqualification provisions.

As the best way to secure urgently needed improvements, the AFL–CIO has long advocated federalization of the unemployment insurance system or, at the very least, establishment of adequate minimum Federal standards.

Thus, for the overwhelming proportion of the poor, work at decent wages and greatly improved work-related social insurance programs offer the most promising hope for adequate incomes. Adoption of the full employment minimum wage, training, and social insurance measures long advocated by the AFL–CIO would reduce poverty rolls considerably. They will be all the more effective if they are reinforced by effective educational, housing, health and other supportive programs the AFL–CIO has long recommended. They would also help many people who are on the edges of poverty. In a larger sense, they would contribute to building a better America.

But work and work-related social insurance would not help another segment of the poor, who cannot work or cannot be expected to work. Primarily, these are mothers and children in fatherless families, but they may also include, even with improved Social Security, some few elderly and disabled.

Some mothers must stay at home because they are unsuited for meaningful jobs. Others want to stay at home, and should be able to, in order to take care of their children. Still others want to work, and could, if they had proper day care for their children. For the benefit of these mothers and children, as well as other unemployables, a humane and vastly improved public welfare program is needed.

The existing public welfare program has been widely criticized and many of the criticisms are justified. It should be overhauled and strengthened in order to meet the needs of those who must rely on it.

Welfare payments are, in most states, at sub-poverty levels. They should be adequate enough to provide decent living standards for those who are dependent on them. Welfare payments should be supplemented by supportive services which would permit those receiving welfare payments to make the best use of them. The aim should be especially to assure a decent break to the children brought up in fatherless families so that when they reach maturity they and their children will not have to depend on welfare.

The existing categorical system which bars many poor families from eligibility should be replaced by a system in which eligibility is based solely on need. Families with unemployed fathers should also be eligible for assistance on the basis of their need too, but these unemployed men should be required to seek work or training. All recipients, male and female, should be encouraged by proper guidance and appropriate financial incentives to obtain part-time and, where qualifications and family circumstances permit, full-time jobs. But in any case, aid should not be denied when there is a real need for help and in determining eligibility for assistance, need should be the only relevant factor.

The AFL–CIO believes if welfare assistance is largely confined to those who cannot or should not work and if there are sufficient jobs at decent wages for those who can work, then the number of welfare recipients can be gradually reduced.

To assure uniform treatment of recipients and adequate financing throughout the country, the welfare program should be administered and entirely or largely financed by the Federal government. Standards of eligibility and payments should be determined on a national basis. We favor adoption of the declaration method of determining eligibility which, supplemented by proper controls, will eliminate time-wasting and degrading detailed investigations. Public assistance payments should be adequate to provide decent living standards to those dependent on them.

In short, the welfare system should be changed to permit those dependent on it to live in decency, dignity and security.

To sum up, then, the AFL–CIO believes the many complex causes of poverty can best be attacked through reorganized and radically improved employment, wage social insurance, welfare and supportive programs.

It can be seen readily that there are no simple solutions. And the programs recommended obviate the need for the single-shot solutions currently being discussed in some circles.

Obviously, with an effective full employment policy, then in fact, there will be a guaranteed annual income for the employed; for guaranteed work automatically will provide a guaranteed income. And by coupling the guaranteed minimum wage proposal with the full employment policy, the guaranteed annual income becomes a built-in factor and there is no need for a new policy or new program for workers or their families. The non-working poor would be assured of adequate income by the establishment of nationwide minimum income standards under the federalized public welfare program outlined earlier.

The attraction of the negative income tax or other general guaranteed income scheme is usually its seemingly mechanical, one-shot approach that is supposed to do away with all or most of the social insurance and other programs. For many academic economists, the problem seems to be finding a simple mechanical model, packaged in one neat and automatic device, that will supposedly end poverty in one fell swoop. For some social workers, their opposition to means tests and demeaning aspects of current public assistance programs leads them to search for a simplistic, automatic device. For many upper-income elitists, the desire seems to be to avoid any of the differing, specific causes and aspects of poverty and brush them all away forever.

Moreover, at almost any conceivable level of guaranteed income, in the period immediately ahead, there would still be the need for individual programs, such as public assistance, to supplement guaranteed income receipts, if the desire is to eliminate poverty and help the poor. In fact, the attacks on the several existing programs can be viewed as irresponsible attacks on social insurance and other social programs—playing into the hands of reactionary opponents of all social welfare measures.

Some have suggested that family allowances, payments made to parents based on the number of children in the family, would eliminate poverty in America. Family allowances cannot be regarded as a panacea for poverty. While most industrial countries do have family allowances, the payments are usually so low that they can provide only a modest supplement to other forms of income.

Nevertheless, for some larger-than-average families, regular incomes may not be enough to adequately meet family needs. The possibility that family allowances might be one effective way of meeting the special problems faced by large families should be explored. However, any consideration of family allowances should recognize that such payments must not be permitted to serve as an excuse to depress wages, must not be regarded as a substitute for other employment, welfare and social service programs and, in any event, are unlikely to be at a high enough level to have a major impact on family incomes .

Simply put, there is no single program which will wipe out poverty. Instead, because people are poor for a variety of reasons, a battery of programs is needed. First and foremost, there must be work at decent wages for everyone who can work, for this is by far the most important remedy for existing poverty. But there are those who cannot work and for them the solution is decent incomes—through updated social insurance for some, and for others through a modernized, humanized and federalized public welfare program.

STATEMENT BY THE AFL–CIO EXECUTIVE COUNCIL AT BAL HARBOUR, FLA., FEBRUARY 21, 1969

TAX REFORM

The basic inequities in the Federal tax system can be simply stated:

1. Many of the wealthiest individuals in the United States pay not one single cent in Federal income taxes. BUT

2. Many of the poorest individuals in the country, who live in what the Government defines as poverty, are forced to pay Federal income taxes.

In the opinion of the AFL–CIO Executive Council this is a reprehensible situation, which must be corrected. We can no longer tolerate a double standard of taxation, which heaps an unfairly great part of the burden of running the Federal government on the shoulders of America's middle-income families, many of whom are trade unionists.

We insist America must achieve a standard of tax fairness and we are therefore pleased that the House Ways and Means Committee has announced its intention of conducting a full-fledged tax reform investigation.

Major reform of the Federal tax structure has been talked about for many years. Yet on April 15, 1969, those who receive billions in capital gains from stock-market and real-estate transactions, from tax-free interest on state and local bonds, from oil- and other unjustifiable mineral-depletion allowances, and from other forms of unearned income, will still enjoy special tax shelters. Some will use their "foundations" and family trusts as tax-dodging schemes, and tax loopholes will still be a major crop of many operators of large farm enterprises. The transfer of large sums by gift and at death will still be accomplished by evasions that make taxation based on ability to pay a sham. Fast depreciation will provide real estate operators with tax-free bonanzas, which are also major factors in the rise of land costs and rents. Some wealthy individuals will don the mantle of philanthropy, but they will use the unlimited charitable-deduction loophole and the Federal government will honor their pledges.

In 1967, 21 individuals who reported incomes above $1 million and 155 who reported incomes of $200,000 or over, paid not a dollar of federal income tax.

In contrast, some 2½ million persons whose incomes fell below the government's "poverty line" paid $100 million in federal income taxes.

These loopholes of special privilege for wealthy people and corporations take their toll of the public's confidence in the federal income-tax structure. They are also expensive in dollars.

Just three major loopholes—capital gains, exemption of state and local bond interest, and tax windfalls to oil, gas and other mineral operations—cost the Treasury approximately $7 billion in 1968.

The 7 percent tax credit for investment in machinery and equipment produces over $2 billion for corporations. Moreover, this special tax privilege contributes to difficulties in the money market and adds to upward pressures on interest rates.

Most of these loopholes have developed over a quarter century of horse-trading for special privileges, frequently under the guise of promoting or encouraging an activity in the national interest. Unfortunately, the costs of these special privileges in terms of dollars, equity, wastefulness and taxpayer confidence have far outweighed any benefits.

Yet despite this sad record, it is becoming increasingly fashionable in some circles to advocate additional tax loopholes for wealthy people and corporations, in the guise of panaceas for virtually every national ill that can be identified. There is talk of adding new tax gimmicks for real-estate operators, many of whom are now more accurately considered in the business of constructing tax shelters rather than shelters for people. And there are tax forgiveness proposals ranging from those which supposedly would provide incentives to industry for on-the-job training and inner-city industrial development to those which would encourage gold mining.

Those who make these proposals would further reward those who already more than adequately share in America's affluence, and use as their excuse, the plight of those who are today in trouble because they do not have their fair share.

We view such schemes as haphazard, costly and wasteful approaches to meeting the nation's goals. Tax forgiveness has the same impact on the federal budget as a direct expenditure.

Yet, through such gimmicks, the federal government relinquishes budgetary control to the wealthy investors and businesses who reap most of the benefits. When a privileged few are provided shelters that enable them to avoid their fair tax share, others must reach deeper into their pockets.

We believe that the nation's interest cannot be served through tax forgiveness schemes or other forms of "no-strings" federal aid that are not subject to the Congressional scrutiny of specific programs, who funds must be used in line with national priorities, under federal performance.

The Congress and the new Administration must assign top legislative priority to substantial and thoroughgoing reformation of the federal income-tax structure.

We call for:

1. Elimination of the loopholes of special tax privilege for wealthy families and corporations.

2. A minimum tax on all income over a total which would provide protection for legitimate small investors but which would require at least some tax payment from those whose huge incomes are now preferentially taxed or totally tax-exempt.

3. Removal of the impoverished from the federal income-tax rolls.

4. Reduction in the relative tax burden for low- and moderate-income families.

5. Rejection of proposals for new tax loopholes, which would provide additional benefits for wealthy people and businesses and create even more inequities in the federal tax structure.

6. Unequivocal dismissal of all proposals for a federal retail sales tax. Whether such proposals are called "value-added" taxes or offered clearly as a tax on consumer, the effect is the same—those who can afford it least, bear the brunt of the burden.

7. Repeal the provision of double depreciation on all new construction, except low- and moderate-rental housing, and the 7% tax credit for business investment in machines and equipment.

STATEMENT BY THE AFL–CIO EXECUTIVE COUNCIL AT BAL HARBOUR, FLA., FEBRUARY 21, 1969

MINIMUM WAGE

The best way to combat poverty is to assure job opportunities that pay sufficient incomes to support a family to all who are able to work.

The amendments to the Fair Labor Standards Act, adopted in 1961 and 1966, represent great steps toward that goal. However, too many millions of workers are still excluded from coverage and the minimum wage is still too low.

Eleven and one-half million non-supervisory employees in private business and approximately 4 million non-supervisory employees in state and local governments are still excluded and many of them earn less than the current minimum rates of the Fair Labor Standards Act.

Moreover, the $1.60 an hour federal minimum (now in effect for previously covered workers and effective in 1971 for most newly covered employees) is inadequate in terms of living costs and family needs. Such hourly wage provides merely $3,200 for a full-time, year-round worker.

For workers on large farms, the top-limit of $1.30 an hour was reached on February 1, 1969.

Thus, substantial improvements of the Fair Labor Standards Act are urgently needed. They reduce poverty and lift the entire economy by providing increased buying power to America's lowest-income workers. Moreover, experience with previous amendments to the federal minimum wage law clearly indicates that further improvements can be achieved without any significant ill side-effects.

In evaluating the impact of the 1966 amendments to the Fair Labor Standards Act, the Secretary of Labor reported to Congress last month that "employment in the areas affected by the extensions of coverage has increased, and there is no evidence of any restraining effect on the broader coverage on employment opportunity. The increased minimum wage levels set in 1966 have not contributed to the current inflationary spiral to an extent which permits reasonable questioning of their net value in strengthening both the position of low-paid workers in particular and the economy in general.

The Secretary of Labor also reported to Congress that hired farm labor on newly covered large farms increased 36 percent from May 1967 to May 1968, while employment on non-covered farms declined 9 percent.

The dire predictions of disaster that preceded initial passage of the Fair Labor Standards Act, as well as every improvement, have never occurred. The economy has always adjusted to the improvements, millions of low-income families have increased their buying power and the national economy has moved forward.

It is time to make further progress toward wiping out the most shameful type of poverty in America—the poverty of the working poor.

Newly covered farm workers certainly should be provided the same automatic increases, in their minimum wage, to $1.45 in 1970 and $1.60 in 1971. that are guaranteed all other workers, newly covered by the 1966 amendments.

The protection of the Fair Labor Standards Act should be extended to the millions of non-supervisory workers who are still excluded from the law's coverage.

The AFL–CIO goal in the 91st Congress will be a $2 minimum wage with universal coverage. We shall make achievement of this goal a top legislative priority for the need is great and the cause is just.

STATEMENT BY THE AFL–CIO EXECUTIVE COUNCIL AT BAL HARBOUR, FLA., FEBRUARY 21, 1969

ECONOMIC PROGRESS OF MINORITIES

The fact that large numbers of Negroes, Mexican-Americans and other minorities remain outside the mainstream of America's economic and social order is among this Nation's most pressing domestic problems.

Despite the persistence of this problem, the significant advances of recent years are testimony to America's capacity for attaining a solution. Federal legislation, assuring equal opportunity, is now on the statute books. The nation's economic progress—built in part on the recent federal manpower, housing and anti-poverty programs, minimum wage legislation and the historic breakthrough of federal aid to education—has planted seeds whose results are yet to be fully realized.

As a result, unemployment among non-white adult men declined from 11.7% in 1961 to 3.9% in 1968—solid and unmistakable progress. Despite this improvement, unemployment among adult non-whites is double the rate among whites and joblessness among Negro teenagers in 1968 was 25%, a disastrous level.

Recent improvements in employment, education and skills have brought increases in the family incomes of many Negroes and other minorities. By 1967, the median income of non-white families was up to 62% of the median of white families—an unsatisfactory situation, but a considerable improvement over the 50–55% ratios of most of the 1950s and early 1960s.

These beginnings need encouragement, support and expansion. There is yet a long and hard road ahead. But the achievements of recent years point the way toward the only rational means of achieving a sound solution of this problem.

For the vast majority of Negroes and other minorities, the route into America's mainstream is manpower skills, education and jobs at decent wages.

The essential underpinning is a national commitment to full employment. Federal expenditure, tax and monetary policies for maximum economic growth must be supplemented by a national public-service employment program—to create jobs, linked with training and supportive services, for the unemployed and seriously under-employed in both rural and urban areas.

Federal manpower programs should be expanded and adequately financed—to provide the unemployed and under-employed with adequate skills that are needed in the job markets, as well as literacy training, counseling and medical assistance.

The forward momentum of federal aid for education, including vocational education, must be maintained. Adequate educational opportunities, to the maximum of the student's capacity, must be made available to all, regardless of race, creed, color or family finances.

Full funding, implementation and expansion of the housing and community facilities legislation of recent years is essential if America is to provide decent homes for all her citizens in the next ten years.

Effective enforcement of the civil rights legislation of recent years is a must.

Sound government and private efforts to assist Negroes and other disadvantaged minorities, who wish to establish business enterprises, should be provided. The critical need is capital formation and technical assistance. The government should establish machinery to provide long-term, low-interest loans and technical assistance to meet this need.

These varied policies and measures are essential to accelerate the upward mobility of members of minority groups into the nation's mainstream.

To do this, America's goal must be the rapid elimination of ghetto conditions and the ultimate elimination of the ghetto itself.

Some people, however, have urged that this route be abandoned for an emphasis on so-called "black capitalism."

At its best, this policy is an illusion. In a society where 90 percent of those who are at work are wage and salary earners—on private and public payrolls—only a small number of people can move into the economy's mainstream through self-employment and small business. Thus sole or major emphasis on this policy would undermine or kill the job-skills-education-housing measures that are essential for the overwhelming majority of Negroes and other minorities.

At its worst, "black capitalism" is a dangerous, divisive delusion—offered as a panacea by extremists, both black and white, some businessmen who see a chance for profit and a few well-intentioned but misguided liberals.

Attempts to build separate economic enclaves, with substantial federal tax subsidies, within specific geographically limited ghetto areas, is apartheid, anti-democratic nonsense.

It is also unworkable, for the ghettos are, in fact, a part of the nation, their inhabitants are Americans, and small pockets of urban or rural poverty cannot be made into viable, separate economic entities. The gross national product, produced by the inter-dependent national economy, should be shared fairly by all Americans.

Moreover, the "black capitalism" proposals to create huge, new tax loopholes for business to locate in ghetto areas is also bad tax policy. If enacted, these loopholes would attract small sweatshops or some marginal plants of big companies—with little additional employment at decent wages, but with considerable tax benefits to the companies.

Some legislative proposals for separate economic enclaves would create development corporations, in each ghetto area, with authority to control the economic life of the area. Such control could be used by extremists to harass businessmen, black and white alike, within these geographically defined enclaves.

Separatist economic schemes offer no hope for the solid advance of the overwhelming majority of disadvantaged minorities into America's mainstream. But they do present a real threat of further division, additional conflict and bitter frustration.

The AFL–CIO Executive Council is unalterably opposed to separatist schemes. We reaffirm our consistent commitment to the principle of integration and the goal of full and equal opportunity for all Americans.

We will continue and redouble our efforts to enable Negroes and other disadvantaged minorities to move as rapidly as possible into the nation's mainstream.

The way to do it is to put massive federal money, manpower and muscle into the programs we have endorsed in this statement—within a framework of full and equal opportunity for all Americans.

America knows the route to solving its minority problems; it needs only the will to reach its goal.

Mr. MEANY. Let me conclude, Mr. Chairman, with an observation that is, indeed, an article of faith with us:

We in the AFL–CIO have faith that the American system will be able to meet the economic challenges that face us.

In our system is the strength and the ability to meet our problems—including economic problems—and come up with solutions that will benefit all of our people.

That, we contend, should be the goal of governmental economic policy—to serve all the people, not just a favored few. That, in truth, is the economic guideline America needs.

Thank you.

Chairman PATMAN. Thank you very much, Mr. Meany, for a very fine statement. It is not only thought provoking, it is very constructive and will be helpful to our committee.

We are paying now in interest in this country, on both public and private debts, about $125 billion a year, which is quite a burden on the poor people, and those of middle income, because so much of their debt payments must go for interest payments. Your statements on interest are unusually good. I am certainly glad that you brought them out in the statement. They will excite the interest of people, I know, all over the country.

The bank profits, brought up by you, have been going up all the time. There is no reason why they should not, Mr. Meany, really, because the banks have the most lucrative franchise ever given to any group on earth. They issue the money for the country and do not have to pay for it, because it is money manufactured on the books of the banks, the most lucrative franchise we know. Although the banks have been paying interest on CD's or time deposits, they of course get their money free of charge by right of manufacturing it on the books, which is very helpful to them.

The interest burden on our national debt, compared to the past, is twice as much—a 100-percent increase. If the rates had prevailed that prevailed for 14 years before 1953, we would just be paying $8 billion a year on the national debt instead of $16 billion; $8 billion is quite a large amount for increase just on the national debt alone.

Regarding the 7-percent rate mentioned by you, I agree with you that for all practical purposes it is at least an 8-percent rate, because of the rules of the banks which require the borrowers to keep a compensating balance. That 8 percent is the low at that. It is much more than that, really, but of course they get their money, part of it, through the Federal Reserve, 5.5 percent. Then they get some on CD's, which, of course, go up to 6 percent. But most of it, they create in a costless way by permission of the Government. So they are not doing so badly after all.

Now, I know you are concerned about the fear of a depression and I share your view that we must do something to stop that and stop inflation. But if you are going to flirt with one or the other, let us flirt with inflation. Do not get over on the brink of depression. There are proven ways to stop inflation. There is no question about that. There is no known, proven way to stop a depression. Once it has started, you are just in for it, you just have to suffer it out.

There is one way I know that you can stop inflation, retard it quickly, and that is by increasing the reserve requirements of banks. Instead of permitting them to extend loans of 10 to 1 on demand deposits, lower that and you shut down on the loans some. That will take a little profit out of the banks. But the supervisory agencies are not leaning in that direction, never have. They do not want to take any profits from the banks. But they could cut down on inflation that way, and save jobs. They would save jobs that way. Then if inflation should become of a ruinous type, or approaching it, there is an additional known, proven way of stopping that, by having a tax to siphon off the excess purchasing power and pay it on the national debt. That would serve two good purposes. It would stop inflation to that extent. It is a definite way to stop it, no doubt about it. Then it helps the Government and helps the people and taxpayers, because by paying it on the national debt, it stops interest on that much of the national debt and it is very helpful.

So we have two known, proven ways of stopping inflation, we know it. But if we begin to lean over and do things that might throw us into depression, we are in very bad shape and of course, unemployment and everything else that you mentioned will be coming along with it.

May I suggest that your statement on the housing is wonderful, too. In your statement you mentioned, "the development of the new form of Government security, authorized by the Housing Act of 1968." I think that is the most important housing act that Congress ever passed. It covers many subjects, but that is a good one.

Now, the Federal Reserve has the power to buy housing mortgages. It has that power now. We were promised in the Banking and Currency Committee of the House that if we put that authority into the law, the Federal Reserve would take advantage of it and help out on the crisis in housing. But the Federal Reserve refused to do that. That is why I accused them of malfeasance in office because they had gone against carrying out the known will of the Congress as expressed by both Houses.

So I wish your fine organization, your very effective and influential organization, would give some thought to that, Mr. Meany, and see if you could not help us by putting in an oar in the direction of compelling the Federal Reserve to help out the housing crisis by buying housing paper.

They could make the interest rate whatever they wanted. They could make it 4 percent or 3 percent and hold that paper until it was marketable. It is possible to do that.

Mr. Eccles also testified one time, and Mr. Martin has testified in a similar way, that so long as the national debt is large, and it is now dominant in the market, the Federal Reserve can fix the rate on long-term Government bonds at 2.1 percent or 2.6, or anything that they want and keep it there. No question about that. They have the power to do it.

To that extent, a large national debt is of some importance to the people. It enables the Federal Reserve to establish lower interest rates on long-term bonds, and this of course is reflected in interest rates of all categories clear across the floor. I wish something could be done to make them work in the public interest in that respect and save all that interest.

Do you not think that your organization could make a special effort in that direction, Mr. Meany?

Mr. MEANY. Well, I sure will take a good look at it, because this is one thing that really concerns us, this high interest rate on housing, because it affects everybody. It affects everybody in the country.

Chairman PATMAN. And now the number of housing starts is increasing. Why? Because the word has gone out, the propaganda, if you do not buy now, the rates are going to get higher, the charges are going to get higher, you can buy cheaper now than you can later, although it is now very, very high. But it is cruel to get people to tie onto those conditions.

What do you think about a campaign to get people to pay their debts while we have some inflation and lots of money? Do you not think it would be a good time to encourage people to get out of debt, pay their debts? Of course, if there are no debts, there is no money. We would have to arrange for some money if everybody paid their debts.

Mr. MEANY. We would certainly be for that.

Chairman PATMAN. In fact, they are monetizing every kind of debt now. But it would be a good thing to encourage people to pay their debts. I know you will agree with that.

Thank you very much, Mr. Meany.

Senator Miller?

Senator MILLER. Thank you very much, Mr. Chairman.

Good morning, Mr. Meany.

I like your word that you use to describe the theory that there is an inevitable mechanical trade-off between unemployment and inflation—"Neanderthal." There are a few economists who I think probably could receive that terminology. I personnally agree very much with you.

As a matter of fact, Congress, in the Employment Act of 1946, a bipartisan-passed bill, set forth two goals for our economic policy—stable dollars and full employment. Yet there are some who persist in saying that that is impossible of attainment. And they use the Neanderthal approach.

That being the case, I am wondering why you state that full employment must be the Nation's primary economic goal? Why not full employment and a stable dollar? Because, you, yourself, recognize that there should be no trade-off. Congress has announced those twin goals as a part of economic policy 23 years ago. I think it might put the whole thing in a little better perspective if you had set forth the twin goal rather than just one.

Mr. MEANY. Well, we are for both of them, but we are saying that full employment should be No. 1. That is what we are saying, that it should be the primary goal.

Senator MILLER. I understand that you say it should be No. 1, but I point out to you that there is no No. 1 as far as Congress is concerned. In the Employment Act, we said there are two of them. Neither is to be traded off against the other. And you recognized that fact very well when you described the idea of a trade-off as being Neanderthal.

Now, I would like to ask you about one of your comments about the fact that profit-laden corporations are continuing to increase their investments in new and improved plants, machines, and equipment. Certainly, people in your organization benefit from that through increased job opportunities, do they not?

Mr. MEANY. Not always. All the new plants do not bring new jobs.

Actually, we find in a good many cases, where they build a new plant and close down an old one, they do that because the old one is obsolete and while they increase production, they do not always increase jobs. In fact, sometimes, it goes the other way.

Senator MILLER. Certainly you have to have people in the building trades to build those new plants.

Mr. MEANY. Yes.

Senator MILLER. And as you well know, the late President Kennedy and his administration came out with the investment tax credit for the social objective of encouraging more investment in new and modernized plant and equipment, with the purpose of trying to provide job opportunities in an area of structural unemployment.

Mr. MEANY. We think the incentive is there. We do not buy this idea that the Government has to create an incentive for people to expand their business. We think the incentives are there, the normal incentives that come with an expanding business.

Senator MILLER. Well, it is my understanding that certainly the previous administration maintained that the investment tax credit did indeed provide an incentive and that there was indeed an increase in jobs in those industries which benefited from the investment tax credit. Do you deny the survey showing——

Mr. MEANY. No; I do not deny that, but I take the position that we do not need that sort of an incentive in order for business to expand.

Senator MILLER. Now, I am sure that you recognize that there has been a very substantial squeeze on our favorable balance of trade and that in the last few years, while our exports have been going up maybe 6 or 8 percent a year, imports have been coming in at an increasing rate ranging from 18 to 24 percent. I am told that inflation has had a lot to do with this. I understand that if this trend continues, a lot of your people are going to be thrown out of work. Do you recognize any increasing problem on the rate of import increases and the——

Mr. MEANY. That is always a problem when it is applied to some special industry or special trade. But I think over the years, our balance of trade has not been unfavorable. Our balance of payments has been unfavorable, but not our balance of trade.

Senator MILLER. Our balance of trade was just great in 1964, and it has come down to where it is about zero now. I understand that you people are very concerned about the pressure of increased imports and potential loss of jobs as a result of that. Certainly job opportunities are affected by increased imports and inflation is at the heart of it.

Have you given any study to the impact of these increasing imports in the last 2 or 3 years on the jobs of people in your organization?

Mr. MEANY. What was that, Mr. Miller?

Senator MILLER. Have you given any study to the impact?

Mr. MEANY. Oh, yes; we have been deep into this. There are many other factors in this outside of the question of inflation. We would be glad to submit a result of our study to the committee on that.

Senator MILLER. I think it would be of great interest to the committee, certainly to me, if such a study would be made available.

Mr. MEANY. We will see that the committee gets it.

(The AFL-CIO subsequently provided the following:)

MAJOR FACTORS IN THE U.S. FOREIGN TRADE BALANCE

Major factors affecting the U.S. position in world trade include several recent developments of growing importance, as well as older, traditional factors of economic competition among firms in different countries.

Merchandise exports from the U.S. have been approximately $29.2–$33.4 billion a year, in the past three years, and merchandise imports have been about $25.5–$33.3 billion in that same period. While foreign trade represents a small share of total U.S. production, it affects specific industries and products and these effects are greater than in the past.

Examination of the record indicates the following: (1) Total merchandise exports have continued to rise, in recent years, but imports have risen at a faster pace, resulting in narrow surplus of exports over imports; and (2) The deterioration of the U.S. position in world trade has been concentrated essentially in manufactured goods.

Frequently there are attempts to explain this deterioration simply in terms of differences in hourly wage rates, between the U.S. and other countries. But buyers do not purchase hourly wage rates—they buy products at a price. The price is importantly affected by profit margins and such costs as raw materials and energy (electricity or coal, etc.) per unit, as well as the cost of labor per unit.

The labor cost, therefore, is one of several different cost factors. Moreover, the unit labor cost is the result of productivity (output per man-hour) and the hourly compensation of employees, so that the combination of high wages and high productivity can result in low unit labor costs. Indeed, America's traditional prowess in world trade has been largely based on high wages, combined with high productivity—on technology, efficiency of operations, manpower skills, large volume of output and a highly educated population—as well as on the availability of raw materials and sources of energy.

However, foreign trade competition does not center on prices, alone. Product design, for example, is of great importance in the export and import of many items. Other non-price, competitive factors in world trade include patent and licensing arrangements and the servicing of foreign-purchased equipment. An additional competitive factor is that, since the mid-1950s, new trading blocs have been formed, with U.S. assistance, and new competitive prowess has come to nations that were previously devastated by war.

All of these competitive economic factors play a part in world trade and have their impacts on U.S. exports and imports. But major factors of another nature have become increasingly important since the mid-1950s. The emergence of these new factors is substantially reducing the importance of the traditional, competitive economic factors in world trade. And these new factors are crucial to any attempt to understand the deterioration of the U.S. trade position in processed and semi-processed goods.

1. The sharp rise of direct investments of U.S. firms in foreign subsidiaries, plants and other facilites has had an impact on U.S. foreign trade, as well as on the balance of payments. For example, such investment outlays on plant and equipment skyrocketed from about $3.8 billion in 1960 to an estimated $10.7 billion in 1968—partly financed by outflows of U.S. capital and partly by profits and depreciation of foreign subsidiaries and by foreign-raised capital. In manufacturing facilities, alone, U.S. firms at least doubled the book value of foreign direct investments—from approximately $11 billion at the end of 1960 to about

$22 billion at the end of 1966 and undoubtedly a significantly larger sum at present. This soaring rise of foreign operations of U.S. firms has had impacts on both the composition of U.S. exports and imports and on the size of the U.S. mechandise trade surplus.

2. Techonology has become increasingly international in the past quarter of a century. The trend towards the internationalization of technology has been speeded up, since the mid-1950s, by the skyrocketing rise of investments of U.S. firms in foreign operations and the transfer of American technology. This trend has resulted in a reduction or elimination of the U.S. technology-productivity lead in many industries. The internationalization of technology and reduction of the U.S. technology-productivity lead—spurred by the sharp rise of foreign investments and licensing arrangements by U.S. firms—provides a distinct advantage to very low-wage countries, even when raw materials have to be imported and energy-costs are expensive. The rapid, international spread of technology has had an impact on U.S. exports, imports, and the foreign trade balance.

3. The rapid spread of multi-national corporations—usually U.S. firms, with plants, offices, licensing arrangements, sales agencies and other facilities in numerous countries—is another factor of growing importance in affecting the U.S. position in world trade. The spread of these U.S.-based, international companies is directly related to the skyrocketing rise of foreign investments of U.S. firms and the rapid internationalization of technology. It contributes to the reduction or elimination of the U.S. technology-productivity lead in numerous industries. And, to an increasing degree, it has made obsolete the traditional, textbook theory of comparative advantage of national economics in the production of differing goods. Moreover, a considerable and probably growing proportion of U.S. exports and imports are now intracorporate transactions, among the various multi-national facilities and operations of these firms—with increasingly important decisions that affect the national economy and international trade relations, made by the top managers of such private companies.

Among the major, U.S.-based international companies, according to *Fortune* magazine, are General Motors, Standard Oil of New Jersey, Ford, Chrysler, Mobil Oil, IBM, International Harvester, Dupont, International Telephone and Telegraph, Caterpillar Tractor, Singer Sewing Machine, Anaconda Copper, Minnesota Mining and Mfg., Colgate-Palmolive, Warner-Lambert Pharmaceuticals, Pfizer Drug, U.S.M. Corporation and Massey-Ferguson. These films have production facilities in as many as 40 or more countries, with large percentages of their total assets in foreign operations.

An article on the multi-national corporations, in the September 1968 issue of "Fortune," states:

"When it (the multi-national company) operates in many different markets with varying labor conditions, market demands, money-market rates, tax laws, etc., the corporation finds multiplying opportunities to buy cheap and sell dear, provided that it can closely coordinate all the parts of its operation. Carrying multinationalism to the logical extreme, a corporation will concentrate its production in the area where costs are lowest, and build up its sales where the market is most lucrative. Thus some U.S. electronics manufacturers are using plants in the Far East to make components for equipment sold in the U.S. market . . .

"The multi-national company can also adjust the prices on these intra-company sales according to a deliberate plan. For example, if a country is in foreign-exchange difficulties, it may earmark the scarce exchange for imports but not allow dividends to be remitted abroad. A multi-national company could simply 'take out' its dividends by raising prices on intra-corporate sales proportionately. Transfer prices are also a useful device for keeping down the over-all corporate tax liability. Subsidiaries can be instructed to set high prices on intra-corporate shipments to high-tax countries, low prices on those to low-tax countries."

4. An additional factor of great importance that affects the U.S. position in world trade is the spread of managed national economies in the past 25 years. While the text book theory of world trade assumes free competition in world markets, with a few interferences, the reality of world trade involves managed national economies, with direct and indirect government subsidies for exports, barriers to imports, policies and practices to encourage exports and discourage imports.

These new developments are drastically changing the factors of major importance in world trade. According to the next book theory, for example, import quotas are supposed to hurt the advance of a country's productive efficiency and inflation is supposed to reduce its ability to compete in world markets. But, in recent years, Japan has achieved susbtantial advances in economic efficiency and great prowess in world markets, despite numerous import quotas and a rapidly-rising price level. Or U.S. firms profitably produce electronic components in very low wage—generally low productivity countries, through the use of mechanized U.S. technology, although raw materials may have to be imported and the components may be shipped great distances for final assembly in other facilities of the companies. There are all-too numerous other examples of the declining importance of traditional considerations in world trade.

The present U.S. position in world trade, therefore, is affected not only by such traditional, competitive factors as price and product design. It has been increasingly affected by new factors of major and growing importance: the sharp rise of foreign investments of U.S. firms, the rapid internationalization of technology, the spread of muti-national corporations and the rise of managed national economies. Yet the foreign trade policy of the U.S. seems strangely to be based on the text book theory of comparative advantage and free, competitive markets in world trade, with a few interferences—as if the world had not changed in the past quarter of a century.

The nature of the U.S. position in world trade needs to be examined in the light of these recent, major developments. America can achieve a rational foreign trade policy, only if it comes to grips with these issues and adopts policies, in the national interest, to deal with these problems in the real world of our time.

Senator MILLER. Have you made a study of the impact of deflation or the depreciation in the purchasing power of the dollar on the retirement pensions of people in your organization?

Mr. MEANY. Our various organizations have made studies. I do not know if we have made an overall study on this. This, if course, is obvious that it has that effect.

Senator MILLER. For example, we made a study and found that since 1965, when the 7-percent increase in social security went into effect, since that time, inflation has cost people under social security $3 billion in purchasing power. It is just the same as taxing them. I wonder if you have made a comparable study to find out how much inflation has cost the workers with retirement pensions?

Mr. MEANY. We do not have an overall study, but our various international unions that are concerned with that, I am sure they have made studies and this has now become the subject of collective bargining. There are many cases where the pension amounts have been raised through collective bargaining in order to bring those people up to date.

Senator MILLER. Another area which inflation hits very hard is people in your unions who are trying to send their young people to college. According to the Office of Education, since 1960, the cost of a college education has gone up over a thousand dollars a year on an average. That is traceable largely to inflation. I would guess that is of serious concern to you and your members.

Mr. MEANY. All of these things are of concern to our members, because our kids go to college these days, too. That is one of the reasons why we say Congress should take a good look at this. We think it is a profit inflation.

Senator MILLER. Did it ever occur to you. Mr. Meany, that maybe the thing starts right down here on Capitol Hill, when those in control of the Congress vote to run your Federal Government billions and billions of dollars deeper into debt year after year? The record shows that in the last 8 years, they have done that to the extent of $70 billion. That has been accompanied by inflation amounting to $240 billion. So it seems to me that this ought to be taken into account at least as to where this starts. I find a very definite relationship between the fiscal management on the part of those in control of your Congress and the inflation that has been hurting your members and the rest of the people in this country. I would hope that your economists would make a close study of that.

My time is up.

Thank you, Mr. Chairman.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. Mr. Meany, I agree with the chairman that this is a very helpful and useful paper that you have given us this morning. I especially appreciate your emphasis in the area of housing, monetary policy, tax policy, the specific recommendations you make, included in part of your presentation.

You put a lot of emphasis, Mr. Meany, on the effect of profits on prices. You feel that the very great increase in profits over the past 8 or 9 years has had a lot to do with the fact that prices have risen so sharply. I think that you made a strong case, as you say; profits have gone up more rapidly than just about any other element of income. Your prescription as to what to do about it is, as I understand it, No. 1, tax reform; and No. 2, repeal of the investment credit which you feel would tend to reduce the profits somewhat.

You do not indicate any support for wage-price guidelines. I understand that is a very serious problem with your organization. Some of us on the committee feel that this might be helpful. And you do not give any indication of support for so-called presidential jawboning. We feel that if the President speaks out against administered price increases designed to increase profits, this has a very salutary effect in persuading those who have this kind of power over increased prices not to do it. One example is in the oil industry in the last 2 or 3 days. Texaco, which had marvelous profits in the last year, the best profits it ever had, started the ball rolling by a big increase in their prices. This was followed within a few days by other major oil companies increasing their prices. My staff tells me this is going to increase the cost of living very greatly. It is going to mean another $1 billion of cost to the American consumer.

Steel mills have increased their profits recently, more moderately, but they have started increasing them.

In view of the high profits that these companies have enjoyed, do you not think it would be desirable for the President of the United States to speak out clearly and emphatically, challenging this kind of action?

Mr. MEANY. No, I do not think in peacetime that we should have Government control of wages and prices.

Senator PROXMIRE. I am not talking about control. I am talking about whether or not the President ought to speak out, as President Kennedy and President Johnson did, calling attention to price increases that are piled on top of situations where these companies have enjoyed big profits.

Mr. MEANY. No, I do not think so. I think we point to some methods to handle this. I am sure that if the 7-percent investment tax credit were repealed, this would reduce profits somewhat.

Senator PROXMIRE. You would rely on taxes entirely, then, as your method of helping here?

Mr. MEANY. I do not believe in the control of these things by the administrative branch of the Government; no.

Senator PROXMIRE. Well, Mr. Meany, it is a question as to whether this is peacetime. We had some real price controls, credit controls and so forth, in the Korean war and World War II. Many would say this is a war period.

Mr. MEANY. We did not object to those. We cooperated in that period.

Senator PROXMIRE. I know you did.

Mr. MEANY. We have stated, I think, at least a half dozen times in the last 7 or 8 years, that if the President of the United States feels that this military situation is such that we should have controls, we will go along. But we want equitable controls. We want controls on everything, not just on the wages of those who work for hourly wages.

Senator PROXMIRE. I am talking about two different things. No. 1, wage-price controls—I understand your position on that. It has been stated clearly.

No. 2 is a different position, however. That is that the President should speak out when these large firms that have price leadership influence increased prices and where the justification seems to be very slight, if there is any.

Mr. MEANY. I certainly will have no judgment on that. I would not presume to tell the President whether he should speak out or not.

Senator PROXMIRE. You have made, I think, a fine analysis of the restraining effect of high interest rates and monetary policy on housing. However, I still feel it would be possible, as the outgoing administration said, for us to achieve the very limited housing goals for low- and moderate-income housing that they set. They only asked for 233,000 low- and moderate-income housing units to be built in 1969. The Secretary of Housing and Urban Development has called the goal unrealistic, indicated that he does not think it can be achieved. Do you think we have the resources to achieve this kind of a goal for low- and moderate-income housing this year?

Mr. MEANY. What do you mean by the "resources"? We sure have the manpower for it.

Senator PROXMIRE. That is what I am asking. In your view, if we follow sensible policies, can we achieve that goal?

Mr. MEANY. Yes, I think so. I do not think it is unrealistic at all.

Senator PROXMIRE. In addition to the credit limitation, one of the difficulties has been the availability of lumber. Lumber prices have been going up at a terrific rate. We are starting hearings on that next week in the Senate Banking Committee. I presume you would agree this is something that requires looking into, investigation.

Mr. MEANY. I think you should look into every phase of it. I do not think it is—when you figure the cost of labor you have to figure all other costs. Onsite labor is not a very large percentage of the cost of a finished home. I think the largest item is the cost of hiring the money.

Senator PROXMIRE. We have had some testimony before the committee during these hearings. It would be very helpful to get your advice, because I think you are one of the most expert witnesses we are going to have on this.

How about the availability of labor—is there enough labor available in the construction business to do this kind of a job?

Mr. MEANY. Yes, I think so.

Senator PROXMIRE. Are you sure there is?

Mr. MEANY. Yes, I am quite sure there is.

Senator PROXMIRE. Pushing that a little farther, we have very ambitious goals over the next 10 years, as you know; 26 million housing starts over the next 10 years. We hope to average 2.6 million housing starts per year. This will involve a big increase in labor in housing.

Mr. MEANY. We are expanding all of our trades. We are expanding the apprenticeship training programs at the present time, reaching out to get minority groups in. I am pretty sure we could meet that demand.

Senator PROXMIRE. All the trades are expanding their programs?

Mr. MEANY. Yes.

Senator PROXMIRE. We have had some testimony before this committee on the minimum wage, an indication on the part of administration witnesses that they feel we should not seriously consider increasing the minimum wage, even if we project the increase a year or two ahead of now. The argument has been that at the present time, we ought to sit tight with what we have. Further, they feel a minimum wage increase might be inflationary. Some of us question this position. You and your organization have had a deep interest in this, a great competence in this area. How do you feel about the possibility of Congress considering an increase in the minimum wage?

Mr. MEANY. Well, I think it is pretty much open and shut. There are millions of people who are getting less than what the Government itself says is a poverty level. I think the least the minimum wage should do would be to bring up the wages to the minimum of those who work a full year, at least to the so-called poverty level. We think this takes $2 an hour.

Senator PROXMIRE. $2 an hour. On the basis of your experience in the past, and you have had a lot of it—we have increased the minimum wage many, many times, as you know—do you feel that such an increase would be inflationary?

Mr. MEANY. I do not know whether it would or not, no.

Senator PROXMIRE. How much urgency would you put on this increase in minimum wage?

Mr. MEANY. Well, I think when you look at the millions of people involved and realize that they are not making a contribution in the way of consumers in the country's economy, I think it is very, very urgent that you bring these people into the economy. Now, of course, we have gotten the same arguments for the last 30 years about minimum wages, they are going to put people out of business and ruin the economy. But our experience shows that this does not happen. Our experience shows that everybody benefits when you take a person who is not in the mainstream of the economy, not carrying his weight as a purchaser, when you put him in the mainstream, everybody benefits; those who are not directly affected—the small businessman, the banker, everybody benefits from this. We think this is fundamental.

Senator PROXMIRE. How about increasing the coverage of the minimum wage?

Mr. MEANY. Well, there are millions still outside. We think they should be covered. We have advocated increased coverage. We do have, of course—we have increased the coverage over the years, but there are millions still outside. We think it should be all inclusive.

Now, of course, there may be some practical areas where you have to exempt, but by and large, our position is that everybody should be covered.

Senator PROXMIRE (now presiding). My time is up. I will be back, Mr. Meany.

Mr. Rumsfeld?

Representative RUMSFELD. Mr. Meany, in your statement, you indicate, under point No. 8, that the trade union movement is disturbed by the accelerated rate of economic concentration in the past few years and the impact of this trend on the national economy. You suggest that the Congress and the executive branch should make the facts fully known and curb the adverse impact of this trend.

I would be interested in some amplification of what you view to be the adverse impact of this trend. I take it from what you say here that you think that the antitrust policy of the last 4 or 8 years has been something less than aggressive. Is that an accurate statement?

Mr. MEANY. I would say so, yes. Frankly, we are very much concerned about this concentration of economic power in the hands of a few people. We would like the Government to take a good look at it and find out if this is not a way by which these people are avoiding the law as it is presently written, the antitrust and monopoly provisions of the law.

Representative RUMSFELD. You mention adverse impact of this trend. What has been the adverse impact? I would be interested in hearing you indicate——

Mr. MEANY. We are not sure.

Representative RUMSFELD. You suggest that the Congress should curb——

Mr. MEANY. We have a suspicion that the adverse impact is on the price levels.

Representative RUMSFELD. On the price levels?

Mr. MEANY. Yes.

Representative RUMSFELD. Your statement, the way I read it, says that you would like the Congress to study it and make the facts fully known and then curb the adverse impact.

Mr. MEANY. If any.

Representative RUMSFELD. If any, of the trend. Does that suggest that you do not want the trend curbed, but you want the impact of the trend curbed? Do you follow me?

Mr. MEANY. Well, I think we would like to see the trend curbed as well as the impact.

Representative RUMSFELD. I see.

Turning to a different area, we had testimony and discussion on the problem of union discrimination against minority groups when the Joint Economic Committee heard witnesses on the subject of the Kerner Commission report. Some of the testimony from witnesses and some of the comments from members touched on the question of the problem of union discrimination against minority groups. In the Kerner Commission report, there was a complimentary reference to the

AFL-CIO and the work that they have been doing in an attempt to see that members of the minority groups have access to union membership. You made a comment, I think to Senator Proxmire, that you are working on this. It would be useful to me, because I don't recall that we had any representative of the trade union movement during the Kerner Commission hearings, if you could supply for the record some of the things you are proud of, some of the progress that has been made, and the specific numbers of individuals from minority groups who have gained access as a result of the effort that has been made in the AFL-CIO. Would that be possible?

Mr. MEANY. We could send you the record to date of our "reach-out" program which I think has been extended now to about 40 cities or more. We have been working on it with the Department of Labor. And this is a program by which we reach out and get these minority groups, coax them, if you will, to come in—and that is just about what we are doing—we train them, give them apprenticeship training, give them on-the-job training, and provide them with jobs. This has been quite successful.

Now, in point of numbers, I would not say the numbers are impressive, but this thing has been only going on since about last spring. We would be happy to furnish you or anyone else with the record on that.

Representative RUMSFELD. It would be useful to me, and I imagine to the committee, to have that information submitted, because we did discuss this at some length. I note in your statement that you properly, and I think accurately, mentioned the problem of unemployment and the downturn of the economy as it very frequently affects minority groups first. These are the people that are so often the last hired and the first fired.

Mr. MEANY. They have the highest rate and if there is a turndown, they will be the first ones affected.

Senator PROXMIRE (presiding). If the gentleman will yield, I agree wholeheartedly. This is an excellent line of questioning.

I agree the AFL-CIO has done a good job. We would like to know if you have anything you can furnish us on this, because labor is often attacked by people who are not very well informed, in this area.

Mr. MEANY. I do not say, Senator, that we should not be criticized, because in the final analysis, we are only too ready to admit that discrimination which existed in this country, by and large, in all areas of the country, also existed in the trade union movement and perhaps does in certain places yet.

But we can document, I think, a record of effort, at least, on our part over the years, an effort which we think is paying off. But that does not mean that there are not some pockets here or there where there is still discrimination. And we are just going to keep on working on it.

In fact, I am quite proud of the progress we have made and I would be delighted to have the head of our civil rights department come to this committee and present you with his records. I think we are making progress. But we have a long way to go.

(The AFL-CIO later supplied the following for the record:)

Examples of Trade Union Efforts to Assist Minority Groups in the Work-Force

APPRENTICESHIP OUTREACH PROGRAMS

Efforts to successfully recruit minority-group young men into labor-management apprenticeship programs that will qualify them for skilled occupations have begun to achieve significant results in the past two years.

Having come to the conclusion that merely assuring non-discrimination would not result in any significant number of minority-group youngsters entering apprenticeship programs, the AFL–CIO Civil Rights Department began to develop, several years ago, special programs that would recruit, motivate and prepare minority-group youth to become apprentices in skilled trades occupations.

A small pilot project started, in 1964, by the Workers Defense League in New York City proved successful and was used as a model for developing Apprenticeship Outreach programs in other cities. These Outreach programs recruit, tutor and counsel minority-group young men, to prepare them to qualify for entry into apprenticeship programs for good-paying, skilled occupations.

In its 1967 convention resolution on civil rights, the AFL–CIO stated:

> "The AFL–CIO Civil Rights Department, with the cooperation of the Department of Labor, the Building & Construction Trades Department and building trades councils throughout the country, have concentrated their efforts in working with the Joint Apprenticeship Committee (Workers Defense League/A. Philip Randolph Education Fund), the Urban League's Labor Education Advancement Program (LEAP), the Trade Union Leadership Council, the Opportunities Industrialization Center (OIC) and other groups.
>
> "All of these have developed programs for recruiting, tutoring and counseling apprentices who qualify in meeting existing standards for apprenticeship programs. The U.S. Labor Department has already made grants to programs of these kinds in 16 cities. The AFL–CIO endorses these programs and recommends that they be studied and emulated in other cities."

In February 1968, in a letter to Secretary of Labor Wirtz, C. J. Haggerty, President of the AFL–CIO Building & Construction Trades Department, stated that his department proposed, both directly and through its affiliated international unions:

"(1) To foster, with the cooperation of appropriate management organizations:

> "(*a*) programs of recruitment of qualified applicants for apprenticeship from the Negro population and other minority groups, and,
>
> "(*b*) programs for special attention to deficiencies affecting the full qualification of Negro and other minority group applicants, if such exist, and remedy the same if practical;

"(2) To endorse and support projects such as Outreach and LEAP. . . ."

On October 7, 1968, the Manpower Administration of the Labor Department reported on the progress of minority-group young men in the apprenticeship programs of the building trades and other apprenticeship-requiring trades:

> "Negroes have nearly doubled their participation in apprenticeship programs in 18 months, Secretary of Labor Willard Wirtz announced today.
>
> "An estimated 8,100 Negroes are currently in apprenticeship programs registered with the U.S. Department of Labor or with State apprenticeship agencies, the Secretary said . . .
>
> "He said that the Apprenticeship Outreach programs, supported by Labor Department technical and financial assistance, have played a decisive role in the improved participation . . .
>
> "All minority groups, including Negroes, Spanish-speaking Americans, Indians, and Americans of Oriental parentage add up to 16,200 or 7.2 percent of the Nation's registered apprentices. Negroes represent the largest minority group, 3.6 percent; Spanish-speaking Americans account for about 4,050 or 1.8 percent; Indians, 2,475 or 1.1 percent, and Orientals, 1,800 or .8 percent.
>
> "During the six-month period ending June 30, 1968, approximately 2,500 or 9.4 percent of the 26,156 *new* apprentices registered with the Bureau of Apprenticeship and Training were minorities, the Secretary said. Minorities represented 6.2 percent of new apprentices in the previous six months.
>
> "'It is quite apparent that not only has there been an increase in the total number and rate of minority apprentices, but the rate of entry has improved considerably,' Wirtz said."

The Apprenticeship Outreach programs have been spreading rapidly in the past two years—with the cooperation of the AFL–CIO Civil Rights Department, the building trades unions, the Workers Defense League, the A. Philip Randolph Education Fund, the U.S. Department of Labor and the Urban League.

An example of the progress of these Outreach programs is indicated in the following: At the December 1967 convention of the AFL–CIO, Roy Wilkins, Executive Secretary of the NAACP, quoted a 1966 Civil Rights Commission report to the effect that in 6 mechanical building trades programs in Cleveland, there were only 6 Negro apprentices. However an Outreach program had begun in Cleveland in October 1967, several weeks before Mr. Wilkins' remarks to the AFL–CIO convention. By the end of 1968, this Outreach program in Cleveland had placed 142 Negro apprentices, many of them in the trades that Mr. Wilkins had spoken of: 21 in the electrical program, 26 in the ironworkers program, 31 in the pipe trades, 11 in the sheetmetal trades.

In February 1969, there were Apprenticeship Outreach programs in 52 cities. By that date, over 2,600 minority-group youngsters had been indentured into apprenticeship programs through Outreach efforts, alone.

It is particularly encouraging to note that not only has the flow of minority-group youth into apprenticeship (building trades and other trades) increased sharply, but their retention rate in these programs is excellent.

TRAINING PROGRAMS

There are a variety of other programs, sponsored by AFL–CIO unions, to bring minority-group workers into the economic mainstream. Perhaps the largest of such programs are those under the Manpower Development and Training Act in On-the-Job Training.

Under the MDTA–OJT program, there are 13 national contracts with seven national unions covering over 15,000 training slots. Under these contracts, the unions agree to recruit, place and train men and women who are unemployed and meet the Labor Department's specifications as "hard-core."

In addition, local unions in every part of the country have individual contracts with MDTA to provide on-the-job training for the "hard-core" group in their local communities. These contracts include such diverse trades as the Arizona Operating Engineers (with 35 training slots) to the Marine Cooks and Stewards (with 150 training slots).

There also are programs under such diverse sponsorship as the Maine State Federated Labor Council, AFL–CIO (300 slots) and New York District 15 of the International Association of Machinists (285 training slots). Over 3,300 training slots are involved in such MDTA–OJT contracts made directly with local unions of AFL–CIO affiliates.

One of the nation's major programs for bringing the "hard-core" from the inner cities into the work-force has been Job Opportunities in the Business Sector (JOBS), which is sponsored by the National Alliance of Businessmen (NAB). At the very outset of this program, the NAB asked for and received the active cooperation of the AFL–CIO. A coordinator for this program at the national level was designated by the AFL–CIO, and subsequently an AFL–CIO person was designated in each of the 50 communities in which the JOBS program was developed. AFL–CIO unions have cooperated with management in making it possible for this program to absorb minority "hard-core" individuals into jobs in the shops and plants.

When the Labor Department and the NAB requested the AFL–CIO to set up a program that would help to retain these "hard-core" workers on the job, a Buddy System program was devised. Union workers are given training, so that they can be teamed up with the trainee during the trainee's first several weeks on the job. This program is being expanded so that eventually each new trainee in the JOBS program can have a Buddy assigned to him to help him adjust to the job.

One of the problems facing disadvantaged workers in that, all too frequently, they are hired at entry-level jobs and because they lack adequate basic education, they are forced to stay at these entry-level jobs, with little or no prospects of promotion. The American Federation of State, County and Municipal Workers, recognizing the need for upgrading workers, has devised such a program for hospital workers in three cities: Boston, Cleveland, and Milwaukee. Under this program, entry-level workers are given assistance to help them move up the job ladder to become skilled hospital technicians.

This upgrading program is only one of several such programs which have been developed by AFL–CIO unions in the hospital field. Similar programs have been developed by several locals of the Service Employees International Union, as well as by Local 1199, the New York City Drug and Hospital Workers Union of the Retail, Wholesale and Department Store Union.

JOB CORPS PROGRAMS

Organized labor has supported the Job Corps and its concept of residential training for "hard-core" disadvantaged youth, from the very start of the program. As the Job Corps program developed, it became apparent that organized labor and the Job Corps could work together constructively on behalf of the youth for whom the Job Corps was created to serve.

The first union to be involved was the International Union of Operating Engineers, which contracted to train 70 young men in heavy equipment maintenance, repair and operation at the Job Corps' Jacob's Creek, Tennessee, conservation center. The Job Corps agreed that the training would be done by journeymen of the Operating Engineers' Union and in accordance with the joint union-industry training curriculum.

In addition, the union agreed to be responsible for placement of these trainees, who complete the one-year cycle of training. In the first year, about 55 men completed the training and were placed on jobs at a minimum of $3.65 an hour. These men will be absorbed in the union's apprenticeship program and ultimately arrive at the regular journeyman's wage of over $6.00 an hour. There are currently two Job Corps conservation centers under contract with the Operating Engineers, covering 140 slots.

The success of the Operating Engineers program encouraged the Brotherhood of Carpenters and Joiners to develop a similar program with the Job Corps, including placement in the apprenticeship program in a locality selected by the Job Corps trainee. The Carpenters contract calls for 60 slots in each of 10 Job Corps conservation centers. A third union—the Painters—also negotiated a contract with the Job Corps for training slots in Job Corps conservation centers. This program will be operated under the same conditions that the Operating Engineers and Carpenters programs are functioning.

These three programs can be expected to produce a total of about 1,500 men for the three trades. It should be noted that since the majority of Job Corps enrollees are black, Mexican-American or Puerto Rican, the men coming into these union-sponsored programs, and ultimately into the unions' apprenticeship programs, will come substantially from minority groups.

In addition to these assured placement programs sponsored by unions, the Appalachian Council of the AFL–CIO, a loose federation of 11 AFL–CIO state bodies in that region, has assumed the responsibility for recruiting 7,500 "hard-core" youth for the Job Corps and, at the same time, it has assumed the obligation for placing 2,000 Job Corps returnees into jobs. Another AFL–CIO group, the New England AFL–CIO Council, has assumed responsibility for recruiting 2,250 young men for the Job Corps. Many, if not most, of the young people involved in these labor-related Job Corps activities are from minority groups and, in most instances, they will find their way into the job market.

There are many additional labor-related manpower training programs, such as those operated by the Seafarers International Union and the National Maritime Union, as well as the numerous, regular apprenticeship programs in apprenticeable trades.

Representative RUMSFELD. Since this is the beginning of an era of approximately total candor, I want to say that I have been one of those who have been critical in the past. If I am wrong, or if I have said things that are no longer completely accurate, I would like to correct it and have the accurate information. I think this has been a particularly important problem, and certainly the difficulties that our society has had, many of which have been discussed in documents such as the Kerner Commission Report, point out the problem that we as a Nation have in this area.

Finally, I would be interested in having you, not as a representative of the AFL–CIO, but as a very knowledgeable individual in labor problems generally, give me some feeling, if you can, for what you foresee in 1969 in terms of work stoppages. You have been talking about the economic situation, and what happens in the economy of the United States depends, to some degree, on what problems this country might have in terms of strikes in various industries during the coming 12 months.

Mr. MEANY. Well, I can't tell you where there are going to be strikes. I know there are contracts coming up. I know in the electrical appliance industry, we are going to have a round of negotiations and I hope they will not result in strikes.

I do not call strikes. Those strikes are called by the membership of the unions. I would not like to predict that we are going to have any bad strikes. I hope we will not, but at the same time, you have to realize that this in free society we have, strikes are always possible.

Representative RUMSFELD. How about strikes that affect the national interest? There was a proposal that President Johnson made in writing and then he never, to my knowledge, sent legislation to the Congress following it up. He suggested that he was going to recommend legislation dealing with strikes that affect the national interest. Do you have anything——

Mr. MEANY. He did not, though.

Representative RUMSFELD. I know.

Mr. MEANY. Neither has anybody else.

Representative RUMSFELD. I am well aware of that. I take it that that suits you just fine.

Mr. MEANY. You are talking about national emergency restriction. Now, the present section of the law, I do not think, works too well. I do not know of anybody who is defending it. This is the so-called 80-day injunction, cooling off period. That has not worked. There have been all sorts of studies made. The President, I think, about 3 years ago—maybe more—sent a message up to Congress and said that he was going to have a study made and was then going to present to the Congress the results of that study.

Well, I do not think Congress ever got the results of that study. I do not know if the President did or not. But I am sure that people at the Cabinet level were studying this problem. Frankly, I do not know the answer to it. I do not like the present system, I do not think it works too well. In fact, in my experience, when you slap an 80-day injunction on the people involved, the net result is that these people to whom you deny the right to strike for 80 days, just go back to work and get prepared for the time when the 80 days is up. In the case of the recent Longshoremen's strike—the 80-day period was up on December 20, and when December 20 came, they went back on strike and stayed on strike for another couple of months.

Representative RUMSFELD. I know my time is almost up. Let me say that I do not like the present system, either. I think it is absolutely idiotic for the Congress of the United States to try to deal with these things on a patchwork, one-shot basis, as we did in the railroad industry. I do not think the Congress of the United States should function in that manner, nor should it pass separate legislation dealing with separate restrictions. It is time for the Congress and the executive branch to address themselves to this problem and try to improve the framework and organization to deal with these matters generally.

I thank you for your testimony and your responses.

Senator PROXMIRE (presiding). Mr. Bolling?

Representative BOLLING. Mr. Meany, I am delighted to see—although I am not surprised—to see how much emphasis you put on measures other than fiscal and monetary to deal with the problems of unemployment and the problems of poverty.

In discussing with some of our previous witnesses the lot of the poor and the prospects of the poor in the year ahead, it became quite apparent that certainly a large percentage of the poor are adversely affected by continuing inflation, and certainly a large percentage of the poor are adversely affected by an increase of the unemployment rate. I said without any disagreement on the part of the witnesses that we had before us, who were then commenting on the general prospects of the economy in one panel and fiscal and monetary policy in another panel, that very clearly the only hope the poor had did not lie in the field of fiscal and monetary policy so much as it did in the areas of manpower training measures and Federal programs to provide jobs specifically for those who are at the lower end of the economic mainstream, or out of it completely. So I am delighted that you have that emphasis. I have feared that what we might be facing in this year is an attempt to solve these problems the cheap way—that is, by fiscal and monetary policy without any necessary attention to the vast appropriations that will be needed to meet the problem of the hard-core unemployed and the poor of this country. There is no cheap way to meet a problem that has been neglected for 30 or 40 years. So I am delighted at that emphasis.

I also heartily agree with your point—many other points, but in particular the point that jawboning does not have much effect on prices and wages. I have felt that from the very beginning, perhaps because I had the experience of seeing what happened in the early days of the Korean war, when an attempt to jawbone just seemed to incite inflation.

There are a couple of things that I think the record ought to be clear on. There is no such thing as a Full Employment Act. There was once proposed, as a matter of fact, by the chairman of this committee, who was the original introducer of the Full Employment Act—and incidentally, I hope I do not embarrass the gentleman who sits to Mr. Meany's right—that he was then a Member of the Congress and he was one of the principal supporters of the Full Employment Act in that particular Congress in 1946, Mr. Biemiller. But Mr. Patman and Mr. Biemiller were very much involved in the full employment bill which, after a very difficult legislative experience, was watered down to the present Employment Act. Our history might have been very different if we had bipartisanship in 1946 instead of a bipartisan compromise which resulted in a very much watered down bill which is the Employment Act of 1946. But I am delighted to hear my friend from the other side take credit for the Full Employment Act. It represents a shift in the point of view which I think is very helpful—not of the individual, but of the position of the party.

Senator MILLER. Would the gentleman yield? I just wanted part of the credit.

Representative BOLLING. I am delighted to give you part of it.

Senator MILLER. Just half of it.

Representative BOLLING. Not half, but part of it.

The record—and I suggest if the gentleman is really interested in credit, there is a remarkably good book on the subject by Stephen Bailey, called *Congress Makes a Law*. It is one of the few books that really does describe what happens when Congress tries to pass a law.

I do not know what happens on the Senate side of the Capitol and what has happened in the last 8 years, but there is some suggestion that the Congress has been derelict in its duty in dealing with some of the problems that we have confronted of inflation and so on. I heartily agree. On my side of the Hill, on the House side, it has been, in my judgment, largely because for all but 2 of the 8 years past, the House of Representatives has been controlled by a perfectly honorable but very clear coalition of conservatives—mostly Republican and some Democrats—despite the apparent party label of the Democrats being in control. I think it is just important for the record to be clear that this Congress, in the House, for three of the last four Congresses, has been controlled by a conservative coalition. It has been that conservative coalition which has been irresponsible on fiscal matters, not just the Democrats.

No questions, Mr. Chairman.

Senator PROXMIRE (presiding). Mr. Brock?

Representative BROCK. I thoroughly agree with the first half of your statement.

I would like to commend you and say that I thoroughly agree with your statement in many, many aspects, particularly the suggestion of guidelines which I think experience has tended to prove can be a floor to prices as well as a ceiling and tends even more to create dislocations in that they choose one individual rather than the whole economy.

There is one question I would like to pursue. Congressman Rumsfeld delved into minority participation and the efforts that you have made. Do you have any figures on the percent of minority membership in the building trade unions, for example?

Mr. MEANY. No.

Representative BROCK. I was just a little curious. It seems to me that if we are going to have this emphasis on homebuilding, and I think this Nation is now committed to that as a policy matter, we have both Federal and private programs, that this will become a major area of employment opportunity for minority groups, and very good employment opportunities, at very high wage-paying scales.

Let me draw that into another point that you were making earlier in relation to the minimum wage. I am not so sure it is relevant any more to talk about minimum wage putting people out of business. But the point has been raised in this committee that it might prohibit people from being in business, people from getting jobs. The low skilled, the black community, which has by and large considerably lower educational attainment, and the very young, the teenager, which is the critical problem, I guess, in employment terms today.

Would you consider or would you comment on the possibility of the phase-in minimum wage—for example, based upon job tenure in an effort for us to open the door of opportunity for some people who simply are unemployable today because of the fact that the manufacturer or the operator of the service business does not think they are capable of earning or producing $1.60 worth of work now? If we go to $2 an hour, would you consider coupling that increase with a phased program based on tenure of, say, $1.50 for 6 months and then go to $2 after 6 months? Something like that?

Mr. MEANY. We have had that, what you call a phased-in program. We have had that in prior legislation. The last minimum wage raise was not extended to the new people for a year and a half. And certain ones are not up to the $1.60 even now.

Representative BROCK. I am not talking about the new groups that were brought in under minimum wage coverage; I am talking about industries that are presently covered but are unwilling to hire at this rate minority group members or teenagers, for example, that have a reduced skill level.

Mr. MEANY. You mean that there should be a special rate for these so-called minority groups?

Representative BROCK. I am saying that in terms of——

Mr. MEANY. Congressman Brock, you are talking about developing skills for these people?

Representative BROCK. Yes. I am trying to give them an opportunity to learn skills.

Mr. MEANY. The minimum wage is not directed toward skilled labor. If people have the skills, then they do not present any problems. Surely, $1.60 an hour is not a skilled wage.

Representative BROCK. Well, let me put it this way: You comment at some length on your rejection of excessive profits and in particular, of the emphasis on inflation, on investment that has taken place with the tax policies that we have, with the 7 percent allowances that we have given. You have mentioned that investment has gone up 100 percent from 1960 to 1968.

The question I would raise for you: Is it not quite possible, or is it not true, that these low-skill jobs are the ones that are most readily replaced by automation, and that as you increase the minimum wage without any exceptions or any incentive programs to generate a higher level of skill for minorities and teenagers, that you are encouraging the very process you reject, the increased emphasis on low-wage jobs and the reduced opportunities for low-wage earners?

Mr. MEANY. I am not sure I understand what you mean, that the advent of automation is displacing people who are getting below the minimum wage.

Representative BROCK. What worries me is that by raising the minimum wage and not giving any thought that people that are unemployed today are unemployed not because of their own lack of skill, but because we have provided inadequate skill and educational opportunities for them, that you further limit their opportunities when you raise the minimum wage without taking their special circumstance into account.

Mr. MEANY. But the record shows that that is not true. This is the argument we have been getting since 1938.

Representative BROCK. No, the argument you have been getting since 1938 is that this will put the small businessman out of business. It does not do that. I think we all agree that business has been fairly flexible in responding to the minimum wage. But they respond by reducing job opportunities at the minimum wage rate. They respond by putting more money into automation. You make automation cheap by not taking into account the special circumstances that apply to minority groups and teenagers.

Mr. MEANY. Well, the Secretary of Labor, in evaluating the impact of the 1966 amendments, reported that employment in the areas affected by the extension of coverage has increased and there is no evidence of any restraining effect on the broader coverage on employment opportunities.

Representative BROCK. I am not so much interested in increasing total employment, which goes up with population, let's face it, as I am with increasing opportunity for those who have no opportunity today. I speak specifically of minority groups and teenagers, dropouts who have not had educational background that allows them to compete with today's market. I think you are eliminating their opportunity unless you put some flexibility in this law which addresses itself to that situation.

Let's go on to this one point which you made at your AFL–CIO convention. I would like to ask you about this "black capitalism." You or many of your membership, unions, have laid some emphasis, an increasing emphasis of late, on participation through profit sharing. Is that not so?

Mr. MEANY. No. We have never advocated that. Particular unions may have.

Representative BROCK. Perhaps it was one of your colleagues who is not quite as close as he used to be.

Mr. MEANY. We have never advocated participation in management through profit sharing, but some of our unions have worked out plans, mainly on an experimental basis—Kaiser Steel in southern California, Fontana, I think, is the outstanding one.

Representative BROCK. I happen to believe in that particular approach. The point I was raising is the seeming desire for participation through profit sharing seems to be a desire to have a piece of the action, the ultimate action, as the case is put. I think that was the whole thrust of the argument for the so-called black capitalism approach, that the proponents of this legislation, including myself, felt that minority groups in this country ought to have the motivation that comes through having a piece of the action, a piece of ownership, a piece of equity. I really was very much surprised that you would take such an adamant position opposing, in opposition to this general concept for people that have suffered rather dramatically for the last 200 years. I wish you would comment a little more on the rationale of your position.

Mr. MEANY. Have you read our statement that was presented on the so-called economic progress of minorities?

Representative BROCK. I read a press report, which, I assume was fairly complete.

Mr. MEANY. It is in the record. This statement I have referred to has been submitted for the record.

Representative BROCK. If you do not care to comment, I would simply comment that I just disagree with your justification. I think there are real prospects for greater participation and involvement in this area.

My time has expired. I appreciate, Mr. Chairman, this testimony.

Senator PROXMIRE (presiding). Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Meany, I think your testimony has been helpful to this committee in its function of advising the Congress not only as to where the economy is today, but it is a little bit of the view to where it might be in the future. Most of the witnesses that have come before us this year have stressed past inflation, and have not, I believe, sufficiently cautioned us on the fact that maybe the course of economic expansion may have changed. Especially your statement that the Government's brake on economic growth may be going too far and it many threaten a sharp slowdown of economic activities. I think there are some economic indicators that should give us some pause on this. Consumer expenditures—in constant dollars—in the third quarter of last year went up 7.5 percent, and in the fourth quarter slowed to a rate of −.3 percent. The change in gross national product—also in constant dollars—in 1968 showed: first quarter, 6.6-percent increase; second quarter, 7.3 percent; third quarter 5.3 percent; and in the fourth quarter, 3.5 percent, which I think gives us a great deal of reason to listen very carefully to you when you say that we may be pushing the brake a little too hard and we may have to ease up on it. I think your statement will be of great help to us in advising the Congress generally.

Mr. Meany, in your testimony, you point out that if, indeed, the economy continues to expand and that we have have to push the brakes harder, we should do so in a way that does not create the growing army of unemployed. One of the phrases you use is "public employment service." Is this the concept that is also called the Government as the employer of last resort?

Mr. MEANY. Yes.

Representative MOORHEAD. You mentioned reduction of bottlenecks. Is this between the job demand over here and the employment surplus there and trying to get those two together?

Mr. MEANY. Yes.

Representative MOORHEAD. Has the AFL-CIO taken any stand with respect to, in addition to the Government as the employer of last resort, the concept of the negative income tax, or the family allowance?

Mr. MEANY. We have a statement on that. This is covered in our statement that was submitted earlier. We are just old-fashioned enough to believe that the one real cure for poverty is a decent job. You can try all these other things, but——

Representative MOORHEAD. I certainly would agree with you, at least to this extent, that before we get into these other programs, we should try out the Government as the employer of last resort to give the individual the feeling of pride and accomplishment holding down a job and reduce the number of unemployed to the ones who are truly unemployable for physical or mental incapacities.

The Nixon administration, as I am sure your are aware, appears to be thinking particularly in the field of manpower training—of proposing a policy of tax incentives for private employers to hire and train the hard core unemployed; that is, opposed to the existing manpower programs—MDTA, JOBS, the Job Corps, and so forth. Has the AFL-CIO taken a position for or against the use of tax incentives for job training?

Mr. MEANY. We have taken a position against these schemes.

Representative MOORHEAD. Could you elaborate? I am interested to know why. A great many of the Members of Congress think that the true budget costs of these programs would be buried and that we should adopt programs where the cost is clearly shown and known. I do not know if that is the same reason the AFL–CIO has taken their negative position.

Mr. MEANY. That is one of the reasons. This is all covered in this statement.

Mr. MOORHEAD. Thank you, Mr. Meany.

Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). Senator Percy?

Senator PERCY. Mr. Meany, I think one of the most important statements you have made is that the primary goal for this country should be full employment, to take away the onus of a person wanting to work, able to work, and not able to get a job. It may well be that the employer of last resort, the Government, will have to be resorted to. But I think we can agree that we have to resort to the private sector as much as we can, as present Government programs are grossly inadequate to achieve this goal. The Job Corps is just a symbol, it just scratches the surface.

I have talked recently to the Assistant Secretary of the Treasury for Tax Policy, Mr. Cohen, and to Secretary of Labor George Shultz about the possibility of an experimental program using tax incentives. I know you have not looked with great favor on this. But would you be willing to see whether we can try to draw out the hundreds of thousands of small employers that we cannot reach through the Alliance for Businessmen and other such major programs? Would you be willing to test out in, say, five or six cities, tax incentives for those businesses that would hire the hard-core unemployed—for people not having the educational or skill backgrounds to hold employment?

Mr. MEANY. I would say we would take a very good look at the legislation, but we, up to this time, do not buy the idea of tax incentives as a panacea for the problems of the so-called ghettos. We would like to get rid of the ghettos and certainly not do something that would perpetuate the ghettos.

Senator PERCY. I take it, then, that you don't have a closed mind on it. You would be willing to take a look at it and experiment?

Mr. MEANY. We would be willing to take a good look at it, but the things we have been offered so far, we just can't seem to buy.

Senator PERCY. Possibly if you cannot go for a whole program across the board, you would look with greater favor upon an experiment which would be limited, which might not even require much legislation, which could be tried out, a program in cooperation with the Treasury and the Department of Labor.

Mr. MEANY. Yes.

Senator PERCY. Could I ask you, also, about your attitude on the relationship of good health and people holding jobs? Our hunger hearings dramatically brought out the relationship between the lack of productivity and the inability of low-income people to hold a job because of poor health, malnutrition, and so forth, and the appalling lack of medical attention available for low-income people in rural areas as well as our slum and ghetto areas. Would you look with favor upon the possibility of extending the Hill-Burton Act, which now really provides only for the construction of bed hospitals, to using those funds, if a State and community wanted to, to build health centers and clinics, comprehensive clinics, in the center of the ghetto or an inaccessible rural community——

Mr. MEANY. We would be very much in favor of it.

Senator PERCY. You would?

Mr. MEANY. We think the question of the health of the American people today is something that should be the concern of every American. I mean the figures—some of the figures—that you get from the draft boards and areas like that show that the American people are not nearly as healthy as we like to think they are. We certainly would be for anything that would get into that problem.

Senator PERCY. I introduced last year at the end of the session, and will again this year, enabling legislation in this area, and I appreciate your comment very much indeed.

In the area of housing, it was almost as though we were anticipating this credit crunch now in the provisions that we made in section 235 of the Housing Act for subsidies to the poor.

I went out just last week and visited the families in Washington that now are paying as little as 1 percent on their mortgages. They have moved out of rented quarters that were almost despicable in their character, into brandnew, rehabilitated housing, paying only 1 percent interest, and their monthly payments are less to buy the house than they were to rent before.

Would you feel that HUD should place great emphasis on this? Should we now marshal all the forces that we can to stimulate this type of housing program?

Mr. MEANY. We are very much in favor of it. We think it is a very fine effort.

Senator PERCY. Could you comment also on the value of emphasizing rehabilitation? The grants so far that have been applied for have virtually overlooked rehabilitation. It is all new construction. In other words, it is homebuilders and developers going in after this subsidy money now and rehabilitation has been a very small part of it. Yet with an investment of $7,000 or $8,000, you can have plumbing that works, you can have kitchens that a woman wants to work in, rather than detests working in. You can take off the peeled plaster and put a clean finish on the walls and rehabilitate the floors. And you can buy these structures at relatively low cost. They exist all over, right in the exact areas we would like good housing to be, in the city. Can something be done to put more attention on the possibilities of rehabilitation as against just always looking at new construction?

Mr. MEANY. Well, we certainly are for anything that will get people decent homes. Your statement on the availability of the rehabilitation techniques—I do not know why it has not been used more. I really do not.

Senator PERCY. Fine.

Mr. MEANY. I know there has been a lot of experimentation with it, but somehow or other, it has not caught on.

Senator PERCY. I am very grateful. We have just drawn up a new commission on low-income housing of which I am a member, and I will be happy to work with you and your people in that area.

There are many questions asked about discrimination among people in the labor unions, and I know from talking with you how much you have done in this area. Is it possible to get any hard facts on what percentage of the AFL-CIO labor force is, say, black, and what the goal should be? Talking now about trade unions that have been talked about a good deal, what is it in the building trade?

Mr. MEANY. When you say "in the building trades," you must bear in mind that the building trades consists of 19 separate callings or skills.

Senator PERCY. I would be willing to take it by glaziers, carpenters, electricians, and so forth, and I would like to see those figures.

Mr. MEANY. The highly skilled area is the area where, in the past, there were no minority groups to speak of. Now, the plasterers, and the bricklayers, and the building laborers, have a tremendous proportion of minority groups and have had them for 50 years. The carpenters have them. The trades where they have not been in are the electrical, sheet metal, plumbing, and the so-called highly skilled trades. It is in this area that we concentrate this reach-out program.

Now, insofar as the overall percentage, I would guess, and this is a guess, that the overall percentage of membership of the AFL-CIO of Negroes is something a little over 12 percent. This, I think, is a guess, but I think it is a pretty good guess. We do not have a breakdown. For many years, we used to identify Federal unions as colored unions and so on, but we have cut that out many, many years ago, because we felt that in itself was discriminatory.

The membership of the AFL-CIO is a pretty good cross section in many ways of the makeup of the people of this country. We have all sorts of groups, all sorts of religions, and I think to the same extent that discrimination existed in the American society as a whole, it existed in the trade union movement. In 1940, there were 23 national unions in the national trade unions centers at that time that had a color bar in their constitution. Well, there are no national unions with a colored bar in their constitutions today. All of that has been removed. The trades where we have had the most difficulty, as I have said before, are the highly skilled trades in the building trades and the highly skilled trades in the manufacturing end of it, too. I think you will find that the percentage of minority groups in the building trades, skilled end of the building trades, is just about the same as the minority groups in the skilled portions of the manufacturing trades.

So our efforts are directed mainly at these groups. In other words, we are not concentrating to recruit Negroes for the plasterers or the laborers because there is no problem. There has never been any problem there. But we are recruiting Negroes and the minority groups for the electrical workers, the plumbers, the sheet metal workers, and those. This we are doing in strict agreement with the U.S. Department of Labor, working with them very closely, in what we call our operation "reach out." And we are having results.

Now, insofar as numbers is concerned, I would say that if you took the numbers compared to the total, you would find that the numbers are still very small. On the other hand, if you want to play the numbers game, you could say that starting from nothing, the first time you put one colored boy in you have made a tremendous percentage increase—if you want to use numbers that way.

Frankly, Senator, our experience has been that the minority groups are not hammering on the doors of these unions. They are not trying to get in. We are trying to bring them in. Take the electrical workers, where a high degree of skill is required, where a certain knowledge of mathematics is required. You just can't take a boy with no education and present him to an apprenticeship program in the electrical industry. It will not work.

Now, I recall about 6 years ago, the NAACP, the Urban League, the Human Rights Commission in New York, all got an invitation from Electrical Workers Union Local No. 3 to bring in a thousand apprentices. At the end of 3 years, they had less than 300. So it is not a question of keeping these people out. The policy of every one of these unions today is the policy of the AFL–CIO. And not only have they adopted the policy, but practically all of these unions have set up civil rights departments that work in conjunction with our civil rights department. And we now have this reach-out program, where we are reaching out, pulling these people in and training them, and I think we are making some progress.

Insofar as trying to figure it out on the basis of numbers, I think it is going to be some time before we can say that the percentage in these highly skilled callings is going to be the same as the overall percentage in the AFL–CIO itself. I think in the final analysis, our membership represents a pretty good cross section of the American people.

We, as a national body, have faced prejudices. We had thousands of our southern members who said they were going to leave the AFL–CIO back in 1956 because we supported the NAACP in the fight on the famous—when it resulted in the famous Supreme Court decision. But we have not changed our policy. Rather, the policy of our national unions is now completely in conformity with the policy of the AFL–CIO. But we still have pockets of discrimination in some of our individual unions, and I suppose we are going to have them for some time.

Senator PERCY. Thank you very much, Mr. Chairman.

I would like to say that I think that is a very good statement; it is a good objective to shoot for. I do think the military has proved beyond any question, as well as many fine industries, that there is no relationship between the competence and ability of a person to hold a technically skilled job and his color. It is just educational opportunity and prejudice. We have to break those barriers down and we have to open up opportunities for them.

Senator PROXMIRE (presiding). Thank you, Senator Percy.

I understand that when the chairman left the gavel, he also left me his position in turn, so I would like to ask you one or two more questions before I yield to Senator Miller.

I would appreciate it, Mr. Meany, if this is all right with you, if Mr. Biemiller and Mr. Goldfinger, both of whom are extraordinarily able, would comment on this question, too, because I know they have some valuable thoughts that would be very useful to the committee also.

I want to ask you this: You put a lot of emphasis—in fact, I would say if there is one theme that emerges from your statement, it is that we simply must not permit unemployment to increase as a price of coping with this very serious inflationary problem we have.

Now, some of us are very concerned that the administration seems to be walking away from measures designed to achieve exactly that, one being the wage-price guideline that you reject. I understand that. No point in talking about that any further.

Another is the Presidential leadership trying to hold down prices. You object to that and many others do. That is aside from the point now.

You indicate that you would put emphasis on manpower training programs so that those who are unskilled will be able to get the jobs now available. You also put some emphasis on antitrust. I think both of those are excellent. Both of those, I understand, tend to be long-range. The amount of resources we are committing to manpower training programs are far too limited to make much of a dent in this serious problem in the coming months.

I have looked at all the charts I can find on the relationship to the so-called Phillips curve, the relationship trade-off between unemployment and rising prices. It seems to be something we have always had in our economy, at least for many, many years. We get unemployment down below 4 percent, prices either that year or the next year go up very sharply. This is something we want to do our very best to overcome. I would like to ask you to tell us what we can do that we are not doing to change that situation.

I think if we do not adopt some new policies, we are going to have to face the very serious problem of 4½-5- maybe 6-percent unemployment. I just do not see that we can just relax and rely on fiscal and monetary policy and then some long-range programs that are good, that this is going to solve this problem.

Mr. MEANY. Well, I think that in the statement I presented, we made some suggestions.

Senator PROXMIRE. Well, you did, but I am wandering if they are enough, if they have enough bite in them. We had the same kind of presentation from the Secretary of Labor, a very able man, as we all know. But just the feeling of confidence—Dr. McCracken took the same position, that somehow we are going to be able to stem this inflationary problem without going above 4-, 4½-percent unemployment. How?

Mr. MEANY. Well, you see, these are long-range proposals of ours. Whether they are long range or not, I think it is time that we have done something about them.

Senator PROXMIRE. I agree. But, No. 1, you put more emphasis, more money, perhaps, into funding manpower training programs.

Mr. MEANY. Well, I have no suggestions, Senator, beyond these. Are you looking for something that can revolutionize this whole problem overnight?

Senator PROXMIRE. Well, you know, you have taken the most emphatic position. It is understandable, but all of us as politicians, and you as the outstanding labor leader in the country, are confronted with the same problem with our constituencies. We all say we are against inflation, but we also want to hold down unemployment. As I say, the whole history that we have had in this country indicates that we do not know how to do it.

Mr. Biemiller?

Mr. BIEMILLER. I yield to Mr. Goldfinger in this area.

Mr. GOLDFINGER. Well, one of the things, Senator Proxmire, that is mentioned several times in Mr. Meany's statement, is the idea of the Government as employer of last resort, the concept behind the bill that was introduced into Congress by Representative O'Hara of Michigan. For example, if the basic concept of that bill were, in effect, to create 1 million public service jobs over a period of a year, that in itself would reduce unemployment, both the reported unemployment rate and hidden unemployment, by about a million, which would be, probably, a reduction in the unemployment rate of about 1 percent or a little more.

Now, that is one of the things that was suggested in Mr. Meany's statement.

Another thing is a much more effective nationwide public emment service. The U.S. Employment Service at this time is not an effective nationwide employment service. We have 50 different employment services in the different States and in the District of Columbia operating rather separately. There have been some improvements made in coordination, but they do not go far enough, by any means. We believe that an effective nationwide U.S. Employment Service would be a very helpful thing here, certainly if it were combined with relocation allowances to assist workers who move from areas of unemployment to areas of job opportunity.

Senator PROXMIRE. Well, I think that the mobility of labor is certainly a very, very important factor, and I think that is an excellent suggestion.

As far as the O'Hara bill is concerned, I think it has a lot of merit. I am just wondering if you can argue from the standpoint of economic experience that if you reduce unemployment in this way, you will not have the same kind of inflationary problem. Maybe not, but I do not see how, if you get your employment down from two and a half million people out of work to one and a half million this way, it will be less inflationary than committing the private sector to it.

Mr. GOLDFINGER. I believe it would be.

Senator PROXMIRE. Why?

Mr. GOLDFINGER. Well, because these people at this point, as Mr. Meany indicated, are not fully participating in the economy. In many cases, they are a charge on the economy in the sense of welfare payments, in the sense of delinquency, and other kinds of social problems.

If these unemployed and seriously underemployed were provided the opportunity to get a decent living on an honorable basis, I do not think that it would be inflationary and I think it would reduce the charges on society caused by, to some degree, welfare payments and delinquency, and other social problems that are the results of widespread unemployment and underemployment.

I would also call your attention, Senator, to some figures that were presented by the Cabinet committee study, presented by Prof. George Perry, who, I believe, has either testified or will testify before your committee——

Senator PROXMIRE. He has already testified.

Mr. GOLDFINGER (continuing). That a lower rate of profit return on investment could be well associated with lower rates of unemployment and lower rates of price increases.

Senator PROXMIRE. I think that is true, but I do not see how you get that. There has been one proposal by Mr. Meany that we repeal the investment credit, and that might be helpful. But overall, I wonder if this would contribute sufficiently to get the lower rate of profit Mr. Meany is talking about.

Certainly on restraint, I think may Presidential leadership would help in achieving, might be useful in this regard. But absent that, I cannot see any factor that is going to retard profits.

Mr. GOLDFINGER. Well, Mr. Meany suggested in his statement that this major economic policy issue requires careful and objective examination by the Congress.

Senator PROXMIRE. Very good.

Well, I think this is the toughest problem facing us, and I think your suggestion is good and useful.

Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Biemiller, I appreciate your sending me a copy of the executive council's statement on social security and medicare at their recent meetings. I was particularly gratified to note that the executive council has come out in favor of automatic increases in social security benefits to keep pace with the increased cost of living. The statement said the "aged beneficiaries, living for the 'few and far between' increases, have had to bear long periods of decline in purchasing power. This will continue to be a serious problem until an automatic adjustment of benefits provision is included in the system."

As you probably know, I introduced a bill on that in 1965, and again in 1967. I regret very much that it was offered by way of amendment and was defeated because of administration-leadership opposition. It has been reintroduced. There has been increasing bipartisan support on this. And with the support of the AFL–CIO, I think we can get this measure passed this year. I hope that you will make every effort you can in conformance with that executive council statement.

Mr. BIEMILLER. Senator, this is not a new position for the AFL–CIO. We have testified to that effect several times.

But I would like to point out that while we regard this as a valuable amendment that ought to be made to the existing law, we are still putting our primary emphasis on bringing the basic rates up to a level that we think they ought to be at. It is not just a question of making amends for the cost-of-living increases that have occurred. We still are going to fight for a 50-percent across-the-board increase.

Senator MILLER. I understand. There are many things that need to have attention on the social security system. But one of the things that inflation, of course, has brought to our attention so much is the very point that is brought out in the executive council memo. I do hope that we can get full support on that, because I think we can get the job done because of the increasing attention that has been given this in the last few years.

Mr. Meany, I would like to get back to this minimum wage. As I understood your answer to the question on this, you indicated that you felt that the minimum wage ought to be such that a person who worked under it throughout the year would at least attain the level of income regarded as above the poverty level.

Now, at $2 an hour on a 40-hour week, that is $80 a week, and figuring a 50-week period, that would come out at $4,000.

Mr. MEANY. It is just a little above the Government's poverty level. But that would only be for the fellow who worked full time.

Senator MILLER. I understood that your point was that the minimum wage ought to be such that one who does work full time will attain that level.

Mr. MEANY. Yes.

Senator MILLER. I know there have been a lot of ideas about where this poverty level is, but something sticks in my mind that $3,000 would be it, and this would be $4,000.

A $1.50 minimum, using the same 50-week, 40-hour a week period, would be $3,000. So, I do not see, unless we are wide apart on what this policy level is, that the present minimum is not attaining it. Hopefully, we can work for a better level of earnings for everybody. But, thinking now in terms of this poverty level and adjusting it upward somewhat to reflect an increase in the cost of living over the past years——

Mr. MEANY. I think the present minimum is about $400 or $500 below the poverty level, Senator.

Senator MILLER. Well, my understanding is that $3,000 is the target and has been for——

Mr. MEANY. No; it is somewhere around $3,600, I think, now.

Senator MILLER. Well, my point would be that unless we get together on what that point ought to be, then we may go off in opposite directions on this minimum.

I do think that Congressman Brock had a very valid point, because while statistics may show increasing employment since 1966, do not forget that the war has had an impact in the form of about 2½ million jobs, over a million more in the armed forces and about a million and a half in industries related to the war effort. That could have a bearing on that employment picture. And then, further, I think everybody recognizes that the hard-core unemployed, the teenagers, and the young people are the ones who are having the most difficult time finding a job. Some way of getting them absorbed into the labor force, and if necessary, at a lower than minimum wage, until they are able to meet, you might say, the economic tests, I think, has merit.

Now, I would like to ask Mr. Goldfinger, especially, if he would care to comment on this statement. I will read it slowly. I want to read it, because I get back to this problem of the favorable balance of trade problem, and especially, the increasing imports. When we had a drop in our favorable balance of trade from something like $6.4 billion in 1964 down to practically zero in 1968, I must tell you that one of the things I think about is how many people in this country suffered losses of jobs on the net. I know there are job increases because of exports, but I am looking at the net. Here is the statement:

Some economists, writers and columnists have sought to play down the seriousness of our inflation problem by citing figures to show that the rate of inflation in many other countries competing with us in domestic and world markets has been higher. For example, they say that, during the 10-year period 1957–1967, the U.S. dollar depreciated at an annual rate of 1.7 percent; whereas the average annual inflation rate in France was 4.7 percent; in Japan, 4.1 percent; in West Germany, 2.2 percent; in the United Kingdom, 2.8 percent; in Argentina, 24.8 percent, and so on. But what they overlook is the fact that low wage scales in these countries can be increased to keep pace with their high rates of inflation and still more than compete with high wage scales in this country increased to keep pace with lower rates of inflation.

For example, the 1966 hourly wage in manufacturing in the United States was $2.71; and this rose 12 cents to $2.83 in 1967. The average in France for 1966 was 79 cents and this rose 5 cents, to 84 cents in 1967—almost $2 per hour less than ours. And note in that example that while our wages went up 12 cents to keep pace with the low rate of inflation, France's only went up 5 cents an hour. The average in Japan for 1966 was 51 cents; and this rose 6 cents to 57 cents, in 1967—$2.26 less than ours. The average in West Germany for 1966 was $1.11; and in 1967 this rose 4 cents to $1.15—still $1.68 less than ours. The average in the United Kingdom for 1966 was $1.29, and this went up 6 cents to $1.35 in 1967—$1.48 less than ours. In Argentina, the 1966 average was 49 cents and keeping pace with its high rate of inflation, which was over 24 percent, the 1967 average would have gone up 12 cents, just the same as we went up per hour, to 61 cents—$2.22 per hour less than ours. Except for Argentina, wage increases in 1967, to keep pace with inflation, put us even farther behind in meeting competition from overseas and the squeeze on our favorable balance of trade should not be surprising.

Senator PROXMIRE. Would the Senator identify for the record the person who made the statement?

Senator MILLER. The person who made the statement is the person who is now speaking, but I based these upon statistics which we obtained from appropriate sources—from the Labor Department and the Commerce Department.

Mr. GOLDFINGER. I think, Senator, that what you just described is a part of the picture, but probably only a small part of the picture. There is a problem that you point to. But, I do not think that it is anywhere as great as you indicate. In the first place, foreign trade competition obviously has a relationship not only to things that are developing in the United States, but what is happening in the other countries in terms of their prices and their efficiency.

Another thing is that in many industries, our productivity levels, our efficiency is greater than in other countries, and this varies, depending upon what industry and what country your are comparing things with.

Another factor in terms of the figures you cite is the hourly wage comparisons are sharply different as you describe. However, the fringe benefits in most of these other countries are considerably greater than the fringe benefits here, so that the hourly compensation, taken as a whole in most of those other countries is greater than the hourly wage figures would indicate.

For example, in Japan, all workers after a certain number of years of work have guaranteed lifetime employment. In France, family allowances are worked into the pay structure on top of the hourly wage. There are all of those factors, plus the factor of productivity, in which we have in many industries, we still have a bit of a lead.

But, let me suggest, as an additional point in the area of foreign trade which we in the labor movement think is very important. Foreign trade at this point in time is not simply based upon price alone. There are a lot of new factors that have crept into the picture during the later 1950's and 1960's. For example, we have had a very large scale increase of private foreign investment, foreign investment of U.S. corporations overseas. We have had the development of international technology so that the degree of technological lead of the United States over many other countries in many industries is now smaller than it was before, if not entirely eliminated.

Furthermore, we have had the large scale development of international corporations. And we are competing not in a competitive free enterprise world market, but we are competing with managed economies in which many other countries subsidize their industries directly or indirectly.

There are all of these new factors in the picture which have to be taken into consideration in looking at the trade picture. Nevertheless, I think that you do point to a problem, to the wage problem that exists in competing industries between us and other countries, where technology is international, such as in the chemical industry, and in a growing number of industries, which are dominated by international corporations. Many of our leading corporations now are U.S. based, but they are really international corporations. Standard Oil of New Jersey certainly is an international corporation; GM, GE, Ford, and many of the chemical companies are now international, operating all over the world, and the imports and exports in those industries are frequently internal corporate adjustments, where they bring in components.

For example, in our electrical manufacturing industries, our unions have pointed out, many of the components of television sets are now made in Taiwan, in Hong Kong, in Japan, and elsewhere, brought in here and assembled here. But the major components are made elsewhere. All of this is within the internal structure of the corporation.

Senator MILLER. I very much appreciate that splendid response. I know you could go on much further on this subject.

I did not want to try to oversimplify this. What I was trying to do was to cut down on the size, so to speak, of the pooh-poohing that some people have done on the impact of our inflation with respect to our foreign competition, and especially with respect to imports, and I think the figures demonstrate that we have been getting further behind on our comparative wage scale, assuming, of course, that there are other factors like productivity, that enter into it.

My time is up. I do appreciate the opportunity to see the witnesses here this morning.

I thank you, Mr. Chairman, for giving me additional time.

Senator PROXMIRE. Thank you, Senator Miller.

Thank you, gentlemen, for a fine job. We very much appreciate it.

The committee will stand in recess until tomorrow morning at 10 o'clock, when we meet to hear the chief economist for the National Association of Manufacturers and the chamber of commerce.

(Whereupon, at 1:05 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, March 6, 1969.)

THE 1969 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, MARCH 6, 1969

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Joint Economic Committee met, pursuant to recess, at 10 a.m. in room 1114, New Senate Office Building, Hon. William Proxmire (vice chairman of the joint committee) presiding.

Present: Senators Proxmire, Sparkman, Miller, and Jordan; and Representatives Reuss and Conable.

Also present: John R. Stark, executive director; and James W. Knowles, director of research.

Senator PROXMIRE. The committee will come to order.

Today we have the concluding section of our annual hearings on the state of the economy. The committee is privileged to hear from two outstanding economists who have proven their perception and analytical ability in the field of public economic policy, Dr. George G. Hagedorn, chief economist for the National Association of Manufacturers and Dr. Carl H. Madden, chief economist of the Chamber of Commerce of the United States.

You gentlemen may proceed in your own way.

STATEMENT OF DR. GEORGE G. HAGEDORN, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HAGEDORN. Thank you, Senator. May I begin?

Senator PROXMIRE. Yes, indeed.

Mr. HAGEDORN. I would like to correct your introductory statement. I am not a doctor, though thank you for conferring the degree on me.

Senator PROXMIRE. I know how those things are. At least you have such a fine background and have demonstrated your understanding so well that you are the equivalent of a doctor.

Mr. HAGEDORN. Thank you, sir. I will consider that the conferring of the title on me.

May I submit my complete statement for the record?

Senator PROXMIRE. Yes, indeed.

Mr. HAGEDORN. And then make a few points in a brief summary.

(The prepared statement of Mr. Hagedorn for inclusion in the record follows:)

PREPARED STATEMENT OF GEORGE G. HAGEDORN

Mr. Chairman and members of the committee, I appreciate very deeply the courtesy of this Committee in finding time to hear my views as a representative of the National Association of Manufacturers.

The starting point of your deliberations is the Economic Report of President Johnson, together with the Report of his Council of Economic Advisers. To this has been added the testimony of representatives of the new Administration, experts from the academic world, and others. My desire to appear before you has been prompted by a belief that important thoughts remain to be added to this record.

This is, of course, a time when national policies are being reconsidered. A new set of policies has not yet crystallized out of that process. The delay is proper and understandable. But the general moods and attitudes which prevail while the process of crystallization goes on will be all important in determining the outcome. The hearings of your Committee, and the report which you will make to Congress, play a large role in setting such moods and attitudes.

Unfortunately, much of what has been said before you reflects a propensity toward understatement. The urgency and difficulty of our national economic problems seem to have been insufficiently stressed. There is danger that the impression will be created that our problems will yield to the light touch. We are left with the euphoric hope that the firm hand will prove unnecessary. If this mood prevails, it could be the basis for economic policies which lean in the direction of underkill.

Superficially, there is a high degree of unanimity regarding the economic problems of the nation and what should be done about them. Much of what is being said—on, for example, the evils of inflation—can hardly be disputed. Yet only a little below the surface there are many misconceptions and illusions. Most alarming of all, there appears to be a great deal of wishful thinking regarding the seriousness of our national problems and our prospects for solving them painlessly.

This is reflected not so much in the specific content of what is said as in the attitudes reflected by the tone of the language. I may illustrate the point, in a preliminary way, by the following examples:

1. There is almost universal agreement on the importance of getting the present inflation under control. Yet when the subject is discussed, the major emphasis seems to be laid on the danger of moving too hastily or too intensely to stop the inflation. The nation seems to be preparing itself to lean backward as it confronts the inflationary enemy. Through obsession with the alleged risks of doing too much too soon, we are creating a real risk of doing too little too late.

2. There is agreement that inflation is currently reinforced by strong psychological factors. Widespread public expectation that inflation will continue makes it that much more difficult to end inflation. The lesson seems to be clear to everyone that this psychological vicious cycle must be broken. Yet there is a reluctance to accept the corollary that only a total national commitment to end inflation will break this barrier. A commitment which is conditional, tentative and hedged about with reservations will not convince the public. A tone which suggests that we will be prepared to retreat as soon as an anti-inflationary effort begins to hurt even a little bit, will not end the expectation of further inflation.

3. There is a widespread illusion that, through toleration of inflation, we can have lower levels of unemployment than would otherwise be possible. No one is quite willing to advocate that we buy full employment with acceptance of inflation. But the false belief that this option is always open to us is a dangerous bit of economic mythology.

4. Practically everyone will agree that reductions in federal spending, and control of future growth in spending, are desirable. But the truth is that government economy is not merely a desirable objective. It has become an unavoidable necessity. All other options have been used up. The mood of taxpayers will not endure any further increase of their burdens, or even an indefinite continuation of present burdens. On the other hand, a re-emergence of large federal deficits is completely unacceptable. We are between the devil and the deep blue, and the only hope of rescue lies in an unprecedented effort at spending control.

5. The subject of "tax reform" is beginning to receive a great deal of attention. It is, of course, always proper to reexamine and reconsider all provisions of the tax code. But in this case the false hope is being held out that middle-income taxpayers will find their tax burden greatly reduced through closing "loop-holes" available to wealthier individuals and to corporations. The fact is that any conceivable program of tax reform would provide only minuscule relief to the middle-income groups—as compared

with, for example, a termination of the 10% surcharge. If we are truly threatened with a taxpayers' revolt, a reshuffling of burdens among taxpayers cannot do much to cure the situation. We shall have to depend on the harder task of controlling government spending.

Other illustrations could be given of current thinking which obscures the real underlying economic issues. In what follows, I will expand on the points already made and apply them to questions of national policy. The comments here will be oriented toward both the Economic Reports provided to you in January by the Johnson Administration and the testimony you have heard since.

Gradualism

There has recently been much emphasis on the importance of taking a gradualistic approach to ending inflation. When one tries to translate this into a concrete program, its meaning is not entirely clear. But some of its implications, possibly unintended by those who use the term, give rise to concern. Perhaps the best contribution that can be made here is to raise some questions about the concept in the hope of clarifying its meaning.

It may be that the concept of gradualism is meant merely as a warning that the present inflation has momentum and cannot quickly be turned off. Even abrupt changes in policy operate on price trends with considerable lag. If this is the meaning of gradualism, it is simply a recognition of an inescapable fact, rather than the advocacy of a particular program. This is quite different from spreading the policy changes themselves over a period of time. In any case, it is helpful to be reminded that the most we are likely to do at the start is to slow inflation down, and the task of ending it must be a longer-term goal.

If gradualism means simply that the nation should not swing from an *inflationary* to a severely *deflationary* monetary and fiscal stance, there is not likely to be much disagreement. Our effort should be to end inflation, not to reverse it in a downward collapse of prices. Attempts to replace the large deficit of fiscal 1968 by an equally large surplus, or to follow the excessive increase in the money supply of last year by an equally rapid drop in money supply, would be disastrous.

If this rejection of radical deflation is all that is meant by gradualism, the stress on it is puzzling since such a course has not been widely advocated. The objective should be to establish monetary and fiscal conditions which are consistent with economic growth under price stability. It is hard to see why there should be any deliberate delay in establishing such conditions. The nation has no time to lose in getting inflation under control.

One possible basis for the gradualistic approach is a belief that a program of anti-inflationary restraint, arrived at by steps spread out over a series of years, would have different (better) end results than an identical program concentrated in a briefer time. If there is any line of economic analysis which supports that conclusion, I do not know of it. It seems more probable that the two programs would have the same ultimate effects, both on employment and on price stability, and the only difference is that such a gradualistic program would take longer to produce those effects.

It may be that, in some minds, the reason for favoring gradualism is that it would allow more opportunity for changing directions before the program is completed. Time is allowed for reconsidering the program as its effects are observed—and then deciding whether to continue or abandon it.

Such flexibility might seem to be a genuine advantage. The trouble is that, if this interpretation of gradualism is correct, it would not be the firm national commitment to end inflation that is needed at present. A tentative, conditional and reversible stance against inflation will never break the self-reinforcing inflationary psychology which now plagues us. "Tapering-off" on inflation sounds like an ineffective way of ending it—as tapering-off is an ineffective way of ending other bad habits.

Fiscal Policy

Fiscal policy must of course play a central role in the effort to get inflation under control. It was therefore a source of some satisfaction that the Johnson Administration fiscal program, as set forth in its budget and economic reports, projected a surplus in fiscal 1969 and 1970. It is also gratifying that the Nixon Administration has firmly endorsed the desirability of a surplus. We should under no circumstances permit a return to the large deficit which occurred in fiscal 1968.

Satisfaction with the surpluses projected for fiscal 1969 and 1970 must however be tempered in several respects. For one thing, part of the expected surpluses is attributable to the expected continuation of inflation, which tends to increase revenues faster than normal. In other words, if our effort against inflation succeeds more rapidly than anticipated, the surpluses may not materialize at all.

The major reason why satisfaction with the projected surpluses is less than complete is that they depend on continuation of the tax surcharge enacted last year. It is better that the burden of increased government expenditures be borne through a tax increase than through inflation. But it is a burden in either case and the primary effort should be directed to controlling the growth in expenditures.

Experience since last June has confirmed the suspicion that a tax increase is an uncertain and less-than-completely-effective weapon against inflation. A dollar of government purchases is a dollar exerting inflationary pressure in the marketplace. But a dollar withdrawn from the public in additional taxation may or may not reduce inflationary pressures by a corresponding amount. Consumers, and business, may react to the tax increase by reduced saving or increased borrowing, thus maintaining their previous spending levels.

This is exactly the way consumers seem to have reacted, at least up to this point, to the tax increase of last June. The tax increase was described as taking from the public an additional "penny on the dollar" of personal income. But instead of reducing their *spending* on goods and services by a penny on the dollar, consumers reduced their *saving* by nearly that amount. The facts can be summarized as follows:

Consumer savings (cents per dollar of after-tax income)	
1967 full year	7.4
1968:	
1st half	7.3
2d half	6.6

Apparently about three-quarters of the counter-inflationary effect of the personal tax increase was offset by a drop in the personal saving rate. And this is a major reason why we have seen no moderation in the pace of inflation since enactment of the tax increase.

I venture no prediction here as to the course of the personal saving rate during 1969. It might indeed rise again to the levels prevailing in 1967 and the first half of 1968. In that case the tax increase may begin to have its intended effect of cooling off the economy. But it might just as well stay where it is, which is not an exceptionally low level by historical standards. In that event our anti-inflationary effort of last June would be largely frustrated. If fear of inflation intensifies, the savings rate might even fall still further.

All these considerations suggest that tax increases are neither an ideal nor a reliable instrument for fighting inflation. The most that can be said for them is that they are preferable to large federal deficits.

But balanced budgets can be achieved by curtailment of expenditures as well as by tax increases. And all the arguments derived from both theory and experience indicate that spending cuts are a more effective way of controlling inflation. Their impact does not depend on the uncertain reaction of consumers to a change in their tax burden.

It is therefore desirable that Congress, and the new Administration, study carefully the spending proposals in the 1970 budget, in order to determine whether they might not be reduced to a point where continuation of the surtax would be unnecessary—or to a point where only partial continuation would be necessary. Whatever success can be achieved in this effort would be to substitute, for the undependable anti-inflationary effects of a tax increase, the more trustworthy weapon of government economy.

Looking beyond 1970, it is clear that a perpetual effort at controlling the growth in federal spending is essential. If the effort is relaxed, even for a brief period, we are in danger of again finding ourselves in the economic trap which caught us in 1968—with our choices limited to acceptance of a large deficit or imposition of a large tax increase. This is a Hobson's choice and the latter has not proven a very dependable way of controlling inflation.

Streamining Tax Procedures

President Johnson's Economic Report recommends that ways be found for accelerating the procedures by which presidential requests for tax changes may become law. He suggests two alternatives: The President might be authorized to initiate tax changes at his own discretion, within limits and subject to Congressional veto. Or Congress might revise its own rules to ensure a prompt decision on presidential tax recommendations.

Proposals of this type have been made from time to time in the past. At this moment the chief argument advanced in their favor is based on the experience of the past two years. Although President Johnson recommended a tax surcharge of 10% in August 1967, it was not enacted until ten months later. The delay represented a loss of valuable time in the fight against inflation. It is contended that, if action by Congress had been more prompt, inflation would be under better control today.

Yet a closer look at what happened during the ten-month period of delay suggests a somewhat different conclusion. It is perfectly clear that if the Congress had acted quickly and passed a tax increase in, say, the early fall of 1967, it would not have been the same measure that was passed in June 1968. The interval gave Congress time to consider the tax proposal in the light of the total budgetary situation. Congress took the time to formulate its own views on government spending and to include them in the legislation which finally emerged. Even aside from the specific restrictions in the legislation, the interval was one in which a renewed consciousness of the importance of controlling expenditures emerged. It may be unfortunate that this process took time, but on the whole I believe that it was time well spent.

I would not presume to instruct Congress in how to frame its own rules. Nor do I mean to suggest that the present occupant of the White House would not use good judgment if Congress turned part of its taxmaking powers over to him. But, whatever changes may be contemplated, I urge that the opportunity for careful consideration in Congress not be sacrificed in favor of speed. Proposals for major changes in the nation's tax burden should be occasions for thorough review of the entire budgetary situation, both by Congress and the President.

In its own report, President Johnson's Council of Economic Advisers went somewhat further in favoring a flexible tax policy. It suggested that tax changes, instead of being exceptional occasions calling for national soul searching, should be a normal and regular feature of fiscal policy. Thus the Council argued: "If Government expenditures move ahead year by year at a rate about equal to the growth of tax revenues, changes in tax rates may not need to be made very often. However, it would be a remarkable coincidence if a steady growth in Government expenditures at that rate simultaneously satisfied the needs of economic stabilization and the Nation's wishes over the long run with respect to the proper allocation of resources between the public and private sectors of the economy."

This view seems in part a survival of the "fine-tuning" philosophy, which was so prominent a few years ago. The Council of Economic Advisers, in earlier years, was confident of its ability to predict the future course of economic events and to prescribe the precise dosage of fiscal restraint or stimulation that would be appropriate. In other sections of its most recent report the Council appeared to have been somewhat chastened by experience and less confident of its ability to fine tune the economy. But it adhered, perhaps through nostalgia, to its advocacy of a highly flexible tax policy.

Each year the expected yield of the existing tax system serves to some degree as a rough gauge of permissible limits for the total of spending plans. It is a limitation which is often breached and sometimes it should be breached. But I would not like to see this line of resistance to increased spending totally abolished. The Johnson Council seems in effect to be saying that the yield of existing taxes should be regarded as wholly irrelevant in making spending plans.

I urge that the Council's suggested approach to fiscal policy be rejected. It is true that tax rates cannot be set for all eternity. But major changes in tax legislation should be solemn occasions, and not routine and recurring matters.

Tax Reform

The subject of tax reform was not dealt with in either President Johnson's Economic Report or the Report of his Council of Economic Advisers. However, the subject was brought before the Joint Economic Committee by the then Secretary of the Treasury on January 17. It has since received wide attention from Congress and the public, and is now the subject of a major inquiry by the Committee on Ways and Means of the House of Representatives.

This is not the place to argue the specifics of any tax reform package. The National Association of Manufacturers will provide expert witnesses as various topics are brought up in the Ways and Means Committee hearings. But it may be appropriate to raise some general points which help to put the whole subject in perspective.

In bringing up the subject, Secretary Barr stated his belief that: "We face now the possibility of a taxpayer revolt if we do not soon make major reforms in our income taxes." He explains this by the assertion that "People are concerned and indeed angered about the high-income recipients who pay little or no Federal income tax. For example, the extreme cases are 155 tax returns in 1967 with adjusted gross incomes above $200,000 on which no Federal income taxes were paid, including 21 with incomes above $1,000,000."

Summary statements of this sort, with no indication of the provisions of the tax code which operated to produce that result, or of the historical reasons for those provisions, are of little help in appraising the equity of our present tax rules. They seem more likely to encourage the very revolt the Secretary fears than to offer any constructive enlightenment.

The features of the tax law which are the usual targets of tax reform are a heritage from past Congresses as they formed the best judgments they could in facing difficult and complex problems. Certainly those past judgments should be reviewed from time to time and some of them perhaps revised. But the belief that the tax code is shot through with obvious absurdities and inequities—implying that past Congresses were very gullible—is one that we cannot accept.

There is another point to be borne in mind. Although there may be inequities in the present tax code, another kind of inequity arises from frequent or drastic changes in the code. Taxpayers, accepting the present tax code as it stands, have made their long-term plans accordingly. They might have been as well, or better, pleased if certain provisions in the code had been different from what they were. But they took the law as they found it, and arranged their affairs to meet it. A change in tax rules may place unexpected and inequitable penalties on them as their past plans, made in good faith, come to completion.

My purpose in mentioning this subject is neither to encourage or discourage any effort in Congress at a major tax overhaul. But if such an effort is to be made it would be unfortunate if it were conducted in an atmosphere either of panic—based on fear of a taxpayer revolt—or of cynicism—based on a belief that past Congresses yielded to undue influences. Neither would be likely to produce a constructive result. What is called for is a technical job of hard work, rather than a crusade.

But there is an even more serious reason for concern over the atmosphere in which current programs of tax reform are being developed. Taxpayers in the middle-income ranges are perhaps being encouraged to hope that their own tax burdens can be significantly reduced as a result of closing "loopholes" available to those higher up the scale.

This is simply not so. The amount of relief that can be given to middle-bracket individuals through any conceivable program of tax reform is trifling compared with the amount at stake for them in other major fiscal issues. Congress can do far more for such individuals by controlling expenditures so as to eliminate the 10% surcharge, than it can do by shifting their burdens to higher income persons.

Thus, at the time of his appearance before you, Secretary Barr analyzed the source of the anticipated tax revolt as follows: "The revolt will not come from the poor but from the tens of millions of middle-class families and individuals with incomes of $7,000 to $20,000. . . ."

Since that time the tax reform package developed in the Johnson Administration Treasury Department has been disclosed. It is interesting to observe the effects of the package on the $7,000 to $20,000 taxpayers to which Secretary Barr had referred. The net effects would be as follows:

1. Taxpayers with incomes between $7,000 and $10,000 would have their taxes cut by 3.1%.
2. Taxpayers with incomes between $10,000 and $15,000 would have their taxes cut by 2.5%.
3. Taxpayers with incomes between $15,000 and $20,000 would have their taxes *increased* by 1.0%.

Thus some of the taxpayers described by Secretary Barr as in the middle class would have their burdens actually increased by his program of tax reform. This would be a strange way of discouraging an incipient tax revolt among them. In any case, the percentages involved are much smaller than the 10% involved in the surcharge. The belief that tax reform can be a bonanza for taxpayers in the middle range is modern mythology.

MONETARY POLICY

President Johnson's economic report expressed the general view that "Our monetary institutions are working well . . ." His only suggestions for change related to such administrative matters as the term of office of the Chairman of the Federal Reserve Board, and procedures for selecting other officials.

The Report of the Council of Economic Advisers went somewhat more deeply into substantive issues of monetary policy. But it too expressed general satisfaction with the conduct of monetary policy in recent years.

Thus the Council contended: "The record of the past 8 years demonstrates that flexible, discretionary monetary policy can make an effective contribution to economic stabilization." As evidence it described the role of monetary policy in supporting the expansion of the early 1960's, in the recovery of homebuilding in 1967, an in curbing "a dangerously inflationary situation" in 1966.

Yet when the record of the past eight years is examined in a larger perspective, we must feel somewhat less than complete satisfaction. The period as a whole was one of exceptionally rapid expansion of bank credit and the money supply, combined with a rise of interest rates to unprecedented levels.

This combination is, in the light of conventional wisdom about monetary policy, a paradox. Shall we describe the past eight years as a period of "easy money"—as evidenced by the rapid expansion of bank credit and the money supply? Or shall we describe it as a period of increasingly "tight money"—as evidenced by the steep rise in interest rates? Clearly new thinking, which abandons some of the old cliches, is called for.

In its discussion the Council argues at several points that: ". . . interest rates and the money supply are inversely related." Although this assumption may be useful in explaining certain episodes during the past eight years, it is clearly contradicted by the experience of that period as a whole.

For these reasons, while I do not feel qualified to suggest any rigid rules for the conduct of monetary policy, I cannot share the past Administration's satisfaction with the record of the 1960's. What is described as a "flexible" or "aggressive" monetary policy may have been useful in dealing with certain short-term problems. In the longer run it has supported inflation and raised interest rates. Something more than flexibility and aggressiveness seems to be called for. Steadiness, consistency, a sense of proportion and a recognition of the limitations on the economy's potential for real growth are also virtues.

BALANCE-OF-PAYMENTS PROGRAMS

President Johnson, in his Economic Report, recommended renewal of the Interest Equalization Tax, continuation of the foreign direct investment controls, and continuation of the guidelines for restraining foreign lending by banks and other financial institutions. He did so despite his belief that: "Capital restraints should never become permanent features of our economy. They should be ended as soon as possible."

Neither President Johnson nor his Council offered any convincing evidence that the several programs of capital restraints served any useful purpose in protecting the U.S. balance of payments during 1968. It is true that a nominal improvement occurred which shifted the "balance on liquidity basis" from deficit to surplus. But this occurred through a combination of developments with which we can't be entirely pleased, and which in any case seem to have been mainly the result of factors other than the capital restraints programs.

We shall not undertake here a comprehensive review of balance-of-payments developments in 1968. It is clear, however, that two major factors dominated the changes which occurred during that year. The first was a further deterioration, in fact the virtual disappearance, of our historic surplus on merchandise trade. The second important development was an enormous increase in the inflow of foreign private capital which, given the methods used in balance-of-payments accounting, was more than enough to offset the decline in the trade balance.

The balance on merchandise trade is the hard-core of the balance-of-payments statement. The decline from a positive balance of $3.5 billion in 1967 to only $0.5 billion in 1968* must be regarded as a matter of grave concern—regardless

*Figures cited in this section are derived from the statement presented before the Joint Economic Committee's Subcommittee on International Exchange and Payments by Undersecretary of the Treasury Deming on January 15, 1969.

of any financial developments which appear to offset it on the over-all balance-of-payments statement. Restraints on the outflow of U.S. capital do not, of course, prevent or relieve such a deterioration in the trade account. In fact, it is rather clear that they must have contributed to it, although it is difficult to estimate the precise amount.

The question then is whether the program of capital restraints helped to produce the inflow of foreign private capital which reached such large proportions in 1968. And here the answer is that this inflow is explicable in terms of events both in the U.S. and abroad which had nothing to do with the government control programs. High interest rates and rising equity prices in the U.S. made this country a more attractive place to invest. Political developments in France and Czechoslovakia made investments in Europe less attractive. The result was an inflow of foreign capital which amounted to $7.0 billion in 1968, compared with only $2.9 billion in 1967. In its impact on the balance of payments, this development dwarfs anything else that happened.

The Council's report maintains that at least part of the inflow was the result of the U.S. controls program. It is argued that the program forced U.S. firms making direct foreign investments to finance them by security flotations and borrowings abroad and that this contributed to the inflow of private capital. But it seems doubtful that this could have significantly affected the total inflow of foreign capital. Foreigners became eager to acquire U.S. equities and obligations of U.S. firms, and did so in whatever form they happened to be currently available. And the willingness of U.S. firms to finance abroad was affected as much by the rise in domestic interest rates as by the controls program.

In winding up its discussion of the balance-of-payments outlook, the Council of Economic Advisers cast its argument in rather peculiar form: "*In view of the uncertain prospects for the balance of payments*, the measures for controlling capital movements must be maintained for the present." [Emphasis added.]

The case for continuation of controls in 1969, thus, is to be based not on demonstrated need, or on demonstrated usefulness, but on uncertainty.

If uncertainty is to be regarded as adequate justification for so widespread an intervention in free markets, then we will have controls forever. There is always uncertainty as to economic developments, and nowhere more so than in the balance-of-payments field. But uncertainty is the very reason for relying on the flexibility of free private markets rather than on government planning or government regulation. If extraordinary conditions necessitate a temporary departure from reliance on free markets, the burden of proof should rest on those who contend that it is so. They should not be entitled to rest their case on "uncertainty." On principle, and on the record, free markets are entitled to the benefit of the doubt.

Meanwhile the disappearance of the U.S. trade surplus remains a matter of grave concern. I do not see any practical way for restoring it except through curbing the inflation by cooling off our overheated economy. The continuation of controls on foreign investment is an obstacle, rather than a help, in restoration of the trade surplus.

Wage-Price Restraints

Incomes policy—which is the general term for various forms of government intervention in the price-wage setting process—has an understandable attraction at this juncture. It seems to offer a way out of the dilemma of using monetary and fiscal restraints, with possible undesirable side effects, as the cure for inflation. If it really worked, it would enable us to both have our cake and eat it. I wish I could endorse such an approach.

Unfortunately incomes policy has not worked in other countries where it has been tried. When the need arose for a determined effort to curb inflation, incomes policy was not substitute for the necessity of cooling off the overheated economy.

In our own country when proposals for an incomes policy are reduced to reasonably concrete terms they never seem able to bear close analysis. They offer little prospect for success and much danger of serious economic disruption. This may be illustrated by considering suggestions advanced in the final Johnson Administration Economic Reports.

Mandatory wage and price controls, as a means of containing inflation, were rejected forthrightly in President Johnson's Economic Report. It declared that: "We surely must not turn down this path—a dead end for economic freedom and progress."

The Council's Report went into more detail in explaining its reasons for rejecting mandatory controls:

"Such controls freeze the market mechanism which guides the economy in responding to the changing pattern and volume of demand; they distort decisions on production and employment; they require a huge and cumbersome bureaucracy; they impose a heavy and costly burden on business; they perpetrate inevitable injustices. They are incompatible with a free enterprise economy and must be regarded as a last resort appropriate only in an extreme emergency such as all-out war."

All this is extremely gratifying. But in seeking an alternative which might accomplish the same end, the Reports suggested a program which would have most of the same objectionable features. This is the so-called program of voluntary restraints on wage and price decisions.

It is, of course, perfectly proper, desirable and constructive for the President of the United States to appeal to private leaders for restraint in wage and price matters. But the program of voluntary restraints which is outlined in the two reports of the Johnson Administration went well beyond such an appeal. It called rather for systematic, albeit extra-legal, intervention by government in private wage and price decisions.

Government interventionism in this proposed program would take the form, first, of the setting of standards for judging private price and wage behavior. Private cooperation is to be sought in establishing such standards but it is to be done, apparently, under government supervision. In any case, it would be a colletcive decision to be imposed on all private individuals, whether they agreed with it or not as applied to their own affairs. Collectivism in wage-price decision making is the antithesis of our traditional reliance on competition.

And the standards so set would not be left merely as general exhortations. They would be applied, in a way that is described only vaguely, to individual cases. The Council advocated that "some competent authority" be set up for the purpose of calling the public's attention to "flagrant departures from standards of responsible decision making."

We can only interpret this as a call for establishing an official body which would hear cases of alleged "flagrant departure" from the informal standards set by the collective process. No suggestion is made as to the rules under which such a group would operate, or even that it ought to have any well-defined rules. But it would have the power of punishing those whom it judged guilty—not through fines or prison terms, but by calling down public shame on them.

It is hard to see how such a program of "voluntary restraints" is any less objectionable than mandatory price and wage controls. The objections to mandatory controls quoted above from the Council's Report seem all to apply to the voluntary program. And one can think of others.

I earnestly hope that neither Congress nor the new Administration will seek the solution to inflation in such a program of government interventionism. Is is no more likely to be successful than the guidepost program which it apparently supersedes—and which failed when it was needed. This new program of voluntary restraints would surely create and intensify distrust and conflict among government, business, labor and the consuming public. A wage-price kangaroo court does not seem to be a good way of promoting harmony.

SUMMARY

Although production and employment are presently at very high levels, there are reasons for serious concern in the general economic situation. Excessive demands upon our economy have produced an inflation, apparently still accelerating, combined with record high interest rates. Closely related is the disappearance of the foreign merchandise trade surplus, on which we rely to provide the means for both government programs overseas and private foreign investment.

There are no shortcuts in solving these problems. The government must conduct its financial affairs—in both the fiscal and monetary fields—in a way which does not create excess demand pressures. When the public becomes convinced that this is the fixed policy of government, psychological forces which have been reinforcing inflation will cease to do so.

Specifically, our recommendations for guiding principles in economic policy at the present juncture are as follows:

1. We must not permit a recurrence of large deficits in the Federal budget.
2. Curtailment of the growth of Federal spending is a more reliable and effective way of suppressing inflation than temporary tax increases.

3. "Flexible" tax rates, and streamlined procedures for changing them, have a certain economic usefulness. We should not, however, for this purpose sacrifice the right and duty of Congress and the Executive to review the whole budgetary situation at the time changes are made.

4. If tax reform is to be undertaken, it should be approached with a spirit of understanding of the reasons for present provisions and of recognition that inequity can result from abrupt or drastic changes. Approaching it in a spirit of haste or panic would not contribute to a useful result. Above all, middle-income taxpayers should not be encouraged in the false hope that they can expect substantial relief through the tax reform route.

5. Monetary policy of recent years should be reviewed to determine whether, in continually adapting monetary actions to short-term needs, undesirable trends are created in the longer run.

6. Plans should be made for an early termination of the Interest Equalization Tax and the program of Foreign Direct Investment Controls. These tend to impede, rather than assist, in a recovery of our balance on merchandise trade which is the acute problem of this time.

7. A government supervised program of voluntary wage and price restraints, as proposed by President Johnson's Cabinet Committee on Price Stability, has all the objectionable features of mandatory wage and price controls. It should be rejected for the same reasons.

At this point, the most immediate economic objective of government must be to break the inflationary psychology which has magnified the inflation problem. The public will be examining government statements to see what attitudes they reflect in this area.

The report of your Committee will carry great weight in the public's mind. I respectfully urge that it declare a firm and unqualified determination to end inflation.

Mr. Hagedorn. The first subject I would like to deal with is inflation.

Senator Proxmire. Incidentally if you are going to refer at any time to any part of the statement it would be helpful to us if you indicated the page so we can follow it.

Mr. Hagedorn. I will do that, sir. I would like to speak briefly on this subject of inflation which has occupied most of your attention during these hearings. I think it would be a disfavor to this committee and to the American people generally for me to tell you that we can cure inflation without any pain for anybody. The fight against inflation is going to take a certain amount of blood, sweat, and tears. But more important than that is the fact that *not* curing inflation would cause even more blood, sweat, and tears.

I cannot believe that we are going to let inflation go on indefinitely in this country. I cannot believe, for example, that the United States will allow the inflation to accelerate to the point where it becomes the astronomical type of inflation they had in certain European countries after World War I. Nor can I believe that we will let it go on indefinitely until it becomes the same kind of inflation that seems to go on forever in the Latin American countries.

So inflation will come to an end, and the question is when is it going to be brought to an end. There is some pain involved in ending it but the pain becomes greater the longer you put off that job. Right at present the dominant factor in accelerating and continuing inflation is the psychological belief that the expectation of inflation leads to further inflation. This has been much discussed before you.

To break that psychological vicious circle it is necessary for you people in Government to take a very firm stand. I would hope, for example, that the report of this committee will take a firm and unqualified stand against inflation. If you take the position that we will try to end inflation provided *this* and provided *that*, I think you will not convince the public that inflation really is approaching its end. It would encourage rather than discourage this psychological expectation of further inflation.

Let me make a few remarks on another subject that has been discussed somewhat before you. That is the trade-off between unemployment and inflation.

I think that as a possible basis for national policy, this is a great and a dangerous illusion. It is true that, when you look at the historical record and make a diagram of rates of inflation against rates of unemployment, it does appear that, in this history, when unemployment was low, inflation was high and vice versa. But I do not think you can from that record draw the conclusion that we have an option that if we are willing to tolerate a certain amount of inflation, we can, by that tolerance, have a lower level of unemployment than we would otherwise have.

The reason I come to this conclusion is that I try to picture what would happen if actually this country chose, as a matter of deliberate policy, that it would accept a certain level of inflation in order to keep unemployment low. For example, suppose you looked at last year's record and said well, we had about a 5-percent inflation but we kept unemployment down to around 3½ percent for the year, and this looks like a pretty good bargain. Therefore let us come to a national agreement that we will tolerate 5 percent inflation as the way of gaining 3½ percent unemployment.

I am talking in hypothetical terms, to determine what would happen if we actually chose this option. Suppose, for example, your committee in its report said, "Let us be willing to take 5 percent inflation as the price for keeping unemployment down to 3½ percent." Suppose the administration agreed with you, and suppose the chamber of commerce, and the NAM, the AFL–CIO, all agreed on this national consensus. Well, then obviously what would happen is that you would have not 5 percent inflation, because of the psychological stimulus you were giving by this national consensus. You would have probably something like 10 percent inflation as the price you would have to pay.

Then if in the next year you brought up the same question and said, "Well, should we take 10 percent inflation as the price for low unemployment," and you decided to do it, it would accelerate again. Sooner or later you would have to break this chain. It could not go very far.

Realistically whatever the historical record may suggest when you put it together in a Phillips curve type of diagram, it is not a real option. We cannot, realistically as a matter of national policy, decide that we are going to accept inflation as the price to pay for low levels of unemployment.

I say that, not because I hear anybody actually advocate that we do just that, but it seems dangerous to have a widespread belief that that option is open to us, and I think it is affecting policy choices.

A third subject I want to speak briefly on in this oral summary is the subject of Government spending. At the base of the problem of inflation is the very high deficit that the U.S. Treasury ran last year, the $25 billion deficit in fiscal 1968. This is one of the important background factors in inflation.

From this the conclusion has been drawn that one of the first important things we must do is end this type of deficit, and I believe that is correct. That is very, very true. We must not permit the recurrence of deficits of any size, and a small surplus is desirable.

But we have to face the fact that this is not an ideal or a reliable cure for inflation. Certainly the tax surcharge that was imposed last year is better than permitting the deficit to run on, but it is not the ideal solution to the problem, and we have seen that by developments in the 8 months since enactment of the tax surcharge last year.

Each dollar of Government spending is a dollar that is exerting inflationary pressures in the market, but each dollar of tax increase may come out of what individuals would otherwise have spent, or it may come out of what they would otherwise have saved, and in practice it usually comes partly out of both.

As a matter of fact, when you look at the record for the past year about three-quarters of the tax increase came out of what would have been saved. The reduction in the saving rate was about three-quarters as great as the increase in taxes.

The tax increase, for individuals at least, was about a penny on the dollar. That was the way it was explained to the people at that time. But what they did in response to the tax increase was to reduce their savings by about three-quarters of a cent on the dollar. So that a tax increase, or even the maintenance of the present tax burden, including the surcharge, is not an ideal solution to the inflation problem.

Another factor we have to reckon with is the mood of the taxpayers in the country. The words "taxpayers revolt" have been used to describe it but that may be an exaggeration. There is no doubt at all, however, that taxpayers are strongly discontented with the magnitude of the burden they have to bear, and their mood is to resist further increases in taxes or even the indefinite maintenance of the present tax burden.

So you are faced with these two things. We cannot afford to have a deficit. We cannot afford to either increase taxes or even maintain the present surcharge indefinitely. The solution, the only option that is left then, is to get Federal spending under control. With expenditures around $200 billion, a surplus is desirable. But it would be much stronger and better as a weapon against inflation to have a surplus with expenditures at a somewhat lower level. In the future, when we move ahead, perhaps that lower level can be maintained by controlling expenditures so that they become smaller in proportion to the size of the national economy.

A final subject that I would like to mention briefly in this oral summary is the subject of profits. There is a tendency in arguments about inflation for business people to blame the inflation on wage increases, and for the labor people to blame the inflation on profit increases.

I had not intended to talk in this area at all. There is nothing in it in my prepared statement. It seems to me that this kind of argument is a bypath away from understanding the real basis for inflation in the country, that it becomes a sort of Mexican standoff with labor and industry pointing fingers at each other.

The real basic cause of inflation lies in the fiscal and monetary field. What happens to wages and what happens to profits is a response to the inflationary forces.

I would go on to say that the particular way in which labor agreements are made in this country does have an effect on the timing of inflation. It tends to spread it out over a sequence of years, rather than to concentrate it in particular right at the moment when the fiscal and monetary inflationary forces are strongest. But as a basic fundamental cause of inflation, I do not think you can point to either wages or profits.

I heard Mr. Meany's statistics yesterday. He made comparisons of the growth of profits, between 1960 and 1968, I believe. Well, you can by varying your base year and by choosing among the available statistics, prove a variety of things. But after hearing those statistics, I went back and it seemed to me that if you are making comparison of the growth of wage costs with the growth of profits, you have to pick 2 years that are in roughly the same phase of the business cycle.

If you picked 1960, that was a year of recession, a minor recession, and compare it with 1968, you are comparing a recessionary year with an inflationary boom. It seems to me you get a better comparison if you take 1957 and 1968, both boom years, roughly the same phase of the business cycle.

I looked at what the statistics showed in comparison in the growth of compensation of employees on the one hand with profits on the other, both before taxes. Compensation of employees in the interval grew by 101 percent. Profits grew by 96 percent.

Now, I would not make any big point out of the minor difference—out of the fact that compensation of employees grew a little faster than profits. The statistics probably are not that accurate anyway.

The fact is both these things approximately doubled. And part of this growth, of course, is the effect of inflation. What I get out of this is that compensation of employees and profits are responding both to the real underlying growth of the economy and to the inflation. Neither of them is a basic cause of the inflation.

Mr. Chairman, I have made many other points in the prepared statement. I think, perhaps, at this point I should be still and let you ask any question you may want to.

Senator PROXMIRE (presiding). Thank you. I think it would be best if we proceeded with Mr. Madden and then the committee will ask questions of both members of the panel.

Mr. Madden.

STATEMENT BY DR. CARL H. MADDEN, CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. MADDEN. Thank you. I want to express our very deep appreciation for the opportunity to comment on the President's Economic Report.

The Chamber of Commerce of the United States welcomes once again the opportunity to comment on the Economic Report of the President and the Annual Report of the Council of Economic Advisers. The significance of the national economic issues and policy questions discussed in these reports qualify them as two of the most valuable economic documents coming from the Government each year. It is encouraging to find the usual high standard of excellence maintained in the 1969 reports.

The wide range of important national questions examined makes it impossible to do justice to each in any brief statement. For this reason I will confine my comments to three particular problem areas which require immediate attention from the Government—inflation, urban problems, and improvements in the international monetary system. This is not to suggest that the other economic issues and problems treated in these documents are unimportant either for the Government or for the business community.

Broadly speaking, the questions considered in the reports can be classified as either domestic or international, and within the domestic sphere the special problems relating to urban affairs loom large. Since all of the questions aired in the reports necessarily take part of their character from the overall condition of the economy, it is well to look first of all at the current state of the economy and the outlook for economic activity in the near term. In this manner each of the leading issues can be viewed in proper perspective.

The Economic Outlook

Last year's "standard economic forecast" for 1969 understated the strength of the inflationary forces in the economy. The Council's forecast also understated this strength. Although signs have appeared of a modest slackening in the rate of growth in the last quarter of 1968 and in the current quarter, expert opinion suggests that it will take longer than anticipated for the "inflationary snowball" to slow down. Last summer the conventional GNP forecast of $915 billion seemed reasonable on the widely accepted assumption that the fiscal restraint called for in the Tax and Expenditure Control Act would soon be felt. But, in the light of continued strength in the economy since then, a GNP figure some $10 billion higher seems much more likely this year. Whether this figure, in turn, proves to be an underestimate depends on the degree of monetary and fiscal restraint exerted and how much unemployment may rise as a result of that restraint.

We have learned afresh the harsh lesson that inflation feeds upon itself—that after consumers and business have lived with inflation for 3 years or more, expectations of further price and cost increases enter heavily into business and consumer decisionmaking. An outstanding example is the escalation of business plans to invest in new plant and equipment for this year despite an historically low rate of plant capacity utilization in manufacturing and a low unemployment rate. As the monetary and fiscal squeeze continues through the year, however, business investment plans are likely to be revised downward, resulting in a 7 or 8 percent spending increase over 1968, instead of the 11 to 12 percent indicated last December.

Consumer spending, in part also motivated by expectations of further price increases, is likely to continue rising throughout the year at a rate comparable to the last half of 1968. This rise may moderate slightly in the first quarter because of the smaller increment of disposable personal income resulting from higher payroll taxes and increased income tax settlements. But the termination of social security payroll deductions for many consumers around midyear and further pay increases for Government workers and others should revive consumer outlays in the second half, even if the surtax is extended at its present rate.

In the Government sector there is growing indication that, despite a projected Federal surplus for this fiscal year and next, Federal spending may easily rise above budget estimates on both defense and nondefense accounts, considering the uncertainties surrounding Vietnam and the continuing lack of budget priorities. One of the dominant elements in total Government spending is the pressing demands of State and local governments for funds to meet their mounting requirements both for traditional public facilities and to combat new urban problems.

In the foreign sector, it is quite possible that our trade surplus will rise from its extremely low 1968 level. But the extent of the rise is difficult to predict, depending as it does upon moderating the substantial volume of imports attracted by our rising incomes and prices.

The outstanding general problem of the economy is still inflation, despite some evidence that the fiscal restraints belatedly started in mid-1968 and the monetary restraints tardily applied by the Federal Reserve in the late fall are finally taking effect.

If the fiscal and monetary restraints are continued, as will probably be required for much of this year, the price level rise may be held to about 3 percent. This would be a considerable improvement over last year's 4.2 percent increase, but it would still be excessive. The projected GNP increase of some $65 billion in current prices would mean a real output increase of about 4.5 percent compared to last year's 4.8 percent. The unemployment rate will probably rise slightly over 4 percent in the second half of the year but should average close to 4 percent for the year as a whole.

Economic Policy Regarding Inflation

The 1969 Economic Reports clearly acknowledge that the attempts by the Kennedy and Johnson administrations to curb inflation by official directive were unsuccessful. The section entitled "Voluntary Restraint on Prices and Wages" gives credit (p. 119) to the wage-price guideposts for some unspecified part of the good 1961–1965 wage-price performance in the economy. But the observation in the same place that the "blemished wage-price record of the past 3 years reflects primarily an excessive growth of demand" comes much too late for timely policy prescriptions.

A good case can be made that the wage-price guidepost approach actually delayed the recognition and response by responsible parties to the true nature of the inflationary spiral that started in mid-1965. The mounting inflation since mid-1965 has resulted from piling the demands of Vietnam spending on a fully employed economy, and should have been arrested early by monetary and fiscal restraint. The Council's dogged adherence to the Keynesian doctrine that monetary restraint is relatively unimportant in combating inflation as compared to fiscal restraint compounded the problems of the Federal Reserve authorities in the period from late 1965 to the present as fiscal restraint failed to appear and, when it did appear, took hold less rapidly than expected.

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The national chamber is gratified to find the new administration endorsing a philosophy of noninterference with supply and demand in the market for products and productive services—especially labor services—while at the same time adopting a cautious, gradualist approach to bringing inflation under control. Such a national economic policy stance puts us all on notice—employers, employees, and consumers—that each of us must make economic decisions in a responsible, informed manner, with full realization of the economic consequences.

The outstanding lesson to be learned from the period since mid-1965 is the great difficulty of coordinating fiscal and monetary policies so as to smooth out the inflationary bumps on the trend of economic growth. Quite apart from the question of leads and lags in the economic responses to monetary and fiscal policy changes is the lack of real independence of action in monetary policy when the Federal budget is heavily in deficit. On such occasions the Federal Reserve is literally forced to insure that Federal borrowing is successful. This causes the central bank to monetize the new Federal debt, thereby pumping greater liquidity into the economy at a time when the opposite course is called for on national economic policy grounds. It is possible to draw different inferences from this experience; but one inescapable conclusion is that Federal deficit spending at a time of high employment not only produces inflationary pressures because of the spending itself but also prevents the central bank from engaging upon the necessary monetary restraints to combat the inflation through slowing down growth in the money supply.

A further lesson of the 1965–68 inflation is the great momentum that a protracted inflationary movement builds up. This momentum cannot be eliminated in a few months. Even with well-timed anti-inflationary measures, the monetary and fiscal brakes must be applied gradually to avoid toppling the economy into deep recession. It is because of this fact that the revised standard economic forecast for 1969, assuming continued monetary and fiscal restraints through the year, no longer contemplates a saucer-shaped contour of economic activity. Instead, assuming no drastic change in Vietnam, the growth rate is expected to slow down gradually as the year progresses.

The national chamber applauds the new administration's determination to fight inflation persistently, but not so drastically as to raise the overall unemployment rate excessively. The chamber endorses a high-level employment policy and believes that, as Secretary Shultz testified before this committee on February 20, manpower policies "can help make possible a gradual transition to a significantly lower rate of price inflation while maintaining a high employment economy." But more thinking needs to be done and more action needs to be taken in the manpower area, especially in the development of reliable and current job vacancy data on the demand side of the labor market and on the supply side in the development of better measures to deal with hard-core unemployment.

The International Economy

The issue of economic growth has been subtly shifted from the domestic economy section to the international section of the Council's report in belated recognition of the great importance of international economic relations to our domestic economic development. In a very important sense this represents a "coming of age" of the Council which, not so many years ago, paid little or no attention to the international aspect of our economy. In this regard it is encouraging that one of the members of the new Council of Economic Advisers is an expert in international economics. It is also a hopeful sign that for the first time there is included in an official document the several alternative proposals currently under general discussion for improving our international monetary arrangements. It should be evident at this late date to all but the most dyed-in-the-wool optimists that some reforms of the international monetary system are in order. But it is equally evident that this is an international problem which cannot be solved unilaterally by the United States, if only because of our leading role in world trade, finance, and the international monetary system established at Bretton Woods over two decades ago.

Recognizing the importance and urgency of this question, the national chamber board has recently approved the following recommendations:

1. Programs to correct inflation and restore stability to the value of money by sound domestic fiscal and monetary policies are essential both in the United States and in other deficit countries if reforms of the international monetary system are to succeed and current balance-of-payments problems are to be resolved.
2. Activation of sufficient special drawing rights annually to equalize desired surpluses, on the one hand, with tolerable deficits plus special drawing rights on the other, but not so fast as to relieve deficit countries from the need to pursue sound domestic fiscal and monetary policies.
3. There should be no increase in the dollar price of gold; such as increase would, among other things, intensify domestic and international inflationary pressures.
4. A major effort should be made to persuade surplus countries to allow their currencies to appreciate to a greater extent, either by changes in fixed parties or by movements in the foreign exchange market. This effort would be facilitated by activation of special drawing rights at a faster annual rate than the $1 to $2 billion currently contemplated.
5. To prevent the emergence of future payments imbalances and recurrent monetary crises, both a wider band of permissible exchange rates and a system of sliding parities should be seriously studied by the free world trading nations.
6. There should also be studied the desirability of introducing into the Monetary Fund accounting system a reserve settlement account consisting of gold, dollars, and special drawing rights, in order to resolve the unsettling effects which follow from the present strong preference of many countries for gold over other forms of reserve assets.

The chamber's board went further and approved a wider band of fluctuation of market foreign exchange rates for major currencies other than the dollar provided the administration makes this proposal to the International Monetary Fund.

URBAN AND RURAL POVERTY

Over the past 4 or 5 years the economic, social, and financial problems of poverty in the United States—especially in the cities, but also in rural America—have been identified, classified, and analyzed in great detail. This has been especially true of the economic problems of our national minorities who, in most instances, are rapidly becoming our urban majorities, especially where Negroes are concerned.

The Chamber of Commerce of the United States has been a leader in defining, studying, and making recommendations on how best to deal with this whole range of questions. This has been done largely through its task force on economic growth and opportunity, which has published four reports on poverty and two on urban problems. The task force is a group of 108 corporate business executives formed independently of but sponsored by the chamber. The first three task force reports dealt with the several faces of poverty—its definition; the sick, disabled, and aged poor; and the uneducated and unemployed poor. A fourth report, "Rural Poverty and Regional Progress in an Urban Society," has just been published. This report examines the ways in which rural poverty relates to urban poverty and, like the other reports in the series, makes numerous recommendations for economic improvement of the poor.

After completing its poverty studies, the task force turned to examine the problems and opportunities of our urban areas in two reports—"America's Cities" and "The Metropolitan Enigma." The latter contains recommendations based on 11 research papers commissioned by the MIT-Harvard Joint Center for Urban Studies, headed until recently by Daniel Moynihan, who contributed one of the papers.

The Council's report stresses (pp. 155–156), as did the task force earlier, the decrease in overall poverty in the United States resulting from economic expansion and the attendant drop in unemployment in households headed by a working-age man. But it also notes and discusses the stubborn structural problems that remain—especially those relating to the poor whose poverty results from inability to work on account of age, disability, sickness, or family circumstances or, if able to work, are not very productive because of lack of education.

Resolution of these structural problems requires a combination of public and private action on many fronts, especially at the local level. The national chamber is providing leadership in this effort through two programs—its urban clearinghouse and its urban action exchange. The first of these services provides examples of successful community and manpower development programs undertaken by all elements at the State and local community level. Other State and local groups are thereby put into a better position to profit from the reported experience before formulating their own approaches to community problems. The urban action exchange provides an up-to-date looseleaf reference guide to published information covering every aspect of metropolitan economic and social problems and problem-solving activities. Guidelines for using this information are provided in the Chamber's "Forward America" manual which describes effective procedures by which local organizations can cooperate in community improvement projects.

Thank you.

Senator PROXMIRE (presiding). Thank you, gentlemen. It is a real pleasure as well as very, very helpful to this committee to have the two great business organizations of this country testify this way, and it is particularly useful because so often on our panels, even when we get labor, management, and government all together, they all agree on everything. You gentlemen do not. You have distinct approaches to this, and I think that is most constructive. They are both responsible, they are both intelligent, they are both very reasonably worded.

Mr. Hagedorn, you say that this gradualism approach to inflation is not likely to do the job, because you think that to some extent our inflationary problem is a psychological problem, that is the expectation of inflation persuades business, for example, to go out and expand plant even when they do not have to do so. As I understand it at the present time they are operating at 83 or 84 percent of capacity which is below the level they were operating in 1964 when we cut taxes to get the economy moving, and yet the expectation this year, according to some of the latest reports, is that they will expand plant at an enormously rapid rate, and this I take it is because of the expectation that it is going to cost a whale of a lot more to build that plant and buy that equipment, 2, 3, 4, or 5 years from now than if they wait so they build it now even though they do not need it now and that contributes to inflation, is that correct?

Mr. HAGEDORN. Yes, sir; that explanation I think derives from the fact that there is no other visible explanation of why this continual stepping up of plans for 1969 capital spending has occurred. The successive surveys we have seen started last fall with a prediction of a 7-percent increase, and I think then later on it went to about 10 percent. Last week, one of the private surveys indicated something like 14 percent.

Senator PROXMIRE. This is on top of an enormous base?

Mr. HAGEDORN. And you cannot explain this in terms of capacity pressing against its limits, and you cannot explain it in terms of cheap capital. The interest rates are higher than they have been in our lifetime.

It seems hard to find any explanation of it, except this psychological spiral.

Senator PROXMIRE. I must say on the basis of what has been happening, since we adopted a different kind of fiscal policy, that is we had a deficit of $25 billion in the last fiscal year; the current fiscal year we are expecting a small surplus, another small surplus next fiscal year, so that the real impact of fiscal policy in the sense that it changes from big deficit to a balanced budget, not really much of a surplus but a balanced budget, should be right now, and yet prices have been rising more rapidly since the surtax went into effect and there was this limitation on spending.

We have had an increase in interest rates more sharply since then than we have had before.

Under these circumstances, it would seem that if it is not working now, this neutral fiscal policy, which is what it really is, the Budget Director admitted to us in testimony, and so did the Secretary of the Treasury, that they expected to have a balanced budget, maybe a little deficit, maybe a little surplus, but it would not very much from that, it seems to me this is a neutral fiscal policy, not a restraining policy. Is that your view?

Mr. HAGEDORN. Senator, may I speak a little bit on this subject?

Senator PROXMIRE. Yes.

Mr. HAGDORN. I think the policy in itself, the fiscal policy at least, is reasonably well adapted to the present situation, to the needs for controlling inflation.

There are two reasons why inflation has not been gotten under control since last June. The minor reason is the Federal Reserve expansive monetary policy last summer. The more important point than that is the fact that the country is not quite convinced that Government will ever go through with a noninflationary fiscal policy or noninflationary monetary policy after it starts to pinch.

Last June I recall that most of us economists said that the tax and spending measures you enacted then were the right thing to do. The country, in a sense, had passed a test. It was willing to take some unpleasant tax medicine in order to control inflation. But we also pointed out at that time that there was another test a little further along the road to be passed. That test was whether we would stick to that kind of a monetary and fiscal policy after it did begin to slow down the economy.

You will recall that the cliche at the time of the enactment of the Tax Act last June was "we want to cool off the overheated economy." Well, that is fine, but many of us in our minds were wondering, when the economy does start to cool off, and some of the indicators fall to less happy levels, will the Government be prepared to back away from this kind of a fiscal policy, from this kind of a monetary policy, or will they still stick to it. Will they say "well, we have got to suffer these things in order to get inflation under control."

It is this doubt that we would stick with the program to the end that is the basis I think for the inflationary psychology.

Senator PROXMIRE. I go further than you do in this regard. I see your point. I think it is a logical point. I do think, however, that the testimony before this committee at least by the Secretary of the Treasury, and by the Council of Economic Advisers, and by others that they intend, they mean business, they intend to stick to the present policy until there are unmistakable signs, that 1967 was a mistake when, as you know, we had little growth in the first two quarters of 1967, and then the policies were changed somewhat, especially monetary policy was changed and eased up, that was a mistake. It will not be repeated.

I think that that kind of position was one of the reasons why, for example, the stock market during that period at least was falling. It is coming back a little bit since. It is still at lower levels than it was before. This is some reflection of the impact on the country to the assertions that the administration intends to stick to this position.

But you see my view is having achieved now a balance in our fiscal policy, and having in January the biggest increase in wholesale prices in many years, the biggest increase in manufacturing prices since 1956, and these are the prices of the future, I just cannot see that we are really making any progress in stopping this inflation, and I am just wondering whether a bare balance in the budget is sufficient, or whether we should not have a little more.

Mr. HAGEDORN. Well, I will tell you, Senator, I cannot give you a neat computation that says this projected surplus of $2 to $3 billion is not enough. You ought to have a surplus of X billion dollars.

I cannot reduce it to those mathematical terms. In my mind the real driving force is the fear of inflation, the fear that the Government determination to end it is not a firm determination, it is not one that would inevitably be carried through to the end. That word "gradualism," and the emphasis on it throughout, worries me in that respect.

Senator PROXMIRE. Then Dr. Madden, I take it that on the basis of this interpretation by Mr. Hagedorn, perhaps there is not the difference that I first anticipated there might be between you gentlemen on this particular issue, is that correct?

Mr. MADDEN. I think that certainly I would not deny the difficulty of achieving the objective that the new administration seems to set for itself of gradualism, but on the other hand I think the objective itself should be applauded. In that sense I think there is no difference between us.

I do feel that the Phillips Curve Analysis, the analysis of the relationship between changes in unemployment downward and increases in prices is, after all, only an empirical record of the past, and in that sense it diagnoses a problem which better management by the economy, better policy at the national level and at other levels should zero in on.

This is why it seems to me encouraging that the Secretary of Labor testified before this committee, indicating a new effort to attack manpower policies by a reorganization of these programs in the Labor Department, and by reviewing the whole field of manpower policy.

Also it seems to me encouraging that studies have been stimulated of the nature of unemployment as the economy moves toward higher and higher levels of utilization of manpower, and that these studies show that the crude simplified notion of unemployment as being associated with hardship and of unemployment as being a homogenous commodity, as it were, have been challenged and have been eliminated, and that we are indeed beginning to recognize that the statistical measures that were established 30 years ago or more to cope with depression situations are not any longer adequate for continuing to maintain a balance between growth, price stability and desired levels of employment.

Senator PROXMIRE. I want to come back to that a little later. I am sure the committee will want to discuss that with you too, but for the time being I take it your position and Mr. Hagedorn's position is that the present fiscal policy is right if it is persisted in. Would you agree with Mr. Hagedorn that we ought to express as he said the determination to continue it?

Mr. MADDEN. Indeed so.

Senator PROXMIRE. I think that is important.

Mr. MADDEN. I find the same difficulty as Mr. Hagedorn in specifying that this fiscal policy is "right" in some sense. I think—speaking logically about the economics of the fiscal policy—it should be more restrictive, but if one takes into account the war in Vietnam, the pressures of various groups in this society for changes, the mood of the country, then I think this fiscal policy is a reasonable compromise.

Senator PROXMIRE (presiding). I want to come back but my time is up.

Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

Mr. Hagedorn, I was interested in the statement you made. You said 1957 to 1968 was a representative period in making a comparison between the growth of wages and the growth of profits, and in your 1957 to 1968 comparison, as I recall, you had a figure of 101 percent for wages, and 96 percent for profits. In other words, there was sort of a standoff there. You said there was very little difference.

My question is in that period of 1957 to 1968, how much of that was inflation? How much inflation did we have in that period?

Mr. HAGEDORN. Well, I will correct the record later and give you an exact figure, if you will let me do a little mental arithmetic rather quickly. We have had something like a 20 percent inflation over that period.

Senator JORDAN. Over that period. And yet as I understand your statement, you thought neither wages nor profits were the villains here. The whole blame lay on excessive Government spending.

Mr. HAGEDORN. The blame for the initiation of inflation I think lies in fiscal and monetary policy.

Senator JORDAN. The blame for the "initiation." This is what I was leading up to. I did not get that word "initiation" out of what you said. I thought you were blaming the whole thing on excessive Government spending.

Mr. HAGEDORN. Well, Senator, when I try to think through the causes of this inflation that we have had for, say, the last 3 years, I come up against this fact.

We had a period from 1958 to 1964 when we had a reasonable price stability in the country. Then after 1964 we have had something like a 10 percent rise in prices, and an accelerating rise, one that has been a little more each year than it was the year before.

Now, I cannot explain that by assuming that either labor or business suddenly became more greedy in these last 3 years than they had been in any previous period. I cannot explain why inflation happened in this 3-year period rather than happening earlier in any terms like that.

When I look at the great acceleration of Government spending in those 2 years, partly because of the Vietnam war, partly because of other factors, and the expansion of money and credit, it seems to me the basic cause may lie there. But let me go on.

The nature of our labor agreements in this country, with 2- and 3-year contracts, is to spread the inflation out over a period, which means that it is harder to get rid of it, once it is started. The contracts are negotiated on the basis of the inflation which exists at the time of the negotiation, and they provide for increases in the 2- and 3-year period thereafter. Even if you cut off the basic causes of inflation very sharply at that point, you still have this momentum that carries it through for a longer period, and this is of course a serious problem, and makes it hard to end inflation.

Senator JORDAN. Do you think it is ever going to be possible to have zero inflation and full employment, say an unemployment at the level of $3\frac{1}{2}$ percent or less?

Mr. HAGEDORN. Oh, I do not think there is any conflict at all between stability of prices and low levels of unemployment. The two go together rather than being opponents of each other. This is a great illusion of our times, a great mistake, and could be a tragedy for national policy, if we assume that we can buy lower levels of unemployment by accepting inflation.

Senator JORDAN. You made the point very well, I thought, when you said that we should not be talking about the tradeoff.

Mr. HAGEDORN. This is a great mistake, sir, to believe that such a tradeoff is possible.

Senator JORDAN. I will get back to that in a little. Dr. Madden, I want to talk to you a little bit about gold. You suggested that an increase in the price of gold is not desirable, and I want to ask what you think of the price of gold in the speculators' market? It got up as high as $46 an ounce and now is fluctuating a full $10 above the base price of $35 an ounce. Do you think that we can sustain this two-level price for gold very long, and if you do, how long?

Mr. MADDEN. I have no way of giving an estimate of how long it could be sustained. I do think that the price of gold in the market yesterday is an indication of the importance of the international monetary problem and the importance of improving the international monetary system.

I do think that despite the level of the price from time to time in the private market, that there is time available for the free world countries to make improvements in the international monetary system, if they will proceed to do so with good faith and with energy.

Senator JORDAN. How wide a difference do you suppose we can tolerate between the private price for gold in the speculators' market and the established base of $35?

Mr. MADDEN. Again I am really in no position to make an estimate. I do not know the answer. I am not sure anyone else does.

Senator JORDAN. What would happen if someone breaks the line and goes to the private market to sell gold? Isn't there a very real danger there that such a wide variation in price, the whole thing is liable to break down?

Mr. MADDEN. There is indeed, if high prices are maintained in private markets. This puts pressure against the countries which have entered into this arrangement for the official price of gold in monetary transfers.

Senator JORDAN. Do you agree with Mr. Hagedorn that neither wages nor profits are responsible for inflation?

Mr. MADDEN. Yes, I do; in the sense that I think it is the role of Government economic policy to maintain an environment of stability, and an environment conducive to economic growth, so that while prices and wages can fluctuate to reflect changes in the demand for various goods and services and therefore changes in the allocation of productive resources to wanted objectives, that the Government is ultimately responsible for this general environment, and in the sense failure on the part of the Government to maintain an environment of stability through excessive monetary creation and Federal deficits at inappropriate times is the ultimate cause of inflation.

Senator JORDAN. Yes; the ultimate cause. The Government probably is the initiator.

Mr. MADDEN. Right.

Senator JORDAN. But you would agree, would you not, that wage increases beyond the increased productivity of labor are inflationary?

Mr. MADDEN. They certainly produce inflationary results; yes.

Senator JORDAN. Yes. All right, at what point do profits produce inflationary results? At what point would you say, if you agree that labor beyond a point of increased productivity creates inflationary results, at what point do profits increase inflationary results?

Mr. MADDEN. I do not think that there is a similar formulation for profits that are defined as inflationary above a certain level. There are efforts to attribute profits or some portion of profits to market power, to concentration of resources, and theoretically such profits would then be considered undesirable for many reasons, including their inflationary impact. But I do not know of formulations that can define this with some degree of operational meaning.

Senator JORDAN. You both have brought up very interesting subjects. My time is up and I yield.

Senator PROXMIRE (presiding). Mr. Hagedorn?

Mr. HAGEDORN. Mr. Chairman, may I make a brief comment so as not to let labor off the hook entirely?

I would say that in my view the effect of labor union power on the price level is to cause the price level to be higher than it otherwise would be, higher all along the time scale by roughly the same percentage. But you see, there is a difference between saying that and saying in effect that the presence of labor unions caused an upward trend in the price level whereas otherwise the price curve would be flat.

I do not think that is true; though I do think it is true that, because of the presence of labor unions, the price level is higher than it otherwise would be.

Senator PROXMIRE (presiding). Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Mr. Madden, we are just delighted to see the chamber's recommendations on the international economy. I am a little embarrassed, I guess, because I was not aware that your national chamber board had made all these. May I ask when this was?

Mr. MADDEN. They did this at their meeting on February 21 and 22 of this year.

Representative REUSS. Were they all fully announced at that time?

Mr. MADDEN. Yes, they were announced at a press conference about a week or so ago.

Representative REUSS. It is good that you are publicizing them again, because the fact that you recommend prompt and serious study of both a wider band and a system of sliding parity for exchange rates, and a reserve conversion account, I think is of first importance. You know this committee has felt that the monetary world has been too complacent, and that we must look for better ways of making adjustments and restoring confidence.

A little point of clarification there. You say in your statement:

> The Chamber's Board went further and approved a wider band of fluctuation of market foreign exchange rates, provided the Administration makes this proposal to the International Monetary Fund.

How does that gear in with your statement under point 5 that you recommended a study of a wider band? My guess is that you say study of a wider band for all currencies including the dollar, but you are ready right now to go for a wider band for currencies other than the dollar?

Mr. MADDEN. We recommend that the nations of the free world study the question of wider bands seriously. We interpret our present policy concerning the gold exchange standards to permit us, not to require us but to permit us, without further action on the part of the chamber's board, to support a proposal by the administration to the International Monetary Fund which presumably would have reflected this careful study that we recommended.

We are not required to support such an administration proposal, but we are permitted to do so. That may seem fine spun to you, but it is a device by which the chamber can act upon any initiative of the administration, and is permitted to consider it without further action of the board respecting the chamber's policy.

Representative REUSS. Again I want to be sure I understand this. Suppose the United States adopted a position—it has not now adopted one but suppose it did adopt a position—for a wider band and a sliding peg or some combination of the two, and offered it to its colleagues on the International Monetary Fund at its next conference, let us say. Would the U.S. Chamber of Commerce, by existing action, automatically approve that position, or do you want another look at it?

Mr. MADDEN. We would be permitted to approve it by our board without further board action, but we would not be required to do so by the board.

Representative REUSS. Who is the "we"—the President and yourself and others?

Mr. MADDEN. The staff of the chamber of commerce expert in this field.

Representative REUSS. Very good. I detected in the testimony both of Mr. Hagedorn and Mr. Madden a sort of requiem mass for Dr. Phillips and his famous "curve," and I think I might join with you in that.

I gather that neither of you think that there is a law of nature which says that necessarily you get higher inflation as you move toward fuller employment?

Mr. MADDEN. Indeed I agree fully.

Representative REUSS. Do you concur? Mr. Hagedorn was quite explicit on that.

Mr. HAGEDORN. Yes.

Representative REUSS. I will let you speak for yourself.

Mr. MADDEN. I would just like to say that this has been a position the chamber of commerce has maintained for several years, and I recall that there was a period when structural unemployment was not considered to be a very important subject, and great emphasis was placed on aggregative measures alone to cope with unemployment.

It seems to me that the message of the current situation—when we have high levels of employment, record prosperity, historic increases in prices and the interest rates, a general feeling of malaise in the country, and a renewed interest in poverty that is not necessarily associated with unemployment, but certainly includes poverty resulting from unemployment—the current situation all adds up to a clear indication to us professional economists that we should not remain preoccupied with aggregative measures and mechanical relationships between highly summarized, crude average statistics.

Representative REUSS. I certainly applaud that. I think there has been too much meat ax fiscal and monetary policy. Would you agree that on both sides of the Phillips curve, both on the full employment side and the inflation side, there are a great many specific ad hoc nonaggregative measures that can and should be taken?

For instance, on the inflation side, in addition to all the fiscal and monetary sanity that one ought to pursue, it is true, it is not, that with respect to things like the cost of health and medical care, like the cost of auto repairs and TV repairs, the major remedy probably lies not so much in how much overall spending and taxing there is and how tight or loose monetary policy is, but in ad hoc measures?

If we do not have enough physicians, let us somehow or other, publicly or privately, get more medical schools. If we do not have enough auto repairmen, let us try to gear up our technical education and our apprentice system so that we do, which has nothing to do with aggregative methods.

That on the inflation side. You have already expressed yourself on the unemployment side. There the problem is surely increasingly structural, and as you have indicated in your testimony, there is a great deal that can be done there. So would you not agree that on both sides of the Phillips curve it is a mistake to pursue only meat ax methods, and that you can make the Phillips curve much less of a law of nature than it is presumed to be, to the extent that you are willing to pursue imaginative private and public methods of dealing with both inflation and employment?

Mr. MADDEN. Yes, subject to the qualification that where one has a relative stability in general prices, and one also has rises in prices in particular sectors, rises in wages in particular sectors, this certainly indicates a shift in the preferences of Americans. It may also indicate temporary difficulties in the structure of the economy and if so then these structural measures should certainly be—as you indicate—pursued by public and private agencies.

Now it seems to me that if there is general inflation, and——

Representative REUSS. I had the qualification in there.

Mr. MADDEN. Yes sir.

Representative REUSS. In any event, I think you have to have sound fiscal and monetary policies.

Mr. MADDEN. Yes, sir.

Representative REUSS. That are aimed at full employment.

Mr. MADDEN. We agree.

Representative REUSS. Without inflation.

Mr. MADDEN. But not those alone.

Representative REUSS. Not those alone.

Mr. MADDEN. Yes, I certainly would agree with that.

Representative REUSS. Let me turn now to Mr. Hagedorn and particularly your colloquy with Senator Proxmire on the secondary effects of inflation, the fact that because businessmen sense that inflation may proceed, they build more plant equipment now than they would if they did not have that apprehension, and these feed the fires.

As you perhaps know, I have felt increasingly that the 7 percent investment tax credit, which we Democrats thought up in 1962, I think because we wanted to be wanted and loved by business, has not really worked. It has bunched so much of the capital investment at the inflationary end of the cycle, like right now, that I cannot see that it really helps either the machine tool industry or business in general. Over the long run, businessmen are going to invest in such plant and equipment as is necessary to produce the goods that the overall demand is likely to take off the market.

If we have a slow economy as we did in 1963, putting in a 7-percent investment tax credit does not do much good at the more ebullient end of the cycle it tends to do too much good, and I think it is one of the reasons why we are now only using 83 percent of our industrial capacity, and investment plans for this year continue huge.

My question is since we all seem to agree that monetary policy must be tighter, and the reason it must be tighter is we want to make it a little more difficult to borrow money and spend it on the part of industry, aren't we working at cross purposes in continuing the 7 percent investment tax credit, and would we not be much better off to repeal it in perpetuity, and since you represent business, I will say I am most happy to take that $3 billion revenue savings and give it back to business by not imposing the corporate surtax. It works out to the same thing.

Mr. HAGEDORN. Congressman Reuss, I do not see how you can deny that with an investment tax credit, whatever the other economic circumstances may be at any time, you will have more equipment purchases than you would have otherwise, more than you would have without it.

Representative REUSS. I do not deny it. What I say is that they are marginal equipment purchases.

Mr. HAGEDORN. Well, sure.

Representative REUSS. Not made by true economic judgment of what total demand will take off the market.

Mr. HAGEDORN. Well, in effect with the investment tax credit, you buy qualifying equipment at 93 cents on the dollar, and there are propositions under those terms that are worth doing that would not be worth doing without that credit.

It seems obvious. I do not know whether you can make any precise calculation of how much it has affected equipment purchases at any time.

On this general subject, it seems to me that in 1963 you in Government made a deliberate decision that you wanted economic growth over the long term to be faster than it had been. You observed that capital formation was an important ingredient of long term economic growth, and therefore you made this decision to give a special tax break to capital formation, I do not think anything has changed to alter those decisions.

Now it is true that we are in an abnormal period now, with inflationary expectations that are in themselves greatly increasing the demand for capital equipment as well as the demand for a lot of other things. But are you going to offset the abnormalities of this particular period by changing—by abandoning—what was a long term decision made 5 years ago?

Representative REUSS. My answer is that we should. Bear in mind the proposition I put to you leaves the same amount of cash flow in corporate coffers, because the proposition I put is——

Mr. HAGEDORN. To cut rates?

Representative REUSS. Repeal your 7-percent investment tax credit, and refrain from imposing the surcharge on corporations, which would put the $3 billion the Government made by repeal of the investment tax credit right back in the corporate coffers, so corporations would have just as much money to invest.

Mr. HAGEDORN. Yes.

Representative REUSS. The cash flow would be equally great. But if you did it this way, then investment decision would be rational rather than heated up by the very ebullient phase of the cycle which you described before as disturbing.

Mr. HAGEDORN. Well, I cannot accept on industry's behalf the bargain that you offer, Mr. Reuss. All I would say, without trying to analyze this proposition through, it is a dangerous sort of experiment, even though the total tax burden on corporations remains the same. It is a dangerous experiment to shift this around, because of a short-term situation.

Mr. MADDEN. May I comment on that question?

Representative REUSS. If I am intruding on somebody's time——

Senator PROXMIRE. Not at all; go ahead.

Representative REUSS. Thank you.

Mr. MADDEN. I think we need to look ahead. I am much impressed with the work, although it is speculative, that has been done by the futurists, those who are attempting to predict technological change, the Institute of the Future that has recently been formed, the effort through the Delphi method to poll experts and find out when inventions are likely to happen, studies of technological transfer—how fast scientific knowledge turns into invention, and how fast invention moves into the market, the spillover of research and development to economic growth, and the like.

Looking at this kind of question, and at the threshold of changes that are coming along, it seems to me there is a valid argument for stimulating long-term economic growth at high levels by use of the tax system.

The chamber of commerce opposed this tax credit when it was first established. It opposes tax credit generally. However, it seems to me the logic that could be advanced in comment on your question is that the proposition you have put would give corporate managers a choice of either investing or purchasing a gilt-edged security, whereas the investment tax credit requires the investment. And it seems to me that in the long run, we should encourage business enterprise to invest in new plant and equipment, in order to move along these benefits that stem from more productive forms of activity generated from research and development.

We are spending huge amounts of money on research and development, and there is a sense in which a balanced advance from the huge amounts spent on research and development to a steady rate of growth is also a consideration for economic policy, aggregative economic policy of interest to this committee.

So it seems to me there are arguments that could be advanced for stimuli to business investment in physical plant and equipment, and indeed measures that encourage business to write off existing capital a little faster, in order that we get the benefits of the scientific revolution as fast as we can assimilate them, with stability and balance in the economy.

Representative REUSS. Thank you very much.

Senator PROXMIRE (presiding). Senator Miller?

Senator MILLER. In your judgment, gentlemen, during the last few years, where have we fallen down the worst as a result of which we have this inflation picture, on the monetary policy side or the fiscal policy side?

Mr. HAGEDORN. If I may answer, I think, if you will let me be frank, Senator, the initial fault lay on the side of fiscal policy, and it came in the 2-year period after the tax reduction of 1964.

You will recall the atmosphere in which that tax reduction was passed. There were statements by national leaders, both in Congress and in the administration, that this was a major national choice. We decided that we would seek economic growth through expansion of the private economy rather than through expansion of Government. This was the interpretation of the decision that was made at that time.

Also at the time that Tax Reduction Act was passed in 1964, the general consensus was that along with it went a commitment to keep Government spending under control. We expected the tax reduction to result in increased revenues rather than reduction of revenues, and by controlling expenditures we would not go into a period of deficits.

Unfortunately, the things that happened in the couple of years after that did not realize at all the hopes that were expressed in those declarations at the time. Partly this was the expansion of the Vietnam war, which I suppose could not have been foreseen at that time. Partly though, it was an expansion of civilian programs in the Government.

In any case, after about 2 years, you found an enormous expansion of expenditures, which culminated finally in last year's $25 billion deficit.

Now as far as monetary policy is concerned, the Federal Reserve System seems to feel this obligation of facilitating the marketing of the Government debt, and with the large volume of Government debt to be marketed, this makes the application of a restrictive policy on the part of the monetary authorities that much more difficult.

I do not say that they did everything right. In fact, Chairman Martin, when he was here before you, said he agreed that the policy of last year had been wrong. But I think in part it was a reflection of the fiscal results that they were faced with.

Senator MILLER. Is it your answer that we fell down worse on the fiscal side than we did on the monetary side?

Mr. HAGEDORN. It is hard to make that comparison, Senator. I would say the initial falling down was the fiscal side; yes.

Senator MILLER. Do you have an opinion on that, Mr. Madden?

Mr. MADDEN. Yes. I think it is an extremely interesting, tough question, but I would proceed a little differently from Mr. Hagedorn. I would feel that the initial error was in fiscal policy, but not in 1964; rather, in the escalation of the Vietnamese war in 1965, and in the failure of the budget to project that increase in expenditure, a failure that you gentlemen on the Joint Economic Committee pointed out and publicized and emphasized in your deliberations.

I also feel that one could make the case, and I think your own studies have been very interesting in raising the question whether this case could not be made, that one might expect of fiscal policy less steadiness over year after year after year, because it absorbs the shocks of changing values, changing events, both domestic and foreign, and the adaptation of the country's posture, the Government's posture to these events.

Thus, one could argue, as some have, that sure, we have had a $25 billion deficit, and we all deplore it, and yet we have fought what has turned out to be a major war, without controls.

On the other hand, it seems to me that the historic role of monetary authorities and monetary policy is to maintain this kind of steadiness, this nonpolitical judicious steadiness—with overtones of analogy to the Supreme Court, the "Supreme Court of Monetary Matters" as the Board has sometimes been called—that will provide a tension against which the Executive and the executive branch must operate.

I think in this connection that the explorations of this committee, the interests of Senator Proxmire and others in raising the question of a steady rise in the money supply as an appropriate posture, long-term posture for monetary policies, is a very salutary kind of investigation to pursue, and fits into the proposition that perhaps fiscal policy has somewhat overwhelmed the determination and perspective of the moetary authorities since 1965.

Senator MILLER. I have the feeling that the monetary authorities like us to believe that fiscal policy is the biggest villain in this situation, and, of course, since we are talking about a $25 billion deficit, it would seem, certainly, for that period of time, they are correct.

I am just wondering if you thought it was prudent to have a tax cut and have to borrow money in order to cover it. You may recall there was quite a bit of debate on this point, and I do not mind telling you that I personally thought it was not prudent to have a tax cut, unless it was within the framework of a reasonably balanced budget. What we did was to have a tax cut and just go further into a deficit position.

I have not run into anybody yet who would not say he would rather have a tax cut without having a deficit. Almost everybody will admit to that. But where you separate a lot of people is in the desirability of having a tax cut in a deficit situation. I personally did not think it was prudent.

I think that the inflation that arose—that say was initiated out of that deficit picture—more than offset the tax dollars that were saved for certainly your low and lower middle-income people. Maybe people in high brackets came out ahead, but not the average low-income and middle-income persons.

I am wondering, as I recall I think both the chamber and the NAM supported that tax cut, even in the face of a deficit. Am I correct in that?

Mr. HAGEDORN. Yes, sir.

Mr. MADDEN. Yes.

Senator MILLER. Hindsight is always better than foresight. Don't you think it would have been more prudent if we had had the tax cut without having a deficit, I mean have a tax cut within the framework of a reasonably balanced budget, rather than having a tax cut which just aggravated the deficit position?

Mr. HAGEDORN. Senator, I do not think it was the tax cut in itself that aggravated the deficit position. What aggravated it was the expansion of spending that occurred right after that period.

If we had lived up to the plans that were made at that time——

Senator MILLER. Yes, but as I recall the recommendations from NAM and the national chamber, they saw what was in prospect for the spending, and I do not believe that they hedged their recommendation on the tax cut by saying "provided there will be enough spending controls so that we will not have a deficit." I do not remember them hedging themselves that way.

Mr. HAGEDORN. Well, I think we have all learned something from the history of that period. No one foresaw the rapid expansion of spending after 1964.

Senator MILLER. Well, now here we are with a $3.4 billion surplus—taking trust funds into account—for fiscal year 1970, and a $6½ billion operating budget deficit. Now if you were asked the question, Do you favor a tax reduction, for example, repeal of the 10-percent surcharge, which would then make about a $15½ billion operating budget deficit—would you recommend that?

Mr. HAGEDORN. No, sir; not under those circumstances.

Mr. MADDEN. Nor I.

Senator MILLER. My time is up, thank you very much.

Senator PROXMIRE (presiding). Mr. Conable?

Senator Sparkman has deferred to you; he came in a little later and he would prefer to have you go ahead.

Mr. CONABLE. Thank you very much, Mr. Chairman.

Gentlemen, I am sorry not to have heard the beginning of your testimony. We are having an interesting time over at Ways and Means on debt ceiling at this point and that is where I was.

I would like to ask: Is it true that inflation harms corporations less than it does individuals, because of the graduated individual income tax?

Mr. HAGEDORN. It is very hard to answer any question like that with a generalization. Generally the basic impact of inflation is to help debtors and to hurt creditors, and many corporations, of course, are debtors. They have bond issues out and so forth.

They, in effect, pay their mortgages over in cheaper dollars. To the extent that a corporation may be deeply in debt, it might be helped by this sort of thing.

On the other hand, some corporations are creditors, and they would be hurt. But there are other factors involved. The price of their product might be regulated, for example, and could not respond to the inflation, while their costs might be going up. That sort of a corporation would be hurt.

I do not know of any general answer I can give to your question.

Representative CONABLE. Looking at it from a tax point of view, inflation would be damaging to an individual who is rising into a higher bracket, even though his margins might remain the same, while a corporation has a fixed corporate income tax. But I can see, therefore, many other factors involved than simply taxation.

We have had a lot of talk about fiscal policy against monetary policy, and I would like to express some disappointment that last year at the time when we were deeply embattled over the surtax, and whether or not it would be imposed, that business did not come down more strongly on the side of restraint on spending than it did. I recall telegrams coming in signed by all the top business executives urging the imposition of the surtax, and great difficulty in getting these same people to take a strong hand on extending cutbacks, although they would say they were in favor of it generally. Do you have any comment on business' posture at that time?

Mr. MADDEN. Well, I can speak for the chamber of commerce in the sense that I was a member of the group that appeared before Ways and Means on the subject in August of 1967 and I believe our position was to oppose the surtax, unless it were accompanied by spending cuts, and that this was the position of the chamber of commerce, and that it expressed this position again I believe in February of 1968. So I am a bit puzzled by your comment.

Representative CONABLE. Well, my comment was not directed at the chamber of commerce. My comment was directed at a large number of businessmen, the leaders of the great corporations of the country, who seemed to be organized in some way to press for the surtax, but were not similarly organized to press for restraint on the spending side, and this group always mystified me. It was not the chamber itself. I believe the chamber's position was correct.

I would like to say with respect to the 7 percent investment tax credit I think one of the most important things we can do in this respect is to decide what we are going to do and do it. I would be very much concerned about our suspending it again, or changing it under circumstances when it was apparent that our decision was not final, because it seems to me that we did a great deal of damage with this in the short-term manipulation of it, following the 1963 imposition of the 7 percent investment tax credit, and then its suspension for a short period of time.

Isn't it true, from a business point of view, that one of the greatest problems with respect to such a device is that to be equitably used it has to be something on which you can depend and plan over a fairly long-term period of time?

Mr. MADDEN. I think there is no question about this, and I think the chamber of commerce shares your view completely that it was terribly ineffective and confusing to suspend the tax credit as was done.

I am not a student of the technicalities of that, but my impression was that some suspensions perhaps are still being negotiated. Certainly it took some time to straighten out the technical implications of the suspension for many corporations.

Mr. HAGEDORN. If I may comment on this.

Representative CONABLE. Yes.

Mr. HAGEDORN. I think to create an atmosphere in which everybody expects that the investment credit will be taken off and put on at short intervals would be to create a very serious destabilizing force in the economy. You would bunch up capital expenditures. When you thought the credit might be taken off you would hasten to make your capital expenditures. Then in the period while it was off, you would be waiting until it came on again for things you might otherwise be doing. This would be a seriously destabilizing force.

Mr. MADDEN. As a matter of fact, if I can refer back to a comment I made earlier, I think some of our distinguished aggregative economists who have been preoccupied and bemused by "fine tuning," in quotation marks, generally would do well to turn their brilliant minds more to solving some of the structural problems that we face in the country, and not relying on fine tuning as being such a useful device for the country, either on the tax side or the monetary policy side.

Representative CONABLE. Well, I would like also to express concern about the political deliverability of the package that Mr. Reuss suggested, of preventing the surtax on corporations in return for the cancellation of the 7-percent investment tax credit, presumably leaving on the surtax on individuals.

Representative REUSS. If the gentleman will yield.

Representative CONABLE. Yes.

Representative REUSS. Not presumably at all. If we plug some other loopholes we would be able to take that off, too, with your help.

Representative CONABLE. I see. You are talking about the reform generally when you say plug other loopholes?

Representative REUSS. Yes. you can raise $3 billion by permanently repealing the investment tax credit, and get your other $6 billion by plugging other quite obvious loopholes, but my point, Mr. Conable, was that this tradeoff would leave corporations with the same cash flow.

Representative CONABLE. Yes.

Representative REUSS. That they enjoy, but presumably with a better opportunity to make economic decisions.

Representative CONABLE. In effect you were coming out in favor of recommending a block grant as opposed to a categorical grant for corporations. Well, that is all, Mr. Chairman.

Senator PROXMIRE (presiding). Senator Sparkman?

Senator SPARKMAN. Mr. Chairman, I am sorry that I had to be at another committee meeting earlier that made me late getting here and I did not get to hear the direct statements of these gentlemen, nor much of the questioning that has followed, so my questions I imagine will be rather general instead of being based upon your statements.

We are always talking about inflation, and nearly always we feel inflation, and yet in the testimony that has been given before this committee, and particularly was it true in the case of Chairman Martin of the Federal Reserve Board, there seemed to be a rather optimistic note.

I recall in his statement he said that he thought that the inflation was tapering off and would taper off, and that we could have disinflation I think was his term, without deflation. I thought that was a rather interesting statement on his part, because I think it is the first time I ever heard him testify on the question of inflation that it did not bring up deflation, always fearing deflation right at the time we had inflation.

But some economists argue that we shall always have gradually increasing inflation. Do you subscribe to that view, either one or both of you?

Mr. HAGEDORN. If your question is do I want to make a prediction of what the history is going to be, then I would say if people like you gentlemen up there really believe this, then it will probably happen. There will be no way of stopping it.

But I believe that we can stop inflation, that it does not increase the level of employment. It does not improve profits or wages in any real sense at all, and if you make up your mind you are going to live without inflation, we can live without inflation, and we won't suffer from it. We would suffer from living with it.

So if your question is to make a historical prediction I would say you gentlemen sitting where you do can make that prediction better than we can. If you have enough determination on our behalf, we won't have the inflation.

Senator SPARKMAN. I wish we felt that we had that power, the power sufficient to do that. What about your view, Mr. Madden?

Dr. MADDEN. I do not believe that we need to resign ourselves to the inevitability of inflation at all. I think that I am optimistic that with the institution such as the Joint Economic Committee, and with the growing concern of people about economic questions, and our growing wealth, that we can have a corresponding growth in maturity and responsibility and understanding on the part of the various groups in the economy, and that as a result, we can recognize the truth of what Mr. Hagedorn has said.

I do think that the major immediate problem is to attack the psychology of inflation, the notion that inflation is inevitable. I believe that this is a very important element in the report you gentlemen will disseminate, and yet I think that I would agree with Mr. Hagedorn that if policymakers recognize and are determined to avoid the evils of inflation that they can be avoided.

Now as for the second part of your question, Mr. Martin's comment about disinflation without deflation, it seems to me that this is an extremely important objective, that it is historically significant as to whether the United States in the coming few years can achieve this.

Certainly it is a more appropriate objective to attain disinflation without deflation than it would be to bring the sledge hammer to bear in order to stop this inflation immediately and because the dislocations that such a sledge hammer tactic would cause.

Senator SPARKMAN. I read I think it was yesterday, I read an article in the paper to the effect that in 1978 the projection was that the Dow-Jones 30 industrial average would be 2100. Now that sounds inflationary to me. Would that be the result of inflation? If we were level, if we had no inflation, would there be an increase from time to time in such a projection as that?

Dr. MADDEN. In the Dow-Jones average?

Senator SPARKMAN. Yes.

Dr. MADDEN. I would have to ponder this more carefully.

Senator SPARKMAN. That is just what I thought. We talk about the fear of inflation, and the desirability of not having deflation, and I just wonder if that is realistic.

May I give just one other example?

Mr. HAGEDORN. Sure.

Senator SPARKMAN. I heard a radio commentator last night, a sports commentator, say that in 1919 the Boston Red Sox sold Babe Ruth to the New York Yankees for $125,000. And of course to me that is big money even today. But then he went on to say, a lot of people will ask why in the world did they get rid of Babe Ruth for $125,000.

He said you know though that was 50 years ago, and that $125,000 today, he said, probably would be as much as $1 million. I am not at all certain he was accurate. I do not suppose he was trying to be absolutely accurate. But it does in a graphic way show us how some of these things have gone up over a long period of time, when we look out into the future. Are they going up? Are they going to continue to go up?

Mr. HAGEDORN. I would suggest, Senator, that projecting these lines you draw by putting a ruler on them and then drawing the line a little further, it is a rather dangerous procedure. An awful lot of people have lost fortunes in the stock exchange by making their predictions that way.

Senator SPARKMAN. You know, I just happened to think——

Mr. HAGEDORN. Somewhere along the line inflation does break itself. I would expect it to happen in this country.

Senator SPARKMAN. Yes.

Mr. HAGEDORN. Because I do not expect us to fall into a Latin-American pattern. Somewhere along the line the inflation is going to be broken, and that may be an unhappy time, and the longer it is postponed the more unhappy it will be.

Senator SPARKMAN. You said putting that ruler down, projecting the line is rather interesting, and it reminds me of something. Did you know Louis Bean who for many years, I believe, was an economist down at the Department of Agriculture?

Mr. HAGEDORN. Statistician.

Senator SPARKMAN. He had considerable success in predicting national elections in that way. He always used that straight line projection, did he not?

Mr. HAGEDORN. Yes, sir, and I may say, Senator, during my lifetime I have discovered many infallible ways of predicting the course of the stock market. At least they were infallible up to the point when I discovered them.

Senator SPARKMAN. Up to the point where it breaks?

Mr. HAGEDORN. Yes, sir.

Senator SPARKMAN. And maybe that is a parallel to what you have just said, that inflation will go on, and finally it will break by itself.

Back after the war I had the privilege of visiting a number of foreign countries. I don't know whether it was inflation or just a weakness of their whole financial and fiscal structure that caused it, but the value of their currency had gone way down.

By the way, I was in England when they devalued the pound back in 1949, wasn't it? I was there at the time. And I believe I was over there this year, this past year, when they cut it to $2.40. But that was a case of a country that had a prety solid financial base.

I remember being in Greece one time. Maybe I have forgotten the correct figure, but it seems to me that the rate of exchange was either 6,250 or 62,500 drachmas for 1 dollar, a tremendous thing, and I wondered how in the world those people got by with it.

Well, I was back there a few years later, and it was $62.50. Now it was not inflation breaking that brought it down. It was simply devaluation. Sometimes when I get to thinking about this inflation, and try to project this thing into the future, I become rather fearful as to what may happen with us sometime in the future. I hope you are right that inflation will feed on itself until it breaks, and I hope we may be able to make some recommendations that will slow it down. I do not know whether I have any hope of stopping inflation or not, but certainly of slowing it down.

Senator PROXMIRE. When the Red Sox sold Babe Ruth to the Yankees in 1919 he was a pitcher and it was later when that big bat began to swing——

Senator SPARKMAN. That is right. He was a pretty good pitcher.

Senator PROXMIRE. Marvelous pitcher, very good, you bet, but not nearly as valuable as he was as a hitter.

One prediction in 1929 that the Dow-Jones index would be 700 in 1938 or 1939, and actually in 1939 it was 200. It had gone down from 350.

Senator SPARKMAN. Well, at that same time, the total revenues to the Federal Government or a couple of years earlier, in 1937, were only about $8 billion, and the gross national product was as I recall it about $50 billion, so there have been some changes. And may I say in that connection, having lived through that period, I think we are living better today than we did then.

Representative CONABLE. Mr. Chairman——

Senator PROXMIRE (presiding). Yes.

Representative CONABLE. The burden of your remarks, gentlemen, has been similar to those made recently in a speech by Dr. Allen Wallis, the president of the University of Rochester, in which he said that inflation was caused by Government through its monetary and fiscal policies, that improper wage policies or improper pricing policies could aggravate it but they could not cause it. And that seems to be the burden of what you are saying as to what we decide, what the Government decides is likely to be the major impact on inflation.

Yet you say there are these natural processes that are likely to take over and break an inflation eventually, so there must be more than Government involved.

Mr. HAGEDORN. Well, the inflation can break in several ways. The astronomical inflations in Germany and France broke because, well, the economy had just ground to a halt. The inflation becomes so rapid that there was not any effective medium of exchange. Their currency was not acceptable at all as a medium of exchange. And the Government then had no choice but to step in and, in effect, create a new currency for the country to start working on again.

The effect of that, of course, was to wipe out the savings of one class, and turn the ownership of the country over to another class, something that left a heritage of great social discontent thereafter.

It has to involve some form of the Government stepping in when the situation just becomes so drastic that the country cannot live with it any more.

Senator PROXMIRE. I would like to get into something else. I might point out something that I think all of us tend to neglect and that is that American economic history did not begin after World War II. We have had many, many, many periods of falling as well as rising prices. There is nothing inevitable about prices going up forever. In fact, the tendency has been after every war in our history prices came down.

Our difficulty it seems to me is that after World War II we had a series of wars. We had the Korean war and the Vietnam war. At least that is one element in it, and I think it is perfectly possible that if we have an era of peace we might have an era of price stability, if not falling prices.

I would like to ask you though, because, Mr. Hagedorn, you are the very first witness to my knowledge, of all the witnesses we have had, who has come down hard on the side of reducing spending. This is interesting to me, because I think there is a very good chance Congress is going to do the same thing. A lot of people think it is impossible. We did it last year as you know. We put a ceiling on spending.

The question I would like to ask though, because in your remarks, though I have not had a chance to study your paper, in your remarks you were quite general about it. Where would you cut the spending? Do you think Congress should make or can make big reductions in specific appropriation bills, or do we do it as we did it last year, with the Smathers-Williams resolution, and set a ceiling?

Mr. HAGEDORN. I think your approach has to be pretty broad again, maybe even a meat-axe approach. As prime candidates, the areas I would suggest would be defense, and in that huge sum there must be cuts you can make, defense, space, farm price supports. They would be the prime candidates for such a reduction.

Now I have to say that——

Senator PROXMIRE. How about public works?

Mr. HAGEDORN. Yes; and public works too. I think that is an area that should be studied for possibilities of cutting expenditures.

Senator PROXMIRE. Do you think we can cut the proposed budget of over $195 billion by $12 or $15 billion?

Mr. HAGEDORN. If you want to badly enough, Senator, and if you are willing to take all the protests that would come. Wherever you cut, I think you are going to find people protesting against it.

Senator PROXMIRE. You know after all the flak last year and all the criticism, a man as responsible and highly respected as Secretary of the Treasury Joe Barr came to the conclusion that Congress did pretty well last year in setting that ceiling.

Mr. HAGEDORN. Yes.

Senator PROXMIRE. It puts the executive department into a powerful but at the same time a very embarrassing position.

Mr. HAGEDORN. Yes.

Senator PROXMIRE. But it seems to work.

Mr. HAGEDORN. Yes, I would agree with that point of view. My first reaction to the ceiling idea was that it is a little ridiculous for Congress first to appropriate the money and then set a ceiling that is less than the total of their appropriations. But the fact is it does seem to work.

Senator PROXMIRE. The ceiling was designed——

Mr. HAGEDORN. I think it is a step in the right direction.

Senator PROXMIRE. To apply not only to the obligations in the appropriations but also the expenditures?

Mr. HAGEDORN. Yes, sir.

Senator PROXMIRE. That would have a more immediate effect on the economy.

Mr. HAGEDORN. And I hope you will do the same this year if the subject of continuing the surcharge comes up, which looks very probable.

Mr. MADDEN. May I comment?

Senator PROXMIRE. Yes, Mr. Madden.

Mr. MADDEN. Going back to Mr. Conable's comments and the chamber's position on the surtax bill, we were much impressed with the argument that Mr. Mills advanced that the problem was really the long-term growth of Government spending, and the acceptance of the philosophy that Government spending was more or less uncontrollable.

So we thought about the tax expenditure package in the long-term sense as well as the short-term cyclical sense.

In my own opinion, it seems to me as an economist that this setting of an overall ceiling on Government expenditures by the Congress was a historic act of great potential significance. It goes to the question that the Congress has no readily convenient means to examine the budget as a whole in its deliberations, but that the appropriations committees consider pieces of the budget, and seldom is this put together.

The setting of an expenditure ceiling by the Congress itself requires all of the individual pieces of the budget to be fitted with that ceiling by whoever may be responsible, but in the Congress and the appropriations committees and in the executive, and it is painful, as you see.

But in some ways this seems to me to be the most promising approach that we have so far seen to this question of the Congress examining the entire budget and acting on the entire budget. It certainly seems to me superior to ideas such as that of establishing a joint committee on the budget, which would present all kinds of historic and procedural problems to the Congress.

Senator PROXMIRE. In terms of its effect on inflation, we had testimony by Dr. Suits of Michigan State that a reduction in spending, I should say an increase in taxes has only about three-quarters of the effect dollar for dollar as a reduction in spending has in his view in combatting inflation on the basis of his study.

Representative CONABLE. At a time of high savings.

Senator PROXMIRE. That is right, and this seems to be concurred in by the other economists who testified with him.

Furthermore the lag effect, as they put it, is especially significant. If we have learned nothing from this from what happened since we increased the taxes with the surtax, we have learned that there is a great lag. That people have an option and they do not change their spending patterns overnight.

When you limit spending, you hold spending down, it seems to me that it is bound to have a prompter, swifter effect, that it hits when you want it to hit, rather than at a time later when you may not want that kind of restraint on the economy.

Representative CONABLE. Speaking to what you were saying about the expenditure ceiling, Dr. Madden, I really think this is the only way we are going to be able to keep things under control. We have such tendency here, using the analogy of the forest and the trees, to look at each tree as it comes along and to admire its beauty and its symmetry and everything else and try to help it grow a little bit bigger because it is likely to become a worthy part of the forest, and there is great concern expressed about the power we were giving to the Executive.

Senator PROXMIRE. It is not only that, if I may interrupt at that point. Anybody who has served around this place very long knows when you get on a committee you become kind of a champion for what that committee supports whether on the Space, Armed Services, Education and Labor Committee, Banking, and Committee on Housing, or whatever it is you are gung ho for that. And this is not only true of the authorizations committees.

Mr. MADDEN. Yes.

Senator PROXMIRE. Is it true of appropriations subcommittees? I am on several of those, and we fiind the chairmen tend to be exposed constantly to the pleas of people to expend money in that area, and you being human, you tend to place a higher and higher value on that. Unless you can do as Mr. Conable says, set some kind of an overall limit, you cannot really expect Congress to do this job effectively in terms of reducing spending. We should, there is no question about it, we should.

Representative CONABLE. We have an obligation to look at the size of the forest, too, and really we are not giving the President any power that he does not have anyway. He does not have to spend everything we have appropriated.

Senator PROXMIRE. We are taking away a power he might want.

Representative CONABLE. We are saying to him, "all right, you are going to take the responsibility for cutting back the size of the forest to some sort of a sensible figure, after we are all through analyzing the relative position of the trees." I just do not see how we are going to do it in any other way, and I think that I personally would like to see this procedure continued.

I think you are dead right when you say that there was a historic decision last year, and I would like to say out of respect for President Johnson that he kept faith with the mandate of the surtax spending cut package, and did achieve a spending cutback that has been the only real effective damper on our fiscal exuberance, up to this point. The surtax has had a very modest impact, while the spending cut has had whatever impact there has been up until now. I think the figures will show that President Johnson did achieve a cutback in expenditures that we directed him to achieve.

Dr. MADDEN. I believe it was in the Brookings Institution volume "Agenda for the Nation" that Herbert Stein, one of the present members of the Council of Economic Advisers, proposed a surtax that would be reconsidered each year. The question is raised procedurally as to how the Congress could arrange to set an expenditure ceiling.

Senator PROXMIRE. An expenditure ceiling?

Dr. MADDEN. An expenditure ceiling each year, and I do not know the answer to that procedural question, whether it hinges on a simultaneous tax decision, so that the power committees of Appropriations and Ways and Means become involved directly, or not.

Representative CONABLE. Without stepping on each other's toes. The debt ceiling is, of course, the Ways and Means tool for control, and it is a very crude tool—everybody acknowledges that.

Senator PROXMIRE. I would like to move briefly to something else and then I will call on Mr. Reuss and Mr. Conable. I am not satisfied, I do not know if you really are satisfied with the way the record has been left on the so-called Phillips curve, this trade-off between unemployment on the one hand and inflation on the other, because after all ,we have a solid economic history of finding that whenever we get to a level of unemployment below 4 percent, that either that year or the next year prices rise at a rate of 3½ or 4 percent or more.

Now it is something we do not like. Everybody has said that they deplore it, including members of this committee and witnesses before this committee, but it is a cruel fact of life.

And there is a reason for this: As this very important part of our productive resources, labor, becomes scarce, its price goes up, not only organized labor. What happened in 1967 is that organized labor wages went up less than wages in the unorganized area. Why? Because the commodity labor was scarce. Unemployment was low. Those people who could work came at a higher price, and therefore the pressure of higher wages and higher pay tended to push up prices.

I do not know how we can say that as far as we are concerned, we are going to forget this law of economics, and we think we can get down to 2½ or 3 percent unemployment with stable prices, because I think this is a force we have to acknowledge and recognize if we are honest.

Mr. HAGEDORN. I doubt that you are going to get down to 2½-percent unemployment with stable prices or with inflation.

Senator PROXMIRE. Well, let us say stay at the present level.

Mr. HAGEDORN. I do not know what the equilibrium level of unemployment is, the level that say the country could live with long term. I suspect it is higher than the present 3.3 percent.

Just exactly where it is I do not know. Somewhere in that range just above that. But my point is that if as a matter of deliberate national policy you try to buy low levels of unemployment by tolerating inflation, then you are going to find the price going up sooner or later beyond what you want to pay. As we take more inflation——

Senator PROXMIRE. We have to recognize we have a very, very painful choice here. By and large the testimony we have had from business economists, labor, top labor officials yesterday and so on was that we can have it both ways. We can have low unemployment and lower unemployment than we have now even, and stable prices.

Unless we are willing to pay the price of wage-price guidelines or wage controls and price controls or credit controls, there is nothing that I can see in our economic history, nothing I can see in new developments or in new devices, that is going to enable us to do that. We would like to do it, and everybody says we must do it, but nobody says how.

Mr. HAGEDORN. Senator, I think the main intent of my prepared statement was, of course, to say we cannot have our cake and eat it, and that we have to be prepared to accept some pain in curing this inflation. But it is an illusion to think that we can indefinitely avoid that pain by simply tolerating inflation. The pain just gets worse as you go along.

Also I think that some of the things that were mentioned as kind of ways out of this dilemma are illusions, too. I do not think that you make the pain any less by gradualism, although I am not completely sure what is meant by that.

It sounds a little bit to me like saying it will hurt less when you get a tooth pulled if it is done gradually, and that does not seem very likely. And frankly, Senator, I do not think either that we can avoid this dilemma, if you want to call it that, by a kind of guidepost approach either. That sounds attractive.

Senator PROXMIRE. You cannot avoid it. I just wonder if you can perhaps slow it down.

Mr. HAGEDORN. I do not think so, Senator. In 1962 when the guidepost idea was first promulgated, I was impressed by this kind of an approach.

Senator PROXMIRE. If only for its educational purposes?

Mr. HAGEDORN. Yes.

Senator PROXMIRE. So that people understand?

Mr. HAGEDORN. Yes, sir.

Senator PROXMIRE. That you have a relationship between wage increases that parallel productivity increases, and if you go above that you are going to get a pressure on prices that will push them up.

Mr. HAGEDORN. Yes, sir, I agree, it has educational value.

Senator PROXMIRE. And there are price leadership situations in the business, it is possible for the oil industry to do what it did this past week, and they had record profits last year, fine prospects for this year, they hike prices so much that you are going to have the consumers pay $1 billion more for gasoline and fuel oil during the coming year.

I think my own view is that an aggressive President would have spoken out on this.

My information is that there are people on the Council of Economic Advisers who wish the President had spoken out on it. He did not speak out on it, and I think that this is going to be an unfortunate pattern we are likely to have for the next year or so, unless the President decides eventually he has got to speak up, when people who are in a position where they have a pricing power and price leadership, they can either together, in concert, or by leadership increase prices unjustifiably, if the President is going to take that in silence, we are going to have a level of inflation that is unjustifiable and unnecessary.

Mr. HAGEDORN. Senator, I do not want to say that the President of the United States should never speak out in situations like this and give his opinion. But I think it would be very unfortunate if it came to be conceived as the President's duty systematically to watch the price behavior and the wage behavior of all elements in the economy, and then to pass judgment and call what he conceives to be wrong behavior to the public attention.

That would be in effect to have Presidential wage and price controls, without specific authorization from Congress. If you want wage and price controls, they should be enacted in clear legislation that says exactly how they will be carried out and what the rights of the various parties are. To set up a sort of kangaroo court, if you will pardon me, where you would hear cases like this, as for example in the recommendations of President Johnson's Cabinet Committee, to set up some sort of a body that would consider all these cases and pronounce on them, that seems to be very undesirable.

Senator PROXMIRE. Well, the option is to leave those who have this great economic power, both labor and business, in a position where they can extort a higher price than is justified, because they have it, and to the extent that the President of the United States, representing the public interest, can have sufficient influence to dissuade them from this it seems to me that it is a good public policy action.

Mr. MADDEN. May I comment?

Senator PROXMIRE. And, of course, at the same time he must exercise the kind of discretion and judgment, and he certainly should not speak out against it if it is justified but that is what he has got a Council of Economic Advisers to do, to analyze this.

Mr. HAGEDORN. I would hate to have the Council of Economic Advisers though in effect become a wage-price court, to hear individual cases. I think that would damage them in their major function, which is to consider the big economic problems of the country.

Senator PROXMIRE. I have gone over my time. I think Dr. Madden had a comment. I will yield to Congressman Reuss as soon as you finish.

Mr. MADDEN. I would like to make a couple of comments in answer to your question. No. 1, my statement did not intend to deny the existence of the Phillips Curve. Rather it was intended to argue that the Phillips Curve could be shifted.

For example, in the studies by the staff of the Cabinet Committee on Price Stability, January 1969 page 33, it is said:

> Employment-oriented manpower programs can affect the unemployment rate in two ways. They can statistically lower the unemployment rate and they can create or open up jobs in the public and private sectors—It has been estimated that manpower programs including NBTA, on-the-job training, Neighborhood Youth Corps reduced the unemployment rate by 15/100ths in 1965, 3/10ths in 1966 and 4/10ths in 1967.

My proposition was that adequate attention to manpower policy, improving the competitiveness of the job market, the information available to people, improving our understanding and reporting on both the demand and the supply sides of that market and final zeroing in on the type of unemployment we know exists could reduce the level of unemployment at a given price level.

Senator PROXMIRE. All these are helpful, but my argument is we are not putting anything like the kind of resources into manpower training that will do this effectively, do this in a big enough way or do this soon enough.

The number of people who are in this long-term unemployed category plus those with incomes below the poverty level who are being reached are less than 10 percent.

Dr. MADDEN. On the other hand, the number of——

Senator PROXMIRE. If you take those who are long-term unemployed and those who are below the poverty designation, and then determine the scope and reach of our manpower programs?

Dr. MADDEN. Yes. The second point I would make is that an approach to the problem of economic policymaking that was calmer, that was clearer, and more mature, and more effective than an openmouth policy on particular price and wage decisions would be an economic policy which did pledge itself to improving the effectiveness of the job market, and thus shifting the Phillips curve, and also a policy that was more vigorous in antitrust enforcement, and study and action, because such policies set a framework within which the various sectors of the society, consumers, business, government, labor, agriculture, are made to recognize that while they have freedom to make their own decisions, they also have the responsibility to take the consequences of those decisions, and I believe that in the long run, this approach to policy protects both freedom and responsibility more so than the noisy and ad hoc and confusing and discriminatory procedure of attacking decisions one by one in the world's most complicated and far-reaching market economic system.

Senator PROXMIRE (presiding). Mr. Reuss?

Representative REUSS. I would like to get back to the discussion of the overall spending ceiling that Mr. Conable and Mr. Proxmire have engaged in.

I would agree, that the idea of a congressional spending ceiling timely adopted is a very sensible one. I would also agree specifically, Mr. Hagedorn, with your I think excellent list of areas in which expenditure cuts could best be made. You mentioned defense, space, agricultural price supports, and public works.

Mr. HAGEDORN. May I say that that is my own personal list.

Representative REUSS. Your own list?

Mr. HAGEDORN. Rather than anything that is endorsed by the National Association of Manufacturers.

Representative REUSS. We agree on that, but your personal thinking is very like my own on that point and I think it is a good list.

However, when we go on from this general consensus to applaud as lyrically as we did the particular action taken by the Congress last year, I think we may go a little far. There you will remember that Congress did not get around to imposing its expenditure ceiling until the fiscal year, this fiscal year had started, and until a large number of appropriation bills had passed.

Therefore, the effect of the expenditure cut was to make the innocent suffer from the guilty. Thus, items like water pollution control, aid to education in central cities, and so on were cut equally with those elements that you and I, Mr. Hagedorn, think should have borne the brunt of the cuts.

Indeed a large part of defense, some $28 billion worth of it, was exempted from the cuts altogether. So that before we point to the 1968 precedent as a model for all time, I think we should recollect the timing on that. I now come to my question.

Should not Congress quite early in the game each year set its expenditure target, even if it disagrees with the administration, it should somehow set its own target? Then, when we consider each individual appropriation, we will be advised as to how that fits into the picture.

As we did it last year, however, we proceeded in a slap-happy way, treating each appropriation on its own bottom, and the result was, as I say, that the expenditure cuts really did not follow a rational pattern. Therefore my question. Instead of waiting until the fiscal year and the appropriation bills are passed, should not there be an initial approach to an overall spending ceiling, and should not Congress then try to stay within those limits, or at least know when it transcends those limits, if it disagrees with the administration spending?

Would you comment on that?

Mr. MADDEN. I would be glad to comment. I would personally favor that approach. I do not speak for the chamber of commerce; we have not examined it. But I would say this.

The question is raised from your question as to whether a resolution could be introduced early in the session which would be debated, and which would involve this ceiling in advance of the beginning of the fiscal year, and whether this should not flow from, whether it would not logically flow from the kind of hearings which the Joint Economic Committee holds on the Economic Report of the President and the administration's. The Government's overall economic policies.

Representative REUSS. I think that would be one possible good way of handling it. Last year, for example, what Congress should have done in February or March, I should think, was to have decided that a $25 billion deficit is just too much when your unemployment rate is 3½ percent, and have passed some sort of a resolution saying that expenditures have to be held to whatever level it was. I like your response very much.

Mr. Hagedorn, what do you have to say?

Mr. HAGEDORN. I have to say, like Carl, that my organization has not studied it. I cannot give you any official verdict on it. In fact, I also have to say that this is the first time I have heard that suggestion, but it certainly sounds as though it is a force in the right direction. I do not see how it could hurt and it might help considerably.

Senator PROXMIRE (presiding). Mr. Conable?

Representative CONABLE. The only difficulty with that is that we did not know it was going to be a $25 billion deficit until July, and that was part of the problem. I have no quarrel with anything you have said.

Representative REUSS. Chairman Proxmire had a pretty good suspicion based on past performance and turned out to be right.

Representative CONABLE. However, those who were actually controlling the checkbook were——

Representative REUSS. Singing a different tune.

Representative CONABLE (continuing). Were mute when faced with these predictions, so we really did not know until pretty late in the year.

I have nothing further to add, Mr. Chairman.

Senator PROXMIRE. I have one final question and that is we had testimony from Chairman Martin—and also from the so-called Federal Reserve staff study—that they expected the monetary supply would increase 3 to 6 percent in the coming year. Interest rates would stay at about the same level during the year. Do you consider this as sufficiently anti-inflationary policy, or do you think that we should have stronger monetary restraints than indicated by the Chairman of the Federal Reserve Board?

Mr. HAGEDORN. I think it is the right policy.

Senator PROXMIRE. You think it is enough?

Mr. HAGEDORN. I would not suggest that we should violently shift to what you might call a deflationary monetary policy, a monetary policy designed to actually cause a reduction in prices. We should find fiscal and monetary policies that are consistent with stable prices and with long-term growth.

Senator PROXMIRE. Why should you not try to keep or strive at least to keep the money supply down between 2 and 3 percent? After all, the long-term growth of the economy is around 4 or 5. It seems to me this is neutral at best and maybe even could be called stimulative.

Mr. HAGEDORN. I think we should seek a neutral policy, Senator, rather than——

Senator PROXMIRE. You believe in a neutral monetary policy under present inflationary circumstances?

Mr. HAGEDORN. That is what I would conceive as an anti-inflationary policy, one that did not support further inflation. I do not think you should try to reverse the past 3 years by an equal price decline. That could be a catastrophe.

Senator PROXMIRE. Mr. Madden, did you want to comment on that?

Mr. MADDEN. Well, I do not want to get tangled up in semantics here. I favor a Federal Reserve policy that attacks and attempts to correct the current increase in prices. I favor such a policy being gradual rather than severe. I favor it being steady, and I would favor——

Senator PROXMIRE. How about the arithmetic?

Mr. MADDEN. All right, getting to the arithmetic, well, the first comment is that the difference between 3 and 6 percent is a great deal more than it appears from the numbers in its effect on the economy, and second, I would favor, over the year, moving toward the lower end of that spectrum, recognizing that moving more than gradually would be dangerous in the sense of being deflationary. But I think that when you have inflation of 4½ percent in the economy as it is, that to talk of increasing the money supply by 6 percent seems to me to be out of reason.

Senator PROXMIRE. Very good. Gentlemen, you have done a marvelous job. I think you certainly ably represent your two organizations, and this has been most helpful to us this morning.

This concludes the series of hearings of the Joint Economic Committee on the President's Economic Report.

(Whereupon, at 12:15 p.m. the Joint Economic Committee on the President's Economic Report was adjourned, to reconvene subject to the call of the Chair.)

[The materials contained in the first three parts of these hearing consist of testimony and statements brought forth in the scheduled sessions. The final volume, part 4, is made up of statements and comments submitted, at the request of the committee, by various leaders of banking, business, labor, agriculture, and consumer organizations.]

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