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THE 1970 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-FIRST CONGRESS

SECOND SESSION

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THE 1970 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 16, 1970

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

The Joint Economic Committee met, pursuant to notice, at 10 a.m., in room G-308, New Senate Office Building, Hon. Wright Patman (chairman of the joint committee) presiding.

Present: Representatives Patman, Bolling, Reuss, Moorhead, and Conable; and Senators Proxmire, Sparkman, Javits, and Miller.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling and George D. Krumbhaar, economists for the minority.

Chairman PATMAN. The committee will please come to order.

This morning the Joint Economic Committee once more takes up its annual task of judging the adequacy of the President's Economic Report to Congress in meeting the needs of the American people.

In a very real sense, the Economic Report is a mirror of the administration's philosophy of government and its commitment to serve those who are most in need of help. Whether that commitment is adequate depends primarily on the course of action proposed to combat the disastrous tight money-high interest rate conditions gripping the Nation's economy. Failure to achieve a solution to this overriding problem makes it impossible to resolve other economic problems.

In this connection, I must say that the administration has utterly failed to convince me it is on the right path. It has not lifted a finger to halt the climb in interest rates with the result that the prime rate went up six times in less than 12 months and the FHA-VA rate went up twice within the same period. The Nation is being crushed under record-high interest rates that are largely responsible for pricing virtually all moderate income families out of the housing market.

Despite its claims of fighting inflation, the administration in effect is helping to create more inflation by allowing, if not openly inviting, almost unbelievable increases in the cost of money which raises the cost of everything.

Moreover, the housing projections contained in the Economic Report indicate the administration may have abandoned the national housing goals. The report's projected investment in residential structures for the 5-year period ending in 1975, measured by today's costs, fails to meet the annual housing goals during any one of the 5 years and leaves the Nation 16 million units short of the overall goal of 26 million units set for achievement just 3 short years later in 1978.

By the same token, high interest rates have made it impossible for State and local governments to market bonds to finance construction of educational, health, and other urgently needed public facilities, a situation which has been further aggravated by the administration's willingness to veto HEW appropriation and to cut back expenditures for urban renewal.

Furthermore, the administration's policy banks on curing inflation through increasing unemployment. What we may get is both evils at the same time—inflation and unemployment. I blame this on the administration's failure to set wage and price standards.

The hands-off policy followed by the present Administration is encouraging inflation; there are no more ground rules to limit excessive wage and price increases. I don't think the Nation can afford the continuation of this inaction.

There are other serious problems. The administration program does not adequately deal with serious unemployment in our central cities. Nor does it meet fundamental needs for improving our cities, both in terms of basic services like transportation and education, and other social services. It remains for the Congress to take up this task and to meet these vital requirements.

In my 24 years on this committee, I do not think we have ever faced more crucial decisions than we do now.

If you gentlemen desire to touch on it during your testimony, I think one of the most urgent is rate increases being asked by all public utilities over the Nation right now, because of high interest rates.

There is one way we could stop that. If we had a redevelopment bank or a development bank or another Reconstruction Finance Corporation like we had for 22 years, those rates could be held down, and they would not have to ask for increases.

Any comments you gentlemen have to make I would appreciate it, and later on I shall ask some questions when it is my turn to ask questions.

We have all three of the members of the Council here.

Mr. McCracken, since you are the Chairman, you may proceed in your own way, sir.

STATEMENT OF PAUL W. McCRACKEN, CHAIRMAN; ACCOMPANIED BY HENDRIK S. HOUTHAKKER, MEMBER, AND HERBERT STEIN, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. McCracken. Thank you very much, Mr. Chairman. I am accompanied today by the other two members of the Council of Economic Advisers, Dr. Houthakker and Dr. Stein, and with your permission all of us will participate in the discussion and the questions.

I do have a fairly short statement that I would like to read.

In the annual report of the Council of Economic Advisers, published about 2 weeks ago, we describe at some length the economic condition of this country and give our views about the main policy issues. In this statement we shall not attempt to summarize the whole range of the report, although we shall be glad to answer questions on any part of it. Instead we shall concentrate on three subjects which seem to require further elaboration. They are: (1) The path to a less inflationary economy; (2) The problem of deciding how the national output should be used; and (3) The problem of balance-of-payments adjustment.

I

It is perfectly natural that people should be asking whether there is any way to reasonable price stability, or any way to it without a serious recession, or without price and wage controls. In fact, the question seems to be somewhat less common than it was, say, 6 months ago. Nevertheless the question persists. Over a year and a half has passed since Congress enacted the Revenue and Expenditure Control Act of 1968 which was supposed to turn the tide against inflation. Over a year has passed since monetary policy became markedly less expensive than it had been. And yet there is hardly any evidence that the rate of price inflation has diminshed. The evidence is strong that the rate is no longer rising, or has not been rising in recent months, though we cannot yet be absolutely certain even about this. Meanwhile, there are signs of a slowdown in production and employment which raise fears of a recession. Indeed, the popular cliche of the day is that we are headed for "the worst of both worlds"—a recession with inflation.

Skepticism and uncertainty about the road to greater price stability has gone through several phases in the past year. For a time last spring and summer questions were being raised about the power of restrictive fiscal and monetary policy to cool off the overheated economy at all. The big swing in the budget position from a $25 billion deficit in fiscal 1968 to a $3 billion surplus in fiscal 1969 had not yielded the predicted results. At the same time there was a belief that through Eurodollars, commercial paper, credit cards, and other devices the banking system and the economy were escaping the consequences of monetary restraint. In the second half of the year, however, it began to be clear that the combination of fiscal and monetary restriction was producing effects. The economy with lags that were well within our historical experience, was responding to changed policies.

Questions were subsequently raised about the will of government to persist on a disinflationary course. The excessive easing of policies after 1966 and again after mid-1968 were often cited. Uncertainty about whether Congress would extend the tax surcharge, first until December 31, 1969, and then until June 30, 1970, contributed further to skepticism about the continuation of a restrictive fiscal policy, and so did the apparent determination of the Congress to enact further large tax reductions. But as time passed the firmness of the Federal Reserve in its course of restraint became clear. Moreover, the administration's action in holding down Federal expenditures for fiscal 1971 has succeeded in preserving the generally restrictive posture of fiscal policy. It is true that the budget surplus will be smaller in calendar 1970 than it was in 1969. This difference will be almost entirely due to the two-step elimination of the temporary surcharge, however, which probably has less economic impact per dollar than the slowdown of Federal expenditures which has been achieved.

Having seen that fiscal and monetary restraint can slow down the economy, and that the Government is capable of maintaining a high degree of such restraint for a considerable period, we now confront another difficult and critical question. Can the slowdown of the economy bring about a significant reduction of inflation without serious losses of production and employment? People have become used to prices going up year after year—and each year more than the year before. They see strong unions demanding and getting large wage increases. Almost every day they see some large business raising some conspicuous price. And they do not see what is going to stop people from raising wages and prices unless there is some great shock to the economy—like a major recession, or government regulation of wages and prices. Some remember the last time we moved from a fairly high rate of inflation to a more moderate rate, which was in 1958, when we had a sharp recession, with the unemployment rate rising to a peak of 7.5 percent in July.

Now it is certainly true that a slowdown in the expansion of demand, which is intended to reduce the rate of inflation, will probably reduce the increase of growth of real output and raise the rate of unemployment. We have already had these developments in some degree. In fact, merely stabilizing the expansion of demand in order to stabilize the rate of inflation is likely to reduce output and increase unemployment at first, but that is another story and we shall not go into it now. The present question is how much restraint on real output and employment for how long is likely to be involved in achieving a significant reduction of the rate of inflation.

This is a complicated quantitative question and it cannot be answered by casual observation or by imagining how other people will behave in other circumstances. The best clue to the answer comes from history. One thing is clear from this experience. The inflationary process is a continuous one, but it goes through different phases. It begins with excessive pressure of money demands on our productive capability. As prices rise, wage rates will also start to rise in response to price trends and for a time favorable profit developments. And rising prices for some are rising costs for others. It is not, therefore, useful to talk about a demand pull inflation and cost push inflation as if they are two types of inflation. They are integral parts of this unfolding process. This does mean, however, that prices and costs may increase "today" because other prices and costs increased "yesterday." There is a "momentous element" to a rising price level. Careful study of the record suggests that statistically the rate of inflation at any time is heavily explained by two factors—the recent past rate of inflation, and the current demand for output relative to the output the economy could produce at high employment. If demand is reduced to a point at which the rate of inflation begins to decline, a cumulative process is set in motion which will go on for some time. The lower rate of inflation in one period becomes a factor tending to reduce the rate of inflation in the next period. We are now suffering from this process in the other direction. We get high rates of inflation because we have had high rates of inflation. But with persistent restraint on the economy this momentum will begin to work towards price stability, and we shall get lower rates of inflation because we have had lower rates.

We have tried to estimate the magnitude of these relationships from the historical experience. This suggests that a significant decline of inflation during 1970 is possible with a small increase in real output from 1969 to 1970. During the first half of the year real output would increase much less than potential output, and it might even decline. This would set the stage for reductions of the rate of inflation in the second half of the year although demand and real output were then rising more strongly. By the fourth quarter of 1970 the rate of inflation, as measured by the GNP deflator, might be about 3 to 3½ percent, compared to over 5 percent during 1969.

Of course, historical relationships cannot predict the future with certainty. However, the behavior of prices in 1969 was approximately what would have been expected from the historical relations. So far there is no reason to think that we are off the map of past experience and that prices will bear a radically different relationship to demand, output, and employment than in the past.

It would be wrong to express a certainty and precision that our knowledge does not justify. We believe that a steady and moderate course will bring the country closer and closer to price stability. We also believe that evidence of movement in this direction will become increasingly clear as the year progresses. More exact forecasts of the future can only be understood as illustrations of general tendencies.

There is great interest in the rate of unemployment that might be involved in the picture we foresee for 1970. This is understandable. The Nation has unfinished business so long as there is anyone looking for work and unable to find a job. Since the objective of policies is to cool off the long overheated economy, not to create unemployment, policies cannot meaningfully be discussed in terms of a "target" unemployment rate.

Countering the inflation does, however, court the risk of some rise in unemployment. We have been reluctant to specify a figure for this. Economic forecasting is never easy, and projections of the unemployment rate and trends in the price level have always been particularly difficult to make. Moreover, the reported unemployment rate has proved to be highly erratic and loosely related to other economic factors. For example, during 1969 we had what was initially reported as a rise of the unemployment rate from 3.5 percent in August to 4.0 per-
cannot meaningfully be discussed in terms of a "target" unemployment
cent in September and a subsequent decline to 3.4 percent. Seasonal revisions have smoothed out this path somewhat but still leave a picture which probably does not reflect true variations in labor market conditions.

We do not, however, wish our reservations about forecasting an unemployment rate to be interpreted as unwillingness to disclose our own projections. With the course of policy suggested in the Economic Report, the associated projection of the unemployment rate for the year as a whole would be in the zone of 4.3 percent. There will be some increase in the number experiencing unemployment during the year, but much of the projected rise in the reported rate would reflect an increase of roughly 1 week in the median duration of unemployment. Figures outside this range are possible in view of the erratic nature of the statistics, particularly in individual months, but this is the zone that seems consistent with our estimates of the pattern of the economy during 1970. Again we wish to emphasize the exceptional difficulty of forecasting unemployment and the need to observe emergent developments closely and to be prepared to respond to them.

The disinflationary process that we describe in the impersonal terms of price statistics consists of the decisions and actions of large numbers of individuals in their roles as business managers, workers, and union officials. The policy depends on the response of these individuals to changing market conditions, including sales, profits, and employment conditions. As the administration has said repeatedly, the policy will work with less delay and pain the more promptly individuals respond to changes in market conditions. Now that a marked change in market conditions has been brought about, it becomes increasingly important to assure that business and labor respond to them in making price and wage decisions. We intend to watch this response closely and use what instruments the Government possesses to encourage and induce the needed response.

II

We now turn to the problem of deciding on the allocation of the national output among alternative uses, which is sometimes called the problem of national priorities. This is the subject of chapter III of our report. In this chapter we are not attempting to say what the national priorities are or should be. We are trying to make a few simple but important points about how the decisions should be made.

The first point is that although we are talking chiefly about decisions made by the Federal Government these decisions will affect not only the use of resources within the Federal budget but also the use of resources outside the budget. The priorities or allocation problem is not simply to divide up the Federal budget but also to rationalize those Federal decisions that inevitably influence the allocation of the whole national output. For example, suppose that the Federal Government is considering whether to spend more for a particular purpose. This is a priorities question—a question of the relative importance of this purpose as compared with other things. But the other things that must be considered are not only things bought by Federal expenditures but also things bought by private or State and local expenditures. For, depending on how the additional Federal expenditure for a particular purpose is financed, it may substitute for private consumption, or housing, or private investment, or State and local spending.

This broader way of looking at things, obvious though it will be to this committee, helps to illuminate a number of decisions. It permits us to put taxation in the context of the allocation problem. A decision to cut the personal income tax can be interpreted as mainly a decision to increase the share of private consumption in the national output. Similarly, it directs us to the real allocation effects of decisions that do not appear in the budget, or do not appear there in full. For example, if the Federal Government subsidizes housing construction the amount of the subsidy will appear in the budget but the much larger total of the cost of the houses built does not appear there. Nevertheless, the Government is making a decision that a certain part of the national output should be devoted to housing construction of a certain kind, and consequently diverted from other uses. This can be seen if we look at the uses of the national output, but not if we look only at the Federal budget. Finally, considering the effects of Federal decisions on the allocation of the national output reveals the significance of the decision to have a surplus or deficit. What it shows is that a major effect of this decision is on the amount of saving available to finance private investment and as a result on the amount of investment that is made. Therefore, decisions about the size of the surplus or deficit should be made with a view to the desired amount of investment.

A second point we wish to emphasize is the need to look farther ahead than 1 year in making decisions about the allocations of the national output. These decisions are not easily reversible. Moreover, their consequences tend to grow. Therefore, it is dangerously easy to make decisions that are relatively cheap in the year immediately ahead but that preempt increasing amounts of resources as time passes and prevent us from doing things that we would rather do.

We are stressing, therefore, the need for budgeting the national output on a longrun basis. We have made a very preliminary start in that direction in our report. We have estimated the potential output of the economy annually to 1975 and we have also estimated how that output might be used under certain assumptions. These assumptions include present tax laws, present Federal expenditure programs, new programs proposed by the administration, achievement of the housing goal expressed in the Housing and Urban Development Act of 1968, and the "normal" behavior of the private, State, and local sectors.

We are not saying that the division of the future national output which emerges from our estimates is either inevitable or the best possible. If some other division is preferred it can be achieved, at least within some range, by appropriate policy. The main point is that the country and the responsible officials should be looking at this kind of picture and deciding whether they would prefer to have more of something and less of something else and whether they also want to take the steps that would be required to effect the change. That after all is what the priorities debate is all about.

As we have said, the estimates made in the annual report are only a first step, and we hope to develop them in many ways. We need to learn more about the effects of different Federal actions—spending, lending, borrowing, taxing, subsidizing, etc.—on the private uses of resources. It would be helpful if we could obtain more information on the longrun plans of States and localities. We would like to be able to classify the uses of the national output in more significant categories than is now possible. So there is a great deal of additional work to be done. However, we are confident that this is a direction in which more work will yield greatly improved understanding and decisions.

One lesson that emerges from our estimates is that the potential output is already largely committed for years ahead. In fact, the claims, calculated as briefly described above, exhaust the available output through 1972 and fall only 1 percent short of the output in 1975. And this is on the assumption of no net addition to Federal expenditures beyond the costs of existing programs and programs already proposed by the administration. This does not mean that nothing new can be done. It only means that we confront the usual conditions of mankind, which is not to have a large pool of unused and unclaimed resources but to have to choose to sacrifice something to get something.

III

The need to use our scarce resources effectively should also be borne in mind whenever the balance-of-payments problem is discussed. We engage in international transactions primarily to make better use of our factors of production—labor, capital, land, and management. By concentrating on the econmic activities in which we have an advantage we also enable other countries to make better use of their resources. In addition, unilateral transfers to assist less developed countries have long been part of our policy.

While these are elementary facts, in balance-of-payments discussions the distinction between means and ends sometimes gets blurred. The only valid test that we should apply to our international transactions is whether they contribute to the attainment of our objectives. No single number, be it the liquidity balance or the official settlements balance, can tell us much about that. What we can say, however, is that we lose, and other countries lose, if transactions that would be mutually advantageous do not take place. In some cases trade or other transactions have to be restricted for reasons of national policy (e.g., to avoid transitional hardships), but the cost of such restrictions should not be overlooked.

Restrictions on international transactions have frequently been motivated by balance-of-payments considerations, a motivation which is recognized by international agreements. Nevertheless the question of means and ends is posed here in a more direct manner. If actions are taken to limit imports, this will normally have a favorable effect on the balance of payments in the short run, and this effect may conceivably outweigh the loss in real income. But in the longer run the balance-of-payments effect is likely to be eroded, while the real loss remains. This erosion is the result of adverse price movements. Imports help keep the domestic price level down and thus improve the importing country's ability to compete in export markets. Similarly restrictions on capital outflows, while helpful to the balance of payments in the short run, will normally deprive the country of the earnings obtainable from the prohibited capital outflow. Thus the blance of payments can in general not serve as a justification for long-maintained restrictions.

This is not to imply that the balance of payments can be ignored in our economic policy decisions. On the contrary, we have been very much concerned with measures that will improve our competitive position and thereby strengthen the dollar. Foremost among these, of course, is the fight against inflation, to which freer imports can make a modest but useful contribution. Beyond this the extended discussion of the international adjustment process in our report may help in developing new procedures for preventing excessive and protracted disequilibria.

The American economy has now begun the difficult and painful process of adjusting to a less inflationary growth path. That this stage would arrive with about this timing has been a reasonable expectation from what we know about the lags between policies and their visible effects in economic activity. The course of policy throughout this period has been reasonably steady. Sentiment about these policies, however, has inevitably been volatile—ranging from initial skepticism about whether these policies would remain, to skepticism about whether these policies would have any real effect even if they held, to emergent skepticism now about whether with these policies we can avoid a recession. Through all of this the objective of economic policy has remained unchanged. That objective is to get the economy on a more noninflationary growth path. The strategy has been to achieve more evenhanded policies that avoid extremes. The task now is to complete the adjustments needed to establish a more stable price-cost level, and to reach the path of vigorous and sustainable economic growth with a dollar in whose future purchasing power we can have more confidence.

That is the end of my statement, Mr. Chairman.

Chairman PATMAN. It is my understanding that this statement represents the view of the three members of the Board?

Mr. McCRACKEN. That is correct.

Chairman PATMAN. Yes, sir. We will proceed to question you, sir. You may designate other members of the Council to answer if you desire.

Mr. McCRACKEN. Thank you.

Chairman PATMAN. And we will ask the members to observe the 10-minute rule of time when we go around the first time.

Mr. McCracken, last year there was quite a bit of activity about a problem that has been with us for a long time. I refer to the one bank holding company loophole in the Bank Holding Company Act of 1956.

Among many other Government officials including the Treasury Department, the Department of Justice, the Federal Reserve Board and others, you are aware, are you not, of the President's message of March 24, 1969, calling for prompt legislative action on this matter? You are aware of that; are you not?

Mr. McCRACKEN. Yes.

Chairman PATMAN. And I assume that you were in agreement with the administration's call for this immediate legislative action?

Mr. McCRACKEN. Yes, sir.

Chairman PATMAN. Now then, we have passed a bill in the House which I consider a good bill. The House voted for it overwhelmingly and out of 435 Members there were only 24 Members who cast votes against it, so it was almost unanimous. Now it is pending in the other body. Are you in favor of action being taken according to procedures that are set out in the two Houses, without unusual delay, or would you like to have delay in the bank holding company bill?

Mr. McCRACKEN. No, Mr. Chairman. I would support action according to the duly constituted procedures which you have indicated.

Chairman PATMAN. The fact that the administration asked for a study of financial institutions does not deter you in that determination for action now, and you do not see in that any implication of delay that is contemplated by the administration?

Mr. McCRACKEN. No. May I comment on that, Mr. Chairman?

Chairman PATMAN. Yes, sir.

Mr. McCRACKEN. I am glad you raised this question, because I want to make it very clear that the President's decision to constitute a commission to study our financial structure is concerned with very broad and very fundamental matters.

There is a rather substantial measure of agreement that we have a good many problems in this area that are urgently needing dispassionate and careful attention. The Commission was not certainly intended as anything to head off this specific area. It was far broader than that.

Chairman PATMAN. May I invite your attention to the fact, my dear sir, and members of your Council, that I consider it very necessary for something to be done at an early date as quickly as possible, something like a Reconstruction Finance Corporation, such as we had for 22 years, that served a good purpose, refinanced municipal bonds when the schools were closed, opening the school houses again. They have not had any trouble like that since. They made loans for deserving projects where money was not available locally. The banks were given an opportunity to finance anything that was contemplated or applications filed for financing by the Reconstruction Finance Corporation.

They were given the first chance if they wanted to finance it at reasonable interest rates. The Reconstruction Finance Corporation would not be the first to entertain the application. Everyone seemed to be treated fairly, and it served a great purpose.

Right now you have mentioned many things here that cause inflation and cause prices to increase, but interest rates are doing more to cause inflation than any other factor.

We have debts now aggregating, public and private, about $1,600 billion. A 1 percent increase on that, of course, is about $15 billion plus per year.

Now then, I cannot very quickly determine how much of an increase is produced by interest of 8½ to 9 percent. It is a terrible amount. It is a very large sum, and obviously the utilities over the country have a good claim for a rate increase based wholly and solely upon the increase in interest rates, and they are making these applications in all states and the increased costs are going to amount to billions of dollars. Don't you think it would be in the people's interest for the Congress to set up some sort of development bank or something in the form of an RFC?

Before we had $500 billion of capital in the RFC. The RFC was allowed to expand 17½ to 1, I believe. To the best of my recollection it is about that. Now then, it is proposed that if we were to establish a similar organization with $1 billion of capital, and expansion of 20 to 1, we could probably do the job that is necessary to keep down inflation and keep our economy on an even keel.

Obviously we cannot keep down inflation if we keep on raising rates on telephones and gas and water and everything else as interest rates rise, because a lot of concerns engaged in manufacturing and production will have to ask for increases, because of increased costs of the utilities. Don't you think that would be an obvious conclusion to come to, Dr. McCracken?

Mr. MCCRACKEN. Mr. Chairman, I share fully the present concern about the high level of interest rates. I think it is very unfortunate that conditions have developed through the years which have brought us to these levels.

One of the major sources of this high level of rates is the long sustained inflation which has raised increasing skepticism about the real rate that savers and lenders would get, in view of their uneasiness about the price level. This highlights the enormous importance of getting on top of this problem, in order to rebuild confidence in the price level. This will have a favorable effect on interest rates and monetary policy.

However, we are in a period here when the demands for savings generally are going to be extremely heavy. This was one of the major points that we made in chapter III of the Economic Report. So one of the most fundamental things that we can do is to try to enlarge the supply or the flow of total national savings. If we do not do this, partly by running strong Federal budgets, funds borowed by government or by a government agency will preempt funds which might otherwise have gone to users of capital in some other way.

Chairman PATMAN. May I say, Dr. McCracken, that I have gotten some figures in just the last few minutes indicating that the increases from applications filed in the States with the Federal Government are from 5 to 15 percent. That would indicate rate increases of about \$2.5 to \$3 billion right off, and, of course, that would be inflationary. Electricity charges amount to \$8 billion a year plus, gas \$4.6 billion plus, and you can conceive of how much that would increase with all these rate increases. We could keep interest rates down and thereby prevent all these rate increases and stop inflation. But unless we act, we are going to have more and more inflation, inflation multiplied many times. Don't you see that that way, Dr. McCracken?

Mr. McCRACKEN. I think the higher interest rates the public utilities will be paying unquestionably will be a factor that will be taken into account in their rate proceedings.

Chairman PATMAN. Yes, sir. My time has expired so I will call on Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

Thank you, Dr. McCracken. I think the whole country is indebted to you and your associates for the extraordinarily gifted work you do, in the great tradition of preceding members and chairmen of the Council of Economic Advisers.

I am much intrigued by a statement I find in your oral statement. You say, "Indeed the popular cliché of the day is that we are headed for the worst of both worlds, a recession with inflation."

I would like to tell you that that seems to be the general attitude in the great banking and business community that I represent, New York, and so I ask you this question. Do you believe that the business community and consuming community of the United States ought to have the confidence now that we will attain price stability without a material recession, or do you still believe that they have a right to be in the doubt which they obviously are and which is so sensationally reflected in the New York Stock Exchange?

Mr. McCRACKEN. I am very glad to respond to that question. The strategy of policy that we embarked upon, and that we have discussed repeatedly, is a strategy of fiscal and monetary restraint which would naturally be expected to slow down the rate of monetary demand for output. Thus, for a time this policy would produce an essentially lateral movement in the volume of real output, or real goods and services being produced.

Now I have used the term "essentially lateral" advisedly. The techniques of forecasting the results of changes in policy are not sufficiently precise for one to be absolutely sure whether that means relatively slow growth or a sidewise movement or possibly some recedence in output.

As we examined the evidence looking toward 1970, when we were preparing the Economic Report, our best estimate was that the first 6 months would show essentially no gain in real output, but that the second 6 months of the year would see a resumption of a more rapid rate of production of goods and services.

In my judgment, the way the economy has developed during the last year should lead to the kind of confidence which you have indicated. Policies were changed. At the outset there was a good deal of skepticism as to whether these policies would really hold, but they did hold. The skepticism then shifted as to whether the policies would ever really produce any visible effects on the economy, and up until, oh, perhaps well into the third quarters of last year, this was a rather pervasive skepticism. But the fact is that the visible effects of these policies did begin to show up in the economy, and with not much more than just the normal lags.

I know of no case where a price level has been stabilized, where we have not had to go through essentially this kind of sequence of events. The economy is now in this period. It is a very difficult period, but the fact that things have been coming along about the way one might have expected seems to me to be a source of confidence that this thing is going to work out.

Senator JAVITS. Just to interpret two points that you made. One, you believe that business and consumers should have confidence in the economy as it is now being run?

Mr. MCCRACKEN. Yes.

Senator JAVITS. The answer is yes?

Mr. MCCRACKEN. Yes.

Senator JAVITS. Second, when you use the term "increase in output" you mean by that the continued forward march and improvement in the real living standard of America, right?

Mr. MCCRACKEN. That is correct, real goods and services.

Senator JAVITS. Now may I ask you this question. Is the fundamental posture of the strategy of policy which you describe, a balanced budget?

Mr. MCCRACKEN. Is that the fundamental policy?

Senator JAVITS. Yes.

Mr. MCCRACKEN. Yes, I think that is absolutely essential.

Senator JAVITS. Do you consider a balanced budget to mean a $1.3 billion surplus or would you accept as a balanced budget anything within whatever order of magnitude you give us either in surplus in dollars or in deficit, because—I am not trying to trap you into any answer—the financial community has little confidence in your figure, and does not believe that the projected small, tiny surplus will stand up.

Mr. MCCRACKEN. The budget that was put forward on the expenditure side prices out the program which the President is recommending. This represented the best pricing out of this program that could be done at this time. The estimate of revenues was such that the total program projected out at that small surplus.

Naturally there are questions that remain. To what extent will this program be adopted or to what extent may it be exceeded in some cases? If so, of course, this goes beyond the President's program.

The $1.3 billion surplus is not as large a surplus as I think one could make a strong case for in this kind of economy. On the other hand, given the tax bill that was passed last year, it seems to me that the job that was done on the expenditure side of the budget was a pretty stiff one.

Senator JAVITS. You still have not answered my question. You gave us a figure for unemployment, a parameter of 4.3 percent. I think you have done a great service in doing that. That should do a lot to restore confidence. Now can you give us any figure as to what you would consider as the basic postulate of the whole proposition of the administration, a balanced budget? Is it $1.5 billion surplus or more or suppose you had a $2 billion deficit. In a budget this size isn't that a balanced budget?

If you could give us anything on that I think it would be very valuable to the country, because I repeat there is no confidence in your $1.3 billion surplus.

Mr. MCCRACKEN. Well, in a $200 billion budget, we do have to be cautious about attaching excessive significance to a minor change of $1 billion or so. I would still consider that it is important to keep the budget in the black. I think a $1.3 billion surplus is still substantially better than a $2 billion deficit. Obviously the $2 billion deficit would be better than a $25 billion deficit.

Senator JAVITS. But the turning point then is the black figure, whatever it may be, is that correct?

Mr. MCCRACKEN. I do not want to attach any peculiar significance to some sort of transonic barrier in this, but I do consider that it is important to be in the black. And as I indicated, I would even be happier if the budget surplus could be a little larger than is projected.

Senator JAVITS. I just have two other questions if the Chair will let me ask them.

Does the administration accept as another fundamental postulate of its program the goal of price stability at the existing level? They do not expect prices to go back, do they?

Mr. MCCRACKEN. That is correct.

Senator JAVITS. And if you can get that again you feel that you will have established the main basis for the confidence you speak of?

Mr. MCCRACKEN. That is correct.

Senator JAVITS. Now my last question relates to this. Are you dismayed in terms of your expectations by the burgeoning effects of the tax bill which was signed by the President into law, and do you contemplate the possibility, if we wish to continue the process that you describe, that we may have to continue the tax surcharge or find some other way to supplement the fiscal situation, bearing in mind—and I state this, not you—that what brought the country to this pass was the effort to make the country believe that you could fight a war without spending money. I refer, of course, to the pyramiding deficit caused by the Vietnam war without the correlative taxation?

Mr. MCCRACKEN. Yes; I would share your concern here. I think it will be important in the period ahead to have a strong budget position. If the course of expenditures makes that impossible with our current tax system we shall have to face up to the problem of strengthening our tax system in some way.

Senator JAVITS. Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, sir.

Senator Proxmire?

Senator PROXMIRE. Dr. McCracken, I want to join other members in congratulating you on an excellent statement. It is certainly a very competent job professionally and I think you make the best of what I think is not a very good case, but you make the best of it.

There are some significant omissions here. Before I come to that, I think it is clear that you lost the war on inflation last year. As we know, we had the worst inflation we have had since 1951, the highest interest rates since the Civil War, and the basic underlying factors are especially dangerous it seems to me in view of the fact that wholesale prices have risen so sharply, and just last month continued to rise. Then we recognize that wage settlements were so high, I understand they were over 8 percent, and that wage costs increased very sharply because wage producivity did not increase much.

The outlook is not quite as cherry as you gentlemen seem to imply in your statement. What is happening to this administration economically is very much what happened to the Johnson administration on Vietnam. I do not mean that you are President Nixon's economic McNamara but whereas he went to Vietnam in 1965 and said the boys would be home by Christmas, I have gotten the impression throughout the year that you feel that the policies are proceeding on target, you are getting prices under control, and if we will just be a little patient around the corner will come the kind of price stability that we hope and expect to have.

The administration gave us body counts in Vietnam. You are giving us kind of economic body counts on the drop in production, which has gone on steadily as we know for 6 or 7 months, the drop in new orders, the falloff in retail sales, the slowdown in personal income, the drop in corporate profits, and now, of course, a rise last month in unemployment.

In my view, Mr. Chairman, you have lost your fight and there is nothing that I can see that would persuade me that you are about to win it in the foreseeable future on inflation. What is your answer?

Mr. MCCRACKEN. My answer first of all is that I do not think we lost the fight. Let us go back a year ago. At that time if we were to have asked ourselves what kind of sequence of developments would have to occur, at least on the basis of what we know from our historical experience, before the price level responds, what would we have answered?

The first thing obviously that we had to have was to strengthen the budget, to have basic fiscal and monetary policies that were less expensive than we had had. These were achieved.

Then there was inevitably going to be a substantial lag before these would show their effects in the economy. Unfortunately the initial visible effects of policies of economic restraint do not show up in the price level, but these visible effects showed up about on schedule. Possibly it took a little longer than usual, but that I think was not at all difficult to understand in view of the momentum of the inflation.

I wish we could have shown more progress last year, but I am not myself discouraged. I think that, broadly speaking, this strategy is working.

Senator PROXMIRE. I do not see any reference either in your statement here today, and very few references in that long and detailed and generally highly competent economic report of yours, to the effect of military expenditures on inflation.

Our whole experience with inflation historically since the Revolutionary War is we have had inflation in wartime, in terms of high military spending, which I think is a highly inflationary type of spending, but I do not see any analysis of this reflected in your statement here or in your economic report.

I am particularly concerned about that, because I understand that you are a member, you are one of the six men who are on the Kissinger Committee on Defense Program Review which the New York Times describes as "playing a central role in shaping American military and foreign policy."

It would seem to me that we should have from you an analysis of the impact of the single by far largest expenditure in the budget, one that is changing now, one that is being cut back, and I think it should be cut back much more sharply that it has been, and we can make a very strong case that it should be cut back more sharply, but you have not given us any analysis, either in the report or in your statement today.

Last year we called attention to the fact that the previous Council only gave us two pages. It seems to me that is two pages more than you have given us on military spending and its economic impact and its inflationary impact. Here is a thoughtful analysis of inflation without any reference to the fact that we are still fighting a war in Vietnam, we are still spending, expect to spend over $70 billion on defense, we have these bases all over the world, and you do not refer to it. Why is that?

Mr. MCCRACKEN. The impact of the defense budget here is within the context of total fiscal policy. The fact is that the budget this year does project a major redirection of our priorities with a very substantial reduction in defense spending, and the impact of the fiscal operations of Government have been taken into account in our projections of the economy and of the price level.

Senator PROXMIRE. You have not taken it into account in anything like the kind of cutback we have been told about. Last October Mr. Laird in a speech said that as of the first of July 1970 our spending in Vietnam would be at an annual rate of $17 billion compared to $30 billion in 1968. Now, that is the beginning of the fiscal year. During the fiscal year we would expect the Vietnam war to be further deescalated. That is certainly the plan, the program and the expectation, so that the cost in the fiscal year in Vietnam should be down $15, $16, $17 billion below what it was in 1968.

In addition the administration has talked about more efficient procurement practices, about using a one-plus war strategy instead of a 2-plus war military strategy, about cutting back Pentagon employees by 100,000. All of this it seems to me would add up to a gross overall reduction of about $25 billion, and counting the fact that we do face inflation and higher pay and so forth, it would seem to me that the military cutback should be $15 billion rather than $5 billion. What happened to the peace dividend? Is it being taken over by the military? Is that in essence, as Mr. Moynihan said, "as evanescent as the clouds around San Clemente"?

Mr. McCracken. According to our projections defense purchases of goods and services in the national accounts, which were running at about $79 billion in the fourth quarter of 1969, will be about $72 billion in fiscal 1971, having risen from a $50 billion rate in calendar year 1965, before the buildup in the Vietnam program.

Now if one tries to look at this program in terms of the volume of real resources available, the figures project out something like this: In terms of fourth quarter 1969 dollars, defense spending, which was $60 billion in calendar 1965 before Vietnam, rose to about a $79 billion rate.

Senator Proxmire. Give that figure again, it rose from what to what?

Mr. McCracken. $60 billion in calendar 1965.

Senator Proxmire. This is leaving Vietnam aside?

Mr. McCracken. No.

Senator Proxmire. Including it?

Mr. McCracken. This is total defense purchases. Then, of course, it rose to the $79 billion rate in the fourth quarter of 1969. These are all in fourth quarter of 1969 prices. And this is projected at about a $68 billion rate in fiscal year 1971.

Now what this means is that there is a very substantial reduction underway in the real resources going into the defense program. In other words, in terms of real resources, these would be only about $8 billion beyond the calendar year 1965 level by fiscal year 1971, including Vietnam. There is a rather substantial redirection of resources here.

Senator Proxmire. My position, of course, is that it is not nearly as substantial as it should be under the circumstances. My time is up. I will be back.

Chairman Patman. Mr. Conable?

Representative Conable. Thank you, Mr. Chairman.

Mr. McCracken, I think it was a fine report, realistic and restrained.

There are really two approaches to the fight on inflation, and we find one rather more pleasant for politicians than the other. The one is to give symptomatic relief, to try to compensate for the damage that inflation causes to particularly vulnerable groups. A good example of this was our inclusion in the tax reform bill of the 15-percent increase in social security cash benefits. I supported this. I do not think we should fight inflation at the expense of the elderly and the poor. But we have to face up to the fact that this type of symptomatic relief is itself inflationary to a certain extent, is it not?

Mr. McCracken. Yes; it can be.

Representative Conable. Let us take the 15 percent, for instance, which as I say I supported. This money goes to people who by their circumstances are very likely to spend it very quickly.

Mr. McCracken. That is correct.

Representative CONABLE. In economic terms, there is likely to be a multiplier effect as the results of such a payment?

Mr. McCRACKEN. That is right.

Representative CONABLE. And therefore it is likely to be rather more stimulative than some other types of government payments might be. That does not mean that it is necessarily wrong, but it does mean that in this case the compensation for the effects of inflation is itself inflationary and contributes to the spiral of inflation, isn't that correct?

Mr. McCRACKEN. That is correct; yes.

Representative CONABLE. There has to be, I suppose, a degree of this sort of symptomatic relief, if we are going to be pursuing the other tough course that is possible and that reflects the economists' viewpoint that we have to strike directly at the inflation itself. Does the administration have any further plans for symptomatic relief for the effects of the battle against inflation and the pain it causes, and if so how can we avoid overdoing this approach because of its political popularity, rather than maintaining our basic fight, which is the tougher one of restraint.

Mr. McCRACKEN. That is a very important point which you have raised. If we look over the program which has been presented during the last year, there are several elements which perhaps might belong in the general category which you have outlined. For example, we have to take a fairly stern line on expenditures.

At the same time the administration has proposed a very substantial increase in manpower training programs. This is an expenditure. On the other hand, our objectives of economic policy or social policy are always complex. We have many objectives.

The proposals for strengthening our unemployment compensation system, I support, might be somewhat along this line. The family——

Representative CONABLE. Or welfare reform.

Mr. McCRACKEN. I was just going to say the family assistance program is perhaps a clear illustration. This would be a fairly expensive program.

Representative CONABLE. And that would have its inflationary impact, wouldn't it?

Mr. McCRACKEN. It would have its inflationary impact, but there is an urgent social problem here that the Nation has to try to make some kind of progress on, so it is a matter of pursuing this with proper balance.

Representative CONABLE. Balance—that is the word that we come back to constantly in government, is it not?

Mr. McCRACKEN. Yes.

Representative CONABLE. Balance. And yet the economist does not have any magic wand to wave over the situation in which we find ourselves, with sharply rising prices, which really will permit a painless solution of the problem and that is what I meant when I said I thought your position was a realistic one.

There are those who are constantly saying let's fight this inflation all the way, but let's not do anything that will be at all painful. Really to get prices under control, we are going to have to unleash economic forces which are going to involve some degree of economic friction, are they not?

Mr. McCRACKEN. That is correct.

Representative CONABLE. And the question is to achieve the kind of balance that will mitigate the hardship and yet still involve some tightening of the belt?

Mr. McCRACKEN. Right.

Representative CONABLE. Is that the basic thrust of the administration's hope here in continuing this war, a war which I do not believe you have lost, but one that certainly requires some additional fighting?

Mr. McCRACKEN. That is very well put. I wish there were a painless way to do this. It would certainly make our job a good deal easier.

Representative CONABLE. Well, the reduction of prices by a businessman is not usually a very pleasant experience for him; is it?

Mr. McCRACKEN. It is not a pleasant experience, and it comes only when back pressures build up which force reductions.

Representative CONABLE. Now with respect to the Vietnam war, let us look at that for a minute, is that an economic institution? Are the decisions in the Vietnam war being made by economists?

Mr. McCRACKEN. No. Our problem is, of course, to take cognizance of the economic implications.

Representative CONABLE. The economic impact——

Mr. McCRACKEN. Yes.

Representative CONABLE (continuing). Is something we have to understand; is it not?

Mr. McCRACKEN. Yes.

Representative CONABLE. But generally speaking do you advise the President a great deal about matters of national defense?

Mr. McCRACKEN. No; only when there is the interface between the decisions that have to be made in the national defense and their implications for the economy.

Representative CONABLE. You support the economic view of history, I am sure, going back to the days of Charles Beard. Do you have an economic theory of wars?

Mr. McCRACKEN. No.

Representative CONABLE. I was interested in that, because, of course, it is suggested sometimes that we should adjust our national defense in order to reflect primarily economic matters.

One question I would like to ask Dr. Houthakker if I have the chance, we have had a deterioration in our trade balance in the past year, particularly with Germany and Japan, and I understand that during the last 12 months for which trade statistics were available our trade with Germany was about $550 million in deficit and with Japan about $1.436,000,000 in deficit.

It is probably not a coincidence that these countries are major beneficiaries in balance-of-payments terms of our military programs. Defense budgets of these countries are very small in proportion to their total budget. Is there a connection between our defense operations in these countries and in the areas that are of particular concern to these countries, and our trade problems with them?

Mr. HOUTHAKKER. I believe there is some connection, yes. The fact is that both Germany and Japan have shown a very high rate of growth, especially in Japan. The fact that these countries have relatively limited defense expenditures has, of course, helped them to concentrate on the improvement of the efficiency of their industry, whereas we have had to spend a great deal on military purposes, and correspondingly have had less to spend on investment in private industry.

I would add though that the military expenditures themselves have had I think only a very limited effect on our balance of payments. As you are no doubt aware, in the case of Germany, we have offset agreements which are intended to neutralize the effect of our military expenditures there.

I believe that similar agreements exist with Japan, although I am not completely positive about them.

Representative CONABLE. The offsetting payments are not as great as the balance of trade deficits with these countries, are they?

Mr. HOUTHAKKER. No ,sir.

Chairman PATMAN. Your time has expired. If you desire to do so you may ask the witness to expand on his testimony when he looks over the transcript. Will that be satisfactory?

Representative CONABLE. Very good.

Chairman PATMAN. Thank you, sir.

Mr. Bolling?

Representative BOLLING. Mr. McCracken, I apologize for not being here earlier. I may repeat something that has been asked.

I have been reading a good deal in a variety of places about the struggle that is allegedly going on in the administration between the Friedmanites and the non-Friedmanites, whatever the different definitions are, and I do not ask this question to needle.

I am curious if there is anybody that does not feel that a reasonable amount of consideration has to be given to both monetary and fiscal policy, if we are to have a reasonably steady rate of growth with a reasonably stable price level. Have we got a school left that believes that one or the other will do by itself?

Mr. MCCRACKEN. That is a very good question, and I think it is very important, and I am glad you raised the question.

I think the short answer is "No." I do not think there are any who feel that it is one or the other, and that the other one, whichever it is, can be disregarded. This was why in the Economic Report itself we said that with the present state of knowledge, and of course with some uncertainty about just how these two instruments of policy interact on each other, "The Government could not prudently let the control of inflation depend on the choice of one of these strategies to the neglect of the other."

Representative BOLLING. What page is that?

Mr. MCCRACKEN. This is on page 23 of the Economic Report in the middle of the page.

Representative BOLLING. Thank you.

Mr. MCCRACKEN. I have sometimes said myself I am more Friedmanesque than I used to be, but I certainly would not disregard fiscal policy. I think it is very important.

Representative BOLLING. I thank you. Could it not also be that at different times in different circumstances the mix of circumstances could very much change the importance of one as opposed to the other approach?

Mr. McCracken. Yes, I think that is true. Indeed as we look at the several years ahead, we find ourselves sympathetic with the view that fiscal policy ought to be making a continuing contribution to the stream of savings, if we are going to be able to take care of our housing and the capital formation that we need, and so forth. This carries with it an implication for fiscal policy that might be different under other circumstances.

Representative Bolling. In other words, it really has not gotten any simpler?

Mr. McCracken. It has not gotten any simpler; that is correct.

Representative Bolling. Now an entirely different subject. For many years I have not agreed with the majority of my colleagues in my party on the question of what I call and many others call jawboning on price and wage matters.

I have been a little bit shaken in my view by the events of the last year in terms of the increased rate of inflation, and I wonder if perhaps those with whom I have disagreed for these many years are not at least in this kind of a circumstance correct. Are we not having, or have we not had—I hesitate to say that we are having it now because there is the lag that is always built in, in our knowledge of what has happened—have we not had a situation where demand was not an adequate explanation for price increases? Have we not had a situation where one could argue, and I do not say one should but one could argue, that there have been what is commonly called administered price increases? And does that not perhaps lead to the notion that we do need some kind of institutionalized approach to the problem of jawboning? I know that is a hopeless question——

Mr. McCracken. No.

Representative Bolling (continuing). But that is the best I could do on a complicated matter.

Mr. McCracken. No; that is a very live question, a question that is very very relevant to the current scene.

You alluded to the term "jawboning," and there is a distinction which ought to be made between jawboning and the guideline approach of the 1960's, at least up until perhaps 1966, where there was a logic articulated, and arithmetic guidelines for wages and certain rules about price behavior.

Jawboning, on the other hand, is more nearly just taking cognizance of a price increase that happens to fly by and trying to get at it some way or other. In other words, the latter would be a more ad hoc, erratic sort of thing.

Now, I think there would be general agreement that the guideline program as such pretty well collapsed specifically with the airline mechanics' settlement in 1966, and that thereafter we were in the jawboning type thing.

We have studied this problem very carefully. We have studied our own experience and what the evidence shows. We have studied international experience with income policies. As I indicated before another committee last year, I would say that it is a verdict of unproven. The evidence is mixed.

There is some evidence which suggests that there may have been some displacement effect on the price level or certainly the wage level in the guideline era. There is other evidence to the contrary.

If one were to single out price increases last year which perhaps tended to reraise this question, the increase in steel prices would be one, and also prices of the nonferrous metals and oil prices.

One would have to be very cautious about simply attributing what happened to steel prices to the difference between being in the jawboning or not being in the jawboning era. There have been other things. The world demand situation for steel was, of course, very much stronger in 1969 than earlier. The import quotas for steel, which were arranged in 1968, also presumably had some effect on the market situation for steel in 1969.

Actually if one excludes two or three of these key areas, the pattern of price changes during the jawboning period leaves one with inconclusive results.

Another point that I would want to make. I do not think there is any question that if the Government wants to move in with very strong action it can effect a displacement on the price level for a time. The question that has to be asked, however, and this is based on internatonal experience as well as our own, is whether this tends to suppress pressures which build up, and then we have a periodic eruption of prices, and whether at the end of the whole sequence of events much has been gained. This has been a troublesome thing for other industrial countries, and I think it would generally be agreed that the results have been disappointing.

Representative BOLLING. Is it fair to say that this is a matter that is still—and again I am not trying to load the question but I will make it as broad as I can—within the administration receiving continuing professional consideration?

Mr. MCCRACKEN. There are certain aspects of this which I think would be in this broad area that are receiving continuing attention. The administration all along, for example, has been concerned about any evidence of malfunctioning markets, such as the case of our inquiry into the multiple or the two price system in copper, and cite the lumber and plywood situation that existed about a year ago. Any government has to be concerned about these kinds of developments, because price aberrations may be a symptom of something that needs to be corrected in the market.

Representative BOLLING. Thank you. My time is up.

Chairman PATMAN. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Dr. McCracken, and other members of the Council, I appreciated the testimony and the fine reports that you furnished us.

In hearing some of the distress expressed, I suppose you might call it impatience, over what I believe you referred to. Dr. McCracken, as the substantial lag in economic changes during 1969 in trying to combat inflation, it seems to me that an analogy might be drawn, and in making the comment I am not suggesting that you or any of the others have more expertise in the field of alcoholic beverages, but I suggest the analogy to one who has gone out on Saturday night and has consumed two quart bottles of Vodka, and then because his horrible hangover is not relieved by Sunday afternoon expresses disappointment.

Do you see an analogy between the horrible hangover after an inflationary binge such as this country went on for several years capped by the $25 billion budget deficit for fiscal 1968, and this substantial lag which you referred to?

Mr. McCracken. Yes; I think that is a very good metaphor. I express only an academic opinion.

Senator Miller. Now the President has presented the Congress with what I suppose we would call a moderately restrictive fiscal policy budget. If the Congress through the appropriations process does not stay substantially within that budget, that Presidenial policy on restrictive fiscal matters, restrictive fiscal policy can be very quickly overturned; can it not?

Mr. McCracken. Yes.

Senator Miller. And if this should happen next July, August or September, when the Congress completes action we hope on the appropriations bills, and turns the Nixon budget around to a deficit budget, then would you feel that that should be accompanied by either an offset in the form of reinstatement of the tax surcharge or postponement of tax relief or some other tax measures so that we will maintain a restrictive fiscal policy budget?

Mr. McCracken. Yes; I would, without regard to the specific actions which might then be taken in case there were a substantial overrun on the expenditure side. I would consider that counteracting measures ought to be considered, because we cannot afford to drift back into a weak budget position.

Senator Miller. Do you believe that in fighting inflation restrictive fiscal policy should be accompanied by restrictive monetary policy?

Mr. McCracken. We have to have a balanced approach.

Senator Miller. I understand the other day that the White House indicated that because the President had presented a restrictive fiscal policy budget, that some easing on the monetary policy side might be indicated. Would it be your position that that easing would be premature until after the Congress has taken action on appropriations measures so we will really know whether this country is going to follow a restrictive or an inflationary fiscal policy?

Mr. McCracken. Let me preface my comment by saying that monetary policy is the responsibility of the Federal Reserve, which is an independent agency within the structure of government, and therefore any comments that we made in the Economic Report, or that I would make here, are within the context of that point.

On the other hand, I think we have to pursue our strategy with a certain amount of confidence and faith that we will stay reasonably on course with both monetary and fiscal policies, unless it becomes clear that the budget situation is going to be significantly different from what has been projected here.

Senator Miller. Would it not be fair to say that the action by those in control of the Congress with respect to fiscal policy, with respect to appropriations and tax revenues, will be decisive as to whether or not the inflation is going to be brought under control?

Mr. McCracken. Yes, sir; I would agree with that.

Senator Miller. Now, in your oral statement you say:

> As the administration has said repeatedly, the policy will work with less delay and pain the more promptly individuals respond to changes in market conditions. Now that a marked change in market conditions has been brought about, it becomes increasingly important to assure that business and labor respond to

them in making price and labor decisions. We intend to watch this response closely and use what instruments the Government possesses to encourage and induce the needed response.

I have a two-pronged question:

The first is what do you have in mind when you say to "use what instruments the government possesses to encourage and induce the needed response?"

One could interpret that to mean wage and price controls, jawboning, or credit controls. Specifically, the second part of my question is, do you think that we should get into some kind of consumer credit controls?

Mr. McCracken. Let me comment first on the question of the instruments that are involved. This was not intended to be any oblique reference to the possibility of wage or price controls or something like that, of course.

Senator Miller. You could not do that without congressional action anyhow, could you?

Mr. McCracken. That is correct, and that was not intended by this language in any case. I think that possibly the most important instrument for us to use is to be as clear as possible as to what the course of policy is, and this we have tried to do in various ways, so that planning in the private sector is not based on any misconception about what the strategy of the policy is going to be.

I recall an address that I gave before the Economic Club in New York City discussing this specifically, that this is going to be the course of the policy, and, to the extend that this is relevant in private planning, this is what policy is. We have an obligation to make that clear.

We certainly have an obligation to study the various segments of the economy, to see if there is any evidence of malfunctioning of markets. Some part of chapter 4 in the Economic Report goes into certain aspects of some of these problems.

I had in mind nothing in that language that goes beyond the boundaries of what we have talked about before.

Senator Miller. More in the nature of planning and informational activities to apprise sectors of the economy of what lies ahead, what certain adjustment would follow from certain actions. That is what you had in mind.

Mr. McCracken. Together with of course surveillance to make sure that markets are functioning properly.

Senator Miller. What about consumer credit controls?

Mr. McCracken. Consumer credit controls were discussed. There has been a good deal of interest in this in public discussions about policy over the past year. I do not see a role for them in our problem now.

Actually the parts of the economy to which they would be specifically addressed, such as the automobile market and consumer durables generally, happens to be a part of the economy that is relatively rather soft.

Senator Miller. Doctor, I was not referring to general consumer controls. I naturally would be referring to selective consumer controls, and there has been a lot of talk about selective consumer controls.

Mr. McCracken. Yes.

Senator MILLER. Do you have any comment on that?

Mr. McCRACKEN. By selective controls something like the old regulation W. You mean controls on downpayments?

Senator MILLER. Yes; in certain selected areas.

Mr. McCRACKEN. Yes.

Senator MILLER. And, of course, where you have a soft auto market, I would expect that that would not be included?

Mr. McCRACKEN. Yes; and the soft areas include not only automobiles but the big ticket items generally, appliances, color television, and so forth, so that I do not myself see that credit controls in this area would get at a significant aspect of our problem.

Senator MILLER. Thank you.

Chairman PATMAN. Senator Sparkman?

Senator SPARKMAN. Mr. McCracken and gentlemen of the Council, I want to say that I greatly appreciate the statement and the answers you have given this morning. I share what I think is the feeling of this whole committee. We have a great deal of confidence in the whole Council. I believe you are working hard to do a good job. There are some things, however, that I sometimes get disturbed about.

By the way, talking about the things we read in the papers yesterday, there was one statement I read that I have not heard any comment on, and that was to the effect that the balance of payments during the past year had a deficit of $7 billion. Is that correct?

Mr. McCRACKEN. Yes; that is the deficit on a liquidity basis. That is the latest estimate.

Senator SPARKMAN. Isn't that a considerable jump over what it was the year before?

Mr. McCRACKEN. Yes.

Senator SPARKMAN. That same article said the year before it was $1.5 billion. Does that sound right? I did not see that in the report.

Mr. McCRACKEN. The liquidity balance in 1968 was about $200 million.

Senator SPARKMAN. How much?

Mr. McCRACKEN. About $200 million. In fact it was a surplus. There was a surplus of about $200 million in the liquidity balance in 1968, and the present rough estimate is something like a $7 billion deficit for 1969.

Senator SPARKMAN. Is that brought about because of a drop in the favorable balance that we have had in trade, that is as between exports and imports?

Mr. McCRACKEN. No. I think the balance on goods and services as a matter of fact has been improving some this year. The surplus on goods and services in the first three quarters was $108 billion. It did slip to $1.2 billion, but then rose to a $2.9 billion rate in the third quarter of 1969. I think that had to do more with this complex flow of Euro-dollar funds. The high interest rates abroad had the effect of attracting some funds from the United States to the Euro-dollar market, which then were borrowed back. This round trip was recorded in the accounts as an addition to our liquidity deficit, so we had the paradox of a quite large liquidity deficit, and on the whole a fairly strong dollar.

Senator SPARKMAN. Let me ask you one or two question about housing. That has been one sector of the economy that has felt probably the heaviest part of the crunch; isn't it?

Mr. McCracken. Yes; that is correct.

Senator Sparkman. You in your statement before the House Banking and Currency Committee a few days ago pointed out that 30 percent of the funds raised in credit markets during the 1970's should flow to home mortgages as compared to 20 percent in 1966 to 1969 percent, and that we will have to tax ourselves more to create a burget surplus substantial enough to meet our goals.

Does that mean that the budget that has been submitted is sufficient to allow 30 percent of the credit funds to go into housing?

Mr. McCracken. The context of that comment was a comparison of the proportions of funds flowing through the credit markets in the 1960's, and what would be needed in the 1970's.

In roughly the first half of the 1960's, as I recall it, about 30 percent of the funds flowing through the credit market did go into residential mortgages. That ratio then dropped to roughly a 20 percent level in the latter part of the 1960's.

Our very rough projections, and they can be no more than that, are that to meet the housing goals for the Nation it would take about a 30 percent flow in the 1970's, which would be about what it was in the first half of the last decade. As we projected this out, we found that the sayings that would be needed to finance capital formation, to keep pace with our rapidly growing labor force, the demands for housing to meet our housing goals, and of course to satisfy other needs for credit add up to a rather strong demand or requirement for savings. Probably private savings would be adequate for this purpose. It is certainly true, however, that if the Federal budget were to run a persisting deficit during this period, so the Treasury were having to dip out of the saving stream to cover a deficit, then savings would be short relative to the needs for financing all these needs.

Senator Sparkman. If you were going to make a prediction would you predict that the housing situation is going to be better this year, for instance, than it was last year?

Mr. McCracken. I certainly hope we can get this turned around, but it is a very difficult problem.

Senator Sparkman. If I remember correctly, when you were before this committee a year ago, and when you were before the Banking and Currency Committee we questioned you, I know we did other officials, the Treasury officials and the Chairman of the Federal Reserve Board on this matter of the flow of funds, the tying up of funds in a greatly stepped up increase in expansion of the plant and equipment. and I remember at that time we urged all of you to the effect that the administration should exercise some control, if nothing more than moral suasion. I do not know what is that term?

Senator Miller. Jawboning.

Senator Sparkman. Jawboning. I prefer to call it moral suasion, that that moral suasion could be used to get the industries and to get the banks that are supporting those financing programs to defer some of that expansion in order that there might be more funds in the market from which housing could draw a reasonable part.

And yet may I say that apparently there was no cutting down during the year, and recently I read in the paper that it was expected to be even greater, a greater increase in 1970 over 1969 than there was over 1968.

Mr. McCRACKEN. I would not expect an acceleration of capital outlays. Indeed I think we shall see some continuing reconsideration of capital budgets in businesses as the year wears on.

We do need to bear in mind, of course, the pattern of these increases in capital expenditures for businesses. A significant area of strength in capital expenditures is in the public utility area. These are the companies where there is a very thin margin between the rapidly growing demands for their services and their capacity, and one even sees occasionally the question raised as to whether—if we were to have an extremely high temperature this summer—our electricity capacity would be enough to handle the load.

I say this because these companies, by and large, are laying out programs to improve and to expand their productive capacity which are probably consistent with the basic forces in their own markets. However, there undoubtedly have been some cases where there was over-expansion I am sure.

The basic problem here is that the total flow of funds through the market has simply been inadequate to take care of all of these requirements. Housing, as was true in 1966 and has tended to be true throughout the postwar period, has tended to be on the end of this whip cracker. It is a very difficult problem. I think we have not yet found the full answer.

I can only say that I consider it one of our most urgent problems that we now face.

Senator SPARKMAN. Thank you, Mr. Chairman. My time is up.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Chairman McCracken and members of the Council, I join my Democratic colleagues in commending you on what in my judgment is the finest Republican Economic Report in history.

I am disturbed, however, as my colleagues are, about inflation. Just a year ago you came before us—incidentally you did not say anything about hang-overs in your testimony then—and said that your goal was that you were going to reduce the 4.2 percent inflation that we had in 1968 to a goal of 3½ percent inflation. In fact as we now know, the inflation rate that we suffered was well above 5 percent on the consumer price index. Many of us, on the Democratic side, feel that policies of fiscal-monetary austerity by themselves are not enough to do the job, and that what the President should do immediately is to impose an across-the-board price freeze for at least 6 months, so that sound fiscal, monetary, incomes, and supply policies could take hold.

Actually, we have a precedent for that in the OPA with which I was associated 25 or more years ago. We did institute a price freeze, and it was remarkedly successful in stemming inflation during the period it was in force. I recall that two of the most dedicated employees of the OPA were a young married couple, Dick and Pat Nixon.

Now with that kind of expertise on price freezes in the White House, is it wise to forceclose the possibility that a price freeze, for 6 months or so, would be a meaningful attack on inflation, which people would really believe?

Mr. McCRACKEN. Let me say first that I felt a little let down at your qualification in rating our report.

Representative REUSS. I will add that it is better than some Democratic reports we have had.

Mr. McCRACKEN. I do not believe that a price-wage freeze or price-wage controls would be wise for the American economy in this situation. The problem of inflation is a very difficult one. We have given great emphasis to it, so it is not a matter of our being casual about the problem.

But our own experience, and also international experience, would lead me to believe that that is not a course of action which we ought to consider at this time.

There are many reasons for this. We would not have the broad based support for the overriding national objective that we had in World War II. If this kind of panoply of controls were to be really effective, it would inevitably mean shortages and imbalances in the economy.

Something that is far more important about prices than the price level really is the pricing system. This is an extraordinarily fluid and dynamic thing. It is something that even a large bureaucracy could not possibly keep up with, and in my judgment a far better course of action is to deal with the basic requirements of an anti-inflationary program. Suppressed inflation would be apt to leave us with very grave side effects for our economy.

Representative REUSS. Over the Lincoln's Day recess, I had occasion to talk to a number of people in the labor movement who gave me the impression that because of price increases and what they regard as the administration's failure to do anything about them, they are going to have to ask for wage increases this year of a very considerable percentage advance. I have said that I was going to be seeing you today, and might learn something. Can you give me any guidance for them on what standards ought to govern them in formulating their wage increase demands?

Mr. McCRACKEN. I am afraid I would be back in the guidepost business if I were to try to articulate standards. We do stress that basic policies of restraint to establish a more noninflationary economy have been in place long enough so that the economy now is starting to move through the difficult phase of adjustment to a less inflationary environment. And this inevitably means that ultimately we have to get to a situation where wage increases and price changes start being less than they have been.

Representative REUSS. In your colloquy with Senator Miller, you discussed credit controls, and you said, and I happen to agree with you, that imposing consumer credit controls, regulation W, at this time, would not be necessary or desirable because throughout the consumer field, and particularly in the hard goods items, there is softness. That is the way I read it, too, and if I were in your shoes I would not take advantage of the power the Congress gave the administration last December to impose consumer credit controls now.

However, having said consumer credit controls are not needed, let us explore where there are inflationary areas in the economy—certainly they must exist some place—and then see whether credit controls would not be useful.

I note, for example, that despite the administration's policies of fiscal and monetary austerity, commercial bank loans to business, made very largely for inventory or plant investment or conglomerate take-over, increased by 13 billion in 1969. Would it not, therefore, be a sensible idea, since this is where the inflation in the economy is taking place. I am sure you agree, to impose qualitative credit controls on that kind of lending?

It has been done successfully in this country, done successfully in France and England and various other places today. What is holding up the works? Why don't we impose that kind of qualitative control?

Mr. McCracken. Selective control you mean?

Representative Reuss. Yes, a freeze, for example, on bank lending for these purposes over whatever base period you select.

Mr. McCracken. This kind of selective control almost always turns out to be considerably more complex than it might seem on the surface. For example, as credit became less available even to businesses, we saw last year, for example, the increasing resort to the commercial paper market, with commercial paper rising very sharply. In other words, as one possible avenue is shut off, another one is apt to be devised in one way or another.

I want to say that I do not have a closed mind on this issue. We still have very difficult problems in housing, specifically. It has been one that has a long history. Government did take very aggressive actions last year to try to channel more funds into mortgages through the Federal Home Loan Bank Board actions, and, of course, through FNMA.

While I remain openminded on this, I find myself also very much aware of the problems and complexities once one moves into this area.

Representative Reuss. Well, we have said no price freezes, no qualitative credit controls. What about the supply side? Perhaps I should turn to Dr. Houthakker because I know he has worked on this. Why don't we get the price of hamburger and the price of heating oil and the price of steel down by relaxing our foreign import quotas a bit? The American housewife could do very well on Australian and New Zealand additions to her hamburger, and American households could do very well with less expensive heating oil, and all of industry could do much better with less rapidly escalating steel prices.

Senator Miller. Will my colleague yield?

Representative Reuss. I yield to my friend Senator Jack Miller for a senatorial defense of the Iowa meat feeder.

Senator Miller. No; as a matter of fact I was merely going to ask if you would include in those items——

Representative Reuss. Dairy?

Senator Miller. Dairy products.

Representative Reuss. Absolutely, yes. Fair enough, Danish cheese.

Senator Proxmire. May I say to my good friend from Milwaukee, he speaks for himself.

Chairman Patman. The time of the gentleman has expired.

Representative Reuss. Perhaps Dr. Houthakker could answer this question for the record.

Chairman PATMAN. Fine. You may do so, sir.

Representative REUSS. I meant later.

Chairman PATMAN. I mean when he looks over his transcript you may answer it at that time. That is what you had in mind; was it not?

Representative REUSS. Yes, sir.

(The following information was subsequently supplied for the record by the Council of Economic Advisers:)

It is quite correct that a reduction in import barriers will tend to restrain domestic price increases. This, indeed, is one of the major arguments for freer trade: it would provide the consumer with a wider range of products at more reasonable prices. At the same time, increases in imports may cause discomfort to those who are selling competitive products, and this explains why producers (whether of oil, steel, beef, or other products) tend to oppose policies which would result in an increase of imports.

United States policies in recent decades have recognized that, in general, the advantages to the consumer and to exporters which come from freer trade more than outweigh the problems which may be faced as the result of import liberalization. Therefore, trade liberalization has been a major part of our international economic policy. At the same time, it has been recognized that trade liberalization cannot take place all at once, and that there may occasionally have to be backward steps when the domestic industry faces particular difficulties, or where the special characteristics of the industry require its protection for defense or other special reasons.

It is desirable that the movement towards freer trade of recent decades be continued in the seventies. The administration bill sent to Congress last year provides for some reduction in import barriers, namely the American Selling Price system of evaluation. In considering future trade policy, it is important that the interests of the consuming public be taken into account.

Chairman PATMAN. Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

Gentlemen, I want to join with my colleagues in commending you for this report. I find it extremely informative and very helpful. Thank you.

In the Economic Report there is one sentence on page 77 where you state that "agencies have been directed to apply a discount factor to all programs which have costs or benefits that occur 3 or more years in the future."

What is the rate of that discount factor?

Mr. McCRACKEN. What page was that?

Representative MOORHEAD. Page 77 of the Economic Report, the second full paragraph.

Mr. McCRACKEN. Oh, I see; yes.

Representative MOORHEAD. I want to know the rate.

Mr. STEIN. I believe it is in the 4 to 5 percent range. I do not know precisely, but we can supply that.

(The following information was subsequently supplied for the record by the Council of Economic Advisers:)

The Budget Bureau's Circular A-94 stipulates that "The discount rate used to evaluate programs and projects should not be lower than the discount rate established by the Water Resources Council, related to the current yield on Government bonds." At present this *minimum* rate is 4⅞ percent, but it will rise to 5⅛ percent for Fiscal Year 1971, in accord with the formula of the Water Resources Council. For actual program evaluation a rate nearer the real yield of Government bonds is used, with the sensitivity of project evaluation to rates of 10 percent and higher being tested. As stated both in Circular A-94 and our Annual Report, a study of the interest rate reflecting opportunities foregone in the private sector is being made.

Representative MOORHEAD. Thank you, Dr. McCracken.

You state in your oral testimony about the need for budgeting the national output on a long-range basis, with which of course I entirely agree. Then in the Economic Report itself at page 81 you have a sentence, "The projected claims which assume no addition to present nondefense programs."

My question, sir, is, Do your projections—there seems to be a negative pregnant in there—do your projections assume an increase in defense programs?

Mr. MCCRACKEN. Well, we did not. All we meant by that sentence was that this assumes nothing beyond new initiatives to which the administration is already committed, such as family assistance and revenue sharing and so forth.

If you will look at page 80 of the Economic Report, you will notice that virtually all of the increase in new initiatives of $15 billion comes through grants-in-aid and transfer payments rather than programs which would show up as purchases of goods and services.

Representative MOORHEAD. Would I assume then that you assume no increase in defense expenditures?

Mr. MCCRACKEN. Well, I do not want to make any specific comment about any specific element of the program except just to make the observation that clearly the new elements here are almost entirely in the transfer area of grants-in-aid and the family assistance program and that sort of thing.

Representative MOORHEAD. What figure does the Council use for this fiscal year's cost of the war in Vietnam?

Mr. MCCRACKEN. We have no figure beyond the statement to which Senator Proxmire alluded, that the cost of the Vietnam program, the Vietnam conflict, would be down to about $17 billion rate by the end of the year.

Senator PROXMIRE. Will the Congressman yield? It was the beginning of the fiscal year, June 1970 was the quotation that I had gotten from the Secretary.

Mr. MCCRACKEN. Yes, all right.

Representative MOORHEAD. And what figure does the Council use in making their economic predictions for the cost of the war in Vietnam in the next fiscal year?

Mr. MCCRACKEN. In making our economic projections, we simply work within the ambit of the budget generally. The defense budget is one element in the total budget picture, but we were not working with a specific and separate figure on the Vietnam conflict. I simply do not have that figure.

Representative MOORHEAD. It would seem to me that as we decrease expenditures in Vietnam, this would have a very important economic effect.

Mr. MCCRACKEN. Yes.

Representative MOORHEAD. And therefore that you would almost have to have a figure, even granted you would have some variations. You cannot foresee the future completely.

Mr. MCCRACKEN. Yes. That of course, however, is reflected in the defense budget generally, and we naturally have to make assumptions about how the total defense item will phase out through the year.

Representative MOORHEAD. Then perhaps the question I should ask you, talking about the need for budgeting the national output on a longrun basis, on what basis does the Council base projections for defense spending, on a constant, on a declining, or on an increasing basis?

Mr. MCCRACKEN. I am not in a position to discuss the longer run components of the Government programs here. The defense budget, the defense purchases of goods and services, would be in the component of Federal purchases of goods and services generally, and the only figure that we have here is the total, projected along the trend given on page 79 of the Economic Report in 1969 prices. This goes from $102 billion in 1969, $93 billion in 1970, and down to $86 billion in 1975. That is total Federal purchases of goods and services. That is not total Federal spending but total Federal purchases of output, in which defense would be a component.

Representative MOORHEAD. Are you saying to us that you did not separately project the biggest item of Federal expenditures or purchases of which the military is a predominant item, and as you projected the totals you did not project what the future military expenditures would be, sir?

Mr. MCCRACKEN. What we tried to do here was to make a reasonable projection for the period ahead for total Federal expenditures, but we do not present the detail, though the trend here in the total is indicated by the table.

Representative MOORHEAD. In last year's Economic Report there was a 25-page section dealing with economic planning for the end of the Vietnam hostilities, and in that report they estimated that there would be a peace and growth dividend amounting to $22 billion by fiscal year 1972. Would it be your testimony today, sir, that your predecessors were just plain wrong in that figure?

Mr. MCCRACKEN. I would like to have Mr. Stein comment on this, since he has been pursuing some of these things specifically in the Council.

Mr. STEIN. Well, the figure that was used in the annual report of the Council last year was an estimate of the costs of the Vietnam war minus what was recognized would have to be added back to defense spending after the war was over, and this was all on the assumption that the war would end at some hypothetical date before fiscal 1972.

I would say that what we are now working with is an estimate of total defense spending which takes into account alternative possibilities with respect to the end of the Vietnam war, and the probable and possible responses on the total defense spending side. The estimate made by the previous Council is not in conflict with what we have here. As you can see, we show a decline of $16 billion in 1969 dollars, in total Federal purchases. A great deal has happened since then, of course, the most important thing being that a good deal of what then appeared as the growth and Vietnam divided has been absorbed by decisions already made, such as the decision of Congress to reduce taxes, and the decision originating to some extent in the Congress to increase nondefense spending beyond the levels then visible, so that it is no longer reasonable to think that we would have the dividend which seemed to be available a year ago, when we had not made these tax cutting and expenditure increasing decisions.

Representative MOORHEAD. Could you lay out for us exactly where that peace dividend disappeared to—how much in increased spending for domestic programs and how much for increased military expenditures?

Mr. STEIN. The peace dividend and the growth dividend are really inseparable if we look out to 1975. By any definition, the growth dividend is very much bigger than the peace dividend, and there always was a problem about the estimates of the costs of the Vietnam war, which at times ran as high as $30 billion a year in previous reports.

Since it was always so difficult to segregate what part of the defense expenditure should be attributed to the Vietnam war, I think it will not be possible for us to answer this question without a division of these figures that we have here on pages 79 and 80 of the Economic Report, and we are not able to give you that division.

Representative MOORHEAD. My time has expired.

Mr. Chairman, my point was as the distinguished Senator from Wisconsin has said, that it would appear that the military has snatched the peace dividend, and I cannot seem to get from you gentlemen corroboration or denial of that allegation.

Chairman PATMAN. Will it be satisfactory for you gentlemen if those of us who want to submit questions to you in writing. You can answer them when you look over your transcript? Will that be satisfactory, Mr. McCracken?

Mr. MCCRACKEN. Yes, sir.

Chairman PATMAN. I would like to ask you some questions about the money, the creation of money and where the savings come from and different things like that, and I will submit the questions.

Mr. MCCRACKEN. Fine.

Chairman PATMAN. Will you file for the record analysis of how credit was used during the year. You can select either calendar year or fiscal year, whichever you desire.

Mr. MCCRACKEN. Surely.

Chairman PATMAN. How much went to each purpose like housing, corporate plant, equipment, et cetera, and also give us a projection of 1970.

(The following information was subsequently supplied for the record by the Council of Economic Advisers:)

Total funds raised in credit markets declined in calendar year 1969 compared with 1968 (see table). The U.S. Government, however, supplied $5.4 billion to the market in 1969, because of a budget surplus, compared with borrowing $13.4 billion in 1968. Despite a sizable decline in total credit raised, therefore, all non-Federal sectors raised almost as much (or more) credit in 1969 as in 1968. State and local governments raised $1.0 billion less, and households raised $0.9 billion less. Nonfinancial business raised $8.3 billion more, and foreign sources raised $0.6 billion more.

These borrowed funds, together with equity funds and depreciation flows, financed capital outlays. The composition of the outlays is shown for households and businesses in the attached table.

The first part of 1970 should see a continuation of the decline in total funds raised, until such time as monetary restraint begins to ease. As the economy continues to slow down, there will also be less intense total demands for credit. This will allow sectors which have been deferring credit demands to raise funds more easily.

TOTAL FUNDS RAISED IN CREDIT MARKETS BY NONFINANCIAL SECTORS BY CALENDAR YEARS

[In billions of dollars]

	1968	1969
Total	97.4	85.7
U.S. Government	13.4	-5.4
State and local governments	10.2	9.2
Households	31.8	30.9
Home mortgages	14.9	15.8
Nonfinancial business	39.1	47.4
Foreigners	3.0	3.6
Disposition of funds:		
Households:		
Net borrowing	31.8	30.9
Plus net equity investment	1.1	3.1
Equals net physical investment	32.9	33.9
Plus capital consumption	76.2	82.7
Equals capital outlays	109.1	116.6
Residential construction	21.2	22.1
Durable goods	83.3	89.6
Plant and equipment (nonprofit)	4.6	5.0
Businesses:		
Net borrowing	39.1	47.4
Plus net equity investment	-2.1	-2.8
Equals net physical investment	37.0	44.5
Plus depreciation	62.3	66.5
Equals total capital outlays	99.2	111.0
Plant and equipment	82.9	92.9
1 to 4 family residential construction	.9	.1
Other residential construction	8.1	10.0
Charge in inventories	7.3	8.0

Note: Flow of funds, Board of Governors of Federal Reserve System, preliminary estimates for 1969 (Feb. 5, 1970).

Chairman PATMAN. Last year commercial banks according to the best estimates I received, created about $25 billion in credit, based upon a reserve of $22 to $1. I did not understand that and I looked into it further and discovered they commingled the reserves. Three percent on time deposits and say a 10 percent or slightly more on reserve demand deposits. By commingling them it made a true ratio of $22 to $1. Does that sound fairly accurate, Dr. McCracken?

Mr. McCRACKEN. You made about $22?

Chairman PATMAN. To $1 reserves.

Mr. McCRACKEN. It sounds high.

Chairman PATMAN. It sounded high to me but I was rather convinced that it was accurate, but I wish you would look into it, please, sir.

Mr. McCRACKEN. Yes, sir.

(The following information was subsequently supplied for the record by the Council of Economic Advisers:)

According to preliminary flow-of-funds data, all commercial banks increased loans and investments (total bank credit) by $9.6 billion in 1969.

At the end of 1969, member banks had total deposits of $288.6 billion subject to reserve requirements, of which $138.9 were demand deposits and $149.7 billion were time and savings deposits. Member banks had reserves of $28.0 billion to meet requirements. The ratio of total deposits subject to reserve requirements to total reserves was 10.3.

Chairman PATMAN. And I will submit some other questions.

Mr. McCRACKEN. Fine.

Chairman PATMAN. Now then, we will yield from side to side like we did before. We will probably get through in an hour's time and not come back this afternoon, but if the members prefer to come back this afternoon, and it is all right with the Council, we will consider that.

Senator Javits, would you like to ask some questions?

Senator JAVITS. Mr. Chairman, I ask unanimous consent that the second round of questioning may similarly be limited to 10 minutes.

Chairman PATMAN. Without objection it is so ordered.

Senator JAVITS. Mr. Chairman, I hope that before the end of the session the witness will answer Congress Reuss' question on imports at a public session. The press ought to hear the reply, and I shall be very brief. And I am sure I may be able to yield to the Congressman for that purpose.

Mr. Chairman, I had one major question relating to one point and I notice you have given a very important estimate of the future at page 72 of the Economic Report, in which you estimate that we will have a 20 percent real improvement by 1975, having had a 40 percent real improvement in the future of the individual in terms of per capita income since 1959, so therefore would you put at the top end of the scale the danger of unemployment? You would agree, would you not, that that is the danger we wish to protect against?

Mr. MCCRACKEN. Yes.

Senator JAVITS. That is the main thing?

Mr. MCCRACKEN. Yes.

Senator JAVITS. Where we know about health, welfare, housing, and many other things, but really unemployment you would agree, would you not, that is the main thing?

Mr. MCCRACKEN. We certainly want a fully employed economy.

Senator JAVITS. Right. Now, you speak of a 4.3 rate order of magnitude as the probable result of the administration's policy. I notice that your proposal for improving the employment security system, which is contained at page 63 of the Economic Report, triggers increased unemployment compensation to a 4.5 percent rate. Therefore, I ask this question:

Would it not be prudent for the administration to coordinate both questions? It may sound like nothing to speak of two-tenths of 1 percent, but if my mental calculation is accurate, that applies to 70 million employable Americans. Hence even two-tenths of 1 percent is a very appreciable number of Americans, about 140,000. I do not want to bog things down with small details, but I do urge you that those figures be coordinated; because I think if you wish to inspire confidence, this basic economic issue of unemployment is critically important. Would you agree with me in that, sir?

Mr. MCCRACKEN. Yes, certainly Senator Javits. The 4.3 percent was simply the figure consistent with our projection for gross national product of $985 billion, that being the midpoint of the range of $980 to $990 billion that we indicated in the report.

It was simply the figure that is consistent with our other projections as to what we think will occur.

Senator JAVITS. Would you then consider using your influence in the administration with respect to the trigger in the Manpower bill? I happen to be responsible for the Administration's Manpower bill in the Senate, so I am very interested.

Mr. McCracken. Yes, sir.

Senator Javits. One other point which I would like to make, and that concerns the attribution of inflationary pressures to bank loans. I think Congressman Reuss may have inadvertently indicated that bank loans were greatly increased during 1969. From my understanding of your figures, from my own understanding, they were rather materially reduced. As a matter of fact, one of the great problems which I find in the business community is the feeling that money is not available for very deservable purposes, and that that is one of the big factors underlying the danger of an accelerating recession. It is shown by the figures on page 38 of the Economic Report, which indicate a sharply declining rate of bank lending, particularly between the second and third quarters of 1969. Could you give us any enlightenment whether that is continuing or whether that is the trend?

Mr. McCracken. These data are from the flow of funds data published by the Federal Reserve. So far as I am aware, data for the fourth quarter consistent with these are just not available yet.

Chairman Patman. Would the gentleman yield to me for a suggestion?

Senator Javits. Certainly.

Chairman Patman. I notice, as I looked that up, that net lending to corporate businesses jumped $6,500 million in 1969, a year of great money tightness. During the same year net bank lending to farm and small businesses was reduced. This points out once more the extreme discrimination inherent in tight money policy. And it argues rather strongly for the credit control bill that was signed by the President about 90 days ago.

Senator Javits. Mr. Chairman, I would ask the witness to produce for us from the most authoritative sources the answer to both questions, to wit, the contribution of banking loans to inflation or deflation, and the mix of bank loans. I think our chairman is absolutely right about that.

(The following information was subsequently supplied for the record by the Council of Economic Advisers:)

During 1969, the extension of bank loans responded to policies of fiscal and monetary restraint in much the anticipated fashion. Total bank loans extended by commercial banks increased by $20.2 billion compared to an increase of $27.4 billion the previous year. The increase in bank loans to business decreased from $9.6 billion in 1968 to $8.5 billion in 1969. Apart from corporate business, the sectors most directly affected were households and finance companies. Among classified bank loans, restraint was felt hardest by mortgage loans, consumer credit loans and security credit loans.

The impact of restrictive economic policies on bank loans was reinforced by a strong trend to disintermediation shortly after mid-year. High market interest rates along with restrictions on the maximum interest payable on bank deposits encouraged a higher than normal flow of savings directly to the credit markets. By the third quarter of 1969, the net change in bank loans outstanding had decreased to $9.1 billion from its high of $35.0 billion in the fourth quarter of 1968. The net change in loans outstanding to corporate business had decreased from $18.2 billion to $4.1 billion. While this trend reversed itself somewhat in the fourth quarter of 1969, it is expected that the increase in bank loans during 1970 will continue at a distinctly more modest rate than had been the case in 1968. Historical data on these trends are presented in the accompanying table.

Representative REUSS. Would the gentleman be good enough to yield briefly at this point?

Senator JAVITS. Sure.

Representative REUSS. I would like unanimous consent to introduce in the record at this point the basis for my statement before concerning the very, very large increase in bank loans to business last year, comprising a flow of funds seasonally adjusted dated February 5, 1970, Division of Research and Statistics, Board of Governors of the Federal Reserve System, and particularly the table entitled "Sector Statements of Sources and Uses of Funds."

Chairman PATMAN. Without objection all members may have the opportunity to extend their remarks in this record, and include any pertinent remarks and also extraneous matter relating to their remarks.

(The following table was supplied for the record by Representative Reuss:)

SECTOR STATEMENTS OF SOURCES AND USES OF FUNDS

[Seasonally adjusted annual rates]

[In billions of dollars]

	Year totals				1968				1969			
	1966	1967	1968	1969	I	II	III	IV	I	II	III	IV
Nonfinancial business total												
1 Income before taxes	139.1	135.8	145.1	147.0	140.2	145.3	147.4	147.4	146.5	148.1	147.9	145.5
2 Gross saving	77.7	78.1	81.0	82.1	76.7	81.7	83.3	82.3	81.4	81.7	82.9	82.2
3 Gross investment	69.6	69.9	74.1	76.7	69.5	73.7	77.6	75.8	76.4	76.0	77.3	76.9
4 Capital expenditures	97.0	93.6	99.2	111.0	92.0	99.2	98.2	107.5	106.5	107.8	114.5	115.3
5 Fixed investment	82.2	86.2	91.9	103.0	90.4	89.1	91.0	97.2	99.9	100.9	103.8	107.5
Business plant plus equipment	76.1	78.2	82.9	92.9	83.0	80.4	82.5	85.8	89.0	91.2	94.7	96.6
1 to 4 family residential construction	–.7	2.0	.9	.1	.1	.9	.4	2.2	1.2	–.2	–1.1	.5
8 Other residential	6.8	6.1	8.1	10.0	7.3	7.8	8.2	9.2	9.7	9.9	10.2	10.4
9 Change in inventories	14.8	7.4	7.3	8.0	1.6	10.1	7.2	10.3	6.6	6.9	10.7	7.8
10 Net financial investment	–27.4	–23.7	–25.1	–34.4	–22.5	–25.6	–20.6	–31.7	–30.1	–31.8	–37.2	–38.4
11 Net increase in financial assets	16.5	14.7	28.2	28.1	33.4	18.3	30.7	30.3	36.9	22.9	28.0	24.6
12 Net increase in liabilities	43.9	38.4	53.3	62.5	55.9	43.9	51.3	62.0	67.0	54.7	65.2	63.0
13 Credit marketing instruments	33.8	37.9	39.1	47.4	32.1	35.6	39.9	48.8	47.1	47.7	47.5	47.1
14 Securities	11.4	17.0	12.1	15.3	12.8	12.8	10.3	12.4	15.0	14.8	15.4	16.1
15 Home mortgages	–1.0	1.1	.3	–.3	–.5	.3	.4	1.0	.7	–.9	–.5	–.5
16 Other mortgages	9.7	9.2	11.0	10.6	10.2	9.8	10.9	13.1	10.8	10.7	10.1	11.0
17 Bank loans n.e.c.	10.1	7.7	10.6	10.2	4.7	8.3	10.8	18.7	13.1	10.6	6.8	10.3
18 Other loans	3.6	2.8	5.1	11.5	4.9	4.4	7.6	3.6	7.5	12.5	15.7	10.3
19 Trace debt	7.4	4.0	6.8	10.4	11.3	.1	8.2	7.6	12.7	8.2	13.2	7.7
20 Other liabilities	2.7	–3.5	7.4	4.7	12.5	8.2	3.2	5.7	7.2	–1.2	4.6	8.2
21 Discrepancy	8.0	8.2	6.9	5.4	7.2	8.1	5.7	6.5	5.0	5.8	5.6	5.3
Farm and nonfarm noncorporate business												
1 Net income	69.8	70.7	72.8	75.4	72.2	72.6	73.1	73.1	73.7	75.6	76.4	75.9
2 Gross saving	16.5	17.0	17.9	19.1	17.6	17.8	18.0	18.3	18.5	19.0	19.1	19.7
3 Gross investment	16.5	17.0	17.9	19.1	17.6	17.8	18.0	18.3	18.5	19.0	19.1	19.7
4 Capital expenditures	19.9	21.1	22.4	24.5	21.3	22.3	22.0	23.8	22.4	22.6	26.8	26.4
5 Fixed investment	19.5	20.2	21.6	23.2	20.8	21.4	21.4	22.9	22.0	23.0	23.2	24.6
6 Change in inventories	.4	1.0	.8	1.3	.5	.9	.6	.9	.4	–.4	3.5	1.8
7 Net financial investment	–3.4	–4.2	–4.5	–5.4	–3.7	–4.5	–4.0	–5.5	–3.9	–3.5	–7.6	–6.7
8 Net increase in financial assets	1.1	1.2	1.5	1.3	1.2	1.6	1.8	1.5	1.1	1.2	1.7	1.1
9 Net increase in liabilities	4.5	5.4	6.0	6.7	4.9	6.1	5.8	7.0	5.0	4.7	9.3	7.9
10 Credit marketing instruments	9.0	8.5	8.1	10.1	6.4	9.0	8.8	8.1	9.6	9.0	11.5	10.3
11 Mortgages	4.5	5.8	5.5	6.1	4.8	5.2	5.3	6.5	6.2	6.0	6.0	6.0
12 Bank loans n.e.c.	2.2	1.3	1.1	1.7	1.1	1.6	1.0	.5	.8	1.1	2.7	2.1
13 Other loans	2.2	1.4	1.6	2.4	.6	2.2	2.5	1.1	2.6	1.9	2.8	2.3
14 Trade debt net	–.4	1.5	1.1	.5	2.5	.2	–.1	2.0	.1	–.7	1.5	1.1
15 Proprietors' net investment	–4.1	–4.6	–3.2	–3.9	–4.0	–3.0	–2.9	–3.0	–4.7	–3.7	–3.8	–3.5

	Nonfinancial corporate business											
1 Profits before tax	71.1	66.2	75.6	77.2	73.3	75.3	75.1	78.4	78.9	78.7	75.2	76.0
2 − profits tax accruals	30.0	28.1	35.6	36.9	34.5	35.4	35.4	36.9	37.6	37.6	36.0	36.3
3 − net dividends paid	18.1	19.0	20.3	21.6	19.7	20.1	20.6	20.9	20.8	21.4	21.9	22.1
4 = undistributed profits	22.9	19.1	19.7	18.8	19.1	19.8	19.1	20.6	20.5	19.7	17.3	17.6
5 + fgn branch profits	1.8	2.1	2.4	2.5	2.1	2.4	2.5	2.5	2.5	2.3	2.4	2.6
6 + inv. valuation adj	−1.8	−1.1	−3.2	−5.6	−5.3	−2.6	−.9	−4.2	−6.1	−6.2	−3.7	−6.4
7 + capital consumption all	38.2	41.2	44.3	47.4	43.2	44.2	44.6	45.1	46.0	46.9	47.8	48.7
8 = gross internal funds	61.2	61.2	63.1	63.0	59.1	63.9	65.3	64.1	63.0	26.7	63.8	62.5
9 Gross investment (10+15)	53.1	53.0	56.2	57.6	51.9	55.9	59.6	57.5	57.9	56.9	58.2	57.3
10 Capital expenditures	77.1	72.5	76.9	86.5	70.7	76.9	76.2	83.7	84.1	85.3	87.8	88.9
11 Fixed investment	62.7	66.0	70.3	79.8	69.6	67.7	69.7	74.3	77.9	77.9	80.6	82.9
12 Plant and equipment	61.6	63.8	68.0	77.1	67.9	65.5	67.6	70.9	74.5	75.6	78.5	79.7
13 Residential construction	1.1	2.2	2.3	2.7	1.7	2.2	2.1	3.4	3.4	2.3	2.1	3.1
14 Change in inventories	14.4	6.4	6.5	6.7	1.1	9.2	6.5	9.4	6.2	7.4	7.2	6.0
15 Net financial investment	−24.0	−19.5	−20.7	−28.9	−18.8	−21.0	−16.6	−26.2	−26.2	−28.3	−29.6	−31.7
16 Net acquis. of finan. asset	15.5	13.5	26.6	26.9	32.2	16.7	28.8	28.8	35.8	21.8	26.3	23.5
17 Liquid assets	1.9	----------	10.1	4.1	13.7	8.5	13.7	4.5	10.3	.7	1.0	4.3
18 Demand dep. and curr	.7	−2.2	1.3	2.6	7.1	3.6	−1.2	−4.3	9.6	.2	2.9	−2.3
19 Time deposits	−.7	4.1	2.2	−8.0	−1.8	−3.2	9.5	4.1	−8.7	−9.1	−11.7	−2.5
20 U.S. Govt. securities	−1.2	−3.1	1.8	−1.1	7.6	−.9	1.7	−1.3	5.0	−4.6	−1.2	−3.7
21 Open-mkt. paper	2.0	1.5	4.5	8.3	.1	6.9	6.2	4.7	1.4	11.1	11.5	9.3
22 State and local oblig	1.0	−.4	.4	2.3	.8	2.1	−2.6	1.3	2.9	3.1	−.4	3.5
23 Consumer credit	1.2	.9	1.7	.9	1.8	1.5	2.1	1.1	1.5	.7	1.2	.4
24 Trade credit	11.3	8.8	14.8	17.7	15.2	9.0	16.5	18.6	20.8	13.5	18.7	17.7
25 Other financial assets [1]	1.0	3.8	.1	4.2	1.4	−2.3	−3.5	4.6	3.2	6.9	5.4	1.2
26 Net increase in liabilities	39.4	33.0	47.3	55.8	51.0	37.8	45.5	55.0	62.0	50.1	55.9	55.2
27 Credit market instruments	24.9	29.3	31.0	37.2	25.6	26.6	31.1	40.7	37.5	38.7	36.0	36.8
28 Corporate bonds [1]	10.2	14.7	2.9	12.7	11.5	13.4	12.1	14.6	14.9	12.4	9.8	13.8
29 Corporate stock	1.2	2.3	−.8	2.6	1.3	−.6	−1.9	−2.2	.1	2.4	5.6	2.3
30 Mortgages	4.2	4.5	5.8	4.3	4.9	4.9	5.9	7.6	5.2	3.7	3.6	4.5
31 Bank loans n.e.c	7.9	6.4	9.6	8.5	3.6	6.7	9.8	18.2	12.4	9.6	4.1	8.2
32 Other loans	1.4	1.4	3.6	9.1	4.4	2.2	5.1	2.6	4.9	10.6	12.9	8.1
33 Profit tax lability	.2	−4.1	3.7	1.5	10.4	3.4	−1.9	2.9	6.8	−3.3	.7	2.0
34 Trade debt	7.8	2.6	5.7	9.9	8.8	−.1	8.3	5.6	12.6	8.9	11.6	6.7
35 Other liabilities	6.5	5.2	6.9	7.1	6.2	7.8	8.0	5.7	5.1	5.8	7.6	9.7
36 Discrepancy	8.0	8.2	6.9	5.4	7.2	8.1	5.7	6.5	5.0	5.8	5.6	5.3
37 Memo, net trade credit	3.5	6.2	9.2	7.7	6.4	9.0	8.2	13.0	8.2	4.6	7.1	11.0
38 Profits tax payments	30.5	32.7	32.0	36.2	23.3	33.3	37.3	34.0	32.0	41.5	36.2	35.1

[1] Line 28 excludes new issues sold abroad, and line 25 excludes direct investment finance by foreign security flotations.

Note: IV/69 data are based on preliminary information subject to revision.

Source: Board of Governors, Federal Reserve System.

Senator JAVITS. Mr. Chairman, I have just one other question.

Mr. McCracken, would you care to tell us when you think, or when your council thinks, we will cross that magic Rubicon of $1,000 billion of gross national product?

Mr. McCRACKEN. I do not think that I could pinpoint that more than in about the fourth quarter. A friend of mine once made the prediction that it would be October 23 at 10 p.m. My own projection would be some time in the latter part of the year.

Senator JAVITS. 1970?

Mr. McCRACKEN. This year.

Senator JAVITS. Thank you, Mr. Chairman. If I have any time I would be delighted to yield to get an answer to Congressman Reuss' question.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. Dr. McCracken, when I was questioning you last, I did not get an answer on who stole the peace dividend. What happened to the $10 billion that we should have had? You gave me some figures on 1965 compared with 1971, but the question I asked was trying to relate the amount of spending we had in Vietnam in 1968 at the peak to the amount that we are going to have in the coming fiscal year. What I would like to do is to ask you at your leisure to look at a detailed specification of all the information we have available that we could get on this matter, and give us your answers on what happened.

It seems to me that what happened is that these additional funds that we had hoped and prayed would come back for domestic purposes have instead been used for weapon systems, for overruns and in other ways, in strictly military areas, rightly or wrongly.

Now I would like to pursue a little further what it seems to me is a very serious shortcoming in the Economic Report and in your estimate to us this morning. Last June I asked you what studies the Council had made concerning the consequences of defense spending on the national economy. To a series of specific questions you replied that the Council had done no work.

Several months ago I asked whether you have done any studies in the area we have discussed. Let me ask again, now, No. 1, have you done any studies distinguishing between the economic impact of the defense dollar and that spent for other Government functions or agencies, and if so what were the results?

Mr. McCRACKEN. No; we have done no specific studies along that line.

Senator PROXMIRE. What studies have you done on the regional impact of defense spending?

Mr. McCRACKEN. We have done some studies there.

Senator PROXMIRE. What do they show, sir?

Mr. McCRACKEN. Well, I do not have the results here now, but we have done some studies about the regional pattern.

Senator PROXMIRE. Certainly in terms of postwar planning this would be very vital. California, for example, Connecticut, some other States that have a very large proportion of the defense dollar?

Mr. McCRACKEN. Yes.

Senator PROXMIRE. And I would think the economic effects would be very substantial. I hope that you will make those available to this committee. It will be very helpful to us and to the Senators from that area and also to those of us who are, of course, interested in legislation that would affect the economic future.

What studies have you done on how defense spending affects manpower?

Mr. McCracken. We have done some work in this area. I have been particularly interested in the construction area and the extent to which manpower training could help to augment the flow of labor into the construction area as people are released from the Armed Forces.

Senator Proxmire. Can you tell us on the basis of your studies whether it has bid up the price for example for engineers, scientists, and highly skilled labor? There is some conjecture that because defense sometimes moves so fast and is so massive that in many areas they demand the labor and they get it, they demand the skilled people and they get them, and the result is a disproportionate increase in inflation that way.

Mr. McCracken. I am sure there are differential impacts here. I would be glad to provide any additional data that we may have.

Senator Proxmire. Have you made any studies at all of the effect of defense expenditures on the rise in prices as distinguished from other areas?

Mr. McCracken. We have made some, trying to identify the differential sectors of the economy, where inflationary pressures have been severe. I would be glad to provide some statistics.

Senator Proxmire. What effect have present procurement practices had on prices in the economy?

Mr. McCracken. We have not looked into that.

Senator Proxmire. Don't you think that is very significant? After all, this is a $35 to $40 billion segment. It is under Government control. We have very strong testimony that the cost of procuring by negotiation, and 90 percent of our procurement is by negotiation, is far higher. I would think the economic impact would be something that would be most useful to us and also the Defense Department to know.

Mr. McCracken. I am sure a study of the procurement practices is a very important matter.

Senator Proxmire. I mean of the economic impact. I think Congressman Conable is right. It is perhaps not your function and is perhaps not the function of this committee to tell the Defense Department how to procure equipment, but we certainly are concerned about the economic impact because it is so serious and far reaching. And that is our responsibility and yours too. You do not have any study of that?

Mr. McCracken. No, we do not, and with our limited resources available, we simply do not have the manpower or have not had the manpower to look into this.

Senator Proxmire. Your resources are much more substantial than those of the staff of this committee. Do you have any means of commissioning capable scholars and experts to make studies outside your staff?

Mr. McCracken. I could only say that I shall certainly take this into account in our program.

Senator PROXMIRE. One of the things the Congress has asked for repeatedly is the projection of spending. Congressman Moorhead referred to this earlier.

There is a law, Public Law 801, which mandates the administration to give a 5-year projection every time they come up with a program that costs more than $1 million, and yet you were unable in response to Congressman Moorhead, as I understand it, to give us any projections on defense expenditures, any explicit projections. They are so important that I do not know how we can have confidence in the estimate you make that 5 or 6 years from now we will need all the resources we have now to achieve our already designated goals.

Mr. MCCRACKEN. This projection, Senator Proxmire, is in the context of our total resources. It is not specifically a budgetary projection. The information that we have used pertaining to those parts of our total economic projection that relate to the Federal sector were based on the parallel work which is to be found in the budget message which also goes out to 1975.

I would want to say that, so far as I am aware, this is the first time the budget message or the Economic Report has taken this kind of a 5-year look ahead. It is not in the detail which in many ways we would have liked ourselves, but it is a major step.

Senator PROXMIRE. What is this worth if you do not have the detailed study to support it, just a projection that on the basis the defense spending will use 7 or 8 percent of the GNP? It seems to me unless you look into the weapons systems, for example, that have been projected, the ABM, the advanced manned bomber, MIRV'ing our missiles, all that kind of thing, that you do not really have a very useful or a very reliable expectation of what it is going to be.

Mr. MCCRACKEN. But I think in this case here one can always have more confidence in a total than in the specifics, because there will be some tendency for the errors of the components to cancel out.

Senator PROXMIRE. This would be true if you were making any calculations on what the components are but when you just move along and expect it to be some particular level it seems to me that having those components would be very helpful in arriving at a figure which would be better informed and more reliable.

Mr. MCCRACKEN. This was as far as we could go on this kind of 5-year look ahead at this time.

Senator PROXMIRE. I just would hope that you would look into the economic effects overall of defense spending. I can think of few things that are more important, because this is something that is within our control. It is consideration we should have. It is not the only consideration. It is not the principal consideration perhaps, but it is of great importance. Members of Congress debating military spending often refer to this economic effect, but I am sure we are not well informed. The debate is based on guesses, and you could perform great services to both the executive branch and the congressional branch, if you could find a way to make a study of this.

I would like to ask on this 4.3 percent unemployment figure, if we go to 4.3 unemployment, as I understand it, it would trigger some manpower programs, if we go beyond.

Would it trigger anything else? Would it trigger any action on the part of the administration to provide jobs for those who are unemployed, by way of Federal programs?

Mr. McCracken. Of course there are certain automatic programs that would come into play. Obviously the unemployment compensation program. The trigger point for the manpower programs and for further strengthening the unemployment compensation program is I believe 4.5 percent. This is a rise that I would not expect to be of any great duration.

Senator Proxmire. Supposing it is? I think what the country wants and certainly what working people want is some assurance that if unemployment does go above this the administration stands ready to move in and act, and act decisively.

I have asked several months ago, I asked for the administration to indicate what kind of a program they had ready in the event unemployment increases substantially, and so far I have not gotten any kind of indication they have anything proposed except as you say some of the automatic things like unemployment compensation. Isn't there anything more to give people a job instead of the unemployment compensation program or training them in the event a job shows up?

Mr. McCracken. But our projections for the latter part of the year do indicate a quickening in the pace of general business activity, and as you have indicated, the most fundamental solution to the problem of the man who does not have a job is a resumption of economic expansion on a sustainable basis.

Senator Proxmire. Absolutely. My time is up, but just let me give you my very strong feeling that one way of assuring that the economic activity will not become seriously depressed is a feeling of confidence on the part of business and on the part of labor too, that the administration is going to move in decisively and effectively in the event unemployment goes above a certain level. So far we get the impression they are not going to do that. They just hope business will improve.

Many times those hopes have been dashed, often in recessions in the past.

Mr. McCracken. Well, it depends. The most important determinant of that path will be fiscal and monetary policies.

Chairman Patman. Senator Miller?

Senator Miller. Thank you, Mr. Chairman.

Dr. McCracken, will you agree that inflationary psychology is a big element in inflation, and that getting inflationary psychology not only tempered but eliminated is an important consideration in getting inflation stopped?

Mr. McCracken. Yes; I think that is a very important part of it.

Senator Miller. Do you think that inflationary psychology is still present?

Mr. McCracken. I think it is, but it is abating now.

Senator Miller. Do you think that it will not only continue to abate but will be practically eliminated, if the Congress follows a policy, a restrictive fiscal policy when it operates on the appropriations bills this year, and any taxation needs to cover any substantial increases in those appropriations over the recommendations of the budget?

Mr. McCracken. I could not think of a more fundamental contribution to getting this thing under control than what you have just indicated.

Senator MILLER. I thank you. Now, is it not true that upward of 20 million jobs are in the so-called agri-business area of this country? By agri-business I am not only talking about the producers, I am talking about the processors, those that manufacture the production items for agriculture.

Mr. McCRACKEN. I do not have the figures here but that sounds reasonable.

Senator MILLER. It is my understanding that it is over 20 million. Would it not be your opinion that the viability of the agri-business industry is dependent upon a healthy basic agriculture?

Mr. McCRACKEN. Yes, sir; and a healthy economy, of course, generally.

Senator MILLER. That is right. Now, my thesis is that agriculture is not healthy and has not been sharing fairly in the national net income, and I premise this reaction on several things.

One is what appears to be very strong prices, for example, in cattle and hogs. As you know, hog and cattle prices have been strong. Some people say "Look, hog prices are averaging $27 a hundredweight." But to me what we ought to do is to take a hard look at it and reduce that, for example, down to 1960 dollars, and we would find that if you shrink the inflation out of $27, you get down to an equivalent in 1960 dollars of only $22 a hundredweight, and so the strong prices do not appear so strong.

I also note in the tables in your report that national net farm income for 1960 was $11.7 billion, and last year it was $16 billion, but when I reflect on the fact that the dollar was worth 47 cents in 1960, and I am basing that on a 1939 dollar worth 100 cents and the 1969 dollars were only about 38 cents, it looks to me like net farm income was practically on dead center.

Then I reflect on the fact that since 1960 national net farm debt, real estate and equipment and the like has increased by $30 billion, and then I add up the increments of increase in national farm income by year, and I come out to $20 billion. It looks to me like in a 9-year period farm debt has gone up $10 billion more than net farm income, and I am concerned.

My concern is not alleviated by the fact that in your table I note that net farm equities have gone up greatly. We know there have been increases in the prices of farmland and the like, and I see an increase up to $249 billion, but if you apply a 6½-percent return to it, that is just about what national net farm income was for the year 1969, and some people when they think that 6½ percent is a far return, and if they do, then the answer to that is that means there is nothing left over for the farmers for their labor and managerial costs.

My evaluation is that our farm economy is not as healthy as it should be, and that the farmer is not sharing fairly in the national net income, that the consumer has been getting a good deal when you realize that 20 percent of the consumer dollar went for food 10 years ago, and only 16½ percent last year, and in the face of these figures, which I have pulled out of your tables in your report, I must say that I am concerned about the viability of over 20 million jobs in agri-business, I am concerned over the state of our farm economy, and I get a little distressed when I hear some people suggesting certain actions which could impinge further on it. Would you have any comments?

Mr. McCRACKEN. Senator Miller, I think my first comment would be that as someone who has a farm in your State, I am increasingly impressed myself with how difficult it is to produce an income statement that looks impressive.

There are problems in this area. Agriculture has of course been receiving a declining proportion of the national income over a long period. There has been some near-term improvement in farm income, of course, in the last year, although if one goes back and looks at the decade of the 1960's as a whole, as you have indicated, it is fairly flat.

This is a continuing problem where it is very difficult to make both the rate of return and the wage earnings that would keep agriculture consistent with the economy.

Senator MILLER. You would agree that the national farm picture is not one of rosy optimism and not one of really sharing fairly in the national net income picture, would you not?

Mr. McCRACKEN. Well, I think it is a picture that does have these difficult aspects that you are talking about here. I think agriculture is strong, but its earnings position has the problems which you have indicated.

Senator MILLER. And you would agree that we in light of this should not take any actions that would depress the net farm income picture, would you not?

Mr. McCRACKEN. We would have to think about that pretty carefully.

Senator MILLER. Thank you, Mr. Chairman.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. Mr. Chairman, I share Senator Proxmire's concern that should the unemployment rate rise to 4.3 percent, there does not seem to be in existence or on the drawing boards any program directed specifically at dealing with it. Is it not a fact that the Council of Economic Advisers' projection for unemployment in 1970 is that 4.3 percent is merely an annual average, and since we now have 3.9 percent unemployment, there are going to be months in this year in which the unemployment rate is pushing 5 percent, is that not so?

Mr. McCRACKEN. You are correct that the 4.3-percent is an average for the year.

Representative REUSS. Turning to another subject, economics is down this year. Ecology is very in, so I wanted to ask something about that.

The goal in the Employment Act of 1946, one of the three goals, is "maximum production," and as has been pointed out, that can mean that as our GNP grows, gross national pollution also grows every year.

Some of us wonder therefore whether it is not time to revisit that statutory goal of the 1946 Employment Act, and I specifically would ask you whether that goal of "maximum production" adequately protects our dwindling natural resources and the quality of our environment, whether it offers guidance for rational judgments as to the relative role to be assigned to consumer and investment goods on the one hand, and to public goods like education, health and environmental protection on the other hand, and finally whether the goal may not need to be modified. I asked the staff to give you a little advance notice on this.

Mr. McCracken. You did, yes. Let me comment just briefly on this. There has been a shift in our thinking about the overall objectives of economic policy. These shifts have occurred, of course, from time to time. At the present time we are very much more interested in this other GNP that you alluded to just now.

In other words, we are very much concerned about the environmental dimension of our life, and that simply producing more output, if it means pouring more smoke into the air or more pollutants into our streams and so forth is not necessarily an index of optimising our economic welfare.

I daresay that as we move along through this period, we are going to want to devote resources to cleaning up our environment or reducing our pollution in a way that was not true in the 1960's or the 1950's, or earlier.

Now on the question of whether it might be wise to modify or amend section 2 of the Employment Act, I am not sure that that is necessary. I would be open-minded on this issue. As I read section 2 of the Employment Act, I find that it is a pretty general discussion committing the Nation to a strong economy.

It does not, for example, have anything in there which explicitly alludes to the price level, though I think every administration since the Employment Act was passed has been concerned about the price level. It could be deemed to be there in terms of maximum purchasing power and the presumption that this obviously carries with it some kind of an implication about the price level.

We could say the same thing, I presume, if our thinking in this area leads us to want to devote more of our resources to the environmental area. This is quite consistent with the act as it now stands, but I would not take a Procrustean position on this.

It may well be that we would want to think about amending our basic declaration on national economic policy.

Representative Reuss. Thank you for a most helpful answer.

Chairman Patman. Mr. Moorhead?

Representative Moorhead. Thank you, Mr. Chairman.

Mr. McCracken, on page 136 of the economic report you begin your discussion about exchange rate adjustments, and I have read that, and from it I conclude that the council has not yet reached a conclusion as to what to recommend to the President on this subject, is that correct, sir?

Mr McCracken. Yes, that is a fair interpretation. As you know, at the annual meetings of the International Monetary Fund in September here in Washington last year, there was a decision that it would at least be worthwhile to study possibilities for building a little more resiliency or capability for moving with the punches, rolling with the punches, into our adjustment mechanism.

Representative Moorhead. Does the council agree with that basically?

Mr. McCracken. Oh, yes; and indeed the Secretary of the Treasury in a speech at the International Monetary Fund meeting concurred in the importance of this.

Now, the section that we have included in the report is hopefully a contribution to the kind of thinking that ought to be going on while these things are being explored. There is no commitment to any change for that matter or certainly to any specific change, but there is I think a widespread sympathy with the idea that the time has come to look at this matter, and this is now underway.

Representative MOORHEAD. I appreciate your earlier statement about the independence of the Federal Reserve within the governmental structure, but if Dr. Burns should come before us now and you say, "What is your advice, has the time come to ease up on monetary policy," would your answer be yes, no, or not yet or what?

Mr. MCCRACKEN. Well, I presume the safest answer might be that yours is of course an independent agency, and therefore off limits.

As we indicated in the Economic Report, the outcome that we have projected for the year does carry with it the presumption of a more moderate monetary policy than we had last year I would not want to make any specific comment at this time on exactly when it ought to be done. But we quite explicitly said here that our forecast of a $985 billion gross national product includes the expectation of a quickening of economic activity in the latter part of the year. This expectation would not be consistent with staying on a course of monetary policy throughout the year such as we had in the latter half of last year.

Representative MOORHEAD. What is the body count when we move from a rate of 3.4 to 4.4 of unemployment?

Mr. MCCRACKEN. That would be about nine-tenths of a percent of labor force. That would be about 700,000, something like that. It is about 700,000.

Representative MOORHEAD. Mr. Stein, I would like to get back to our discussion of the cost of the war in Vietnam. Is it your testimony that one reason for the omission of the Vietnam costs in this year's report is the difficulty of segregating military outlays between Vietnam and non-Vietnam expenditures?

Mr. STEIN. Then?

Representative MOORHEAD. Then is it possible that the previous figures for the costs in Vietnam were inaccurate, and that we in fact spent considerably less on Vietnam than was indicated by the previous official figures?

Mr. STEIN. Well, to say this would imply that there is some accurate figure that you know which we don't. It is really a very difficult problem of definition.

As you know, much of the activity that is going on in connection with the Vietnam war would, of course, be going on in any case, the ships that are sailing around in the neighborhood of Vietnam would be sailing around somewhere and they would be costing us something, and the question is how much of this do we call costs of the Vietnam war.

A situation was created in the Revenue and Expenditure Control Act of 1968 which created a considerable incentive to call things costs of the Vietnam war, because costs of the Vietnam war were excluded from the expenditure ceiling, so this created or had some influence I expect on what was defined as costs of the Vietnam war.

I think the basic explanation is that this thing is difficult to define, and as I indicated earlier, in last year's report although the Council estimated the costs of the war then at about $30 billion, they did not estimate that when the war was over the expenditures would decline by $30 billion.

Representative MOORHEAD. Would it not follow then that the non-Vietnam budget was inflated? In other words, there was the temptation to inflate it because it was a lot easier to get appropriations when the war was involved than it was for nonwar associated military expenditures? Was the war used as a smokescreen to build up the military budget? That is what I am asking.

Mr. STEIN. I think there were certain conveniences——

Representative MOORHEAD. To try to get a bigger share of the budget?

Mr. STEIN. I do not know whether this happened or not. I am talking about a period really before we appeared, and I am talking about the incentive that existed to classify things in a certain way, not an incentive to spend things in a certain way.

However, I think the most reasonable answer that can be given to all these questions is the one that Dr. McCracken gave earlier, in which he showed that estimated defense expenditures in fiscal 1971 in constant prices would be about $8 billion above the rate at which defense spending was running before the Vietnam buildup. So that you can say by how much in real terms will defense expenditure have increased as compared with the pre-Vietnam situation, and the answer is, for fiscal 1971, about $8 billion.

Of course, this is for a year in which the war is still assumed to be going on. Now, the question whether it should have increased by $8 billion or some other number is really beyond my competence.

Representative MOORHEAD. I realize that your function is not to decide how much we should spend on defense, but I think it is the function of the Council to keep an eye on this in the future, and we all know that there are some weapons systems which the military are requesting—the costs for which are going to mount astronomically in future years, and I just wondered if in making your gross predictions you took this into account and figured apparently that there were offsets in reductions of manpower. Did you contemplate this at all? It would seem to me you would have to.

Mr. STEIN. We did not build up a defense program for the next 5 years. What we are reflecting here is kind of an estimate for the total which as we have indicated we are unable to break down for you.

Representative MOORHEAD. Would it not be appropriate in making a 5-year prediction to ask the Secretary of Defense for his estimate of his part of the expenditures, as you probably would have other Cabinet officers?

Mr. STEIN. I think one thing should be made clear. That these 5-year projections are not 5-year programs to which all the Cabinet officers have committed themselves. They are estimates made by the Budget Bureau and ourselves of what we see as the future costs of programs now on the books or now proposed by the administration. That is we are in a sense forecasting this just as we might be forecasting private investment, so that these figures do not have the kind of status that a budget does. But we do believe that they throw a great deal of light on the problems facing the country, and have a considerable reliability, and I should not give the impression that in considering the problems of the budget in the years ahead that the decisions of the administration are based entirely on aggregate figures as are shown here. Of course they are not.

Representative MOORHEAD. Thank you very much.

Chairman PATMAN. Recently there has been a lot said about the independence of the Federal Reserve. I do not want this occasion to go by with no one objecting to the independence of the Federal Reserve. I object to it for the many reasons I have given in the past.

You know there was not much said about the independence of the Federal Reserve for decades after the law was passed. There is nothing in the discussions in the House and Senate during the time that the bills were pending in the Senate and the House for the Federal Reserve Act about independence. Nobody claimed it was independent. The word "independent" is not mentioned in the discussions or in the reports.

It was only in later years that the word "independence" was used now and then. Many efforts have been made in the courts to test the constitutionality of the independence, the alleged independence of the Federal Reserve, and because they could not qualify the people who were trying to test this, they did not get the case to the Supreme Court.

If this independence keeps on going on, I think I shall offer a resolution in the Congress to provide that the Supreme Court of the United States be called upon to pass upon the question.

I do not think it was ever intended that the big financial interests dictate monetary policies. I do not think there is any doubt about this. It was never contemplated that somebody who is not elected and who is under no obligation at all, would have any power to dictate monetary policies, including interest rates. It is certainly unfair.

I can see more and more efforts being made by people outside the Government to get appointed on committees for the purpose of passing on very important questions.

We had one on the Commission on Mortgage Credit, five public members appointed by the President, and 10 members of the House and Senate. We sat in the committee meeting for days and weeks.

The five public members were always right there for the meetings. They had nothing else to do. People like the Senator here and myself were running errands for our constituents and being the good ombudsmen that we should be, by attending committee meetings, and we were not always there.

Each one of those fellows sat across the table from Members of Congress, and they could kill the vote of a Member of Congress. We did not know whether they had any special interest, conflict of interest, or anything like that. They had nothing to lose. They could just vote any way and use their influence to get most anything done, and if it was destructive to the interests of the country, no one could do anything about it. They had nothing to lose, whereas the Member of Congress has a career. He has a reputation to maintain.

He obviously cannot do things that are against the public interest. He has his neck on the block. He would just lost his political life. But the people who come in on these commissions have nothing at all to lose.

The Federal Reserve claimed independence by claiming something that was never contemplated would be used in the law. It could take our Bureau of Engraving and Printing money and trade it for Government bonds that provide interest. Of course the bonds ought to have been canceled because they are paid when you use one Government obligation to substitute for another. If you have a bond and you would rather have paper money, you should have a right to get it, but you should not be allowed to keep the bonds, and keep on drawing interest. That is what they were doing, and they accumulated quite a bit of interest.

They have over $3 billion now in taxes coming from the Treasury to pay interest on $55 billion in bonds they have accumulated. Those bonds have been paid for once and should be canceled. They ought to do as churches do sometimes, when they pay outstanding bonds off. They have a bond burning, and a great celebration. But we have got $5 billion in bonds in the New York Federal Reserve Bank right now that have been paid for once and we are still drawing interest.

No one else in Government has $3 billion a year with no strings tied to it, not even an audit. The General Accounting Office cannot even audit them. You know that is something that people cannot understand, why Congress would let that happen, but it has happened for a long time.

Of course with that money they pay all their expenses. They even make contributions to the banking lobby with it. They are card-carrying, dues-paying members of the banking lobby. They are supposed to supervise the banks and regulate them. Yet they are paying into the lobby. They are doing a lot of things like that. I could name lots of them. With $3 billion, of course, they can spend it for a lot of purposes and they do. They do not have to go before the Congress, before the Appropriations Committee that Senator Proxmire is on. If they did he would ask them about these things and find out what they were doing and stop them. But, of course, the Congressmen are bypassed.

The business of the independence of the Federal Reserve is one that is not settled at all. I expect to do something about it when I can, but it is an awfully hard job.

You have heard that you can't whip a million dollars. Certainly it would be awfully difficult to whip billions of dollars, and you have an uphill fight on things like that, but I am not through with it and we are going to keep on.

I respect gentlemen like you who sincerely believe in that, and I am not questioning your motives or your sincerity or honesty of purpose, but I feel very strongly about it, and one of these days we have got to have a settlement on that issue, and I think the Supreme Court might be the right one to settle it. Every time they sell the bonds back into the market people have to pay for them again, and we are paying that debt two and three times over.

There is $55 billion in that bank. One of these days they are going to try and feed them back into the commercial banks free of charge by giving them the reserves to pay for them. It does not cost them anything. They tried it in 1959. I led the fight in the House to stop it and we did stop it, and we hope to stop it again, but that fight is coming up in the future. There is a lot behind it that has not been brought out. I want you to know, Dr. McCracken, I respectfully disagree with you on that point and I disagree with Dr. Burns and others who feel as you do about it.

No President ever said the Federal Reserve is independent until President Eisenhower was asked the question by Sara McLendon, a newspaper reporter. He said, "I don't know a thing about that, they are just independent." That was the first time it was ever brought up. Of course when Mr. Truman was President and they said they were independent he called them into his office and he called them names. He said, "You are not going to get by with that. You are going to keep that interest rate just like it has been as long as I am President," and they did. He is the only man that ever went to the mat with them. We are going to have another battle with them one of these days.

All right, Senator Proxmire?

Senator PROXMIRE. I would just like for a minute to ask you, Mr. Stein, why in the world we cannot get figures on the cost of the Vietnam war. It is beyond me. We have had this estimate that Secretary Laird gave us on the cost of the Vietnam war last October. If he could estimate it then why can't he estimate it now?

After all, there is no value that I can see to any enemy? They are giving us the figures on a monthly basis on the number of troops in Vietnam and as they are withdrawn. We can see why that might be of some significance to the North Vietnamese and the Vietcong, but the cost of the war we have a right to know and we ought to be told and it has great economic significance.

Mr. STEIN. Well, this is not a decision that we made, of course, you realize.

Senator PROXMIRE. Of course not. I am not critical of you at all, but I am saying this is something that the administration could provide and should provide. As I understand it, you are one of the experts on the Council in this area?

Mr. STEIN. Insofar as we have one, yes, sir.

Senator PROXMIRE. Let me ask you pursuing to some extent what the Chairman has been talking about, to a very limited extent, let me say I get a kick out of what appears to be the affiliation with Friedman, either Friedmanite, Friedmanesque, or what not on the part of those who have no constitutional authority really over monetary policy. In the Constitution, article I section 8, paragraph 5 says that Congress shall coin the money and regulate the value thereof, not the President. That is a money power given to the Congress and I agree with the Chairman that the Federal Reserve Board is not and cannot be independent of the Congress but it is independent of the Executive.

Chairman PATMAN. May I ask one question, Senator?

Senator PROXMIRE. Yes, sir.

Chairman PATMAN. Of course article I says that Congress shall make the laws and article II says that the President shall execute them.

Senator PROXMIRE. That is right.

Chairman PATMAN. That does not say the Federal Reserve Board shall execute them.

Senator PROXMIRE. No.

Chairman PATMAN. It does not say anybody designated by the Congress shall.

Senator PROXMIRE. It says very explicitly we have the money power and Congress has delegated the money power to some extent to the Federal Reserve Board, but we can reclaim it at any time. We can repeal that law, call them up, pass laws and resolutions directing them to do anything we wish. We do not do it but we could.

You see what I am getting at? There seems to be a number, an increasing number of economic policymakers in the executive branch who are monetarists. The Federal Reserve Board on the other hand and I think Mr. Burns is going to be converted as time goes on but the rest of the Federal Reserve Board seems to be resisting Friedman.

It seems you think that the influence ought to be exerted in the area where you have no constitutional authority and on the other hand where the Fed does not have any authority over fiscal policy, they think that you fellows ought to be doing better.

It seems to be a pass-the-buck operation. If you are in the executive branch, you are more inclined to be Friedmanite than if you are in the Federal Reserve Board where you are more inclined to be a fiscal advocate. Is there any validity to that? Does it just happen that way?

Mr. McCracken. We take, of course, ourselves a completely balanced position on this.

Senator Proxmire. Yes.

Mr. McCracken. In the Economic Report we did try to make clear that given what we know and what we do not know about the effect of alternative instruments of policy, if we are going to be prudent we have to pay attention to both.

I think it is fair to say that in the profession of economics generally, there is a growing recognition that monetary developments have an important influence on employment, production and purchasing power—certainly more than was true, say, a decade ago.

Senator Proxmire. The view has changed or the facts have changed?

Mr. McCracken. Well, that is hard to say. I would assume it is more nearly that the view has changed, but we cannot be sure. Certainly at the time I was a graduate student in economics, one of the least interesting subjects would have been monetary policy, but it has come quite a bit to the fore in the last 25 years, so I think to some extent what we are seeing here is something that we see in the discipline of economic policy generally.

Senator Proxmire. Let me ask you about what the effect of your policies is. Certainly fiscal policy has an effect on monetary policy and vice versa as we all know.

You said "The budget surplus combined with a moderation of monetary restraint should become possible," implying that to the extent that you have fiscal restraint you can have somewhat easier money.

Mr. McCracken. Yes.

Senator Proxmire. And you can have a diminution in the rise in interest rates or maybe a fall in interest rates, but the difficulty in this. The surplus is in large part achieved by sale of mortgage assets.

It seems to me that that kind of action would tighten money markets, and it is a dramatic increase in the sale of mortgage assets. In 1969 the sale was $1.3 billion, it went up in 1970 to $2.1 and this year to over $4 billion. In other words, it doubled since 1960, and it has tripled since 1969.

As you sell these assets, wouldn't they have a substantial effect on the credit market in driving up interest rates?

Mr. McCracken. That in itself, of course, would, because it would absorb purchasing power.

On the other hand, when we look at the total budget, we also want to look at the expenditure side of the budget, and the projected increase in total expenditures is really quite limited. In that sense I think we can say this has been a very stern budget that has been put forward for the fiscal year.

Senator PROXMIRE. Without that sale of assets, you would have a substantial deficit, at least you would have a deficit twice as big as the surplus you now have?

Mr. MCCRACKEN. If we had none. If we had no sale you mean?

Senator PROXMIRE. That is right.

Mr. MCCRACKEN. Yes.

Senator PROXMIRE. And the sale of these assets has a profound and direct effect on monetary policy.

Mr. MCCRACKEN. On monetary conditions.

Senator PROXMIRE. On monetary conditions I should say.

Mr. MCCRACKEN. Yes.

Senator PROXMIRE. Let me ask Mr. Houthakker, I just have a couple more brief questions, do you believe that the unsolicited distribution of credit cards contributes to inflation?

Mr. HOUTHAKKER. Well, I think that credit cards are a very minor element in the provision of credit to the economy as a whole.

Senator PROXMIRE. Isn't it true though in the last year it has expanded enormously, a couple of billion dollars in the amount of credit increase in the credit card area, something like $2 to $5 billion?

Mr. HOUTHAKKER. There has been an increase I think but it is still a quite small component of the total outstanding.

Senator PROXMIRE. Would the prohibition of sending unsolicited credit cards have an adverse effect on competition in your view?

Mr. HOUTHAKKER. I think it may well have an adverse effect on competition in certain areas. For instance, it would be more difficult to establish a new chain of gas stations unless this chain could send out credit cards to prospective customers.

Senator PROXMIRE. Would they have to be unsolicited though? This is not the only way to do it. They send them out to everybody in the city directory or the phone book, it has on the basis of studies I have seen, such as by Janeway and Rinfret, been pretty effective in giving people Aladdin lamp credit that they can use, many people without much experience and they do use it.

Mr. HOUTHAKKER. I think there is certainly room for some tightening up in this area, but I believe that the banks and the other credit card companies are already following a rather cautious policy. On the other hand, when you get to credit cards that are used for rather small purchases like gasoline, then I think one has to worry about the effect on competition, too, so I think there has to be a balance here between those two considerations.

Senator PROXMIRE. I would like to ask just one more question.

Following up what Senator Sparkman and Congressman Reuss asked about, I agree wholeheartedly that we have a highly inflationary effect in the accelerating of business plant and investment equipment which has been going up steadily since 1964 and is going up again sharply this year. How sharply we do not know, but it will break all records, and the appalling aspect of this that has not been mentioned here before is that were operating in the fourth quarter of this year at less than 82 percent of capacity. Undoubtedly in the first quarter of this year it will be less than that.

The only way you can explain why people are buying more plant when they are already operating far below optimum capacity, far, far below it, is because they expect inflation. It is unsound. They expect that if they do not buy that plant now they will have to pay more for it 5 or 10 years from now.

This is one area where the bill that we passed providing for a whole arsenal of credit controls which the President can use at any time in any area on any basis would enable him to slow down this increase and it seems to me contribute not only to slowing down inflation but to a much sounder capital goods situation. We are getting very badly overbuilt in the capital area.

Mr. McCracken. I would like to make a comment about that. I think the picture in the capital goods area is more complex than that. We have a very uneven pattern here.

When we look at the projections for 1970, the really large increases are in the public utility area, and it is here that there is a real bona fide need for capacity. In other words, operating rates are high, if they went much above the projected increases in loads we could have some problems this year.

In the industrial area, where this matter of lower operating rates is more relevant, the projected increases are lower, and moreover I find the figures on operating rates themselves to be very difficult to interpret.

These figures undoubtedly include some facilities that are really basically obsolete, and——

Senator Proxmire. If these figures are no good we certainly want them corrected.

Mr. McCracken. No; they are useful.

Senator Proxmire. Because we rely on them.

Mr. McCracken. They are useful. You mean in the operating rate area?

Senator Proxmire. Yes, sir.

Mr. McCracken. The case here is the same as with many data. One has to interpret them carefully. So far as the projections are concerned though I think the basic pattern that is implied there is probably correct. The great strength is in the public utility area, where they also have very limited excess capacity.

Senator Proxmire. That is still a small sector though.

Mr. McCracken. It is fairly large.

Senator Proxmire. Of GNP. It would seem to me in overall terms you cannot explain that increase based on that one industry.

Chairman Patman. We have one more question by Senator Miller and then we will try to arrange for you gentlemen to be excused for the present.

Senator Miller. Thank you, Mr. Chairman.

Chairman Patman. Senator Miller?

Senator Miller. Dr. McCracken, in my last question to you it suggested that the Council would be opposed to any action which might impinge upon net farm income, and your response was that you would have to take a good hard look at it.

Perhaps I was not specific on that, and I can understand why you would have to give the answer to that question the way you did, because I assume that that would depend upon compensating actions or offsetting actions which might accompany such an action, and it would probably also include considerations with respect to the overall economy and where the national net farm income stood.

That being the case, Secretary Hardin recently sent to the Congress a proposed series of farm programs to be enacted this year as follow-on programs for those that expire this year, and he stated a policy objective, and that was that the cost of farm programs not be materially reduced as a means of insuring that net farm income would be maintained. And further, I think, implied in this was that any substantial reduction in the cost of farm programs would have to await compensating actions on the part of the markets.

Do you believe that it is a sound policy objective that real dollar net income should be maintained for agriculture in relation to our overall national economy?

Mr. McCRACKEN. The basic objective here ought to be a balance between real income per person in agriculture and real income per person in the nonagricultural part of the economy; yes.

Now, as to just how this would work out in terms of total farm income would depend on the extent to which the economy over a long period of time becomes an industrial or urbanized economy.

Senator MILLER. Doesn't this go beyond the person, because it seems to me that the net equity in agricultural production ought to also be taken into account.

Mr. McCRACKEN. Yes.

Senator MILLER. We have seen a loss of farm population of 3 million in the last 9 years. We have seen about 1 million farms go out of existence, and it seems to me that the agricultural element of our overall economy is the thing we should concentrate on, taking into account the number of people engaged in it as well as the net equity involved in it.

Mr. McCRACKEN. In putting it the way I did, I merely wanted to indicate that the important thing is that the economic perquisites enjoyed by persons in agriculture ought to balance with those enjoyed elsewhere.

Senator MILLER. In terms of real dollars?

Mr. McCRACKEN. In terms of real purchasing power.

Senator MILLER. Thank you very much. The only reason I came back to this subject is because I feel just as strongly on this subject as our Chairman does on the Federal Reserve.

Chairman PATMAN. Thank you very much, gentlemen. If we need you in the future we will get in touch with you and try to arrange some time that is mutually satisfactory.

Mr. McCRACKEN. Thank you.

Chairman PATMAN. Thank you very much for your testimony and your cooperation.

The committee will stand in recess until 10 o'clock in the morning at which time Senator Proxmire will preside as chairman.

(Whereupon, at 1:20 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 17, 1970.)

APPENDIX

(The following additional questions asked by Chairman Patman and Senator Miller in the letter below and answers thereto were subsequently supplied for the record by the Council of Economic Advisers:)

FEBRUARY 16, 1970.

Hon. PAUL W. McCRACKEN,
Chairman, Council of Economic Advisers,
Washington, D.C.

DEAR MR. CHAIRMAN: By direction of the Chairman, I am transmitting to you a question regarding the full employment surplus. On pages 67 through 71 of the Economic Report there is an interesting and useful analysis on the role of fiscal policy and monetary policy in achieving economic stability. It points to the need for avoiding large destabilizing shifts in policy, particularly fiscal policy and goes on to say . . . "it should be possible to decide on the desired full employment surplus or deficit on grounds other than stability, and without sacrificing stability if the target itself is kept reasonably stable." It is particularly interesting to the Committee since the Subcommittee on Fiscal Policy recently recommended achieving a high employment surplus of as much as $8 to $10 billion in each of the fiscal years 1970 and 1971.

Neither the Economic Report nor the Budget contains any figures detailing what has happened to the full employment budget in recent years or what could happen to it in fiscal 1970 and 1971 under the Administration's proposal. To enable the Committee to correctly judge the impact of the Administration's proposals would you please supply estimates of the full employment surplus or deficit through fiscal year 1971? Also because trends within the fiscal year may prove destabilizing even if the annual total were correct, it would be helpful to have your best estimate of the surplus or deficit on both the budget and full employment budget basis by either quarters or by six month periods for fiscal year 1969 through 1971.

The Chairman has also asked me to forward to you the following additional questions submitted by Senator Miller:

1. On page 15 of the Council's statement is a reference to "the difficult and painful process of adjusting to a less inflationary situation." What kind of "pain" is referred to? Increased unemployment? Holding the line and/or postponing various Federal expenditures for desirable domestic programs?

2. Would you say that inflation has been the principal cause of the loss of our favorable balance of trade? What percentage of the loss would you attribute to inflation?

3. Although expenditures for war are generally regarded as "inflationary", must not our national security and foreign policy interests take precedence over considerations of inflation?

It is generally regarded that spending for education is a most productive type of spending and is, therefore, not inflationary. However, is not spending for an educational program which would be classified as "wasteful" (e.g., high cost for poor output, cost where not needed, etc.) properly called "inflationary?"

4. Please define a "mild recession", with particular reference to rate of unemployment and real dollar GNP.

Sincerely yours,

JOHN R. STARK, *Executive Director.*

[NOTE.—The memorandum, dated Mar. 2, 1970, below refers to paragraphs 1 and 2 of letter above, dated Feb. 16, 1970]

COUNCIL OF ECONOMIC ADVISERS,
Washington, March 2, 1970.

Memorandum for James W. Knowles.
Subject: The Full-Employment Surplus.

Estimates of the full-employment surplus have been used in the past for two purposes:

1. They have been interpreted as showing the direction of the "independent" influence of the budget on the economy—i.e., the direction in which the budget would be pushing the economy if economic conditions were stable as distinguished from the effects of changing economic conditions themselves on the budget. Calculating the budget surplus or deficit as it would be at full employment was considered to be equivalent to calculating it under constant economic conditions. Also the change in the surplus or deficit was considered to indicate at least the direction if not the magnitude of the change in the influence of the budget.

2. The estimates of full-employment surplus were also interpreted as showing what the budget results would be under economic conditions that were desirable and that public policy was aiming to create. Thus the estimate would permit us to say whether the existing tax rates and expenditure programs would yield some desired surplus if policy was successful in maintaining full employment on the average, even though in a particular year we might be short of full employment.

It was always recognized that in the short run at least the budget position with given tax rates and expenditure programs would depend not only on the unemployment rate but also on the price level. However, the usual assumption was that for all practical purposes prices could be assumed stable or rising at a stable, moderate, tolerable rate, under conditions of full employment. Once that assumption became unrealistic, interpretation of full-employment surplus calculations became very difficult and use of the concept by economists diminished.

Another factor particularly obvious today is that the budget position in any year depends also on the level of productivity, which grows at an uneven rate from year to year. Moreover, variations in the distribution of the GNP, notably variations in the relation between GNP and personal income, can significantly affect the budget results at any assumed combination of unemployment, prices and productivity.

These qualifications are not meant to deny the value of the full-employment surplus concept. In fact, the Annual Report of the CEA relies heavily on this concept in its discussion of fiscal policy in the long run. The concept offers a useful guide to fiscal policy as the economy moves along a path which is a satisfactory combination of unemployment price and productivity behavior or where departures from the path are all associated with departures of the employment rate. It becomes more difficult to interpret in other circumstances, such as the present, when productivity is off its trend and the inflation rate is high and at least in part independent of the current rate of unemployment.

The attached table presents estimates of full-employment surpluses on a number of definitions of the term.

In these unusual circumstances possibly the relevant question is how the surplus or deficit would change if the GNP moved along the path which offered the best *feasible* combination of price and employment behavior, given the existing conditions. If the surplus along this path was declining one could say, as a first approximation, that the budget was tending to push the economy above the path, and conversely if the budget surplus was rising. Of course, by itself this would not tell whether the budget was more or less expansive than would be appropriate in the circumstances. Thus, it appears that the budget surplus will decline between calendar 1969 and calendar 1970 if the economic path projected in the Economic Report is realized. This does not mean that the decline in the budget surplus will push the economy above that path. It means that this tendency of the budget is expected to be counterbalanced by other factors.

PROJECTED AND FULL-EMPLOYMENT SURPLUS, CALENDAR 1969 TO FISCAL 1971, INCLUSIVE, UNDER VARIOUS ECONOMIC ASSUMPTIONS

[National income accounts; billions of dollars at seasonally adjusted annual rates]

Year and quarters	Budgetary surplus (1)	Full-employment surplus: CEA projection (2)	1969 productivity (3)	Low-price increase (4)	Profits/GNP at 1969 level (5)
1969:					
I and II	11.8	10.0	(1)	(1)	(1)
III and IV	7.4	9.4	(1)	(1)	(1)
1970:					
I and II	-.4	4.8	2.3	3.1	8.4
III and IV	0	6.2	1.5	2.4	10.4
1971: I and II	5.6	12.6	7.0	7.5	16.3

1 Not applicable.

NOTES

Col. 1 is the actual and forecast surplus.

Col. 2 is the full-employment surplus assuming that potential GNP follows a longrun growth path of 4 percent per year from 1965 IV, that prices rise as projected by CEA, that profits as a share of GNP are as projected by CEA, and that the unemployment rate is 4 percent.

Col. 3 modifies the assumptions of col. 2 by taking as the starting point for the 4 percent annual rate of growth of potential GNP 1969 full employment output, which is below the long-range trend because of the drop in productivity in 1969.

Col. 4 is the full-employment surplus if prices rise at a 2 percent annual rate, which would be more consistent with a long-run unemployment rate of 4 percent.

Col. 5 is the full-employment surplus on the assumption that corporate profits represent 10.08 percent of GNP as in 1969, rather than the 9.2 percent projected by CEA for 1970.

The idea that changes in the full-employment surplus indicate the direction of the fiscal impact on the economy depends upon there being no significant changes in the composition of the budget. Ordinarily as between years this is a good enough assumption. However, as between 1969 and 1970 the dominant factor causing a reduction of the surplus is the two-step elimination of the temporary surcharge. Without that the surplus would be the same in the two calendar years on a national income accounts basis. Moreover, between the two years there is a significant reduction of Federal purchases and a large increase of transfer payments. The shifts within the budget between the two years serve as a decline in the NIA surplus between 1969 and 1970.

All of this is aside from the question whether or how far the apparently "expansive" effects of a reduction of the budget surplus are offset by the restrictive effects of the reduction in the Federal Government's supply of funds to capital markets via the surplus. It is also aside from the basic question whether the expansive effect of the reduction in the surplus between 1969 and 1970 is too much or too little.

The second use of the full-employment surplus calculation, in addition to showing the short-run impact of fiscal policy, is to show what the average budget result would be over a considerable period of years in which the full-employment objective would be achieved. In fact, however, the full-employment surplus no longer gives a good picture of this when we have on the books legislation calling for important expenditure and tax changes in the future. To see the long-run state of the budget it is necessary to make explicit long-range projections of receipts and expenditures as is done in the Economic Report and the Budget this year.

HERBERT STEIN, *Member*.

[NOTE.—The following answers refer to additional questions of Senator Miller, referred to in the letter dated Feb. 16, 1970, paragraph 3 and those that follow]

Answer 1. The pain involved in shifting to a less inflationary growth path results from the failure of wages and prices to respond immedately to a reduction in what had been an inflationary rate of growth of total demand. Because price and wage increases do not slow down immediately the rate of growth of real output will slow down for a time and real output may even decline temporarily. The pains of disinflation are derived from this loss of real output and from the way the loss is distributed.

Ordinarily a relatively large part of the loss is suffered by the recipients of business profits, because production costs—consisting chiefly of wage payments—tend to be sustained during a temporary period of reduced output. We expect this to be true in 1970. Part of the burden will be borne by those who experience more unemployment than otherwise. We expect this in 1970 to be reflected primarily in moderate lengthening of the period of job search. Some of the pain of adjustment will be borne by the beneficiaries of government services, as the Federal Government holds back its own expenditures to help bring about the transition to a more stable economy.

Answer 2. U.S. inflation has no doubt been a major contributor to the decline in the favorable balance of trade in recent years. There is, however, some difficulty in quantifying the effects of this inflation. In part, this is due to the very complexity of the international economy, which severely strains our capacity to analyze it. In part, it is due to limitations of data: for example, reliable information on export and import prices is difficult to come by.

A further problem involves an estimate of what "would have happened" in the rest of the world in the event that the United States had been more successful in restraining price increases. Because of the size of our economy, there is a tendency for forces originating in the United States to influence the path of events in foreign countries. Thus, it is reasonable to assume that, if the United States had been more successful in coping with inflation here, inflationary pressures in other countries would have been somewhat less strong. This is not, of course, to deny that foreign countries were subject to their own home-grown inflationary tendencies, too.

Perhaps the most straightforward way of dealing with this problem is to ask how much larger our merchandise trade surplus would have been if prices in the United States had risen no more rapidly than the average prices of our trading partners. If such a price pattern had been experienced between 1965 and 1969, econometric evidence suggests that the U.S. trade balance would have been roughly $2 billion stronger than it was in 1969. While the imprecision of this estimate must be stressed, this suggests that something like half of the $4.1 billion decrease in the U.S. trade balance was attributable to the more rapid rise in prices in the United States.

Answer 3. While expenditures for war are generally considered inflationary, it is not necessarily appropriate to do so. If the total demand upon national output exceeds our capacity to produce, inflation occurs. Thus, relative to a noninflationary situation, an increase in expenditures for war not offset by reductions in other expenditures—public or private—is inflationary. But it is a matter of semantics to label the inflation the result of the expenditures rather than of the neglect of policies to reduce other expenditures sufficiently to maintain price stability.

There is widespread agreement that within fairly broad limits we can increase spending for defense or for any other purpose without setting off or accentuating inflationary pressures, *provided* we act to reduce spending elsewhere, say by raising taxes or by tightening monetary policy. This, of course, is but another aspect of the need for consciously setting national priorities—the aspect that unfortunately was neglected from 1965 to 1969. The only meaningful trade-offs are between uses of real outputs; if the necessity to set priorities is neglected, the priorities will be set by inflation, as they have been for the past 4 years.

To the extent that spending on education adds to aggregate demand it is as inflationary as other spending. Though it increases our productive capacity, investment in education, like many other types of investment, has such a long gestation period that whether or not it is "productive" has little bearing on whether or not a given dollar spent for education is inflationary. This is not to say that we should not object to unproductive spending for education. Clearly, the more productive the program the more output we shall have in the future.

Answer 4. We have no definition of a "mild recession" or, for that matter, of a recession. According to the National Bureau of Economic Research, there have been 4 recessions in the United States since the demobilization following the end of World War II. These are shown in the first column of the attached table.

Decreases in real GNP and increases in unemployment have partially overlapped these periods. In columns 2–4 are shown periods of decrease in real GNP, the percent change in real GNP and the associated average rate of unemployment. Typically unemployment has tended to increase beyond the low point in real GNP. The last column shows the quarter in which unemployment reached its high.

NBER peak and trough (and time interval)	Real GNP peak and trough	Percent change from trough to peak	Unemployment rate	High quarter for unemployment rate and unemployment rate in that quarter
November 1948	4th quarter 1948		3.8	
October 1949 (11 months)	2d quarter 1949	−1.9	5.9	4th quarter 1949—7.0.
July 1953	2d quarter 1953		2.6	
August 1954 (13 months.)	2d quarter 1954	−3.4	5.8	3d quarter 1954—6.0.
July 1957	3d quarter 1957		4.2	
April 1958 (9 months.)	1st quarter 1958	−3.9	6.3	2d quarter 1958—7.4.
May 1960	1st quarter 1960		5.2	
February 1961 (9 months.)	1st quarter 1961	−1.6	6.8	2d quarter 1961—7.0.

(The following additional questions asked by members and staff and answers thereto were subsequently supplied for the record by the Council of Economic Advisers:)

Budget Surplus

Question 1. Mr. McCracken, you have stated that a strong economic case could be made for a larger budget surplus than the Administration has proposed. Ideally, how large a surplus should we have in the fiscal 1971 budget?

How large a full-employment surplus is implied by the recommended actual fiscal 1971 surplus of $1.3 billion?

On page 67 of the Economic Report the Council states that, "The likelihood of achieving economic stability would nol be greatly affected by the size of the surplus or deficit, within a reasonable range, . . .". I assume you refer here to the full-employment surplus. Could you put quantitative limits on this range within which the average size of the full-employment surplus is irrelevant to economic stability?

Answer. Ideally we should like to see the budget surplus left essentially unchanged from year to year. Thus we would have been pleased with a budget surplus of about the magnitude of the surplus for calendar 1969, that is, about $5 billion on a unified budget basis. This would have facilitated the monetary easing that the housing industry so badly needs.

Our memorandum previously supplied contains a table showing the budgetary surplus and the full-employment surplus through fiscal 1971 calculated under various assumptions about economic conditions. It also explains the difficulty of using the full-employment surplus as an indicator of budgetary restraint under conditions such as we are experiencing now.

The sentence quoted in part from page 67 of the Economic Report should be read in full, including the words not quoted, "if that size were itself stable or changing only slowly, and if the effects on liquidity resulting from secular increases or decreases in the Federal debt were offset by monetary policy." In the most common situation the sentence can be understood as referring to the full-employment surplus. More generally, it refers to the surplus that would be generated as the economy moved along whatever path is considered to be "economic stability."

It is difficult to quantify the range within which the size of the surplus or deficit would not endanger the achievement of economic stability. But in an economy the size of ours it would seem that the latitude for decisions about the optimal size of surplus to augment private saving would be not less than $10 billion, provided that monetary policy would be adapted to differences in budgetary positions and that the budgetary position remained fairly stable in the shortrun. These provisos are, of course, quite crucial, and should never be overlooked or omitted.

Government Pay Freeze

Question 2. The Administration has maintained a consistent position of opposition to wage or price controls or "freezes." Yet, the fiscal 1971 budget proposes a six month postponement of Federal pay increases. Is this consistent with a *policy of opposition to wage freezes? Is this postponement of Federal pay increases intended as an example to the private sector? If so, isn't it incumbent on the Administration to state this explicitly and to recommend similar guidelines for the private sector?*

Answers. It is absolutely essential to maintain a reasonable relationship between wage rates for federal employees and wage rates for employees in the private sector of our economy. This relationship cannot be maintained precisely, but helpful comparability studies have been made to provide guidance in setting wages and salaries of federal employees. Postponing the federal employee pay increase for six months is within the margin of uncertainty so that it would not severely upset the relationship between wages in private sector and federal employees. In addition, the postponement will have beneficial effects in helping to reduce the federal expenditures in FY 1971. We are not proposing a general wage freeze. We do think that employers and employees should make realistic decisions within the context of their own capabilities and responsibilities. If we are setting any example, that is it.

Defense Budget

Question 3. The Economic Report refers to studies conducted through the National Security Council and the Cabinet Committee on Economic Policy examining alternative defense strategies. Has the Council participated in these studies? Can they be made available to this Committee? Why should hypothetical defense strategies and hypothetical non-defense strategies and their associated costs as estimated by the Administration be kept a secret from Congress and the public? Why not disclose them so that we can improve our understanding of the trade-offs between alternative national priorities?

Can you supply for the record the names of all the members of the Defense Program Review Committee and briefly explain how this body operates and what authority it has?

Answer. The role of the Council of Economic Advisers in the Administration's studies of alternative defense strategies has been to attempt to identify the long-term budgetary and economic implications of the various strategies under discussion. Since the Chairman of the Council serves as a member of the Defense Program Review Committee, which is expected to continue such studies, it is likely that the Council will continue to play this role. This is in keeping with the Council's statutory concern with such matters.

The Council sympathizes with the idea that issues affecting the determination of national priorities should be freely discussed by the Congress and the public. Indeed, Chapter 3 of the Economic Report was intended to contribute to such public discussion. However, the studies of Defense programs which have been undertaken by this Administration, and in which the Council has participated, are not of hypothetical nature. The alternative defense strategies under discussion represent the real choices that must be made at the highest levels of government. In the interests of the national security, they cannot become public information. The Congress, in executive sessions of the Armed Services Committees is, of course, privy to much classified information. This has always been the practice followed with regard to classified information, and the reasons for such classification are the same in this case as in any other.

The Defense Program Review Committee under whose aegis studies of the overall implications of alternative defense strategies are made, is chaired by the Assistant to the President for National Security Affairs, Henry Kissinger. Also on the Committee are Under Secretary of Defense, David Packard, the Under Secretary of State, Elliot Richardson, the Director of the Bureau of the Budget, Robert Mayo, the Chairman of the Council of Economic Advisers, Paul McCracken, the Director of the Central Intelligence Agency, Richard Helms, and the Chairman of the Joint Chiefs of Staff. Gen. Earle Wheeler. The Committee reports to the National Security Council. It is concerned, within the context of the overall national priorities, with the economic, diplomatic, and political implications of various defense strategies, as well as with the military and strategic implications. In performing its duties, the Defense Program Review Committee undertakes long-term studies of the economy, the budget, and the international political and diplomatic situation in light of alternative defense strategies.

Transportation Regulatory Agencies

Question 4. In the Council's Report, Government regulation of the transportation industry is criticized for discouraging competition and inhibiting new entry. Could you describe in more detail how you think our regulatory philosophy and institutions should be changed?

Answer. As the Council's Report indicated, we think that transportation is inherently a very competitive sector of the economy. Back in the 19th century the railroads did have substantial monopoly power and thus there was considerable justification for their regulation. In today's climate no sector of transportation has a dominant monopoly position. Trucks compete with barge carriers and with railroads and each of the others compete with the others. Pipelines can and do compete with railroads and with other forms of transportation. There may still be places and products in which a railroad would have a monopoly in its transportation but these areas are rare and growing rarer. Consequently we believe that competition can be relied upon a great deal more than it has been to protect the public. In recent years too much emphasis has been placed by some regulatory agencies on protecting one carrier from the inroads of other carriers. The emphasis has often been not on the places where monopoly may still exist but on parts of the market which are highly competitive. Regulators have spent considerable time in keeping prices up rather than down. More consideration should be given to revising our transportation acts to promote competition and to reflect the existing more competitive environment. In certain areas where competition can be expected to provide adequate safeguards for the consumer's interest, de-regulation should be considered.

Labor and Manpower

Question 5. (a) How good are our employment statistics? The unemployment rate has been quite erratic in recent months. Do you feel we attach too much importance to this single indicator? What other measures of labor market tightness should we look at to obtain a more complete estimate of the true extent of unemployment?

(b) The Administration's manpower bill contains a provision for an automatic increase in appropriations if the unemployment rate average 4½ percent for three consecutive months. How do you feel about the appropriateness of using manpower programs as a counter cyclical device? In view of the erratic nature of the global unemployment rate statistic, is it really appropriate to tie policy to this single indicator? In any case, don't we really need manpower training just as badly when labor markets are tight, skilled labor shortages exist, and jobs are available for those completing training?

(c) How much of a contribution do you think job training programs can make to the aggregate improvements in labor market efficiency which, in theory, should improve the ability of the economy to combine price stability with high employment? What attempts have there been to measure and evaluate the actual or potential aggregate contribution of manpower programs?

Answer. (*a*) In general, we have a very good set of employment statistics. But at the same time we must recognize that monthly satistics in particular are subject to substantial variation, partly as a result of sampling variability and partly due to the adjustments of the raw data that are required to interpret the statistics. The monthly statistics on unemployment do receive a great deal of public attention, and there may be some tendency to place too much emphasis on a single widely circulated figure such as the most recent unemployment rate. A more balanced view of current market conditions can be obtained by examining in addition the statistics on payroll employment, insured unemployment, and GNP as well as those series that comprise the economic indicators.

(*b*) The unemployment rate has recently moved somewhat erratically on a month-to-month basis. Increased appropriations under the Administration's manpower bill would occur if the unemployment rate reaches 4.5 percent for three consecutive months. Thus an erratic increase for a month or two would not trigger an increase in appropriations. It is true that the need for trained manpower is most evident when labor markets are tight and skill shortages exist. But it may be more efficient to increase the provision of manpower training services when there is more slack in the labor market, so that a more highly skilled work force is available as the labor market tightens and more job openings are available.

(c) Studies of the impact of job training programs seem to indicate that they can make a significant contribution to labor market efficiency and hence improve the performance of the economy at high levels of employment. Evaluating their contribution at an aggregate level to higher levels of employment and price stability is a very difficult empirical problem, but there is some evidence that manpower programs have made a contribution toward improving operation of the labor market.

Private Versus Public Spending

Question 6. The Council's longer range projections imply a drop in the rate of real per capita growth of State and local government services and an increase in the rate of growth of real per capita personal consumption. Thus, under the Council's assumed spending patterns, the private sector will be growing at the expense of the public sector. Do you think, in view of the many remaining unmet needs for local public services, that this is an appropriate change in the distribution of total output? Or do you think that there should be changes in present tax laws which would make more money available for the public sector?

Answer. The Council's longer range projections were an attempt to estimate the implications of current and proposed programs and projected behavior patterns for the allocation of the national output. We provided these estimates as an aid to public thinking about what the preferred allocation of the national output might be. We do not think it our function, as a Council of Economic Advisers, to go further. We should point out that the relatively rapid projected growth of per capita private consumption is to a considerable extent a result of the large personal tax relief enacted by Congress against the advice of the Administration. Per capita private consumption also includes the consumption of families, including poor families, out of transfer payments made by government, which will be growing in size. It should not be automatically concluded that there is a conflict between "private consumption" and "social needs."

Agricultural Policy

Question 7. The Council's Annual Report endorses an agricultural policy based on market prices and direct income maintenance. Could you describe the program changes the Administration has proposed or will propose to accomplish this objective and tell us when they might become effective? Would you anticipate that the sort of program you favor would result in a lower total Federal budget cost? What do you think the effect on consumer prices would be? On farm income?

Answer. Legislation authorizing the current price support and supply management programs for feed grains, wheat, and cotton effectively ends with the 1970 crops to be planted this spring, and officially expires December 31, 1970. Unless new legislation is enacted, statutes and programs in effect under the Agriculture Act of 1958 would automatically be reactivated. The likely outcome would not be in the best interest of agriculture. The Administration has not independently proposed a new farm bill but has worked jointly on a bipartisan basis with the House Agriculture Committee to develop a "consensus" bill.

The intent is to place greater reliance on the market place, expand domestic and foreign markets and achieve better over-all resource adjustment by providing a wider range of decision-making for farmers. The proposals of the "consensus" bill are built around the set-aside program. Producers that participate in the program would be required to set aside (idle) a specified portion of their cropland. In return, the producers would be eligible for a price support loan on their total crop and a payment only on the base acreage. This differs from current programs in that certain acres would be retired from production rather than controlling the acreage for each crop. A producer could plant his entire farm less the specified set-aside acreage to one crop, if he so desired. However, to provide an orderly transition, authority is provided to place limits on individual crop acreage for the first two years, 1971 and 1972. For feed grains and wheat the Secretary would have discretion to set the loan anywhere between zero and 90 percent of parity. For cotton there would be discretion for the Secretary to set the loan anywhere from zero to 90 percent of the estimated world price.

Under the "consensus" bill upper limits for payments would be set in relation to parity for feed grains and wheat, and in relation to the estimated world price for cotton. Payments would be subject to the annual appropriation process. Amounts would be proposed in the President's budget and included in the annual appropiration bill for the Department.

A graduated limitation would be placed on payments to each producer under each commodity program. The second $20,000 or portion thereof to be paid a producer would be reduced by 10 percent, the third $20,000 or portion thereof would be reduced by 20 percent and so on. The maximum a producer would receive would be $110,000 *per program*. However, his mandatory acreage diversion would be reduced in line with the reduction in his payment.

The proposal also includes a provision permitting the Secretary to provide an additional payment to producers who agree to permit, without other compensation, access to the farm by the general public for hunting, trapping, fishing and hiking.

Government costs for this set-aside program are unlikely to be reduced for the first one or two years. However, as desirable adjustments take place within agriculture, it may be possible to phase-down governmental payments without serious consequence to income per farm. Similarly, increased farm efficiencies and greater reliance on market forces should eventually result in lower consumer prices.

Productivity

Question 8. Productivity gains were unusually small in 1969. The Council's Annual Report seems to contain two somewhat conflicting explanations for this. One explanation offered is the retention of the work force in the face of declining product demand—the labor hoarding theory. This is a labor surplus theory. The other explanation is that a labor shortage forced the hiring of "marginal workers such as teenagers and housewives." This is a labor shortage theory.

(*a*) *Did we really have both a labor surplus and a labor shortage in 1969? If so, what does this imply about labor market efficiency?*

(*b*) *Can you cite empirical studies demonstrating that housewives are marginal workers, or is this just a supposition?*

(*c*) *Do you anticipate that productivity gains will improve in 1970?*

Answer. (*a*) In the Annual Report the Council offers two tentative explanations of the poor productivity performance in 1969 that "differed in importance from industry to industry and time to time." The labor shortage explanation was probably applicable to the first half of the year when employment growth was rapid and unemployment rates were extremely low. Labor hoarding probably existed throughout the year but was perhaps more important in the second half of 1969, when the slowdown in demand became more pronounced.

It is possible to have labor shortages and surpluses existing simultaneously, as evidenced by the large number of job vacancies that have existed in periods of slack demand for labor. This is a manifestation of an inefficient working of the labor market that the Administration is attempting to overcome with its manpower programs.

(*b*) It is well known that housewives make up a sizable fraction of the labor force. This share has been growing over the long run. Even so, there can be little doubt that an intense demand for labor such as existed in early 1969, does attract unusually large numbers of adult women into the labor force, as suggested by Table 6 on page 47 of the Report.

(*c*) The Council anticipates a small increase in productivity in 1970 most of which will occur in the second half of the year.

Highway Trust Fund

Question 9. The Subcommittee on Economy in Government has just issued a report recommending the abolition of trust funds for the financing of Federal investment or construction programs. The Administration's new budget recommends an extension of the highway trust fund.

How do you feel about the advisability of trust fund financing in general?

How do you feel about the resource allocation effects of the Federal interstate highway program, particularly its effect on the allocation of local funds as between highways and public transportation?

How do you feel about the request for budget authority of $5.7 billion for highways in a year of budget stringency and at a time when inflation continues to be such a major problem?

Answer. Trust funds can be useful devices for collecting revenues from the beneficiaries of certain government expenditures. That is, they can serve to facilitate the financing of projects that will benefit certain selected groups. The essence of a trust fund should be that the taxes or the sources of the revenues come from the groups that are benefiting. Thus the trust fund acts as a conduit for the resources. Presumably the level of the taxes and the size of the expenditures will be adjusted to reflect the desires of the beneficiaries/taxpayers.

For example, the Highway Trust Fund collects revenues from the highway users and spends the funds to benefit the highway users. It would be both inequitable and inefficient to use general revenues which are in part derived from non-highway users to benefit those who do use highways. In general, therefore, wherever the taxes can be imposed on the group benefiting, trust funds are suitable vehicles.

The resource allocation effects of the Federal interstate highway program on the allocation of local funds as between highways and public transportation are significant. Since the Federal Interstate Program will pay 90% of the cost of the highways and federal funds to aid public transportation will pay a much smaller proportion (if any) of the cost of public transportation, states and localities can get more transportation for a local dollar with the Federal Highway Program than with expenditures on public transportation. It is not the trust fund that creates the distortion in resources but the differing proportions of federal aid that affects relative expenditures.

The request for budget authority of $5.7 billion for highways simply reflects the sum authorized by Congress in 1968 except for a transfer of funds for Forest Highways. Thus the Administration is simply reflecting a Congressional mandate.

Housing

Question 10. Could you supply for the record the numbers on which Chart 10 in the Economic Report is based and a comparison of the total number of conventional housing starts you are projecting in this chart with the national housing goal of 26 million units?

What studies are being made within the Administration concerning the supplies of labor and physical resources, as well as the volume of credit, required to meet the housing goal? Can you supply a brief statement for the record concerning the adequacy of our supply of such resources relative to the need?

What studies are being made within the Administration concerning the rate of deterioration of our existing stock of housing and the effect this may be having on the adequacy of the 26 million unit housing goal?

Answer. The following table contains the data upon which Chart 10 of the Report is based:

Year	*Total conventional starts (thousands)*
1960	1,296
1961	1,365
1962	1,492
1963	1,641
1964	1,592
1965	1,510
1966	1,196
1967	1,322
1968	1,548
1969	1,463
Projections:	
1970	1,425
1971	1,700
1972	2,050
1973	2,325
1974	2,475
1975	2,500
1976	2,500
1977	2,500
1978	2,500

The data for 1960 to 1969 are available in *Housing Construction Statistics* and in *Reports on Housing Trends*. The projections to 1978 show one possible path to achieving the housing goals. It is the target path agreed upon by the Administration's Task Force on Requirements for the Housing Program, and is consistent with the path that will be reported to the Congress in HUD's annual report (the actual numbers differ because HUD will report the path in fiscal years).

The path projected in Chart 10 allows for the construction of 21 million conventional units during the goal period 30 June 1968 to 30 June 1978, and can be derived from the table above by summing the figures from 1969 to 1978, and then adding roughly half the level of starts in 1968 and half the level projected for 1978. It should be noted that the Council and the Task Force do not assert that this will be the actual path followed; however, it is believed that if the goals are to be achieved the actual path will be similar to the one projected. That is, the projections are not completely arbitrary, and they reflect the inherent difficulty in expanding the supply of certain required imputs by relatively large amounts in the short-run. Thus, while the target for a given year need not be met precisely, a serious short-fall could not simply be made up in the following year. In addition to the 21 million conventional units in Chart 10, it is expected that 1 million housing units will be rehabilitated with public assistance during the coming decade. These publicly assisted rehabilitations and 5 million of the new conventional units will provide housing for low income families. Finally, the production and shipment of mobile homes is projected to account for another 4 million units. If these projections are fulfilled, the goal of 26 million additional units will be realized during 1978.

A Task Force on Requirements for the Housing Program was established under the direction of the Cabinet Committee on Economic Policy to identify bottlenecks which may prevent the attainment of the housing goal and to recommend remedial measures where they are required. The Task Force has attempted to determine the nature and the quantity of the inputs necessary to produce 26 million dwelling units and the likelihood that the supply of inputs will be forthcoming. While there is a serious shortage of the data required for exhaustive studies of the feasibility of constructing 26 million units by 1978, the Task Force has, where possible, evaluated those inputs that may be in short supply.

It is as a result of this work that the Administration has recommended that the Congress provide for a program of accelerated management of softwood lumber production. Labor requirements are of obvious importance, and an attempt has been made to match the likely supply of skilled labor against that which will be required to meet both the residential and non-residential construction needs during the 1970s. The work done in this area indicates the needs for a significant expansion of the supply of skilled labor, and the Departments of Labor and of Health, Education, and Welfare are attempting to expand manpower training and vocational education programs, respectively.

The financing of the housing goals is yet another area which is unlikely to be sufficient without assistance of the Government sector. With the economy operating near full employment in the decade ahead, a large volume of savings will be generated annually. There is, however, no assurance that the volume of funds required to meet the housing goals will automatically flow into residential construction. Thus, some institutional reforms may be necessary. In any event, claims must be balanced against resources. Consequently, assuring that residential construction receives a supply of funds sufficient to purchase the resources necessary to meet the goals may require budget surpluses which are large relative to recent experience.

Information on the rates of deterioration of existing types of housing is sorely lacking, and studies requiring this knowledge must generally employ the limited amount of information which can be gleaned from a comparison of the 1950 and 1960 census, and from a survey made by Census for OEO in 1966. The President noted the inadequacy of this data in the *First Annual Report on National Housing Goals*, and the Department of Housing and Urban Development is involved in various efforts to rectify this situation. Further, the 1970 Census will include questions on the components of change of the housing stock, the answers to which should provide valuable information on the deterioration of dwellings since 1960. At the same time HUD has been working with the Bureau of the Budget to establish a program which will provide for the collection, on a regular basis, of data essential to a continuous monitoring of housing needs.

Balance of Payments

Question 11. In 1968, the United States enjoyed a balance-of-payments surplus according to the official settlements calculation, of $1.5 billion and a deficit, according to the liquidity computation—if we discount the benefit of so-called "special transactions"—of $2.1 billion. The indications are that in 1969 we recorded an official settlements external surplus of $2.5 to $3 billion, but a liquidity deficit of over $6 billion. Thus, both the official settlements surplus and the liquidity deficit apparently grew substantially last year. Given these contradictory data, does the United States have a balance-of-payments problem or not? If so, what type of problem do we have and just now serious is it?

Answer. The sharply contradictory movements last year of the liquidity and official settlements measures of the U.S. balance of payments clearly indicate that it is impossible to properly evaluate the state of the U.S. balance of payments or the international strength of the dollar on the basis of any one number. This is true to some extent of the balance of payments position of any country, but it is especially so for the United States because of the important roles of the dollar in international finance. Because of the use of the dollar as reserve currency, the United States does not face a direct quantitative limit to its international reserves in the sense that other countries do, and this means that the United States does not face a balance of payments problem in the direct way that other countries do. But this does not mean that the United States has no concern with the international financial position of the dollar. It is important that confidence in the dollar be maintained and at the present time the most important factor in preserving confidence in the dollar, both at home and abroad, is success in our fight against inflation.

Question 12. During his campaign for the Presidency, Mr. Nixon committed himself to abolition of the restrictions and controls limiting the export of capital from the United States and in his balance-of-payments statement of April 4, last year, he reaffirmed this commitment. Why are we still retaining these limitations on capital exports and when will they finally be removed?

Answer. The President has committed himself to move away from controls on capital movements. In line with this commitment the direct investment program was liberalized twice during 1969. As long as the structure of our balance of payments remains unsatisfactory further liberalizations can only be made with caution. At the present time we are not able to predict when it will be possible for all restrictions to be removed.

Environmental Financing Authority

Question 13. The environmental measures recently proposed by the Administration raise some difficult questions of resource allocation. The Administration has proposed an environmental financing authority which would lend money to State and local governments only for anti-pollution purposes. If we make funds more readily available to States and localities for some purposes than for others, doesn't this restrict the freedom of local governments to order their own priorities? Isn't this the kind of restrictive approach which this Administration to trying to move away from? Why aren't you recommending a more comprehensive financing authority which would make funds available to States and localities for all the purposes for which they now issue tax exempt bonds?

Answer. It is almost certainly true that restricting the use that can be made of funds from Federal grants or loans redirects the expenditures of State and local governments—I say almost certainly because in some instances such funds simply replace what would have been spent anyway. In many cases there is no good reason for restricting the use of funds, since it is reasonable to believe that State and local governments can judge better than the Federal Government how they should spend their money. But in the case of environmental quality control this is not necessarily the case. The benefits of pollution control extend across jurisdictional lines, so that this is more than a purely State or local question. And because it has been neglected so long, the problem of environmental quality control has come to assume paramount importance.

Interest Rates

Question 14. In your recent testimony before the Banking and Currency Committee, you agreed to look into the question of who are the recipients of the income flowing from higher interest rates. Could you also supply the Joint Economic Committee with whatever information the Council develops on this subject?

Answer. There is very little information on the ownership of different types of financial assets, and therefore it is difficult to characterize the groups which benefit when interest rates rise. Some information on liquid-asset ownership is provided by the table on page 69. This covers demand and savings deposit and U.S. savings bonds. When interest rates rise, these assets, unlike marketable bonds, do not decline in value. Consequently, the holders of these liquid assets receive more net interest income. Interest is not paid on demand deposits, but holders of such deposits do receive services in lieu of interest and the value of these services tends to rise when interest rates rise, although probably not proportionately.

(The following additional questions asked by the minority members and answers thereto were subsequently supplied for the record by the Council of Economic Advisers:)

Question 1. When he Revenue and Expenditure Control Act of 1968 was enacted, there were many who felt it was an "overkill" measure, that it would slow down the ceonomy much too abruptly. Certainly most of us felt that it would reduce inflation over the near term. However, it is now more than 18 months since the enactment, and we have yet to see a significant slowing in the growth of prices.

Why is it that the income tax surcharge and the spending ceiling imposed in 1968, as substantial in size as they were, failed to fulfill this country's hopes in halting inflation and high interest rates? Does the experience with this "temporary" tax increase call into question the whole theory of using tax changes for short-run economic stabilization purposes? Would expenditure cuts prove more effective in reducing inflation than temporary tax increases? How much importance do you attribute to the expansion of the money supply in late 1968 in the failure of the tax increase to restrain the economy? Would the same 10 percent tax surcharge have done the job if it had been passed earlier in the military spending buildup?

Answer. The Revenue and Expenditure Control Act of 1968 had mixed results. That it was not successful by itself in restraining the price rise was due to a number of factors that are discussed in the Economic Report. There was a failure to coordinate monetary policy with fiscal policy. The expected impact of the surcharge on private spending did not materialize partly because consumers and businessmen viewed the surcharge as temporary. The imposition of the ceiling on Federal expenditures was helpful in restraining the rise in Government spending and thus the rise in total demand.

The surcharge was intended to dampen the increase in spending by business and consumers. The impact on business spending was particularly small, relative to the size of the tax increase, because business investment decisions depend on anticipated returns over a much larger period than the period for which the tax was expected to be in effect. The influence of the tax on business was dwarfed by the influence of expansionary factors in 1968 such as the sharp rise in business sales in the first half of 1968, the improvement in before-tax profits, the continuing rise in plant and equipment costs and in labor costs, and the easy money policy pursued in the second half of 1968.

The response by consumers in the first year of the surtax turned out differently from original expectations. Just before the surtax was passed consumers had been saving a higher than normal proportion of their after tax incomes. The reasons for this are still not clear, but it was recognized that the effectiveness of the surtax could be diminished if consumers reverted to a more normal (lower) saving rate. It was also recognized that the effectiveness of the surtax would be lessened if consumers viewed the tax rise as temporary since under such circumstances they would maintain their consumption, that is, would tend to save less. Both of these outcomes materialized—and to an extent that was not anticipated. Whereas the personal saving rate during the year prior to the passage of the surtax was 7.3 percent, during the year following passage the rate fell to 5.6 percent.

Experience with the surtax in its first full year of operation does raise questions regarding the effectiveness of temporary tax changes. Tax changes known in advance to be temporary by individuals and businesses appear to be of limited effect, or at least much less effective than tax charges expected to be permanent. If temporary tax changes were used frequently, individuals would adjust their spending-saving pattern to what they considered the normal tax rate to be. Also, the entire issue of timing cannot be ignored, since the requirement that tax changes be passed by the Congress frequently involves a long and drawn-out process.

Expenditure cuts are probably more effective than tax increases as an anti-inflationary weapon. The President has a certain amount of discretion regarding the timing of expenditures. Furthermore, the effect of expenditure cuts on economic activity is probably more predictable, since with an expenditure cut one need not be concerned with the extent to which higher taxes are absorbed initially by reductions in saving rather than in spending. It is true that past and implied commitments limit the amount of variation in spending that can be brought about, but changes can be made, as in 1969.

We cannot qualify the extent to which the easy money policy in late 1968 worked at cross-purposes with the surtax, but we feel certain it hampered the effectiveness of the new fiscal legislation. From the second quarter of 1968 to the first quarter of 1969 fixed investment—nonresidential as well as residential—rose at an annual rate of 13.8 percent, an unusually large amount. As indicated earlier not all of this increase was due to the easy money policy, but part of it was undoubtedly the consequence of monetary policy.

If taxes had been raised earlier in the military spending buildup the country would be suffering from less inflation than it is now experiencing. Failure to increase taxes, say, at the start of 1966 gave rise to excessive demands in 1966 and placed the burden of restraint on monetary policy. If taxes had been higher, it would have been possible to follow a less restrictive monetary policy in 1966 and a less expansive one in 1967. Moreover, delay in tackling the inflation problem led to inflationary expectations which weakened the effectiveness of anti-inflation policies pursued later.

Question 2. In 1969, it was often argued that the home construction industry was depressed by a tight monetary policy, and if only the Federal Reserve would insure a flow of money and credit into this sector, we could achieve our housing goals. Yet the 1969 experience in construction also indicated that there are serious problems with the supply and allocation of labor. For example, how does it happen that the unemployment rate in construction has been running about twice that for the whole non-farm economy yet the median wage and benefit settlement in 1969 for construction workers was about 12.5 percent?

The Council Report notes that the situation in the residential construction sector is comparable to that for the whole construction industry. How can workers in a depressed industry obtain such unusual increases in compensation? Once tight money pressures on homebuilding are reduced, will there be enough labor available at reasonable wage rates to construct the volume of housing this nation needs?

Answer. The labor market for construction workers was extremely tight in 1969, which is one of the major reasons for the high negotiated wage settlements in the construction industry. The unemployment rate for private wage and salary workers in construction was 6.0% compared with 3.5% for all civilian workers. The relatively high unemployment rate in construction results from the structure of the construction industry. Since employment tends to be of short-term duration, a construction worker may work on many different jobs during the year, experiencing spells of unemployment between jobs. The 6.0% unemployment rate in construction may appear high compared to the 3.5% rate for all civilian workers, but it is much lower than the average unemployment rate of 11.3% in construction from 1959–68. The tightening of the labor market in construction is also demonstrated by the decline in the ratio of the unemployment rate in construction to the total unemployment rate from 2.3 in 1959–68 to 1.7 in 1969.

The Council Report indicates that inflationary trends were evident in 1969 in the construction industry including the home building sector, but it does not indicate that the entire industry was depressed in 1969. In fact, the reason for the reduction by 75 percent of new contracts for direct Federal construction announced on September 4, 1969 was the excessive demand in the nonresidential sector of the construction industry.

The Administration has taken two important steps to increase the supply of construction workers. First, on September 5, the President directed the Departments of Labor and of Health, Education, and Welfare to apply more of their manpower training programs to increasing the number of skilled construction workers. The Cabinet Committee on Construction is considering further action in this regard (which was announced in the President's message of March 17, 1970). Second, on September 22, the President established a tripartite Construction Industry Collective Bargaining Commission to consider solutions to manpower problems in the industry.

A SURVEY OF CONSUMER UNITS PUBLISHED BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM SHOWS, BY INCOME CLASS, THE HOLDINGS OF LIQUID ASSETS (DEMAND AND SAVINGS DEPOSITS AND U.S. SAVINGS BONDS)

SIZE OF LIQUID ASSETS, DEC. 31, 1962

[Percentage distribution of consumer units]

Group characteristic	All units	Zero	$1 to $199	$200 to $499	$500 to $999	$1,000 to $1,999	$2,000 to $4,999	$5,000 to $9,999	$10,000 to $14,999	$15,000 to $24,999	$25,000 to $49,999	$50,000 and over
1962 income:												
0 to $2,999	100	44	14	8	10	4	10	5	2	3	(1)	(1)
$3,000 to $4,999	100	26	25	13	10	8	8	5	4	1	1	(1)
$5,000 to $7,499	100	14	25	16	14	8	12	6	3	1	1	(1)
$7,500 to $9,999	100	4	18	16	15	17	16	7	3	2	2	(1)
$10,000 to $14,999	100	4	9	13	13	16	24	10	4	3	3	1
$15,000 to $24,999	100	(1)	2	9	6	16	29	13	5	11	6	3
$25,000 to $49,999	100	1	(1)	2	2	6	14	20	10	24	12	10
$50,000 to $99,999	100	(1)	(1)	(1)	4	1	12	4	3	37	28	12
$100,000 and over	100	1	(1)	(1)	(1)	1	1	(1)	3	11	60	24

1 Less than ½ percent.

Source: Board of Governors of the Federal Reserve System, Survey of Financial Characteristics of Consumers, August 1966, p. 102.

Question 3. A number of the Federal Government's own activities have a significant and direct impact on costs and prices in the economy. Among these are included federal employment and pay policies, purchasing, procurement and contracting practices, direct lending and loan insurance, commodity stockpiling and import restrictions. Also included is Department of Labor Administration of the Walsh-Healey and Davis-Bacon acts, under which wages and salaries on jobs connected with the federal procurement and construction are determined.

Has the Administration devised any way of coordinating these policies and programs to insure they do not contribute to inflation? During the final years of the Eisenhower administration, these activities were under continuous scrutiny by a Committee on Government Activities Affecting Costs and Prices. Don't you think reactivation of such a group would be valuable?

Answer. The impact of the Federal Government's own activities on costs and prices in the economy is presently within the purview of the Cabinet Committee on Economic Policy. This Committee has already established subcommittees to study specific problem areas such as lumber and copper.

Question 4. You state in your testimony that restrictions on international transactions effect losses in real income, and that their balance of payments effect is likely to be eroded in the longer run. What does this imply for the future of the restrictions presently in effect under the Office of Foreign Direct Investment and the Federal Reserve Program? How long a period are you thinking of when you state that "in the longer run" the balance of payments effects of these restrictions are likely to be eroded? Approximately how much loss in real income can be attributed to these controls?

Answer. For a number of reasons, the short-term balance of payments gains of a program such as the foreign direct investment program will tend to be eroded over time. As the foreign direct investment program was aimed at encouraging the foreign financing of direct investment, rather than decreasing direct investment as such, the most obvious offsetting balance of payments cost is the future interest payments which will have to be made on the foreign borrowing.

But the offsetting balance of payments costs go beyond the interest cost. While considerable care has been taken to affect the financing rather than the amount of foreign direct investment as such, the program undoubtedly has some effect in reducing the attractiveness of investment abroad. Insofar as this is the case, the flow of income from foreign investment in future years is diminished.

In addition, the reduction in foreign dollar holdings may have more indirect and hard to identify offsetting effects on the U.S. balance of payments. While the international adjustment mechanism works very imperfectly, there is some tendency for U.S. expenditures abroad to trickle back to the United States. Thus, the ultimate balance-of-payments gains or costs of U.S. policy decisions will tend to be less than the direct original balance-of-payments gains or costs.

Together, these considerations suggest that a very prolonged period of foreign direct investment controls is difficult to contemplate. Unfortunately, it is difficult to see how the controls can be ended in the immediate future, however.

Question 5. The Eurodollar market has had a rapid development in the past two years, but it still does not constitute a true European capital market. For example, it is most unregulated and thus could pose a threat to national currencies and domestic liquidity in times of financial crisis. It is supported to a large degree by short term capital. Partly for this reason, it is susceptible to rapid shifts in the funds of depositors, which characterized the market last year. What future do you see in store for the Eurodollar Market? What do these developments imply for U.S. policy? In your opinion, did the action of the Federal Reserve in limiting the extent to which U.S. banks could turn to Eurodollar borrowing to satisfy domestic credit demands, together with the actions of some European countries in restricting the outflow of funds from their domestic capital markets into the Eurodollar markets, constitute the best and most efficient way of dealing with the pressures on the Eurodollar market in 1969?

Answer. The Euro-dollar market has become one of the major links between national short-term money markets and appears likely to remain so for the foreseeable future. While its growth received strong impetus from restrictions on competitive financial practices in many major money markets, it has now reached a stage of specialized financial intermediation which should assure its survival even if the national financial restrictions which fostered its development were removed. The market has shown a remarkable ability to adapt quickly to changing conditions and to handle large shifts in the demand and supply of funds. It is largely unregulated and there is no single financial institution which has the power to act as a lender of last resort to assure the avoidance of a financial collapse in the way that the Federal Reserve protects our domestic banking system. However, the Bank for International Settlements and the major national central banks have cooperated as a group in helping to smooth the market when necessary by adding or drawing off funds.

There seems to be little danger that the Euro-dollar market would be the cause of a major financial crisis.

As a major vehicle for short-term capital flows between national money markets, the Euro-dollar market has become a symbol of the increased interdependence of national monetary policies. Because of its large size, the United States feels the influence of monetary conditions abroad less strongly than do smaller countries, but in turn, U.S. monetary conditions have a greater influence on monetary conditions elsewhere. Recently high interest rates in the U.S. have placed heavy pressures on interest rates in the Euro-dollar market and in turn, in the national money markets in Europe. These interest rate pressures and concomitant heavy borrowings of U.S. banks from abroad caused concern on both sides of the Atlantic. The actions taken by a number of European countries to limit lending to the Euro-dollar market and by the Federal Reserve to limit the extent of U.S. borrowing from the market resulted from this concern, and under the circumstances we do not consider them inappropriate. The basic solution to recent pressures on the Euro-dollar market, however, will come with the easing of interest rates in the U.S. that should occur as domestic inflation is dampened.

It should be added that the heavy Euro-dollar borrowings by U.S. banks during 1968 and 1969 were the result not only of general monetary conditions in the U.S., but also of regulations affecting competition for funds by domestic financial institutions, especially Regulation Q. The appropriateness of the Federal Reserve actions to limit Euro-dollar borrowings must be reviewed in light of the equity and efficiency considerations surrounding the structure of our domestic financial system, a subject to be studied by the Presidential Commission on Financial Institutions soon to be appointed. It should also be added that, while the Euro-dollar market has proven to be the most convenient channel for most of the recent inflow of short-term capital into the U.S., these flows are primarily the result of the increasing international mobility of financial capital *per se*. In the absence of the Euro-dollar market, alternative channels for the flow of most of these funds would probably have been found.

THE 1970 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 17, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:10 a.m., in room G-308, New Senate Office Building, Hon. William Proxmire (vice chairman of the joint committee) presiding.

Present: Senators Proxmire, Miller, and Percy; and Representatives Reuss, Griffiths, Moorhead, Widnall, and Conable.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling and George D. Krumbhaar, economists for the minority.

Senator PROXMIRE (presiding). The committee will come to order.

Today we welcome Mr. Robert Mayo, Director of the Budget.

The Budget Director is always a central figure in our annual hearings but this year his appearance is more important than ever. The administration has given tremendous weight in its economic policy mix to the projection of a very small surplus, $1.3 billion.

It seems obvious to me, Mr. Mayo, that this surplus is a highly tenuous and uncertain one. It depends on speeding up tax collections, enactment by Congress of $650 million in user charges, extension of the excise tax rates at present levels, increasing the social security tax base, and raising the revenue from the railroad retirement system. It also depends on Congress taking action to end or revise various programs and deferring the civilian and military pay increase. It also assumes an increase in postal rates and other revenues of the system. All in all, these items aggregate over $5 billion. If none of them were adopted then we would have a deficit of $4 billion instead of a small surplus.

I don't think these proposals will be adopted in their entirety. Some of them may be and some will not. But I do say that this Congress will cut the budget as submitted. During 1969, the Congress cut defense spending authority by $5.6 billion and foreign aid by $1.1 billion. We increased labor and welfare items—originally by $1.1 billion. We therefore cut the budget substantially and yet reordered priorities by using some of the savings from defense for needed domestic programs.

I predict further reduction in the budget during 1970. I believe there should be further defense cuts, we should vastly reduce the thousands of bases scattered throughout the world. I believe we ought to bring home and discharge at least a hundred thousand of our troops in Europe. We should stretch out the space program and substitute unmanned for manned flights. Our $5 billion highway construction should be slowed down and reduced. We ought to fight pollution by placing an effluent charge on the polluters. Furthermore, there is a great deal we can do to improve the effectiveness and efficiency of Government programs, as was indicated in the recent report of the Subcommittee on Economy in Government on Economic Analysis and the Efficiency of Government.

I want to welcome you and tell you that I have had a chance to study your statement, and I think it is a fine one. You proceed in any way you wish.

STATEMENT OF ROBERT P. MAYO, DIRECTOR OF THE BUREAU OF THE BUDGET; ACCOMPANIED BY JAMES R. SCHLESINGER, ACTING DEPUTY DIRECTOR; MAURICE MANN, ASSISTANT DIRECTOR; AND SAMUEL M. COHN, ASSISTANT DIRECTOR FOR BUDGET REVIEW

Mr. MAYO. Thank you, Mr. Chairman. In reflecting on your openings remaks, I think we will develop some of the points as we go along. I merely want to start out by complimenting the Congress for ratifying the defense cuts that we proposed last July. I think that was a splendid accomplishment on behalf of both the Administration and the Congress.

Senator PROXMIRE (presiding). Well, you put it the other way, you know. But we will come to that.

Mr. MAYO. Yes, sir.

Mr. Chairman and members of the committee, when I testified before this committee last February, I observed that balanced economic growth at a pace consistent with optimum use of the Nation's resources does not just happen. Fiscal, monetary, and other economic policies must work in harmony to support basic economic objectives. A year ago, a policy of fiscal restraint was appropriate because of the strength of inflationary forces in the economy. Such a policy was adopted and maintained throughout the year. In addition, an appropriately restrictive monetary policy of the Federal Reserve System limited the flow of money and credit.

The effect of these policies of restraint are reflected in many of the tables and charts of Economic Indicators. There can no longer be any doubt that the economy is cooling off. As in similar situations in the past, however, price increases stubbornly persist at an unacceptable rate despite the slower pace of economic activity.

The slow reaction of prices to changes in the pace of economic activity is especially true in periods like the present, when cost and price inflation has persisted for a sustained period of time and has become deeply imbedded in the structure of the economy. Time will be required to dislodge the inflation. If we retreat, or relax our efforts before inflation is brought under effective control, whatever progress we might have made can be lost quickly as economic growth resumes. This is why the President proposed in his budget message that fiscal restraint be maintained in the current fiscal year and continued in 1971.

Emphasis on fiscal restraint is particularly appropriate now. The need to reduce inflationary pressures and expectations is clear. Fiscal restraint performs this function directly by reducing the demand for goods and services. It also helps relieve pressures in financial markets by reducing the Federal Government's demands for credit. For both of these reasons, continued fiscal restraint increases the possibility that the Federal Reserve System will find it possible to move modestly away from as restrictive a monetary policy as we had in 1969. Relief on the monetary front would be particularly welcome in those sectors of the economy—notably, housing and State and local governments—that have borne a large share of the burden of past imprudent budget deficits and the necessarily tight credit conditions growing out of them.

BUDGET TOTALS

The 1971 budget meets these fiscal policy requirements. It provides for a third successive year of surplus—a necessary antidote to the $25.2 billion deficit of fiscal year 1968. Outlays in fiscal year 1971 are estimated at $200.8 billion and receipts at $202.1 billion, producing a surplus of $1.3 billion.

This is a prudent and a responsible budget. The surplus results from stringent expenditure control. Budget outlays are estimated to be $2.9 billion higher than in 1970, an increase of only 1.5 percent.

The outlook for budget receipts will be discussed in some detail on Thursday by Secretary Kennedy. In brief summary, however, let me mention that termination of the income tax surcharge will cause revenues to decline $8.5 billion from 1970 to 1971. The surtax itself brings in $9.9 billion of revenue in fiscal 1970 and $1.4 billion in 1971, which is merely spillover from 1970. The difference between these amounts is the $8.5 billion.

On the other hand, higher incomes and administratively accelerated collections of income and excise taxes will produce $9.7 billion of additional receipts, and the extension of the automobile excise and the telephone excise taxes will be expected to add $1.6 billion more. Thus, total receipts will rise by $2.7 billion in the fiscal year 1971.

BUDGET TOTALS

[Fiscal years. In billions]

Description	1968 actual	1969 actual	1970 estimate	1971 estimate
Receipts	$153.7	$187.8	$199.4	$202.1
Outlays	178.8	184.6	197.9	200.8
Surplus (+) or deficit (−)	−25.2	+3.2	+1.5	+1.3

There is reason for confidence that fiscal restraint is effective in helping to curb inflation now. Price movements are influenced by a number of factors, including the Federal fiscal position and the pace of economic activity.

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Between fiscal years 1960 and 1965, budget outlays rose by an average annual rate of 5.1 percent, and the budget was continually in deficit. But this was also a period of under utilization of the Nation's productive capacity, and the fiscal stimulus served primarily to increase production rather than to inflate prices. The consumer price index rose a modest 1.2 percent per year on the average.

The table that follows indicates what has happened to the budget surplus or deficit over the years from 1960 through estimated 1971, the GNP gap as a percentage of full employment GNP—which is a rough measure of capacity utilization in the economy—percent change in budget outlays, and, finally, percent change in consumer prices.

BUDGET TOTALS, ECONOMIC ACTIVITY AND CHANGES IN PRICES, FISCAL YEARS 1960-71

Fiscal year	Budget surplus or deficit (−) (in billions)	GNP gap as a percentage of full employment GNP	Percentage change in— Budget outlays	Percentage change in— Consumer prices
1960	$0.3	5.6	0.1	1.4
1961	−3.4	8.2	6.0	1.3
1962	−7.1	6.1	9.2	1.1
1963	−4.8	5.2	4.2	1.1
1964	−5.9	3.8	6.5	1.4
1965	−1.6	2.6	−.1	1.3
1966	−3.8	[1] −1.4	13.7	2.1
1967	−8.7	[1] −.6	17.5	3.1
1968	−25.2	[1] −.3	13.0	3.3
1969	3.2	[1] −.9	3.2	4.8
1970 (estimated)	1.5	[2] .7	7.2	[3] 5.7
1971 (estimated)	1.3	[4]	1.5	[4]

[1] Actual GNP was higher than full employment GNP.
[2] 1st half of fiscal year 1970.
[3] Increase during 1st half of fiscal year 1970 over 1st half of fiscal year 1969.
[4] Not available.

During the period 1966 through 1968, both budget outlays and the size of the budget deficit increased substantially. In fiscal year 1966, the economy was operating at an unsustainably high level, however, and the fiscal stimulus added significantly to upward pressure on prices. While consumer price index grew moderately, by current standards, the rate of increase was more than twice that of the years 1960–65—and rising. Moreover, this stimulus—especially the 1968 deficit—helped create the momentum of price increases and the imbalances that are serious factors in today's economy.

The shift to restraint in fiscal year 1969 represented the beginning of the process of breaking the momentum of rising prices. First, there was a sharp drop in the rate of increase in budget outlays and a dramatic shift from deficit to surplus. During fiscal 1969, however, the economy continued to operate at faster than its optimum rate, and price increases accelerated. In the first half of fiscal year 1970, the gap between actual gross national product and potential gross national product reappeared. It is likely to grow over the next few quarters as the effect of the recent policies of fiscal and monetary restraint take firmer hold. As it does, aggregate pressure on prices will ease.

Even so, the 1.5 percent increase in budget outlays in fiscal year 1971 is less than the probable increase in prices over the same period. This means that budget outlays will actually decline in real terms—a further indication of the outlay restraint built into the 1971 budget.

Budget outlays are expected to increase $2.9 billion in 1971. Increased public assistance and social security benefits alone will account for $6.8 billion, while proposed new initiatives of this administration will add another $3.2 billion—for a total of $10 billion. Increases of this magnitude for certain kinds of Federal programs cannot be regarded as abnormal in an economy as large as ours. But we cannot and should not rely solely upon the availability of increased tax receipts to finance them.

With this principle in mind, we examined the base of the budget along with proposed additions to the base when we prepared the 1971 budget. These efforts led to:

Reductions of $6.3 billion in defense and space expenditures, and

A net decrease in other programs of $0.8 billion, even after an allowance of $1.4 billion for a pay increase for Federal employees to move toward comparability with pay in private industry.

Proposed terminations, restructuring and reductions will lower outlays by $2.1 billion in 1971. These relate to programs that, however worthy, are no longer of high enough priority to justify their cost to the taxpayer. The proposals are itemized in the budget document. The largest of them are:

Program terminations, restructuring, and reductions

[Fiscal year 1971. Outlays in millions]

Item	*1971 savings*
Program terminations	$300
Special milk and agricultural conservation	(130)
Federal ownership of the Alaska Railroad	(100)
Program restructuring	1, 396
Sale of excess strategic and critical materials now stockpiled	(751)
Education aid to federally affected areas more closely related to need	(196)
Eliminate duplicate or unnecessary veterans benefits	(106)
Program reductions	436
Postponement of additional procurement (launch vehicles and spacecraft) and lunar flight schedule	(402)
Total, program terminations, restructuring, and reductions	2, 132

CHANGING PRIORITIES

New initiatives, by which we mean tax reduction and debt reduction as well as new or expanded programs, are part of the shift in priorities reflected in the 1971 budget. The initiatives include long-overdue reforms and improvements in several Government programs, such as—

Programs to improve the quality of our physical environment;

A vigorous attack on crime;

The family assistance program, which will replace an outmoded and unworkable welfare system;

The food stamp program;

Revenue sharing with State and local governments;

Modernization of the Nation's system of airports, airways, and public mass transit; and

An expanded rural housing program to help families with low-to-moderate incomes obtain adequate housing.

As a result of the emphasis given to these and other relatively high-priority programs in the budget, the Federal Government plans to spend more on human resources programs than on defense for the first time since 1950. The shift was gradual during the 1960's, as defense spending—which was 62 percent in 1953—dropped from 50 percent of the total in 1960 to 44 percent in 1969 and spending on human resources programs rose from 28 percent to about 34 percent. The shift between 1969 and 1971 will be as great as that during the preceding 9 years. Defense outlays will drop to below 37 percent of the total in 1971, while outlays for human resources are expected to rise to almost 41 percent of the total. Between 1969 and 1971—

National defense outlays will decline by $7.7 billion or at an average annual rate of 4.8 percent;

Spending for space research and technology, and for international affairs and finance, will be $1 billion lower in 1971 than in 1969;

Outlays for human resources programs will increase $18.3 billion, or at an average annual rate of 13.5 percent;

Law-enforcement and crime-prevention activities rise from $658 million to $1.3 billion—an increase of 91 percent;

Federal spending to improve the quality of the environment is expected to be $471 million higher in 1971 than in 1969—an increase of 73 percent—as we step up our efforts to control air and water pollution and develop our recreational resources. Moreover, under the plan proposed in the budget, 1972 outlays for these purposes will reach $1.5 billion, and higher figures in later years.

The growth in human resources programs is substantial quite apart from trust fund benefits which, of course, are growing. Between 1969 and 1971, when total budget outlays are increasing by $16.2 billion, outlays for human resources programs financed outside of trust fund receipts are rising by about $6½ billion—more than one-third of the total.

CONTROLLABILITY OF BUDGET OUTLAYS

A major reason for the budget's generally slow reaction to changing needs is the relative uncontrollability of budget outlays in the short run. Only 31 percent of budget outlays in 1971 is today subject to discretionary control. Moreover, the proportion of outlays that is relatively uncontrollable is rising—from 64 percent of total outlays in 1969 to 66 percent in 1970, and to an estimated 69 percent in 1971.

A classification of major outlays according to their relative controllability is shown in the following table. The table contains the factual support for the statement that I just made.

CONTROLLABILITY OF BUDGET OUTLAYS

[Fiscal years. In billions]

Controllability in 1971	1969 actual	1970 estimate	1971 estimate
Relatively uncontrollable outlays under present law:			
Open-ended programs and fixed costs:			
Social security, medicare, and other social insurance trust funds under January 1969 laws	$39.8	$43.8	$46.9
Social insurance benefit increases recently enacted		1.8	4.6
Military retired pay	2.4	2.9	3.2
Interest	15.8	17.8	17.8
Veterans benefits: Pensions, compensation, education, and insurance	5.7	6.4	6.7
Public assistance grants (including medicaid)	6.3	7.5	8.5
Farm price supports (Commodity Credit Corporation)	4.1	3.5	3.7
Postal operations directly related to mail volume	0.5	0.9	0.9
Legislative and judiciary	0.4	0.5	0.5
Other	1.5	2.2	2.2
Outlays from prior-year contracts and obligations:			
National defense	25.5	25.5	23.7
Civilian programs	16.4	18.5	19.6
Subtotal, relatively uncontrollable outlays	118.6	131.3	138.4
Relatively controllable outlays:			
Proposed allowance for revenue sharing			0.3
Civilian and military pay increases		0.2	1.4
Postal rate increase		−0.2	−1.2
Other national defense	53.2	51.1	46.7
Other civilian programs	17.9	21.6	21.8
Undistributed intragovernmental transactions	−5.1	−6.1	−6.6
Total budget outlays	184.6	197.9	200.8

The brunt of the shift in priorities in the 1971 budget is borne by defense. The budget calls for $73.6 billion in outlays for national defense—this is our broad functional classification of national defense—down $5.8 billion from 1970, and $7.7 billion below 1969. The decrease is $10 billion below 1969 if pay raise effects are eliminated to put the 1969 and 1971 numbers on a comparable basis.

We believe in a strong national defense, and we are committed to maintaining one. In the uncertain world of today, with changing threats and new technology, our commitment implies substantial resources for defense. It does not mean that we spend money unquestioningly. Indeed, our defense requirements have been subjected to a long-needed, intensive scrutiny. As a consequence, our defense forces are being restructured so that they can carry out their functions at lower cost and with lower manpower levels. The reductions in defense programs in 1971 are based on such reexamination, and a consequent restructuring of our forces. Even so, as the "controllability" table indicates, more than one-third of defense outlays in 1971 will be uncontrollable, consisting either of the pay of retired military personnel—$3.3 billion—or commitments under prior-year contracts and obligations—$23.7 billion.

The largest reductions in defense spending are in military activities of the Department of Defense, and include:

$1.1 billion in military personnel—a $1.4 billion reduction for active military personnel and a $0.3 billion increase for retired personnel;

$1.8 billion in operations and maintenance; and

$2.8 billion in procurement.

The reduction in military personnel costs—including retired pay but excluding the proposed pay raise—reflects a drop of more than 385,000 in the size of the Armed Forces between December 1969 and June 1971.

The decline in outlays for operation and maintenance partially reflects lower support requirements for general purpose forces, including deactivation of older ships and aircraft. The balance of the decrease reflects a reduction of Defense Department civilian employees of more than 82,000 from the end of calendar year 1969 to June 30, 1971.

The bulk of the reduction in procurement outlays is concentrated in conventional weapons such as aircraft, vehicles, ammunition, and tactical missiles.

LONG-RANGE OUTLOOK

A major innovation in the 1971 budget is the inclusion of a 5-year projection—a preview of the future. We know that our ability to satisfy the Nation's needs will be limited by the available resources—our capacity to produce goods and services. We are the richest nation on earth and the most productive nation on earth. We have great imagination, and we have great desire to satisfy human wants and human needs, in addition, but our capacity is not unlimited. If demand is in excess of this capacity, inflation follows. If demand is deficient, unemployment ensues. The Federal Government has an important role to play in seeing that demand is roughly equal to potential output, as part of its responsibilities related to high-level employment and price stability.

In addition, the Federal Government has a significant voice in allocating the Nation's output—both between the private sector and the public sector and within these sectors. Of course, the budget allocates resources within the Federal sector, and the proportion allocated to grants affects the distribution between the Federal Government and State and local governments. The budget impact on financial markets influences the private allocation between consumption and investment. We believe that the longer range influence on the budget should be recognized, its effects appraised, and decisions consciously made to achieve the effects that are preferred.

We are particularly conscious of the long-range impact of budget decisions already made or those likely to be made in the near future. It is for this reason that the 1971 budget document includes a section on the outlook for 1975. These projections are not forecasts or precise estimates. They are indeed quite rough. They are intended only to present a broad, general picture of the problems we may face under certain assumptions.

The budget projections for 1975 are, of course, consistent with the economic projections contained in the Economic Report. The methodology is as follows:

A projection of gross national product was made, based on assumptions of high employment, growth in productivity, and a return to relative price stability;

Federal receipts consistent with the GNP projection were estimated, assuming existing and currently proposed legislation consistent with the potential GNP; and

Federal outlays under existing and currently proposed legislation were estimated.

The difference between Federal receipts and outlays represents the margin remaining for new initiatives—either tax reduction, debt reduction, or new or expanded spending programs. I stress that we have to think in terms of all three, not just new or expanded spending programs. The margin can be increased, of course, if we can cut further into the existing budget base, or if we decide to raise taxes to finance urgently needed programs or to provide a surplus which in turn would permit greater credit availability in the financial markets.

The table below shows the projections of 1975 Federal receipts and outlays and an estimate of the margin remaining for discretionary action between 1971 and 1975.

PROJECTED RESOURCES

[Fiscal years. In billions of current dollars]

Item	1971 estimated	1975 projected
Revenues [1]	$202	$266
Outlays:		
Current programs	200	228
Price, pay, and workload increases		(20)
Net increase in other current programs		(8)
Initiatives reflected in this budget	3	18
Less outlays for terminations, restructuring, and reductions	−2	−2
Total	201	244
Funds to cover new initiatives		22

Includes effect of legislation proposed in this budget.

Federal receipts under present law and legislation proposed in this budget are estimated to increase to $266 billion in 1975. The ratio of revenues to GNP is likely to be slightly lower in 1975 than in 1970 because of the termination of the surtax and the provisions of the Tax Reform Act of 1969. Continuation of the same ratio of receipts to GNP as in 1970 would raise total revenue in 1975 by $16 billion.

Outlays for existing programs are estimated to increase $28 billion between 1971 and 1975, an average of $7 billion per year. Much of this expansion is "built in." Some results from a growing population in which increased numbers of people will be eligible for benefits under the veterans and social security programs, and some is for higher pay and prices.

The cost of new initiatives proposed in this budget is expected to increase from $3 billion in 1971 to $18 billion in 1975. That includes family assistance, revenue sharing, environmental quality, and other programs.

This leaves a $22 billion margin, net, to cover new initiatives during the 1972–75 period. This amount is very small—only about 1½ percent of our estimated national product—and certainly inadequate to accommodate needed programs or likely proposals.

The projections are not shown by program or program categories because detailed projections would be made more illusory than helpful. The principal value of the projections is to measure in broad, general magnitudes the gap that may exist in 1975 between Federal revenues under existing and currently proposed legislation and projected Federal spending for programs proposed in the 1971 budget. Almost certainly, the 1975 budget will not fit any projection we might make at this time. The $22 billion margin is not available for spending now and—because of actions taken in the interim—undoubtedly will not be available by the time we get to 1975. However, the projections serve the important function of highlighting the fact that our resources are not sufficient to satisfy all likely potential meritorious claims on them.

The message of these projections is that we will have to establish priorities and face up to hard choices in deciding what is most important. Each of us has different priorities, and these differences will be the source of much debate among us. These differences will be resolved through the budget process—as the President makes his budget recommendations and the Congress acts on them. Budget formulation is, as I stated before this committee last September, a highly political exercise in the American democratic system. And it should not be otherwise. We have attempted, in intiating this new departure in Federal budgeting, to provide a broader perspective in which the annual budget process can be carried out by both the executive branch and the Congress.

Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). Thank you very much, Director Mayo. You are certainly one of the most competent men in Government. We all know that, and I think this statement of yours demonstrates it once again.

What's your answer to the frequent criticisms of the size of this surplus? You have indicated that it is \$1.3 billion, you have indicated that it is an element in fighting inflation, you have indicated that it is an element in helping to hold down other inflationary forces so the Federal Reserve Board can ease credit and, hopefully, it can come down. Yet it does seem to be pitifully small.

Mr. Mahon pointed out that, if we base this budget on the same basis that President Kennedy and President Johnson did, it would be a \$7 billion-plus deficit. I pointed out in my opening remarks that if we don't get the somewhat questionable—questionable in terms of whether we can get them or not—proposals the President has made, there will be a \$5 billion deficit even on your terms. What's your answer to this precarious deficit at a time when inflationary forces seem to call for a more substantial one?

Mr. MAYO. This is, indeed, a thin budget surplus. There is no question about that, Mr. Chairman. But let us go back to what the budget is in the first place, though, as we analyze the point which you so properly raise. The budget is the President's financial plan. It is his proposals not only for what he can do himself within his administrative, constitutional powers, but also his recommendations to the Congress. Indeed, the first page of the budget, if I need remind any of you, starts off "To the Congress of the United States."

In doing a financial plan, the President finds it incumbent upon him, if he is to do a good job, to present a plan that he thinks serves the best interests of the country. Indeed, he must not only present it and let it sit there, but go up to the Hill with us as his agent, and to try to convince the Congress that this is the proper way to run the financial affairs of the U.S. Government.

The President is not naive in thinking that the Congress is going to go along automatically with every single item that is in this budget;

for example, on postal rate increases, and many of his other recommendations. Yet as you face up to the problems of responsibility of the Executive, you come out with a plan which the President urges the Congress to enact, I think, basically, that is my answer. It is our fervent hope that the President's plan will be embraced by the Congress in its entirety, as a proper expression of the needs of the country at this particular time.

Senator PROXMIRE. I think that is true, but you see, my question related to the impact of this budget on what many people feel is our most serious domestic economic problem—inflation.

Mr. MAYO. Yes.

Senator PROXMIRE. And it does not seem to be a budget which will contribute to holding down prices by providing a substantial surplus. In order to achieve that, some of us feel that you should and could—this is something I imagine we will debate a little further—cut military spending much more sharply than you have.

You have cut it, it is true. But that cutback, in view of the announced plan for Vietnam, seems to be grossly inadequate and does not measure up to the kind of deescalation that the President has indicated. It is only a $5 billion cutback, as I understand it, in a $76 billion military budget.

As I pointed out yesterday, the Secretary of Defense announced that as of the beginning of this coming fiscal year the spending in Vietnam would be down to $17 billion, which is $13 billion below what it was at its peak, and throughout the period, it would continue to drop. Presumably, there would be a great saving there and there doesn't seem to be anything like that reduction in the very limited, modest reduction you have in the budget.

Mr. MAYO. We have, I think, a much more substantial cut in the military budget than your figures would indicate, Senator Proxmire. The cut of $13 billion that you refer to was from a $30 billion peak, an annual rate peak that I believe was calculated for sometime during the fiscal year 1969. The figure of $17 billion that you use for Vietnam spending at the end of this fiscal year is a figure which Secretary Laird used here up on the Hill as recently, I believe, as November or December. That figure was also an annual rate, at the end of the year.

Senator PROXMIRE. The end of this 1970 fiscal year.

Mr. MAYO. Yes, this is right.

Senator PROXMIRE. The beginning of the coming fiscal year.

Mr. MAYO. That is right. But let me hasten to add that even if you accept the premise, which I really do not, that these figures on Vietnam spending are good, sound figures—even if you accept that premise——

Senator PROXMIRE. I hesitate to interrupt, but at this point are you implying that Secretary Laird's figures are not sound?

Mr. MAYO. I am merely saying that those are figures based on a concept that was carried over from the prior administration in an attempt originally to measure incremental costs and then the associated costs of Vietnam. I think such figures give some illusion as to the size of Vietnam spending by suggesting that all of this estimate would be available for other purposes if Vietnam disappeared. And that, I think, is one of the reasons why this set of figures has been warped out of its original context.

Senator PROXMIRE. I am sure they are not available. One of the original problems is that they should be available. I realize that the inventories that have been depleted have to be replenished. I realize that some procurement actions have been postponed. I also realize that there are ambitious weapons systems that are going to cost a lot of money. It is going to be helpful to us, and I think Congress could make better judgments on these weapons systems, if we had a specific projection of the costs of these weapons systems and how much they are going to contribute to the size of budgets in coming years—how much MIRV is going to contribute, how much ABM is going to contribute, how much the Advance Manned Satellite system, and so on.

You have given us a projection, but it doesn't even break down the military costs, as I understand, the increased costs over the next 5 years.

Mr. MAYO. I would like to return for a moment to this concept of a $13 billion decline in Vietnam spending, which is at the heart of your analysis of what happened to the peace dividend. I would emphasize that, basically, the only way we can make an analysis like this is to deal with fiscal year totals rather than rates at different points during a year. I think we will find, again using the figures that Secretary Laird has used, that there was a cut in Vietnam spending of $5.6 billion from the fiscal year 1969 total to the fiscal year 1970 total. That, of course, is quite different than the suggestion that there has been a cut from $30 billion to $17 billion, which only deals with annual rates at a peak and at the end of a period.

Senator PROXMIRE. Once again, I am talking about the reduction in the coming fiscal year.

Mr. MAYO. Yes; I would like to come to that.

If we take out our pencils and paper here and take this $5.6 billion, which was the cut in Vietnam spending in fiscal 1970, according to Secretary Laird's figures, we would then also find that there are military personnel reductions through 1971 over and above the cut in Vietnam spending of another $2.5 billion. There are other savings not associated with personnel of $4.7 billion in the 1969–71 period. So, by these calculations we have a figure, Mr. Chairman, of $12.8 billion of savings, gross savings, in the budget figures for the military activities of the Department of Defense going from 1969 to 1971. This is comprehensive.

We have to add back, though, some things that have happened in this same 2-year period. For instance, there have been pay increases affecting both the military and the civilian employees in the Defense Department that would add back $2.6 billion during this same 2-year period.

We find that retired pay is up $700 million. We find that price increases, costed out during this same 2-year period, account for another $2.6 billion. These items add to $5.9 billion.

If we subtract that figure of $5.9 billion, Mr. Chairman, from the $12.8 billion that I indicated as gross savings, we come up with a figure of $6.9 billion for net savings in the budget for the 2 fiscal years. As you know, these savings are reflected in the budget as expenditure cuts of $1.7 billion from 1969 to 1970 and $5.2 billion from 1970 to 1971.

Senator PROXMIRE. My time is up, Mr. Director. I will be back. Before I yield to Senator Miller, I would like to say that it is very difficult for us in the committee when you come up and give us this kind of response, which is completely honest, and I am sure competent. You see, this kind of analysis ought to be in the budget when we get it. We ought to know what the cost of Vietnam is. It was reported before. It is not reported this year. You don't break it out at all. It is being concealed from the American public this year. And unless we have that so we can analyze it, unless we have projected cost of weapons systems and so forth, we are not going to be able to make thoughtful, intelligent decisions, which we have to make, it seems to me, if we are going to provide the kind of defense we need and also the kind of provisions for the other costs of Government.

Mr. MAYO. I understand your point, Mr. Chairman. I merely urge you and, in fact, all of us, to look at military spending as a whole rather than trying to split the figures into Vietnam and non-Vietnam. The "Vietnam" figures are, as I suggested earlier, without any real accounting basis.

Senator PROXMIRE (presiding). I will be back on that one.

I yield to Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

Nice to have you here, Mr. Mayo.

First, let me say that I am encouraged when my colleague, the acting chairman, forecasts that Congress will cut the budget this year. May I say that I will believe it when I see it, that Congress has cut the proposed spending budget outlays from $200.8 billion. I understand that my colleague will be offering amendments, some of which I have supported in the past and some of which I will continue to support. But unfortunately, he has been outvoted and I must say that I think he is in a good position to say he would like to and will try to cut the budget. But a majority of the Members of the Congress have not agreed with him or with me on this point.

So only time will tell whether this will happen, but on the basis of my experience, I will believe it when I see it.

The acting chairman did make a comment, however, that Congress had cut the budget by $5.5 billion this year. I thought this had all been gone into in my colloquy on the floor of the Senate with the Senator from Washington, Mr. Magnuson. I think for the record, I will simply have to go into it all over again now.

It is my understanding first of all, Mr. Mayo, that there was $135 billion of formal budget requests presented to the Congress and that, subsequent to the presentation of those figures to the Congress, the administration, on its own initiative cut those figures so that by the time the Appropriations Committees were taking action on the various programs, in effect, they ratified the cuts that were already made by the administration.

Is that correct?

Mr. MAYO. That is correct.

Senator MILLER. So that it is true that the formal budget requests which were sent over to Congress early last year were cut. They were cut on the initiative of the administration and ratified by the Congress. Is that so?

Mr. MAYO. Yes; that is correct.

Senator MILLER. Then may I say further that to make this eminently clear to the people, the $135 billion quite obviously does not represent the total spending for the fiscal year, because the total spending comes out at about $198 billion, is that so?

Mr. MAYO. Yes.

Senator MILLER. So we have a gap between $135 billion and $198 billion, and not much is said about that gap, because it is my understanding that the Congress increased the spending in that area by over $5 billion, is that so?

Mr. MAYO. Yes, total outlays in 1970 are now estimated to be $5 billion above the administration's April estimate.

Senator MILLER. So that the overall action by the Congress on the $198 billion of spending actually exceeded what the President requested the Congress to do or by his own initiative reduced the original budget figures by, is that correct?

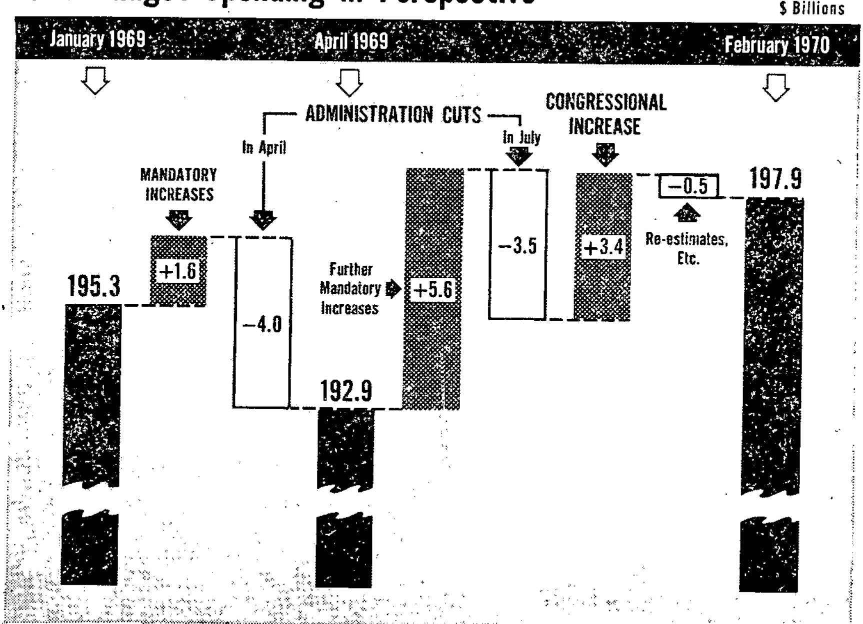
Mr. MAYO. Yes. There are three basic factors, Senator Miller, that are important here.

There are the cuts that we made. There are the increases in the mandatory items—uncontrollables—over which as a practical matter neither the Congress nor the Executive has very good control, indeed if any control. Then there are the increases that resulted from either congressional action or, in some important cases, the decision of the Congress not to approve administration proposals, such as an increase in postal rates and certain adjustments in spending programs. I have a chart here that, with the chairman's permission, I would like to see introduced into the record.

Senator PROXMIRE (presiding). Without objection, that will be done.

(The chart referred to follows:)

1970 Budget Spending in Perspective



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Mr. MAYO. This will show the 1970 budget picture in perspective, Senator Miller.

Your point is very well taken that the difference between budget authority or permission to spend and actual spending can be a source of confusion on many occasions. I think the chart I have in front of me here, which has been publicly released before, will clarify that.

We started out a year ago inheriting a budget of $195.3 billion of spending for 1970. By the time we came down the line 3 months later to announce our first budget—a budget in which we cut estimated spending by $4 billion—we found that mandatory increases in the budget had already risen by $1.6 billion. The sum of those figures, the $1.6 billion increase and the $4 billion in cuts, gave us the figure of $192.9 billion which is familiar to all of us by now.

However, the world kept moving along. Interest rates, social security benefits and other relatively uncontrollable programs rose further without any congressional or Executive action, adding another $5.6 billion to the budget. We cut another $3.5 billion in July. As I indicated in response to the chairman's opening statement, we are very pleased that the Congress saw fit to validate this reduction of $3.5 billion a few months later. But then, also, the Congress did add $3.4 billion, either through inaction on administration proposals or through action of their own, such as increasing social security benefits by 15 percent rather than by the administration's estimated need of 10 percent. Thus, we come out with the current estimate of $197.9 billion for spending in fiscal year 1970.

Senator MILLER. Thank you, Mr. Mayo.

I regret that it was necessary to go into this. As I said, this was all gone into in a colloquy I had with the Senator from Washington, Mr. Magnuson, some time ago. The figures you refer to are largely contained in a table which I inserted in the Congressional Record, based upon, or taken out of, I should say, a report by the Joint Committee on Reduction of Federal Expenditures headed by the distinguished chairman of the House Appropriations Committee, Mr. Mahon, which covered the whole range of spending and not just the $135 billion. But for the record, I guess we will have to clear it up again. You are right, there is some confusion on it, probably arising from the failure to carefully look at the Congressional Record.

For example, I noticed an editorial in the New York Times the other day which fell into the same trap. I appreciate your elaborating on this and also the table that you placed in the record.

Now, is it not true that the President's budget request to the Congress, certainly as far as spending is concerned, is pretty well determined by the congressional action that was taken on the Tax Reform Act of 1969?

Mr. MAYO. That had an important role to play in the figures that finally emerged. As we have said on occasion before, the Tax Reform Act of 1969 did provide the revenues that we thought desirable in our original request in April as far as fiscal 1970 is concerned. As far as fiscal 1971 is concerned, there is a shortfall of $3 billion, comparing Treasury's original request in April of 1969 with the receipts as we estimate them now. And further, which is even more important, there is a shortfall compared to the April request of $12 billion by the time we get to the fiscal year 1975. If we had that $12 billion, the $22 billion that we have posed as a residual for the 1975 analysis of funds available for initiatives would be increased by more than 50 percent.

Senator MILLER. Is it not true that the administration recommended a certain amount of tax relief but that the Congress itself exceeded the amount of tax relief recommended by the administration, which resulted in the shortfalls to which you have referred?

Mr. MAYO. That is correct.

Senator MILLER. In other words, would it not be fair to say that those in control of the Congress in their action on the Tax Reform Act of 1969, and more particularly in connection with the amount of tax relief, placed No. 1 priority on this additional amount of tax relief and tied the President's hands so that additional outlays for some of these spending programs are simply not available?

Mr. MAYO. I think that is true. In a sense, you might say that the Congress anticipated well ahead of time the appearance of the peace dividend and proceeded to distribute it, or quite a bit of it.

Senator MILLER. So that the priority No. 1 was established, really, last December?

Mr. MAYO. Yes, sir.

Senator MILLER. And we are talking really about other priorities, they are No. 2, No. 3, No. 4, but No. 1 was the additional tax relief.

Mr. MAYO. Yes, I think that is an important point, Senator.

Senator MILLER. Thank you.

Senator PROXMIRE (presiding). Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Mr. Mayo, Mr. Proxmire has pointed out that somehow, in the 1971 budget, the peace dividend got hijacked. I am more interested in 1975, and there, too, it appears that the $40 to $50 billion peace dividend, which certain people have been promising us for some time, is not going to materialize. In fact, your projection shows just a $22 billion margin by 1975. As you say in your statement, this amount is very small, and certainly inadequate to accommodate needed programs.

Mr. MAYO. I am interested in your observation of $40 to $50 billion as the definition of the peace dividend. That is a new one on me. In a defense program that this year is spending $77 billion, a $40 to $50 billion dividend is a pretty hefty dividend.

Representative REUSS. Peace and growth dividend, I should say.

Mr. MAYO. Oh, and growth. I see.

Representative REUSS. And you are talking about peace and growth too, of course.

Mr. MAYO. Peace and growth, yes.

Representative REUSS. Now, in coming up with this very gloomy outlook for 1975, in which you say that the dividend is just inadequate to accommodate needed programs, what did you allot the Pentagon in this growth? Are they to get the ABM's, the MIRV's, the new bomber fleets, the new aircraft carriers that they have been after?

Mr. MAYO. We made no judgment, Mr. Reuss, as to whether they would indeed get x amount of each of these. We figured that, as we went up to 1975, the decisions between or among defense weapons, as well as the decisions between defense spending on the one hand and civilian programs on the other hand, would be, shall we say, fought out on their merits, item by item. We constructed the 1975 figure in terms, obviously, of some specific assumptions, all of which should and have disappeared into the background when we finished cooking the pie. We can't give a measurement at this point of how much of "this" versus how much of "that" is included. You could have an infinite combination, within reason—an infinite combination of health programs versus MIRV versus manned bombers versus lunar exploration and so forth.

We tried not to interject ourselves into that particular exercise, feeling that it would destroy the basic value of the overall projection of the budget for 1975. There is the very real risk that you suggest—that all of you in the wide audience for this would tend to drool, if I may say so, and think, "My, wouldn't it be nice to have the administration's judgment at this point as to how the pie is to be split up." Our job was to bake the pie as best we saw it, not to do the allocation of the pie.

Representative REUSS. Well, every schoolchild knows, though, that if the Pentagon is to be given free reign, they will gobble up everything in sight and bring about a situation where the 1975 surplus will, in your phrase, be "certainly inadequate to accommodate needed programs." So if you do not tell us what assumptions you made about the Pentagon, we don't know whether we are just helplessly afloat on the stream of history or whether we can do something about it.

Mr. MAYO. I like the phrase, "helplessly afloat on the stream of history." We are not in that unfortunate position, and we can do something about it. That is why we haven't tried to prejudge what we would do about it.

I would emphasize again that this is the challenge of coming up with an estimate that we find to be a reasonable statement of tax resources according to present law. This doesn't prejudge whether we are going to ask for more taxes or cut taxes to relieve our decisionmaking process of the $22 billion that is left. We are not prejudging that. This is merely an indication of the constraint on the budget spenders as they look to 1975, and scratch their heads and say, "Well, we have a problem of allocation of scarce resources. We had better be careful here in terms of what we are trying to get."

We also should look at the base of the budget, as we have indeed tried to do this year. We should also look at our tax system to see if it is really the kind of tax system we want, as well as whether it produces enough dollars.

Representative REUSS. Trying to get more specific, Mr. Mayo, I notice in table 14 on page 80 of the economic report, there is a projection of Federal expenditures between 1970 and 1975. There one finds that we have Federal expenditures for goods and services of $92 billion in the 1970 budget. This declines to $84 billion by the 1975 budget. Can you tell me how that is divided between military and nonmilitary?

Mr. MAYO. No, I had no part in the preparation of the purchases of goods and services line in the economic report, Mr. Reuss. I would say that it is perhaps more appropriate to ask Dr. McCracken this question.

Representative REUSS. Do you know who did make that projection of Federal expenditures?

Mr. MAYO. I would assume that the projection here was checked out with our staff people.

Representative REUSS. It says "Source: Bureau of the Budget."

Mr. MAYO. So it does.

Representative REUSS. Have you sprung a leak?

Mr. MAYO. It was done by the troika staff, which includes Treasury as well as the Council of Economic Advisers and the Budget Bureau.

Representative REUSS. You can't tell us how much of that decline is defense and how much is nondefense?

Mr. MAYO. No, I can't. Again, I think you could have quite different combinations of figures that add up to the figures that you just cited. You could set up an extreme either way on defense, and either way on the human resources and housing programs, and come up with a plausible set of ingredients for the figures that are shown there.

Representative REUSS. On page 77 of the Economic Report, it is set forth that the President has set up a special evaluation office to make "an independent appraisal of Federal social programs affecting the disadvantaged."

Well, I am all for a gimlet eye on those programs affecting the disadvantaged, but has there been any special agency set up to make an independent appraisal of Federal defense programs affecting General Electric, General Dynamics, Lockheed, Westinghouse, and some of the others?

Mr. MAYO. Well, we have the blue ribbon panel looking into defense spending at the present time.

Representative REUSS. Who is on that?

Mr. MAYO. The chairman is Gilbert Fitzhugh of the Metropolitan Life Insurance Co. I have forgotten the names of some of the members. It seems to me George Stigler, of the University of Chicago, is one, and Wilfred McNeil is another. The others don't come to mind at the moment.

Representative REUSS. That is not a full-time Government office?

Mr. MAYO. Oh, no, this is a task force appointed by Secretary Laird; of course, Presidential support.

We do have within the Government the Defense Program Review Committee of which I am a member, which considers within its purview the examination of some of the things that you have mentioned.

Representative REUSS. Well, here we have this special evaluation office making this independent appraisal of these social programs for the disadvantaged, which I have said is fine. Who do we have doing that for the programs for the defense establishments?

Mr. MAYO. Well, you have picked on a fairly small office within OEO. Throughout the Government, particularly in the Budget Bureau, the name of our job is to make an independent evaluation of the programs, both in the national defense area and in the civilian area, in some depth. That is why we have approximately 300 professionals on the job.

Representative REUSS. Thank you. My time is up.

Senator PROXMIRE (presiding). Congresswoman Griffiths?

Representative GRIFFITHS. Thank you.

Mr. Mayo, I would like to ask you on the welfare program, in your estimate of what will happen through 1975, are you estimating that the welfare program will go into effect at $1,600 for a family of four and continue that way through 1975?

Mr. MAYO. The assumptions used in costing out our new initiatives to 1975 are perfectly consistent, Mrs. Griffiths, with the President's proposal for the family assistance program.

Representative GRIFFITHS. Well, you are not assuming that, between now and 1975, any amendments will be added?

Mr. MAYO. I do not think so. We estimate the cost of the proposal as submitted. We have tried to cost most things out with reference to the growth in the economy, both real and through price inflation. I think it is probably fair to suggest that an allowance for what the $1,600 may be worth as we go ahead should be introduced into the pricing up, so to speak.

Representative GRIFFITHS. Do your assumptions include the idea that because people are paid to work there will be some who go off welfare altogether? Do you assume that some of the training programs will take people off welfare altogether?

Mr. MAYO. Oh, yes. We assume that this is one of the purposes of proposing the program, Mrs. Griffiths, to try to get those who are indeed trainable and are willing, as well as able, to move into productive employment. That is part of it. The figures that we have used assume some modest success in this direction.

Representative GRIFFITHS. What number of people do you now anticipate that $1,600 will pick up on the welfare rolls?

Mr. MAYO. I can't answer that right off the bat, Mrs. Griffiths, but we can supply it.

Representative GRIFFITHS. Would it seem reasonable if I said to you that it will pick up between 12 and 15 million additional people?

Mr. MAYO. The figure sounds a little high, but I think I did hear a 12 somewhere; whether it was our figure or not, I am not prepared to answer.

(The requested information follows:)

The estimated minimum of $1,600 for a family of four would increase by 9 to 10 million the number of persons covered in calendar year 1971.

Representative GRIFFITHS. Well, the thing that I think that you have to consider is that the program is not going to go—if it goes into effect at $1,600—even out of our committee; it probably it not going to pass this Congress at $1,600. In your judgment, is the program inflationary or not inflationary?

Mr. MAYO. This is a program which represents a basic welfare reform. To the extent that it achieves what you suggested earlier—puts more people back into the work force, trains more people, makes them carry their weight in the society—it obviously helps us in the battle against inflation. The more production we have, the better off we are, everything else being equal.

Representative GRIFFITHS. Fifty percent of the people that you pick up are now in the South. In one of the areas of the South, the mean average wage in 1960 was $1,900. You propose to pick them up at $2,460. Do you think that is going to put them into production?

Mr. MAYO. It may. I see the force of your argument. They are not going to go out and get involved, so to speak, in working for a living just to get a smaller monetary return. That, of course, is a valid point.

However, the proposed program offers greater incentive for work than does the existing program, and it offers training and child day care to encourage those who can work to better themselves.

Representative GRIFFITHS. But that money also is going to be spent, the money that you are going to give them is going to be spent.

Mr. MAYO. Oh, yes.

Representative GRIFFITHS. It seems to me that, while I personally think there is real merit in the program, I personally think that it has some inflationary tendencies. Do you or not?

You cannot answer it by saying it is going to get them into production, because for a lot of these people I do not think it is.

Mr. MAYO. Obviously, the more income you pour into the income stream, everything else being equal, the more inflationary you are. The proposed program may be inflationary in that sense. It may mean that other noninflationary steps will have to be taken to counteract this and, therefore, the job of controlling inflation may be made a little more difficult. I can't deny that a dollar of increased spending, per se, is an increase in inflationary pressure. However, in the longer run, the increased production resulting from having a larger trained work force should have the opposite effect.

Representative GRIFFITHS. What noninflationary steps are you going to take?

Mr. MAYO. Well, I would say that this would depend on how we roll through into fiscal 1972, which would be the first full year that this program is in effect. You can be assured that in the President's budget message a year from now, if family assistance has been enacted and is in effect, steps will be taken to encompass it in a balanced program of resource allocation within whatever economic environment we face at that time.

Representative GRIFFITHS. Well, is not one of the suggestions, even of the administration, that the next move on this program be to pick up married couples who work but who do not have children, single people who work but who do not have children? Is this not really the next step?

Mr. MAYO. Who work, you say?

Representative GRIFFITHS. Yes, the working poor. You are only picking up under the program you suggest the working poor who have children. The next step is to pick up the working poor who do not have children. In fact, could it not really be said that the action of picking up only those who have children is contrary to public policy right now?

Is it really the public policy of this country to encourage early family formation at this time? Should it be?

Mr. MAYO. I would answer only in terms of where do you draw the line? You could, of course, continue the present program, and in a sense that is less inflationary. But we are getting deeper and deeper into other problems. I think we could counteract the inflationary influence of further budget spending here in other fields.

In regard to the administration's position on encouraging family formation, I think we are firmly on record we support spending more funds for family planning and the goal of extending the benefits of family planning over a 5-year period to 5 million women who are seeking such benefits. I think that must be my answer to you on the family formation side.

Representative GRIFFITHS. Don't you think that the inflationary effects of the welfare proposals mean we must plan for a larger full-employment surplus—that is, higher taxes—than would be otherwise needed?

Mr. MAYO. Well, in a sense, we have to consider the proposals on welfare reform, Mrs. Griffiths, along with the proposals for pollution control and for other programs. The latter can be said to be inflationary if they add to construction at a time when we are trying to hold back construction. But again, all of these are not net additions. In fact, the net balance may work the other way when you roll all of your programs together.

Representative GRIFFITHS. On the matter of pollution control, as a matter of fact, the requirements for cars, the suggested requirements for antipollution by cars, what's your anticipation of the effect upon the market for cars?

Mr. MAYO. Well, I would suggest that the market for cars is going to continue at a very high level for as far into the future as we can recognize. How those cars will be designed, what will be done to eliminate the pollution effects of the present engine and so forth, gets into an area of speculation. Yet we have not really seen the development, although we are encouraging it, of an engine that would really be free from pollution.

Representative GRIFFITHS. If it increases the cost of a car substantially, do you still think it will increase the demand for the car?

In case you had not noticed it, there is a dropping demand for cars.

Mr. MAYO. Yes.

Representative GRIFFITHS. There are quite a few unemployed now in Michigan.

Mr. MAYO. That is right. This, again, is one of the manifestations of the cooling down of the economy that has resulted in real GNP being quite level in the fourth quarter.

Representative GRIFFITHS. My time is up. I would like to return to this subject.

Senator PROXMIRE (presiding). Congressman Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

I commend you on an excellent statement, sir. It is a pleasure to hear from you.

Mr. MAYO. Thank you.

Representative MOORHEAD. I would like to get back to this military budget which concerns me. One of the problems, as I see it, is that it would seem to me from the defense budget that we are embarking on the procurement of some very expensive weapons systems. One of your predecessors, Mr. Schultze, was before this committee last year and he talked about the F–14 aircraft procurement. That item in this year's budget is a mere—that sounds terrible, "mere"—$938 million. But Mr. Schultze said the total cost of procuring that system and operating it over a 10-year period would be in excess of $20 billion—in fact up to $26 billion. So I think that we should, before we decide to buy the first or the thin edge of the wedge, decide what this thing is ultimately going to cost us. Could you supply, for the record, the cost figures for weapons systems included in this year's defense budget along with the 5-year or 10-year systems costs of these various weapons systems—the F–14, F–15, AMSA, ABM, the AWACS system, the nuclear carrier CVAN–70, and the ULMS? If there are any others that I have left out that would demonstrate the future budget impact of current decisions on authorizing and appropriating funds for weapons systems—so we can know what we are getting into.

Would this be possible?

Mr. MAYO. I certainly agree with you that we must look at the razor edge or the camel's nose under the tent. These phrases are quite apt at describing the philosophy that says, "Oh, it does not amount to very much this year"—a mere $900 million, to quote you—"but the costs will be larger in future years." We are quite conscious of this. It is a subject that the men in our National Security Programs Division spend a great deal of their time working on with the men across the river.

As to the availability of specific figures on the full funding of any of these weapons systems, I do not have them in mind as we sit here today. I would suggest that we would be glad to call the attention of the Department of Defense to your request. I think that would be the fairest way to approach it.

(The requested information follows:)

The Department of Defense advises that the information on the majority of the major procurement systems that are of interest to Representative Moorhead is contained in the Selected Acquisition Reports that are on file with the Armed Services Committees of both houses. As to the cost of the Safeguard ballistic missile defense system, the Department of Defense now estimates acquisition costs for the presently-proposed Modified Phase II Safeguard system, which includes one new site at Whiteman Air Force Base, at $5.9 billion in December 1969 prices. Total budget authority requested for the 1971 Safeguard program is $1.49 billion and total FY 1971 spending for Safeguard is estimated at about $920 million. The systems acquisition cost of the full Phase II Safeguard defense of 12 sites—should this option be exercised later—is presently estimated at $10.7 billion.

Representative MOORHEAD. I respect the Department of Defense very much, but I would like to have your expertise and sharp pencil so that they are not giving us too rosy a picture because I think this is their tendency. I think they really believe that is the patriotic thing to do.

Mr. MAYO. In all fairness, I know of no Government program, especially in these inflationary times, which does not end up costing a bit more when we get through than when we started. So that any estimates that are prepared, especially for systems which have not yet been fully tested, or on which procurement has not started, would be fairly guessy figures.

It comes to mind that our estimates on medicare and medicaid in the last 5 years have been, shall we say, rather poor estimates.

Representative MOORHEAD. I am not worried about the figure being too small. I think if we look hard at what these weapons systems are going to cost for R. & D. procurement and operation during their life, even if we do underestimate inflationary impacts, it is still going to be a large enough chunk of money to make the Congress realize that, before we take the first step, we should realize where we are going to come out. I think if Mr. Schultze could give us some figures, the Bureau under your direction—put any caveats around it, approximates and so forth—certainly could make some sort of ball park estimates. This is exactly the kind of thing that is required under Public Law 84–801 requiring the Executive to make 5-year projection of major new programs.

Mr. MAYO. Yes. That law is aimed, of course, at the agencies themselves in terms of their responsiveness to congressional requests. I know of no disagreement on this point. I can be corrected, but I know of no disagreement in terms of the general ball-park sort of guesses that might be involved in this sort of a projection.

I would hasten to add that one of the valuable attributes of the exercise we went through for 1975 is to serve as a very clear warning to anyone who wants to expand all sorts of weapons systems, or all sorts of social programs: "Beware, there is no well in the yard at the Treasury Department from which money can be pumped out indefinitely."

Representative MOORHEAD. It seems to me, Mr. Director, that in this budget there are severe contradictory lines of reasoning. One, as I have said, is the thin edge of some very expensive weapons system which, to me, would say we are headed for another substantial increase in the Defense Department budget.

However, then I look at your projections into 1975 and find that you have total purchases of goods and services of $84 billion. For this year, there is a breakdown of total purchases between defense and nondefense—nondefense being $23 billion. Well, I am quite confident that, as we look into the future, there is not going to be a decline in nondefense purchases. So therefore I would have to conclude that the defense purchases under that assumption would be $61 billion, which is quite a decline.

And I compare that with this camel's-nose budget of these new weapons systems and it seems to me that this reveals one of two things in your projections—either, one, you are going to have a substantial cut in civilian or nondefense programs, or you are contemplating quite a radical change in defense strategy from a flexible response to a return to the massive-nuclear-retaliation strategy of the 1950's.

Can you tell me whose ox is going to be gored, the nondefense or defense?

Mr. MAYO. Well, I think you are illustrating why Dr. McCracken and I decided to go forward and recommend to the President that he do what he has done in the Economic Report and in the budget; to set up an arena for spirited debate on just the sort of issues that you are raising. I, of course, would point out that much of the increase in Government spending over a period of years is in transfer payments, which are technically not payments of goods and services. This includes social security programs, retirement programs, and welfare programs.

I would say that the battle between new and existing weapons systems is a battle that will rage long after we pass 1975; so will the battle, if we want to use that word to describe it, over the allocation of resources between civilian and military programs. So I go back to my earlier statements here that we have merely set up some assumptions that are quite provocative in terms of looking at what a reasonable composition of this total could be. I do not think that any of us is in a position to suggest that we are committed to any particular component of what the expenditures for 1975 might look like. They will reflect the very sort of thing you are suggesting. If new weapons systems are going to be terribly expensive, we are going to have to have a very careful evaluation of those as we go along, or we are going to sacrifice some of our other elements of national defense posture, or we are going to take it out of the hide of civilian programs. We are looking for a balance in our expenditure planning going out through 1975. None of us is willing to fill in the blanks, so to speak, as to what would go to make up this $244 billion of outlays or $266 billion of receipts—the universes for 1975.

Representative MOORHEAD. My time has expired.

Senator PROXMIRE (presiding). Congressman Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Welcome before the committee, Mr. Mayo.

The administration's fiscal 1971 budget was formulated under severe restraints of rising Federal expenditures and a drastic decline in the growth of Federal revenues. As a result, the 1971 budget shows a small $1.3 billion surplus. This committee's Subcommittee on Fiscal Policy has recommended a budget surplus for 1971 of about $8 to $10 billion as consistent with the need to maintain a fiscal policy to fight inflation. The CED has made a similar recommendation. Do you believe the 1971 budget, with the surplus projected by the administration, adequately meets our stabilization needs and will allow monetary policy to loosen up?

Mr. MAYO. If the President's program is enacted as reflected in the budget, I believe it does represent an adequate statement of our fiscal policy needs.

Representative WIDNALL. Would you support the CED recommendation that the 5-percent income tax surcharge on individuals and corporations be extend at least through calendar 1970?

Mr. MAYO. We do not feel that this is necessary in the present environment.

Representative WIDNALL. Do you feel that another expenditure ceiling of fiscal 1971 employing the modification as the President recommended in his budget message could be effective in securing a larger budget surplus?

Mr. MAYO. We have, I think, already pretty well demonstrated our conviction that we want a tight budget for 1971. I see great advantage in setting targets such as we have imposed upon ourselves. Our targets are stringent, representing only a 1½-percent increase in Federal spending and a decline in Federal spending in real terms from 1970 to 1971.

I think it is an open question as to whether the imposition of a congressional ceiling, over and above our statement of intent, represents a further constraint that will indeed result in an additional reduction in Federal spending, particularly, Mr. Widnall, if it is cast in the way that it was this year—with a fixed ceiling on both uncontrollables and on the Executive, but with a rubber ceiling on the Congress. Thus, when the Congress had reduced spending, in fact in response to administration requests, it has reduced the ceiling, and when the Congress has added to the budget, it has added to the ceiling. I find this a bit like doing it with mirrors, so that there is no constraint on the Congress to economize. The constraint is all on the administration, and could result in spending cuts late in the fiscal year. We might be in the unfortunate position of having to meet a technical, legal obligation at the expense of the efficiency of Federal programs.

Representative WIDNALL. When the Revenue and Expenditure Control Act of 1968 was enacted, there were many who felt it was an overkill measure, that it would slow down the economy much too abruptly. Most of us felt it would reduce inflation only in the near term. However, it is now more than 18 months since the enactment. We have yet to see a significant slowing in the growth of prices. Why is it that the income tax surcharge and the spending ceiling imposed in 1968, as substantial in size as they were, failed to fulfill this country's hopes of slowing inflation and high interest rates?

Mr. MAYO. I think it is doing it, but after considerable delay that was occasioned, very frankly, by a movement to ease money prematurely in the summer of 1968 in anticipation that there would be overkill. This was not the Federal Reserve acting on the strength of internal recommendations and deliberations. There was a common feeling throughout the financial community and among industrial economists, too, that there was danger of overkill in moving from a $25 billion deficit to a balanced budget.

In hindsight—and we are all good Monday morning quarterbacks—what everyone lost in this interpretation was that the inflation had become so deep seated and so cancerous that it would take even a 10-percent surtax and strict expenditure control much, much longer to take effect than really any responsible economic analyst at the time foresaw.

Representative WIDNALL. Well, has not the overextension of credit had a lot to do with continuing the inflationary forces?

Mr. MAYO. Certainly the extension of credit has had quite a lot to do with it. The fact that corporations can go out and borrow in the commercial paper market when bank credit becomes tight has something to do with it. With money supply having leveled off in the second half of 1969, and indeed gone down if you include time deposits, we have a stringency that is, I think, finally beginning to bite. People are beginning to cry "Uncle" with regard to the overall credit position.

So I think that even this is coming under control finally. But I must admit that this inflationary beast is a terribly stubborn and strong-willed one.

Representative WIDNALL. It is rather discouraging to me to drive along a highway and see a big billboard saying you do not need any money, you do not need any savings, just draw a check.

Mr. MAYO. That catches up with one, but I happen to be of the same school as you, Mr. Widnall. One of the problems that we have is that there is a tendency in the Government to buy now, pay later, too.

Representative WIDNALL. Would expenditure cuts prove more effective in fighting inflation than temporary tax increases?

Mr. MAYO. We have felt that this was a sound position in the presentation of the 1971 budget. That is why we went our of our way to try to suggest termination of some existing programs and to cut spending in a very prudent way for 1971, rather than going up and asking for a substantial tax increase. I think there is a question of credibility here, too. The Congress, as recently as late in December, lest we forget, came through with the extension of the surtax at 5 percent through June only by attaching a great deal of other reform and, I must add, relief to its package. It seemed to us that there would be some question of credibility of the budget if we proposed a significant increase in taxes just 2 months later.

I might just give an opinion that goes one step further. If we had a significant surplus that was based on a tax increase right now, I think we might end up with the Congress in its wisdom deciding that if there is to be that big a surplus, maybe the constraint on spending need not be quite so great, so we—the Congress—will appropriate a little more and, oh, by the way, we will not enact the taxes anyway. So I think we would be in a poorer anti-inflation posture than if we did not ask for the tax increase in the first place.

Thus, we confined our tax asking, so to speak, to fairly modest proposals such as the ones the chairman mentioned at the beginning of the meeting; namely, the extension of the two excises and user taxes, more than half of which are already well through the Congress, and very small changes in social security and railroad retirement.

Representative WIDNALL. Do you believe the 10-percent tax surcharge would have done the job if they had been passed earlier at the time of the military buildup?

Mr. MAYO. Yes.

Representative WIDNALL. That is all, Mr. Chairman.

Senator PROXMIRE (presiding). Senator Percy, everybody has had one round of questioning. You are next. If you want to defer, you can do that or you can go right ahead now.

Senator PERCY. I am very sorry that mechanical difficulty on an aircraft out of Chicago prevented my getting here before this.

I would like to just put a couple of questions that may not be directly related to the testimony this morning, but they do have a bearing on the budget.

The first is a question on NATO and our expenses there. We are bearing a burden of about $15 billion for NATO expenditures. We have not only a balance-of-payments problem, but also a burden-sharing problem, as to whether other NATO countries should share a larger part of this NATO expense. If you would rather not answer, I would not press a question on this now. But if you care to comment, given a $7 billion balance-of-payments deficit last year, and the sheer necessity of our finding real offsets for military expenditures and, I hope, more so through burden-sharing and expense absorption on the part of European countries such as Germany. If you care to comment on the need to do that in the future, I think it would be very interesting and helpful.

Mr. MAYO. Yes, Senator Percy. I will comment only briefly.

To some extent, the problem of making an evaluation of NATO costs falls into the same category as the problems that I feel are important to point out to the public with regard to costs in Vietnam. There is indeed a heavy expenditure of American funds for NATO. I am not qualified to even guess the precise amount. But I would like to join you in the expression that you made of the importance of cost-sharing if we are to do the job that we must do in support of our free world allies and, at the same time, be very conscious of our balance-of-payments problem and, indeed, our budget.

Senator PERCY. I notice in your testimony that you indicate publicly for the first time, I believe, that the administration is planning to reduce U.S. troop strength by over 385,000 men. I have advocated reduction from 3.4 to 2.9 million. This is really very close indeed. Is this primarily to save money, or is this a conscious review of the doctrine that we must have the capability of fighting two major wars and one minor one.

Mr. MAYO. This reflects our second look at the defense strategy and our evaluation of the events pointing toward the conclusion of the Vietnam conflict. This figure is, by the way, in the special analysis part of the budget and is, therefore, a published figure.

We feel that this is working in the right direction. It is obviously a figure that could be subject to further change within the fiscal year 1971, and we are looking toward a lower figure later on.

Senator PERCY. Mr. Sato mentioned the other day that, because of the large majority he had in Japan, he looks on this as a mandate of support for his policies and he intends to increase the size of the military force. Considering the close alliance we have with Japan, I would presume that this is a policy that we are coordinating with them. Does this, then, mean that not only in Europe can we look forward to burden-sharing, but also in Asia as the economic power of Japan increases? Will Japan take on a greater share of the military cost of maintaining security in that area?

Mr. MAYO. I would hope that that would be the result, yes, Senator Percy.

Senator PERCY. I understand that there has been some discussion of the surtax and that you don't deem it necessary to extend that tax.

Mr. MAYO. Yes, that is correct.

Senator PERCY. Has there been any consideration given, taking into account that taxes are unpopular, particularly now in an election year and have been turned down rather universally at local levels, to the possibility of earmarking certain revenues? I know we do not like generally to earmark too much in the budget. But if, for instance, to fight inflation the extension of the surtax would be required, could we finance highly popular programs with the 5-percent extension? Could we earmark it for programs such as environmental control, for fighting pollution, or for education? If directly tied to programs such as these, the people might not resist the extension of the tax, if it were tied to things that they were willing to sacrifice for. I see on the country's part a great willingness to sacrifice some present material prosperity for the sake of posterity.

Mr. MAYO. This is an interesting approach, Senator Percy. I must confess, however, that my dislike of earmarking would probably extend to this, too. I am quite unsure in my own mind whether such an earmarking would make it easier for the Congress to accept an extension of the surtax, which has apparently become somewhat unpopular at this end of the avenue and, I might say, that unpopularity is shared at our end of the avenue, too.

Earmarking tends to feed upon itself. We have examples in many of our State governments now where more than 50 percent of their revenue is earmarked. You then get down to the things that do not lend themselves to earmarking and the ability to control outlays is reduced considerably. When some of the people in the administration have suggested earmarking funds, I have replied that, if we pursue this long enough, all the scientific programs and indeed the defense programs will somehow figure out a way of becoming a trust fund so that they can have the benefit of protection against the budget process.

Senator PERCY. When we put the surtax on, we called it a fight against inflation, but really, it was a war tax, to pay for Vietnam. It would really seem to me that the possibility might exist that, if the Congress forces more money on the administration than it really wants in environmental control, as for many years we have in health, for instance, maybe it might be well for the administration to come back and simply say to Congress to earmark the revenue and give it the source of revenue. Give it revenue if you want more money for programs such as environmental control.

Mr. MAYO. Well, yes.

Senator PERCY. I merely pass that on as a possible suggestion.

Mr. MAYO. We prefer, when we go, to have the budget allocate resources in a way that will result in a specific decision uninhibited by earmarking. Thus, we can decide whether we want to put more money into environmental quality improvement this year and perhaps next year and the year after, but not have that decision set in concrete so that we would find it difficult to change later on. Without any reflection specifically on the substantive program that is involved, I would suggest that we have found that the highway trust fund has become a little stickier because it is indeed a trust fund. The Governors like the highway trust fund very much. There has been quite a bipartisan applauding of the principle of the highway trust fund. If you are a program manager, there is always a tendency to like to feel that your security blanket, if I may use the term, is connected—that there is protection against the real world in which both the Budget Bureau and the Congress make a continuing reevaluation of the program.

Senator PERCY. Mr. Chairman, I would like to just commend the Director of the Budget for the last round of budget cuts that the administration made. They were down to an irreducible minimum but once again took another crack at it. I know how painful it is, excruciatingly painful, for agencies to cut, but they did; and I hope the Congress is going to cooperate in helping to conserve that money.

Mr. MAYO. Thank you.

Senator PROXMIRE (presiding). I am going to say I am not going to get into a long, protracted, question-and-answer session answering you and Senator Miller on your mistakes on what the Congress did on cutting President Nixon's spending proposals. This is my view and I am going to state what I think is the record and then go on to ask other questions.

I have here in my hand the table indicating the contrast between the latest revised request of the administration for this past year and the amount that was actually enacted by the Congress. What it shows is that the Congress cut 10 out of 14 appropriation bills below the President's last revised request, that it cut appropriations by $5.594 billion in terms of obligational authority, and $2.9 billion, almost $3 billion, in terms of outlay.

Now, the sequence of events was this:

1. Insofar as the military budget is concerned, we cut in these other areas, too. The Nixon administration did cut the Johnson military budget by $1.1 billion. They announced these cuts on March 19, and again on July 22.

On August 21, Secretary Laird complained about the deep cuts Congress was making. In other words, Congress cut the budget and the administration complained that we were cutting too much. He said that they would cut $3 billion because of what Mr. Mahon and Congress had done. He said he did this reluctantly. He said, "I want the American people to know that there will be an inevitable weakening of our worldwide military posture." He opposed the cuts. He said he took the move because "a chaotic situation could develop if the Pentagon waited for Congress to finish with the military budgets."

To my knowledge, and if you can correct this I wish you would, neither the Budget Bureau nor the Pentagon ever sent up any revised estimates. They did announce the cuts because of the cuts Mr. Mahon forced on them and they did it reluctantly.

At the end of the year, Secretary Laird came before the Senate on December 9, complained about "severe congressional cuts" and asked that certain cuts be restored.

So after opposing the cuts, Mr. Mayo, now you claim credit for them, whereas the administration were the opponents of these reductions.

Mr. MAYO. Mr. Chairman, these cuts were announced by the President in July. The cut of $3 billion in the defense budget was a matter of public record as of the 22d of July.

Senator PROXMIRE. Yes, but it was on August 21 that Mr. Laird explained that the cuts were made with great reluctance, they were opposed to the cuts, they were wrong, they would weaken the country militarily?

Mr. MAYO. I don't believe Mr. Laird ever said he was opposed to the cuts.

Senator PROXMIRE. What did he mean when he said, "I want the American people to know that there will be an inevitable weakening of our military posture"?

Mr. MAYO. I will go back to the statement on July 22 when we announced these cuts of $3 billion. These were our cuts, the Nixon administration.

Senator PROXMIRE. He explained as the principal spokesman, certainly, for the Nixon administration in the military area, that a chaotic situation would develop if the administration waited for the Congress to finish with the military budgets.

They cut because they knew Mr Mahon's cuts, which he in turn recommended to the Senate and the House, would probably follow.

Mr. MAYO. Our cuts in July, I believe you will find, predate the appearance of any of the reports of the Armed Services Committee.

Senator PROXMIRE. No revisions were sent up. Isn't that the way that the administration would ratify this? Wouldn't they send revisions up?

Mr. MAYO. This was done in some cases, yes. If it is better to keep our books that way. Perhaps we should have sent up revisions, but we didn't. We announced publicly on July 22 that defense cuts were being made to the tune of $3 billion. These cuts were also fully reflected in the official budget review that came out in September, months before the enactment of the appropriation bills.

Senator PROXMIRE. Well, I just ask unanimous consent that this table be printed at this point in the record.

(The table referred to follows:)

SUPPORTING TABLE NO. 1.—EFFECT OF CONGRESSIONAL ACTIONS AND INACTIONS ON BUDGET AUTHORITY AND OUTLAYS (EXPENDITURES) DURING THE 91ST CONG., 1ST SESS.

(AS OF DEC. 23, 1969)

[In thousands of dollars]

Items acted upon	Congressional actions on budget authority (changes from the revised budget)[1]			Congressional actions on budget outlays (changes from the revised budget)[1]		
	House (1)	Senate (2)	Enacted (3)	House (4)	Senate (5)	Enacted (6)
Fiscal year 1970:						
Actions on individual bills affecting budget authority and outlays:						
Appropriation bills (changes from the revised budget):						
Treasury, Post Office, and Executive Office (H.R. 11582, Public Law 91-74)	−42,382	−34,519	−38,482	−37,000	−30,600	−34,000
Agriculture and related agencies (H.R. 11612, Public Law 91-127)	−160,907	+405,236	+251,341	[2] +53,000	+294,000	+166,000)
2d supplemental, 1969 (H.R. 11400 Public Law 91-47)				−92,700	−64,700	−75,000
Section 401 outlay ceiling[3]					(−1,900,000)	(−) 1,000,000
Independent Offices and Department of Housing and Urban Development (H.R. 12307, Public Law 91-126)	−471,325	[4] −177,521	−226,099	−61,000	−25,900	−40,000
Interior and related agencies (H.R. 12781, Public Law 91-98)	−15,810	−8,090	−10,481	−15,300	−11,800	−7,800
State, Justice, Commerce, the Judiciary, and related agencies (H.R. 12964, Public Law 91-153)	[4] −130,070	[4] −83,350	[4] −111,272	−71,000	−40,600	−60,000
Labor and Health, Education, and Welfare and related agencies (H.R. 13111)	+1,078,365	+1,637,686	[5] +1,139,028	+521,000	+653,000	[5] +565,000
Legislative branch (H.R. 13763, Public Law 91-145)	−26,850	−29,842	−27,826	−7,900	−8,800	−8,700
Public Works (H.R. 14159, Public Law 91-144)	+301,469	+789,451	+552,030	+10,500	+67,400	+50,000
Military construction (H.R. 14751, Public Law 91-170)	−466,741	−313,854	−356,844	−37,000	−26,500	−29,000
Transportation (H.R. 14794, Public Law 91-168)	+34,546	+106,679	+89,265	−172,000	−43,200	−133,000
District of Columbia (H.R. 14916, Public Law 91-155)	−40,151	−55,295	−60,332	−14,000	−13,800	−12,500
Department of Defense (H.R. 15090, Public Law 91-171)	−5,318,152	−5,955,544	−5,637,632	−3,000,000	−3,250,000	−3,200,000
Foreign Aid (H.R. 15149)	−1,071,544	−960,779	[5] −1,120,654	−167,000	−146,000	[5] −120,000
Supplemental, 1970 (H.R. 15209, Public Law 91-166)	−63,490	−17,721	−36,317	−5,670	+30,000	+19,000
Subtotal, appropriation bills	−6,393,042	−4,697,463	−5,594,275	−3,096,070	−2,617,500	−2,920,000

[1] The budget figures to which these adjustments apply are the April 15 estimates as amended. Accurate estimates of the cost impact of congressional actions on mandatory spending legislation are frequently difficult to obtain—especially for outlays. Cost estimates are obtained from various sources, including Committee reports, floor debates, Government agencies, and informal staff contacts. Sometimes cost estimates on new legislation are not available. What is reflected in this congressional action table is the best that the staff has been able to put together. Occasionally it is necessary to revise an estimate as more current information becomes available.

[2] Reflects floor action increasing milk funds by $120,000,000, but does not reflect effect of $20,000 limitation on subsidy payments adopted by House. The Appropriations Committee assumed a reduction in Public Law 480 spending which if not realized will result in higher spending than estimated.

[3] The Second Supplemental Appropriation Act, 1969, carried an overall expenditure limitation for fiscal 1970 which was different in all three versions. The House-passed version set the ceiling at the April 15 budget figure of $192,900,000,000 with provision for increases or decreases depending upon actions or inactions of the Congress affecting the budget. The Senate version made a flat reduction of $1,900,000,000 in the overall ceiling but exempted certain items from the ceiling. The enacted version made a flat reduction of $1,000,000,000, provided for increases or decreases depending upon action or inaction of Congress affecting the budget, and granted up to $2,000,000,000 of flexibility in the ceiling to the President for certain uncontrollable items.

[4] Figures posted for scorekeeping purposes for these items vary from Appropriations Committee reports as follows: $175,000,000 in contract authority provided in basic legislation for Appalachian development in lieu of appropriation as requested and reflected in committee reports on HUD-independent bill; and $10,000,000 in 1971 advance appropriation for census eliminated and shown as 1970 reduction in committee reports on State-Justice-Commerce-bill.

[5] Conference committee action.

Mr. MAYO. I have a table here that I could ask to be introduced into the record on the congressional action on appropriations and its effect on outlays.

Senator PROXMIRE (presiding). We are happy to print that in the record.

(The table referred to follows:)

CONGRESSIONAL ACTION ON APPROPRIATIONS, EFFECT ON OUTLAYS, JANUARY 1970

[In millions of dollars]

	April estimate	Amendments	Total request	Enacted	July reduction	September estimate	Amount enacted— Change from April estimate	Amount enacted— Change from request	Amount enacted— Change from September estimate
Agriculture and related	7,214	262	7,476	7,642	+167	7,643	+428	+166	−1
Public works and AEC	4,441	27	4,468	4,539	−23	4,445	+98	+71	+94
Independent offices and HUD	15,192	86	15,278	15,252	−212	15,066	+60	−26	+186
Labor-HEW (as in budget)	18,868	16	18,884	18,897	−159	18,725	+29	+13	+172
(Pending conference bill)				(19,534)			(+666)	(+650	(+809)
Interior and related	1,756	8	1,764	1,769	−75	1,689	+13	+5	+80
Legislative branch	330	9	339	329		339	−1	−10	−10
Transportation	6,502	81	6,583	6,458	[1] −100	6,482	−44	−125	−24
District of Columbia	195	23	219	213		249	+18	−6	−36
Treasury-Post Office	2,112		2,112	2,078	−19	2,093	−34	−34	−15
State, Justice, Commerce	2,531		2,531	2,469	−6	2,525	−62	−62	−56
DOD-military	75,737		75,737	72,841	−2,960	72,777	−2,896	−2,896	+64
Military construction	1,862		1,862	1,825	−40	1,822	−37	−37	+3
Foreign aid (as in budget)	2,890	415	3,305	3,204	−15	3,290	+314	−101	−86
(Pending bill adding items in disagreement)				(3,224)			(+334	(−81)	(−66)
2d supplemental, 1969 (1970 outlay effect)	726		726	651		726	−75	−75	−75
1st supplemental, 1970, and claims	25	222	247	266		247	+241	+19	+19
Total	140,381	1,149	141,531	138,433	[1] −3,442	138,118	−1,948	−3,098	+315
Total, substituting items pending for those in budget								(−2,441)	(+972)

[1] Excludes reduction in highway trust fund not related to appropriation action.

Mr. MAYO. Thank you. It is based on what I might call the toting up of all of the appropriations bills. I merely come back to what I said at the beginning: I think you and I could probably talk about who did what to whom for quite a while.

Senator PROXMIRE. Well, that is right. I agree with that.

Mr. MAYO. I think also you and I would agree that we are both very glad these cuts were made, period.

Senator PROXMIRE. Furthermore, the President is the definitive authority on spending. He does not have to spend the money.

Mr. MAYO. No, he does not, and, if the Congress had not ratified this, I dare say a good share of this would have been done anyway. The President had committed himself to the $192.9 billion. The only way he had a chance to maintain that was with the $3 billion of defense cuts. So he put his name on the line on that one.

Senator PROXMIRE. Let me get back to the costs of Vietnam. You know, it is curious to me that the Executive now chooses to conceal from the taxpayer the cost of the war. Knowledge is power, as we know. If we do not know how much the cost of the Vietnam war is, we shall be inhibited, it seems to me, from acting sensibly on the military budget according to our own value judgments and our own feeling about what we are doing in Vietnam. For years, the administration justified military increases on the basis of what we are doing in Vietnam when there was public support of the Vietnam war. Now that there is not public support for it and we are deescalating, it is a mystery.

On page 74 of the budget last year, there is a table showing the Vietnam cost. It shows the personnel, it shows the dollars expended. The administration is telling us about the reduction in Vietnam every month, in personnel—how many people are coming back, how many are there. This might be of some value to the enemy; I do not think it is. I think they are wise to tell us.

But, certainly, the dollar figures should be revealed. There is no sense in the world in classifying those, and we would be in a far better position to know how to act on these expenditures if we could be told how much the cost of the Vietnam war is.

Mr. MAYO. I would respond, first of all, by agreeing with you that the figures as they come about on deescalation and troop withdrawals are indeed facts, and they are quite appropriately revealed to the American public as soon as they are available. I also make the obvious point that I do not consider what the prior administration did in terms of working up guesses on Vietnam costs, on whatever basis was used, to be binding on the new administration. We felt that the President's flexibility is better served by not getting involved in a debate as to what is Vietnam and what is not Vietnam. In addition, the accounting basis for such a determination tends to be more confusing than helpful.

There is no attempt, Senator Proxmire, to conceal in any way the cost of the Defense Establishment in this country. You will find infinite detail throughout the budget on that. We feel that it is confusing to the American people to have figures bandied around on the cost of Vietnam which are neither here nor there. The $17 billion figure which Secretary Laird used was, in effect, a carryover figure. I do not deny that it has some relevance in indicating a downward trend. I think that trend, however, can be illustrated in many other ways that are more substantively correct.

I would also indicate, if I may, that the $17 billion figure creates an illusion that there is $17 billion available to spend on urban programs or on other defense programs once Vietnam actually comes to a halt. I think that is misleading.

Senator PROXMIRE. You are afraid that if we get this information we will make bad judgments because the information will be misleading. All you have to do is tell us what the facts are, qualify the information in any way you wish, express the fact, express your conviction that this is not available; then we shall be in a better position to act. We have to rely on the Budget Bureau very greatly for our understanding and information on these expenditures. You are by far our most reliable source, more reliable than the agencies are.

Mr. MAYO. Well, thank you.

Senator PROXMIRE. If you do not get that to us, and we cannot break it out, we are not going to be in the position to do the kind of job up here that we should do.

Mr. MAYO. I think the sort of breakdowns you people need up here are the very breakdowns that are available in the budget. This does not include, in my estimation, a breakdown on a fairly iffy basis of so-called Vietnam costs. The judgments that I assume you will be making in your evaluation of the Defense budget are judgments that relate to procurement, military personnel, to civilian personnel, and so forth, which are the guts of the operation of Vietnam and non-Vietnam.

You want to look at these as a whole.

Senator PROXMIRE. Why, in your statement, do you indicate that there is only $1.1 billion in military personnel cutback? You say that this does not reflect the proposed pay raise and you say it does reflect a drop of more than 385,000 in the size of the Armed Forces. A drop of 385,000 should certainly translate into a much larger reduction in military personnel costs than $1.1 billion. We have been told it is $10,000 per soldier in this country, and up to $25,000 abroad. Those figures may or may not be accurate, but certainly a reduction of 385,000 personnel ought to save a lot more than $1.1 billion.

Mr. MAYO. First of all, the figure cited is an end-of-period figure. As you realize, many of these people are still on deck, at least during part of the fiscal year, when we are toting up our spending estimates.

Also, there are separation costs involved for each of these men. This means that you cannot possibly have a translation in terms of even the $10,000 per man if you are making an effective analysis of the demobilization part of it.

Of course, to include the cost of equipping a man, which would run the figures higher, is, I think, rather obviously incorrect since you are not going to sell the man back his equipment when he leaves, or sell it to anyone else, for that matter.

Senator PROXMIRE (presiding). My time is up.

Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

May I ask the Chair, just so that we have the record complete now, that in view of the earlier table that the vice chairman introduced, which only relates to the $135 billion, that we now have inserted in the record the table entitled "Supporting Table No. 1.—Effect of Congressional Actions and Inactions on Budget and Outlays (Expenditures) During the 91st Cong., 1st Sess. (as of Dec. 23, 1969)," contained in the 1970 budget scorekeeping report, staff report No. 14?

Senator PROXMIRE (presiding). Without objection, that will be included.

(The table referred to follows:)

SUPPORTING TABLE NO. 1.—EFFECT OF CONGRESSIONAL ACTIONS AND INACTIONS ON BUDGET AUTHORITY AND OUTLAYS (EXPENDITURES) DURING THE 91ST CONG., 1ST SESS., AS OF DEC. 23, 1969

[In thousands of dollars]

Items acted upon	Congressional actions on budget authority (changes from the revised budget)[1]			Congressional actions on budget outlays (changes from the revised budget)[1]		
	House	Senate	Enacted	House	Senate	Enacted
	(1)	(2)	(3)	(4)	(5)	(6)
Fiscal year 1970 actions on individual bills affecting budget authority and outlays:						
Appropriation bills—changes from the revised budget:						
Treasury, Post Office, and Executive Office (H.R. 11582, Public Law 91-74)	−42,382	−34,519	−38,482	−37,000	−30,600	−34,000
Agriculture and related agencies (H.R. 11612, Public Law 91-127)	−160,907	+405,236	+251,341	[2] +53,000	+294,000	+166,000
Second supplemental, 1969 (H.R. 11400 Public Law 91-47)				−92,700	−64,700	−75,000
Section 401 outlay ceiling[3]					(−1,900,000)	(−1,000,000)
Independent offices and Department of Housing and Urban Development (H.R. 12307, Public Law 91-126)	−471,325	[4] −177,521	−226,099	−61,000	−25,900	−40,000
Interior and related agencies (H.R. 12781, Public Law 91-98)	−15,810	−8,090	−10,481	−15,300	−11,080	−7,800
State, Justice, Commerce, the Judiciary and related agéncies (H.R. 12964, Public Law 91-153)	[4] −130,070	[4] −83,350	[4] −111,272	−71,000	−40,600	−60,000
Labor and Health, Education, and Welfare and related agencies (H.R. 13111)	+1,078,365	+1,637,686	+1,139,028	+521,000	+653,000	[5] +565,000
Legislative Branch (H.R. 13763, Public Law 91-145)	−26,850	−29,842	−27,826	−7,900	−8,800	−8,700
Public Works (H.R. 14159, Public Law 91-144)	+301,469	+789,451	+552,030	+10,500	+67,400	+50,000
Military Construction (H.R. 14751, Public Law 91-170)	−466,741	−313,854	−356,844	−37,000	−26,500	−29,000
Transportation (H.R. 14794, Public Law 91-168)	+34,546	+106,679	+89,265	−172,000	−43,200	−133,000
District of Columbia (H.R. 14916, Public Law 91-155)	−40,151	−55,295	−60,332	−14,000	−13,080	−12,500
Department of Defense (H.R. 15090, Public Law 91-171)	−5,318,152	−5,955,544	−5,637,632	−3,000,000	−3,250,000	−3,200,000
Foreign Aid (H.R. 15149)	−1,071,544	−960,779	[5] −1,120,654	−167,000	−146,000	[5] −120,000
Supplemental, 1970 (H.R. 15209, Public Law 91-166)	−63,490	−17,721	−36,317	−5,670	+30,000	+19,000
Subtotal, appropriation bills	−6,393,042	−4,697,463	−5,594,275	−3,096,070	−2,617,500	−2,920,000
Legislative bills with spending authorizations—changes from the revised budget:						
Civil service retirement benefits (Public Law 91-93)	(6)	(6)	+145,000	+86,100	+94,700	+65,000
Defense: overseas mailing privileges (H.R. 8434)	+8,090			+8,900		
Veterans readjustment benefits (Public Law 91-22)	+1,362	+1,362	+1,362	+3,952	+3,952	[5] +2,300
Veterans hospital care for 70-year-olds (H.R. 693)	+16,225	+16,225	(7)	+16,225	+16,225	(6)
Veterans care in State homes (Public Law 91-178)	+2,803	+2,803	+2,803	+2,803	+2,803	+2,803
Veterans care in community nursing homes (H.R. 692)	+5,954			+5,954		
Veterans outpatient care (Public Law 91-102)	+8,000	+8,000	[8] +4,000	+8,000	+8,000	[5] +4,000
Veterans nursing home care (service-connected) (Public Law 91-101)	+1,500	+1,500	[8] +750	+1,500	+1,500	[5] +750
Veterans non-service-connected benefits (H.R. 372)	+8,538			+8,538		
Additional district judges (S. 952)		+1,473			+1,473	
Additional clerks for House Members (H. Res. 357)	+3,600		+3,600	+3,600		+3,600
Appalachian highways (Public Law 91-123)	+20,000					
Food for needy children (H.R. 11651)				+100,000		
Veterans education assistance (H.R. 11959)	+206,500	+383,000	(7)	+206,500	+380,000	(7)
Veterans Vietnam insurance (S. 2003)		+1,700			+1,700	

Veterans additional $5,000 insurance (S. 1479)		+45,000			+45,000	
Veterans double indemnity insurance (S. 1650)		+100,000			+100,000	
Veterans dismemberment insurance (S. 2186)		+10,000			+10,000	
Veterans increased dependency and indemnity compensation (Public Law 91-96)	+61,565	+52,840	[8] +31,300	+61,565	+52,840	[8] +31,300
Navajo Indian road (S. 404)		+5,000				
Travel per diem (Public Law 91-114)		+13,000	+13,000		+13,000	+13,000
Federal salary comparability (H.R. 13000)	[9] +750,000	+696,000	(7)	[9] +750,000	+696,000	(7)
Public Health Service retirement (S. 2452)		+110			+110	
Prisoner-of-war medical care (S. 1279)		+1,017			+1,107	
Military lawyers retention (H.R. 4296)	+7,000			+7,000		
Judges' 20-year retirement (S. 1508)		+636			+636	
Housing and Urban Development Act (Public Law 91-152)	+1,500,000		+1,500,000	(6)		(6)
Outdoor advertising controls (S. 1442)		+15,000				
Expanding mortgage market (Public Law 91-151)	(6)	+3,000,000	+3,000,000	+123,000	(6)	+123,000
Adjustment of military retired pay (Public Law 91-179)	+14,000	+14,000	+14,000	+14,000	+14,000	+14,000
Unemployment trust fund (H.R. 14705)	+14,000					
Family separation allowance—residence (H.R. 110)	+9,000			+9,000		
Per diem allowance (Public Law 91-183)	+41,000	+41,000	+41,000	+41,000	+41,000	+41,000
Air evacuation subsistence (H.R. 9654)	+25			+25		
Federal-aid highways (H.R. 14741)	+26,000					
Additional super grade positions (Public Law 91-187)		+93			+93	
Legislative and judicial salaries (Public Law 91-67)		−38	−38		−38	−38
Social security benefits (Public Law 91-172)				+1,000,000	+1,900,000	+1,050,000
NSLI trust fund for veterans home loans (H.R. 9476)				[10] +1,000,000		
Urban mass transportation (S. 3154)		[10] +2,800,000				
Subtotal, legislative bills	+2,705,972	+7,209,721	+4,756,777	+3,457,662	+3,384,011	+1,350,715
Total, actions on individual bills	−3,687,070	+2,512,258	−837,498	+361,592	+766,511	−1,569,285
Inactions on legislative proposals to reduce budget authority and outlays, see part I of supporting table No. 4 p. 11	+1,313,513	+1,313,513	+1,313,513	+1,231,913	+1,231,913	+1,231,913
Total, fiscal year 1970	−2,373,557	+3,825,771	+476,015	+1,593,505	+1,998,424	−337,372

[1] The budget figures to which these adjustments apply are the April 15 estimates as amended. Accurate estimates of the cost impact of congressional actions on mandatory spending legislation are frequently difficult to obtain—especially for outlays. Cost estimates are obtained from various sources, including committee reports, floor debates, Government agencies and informal staff contacts. Sometimes cost estimates on new legislation are not available. What is reflected in this congressional action table is the best that the staff has been able to put together. Occasionally it is necessary to revise an estimate as more current information becomes available.

[2] Reflects floor action increasing milk funds by $120,000,000, but does not reflect effect of $20,000 limitation on subsidy payments adopted by House. The Appropriations Committee assumed a reduction in Public Law 480 spending which if not realized will result in higher spending than estimated.

[3] The 2nd Supplemental Appropriation Act, 1969, carried an overall expenditure limitation for fiscal 1970 which was different in all three versions. The House-passed version set the ceiling at the April 15 budget figure of $192,900,000,000 with provision for increases or decreases depending upon actions or inactions of the Congress affecting the budget. The Senate version made a flat reduction of $1,900,000,000 in the overall ceiling but exempted certain items from the ceiling. The enacted version made a flat reduction of $1,000,000,000, provided for increases or decreases depending upon action or inaction of Congress affecting the budget, and granted up to $2,000,000,000 of flexibility in the ceiling to the President for certain uncontrollable items.

[4] Figures posted for scorekeeping purposes for these items vary from Appropriations Committee reports as follows: $175,000,000 in contract authority provided in basic legislation for Appalachian development in lieu of appropriation as requested and reflected in Committee reports on HUD-Independent Bill; and $10,000,000 in 1971 advance appropriation for census eliminated and shown as 1970 reduction in committee reports on State-Justice-Commerce-Bill.

[5] Conference committee action.

[6] Not available.

[7] Subject to or in conference.

[8] Revised estimate based on late enactment.

[9] As amended on House Floor costs could vary between $500,000,000 and $1,000,000,000.

[10] Committee action.

Senator MILLER. That committee was headed by Congressman Mahon, the chairman of the House Appropriations Committee, which I earlier referred to, which gives the complete picture for the total expenditures of the year.

Senator PROXMIRE (presiding). That has been made a part of the record.

Senator MILLER. Mr. Mayo, harking back to the question by Congressman Reuss, do I understand that the administration, particularly the Budget Bureau, has taken further steps in the budgeting process to tighten up on the actions relating to the Defense budget?

Mr. MAYO. Oh, yes; I think we have taken steps to tighten up the budget process throughout the Government. We have declared, as I noted before this committee some months ago, that obviously, we only do this for the President and with his complete support. We have taken a position that the procedures applying to the Defense Department should be the same as those relating to other agencies.

This includes the procedure of giving a target——

Senator MILLER. On that point, do you imply that prior to this time, the Defense Department had a special budgeting process of its own as distinguished from the other agencies, and that now you have taken action to put them on the same footing as the other agencies?

Mr. MAYO. Yes; that does not mean to say that the budget process was completely independent of Defense in earlier years. At the staff level, there has always been a very close coordination between the staff of the Bureau and the staff putting the budget together on the other side of the river. So, in fact, for many years, there has been intimate knowledge of what was going on in the preparation of the Defense budget.

Where the change has taken place is at the decisionmaking level, with the President himself, and with me trying to serve him in the best way.

We gave the Defense Department a target, just as we did each of the other agencies. The Defense Department presented its budget through the Budget Bureau and, if there was disagreement, the Secretary of Defense had exactly the same right, and—for that matter—duty to the President to appeal budget decisions that he did not think were right or those he disagreed with.

This is exactly the way it worked out.

Senator MILLER. Now, in your colloquy with Congressman Moorhead, looking down the road to 1975, he was trying to ascertain where the reduction in Government procurement of goods and services might fall. Because of the weapons systems that could cost a great amount of money, extending them out into the future, he was concerned, and I am sure all of us are concerned, as to where the cutback would come—whether it would come at the cost of civilian programs, or just where. It is my understanding, and I think it is borne out in part by your statement, that a very substantial reduction in the personnel, in the Defense Establishment, is going to take place.

I understand further that about half of the Defense budget is attributable to personnel and related costs. So would it not be a fair deduction that part, at least, of this reduction that is projected forward would be the result of a reduction in the personnel strengths in the Military Establishment?

Mr. MAYO. Well, certainly through 1971, I believe that is apparent from the detail that is published in the budget, Senator Miller. Going on out to 1975, I can conceive of a great many different paths to those 1975 figures.

While I would seriously doubt that all of the new weapons systems would actually transpire in this period of time, let us assume that many of them would. The budget control that would be exercised in the wisdom of the Congress, would, in effect, be expressed in stretching out some of these. Even if they were quite desirable in all of our eyes, there is the whole business of trying to get a balance between new strategic weapons and the elimination of antiquated forces, and as you suggest, further reductions that might come down the road in personnel.

I do not want to prejudge any of these possibilities, but merely suggest, again, that we are trying to project here a total pie without inhibiting any decisions on distribution of the pot.

Senator MILLER. Now, you stated that the restoration of the surcharge was not necessary in the present environment.

Mr. MAYO. Yes.

Senator MILLER. But suppose the present environment, which includes a proposed budget with a slight surplus, is not achieved. Suppose that the optimism of my colleague from Wisconsin is not borne out and the Congress does not cooperate with the administration and ends up with what otherwise would be a budget deficit. Would it be your thinking that that change in the environment would indicate a reaction on the part of Congress to be requested to restore the surcharge, or postpone some of the tax relief that was enacted in the Tax Reform Act of 1969?

Mr. MAYO. I certainly could not deny the possibility of either of the suggestions that you make. I would suggest, first of all, that we are going to fight with all the bows and arrows that we have at our disposal to try to convince the Congress that our financial plan is the right one. If, as you suggest, we somehow fail to convince the Congress of our wisdom, and they substitute their own plans, which is higher spending, I would suggest that we have two obvious alternatives in an environment that looks then as it looks today.

One would be to cast about for further cuts in spending. The other would be to consider various possibilities on the revenue side.

Senator MILLER. I am assuming in my question that the Congress in its appropriations actions has run up over that $200 billion spending figure that the President has suggested, or requested. Following along with what Congresswoman Griffiths intimated in connection with the family welfare allowance—she has forecast that the $1,600 figure would be increased—if, as a result of the Congress' action on the appropriations bills, the spending goes up to the extent that it would otherwise throw us into a deficit, it would seem to me that the Congress, by its actions, has only invited the administration to ask for tax increases or postpone tax relief.

Mr. MAYO. Or further spending cuts, we would have to hold funds that the Congress has authorized for spending.

Senator MILLER. If Congress gives you the authority, or does not tie your hands on that?

Mr. MAYO. Yes. We have that authority in most cases. We do not, as you know, in some educational programs.

Senator MILLER. As I understood it, the Congress enacted a $192.9 billion spending ceiling last year.

Mr. MAYO. $191.9 billion.

Senator MILLER. And it was widely heralded. Yet we find that we have $198 billion that we are going to spend.

Mr. MAYO. Yes.

Senator MILLER. Will you tell us how that happened?

Mr. MAYO. Yes, I shall be glad to.

Let me have the last chart in our set of charts.

This $192.9 billion is the figure that we had set as our target in April, and the one that the President reiterated in the summer and, indeed, in the September budget review. The base for the statutory ceiling that Congress enacted in July was $191.9. The Congress did allow for any increased spending up to $2 billion for certain specified uncontrollables; namely, those on which the Congress does not itself have to provide authorization. Interest on the public debt and the trust fund benefits are the two most important. On the negative outlay side, sale of assets is also included. The $191.9, therefore, became $193.9, since all of the allowance for uncontrollables was used up.

What has happened, from then until now, is simply this: Congressional action since the imposition of the ceiling, which represented endorsement of administration plans, cut the budget by $2.5 billion net. This includes the additions, working the other way, that the Congress made in SST and Export-Import Bank and in the food stamp program. That $2.5 billion reduced the ceiling.

The Congress, however, by its action or its unwillingness to act on things like postal rate increase, raised the ceiling by $3.4 billion. This was in the first session of this Congress.

We anticipate that additional appropriations action of $0.9 billion will be needed in the current session, and this is reflected in the budget.

If you take these figures together, you would add up to a total of $195.7 billion, which is ouor interpretation of the ceiling at the end of the year.

Now, $195.7 happens to be $2.2 billion shy of the $197.9 billion that we have portrayed as our best estimate for total spending in the fiscal year 1970.

The $2.3 billion of that difference—in other words, one-tenth of a billion dollars more than the total difference—represents increases in uncontrollables above the $2 billion originally allowed by the Congress. I would suggest, therefore, that the first step in remedying the problem of the 1970 statutory ceiling is a repeal of the allowance for uncontrollables, which is, in fact, a contradiction in terms. A ceiling on uncontrollables really is a little bit difficult to understand. If the Congress does remove the ceiling, on uncontrollables and provides no other relief, it would give us literally one-tenth of a billion dollars leeway under the revised ceiling.

One-tenth of a billion dollars is hardly a margin that is becoming an enterprise which, even aside from the uncontrollables, results in Federal spending of more than $66 billion in fiscal year 1970. I do not think anyone needs to kid himself that we are so smart that we can estimate the path of all these items of Federal spending, including a lot of "controllables" that are in fact, not very controllable.

So, even if the uncontrollable limit were raised or removed, we are permitted a margin of error of approximately one-tenth of 1 percent. This is hardly a very discreet sort of way to go about doing our business.

Some modification of the basic ceiling of $191.9, perhaps restoring it to the $192.9, which was our base in the first place, would be appropriate if we are to conduct our business so that we do not cut back in an almost punitive fashion programs where we have control late in the fiscal year to make sure we do not break the law. I cannot sit there as Budget Director and advise the President to take the chance that he would, in effect, violate the expenditure ceiling. I do not think that would be appropriate.

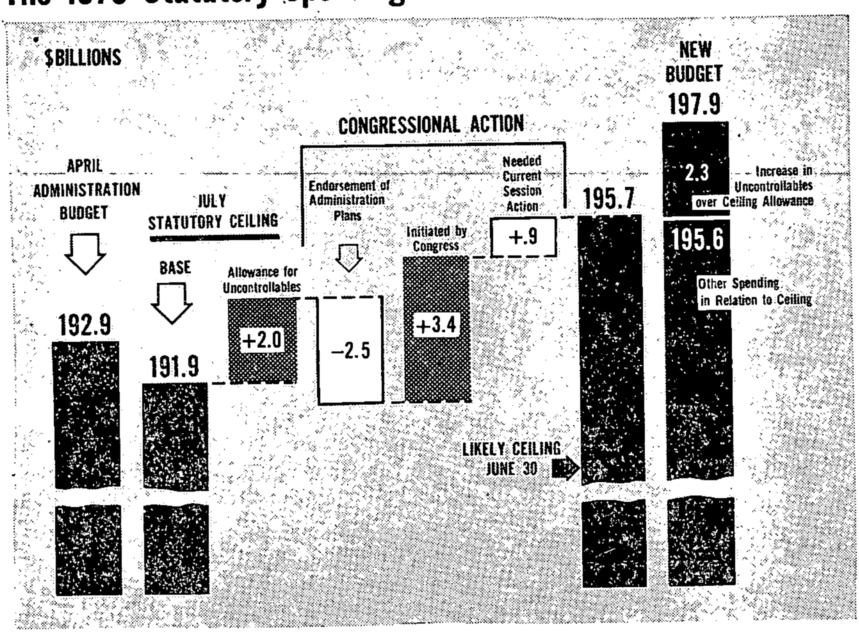
Excuse the long-winded explanation, but I again have a chart here that, with the vice chairman's permission, I would like to introduce into the record on the ceiling problem.

Senator Proxmire (presiding). Without objection.

Mr. Mayo. Thank you.

(The chart referred to follows:)

The 1970 Statutory Spending Problem



:xecutive Office of the President / Bureau of the Budget

Senator Miller. Thank you, Mr. Mayo.

Senator Proxmire (presiding). Congressman Reuss?

Representative Reuss. Mr. Mayo, I thought you made an excellent answer to Congresswoman Griffiths before, when she put to you the question that was the President's welfare program not inflationary.

You answered that to the extent it took people who otherwise would be idle and put them to work, making useful goods, which could sop up purchasing power, it was in part, at least, anti-inflationary.

Mr. MAYO. Yes.

Representative REUSS. Have I correctly interpreted that?

Mr. MAYO. Yes, you were interpreting me correctly; yes.

Representative REUSS. I think you were exactly right, and I wish you could use that same, cold, clear logic on your friends in the administration to get them to get rid of their, I think, silly current economic policy. See what they are doing. They are cutting down on production in this country, even though we are operating at only 83 percent of industrial capacity. They are putting men out of work, hundreds of thousands last year, would otherwise have been at work, and some 700,000 if the administration program has its way this year.

You, as the other administration witnesses, demonstrate some surprise. You say on page 1 that there can no longer be any doubt that the economy is cooling off. However, price increases stubbornly persist.

You bet they do stubbornly persist, because your policies are working in the wrong direction. When you put men out of work, you are preventing them from making things which people would otherwise buy and could sop up purchasing power. You see, you are creating inflation.

Why don't you stop it and——

Mr. MAYO. I do not agree, Mr. Reuss, that we are creating inflation. We are trying, in the process of judging the impact of fiscal and monetary policies, to create an environment that is more conducive to slowing down the price increases. We must not give up just because the 10 percent surtax did not exercise its magic 18 months ago, as most of us really expected.

I think that the process of getting prices under control must have some of its more distasteful side effects; there is just no question about it.

I must make it very clear to everyone that as long as there is one able-bodied willing man out of work in this country, we have unfinished business. Yet I must admit that because of this great stubbornness of inflation, some unemployment is one of the prices that I think has to be paid for achieving price stability.

I think it is unfortunate, but I do not think it can be avoided.

Representative REUSS. Could it not be that the reason that your antiinflationary program is such a dismal, complete, utter failure is because the administration's thinking is muddled? The way you bring prices down is by having fiscal and monetary policies that equate supply and demand, and then you impose a price freeze such as we Democrats advocate so that you do not get this after effect.

Instead of doing that, though, you cut demand below the level that is needed to employ the people in this country and the resources that demand employment.

It seems to me that you are so right in your thinking on why it is not inflationary to get people off of welfare and back into useful work that I cannot understand why you and your colleagues are making this dreadful, awful mistake which is creating great havoc in this country, and is making more inflation rather than less. Why is that?

Mr. MAYO. Naturally, I, in my modesty, think that I have it perhaps more clearly in mind than you do, Mr. Reuss.

Representative REUSS. But on this point, why? How?

Mr. MAYO. Because I feel that we must attack the problem, and have attacked the problem, at its root source. We still have to have a bit more patience than we have had to date if we are to unwind the price inflation that is yet to come. We admit this.

I consider a freeze of prices and wages to be an oversimplified solution. We would be creating far more havoc in the process of doing that than it would be worth. We have not yet found a way to apply direct price and wage controls without, in effect, rewarding the dishonest in the economy. It is very difficult to try to police any sort of a freeze or price and wage control and do it equitably. You are asking Washington to supplant the market system and somehow to roll up, in its wisdom, the checks and balances of that system. I know of no man who is strong enough or wise enough to reflect the effect of market forces here.

So I ask merely that we all be patient a little longer. I think the right steps have been taken to make the correction that is necessary although distasteful.

Representative REUSS. Now, you have said that you are against freezing prices. Is it not a fact that in your budget you have frozen the wages of workers in the governmental sector for 6 months? Do you think——

Mr. MAYO. We have——

Representative REUSS. Do you think it is fair to take it all out on workers and not do anything about prices?

Mr. MAYO. Well, this is a familiar question to me, Mr. Reuss. As you can appreciate, we did this deliberately, with the idea that the administration had a very direct responsibility to the American people to set an example of wage restraint at the Federal Government level. We have 2.5 million permanent employees, plus all those in the Armed Forces, who are being asked to sacrifice a wage increase which, in all equity, they are entitled to on July 1. We recognize that there is a question of comparability here.

The study has been made by the Bureau of Labor Statistics, and by all standards of equity, Federal employees are entitled to a 5¾-percent increase on July 1. We are asking, however, that the increase be made effective January 1, because we think that there is a powerful impact when the President of the United States and, with the cooperation of the Congress, the U.S. Government takes the lead in showing that we can set a pattern. This pattern will have a dampening effect on union wage demands during 1970 that otherwise would be just a little bit higher.

Representative REUSS. Well, I appreciate your responsiveness. I do have to record, however, my own view that the Nixon economic policies are a disaster, and we Democrats hope the administration will reconsider, because they are not making contact with inflation and they are putting people out of work—the worst of two worlds.

Mr. MAYO. Well, I must record that I do not agree with you.

Representative REUSS. Thank you.

Senator PROXMIRE (presiding). Congressman Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Mayo, I would like to go back to the 1975 projection again.

Mr. MAYO. Yes, Mr. Moorhead.

Representative MOORHEAD. I would like to see if I can get this cleared up.

When I look at the table on page 177 of the Economic Report and look at the trend of purchases of goods and services other than national defense, it seems, at least since the midfifties, to be always inching up, never going down. So that I would imagine that anybody making a projection into 1975 would certainly not predict a downward trend or reverse of that.

Therefore, the likelihood would be simply that you predict a slight increase.

Even if you predicted a flat $23 billion out of the projected $84 billion in purchases for 1975, that leaves a maximum of $61 billion, and probably less than $60 billion for a Defense budget in 1975. Is that not correct?

Mr. MAYO. One can make quite a few different assumptions, Mr. Moorhead, on the construction of the components of our pie here. I cannot deny, looking at the page you refer to in the back of the Economic Report, that there has been a pervasive upward trend in nondefense purchases of goods and services. However, I do not want to be in any position of prejudging the distribution of our pie in 1975.

Representative MOORHEAD. Is it not true in earlier internal drafts of the budget that there was a breakout of national defense in these projections?

Mr. MAYO. Pardon? What was the question?

Representative MOORHEAD. Is it not true that in earlier internal drafts of this year's budget, there was a breakout for national defense and other expenditures in these projections?

Mr. MAYO. Earlier drafts? You mean of the budget message?

Representative MOORHEAD. Of the budget, yes.

Mr. MAYO. No. There was no breakdown of defense and nondefense in the budget message drafts that came across my desk.

Representative MOORHEAD. In the drafts that came across your desk, there was not at any time any attempt to break that out?

Mr. MAYO. No.

Representative MOORHEAD. I note in your statement, you talk about a greatly reduced amount of manpower, and Senator Miller mentioned the figure of one-half the present strength. In your projections into the future, are you contemplating a volunteer army?

Mr. MAYO. This is one of the options that would be consistent with various other assumptions on the defense and civilian budget. We have not prejudged one way or another the volunteer army. If it were indeed adopted and it cost more, something else would have to give in the way we have constructed the pie.

Representative MOORHEAD. I notice in your testimony, you talk about deactivation of older ships and aircraft.

Mr. MAYO. Yes.

Representative MOORHEAD. Has there been consideration given to deactivation of the oldest aircraft carriers to reduce the total number of aircraft carriers in the fleet?

Mr. MAYO. Consideration has been given to that, yes, sir.

Representative MOORHEAD. Am I correct that the annual cost of operating an aircraft carrier task force is around $300 to $400 million?

Mr. MAYO. I do not have that particular figure in mind.

Representative MOORHEAD. If I am wrong, would you, in the record, correct that?

Mr. MAYO. I shall have that looked into.

(The requested information follows:)

Current information available to the Bureau of the Budget indicates that the annual operating cost of a task force consisting of our oldest class of attack carrier, six escort ships, and six replenishment vessels is about $125 million. This estimate includes the cost of personnel, operations and overhaul expenses. Initial procurement costs are not included.

Representative MOORHEAD. If that figure is correct, that would be about double what we spent on Federal grants for water pollution last year, is that not correct?

Mr. MAYO. In terms of outlays on water pollution, I have forgotten the figure; it is in that general area. Of course, that is growing rapidly now, or will be growing rapidly.

Representative MOORHEAD. I think that this is the kind of thing the people want you and the Congress to consider more carefully.

Mr. MAYO. Of course.

Representative MOORHEAD. Where we have 15 to zero superiority over all the Communist nations in aircraft carriers, then the cost of the 15th one, that is double what we spent on Federal grants for water pollution last year—which do the people want, which has the greatest payoff for the national interest, for which should we allocate our scarce resources? I think these are the difficult kinds of questions that we have to answer.

Mr. MAYO. Yes, that is a good question. It is typical of the questions that I think, as I said earlier, will grow out of our publishing budget estimates for 1975. People can use these estimates as a measurement of an environment in which spending plans will have to compete with one another. We do indeed, want to spend more for water pollution. Maybe, in our wisdom on national defense policy, the President will determine that we can get by with a fewer number of aircraft carriers and accompanying forces. This is a very good illustration of the sort of debate that will go on, both up here and at our end of the avenue.

Representative MOORHEAD. Thank you, Mr. Chairman.

Thank you, Mr. Mayo.

Senator PROXMIRE (presiding). Senator Percy?

Senator PERCY. My first question on the second round is on housing. I read this morning in the Wall Street Journal in the plane coming to Washington—I almost fell out of the plane—a statement attributed to Dr. McCracken yesterday.

In 3 years, I have tried modestly to work in the field of housing to see what could be done.

We have had magnificent goals established—2,600,000 housing starts on an average, per year. We have had a shift in emphasis to housing for low-income people. We have accomplished the latter. We are really building more units, for home ownership and rental, for lower income people than previously related to those built for the relatively affluent. But we are in a disastrous situation on the total number of units.

Fourth quarter housing starts were at the annual rate of 1,300,000, which meant that during the course of the year the average per quarter construction for new starts was down 9 percent per quarter on an average during the course of the year. So we have just come up to 50 percent now of our goal for the year.

Yesterday, Dr. McCracken said: "The United States still has a difficult problem of diverting enough credit into housing." Mr. McCracken said, "So I remain openminded about the approach of limiting lending to corporations."

Later, Mr. McCracken told a reporter that consideration of such a move isn't imminent and that "a possible response to the unsolved housing finance problem would be to let it remain unsolved."

Now, in view of the national goal established by Congress and concurred in by the present and past administration I would like to ask your comment on that position as a matter of policy for the administration.

I also will ask him later, because it is possible that his comment could have been excerpted out of context, though it is a fine newspaper that it is reported in, with very careful reporting generally. It might have been taken somewhat out of context. But so far as figures are concerned, on page 276 of the Budget Special Analyses, we show on authorizations a drop from $2,644 million in 1970 to $929 million in 1971.

Under outlays, an increase for 1970 from $1.586 billion to $1.785 billion a modest increase of $153 million, on page 336 of the budget.

So there is a very small increase in outlays planned. I would like a policy statement as to what we are going to do to solve this increasingly critical condition in housing, which is disastrous for the industry and disastrous for young married people today, or anyone looking for housing.

Mr. Mayo. Senator Percy, I have not read the remark attributed to Dr. McCracken, that one of the possible ways of approaching this is to leave it unsolved. Without meaning to put words into Dr. McCracken's mouth, he was, I think, just trying to say that this is one possible approach—not that he subscribes in any sense to the approach of leaving it unsolved.

You also suggested that he has an open mind on it. This was on the question of——

Senator Percy. The approach of limiting lending to corporations.

Mr. Mayo. Oh, yes, on limiting lending to corporations. I think this is quite an appropriate stance for any of us to take. It does not, however, as far as I am concerned, indicate that we would actually favor either of the two points of view that were expressed here as possibilities; namely, some sort of direct control on corporate credit extension or, on the other hand, just sticking our heads in the sand.

Those are extremes in a position that I would not say characterize any of our points of view as far as I am aware.

We do need to do something on housing and there are at work right now groups at a very high level in the Federal Government working toward figuring out what steps need to be taken. I think Secretary Romney will have something to say about that when he appears next Tuesday, I believe it is, before the House Banking and Currency Committee.

We all know that the housing industry, perhaps even more than State and local governments, has been the victim of the tight credit conditions which unfortunately have grown out of the imprudent budget deficits of earlier years and the inflationary environment the deficits foisted upon us. I would suggest that if the assumptions of a somewhat moderate Federal Reserve policy later this year, which have been made by the administration both in the budget and in the Economic Report, are indeed correct, the housing industry will be the beneficiary of this change in posture, perhaps as much as or more than any other.

That does not mean that this is a cure-all. The housing industry has particular attributes that make it a feast or famine sort of industry because of the way that it gets clobbered by tight credit conditions.

Senator PERCY. Could I interrupt there at that point, Mr. Mayo?

Mr. MAYO. Yes.

Senator PERCY. I would like to ask specifically—as I understand your comments, the statement taken out of context this way does not represent your understanding of the administration policy?

Mr. MAYO. No.

Senator PERCY. That you are just going to leave the problem of financing housing unresolved?

Mr. MAYO. No.

Senator PERCY. It has a very high priority in the administration's program, as I understand it.

Mr. MAYO. It does.

Senator PERCY. That is all I want to clarify.

Mr. MAYO. If I may refer to page 209 in the special analyses in the budget, I think you will see that we have a definite interest in an expansion of new housing units committed under Federal programs. There is a continuation of the rise from 1970 in both new and rehabilitated housing areas and existing housing.

We have spent more money at the Federal level in federally assisted housing in 1969 than in any other year in our history. We would not have done that if we did not have a dedication not only to the low-income problem but to the rest of the problem, too. The extent to which we have encouraged FNMA and the home loan banks to go out and undertake more aid to the institutions originating mortgages, I think, is quite self-evident for 1969.

Senator PERCY. We can leave it, then, that it is a matter of high priority; the administration is continuing to look for new creative ideas to solve the housing problem and would be receptive to any ideas we might discuss with the administration for what could be done to overcome this recession in the industry and the great unmet needs?

Mr. MAYO. Yes, sir.

Senator PERCY. Could I talk about recession for just a moment?

Mr. MAYO. Yes.

Senator PERCY. A columnist recently said it is not a question as to whether we are going to have a recession. She said we have a recession; that you are in a recession if you are a low-income person, living on a fixed income, if you are a small businessman living on borrowed money, if you are in the housing industry, if you are ill and have to meet medical expenses that increase 13 percent a year, if you own stocks, if you own bonds, or if you are a farmer. Any number of groups are in a recession, and some of them a deep recession, right now.

How do you categorize that analysis? Is it true that we are actually in something of a recession right now?

Mr. MAYO. I do not believe that we are in a recession at this point. We have had some leveling off, as we are all aware, in the economic growth pattern. We have seen in the last few days industrial production again showing a very slight decline. We have seen personal income with a far less than normal increase. We know that we are close to 4 percent in unemployment.

I can take this list, Senator Percy, and extend it on a geographical basis to some of our friends in the lumber industry, to some of the various areas in the country associated with certain areas of aerospace, where we have cut back contracts ourselves, to the closure of the ERC facility in Cambridge. I could go on and on. There are pockets which, indeed, in terms of local conditions, suggest that we are in a recession.

But as we must look at the United States as a whole, I do not think that economists are in a position yet, on the basis of an analysis of the coincident indicators—which is probably the best way to look at whether we are in a recission or not—to define February 1970 as a month of recession.

Now, we are not all that smart, and it is possible that when economic statistics are fully in for the month of February, some such suggestion might come out of it. But as we look at February 1970 right now, I do not conclude that we are in a recession.

Senator PERCY. Thank you very much.

Senator PROXMIRE (presiding). Director Mayo, as long as Senator Percy has brought up this housing problem, I would like to point out that the administration is really hurting housing badly. I am not saying that they can control the credit situation, and I know they are anxious to have credit eased, and that would be the important, significant thing to do.

However, in the budget on page 72, it is pointed out that this year, there will be the sale of $4 billion of mortgages, principally Farmers Home Administration, but in other areas, too, of home mortgages, a net sale of $3.6 billion. This is up four times as high as the sale last year, far higher than the sale in 1969, and this can do nothing but raise interest rates, soak up available capital, and hurt housing.

This is one of the ways that you gentlemen are balancing your budget.

I cannot see that this does anything but explicitly and directly hurt the housing industry.

Mr. MAYO. We have purposely moved some of the sales of assets originally scheduled for the fiscal year 1970 into 1971 for the very reason that you suggest. We did not want to interfere with the availability of funds going into housing. Indeed, we felt that if we pushed the sale of paper by the Farmers Home Administration, by other housing agencies, and by the Export-Import Bank, we would be counterproductive in the movement toward lower interest rates in 1970.

Senator PROXMIRE. That is the most optimistic implication, at least, of your statement, about the most optimistic I have heard in housing. I do not know of anybody who expects housing to have a resurgence in the coming year. The fiscal year, after all, only has 4 months to run.

Then you begin, according to this, unloading your mortgages.

During 1970–71, from July 1, 1970, to July 1, 1971, you are going to have a very adverse effect on the availability of credit, which has the effect of driving up interest rates.

Mr. MAYO. It depends entirely, of course, on the shape of our program as it progresses through the year, Senator Proxmire. As we put these figures together, we did not, in fact, feel that a movement from $2 billion of sales in 1969 to $3 billion in 1970 to $4 billion in 1971 was in anyway unreasonable, given our basic assumption of some moderation of Federal Reserve policy during the course of the year.

Senator PROXMIRE. Let me very quickly get into something else just briefly. I have discussed the military aspects of this at some length, and I do want to have just one more question on it.

Time and again, during the debating of the military budget in 1969, it was pointed out that we cannot really reduce our military personnel, our expenditures, until we change our strategy. We had a two-plus war strategy; now we are told we have a one-plus war strategy, but there is no indication in the budget, nothing you have said or that anybody else has said, that this has given us any reduction in military expenditures.

Either we do or we do not have a different military strategy than before, and the Secretary of Defense has assured us we do have.

Mr. MAYO. The construction of the 1971 budget was made specifically with the change in assumptions that you are suggesting here in mind. There is no question about that.

Senator PROXMIRE. Well, if that is true, why is there not a greater reduction? Why is it only a five and a fraction billion reduction? We attributed most of that, virtually all of it, to the Vietnam war de-escalation.

Mr. MAYO. As to the $6.9 billion reduction in defense-military outlays from 1969 to 1971, I do not have any figures in mind as to what part of that is Vietnam and what part of it is not Vietnam. But I submit that the net cut of $6.9 billion could not have taken place without some recognition of the change in our basic national defense posture.

Senator PROXMIRE. Now, this is exactly why it seems to me we need a greater detail and greater specification in this military area. We have a vague feeling that we are cutting back in Vietnam, a vague feeling that we are shifting our military strategy. But in terms of the really bullet-biting problem for Congress in deciding on a military appropriation, we are not in a position really to make any kind of judgment on it, because you will not tell us how much the Vietnam cutback is, you will not give us any indication of what this shift from a two-plus war strategy to a one-plus war strategy is, except that it has been worked into the budget and is a factor.

We would like to have some indication what that means.

Mr. MAYO. We think that the figures that we show on overall procurement and on overall personnel, military and civilian, reflect this better than what I consider to be misleading Vietnam figures that throw us off the track as to what our basic defense posture is. In the last analysis, the Congress must look at overall procurement and overall personnel as it evaluates defense.

Senator PROXMIRE. Mr. Mayo, there has to be something in your mind when you come up with those figures of a particular amount of billions of dollars, $47 or $48 billion, whatever it is, in that area. You must somehow have been thinking of how much of this would be military and civilian in the various programs.

Do you just project some figure from the past? It seems to me Jean Dixon could give me a better prediction than the Budget Bureau on this basis.

Mr. MAYO. I would be very interested in what that prediction might look like. But the prediction was done in very careful fashion by constructing what seems to be a reasonable projection through 1975. I am waiting with interest to see what the many different groups will do with the complete freedom we have given them by setting up a general environment for 1975. I am sure we will get many suggestions as to alternative, quite plausible, paths to this same sort of result.

This is, I think, one of the fruitful major products of this sort of a projection. It will encourage people—your people—Brookings, the National Planning Association, and others—to discuss how we get there from here.

Senator PROXMIRE. Yes, but unless you have the roadmap, you are the principal initiator of legislation and of the kind of budget and program we are going to have. Unless you have a specification, these debates that you have at Brookings, or even on the floor of the Senate, or even on the Appropriations Committee, are not going to be really very meaningful unless we have some idea what your programs and plans are in detail—in detail.

We have a law, as you know, which you say—that was the 84th Congress, 801. This is a law which you say committee chairmen can get 5-year projections if they request the agency to give it to them. Why in the world cannot the Budget Bureau get that kind of information? Would you be refused by an agency if you asked for this 5-year projection?

Mr. MAYO. The answer to that is basically that to publish any figures on specific programs tends to set them in concrete. This is just what we do not want if we are to maintain flexibility as we look to the future.

Senator PROXMIRE. Then you are against 5-year projections?

Mr. MAYO. I am in favor of 5-year projections of the cost of specific programs to provide the information that you people need and that we need for enactment of the appropriations and the legislation for the years to come.

I am in favor, obviously, of 5-year projections of the overall environment in which fiscal policy may find itself 5 years from now. Otherwise, you would not see the projections that we put into the budget document and the economic report.

I do not feel that the publication of detailed projections to, in effect, cross-reference the summary date in the budget is an appropriate endeavor of the executive branch at this point in time.

Senator PROXMIRE. You say you favor it, but at the same time, we do not have it.

Mr. MAYO. I think there are two jobs for the long-range projections to do. The first is to give the Congress and the public an understanding of the fiscal and economic implications of any specific program.

I also feel that it is our duty to do the best that we can in terms of setting a fiscal environment for the future that will, as we have pointed out here today, indicate the degree of restraint that we must exercise if we are going to keep our options open.

I do not feel, however, that we can present detail, program by program after program. We prejudge administration decisions which would be far ahead of their time. We also get into what we believe is a needless debate, such as, "Well, back in 1967, Mr. Mayo, you had this amount in for the community health centers and now you are coming up with a different figure. Why is this?" I think this tends to be useless debate.

Senator PROXMIRE. Well, I just keep coming right back to the basic point: Either we have the projections or we do not. I know they are embarrassing sometimes to the administration. It is true that Congress is going to say, you have made such and such plans and then you have done something else. But this is the heart of it. This is what, it seems to me, we need to have if we are going to make any kind of analysis of what we do when we authorize a program, when we approve a program, when the administration asks us for a program. And, painful and difficult as it is, I cannot see, I cannot see why this should freeze anybody in concrete.

These can be expressed as tentative proposals subject to change, and the debate, the whole point in providing them, is so that there will be a debate which can modify them. The administration can change its mind and the Congress can and would change its mind. But without that kind of specific proposal, we are just debating in an amorphous, vague, and not-very-helpful kind of atmosphere.

I would like just to refer very quickly to your answer to Congressman Reuss when you pointed out that you were not going to recommend an increase in salaries for Federal workers for January 1 because of the inflationary situation.

Mr. MAYO. Yes.

Senator PROXMIRE. If you were an elected official, Mr. Mayo, you would be very conscious of the reaction we get from those of our constituents who work for our Federal Government, who say, you did not hesitate very much in increasing your salary by 40 percent—and increasing your salary by what, 60 or 65 percent?

Mr. MAYO. I would accept that $60,000; just send the check directly to me. I happen to make the same salary you do.

Senator PROXMIRE. I do not feel sorry for you. And we doubled the President's salary.

You know, there is a lot of hypocracy. It is easy for us to fight inflation up here when it does not at all affect our salary. Then I come to the other point, that the people who really have to pay for the inflation on the basis of the administration programs are the inarticulate people, the people who do not vote, who have very little income; they are unemployed when the unemployment hits, or increases. They are the people who suffer from it.

Yesterday, Mr. McCracken told us he knew of no standby program to put people to work if unemployment should go above 4.3 or 4.4 percent. It was brought out in the course of questioning that unemployment probably would go above 5 percent in the coming year, and is going to average 4.3. Is there any level at which the administration would put into effect any kind of standby program to put people to work?

I know you have manpower training triggers. How about job triggers for people who do not have a job?

Mr. MAYO. Of course, we are mindful of this possibility. I reiterate, I do not believe we are in a recession at this point. We are in the process of cooling off the economy, which is quite a different thing.

If we get to the position, however, that the cooling off has gone a bit farther, and some desirable stimulation is necessary on the part of the Federal Government, I am sure you would not find us hesitant to come forth with a program.

Senator PROXMIRE. Well, I know that your heart is in the right place and that there is a general feeling that, somehow, the administration would act if unemployment got too high. But it seems to me we would be in a much healthier position if the administration could assure us that they had a definite specific program, that they would not let—they would not have to reveal the precise figure, but at some point, they would not let the economy drift further, that they would have a program of jobs, putting people to work, seeing that we are drifting into heavy unemployment.

Mr. MAYO. One of the figures in the budget with which I am sure you are familiar, relates to this particular problem, if it should arise. A construction cutback was instituted by the President last September—a 75 percent cutback in direct Federal spending for construction as far as new obligations were concerned, plus an encouragement to State and local governments to also cut back on their construction projects. The cutback is producing results now by reducing obligations for construction, both Federal and State and local, and will have outlay effects, of course, that go on into 1971.

It is stated frankly in the budget that there has been no Presidential determination as to when the construction cutback would end. But for planning purposes, we have assumed that it would not be in effect in fiscal 1971. That in itself allows for some increase in new contracts in 1971, and those could be expanded.

If, on the other hand, we are still in a position where further extension of the construction cutback were economically the right thing to do, we would not hesitate to extend it further when June comes around. I merely mention this to illustrate that there is some flexibility here. Although I think all of us, to be perfectly candid about it, must admit that we do not have lots of spigots in the Federal Government that you just turn on and off with immediate effect in terms of pouring money into the economy. I do not think that is really the way we should operate.

Senator PROXMIRE. Well, you cannot operate that way. I think that last caveat is very well taken, because the construction cutback has been pretty small. Many people, from the standpoint of stemming the expansion of the economy—it has been feeble in the view of many people.

On the other hand, to the extent that you try to turn it around, it is not going to have very much of a stimulating effect to provide jobs and stop unemployment.

Mr. MAYO. No.

Senator PROXMIRE. It seems to me we need much more than that. We need a program on the shelf ready and available in the event unemployment goes above a certain level so we can move in quickly and provide, not only employment, but it would help the whole economic situation.

Now, let me just briefly point out that we may not be in recession. I think Senator Percy's question was excellent in pointing out that many people suffer recession. We have not just a slight decline in production, but something like 5 or 6 months' steady decline, each month more than the month before.

The last drop was a drop of an annual rate of 8.4 percent, which is certainly not just a decline; it is a pretty precise drop. It does seem to be in the direction of a slowdown.

Let me simply ask if 5-year projections on individual programs are available, will you provide this committee with a file on these separate documents?

Mr. MAYO. I am not sure to what extent we can comply with that without going back to the agencies. We have viewed the requirement in the law here as basically making sure that the agency was responsive to the appropriate congressional committees, when these committees examine specific programs. We have made no attempt to collect various 5-year projections.

Senator PROXMIRE. Let me do this: I shall write you and ask you to specify those individual programs in which you have a file, in which you have any information and projection. Those that you do not, we shall do our very best to secure them as comprehensively as we can.

Mr. MAYO. I shall look into it, Senator Proxmire.

Senator PROXMIRE. Now, as you know, the Economy in Government Subcommittee of this committee made a pretty free-swinging attack on the Budget Bureau—not on you. It was on some traditional practices of the Budget Bureau that have gone on over the years. You have started to make, I think, some improvements. Your attitude of cooperation has been fine.

I do not mean to criticize you directly. We did point out that Congress does not have the information it needs, not only in the area we are talking about, but many, many other areas. Among specific failures we cite, and I would like your comment on them, is that there is no adequate analysis of the $128 billion of nondefense expenditures in terms of benefits and costs, in terms of whether they work, in terms of who gets the benefits.

Mr. MAYO. Well, I would not say there is no adequate analysis. We certainly attempt to do some analysis. I believe Jack Carlson has worked quite a bit with you along that line.

Senator PROXMIRE. Dr. Carlson is a very fine official. He testified to us that it was at a low level. It was something like 15—he did not say 15 percent of potential exactly, but that was the implication. There is very little of its real potential in terms of cost-benefits analysis.

Mr. MAYO. There is much more to be done in terms of economic analysis. I would be the first to agree with you on that. We are attempting to beef that up. I think we could say also that we are being encouraged in the executive branch to do a more positive program evaluation that will get, let us say, away from some of the cloud nine type of analysis. We should recognize that we do not have adequate data and that the range is so great that we really have to get in and start from a more basic level—to get the first 1 percent of some of these things.

But even more important than that, one of the problems that I found, when I came to this job, was that much of the analysis being done was done in a more or less academic fashion that did not produce fruit at the time that the fruit needed to be picked to work into the budget cycle.

So it became an interesting economic exercise, but it was not a viable part of the budget process. We have taken considerable steps to remedy that. Indeed, our spring preview of the 1972 budget will incorporate much more of this type of analysis than ever before.

Senator PROXMIRE. You see, the trouble is that we do not get the information you have. Your immediate predecessor, Mr. Zwick, said he though it was time to begin a really competent study of how this information can be shared with the Congress. I know it is not easy, but how it can be shared. It would help us greatly; we would do a much better job if it could be shared with us.

I am very hopeful that you will do that.

For example, one benefit-cost study I know of shows that an HEW manpower program has a benefit-cost ratio with a 10-percent discount of better than 6 to 1. Now, if we knew that, we would be in a far better position in advancing this program and pushing the program.

We know of another manpower training program which has a very low benefit-cost ratio. Perhaps Congress would then be in a position to push one program and not push another program. Of course, these things depend on other things than a benefit-cost ratio, but this is an objective and an appropriate element that we ought to have. There is no reason in the world why it should be concealed from us, but it is. I think if we could work out an arrangement where we could get some of this information, it would be very useful to us.

Mr. MAYO. I shall speak specifically to the type of illustration you mean. If those cost-benefit ratios are of substance and are instrumental or important in making the administration's decision on a specific program, I see no reason why that fact would be shared with the Appropriations Committees or the substantive committees as they reflect on the desirability of the program.

You and I are both quite aware that economic analysis is not the be-all and the end-all. We are talking about a political process. I can conceive of the possibility that the use of higher discount rates would wipe out the economic justification for a very large percentage of the public works projects in this country. Yet, I do not think either of us could argue that we could so easily dispose of them.

Senator PROXMIRE. Well, I could and have and will. I think we are really wasting money in that public works area. This is the best example of this. If we had an appropriate discount factor, we would not build a lot of these things. We would not misallocate our resources. You would not find any fiscal expert who would advise that we spend money on projects that have a return of 3 or 4 or 5 percent and we are taxing out of the private sector, where it earns a great deal more, and other Government programs have a much better return.

Let me ask about whether or not you have any kind of economic analysis of the $10 billion of direct subsidies to farmers, to maritime unions, that kind of thing.

Mr. MAYO. You may recall, Senator Proxmire, that two and a half years ago, one of the recommendations of the Budget Commission on which your committee held hearings was the identification of the subsidy element of loan programs and the separate display of those within the Federal budget. This is one of the yet unimplemented parts of the Budget Commission's report, but one that we obviously have not lost sight of. We are trying to get over the hurdles of how to get a better accounting system first, and the same people cannot do both. So we are trying to do some of these things sequentially.

But I share with you the very desirable display and enumeration of Federal subsidy programs, as such. I think this is desirable.

Senator PROXMIRE. How about the economic analysis of the $40 or $45 billion of tax expenditures that we have? There has been a lot of talk of getting those out in the open so we can see them and so we can find out the extent to which we are duplicating our expenditure programs, some of our direct expenditures and some of our tax expenditure programs.

Mr. MAYO. I know that you and I discussed this last fall, and I did tell you that I would discuss this with Secretary Kennedy. I raised the possibility that maybe we could get something on it in the 1971 budget. That was not forthcoming. We did discuss it. The reason it was not in the budget was a very practical one, involving the number of people available that could do this sort of thing. During the month of December, the people involved—this, of course, would have to be done in Treasury, basically—were spending night and day working on the Tax Reform Act of 1969. There just was not time to give it proper attention before we had to go to print with the budget.

Senator PROXMIRE. Would it be possible to give an example for us to get a real cost estimate of phases 1 and 2 of the antiballistic missile or the MIRV and nuclear submarines converting, or an ultimate estimate for the undersea long-range missile, which I understand is the successor to Poseidon? Would it be possible for you to get that for us?

Mr. MAYO. I again would have to consult with my Defense people as to the availability of these particular estimates.

Senator PROXMIRE. This could be of such great value. We hear of so many claims in the Senate. One Senator says it is going to cost $20 billion, another says $50 billion, another says more than that. I think it would be most useful. I know they have had overruns on the basis of inadequate estimates in the past, but whatever you can give us would be very helpful to us.

Mr. MAYO. I shall be glad to look into it.

(The requested information follows:)

The Department of Defense advises that the information on the majority of the major procurement systems that are of interest to Senator Proxmire is contained in the Selected Acquisition Reports that are on file with the Armed Services Committees of both houses. As to the cost of the Safeguard ballistic missile defense system, the Department of Defense now estimates acquisition costs for the presently-proposed Modified Phase II Safeguard system, which includes one new site at Whiteman Air Force Base, at $5.9 billion in December 1969 prices. Total budget authority requested for the 1971 Safeguard program is $1.49 billion and total FY 1971 spending for Safeguard is estimated at about $920 million. The systems acquisition cost of the full Phase II Safeguard defense of 12 sites—should this option be exercised later—is presently estimated at $10.7 billion.

Senator PROXMIRE. I am almost through, but I do want to ask you a couple more questions.

What are the procedures to provide for the so-caled carefully selected weapons systems in prudent research and development programs stated in the budget message? They talk about this, and we know, as I have referred to, the enormous overruns we have had in the past, the fact that some of these weapons do not work after we get them, even though we pay more for them than we are told we will have to pay for them when we begin with them.

Mr. MAYO. Well, the initial setup in the budget process is having our people and the budget people across the river working hand-in-glove. That is the first stage of appraisal as to the very problems that you are sensitive to. Obviously, the National Security Council comes into this question; so does the Defense Program Review Committee. The latter is a new device, as you know, and has not had a chance to make any real budget impact yet. It was started too late in the 1971 budget process.

The 1972 budget process has already started, and I would expect that there will be some critical review of many issues by the Defense Program Review Committee.

Senator PROXMIRE. Are we getting a recommendation from the Budget Bureau on these enormously expensive weapons systems that are going to be very, very costly in years to come, without any available analysis on your part?

Mr. MAYO. You can be sure we will have an input in this regard.

Senator PROXMIRE. What does that mean?

Mr. MAYO. That means that we will be looking at the weapons systems and their efficiency, in the same way that we look at a Job Corps program or an EDA program or a health program—applying the best analysis, analytical tools, that we have at our disposal.

Senator PROXMIRE. Dollar for dollar, you are now putting the same amount into defense inquiry that you do into nondefense inquiry?

Mr. MAYO. We are putting more personnel——

Senator PROXMIRE. Professionals?

Mr. MAYO (continuing). More analysts on the defense side per dollar of expenditure than on human resources, for instance.

Senator PROXMIRE. This is in the controllable area?

Mr. MAYO. This is looking at the overall budget.

Senator PROXMIRE. But that would not be true of the controllable part of the budget?

Mr. MAYO. No, I do not believe it would be on the controllables, but we have the problem, as you can well appreciate, that we have an awful lot of small items that we have to analyze, too. We do not spend just 3 minutes on an independent agency item, because it is only $700,000.

I will also raise the question that you and I discussed before. I believe we have in the Budget Bureau, not only in numbers but in competence, an exceedingly able and effective group to deal with the problems of the entire Defense Department. One of my jobs, as I think we talked about close to a year ago, is to make sure that we make effective use of those analytical talents.

Senator PROXMIRE. I want to make sure I button this up, because neither the staff nor I were very clear on your answer. Your answer might have been clear, but we missed it.

You indicated a change in the way the Budget Bureau reviews the defense budget. Have you abandoned the joint review approach to the defense budget? Is it true that the Defense Department is now treated exactly the way other agencies are?

Mr. MAYO. The only difference is that at the level of the initial building of the budget, the staff operation still goes forward on a joint basis. This is in the construction of the budget, not in the Director's review of the budget or the appeal of the decisions that the President and I——

Senator PROXMIRE. In the Director's review and the appeal, they are treated exactly the same?

Mr. MAYO. As other agencies, yes.

Senator PROXMIRE. This is a change in past practice?

Mr. MAYO. Yes, sir.

Senator PROXMIRE. All right, sir. I just wanted to call to your attention one thing in the record.

You referred to the Fitzhugh Panel as a watchdog for Defense. That Fitzhugh Panel consists of 15 people, eight of whom have an average of $100 million of Defense contracts, and among the independent members that do not have that conspicuous conflict of interest, they have a woman's dean, a football player, a female lawyer, and a magazine president.

The football player is Buddy Young, a fine football player. I do not know how he can help in this area, but perhaps he can.

But then we turn to the staff. The staff director—and, obviously, on a panel like this, the staff would be important, perhaps more important than the committee—is Fred Buzhardt. He used to work for Strom Thurmond. He is now called "My Man Friday," by Robert Froehlke, Assistant Secretary of Defense. Buzhardt gets his check from the Pentagon.

Under these circumstances, I doubt very much that the Fitzhugh Panel is going to give us a very objective, dispassionate, and critical review of the Defense expenditures in this area.

Mr. MAYO. I will still be interested in what they come up with.

Senator PROXMIRE. I will be very interested in it, especially in view of that background.

Would you supply for the record, to the extent that you can, the precise amount of personnel and expenditures of the changes in Defense spending over the projected 5 years, to the extent that you can?

Mr. MAYO. Well, those figures are not available, Senator Proxmire.

Senator PROXMIRE. None of those figures are available?

Mr. MAYO. No.

Senator PROXMIRE. Can you provide the effective changes in Vietnam spending in the Defense budget over the next 5 years?

Mr. MAYO. No, I cannot. As I emphasized earlier, we were creating a pie here. We were not trying to give in any way the distribution of that pie which could follow any number of "plausible courses."

Senator PROXMIRE. Can you provide a full employment budget over the period?

Mr. MAYO. The full employment budget over the period?

Senator PROXMIRE. Over the projected period, yes.

Mr. MAYO. I would say the budget figures for 1975 represent a full employment budget for 1976.

Senator PROXMIRE. Do they for the full period?

Mr. MAYO. You mean each of the years in that period?

Senator PROXMIRE. That is right.

Mr. MAYO. We have not tried to do the intervening years.

Senator PROXMIRE. Can you?

Mr. MAYO. I do not think it is meaningful.

Senator PROXMIRE. If you do it for 1975, why cannot you do it for 1974, 1973, and 1972?

Mr. MAYO. Well, the point of the 1975 projection is to establish a framework of environment. I do not believe that year-to-year changes from 1972 to 1973 to 1974 to 1975 are particularly relevant to the establishment of that environment for 1975.

Senator PROXMIRE. Will you do the best you can? After all, you are not sticking your neck out any further to give us the year by year than you did for the 1975.

Mr. MAYO. I would like to stick by the availability of the 1975 figures in the Departments.

Senator PROXMIRE. So you cannot give us those figures?

Mr. MAYO. I would rather not.

Senator PROXMIRE. Can you give us a budget surplus or deficit within the period 1969 to 1971 by quarters or half years?

Mr. MAYO. There are figures available on a national income accounts basis. We do not do the figures on a unified budget basis.

(The requested information follows:)

Period (fiscal year):	*Budget surplus (+) or deficit (—) (in billions of dollars)*
1969	
1st half	—1.4
2d half	+11.8
1970	
1st half	+7.1
2d half	[1]—0.4
1971	
1st half	[1]—0.3
2d half	[1,2]+5.8

[1] Estimate.
[2] Follows Office of Business Economics, Department of Commerce (OBE) procedure with respect to smoothing social insurance contributions for the calendar year. A social security tax wage base change becomes effective Jan. 1, 1971. OBE spreads the effect of this change evenly throughout the quarters of the year, although the change affects the second half of the calendar year much more than the first. If the OBE procedure were not followed, receipts would be $2,300,000,000 (annual rate) lower in the 2d half of fiscal year 1971, and the surplus correspondingly reduced.

Senator PROXMIRE. Can you give us for the record the number of Budget Bureau personnel working on the Defense Department area?

Mr. MAYO. I shall be glad to put that in the record.

(The information referred to follows:)

Number of Bureau of the Budget personnel working on the national defense budget:

Fiscal year	Number of examiners: Total	Number of examiners: National defense	Percent national defense
1970 (authorized)	189	51	27.0
1971 (estimate)	197	54	27.4

	Number of accounts per examiner: Total	Number of accounts per examiner: National defense
1971 (estimate)	5.7	1.6

Mr. Mayo. We have expanded that number, by the way. There are more authorized for 1971 in that budget if it is approved by the Congress. We are providing for expansion in this area because we recognize it is a very important area.

Senator Proxmire. On page 85 of the Economic Report, there is a chart showing projections of the economy as compared with potential GNP. Without objection, I include in the record the quarterly figure relating to this projection. The figures were obtained by the staff and the counsel from the Commerce Department.

(The table, "GNP, Actual and Potential," follows:)

GNP, ACTUAL AND POTENTIAL

[In billions of dollars, 1958 prices, seasonally adjusted annual rates]

Period	Actual GNP	Potential GNP [1]
1960:		
I	490.2	514.4
II	489.7	518.8
III	487.3	523.3
IV	483.7	527.8
1961:		
I	482.6	532.4
II	492.8	537.0
III	501.5	541.6
IV	511.7	546.3
1962:		
I	519.5	551.0
II	527.7	555.8
III	533.4	560.6
IV	538.3	565.4
1963:		
I	541.2	570.6
II	546.0	575.9
III	554.7	581.2
IV	562.1	586.6
1964:		
I	571.1	592.0
II	578.6	597.5
III	585.8	603.0
IV	588.5	608.6
1965:		
I	601.6	614.2
II	610.4	619.9
III	622.5	625.6
IV	636.6	631.4
1966:		
I	649.1	637.6
II	655.0	643.9
III	660.2	650.2
IV	668.1	656.6
1967:		
I	666.5	663.1
II	670.5	669.6
III	678.0	676.2
IV	683.5	682.9
1968:		
I	693.3	689.6
II	705.8	696.4
III	712.8	703.3
IV	718.5	710.2
1969:		
I	723.1	717.2
II	726.7	724.3
III	730.6	731.4
IV	730.5	738.6
1970:		
I	730.2	746.4
II	732.6	754.3
III	737.8	762.3
IV	743.4	770.4
1971:		
I	750.8	778.7
II	758.6	787.1
III	769.2	795.6
IV	781.7	804.2
1972:		
I	794.4	812.7
II	807.2	821.3
III	820.4	830.0
IV	833.6	838.8
1973:		
I	846.3	847.7
II	856.7	856.7
III	865.8	865.8
IV	875.0	875.0
1974:		
I	884.2	884.3
II	893.6	893.7
III	903.0	903.2
IV	912.6	912.8
1975:		
I	922.2	922.5
II	932.0	932.3
III	941.9	942.2
IV	951.8	952.2

[1] Trend line of 3½ percent from middle of 1955 to 1962 IV, 3¾ percent from 1962 IV to 1965 IV, 4 percent from 1965 IV to 1969 IV, 4.3 percent from 1969 IV to 1970 IV, 4.4 percent from 1970 IV to 1971 IV, and 4.3 percent from 1971 IV to 1975 IV.

Sources: Department of Commerce and Council of Economic Advisers.

Senator PROXMIRE. Mr. Director, I apologize for keeping you so long. You have been most patient and cooperative and helpful. You did another brilliant job. I thank you very much.

Mr. MAYO. Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). We stand adjourned until tomorrow, when our witness will be Arthur Burns, Chairman of the Federal Reserve Board, in this room, at 10 o'clock.

(Whereupon, at 1:35 p.m., the committee adjourned, to reconvene at 10 a.m., on Wednesday, February 18, 1970.)

APPENDIX

(The following additional questions asked by members of the committee and answers thereto were subsequently supplied for the record by Mr. Mayo:)

Question 1. How does inflation affect the Federal budget? Does it tend, for example, to increase receipts more than expenditures or vice versa?

What inflation factor is built into receipt and expenditure estimates for 1971?

Answer. The short-run effect of inflation on the Federal budget is different from the long-run effect. In the short run, inflation causes receipts to increase faster than outlays. (One reason for this is that income tax receipts increase automatically when price increases cause incomes to rise. There are few such automatic increases on the outlay side. Moreover, with respect to outlays, budget estimates are, for the most part, based upon current prices at the time the estimates are made.) In time, however, approximate balance is reached, and the receipts and outlay effects are essentially offsetting. If there is a net "advantage" over time, it probably lies on the side of receipts.

The price assumptions described in the Economic Report were used in developing the national income account parameters from which the revenue estimates for fiscal year 1971 were derived. Specifically, the rise of overall prices (as measured by the GNP deflator) in early 1970 may vary little from that in late 1969, but by mid-year the rate of inflation is expected to drop.

Question 2. The Subcommittee on Economy in Government recommended in its December report on the Military Budget and National Economic Priorities that the Bureau of the Budget define "defense-related" programs, including those for past and current military activities, and identify all such expenditures so that in the future they can be tabulated in the budget document. Does the Bureau of the Budget plan to do this?

If all defense-related expenditures were properly identified including the portion of the interest on the national debt attributable to past wars, what do you estimate defense outlays would total as a percentage of Federal expenditures?

Could you supply for the record a tabulation of the defense-related expenditures contained in the 1971 budget?

Answer. The Bureau has no plans at this time to define "defense-related" programs in the manner recommended by the Subcommittee on Economy in Government in its December report on the Military Budget and National Economic Priorities. There are always demands for different budget classifications that reflect differing points of view and different sets of circumstances. The budget is presented in great detail so that the Subcommittee, or other users, can compile data in accordance with whatever definition seems most appropriate to them.

Question 3. The Subcommittee on Economy in Government of the Joint Economic Committee in its recent report on Economic Analysis and the Efficiency of Government recommended that "The trust fund should be abolished as an instrument for financing Federal programs involving investment, construction, or the provision of facilities or services." I note in your statement your comment that the uncontrollability of budget outlays is responsible in large measure for the budget's generally slow reaction to changing needs. Do you support our recommendation that the trust fund be abolished?

Is the extension of the highway trust fund as recommended in the budget, consistent with the need to achieve greater controllability of budget outlays?

Answer. The Bureau's position on these questions has not changed from the Budget Director's reply to similar questions submitted for the record after his September 25, 1969 testimony.

Little would be gained from the complete abolition or elimination of the trust fund method of financing. While there are some problems involved in using trust funds, eliminating the existing trust funds would not necessarily remove the problems.

Basically, trust funds are established for moneys held by the Government in a fiduciary capacity for the purpose of carrying out specific programs. Some trust funds—like the Federal-aid highway program—are financed by earmarked receipts. The present method of funding the Federal-aid highway program does reduce flexibility in the annual program and budget review. The "culprit," however, is not so much the use of a trust fund, as the granting of contract authorizations in advance of each fiscal year—especially the practice of granting them for several years in advance, as in the case of the interstate highway system. This system of "permanent" budget authority is what really reduces budget flexibility. If the trust fund were abolished, but the present system of contract authorizations retained, the problem of reduced budget flexibility would still exist. The frequent coupling of trust fund financing and permanent budget authority has made the Bureau sympathetic to the point of view expressed by the Subcommittee on Economy in Government, but we do not agree that the abolition of trust funds is a desirable solution.

Against the disadvantage to resource allocation caused by the reduced budget flexibility associated with trust funds must be weighed the advantage to program planning that results from the present arrangement. Undeniably, the system enables States to plan further ahead in their highway construction than they might find feasible under strictly annual authorizations, especially if the annual grants of funds were as late after the start of the fiscal year as is often now the case with Federal appropriations.

As a final point, the President's Commission on Budget Concepts observed that trust fund programs have grown rapidly and cover an important segment of Federal activity. The Commission's report noted (on page 26) that: "Legislative changes affecting one or another of the major trust funds occur almost every year. Rather than removing funds from the influence of the administration or the Congress, the trust fund technique, in the case of major trust funds, earmarks certain expenditure programs for financing by specific taxes or other revenue sources. This couples the benefits and costs of these programs more closely, and it also lends a degree of assurance to beneficiaries and grantees that trust fund benefit or grant schedules once established will be protected."

THE 1970 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 18, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:05 a.m., in room G-308, New Senate Office Building, Hon. Wright Patman (chairman of the joint committee) presiding.

Present: Representatives Patman, Reuss, Widnall, Conable, and Brown; and Senators Proxmire, Sparkman, Symington, Javits, Miller, Jordan, and Percy.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling and George D. Krumbhaar, economists for the minority.

Chairman PATMAN. The committee will please come to order.

Today we resume the hearings of the Joint Economic Committee to hear the Chairman of the Federal Reserve Board, Dr. Arthur Burns.

I have already had the pleasure of welcoming Dr. Burns in his new capacity as Chairman of the Board of Governors when he appeared before the House Banking and Currency Committee earlier this month.

I might add that the basic problem that concerned me then is also a central problem in our considerations here at the Joint Economic Committee. The fantastic level of interest rates has devastated our housing program and is making a shambles of our communities. More and more of them are priced out of the market so far as schools, hospitals, and other facilities are concerned.

We are building up a terrible deficit that will handicap our growth and development for a long time to come, I am afraid.

I know Dr. Burns is aware of this problem. And I will be very interested in hearing from him how he is prepared to deal with it.

Dr. Burns, you may proceed in your own way, sir. We are glad to have you as a witness.

We are ready to hear from you now, sir.

Mr. BURNS. Thank you, Mr. Chairman.

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

Mr. BURNS. I am glad to have the opportunity to present to this committee the views of the Board of Governors of the Federal Reserve System on the state of the economy.

I would like to begin by reviewing the progress made during 1969 in combatting the inflation that has been so damaging to our economy and to our international balance of payments during recent years.

PROGRESS IN 1969

A year ago the prevailing view of the public—and especially of the business and financial community—was that the administration and the Congress lacked the will to pursue fiscal restraint with sufficent vigor to accomplish lasting results. The income tax surcharge, it was assumed, would not be extended beyond mid-1969. More importantly, perhaps, it was widely believed that when fiscal 1970 began the gates would be opened to a new flood of Federal spending that might engulf the economy once more.

In the monetary field, we faced a similar problem. The financial community was inclined to assume that monetary restraints of any real significance would last only a few months—that the Federal Reserve would lose courage and begin to back off at the first signs that financial restraints were beginning to bite.

These expectations of an early resumption of inflationary policies, however, were not fulfilled. On the contrary, the Congress, the administration, and the Federal Reserve demonstrated by their actions during the past year that they were willing to apply the restraints needed to bring inflation under control. The administration asked for, and ultimately obtained, extension of the income tax surcharge at 10 percent through the end of the year and also a repeal of the investment tax credit effective April 21. The growth of Federal expenditures was kept down. Between the fourth quarter of 1968 and the fourth quarter of 1969, total Federal spending, as recorded in the national income accounts, increased only half as much as it had in the previous four quarters.

As a result of these measures, we were still enjoying a surplus in the Federal budget at an annual rate of $7 billion during the latter half of last year.

In the field of monetary policy, the view that financial restraints would last only a few months also proved to be wrong. Monetary restraint intensified during the year, as the Federal Reserve modified its open market policies and regulations, thereby limiting the growth of the money supply and the provision of credit through the banking system. By the last half of 1969, growth of the money supply had virtually ceased. And the growth of bank credit—even including all of the funds that the banks were able to obtain from such nondepositary sources as borrowing in the commercial paper market and in the Eurodollar market—had slowed to an annual rate of less than 3 percent.

Thus, great strides were made in 1969 toward demonstrating the Government's determination to follow an effective economic stabilization policy. But we accomplished more than this, too. As the year unfolded, evidence accumulated that the growth of total spending was finally slowing down. By the second quarter of 1969, a new mood of caution gripped consumers, and retail sales began to show signs of weakness. In the durable goods area, particularly, sales declined in the late summer and autumn to the point where substantial cuts in production of autos, appliances, and other consumer durables became necessary. Output of defense equipment began to drift off in the spring months and to decline sharply in the summer, when total Federal employment also began to contract. The availability of mortgage credit declined substantially, despite massive funds poured into the mortgage market by FNMA and the Federal home loan banks, and housing starts fell to an annual rate of 1.3 million by the fourth quarter—one-fifth below the year-earlier level. Many State and local governments, meanwhile, found credit so difficult to obtain and so costly that they were forced to curtail their planned capital outlays.

The effects of monetary restraint last year—though uneven—were not, however, confined to housing and to State and local construction. Many businesses, including even some very large firms, were unable to raise the funds on which they had counted. Furthermore, the protracted decline in the bond and stock markets strongly affected expectations as well as asset values, and may well have been an important factor in the conservative spending patterns of consumers.

The results of our monetary and fiscal restraints showed up most clearly in the moderating pace of the major indicators of aggregate economic activity. Industrial production began to decline last August and has continued to fall since then. The markets for labor likewise began to ease in the summer, and by the late fall and early winter months the more sensitive measures of labor market conditions were pointing to reduced demand pressures. By the fourth quarter of last year, the expansion in our Nation's total output of goods and services apparently came to a halt, and this January the unemployment rate again approached 4 percent.

Regrettably, these evidences of cooling in the economy have not yet been reflected in a moderation of prices. I hope, however, that disappointment about the recent performance of wholesale and consumer prices will not distort our judgment. We need to bear in mind that the response of costs and prices to changes in the underlying balance between demands and supplies entails a process that takes a considerable period of time. Businesses continue to be faced with rising costs as economic growth slows, since productivity gains typically are depressed while wage increases remain large for a time. The response of business firms in these circumstances is often to test their product markets by passing on rising costs in the form of higher prices, but then to back away from list prices when the volume of sales begins to decline. Such discounts from list prices are not fully reflected in our price indexes which may, in the early stages of disinflation, continue to register unusually large increases, as they have recently. Eventually, however, list prices, too, will begin to give way under the pressure of increased competition; and as the easing in prices at the wholesale level carries through to the consumer level, the prospects for more moderate wage settlements are enhanced.

The lags involved in this process are long, and they are likely to be longer the more deeply entrenched are the inflationary expectations. We are paying the price now for letting inflationary developments build up a head of steam over the past 5 years. By the end of

1969, however, we had succeeded in eliminating the excess demand for goods and services that has been at the root of the inflationary problem. We must now have the patience to wait for the improvement in price performance that will eventually result.

In the international field, we also began to make some progress last year toward improving our fragile trade balance. Once the effects of the dock strike were over, exports responded to the rising demand abroad, while the dampening of excess demand in the United States slowed the rate of increase of our imports. Nevertheless, our overall balance of payments registered a heavy deficit on the liquidity basis—as other components of the accounts worsened, especially the outflow of U.S. private capital. Financing of the deficit was mainly accomplished by enormous borrowings in the Eurodollar market by U.S. banks. I should add, and if time permitted I would give emphasis to the fact, that a very significant improvement in the stability of the international monetary system occurred last year, as some necessary exchange rate adjustments were made, as the issuance of SDR's was agreed to, and as the status of gold was stabilized.

While we can take some satisfaction from the changes in our international accounts and in international financial arrangements during 1969, we need to recognize that the condition of our balance of payments still remains very unsatisfactory. The need to restore a reasonable surplus in our trade with other countries reinforces the domestic reasons for making sure that inflation subsides.

EXPECTATIONS FOR 1970

Let us turn now to the year ahead. What can we reasonably expect and hope for in the fight against inflation during 1970? We must, of course, be realistic. The battle against inflation is not over, and further adjustments must be made to regain a path of sustainable noninflationary growth. There is now room for substantial optimism on this score, given the progress already made.

We must also be realistic about our ability to forecast economic developments. The uncertainties are especially large in a period of transition such as we are now experiencing. On the one hand, there is still the possibility that the cooling off process will be cut short, and that longer run inflationary expectations will thereby be reinforced and intensified. But there is also the possibility that the recent weakening tendencies in the economy will persist and intensify, delaying the time when a satisfactory rate of growth will be resumed.

In a situation like the present, we must therefore be especially alert to new and unexpected developments. With this reservation, it seems to me that the projection of the gross national product for 1970 presented by the Council of Economic Advisers is a reasonable one, in terms of what is both achievable and desirable. The Council has projected a period of little economic growth early this year, followed by moderate expansion thereafter. The Board of Governors also expects to see a resumption of growth in total real output and in industrial production before too long. But no one should be surprised if the sluggish pace of total spending that developed in the fall and winter months of 1969 continues for awhile.

In the homebuilding industry, some further decline in housing starts appears likely, in view of the current state of the mortgage market and the lag with which changes in this market affect construction. For State and local governments, also, funds have been exceptionally scarce and expensive in recent months, and the postponements and stretchouts of projects that have already occurred will continue to affect activity in the months ahead. We may also see some retrenchment in the rate of inventory investment early this year. At present, stocks of durable goods are rather high in relation to sales, and efforts to bring stock-sales ratios down, already underway, could well continue. Defense spending, furthermore, is moving downward, and substantial additional cutbacks are scheduled for 1970, reflecting both reduced purchases of defense goods and a decline in the size of the Armed Forces.

Prospective weaknesses in these areas, however, will tend to be offset by elements of strength in other sectors of the economy. Business investment in plant and equipment has been growing at a rapid pace, and various surveys point to substantial further increases in the near term. Furthermore, the demand for consumer goods is likely to be shored up by the rise in disposable income that will accompany the phasing out of the surcharge by midyear and the second quarter increase in social security benefits.

If events develop along these lines, we would be setting the stage for the resumption of sustained economic expansion later this year. Furthermore, that expansion would, I believe, display a better distribution of output in two respects. First, over this past half year, retail sales—in real terms—have actually declined, while businesses have continued to add substantial amounts to plant capacity. If this imbalance continued through 1970, it would be a matter of real concern. However, as the year progresses, retail sales are likely to pick up, while the expansion of business investment in new plant and equipment tapers off in response to the cost-price squeeze in which business is now caught. Second, if economic developments proceed as outlined above, we would have both the real and the financial resources later this year for the resumption of growth in homebuilding which is so vital to the welfare of our society.

There has been considerable concern in some quarters that the economy during the second half of this year is likely to experience such a vigorous rebound as to destroy our chances of getting inflation under control. With the release early this month of the administration's budget, some of the fears expressed earlier have been quieted. We are all aware, of course, that budget expectations and budget results are often at variance. However, if the degree of fiscal stringency called for in the administration's budget is realized, the resumption of economic growth we are looking forward to later this year will not, I believe, be excessively rapid. Instead, we should find that the pace of economic expansion stays well within the bounds of our resource capabilities, and that a gradual process of disinflation continues throughout the year.

I wish I could assure this committee that the disconcerting advance of the consumer price level will soon come to an end. Unfortunately, such optimism is not warranted. This year there will be wage contract negotiations in a number of major industries. Workers will be striving to obtain wage increases large enough to permit some improvement in their standard of living besides making up for the erosion in real earnings caused by inflation during recent years. These negotiations will take place in an atmosphere in which product markets are more competitive and business profits are being squeezed. Employer resistance to inflationary wage contracts will, therefore, be larger than in recent years. Nevertheless, it seems evident that negotiated contracts will provide for wage increases exceeding the growth rate of productivity, so that unit labor costs will still be rising. We should not, consequently, expect an end to inflation this year, but we can look forward to a progressive moderation in the rate of price advance.

Such a course of economic developments in 1970 would provide an opportunity for improvement in our balance of international trade. The readjustments of the economy in the first half of the year should help to hold down the rise in imports. On the other hand, with strong expansion continuing in Europe and Japan, our exports should fare reasonably well. Our trade balance would thus be showing a gain over the depressed level of the past 2 years, but there would still be ample room for future improvement.

Unfortunately, these gains in our trade account could be canceled by adverse flows of capital, so that our balance of payments would continue to suffer. Larger outflows of U.S. capital may occur if credit conditions in our country become markedly easier than in other industrial countries. Moreover, U.S. companies appear to be planning larger outlays for foreign plant and equipment this year. Our balance-of-payments accounts on the official settlements basis will also be affected adversely if—as now seems likely—the large inflow of Eurodollars to U.S. banks that occurred last year is reversed or even reduced.

IMPLICATIONS FOR MONETARY POLICY

Let me now turn to monetary policy and its role in assuring that the gradual diminution of inflationary pressures anticipated for 1970 becomes a reality.

Monetary policy moved progressively, in the course of the past year, to a posture of severe restraint—virtually halting the growth of the money supply and putting an extremely tight rein on the ability of banks and other financial intermediaries to finance the Nation's economic needs.

From the perspective of history, we know that a policy of such severity could not and should not be continued indefinitely. Quite apart from the cumulative effects of such a policy on aggregate demand, its uneven impact on key sectors of the economy would become intolerable. The continuation of such intense monetary restraint for any extended period would threaten marked further declines in homebuilding and in State and local government activities, and would increasingly dry up the sources of finance for small- and medium-size businesses that are not able to tap the public capital markets.

As we all recognize, monetary policy must stand ready to adapt quickly to unanticipated developments in the economy and in financial markets. At the present stage of our battle against inflation, this principle has particular force. The Board cannot overlook the possibility that the present slowdown in economic activity, which is a healthy development, may yet be followed by a recession. Monetary policy might have to change quickly if that risk should become larger. There is also the possibility, however, that the inflationary processes with which we are dealing may prove more stubborn than we realize. If too vigorous a rebound in the total demand for goods and services were to occur later this year, as was the case in late 1967 and early 1968, we could lose the battle against inflation that the combined forces of our Government have so courageously fought.

For some time this year, our monetary and credit policies are therefore likely to trend a narrow path between too much restraint and too much ease, as we go through the transition from an overheated economy to a path of noninflationary growth. As I indicated in my testimony to the House Banking and Currency Committee earlier this month, a tight rein on Federal expenditures, as called for in this administration's budget for fiscal 1971, would lay the basis for moderation in overall credit conditions. I may add here that if the economy follows the course that I have outlined and a dimunition of inflationary pressures is realized, monetary policy could well move as the year progresses toward a posture more nearly in keeping with our economy's longrun needs for money and credit. And, as inflationary expectations abate, we should see a significant reduction in the overall tensions in credit markets, one aspect of which would be a downward movement of interest rates toward historically more normal levels.

I trust that the committee will understand why it would be difficult, if not improper, for me to present a more precise projection of the monetary outlook. Despite centuries of disinterested thought and inquiry, the role of monetary variables in economic activity and in prices is still subject to troublesome margins of uncertainty. I can perhaps best illustrate this point by reference to the projections of GNP and financial flows that were presented by the Board's staff to this Committee a year ago. Looking back at those estimates, you will find that the actual growth of the dollar value of our Nation's total output in 1969 proved to be in excess of the amount projected. So also was the level of private borrowing. On the other hand, the actual rates of growth of bank reserves, the money supply, commercial bank time deposits, and bank credit during 1969 were all below the lower limits of the projected ranges.

For example, the Board's staff a year ago projected a growth rate of the money supply in the range of 3 to 6 percent. The actual increase was 2½ percent. Time deposits at commercial banks were projected to increase within a range of 1 to 5 percent. In fact, these deposits declined by 5 percent.

I do not cite these statistics by way of criticism of the Board's staff, which I hold in the highest regard. The nub of the matter is that the financial restraint needed to keep inflation from getting out of hand last year proved to be much greater than almost anyone had anticipated, and the monetary authorities therefore found it necessary to follow a highly restrictive course.

The release of those projections a year ago helped to foster the mistaken judgments, which I mentioned earlier, that the Federal Reserve planned only a brief period of monetary restraint. As a result, commercial banks and other lenders were more willing to make loan commitments to businesses, and the effects of monetary restraint on business spending were delayed. Our effort to get inflation under control was therefore hampered. I do not think this committee would like to see such a misadventure repeated.

The Board is watching very closely developments in the economy during this difficult period of transition. I assure this committee that the Federal Reserve will do everything in its power to prevent a recession. Large backlogs of demand have been built up in important sectors of the economy, so that total spending can be expected to respond with speed and vigor to monetary stimulus. But I also want this committee to know that the Board is determined not to forsake the present opportunity to obtain control over inflationary pressures.

A LONGER RANGE VIEW OF STABILIZATION POLICIES

Before closing, let us look ahead briefly to the challenges and the opportunities of the decade just beginning. Our recent overriding problem, of course, has been to deal with inflation. In longer range planning, our national attention has tended to shift from a focus on economic growth to a concentration on reevaluating our national priorities for resource use. This shift in emphasis in longer range planning was badly needed. But we cannot overlook the fact that the economic and social problems of this country will be more readily resolved if our resources are utilized in ways that maximize the long-run potential for economic expansion.

The potential for economic growth and prosperity over the next decade is, it seems to me, enormous. In just the last 5 years, over $100 billion has been spent for research and development carried out in the private sector. Surely, this is the very foundation of economic growth—the new ideas, the new products, and the new processes that innovations, embodied in a growing stock of machines and industrial plants, make possible.

Demographic factors will be working in our favor during this decade. Projections by the Bureau of Labor Statistics suggest that growth in the labor force will be even more rapid in the 1970's than in the 1960's. The composition of the increase in labor force will also be favorable to economic growth, since the proportion of adult males in the total expansion is expected to rise appreciably. Steady increases in the number of young adults in the labor force should provide employers with a pool of more highly trained and dependable workers. Productivity increases should quicken, because these additional workers will be better educated than their predecessors and will be provided with more machinery and equipment in handling their jobs than previously.

There is little reason to expect that deficiencies in demand will keep us from enjoying the fruits of our enhanced capacity to produce. Growth in demand for goods and services will continue to be supported by an ever-increasing population, even if birth rates continue the downtrend of recent years. In addition, the age distribution of our population assures a substantial increase in the number of new households, with accompanying large needs for housing, for schools, and for a wide variety of services requiring massive capital expenditures by State and local governments. Indeed, outlays on housing must rise substantially just to make up the deficiency that has accumulated in recent years.

There is no automatic assurance that we will enjoy all of the potential benfits that these opportunities present. The challenge that faces us now, in the area of stabilization policy, is to see whether we can learn from the experience of recent years—whether we can devise the means to avoid inflation and to maintain the rapid economic growth which our resources make possible.

On the fiscal side, the most obvious and pressing need is to avoid the disruptive changes in the level of Federal expenditures that give rise to huge budgetary deficits, to inflation, and to misallocation of resources. If sharp increases in high priority outlays are required, as may happen, other Federal expenditures must be curtailed through a reordering of priorities, or offsetting adjustments in taxes must be considered immediately. Discipline will also have to be maintained to avoid wasteful use of resources in outmoded programs. We must, I believe, anticipate that the resources utilized for new Federal programs—of which there are likely to be many in the years ahead—will have to come principally from discarding old programs or from the revenue increases that normally accompany economic growth.

In our search for fiscal stability and efficient use of resources at the Federal level, we cannot concentrate simply on activities that register their effects in the budget totals. It will be necessary to maintain a watchful eye on the lending and borrowing programs of Government-sponsored agencies, and also on the growing volume of Government guaranteed credits—both of which go on outside of the budget. The programs of these agencies have a legitimate and important role to play in a competitive economy. They improve the functioning of our financial markets by absorbing risks that private markets do not now assume. They facilitate credit flows to sectors of high social priority that for one reason or another cannot adequately compete in private financial markets. They help to buffer the effects of financial restraint on the housing market. Nonetheless, these programs, too, must be carefully scrutinized because of their impact on resource utilization and aggregate demand.

In the monetary area, one of the important considerations for future policy will be to determine the appropriate range of variation in the major monetary and credit aggregates. This committee has expressed its concern repeatedly that monetary policy has permitted excessively wide variations in the growth rates of money and bank credit. Let me assure you that the Board shares your concern on this matter. We have lived through a period in which the disadvantages of marked changes in the degree of monetary restraint or ease have been all too evident. We are well aware that monetary policy works in complex ways, with lagged effects that are difficult to predict as to timing, magnitude, and sectoral impact. Certainly, if fiscal policy makes a more positive contribution to economic stability in the years ahead, wide variations in the posture of monetary policy would be less appropriate.

If monetary policy is to make a better contribution in the future to economic stability and a proper distribution of resources, we must do more than merely adjust our policies in ways that alter the growth rates of the monetary aggregates. We must find the means to reduce the uneven impact of monetary restraint on such sectors as housing and State and local governments. I do not come here today with solutions to offer, but I can assure you that the problem will be under intensive study in the Federal Reserve.

Finally, it seems to me that our policies will need to be directed toward promoting a greater adaptability of all of our financial institutions to changes in financial markets and in the needs of the economy. Our financial institutions have shown an extraordinary ability to innovate and adapt, but more recent developments have suggested that more still remains to be done in this regard. We will need to reconsider our regulatory devices and procedures in light of the way financial flows have been affected in recent years.

The decade just closed might well go down in history as marking the renaissance of central banking. We rediscovered how terribly important monetary policy is to the health of our economy, and the need for a proper balance of monetary and fiscal actions to promote our national economic objectives. We also learned that we knew less about the workings of these policies than we had supposed. We must now move forward rapidly to begin closing the wide gaps in our knowledge if we are to fulfill the promise of the years ahead.

Chairman PATMAN. Thank you very much, Dr. Burns, for your very interesting statement. It will be very helpful to us in our conclusions.

I believe you testified, and I believe the Council of Economic Advisers also stated that we could expect about 4.3 percent average unemployment this year. Is that fairly correct?

Mr. BURNS. I cannot quarrel with that figure. My expectation is that unemployment will run a little higher than it is at present, but that we will not run into very serious unemployment next year. I would not quarrel with a figure of 4.3 percent.

Chairman PATMAN. I mention that as the average. Suppose that is the average. What would you expect the maximum to be, the maximum and minimum under those conditions?

Mr. BURNS. I am not very good at figures, as you know, Mr. Chairman. The maximum might be 4.4, it might be 4.5.

Chairman PATMAN. It could be six?

Mr. BURNS. Mr. Chairman, if we are going to talk about possibilities, we can be all over the numerical range.

Chairman PATMAN. So it would not be too far out of line to suggest, say, between 3 and 6, something like that, which would average about 4.3 or 4.4?

Mr. BURNS. That would be much too high in my judgment. And I see no good purpose, sir, in making any such extrapolation.

Chairman PATMAN. Thank you, sir.

Now, then, over the years we have had a problem with the Chairman of the Federal Reserve Board and the Federal Reserve Board itself in getting the annual reports. It was contemplated, I think, when the Employment Act of 1946 was passed and the Joint Economic Committee and the Council of Economic Advisers were created that we would have the benefit of the report of the Board of Governors by the first of the year to help us in our work here. But we would get the Federal Reserve Board report sometime in April or sometime in May, and I know a time or two even beyond that. And I took it up with the Board one time, and tried to persuade them to give us that report at the end of the year.

I am not convinced that there was not any reason why this could not be done. But I do not think we have received it even once by the end of the year. In fact, we have not received it now for 1969. And we needed it in preparing our work. So if you will give consideration to that, Dr. Burns, and also see if you can furnish us a report soon after the first of the year in the future, it would be very much appreciated, sir.

Mr. BURNS. I would be more than glad to do that.

What you just told me I did not know. And my offhand opinion is that you ought to have that report earlier in the year so that we can consider it together with the Economic Report.

Chairman PATMAN. Dr. Burns, during the last year there has been quite a bit of activity concerning the one-bank holding company problem among many Government officials, including the Treasury Department, the Department of Justice, your predecessor at the Federal Reserve Board, and others. I am sure you are aware of the President's Message of March 24, 1969, calling for prompt legislative action on this matter.

In addition, I was very pleased to note that you stated just last December before the Senate Banking Committee that you considered this a matter of top priority. Do you still feel that the Congress should plug the one-bank loophole as soon as possible, preferably during this Congress, Dr. Burns?

Mr. BURNS. If you would be good enough, Mr. Chairman, to repeat the last sentence——

Chairman PATMAN. Yes, sir, I would be very glad to.

Mr. BURNS. I did not hear the last few words of that.

Chairman PATMAN. Do you still feel that—I will start back two sentences.

In addition, I am very pleased to note that you stated just last December before the Senate Banking Committee that you considered this a mater of top priority. Do you still feel that Congress should plug the one-bank loophole as soon as possible, preferably during this Congress?

Mr. BURNS. Yes, I very much do. My answer is an unambiguous yes.

Chairman PATMAN. Since the President's call for prompt legislation in this area the formation of one-bank holding companies and the nonbank acquisition of one-bank holding companies have continued unabated. There have been more than 100 such transactions over the last year. In the light of this, do you see any reason why the Congress should not heed the President's request and act on the holding company legislation before the end of the 91st Congress?

Mr. BURNS. I would like to see the Congress act on this legislation, yes.

Chairman PATMAN. Thank you, sir.

I will forego asking questions at this time, but I will yield to Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

Dr. Burns, if I say nothing else today I would like to stress the enormous pleasure of one Senator and one American in seeing you in your present place. It gives me tremendous satisfaction. And I believe it will work out to be a tremendous boon to the Nation and the world. Whatever may be the merits of your predecessor, whom I have known and respected as both a friend and a public official for some years, I think there is a new voice and a new feeling in the Fed. And I think it will be reflected most helpfully to all of us, and I think it is already reflected in your testimony.

And I would like to say to our Chairman, for whom I have deep affection of very long standing, that I hope he, too, having had his troubles with the Fed and its Chairman, will feel that this is a new page in history, and will take Arthur Burns for what he appears to be: a man very anxious and willing to cooperate with Congress.

Chairman PATMAN. I think the statements I have made indicate just that.

Senator JAVITS. I thank you.

Now, Dr. Burns, I have just a few questions. Do you feel that the time has come to consider some form of credit control, for example—and I only cite this as an example—a Capital Issues Committee? Such credit control would direct itself precisely to the point which you make in your statement, that as there is a release of monetary restraint, such sectors as housing and State and local governments—I think that could include small business which you included in another point in your remarks—will not get their share of credit, but credit will instead flow into much more attractive and proper channels of plant and equipment expansion, and perhaps even speculative activities.

Mr. BURNS. Senator Javits, first of all, let me thank you for your most gracious remarks. You and I have long been friends. We both come from New York, and we often say kind things to one another, I appreciate your remarks very much.

If you had put this question to me several months ago, I probably would have told you that I would consider sympathetically such a suggestion. At the present time, I think that readjustments are going on in our economy, and I do not think we ought to rush into any kind of control right at this point. My information is that many manufacturing businesses over the country are reappraising their capital expenditure programs, and there is a movement already to reduce them downward.

On the other hand, public utilities and communications concerns are not only staying with their earlier capital expansion plans, but in many instances are raising them. They are doing this on the basis of need, you see. There are shortages, and these shortages need to be met in these industries which are so vital to all of our people.

And therefore my final word, as far as your basic question is concerned is, let us keep this under observation. Let us not be ideological or dogmatic on the issue. As of today, on the basis of what I know or think I know, I would not move into controls in this area.

Senator JAVITS. You tell us on the same page that:

I do not come here today with solutions to offer, but I can assure you that the problem will be under intensive study in the Federal Reserve.

Can you assure us as soon as you can say something how you intend to handle this very real problem; does the fact that you negate the idea of some form of control, or the Capital Issues Committee, mean that it still can be handled by the automaticity of the marketplace? Will you come back and tell us seasonably when you do decide what ought to be done about being sure that housing, small business, State and local governments, and perhaps other categories, get their share of the credit, in view of the fact that you yourself say that housing is very badly depressed, and is very likely to continue to be unless it finds some way of getting its part of the credit pool?

Mr. BURNS. Senator Javits, I most certainly will come back to this committee. Moreover, while I hope my business here will be frequent as well as pleasant, I will not wait until my next visit. I am engaged in conversations with other Government officials constantly with a view to helping solve some of these problems, particularly in the housing industry.

Senator JAVITS. We can look to you, therefore, and to the Fed for, one, recognition of the problem; two, a determination to solve it, and three, the taking of the measures within the competence of the Fed which will, however, seek to realize the objective of seeing that these less-advantaged areas of the economy do get their fair share of the credit pool?

Mr. BURNS. My answer, sir, is very definitively yes.

Senator JAVITS. One other point. I am very interested in your views on monetary policy, and sometimes as we write we kind of reveal our minds. I would like to call your attention to two points. You say in your statement:

As we all recognize, monetary policy must stand ready to adapt quickly to unanticipated developments in the equity and in the financial markets.

Then you say in your statement:

We are well aware that monetary policy works in complex ways, with lagged effects that are difficult to predict as to timing, magnitude, and sectorial impact.

Now—and here we come to our friend Dr. Friedman—if monetary policy is, as stated in your statement, the handy and quickly adopted tool, and later in your statement it lags—and I think that is the general opinion—how can we reconcile these two?

Mr. BURNS. I have no difficulty reconciling them, Senator. After all, in spite of the limitations of our knowledge, each of us must do each day the best that he can with the knowledge that he possesses and the knowledge that he can gather by consulting his colleagues and others.

Now, as for lags, you have got to draw a vital distinction between the effects of monetary actions on the overall level of prices and the effects of monetary actions on economic activities. There is a difference here in the length of the lag, a very considerable difference. The second is considerably shorter than the first.

Then you have to recognize that the length of the lag depends on conditions. We live in a world that we cannot consider or govern in terms of averages. As I pointed out in my original statement, when confidence is running high and a huge backlog of demand exists, monetary stimulus can give us very quick results.

Senator JAVITS. And that is what you anticipate, in speaking of the effectiveness of monetary policy?

Mr. BURNS. That is what I anticipate under the conditions that I specify; namely, a high degree of confidence and a huge background of credit demand in existence.

Senator JAVITS. And generally speaking I gather from you and other administration witnesses that your thought is that some sort of monetary stimulus is likely to occur in the latter part of this year?

Mr. BURNS. Well, we have great confidence now, and there is a great backlog of demand now. But as to monetary stimulus and its degree, that is something else again. The Board will do the very best that it can. And I assure you that the Board is not idle or dormant.

Senator JAVITS. It reserves its options.

There is one question I would like you to answer, perhaps in writing, if I may just ask it. I gather from your statement in a number of places that there is some question as to how we got into this inflation, and not a very clear explanation as to whether it was due to demand and inadequacy of supply or other causes. I certainly think that as we adjust the remedy, it might be very useful to have a very clear delineation by you, with facts and figures, as to how you think we got into it.

Mr. BURNS. I would be glad to give you that now or later, as you prefer.

Senator JAVITS. My time is up. Thank you very much.

Chairman PATMAN. If you will extend your remarks when you look over your transcript, we would appreciate it.

Mr. BURNS. I would be glad to.

(The following material was subsequently submitted for the record:)

Senator Javits' question is answered in the following excerpt from: Arthur F. Burns, *The Business Cycle in a Changing World* (New York: National Bureau of Economic Research; distributed by Columbia University Press, 1969), pp. 287–295:

* * * To what factor or factors in the overall situation can this inflation be attributed?

One popular notion attributes the inflation to the war in Vietnam. The Council of Economic Advisers has put this explanation as follows: "Around mid-1965, the growth of demand for industrial products suddenly accelerated as the direct and indirect consequence of the enlarged commitment of U.S. forces in Vietnam . . . The upward pressures on prices and wages in this period . . . tripped off a price-wage spiral." This explanation has an element of plausibility, but it cannot be readily accepted.

In the first place, the new inflation started before Vietnam was of any financial or economic consequence. Prices of raw materials began moving up in spirited fashion as early as the fall of 1963. By June of 1964, the average level of all wholesale prices began rising. Between that month and June 1965, the wholesale price index rose 3 per cent.

Moreover, prices advances spread out over the economy well before mid-1965.

During the second half of 1964, twelve of the fifteen major groups of commodities covered by the official index of wholesale prices registered advances. During the next six months, fourteen of the fifteen groups showed price increases. Clearly, inflation had already taken hold and become widespread many months before Vietnam began adding appreciably to aggregate monetary demand.

In the second place, total federal expenditures, as estimated in January, show an increase of $53 billion between mid-1965 and mid-1968. Less than half of this increase, that is, about $25 billion, is attributable to the war. Hence, if the war expenditures are regarded as a cause of the recent inflation, then nonwar expenditures must be considered a still more important cause.

In the third place, while it is true that spending for Vietnam added powerfully to aggregate demand after mid-1965, this effect could surely have been offset by reducing nondefense spending or by raising taxes or by making credit more expensive and less readily available to private borrowers. The simple explanation that the recent price-wage spiral is attributable to the war in Vietnam must therefore be rejected.

Another popular explanation of the recent inflation is that business firms have lately found it expedient to use their market power—which is a polite term for monopolistic power—more aggressively. If this were actually the case, it would be reasonable to expect profit margins to rise. That, however, has not happened during the past two years. On the contrary, profit margins in American industry, taken as a whole, declined in 1966 and declined again last year.

The main reason for the narrowing of profit margins is that, on the average, prices of late have risen less than unit labor costs of production. And this brings me to a third popular explanation of the inflation, namely, that trade unions have been using their market power irresponsibly during the recent years of low unemployment.

There can be little doubt that some trade unions have lately been able to achieve extraordinary increases in wages, just as some business interprises have been able to raise prices out of proportion to the increase in their costs. But the theory of labor monopoly does not hold up any better than the theory of business monopoly.

Between 1966 and 1967, wages rose all around. But where did the sharpest increases take place? Not in manufacturing, mining, or transportation—all of which are heavily unionized. In these industries, the percentage rise was below the national average. On the other hand, in agriculture—where trade unions play practically no role—wage rose most. Abnormally large increases occurred also in retail trade, wholesale establishments, service trades, financial institutions, and the construction industry. Except for the latter, these are industries in which trade unions are notoriously weak.

The pattern of wage increases between 1964 and 1966 was very similar to that from 1966 to 1967. The behavior of wages in recent years cannot, therefore, be explained in terms of monopolistic power, unless one is prepared to argue that trade unions have been using their power to restrict rather than to intensify wage increases.

What has happened of late in the wage sphere can, however, be explained quite simply in terms of a competitive market. As the aggregate demand for goods and services kept growing, the labor market became increasingly tight. Workers in low-wage industries, such as agriculture and the service trades, saw an opportunity to get jobs in high-wage industries, such as manufacturing. The outflow of labor from the low-wage industries therefore tended to raise substantially the wages in those industries, while the movement of workers to the high-wage industries served to moderate the wage increases in that sector. Such shifts in demand, supply, and relative wages express the normal workers of a competitive market.

There is an additional fact that we should bear in mind. Contrary to a widespread impression, the real income of the average American worker has not improved at all during the past two or three years. Once wages are adjusted for the rise in consumer prices and for social security and income taxes, what we find is that the weekly earnings of the average worker in private nonagricultural employment were actually a trifle lower in 1966 than in 1965 and again a trifle lower in 1967 than in 1966.

Let me turn to still another explanation of the recent inflation, namely, that the Congress is responsible because it has failed to accept the President's repeated request for a 10 per cent surcharge on income taxes. If the Congress had done what the President wanted, so the argument goes, the increase in aggregate demand would have been curbed and the advance in prices would have been much slower.

This explanation again ignores much of recent history. Apart from the suspension of the investment tax credit, which became effective in November 1966, the President did not ask for an increase in taxes before January 1967. By that time the wholesale price level had already been rising two and one-half years. And when the President did ask for higher income taxes he asked merely for an increase of 6 per cent, to become effective at mid-year. In the face of an explosive increase in federal spending, this request did not convey any great sense of urgency.

Moreover, within a few weeks of asking for a tax increase in the interest of restricting the growth of aggregate demand, the Administration actually stepped up its efforts to stimulate demand. Substantial funds for housing and highways, which had only recently been impounded, were released by March of 1967. In March, also, the President requested the Congress to reinstate the investment tax credit for machinery and equipment. This meant, of course, that the President was now asking for a substantial tax cut for business firms instead of the tax increase he had suggested a few weeks earlier.

The abrupt shift in early 1967 toward a more liberal fiscal policy was accompanied by a shift to a more liberal monetary policy. The Federal Reserve authorities lowered the discount rate. They reduced reserve requirements on time and savings deposits. Most important of all, they now pumped reserves into the commercial banks at so fast a rate that the money supply during 1967 grew more than 7 per cent. This was a faster rate of growth than in any year of the entire period since World War II.

Thus, despite the war in Vietnam, the government acted during much of last year as if a recession were under way, instead of coming to grips with the menacing reality of inflation.

True, in August 1967, the President made another switch in fiscal policy. Announcing that the nation was threatened by ruinous inflation, he then requested from the Congress a 10 per cent, instead of the earlier 6 per cent, surcharge on income taxes. By this time, however, the Congress as well as the rest of the nation was quite confused about the direction and purpose of national economic policy.

Many Congressmen asked: Why is the nation being whipsawed by sudden and apparently capricious shifts in tax policy? Has the danger of inflation now really become more acute? If so, did not the Administration bring on this difficulty by its aggressively expansionist policy since February? If the Administration was wrong then, can its judgment be trusted now? And if the Administration is really so concerned about inflation, why does it not curb the projected increase of federal spending and thereby reduce the need for a tax increase? It is largely because the Congress has not been satisfied with the answers that it has received to these questions that no increase in taxes has yet taken place.

The delay on the subject of taxes may be regrettable. I happen to think that it is very regrettable. But if Congress is to be blamed for the inflation which we are experiencing, the Administration's entire monetary and fiscal policy must be blamed much more.

When President Kennedy took charge of our government in January 1961, there was considerable slack in the economy, but the price level was steady. In fact, it had been quite steady for two years.

The new administration proceeded to shape its economic policy on the basis of an ingenious theory, namely, that by adjusting taxes or its own rate of spending the government would be able to keep the aggregate demand for goods and services closely adjusted to what our economy can produce at full employment. According to this theory, as long as a gap existed between actual output and potential output, it was the responsibility of the government to stimulate demand by increasing its expenditures or by cutting taxes, but maintaining in either case an easy monetary policy.

The proponents of this theory realized that inflation could create an imbalance between production and sales or between business investment and consumer spending, and thereby lead to a recession before the gap between actual and potential output was closed. They believed, however, that price increases could be staved off by getting workmen to accept wage increases that equaled the overall increase in output per man-hour and by getting businessmen to set prices so that the ratio of the price of a commodity to its labor cost of production would be constant.

The Administration's economic policy therefore came to rest on two articles of faith: first, that monetary and fiscal stimuli would serve to expand employment and close the gap between actual and potential output; second, that wage and price guidelines would serve to keep the price level stable while these stimuli were being applied.

This theory worked reasonably well as long as our factories and mines had considerable idle capacity and unemployment was moderately large. Under such conditions, an aggressive fiscal and monetary policy could be pursued without resulting in a wage-price spiral. By 1964, however, the gap between actual and potential output had narrowed substantially. As demand began pressing on available resources, bottlenecks developed and prices rose.

The new wave of inflation did not come without warning. By the late summer of 1964, a large increase had already occurred in the number of business firms reporting slower deliveries. By the end of 1964, the average workweek in manufacturing was already at the level reached during the Korean war, and price increases in wholesale markets—as I previously mentioned—had already become general.

The price increases, however, were as yet small and the Administration paid no attention to them. The official view was that the government's economic policy was working out as expected, that fiscal and monetary stimuli were narrowing the gap between actual and potential output, and that the guidelines were keeping wages and prices in check.

Indeed, since its policy of economic stimulation seemed to be working so well, the government felt it was desirable to push this policy more energetically. Thus, during 1965, when the economy was already advancing rapidly of its own momentum, the government accelerated the application of monetary and fiscal stimuli, instead of moving gradually toward a policy of restraint.

Practically every weapon in the arsenal of economic stimulation was released during 1965. In that year, we had the second installment of the cut in personal income taxes enacted in 1964. In that year, the second installment of the cut in corporate income taxes became effective. In that year, a significant reduction of excise taxes was enacted. In that year, spending on programs of the Great Society was enlarged. In that year, the rate of increase of the money supply and of bank credit was stepped up sharply. All this happened despite the expansion of federal spending on account of Vietnam.

This aggressively expansionist policy did indeed help the nation reach full employment by the end of 1965, but that was not the only result. By that time, wholesale prices were already 4 per cent higher than in mid-1964, and the rise of wages was already accelerating. As experienced observers had predicted, the price-wage guidelines proved a fragile barrier to inflation once labor and commodity markets tightened.

The architects of the policy that produced these results had promised that once full employment was approached, governmental policy would assure that aggregate demand rose no faster than the nation's productive capacity. This promise has not been fulfilled. In these recent years of prosperity and full employment, the federal budget deficit has continued to mount.

The yardstick on which economists nowadays rely to gauge the degree to which federal finances exert a stimulating or restraining influence on the economy is, however, the full-employment deficit or surplus rather than the actual budget deficit or surplus. This yardstick of the economist indicates that the fiscal stimulus applied by the federal government to our economy has grown progressively, year after year, since 1963.

The record of monetary policy has not been much better. True, over an interval of some seven or eight months during 1966, the Federal Reserve authorities pursued a restrictive monetary policy. In the past three or four months, they have also moderated the expansion of the money supply and credit.

However, the broad thrust of monetary policy during the past few years has been more and more expansionist. Between mid-1960 and mid-1964, the money supply grew at an annual rate of only 2.7 per cent. This rate was stepped up to 4 per cent between mid-1964 and the spring of 1965, and to 6 per cent over the next year. During 1967, as already noted, the rate was above 7 per cent.

It is this combination of an accelerating growth of the money supply and an increasingly expansionist fiscal policy that is the basic cause of the wage-price spiral that we have lately been experiencing. It may, perhaps, be debated how much of the responsibility for the recent inflation is to be attributed to the Congress and how much to the Executive Branch. But there can be no escape from the conclusion that the federal government has pursued an increasingly expansionist policy in the face of practically full employment and a soaring price level.

Now, as in other times of inflation, the administration in power has been blaming greedy businessmen, irresponsible trade union leaders, and unruly Congressmen. But the new inflation is mainly the result of the excessively rapid creation of new money and of our unbalanced federal budgets.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. Dr. Burns, when you appeared before the Senate Banking Committee I paid my respects to you and said I thought this was perhaps in my view the best appointment that the President had made. And I reiterate that now.

I would like to ask, in your statement you say:

If the economy follows the course that I have outlined and a dimunition of inflationary pressures is realized, monetary policy could well move as the year progresses toward a posture more nearly in keeping with the economy's long-run needs for money and credit.

Now, what more do you want? You look at the economy today and we have had 5 or 6 months of steady, consistent drop in production, the industrial production index. Unemployment has increased sharply—true, that is fairly recent, but it has increased sharply. You have got a steady fall in the rate of increase in personal income. You have got a drop in new orders, you have a steady and almost a disastrous drop in housing. As a matter of fact, this morning the housing starts are enumerated at 1.1 million——

Mr. BURNS. 1,166,000.

Senator PROXMIRE. Right. I just wonder what other evidence you want. Do you want to have before you begin to ease up on credit a turn-around on wage settlements, do you want them to begin to drop, do you want wholesale prices to begin to fall, or do you want consumer prices to begin to drop, or do you want just a continuation of what we have had in these other statistics?

Mr. BURNS. Senator, you are putting a very difficult question to me. I am now in the central banking business. And by tradition—and I think the tradition has arisen out of necessity—there are some questions on which central bankers cannot speak with great freedom. And the reason is that if they do, they may have a very unhappy effect on markets. The capital market may swing and money will be made and money will be lost. There is a great moral responsibility here.

Let me therefore, not trying to be evasive, indicate to you, first, that all the facts that you have mentioned I know and I know fully well. Second, that I am not asleep, and neither are my colleagues on the Board.

Senator PROXMIRE. I am not asking you to tell us the date on which you are going to ease money. I am just asking you what criteria you are looking at which will give you assurance.

Mr. BURNS. I am looking at the evidence that you have cited.

Senator PROXMIRE. Do we have to get a drop in the Consumers' Price Index?

Mr. BURNS. To do what?

Senator PROXMIRE. Before you act to ease credits.

Mr. BURNS. The answer is definitely no.

Senator PROXMIRE. Do we have to get a drop in the wholesale pricing?

Mr. BURNS. The answer is definitely no.

Senator PROXMIRE. Thank you. Then I take it that we simply have to have a continuation of the other unfortunately gloomy statistics on the economy, in other words, as the economy eases up even further, then at some time you feel it will be possible——

Mr. BURNS. That conclusion does not follow, and my remarks do not imply that.

Senator PROXMIRE. What do they imply?

Mr. BURNS. They imply that the Federal Reserve has not been asleep in the past, at least in the very recent past, nor will it be asleep in the future.

Senator PROXMIRE. I will not retract my assertion that I think you are the best appointment the President has made. But frankly, I am beginning to be a little shaken.

Chairman Burns, in the past Chairman Martin has told us that the Federal Reserve has no responsibility——

Mr. BURNS. Before your confidence is shaken too much, Senator, we can at any time go into executive session.

Senator PROXMIRE. What is wrong with letting the country know about this?

Mr. BURNS. I have indicated what I think is wrong.

Senator PROXMIRE. It will make some money——

Mr. BURNS. Some will make and some will lose. I do not mind seeing anyone make money in this country, but I certainly do not want to be the instrument or the agent through which or because of which people, poor people, uninformed people, lose money. And I think you share that opinion. I am sure you do.

Senator PROXMIRE. Of course. But I do think the Congress cannot act effectively and wisely until we have the best advice on the way you look at the economic situation, and the basis on which you act. And I think you recognize that your Board is the creature of Congress, and Congress is the superior of the Federal Reserve Board, and it is up to us to get enough information so that we can give you guidance.

Mr. BURNS. Senator, we can create instrumentalities whereby the Congress will be completely informed, but we cannot do that in a public session.

Senator PROXMIRE. You have more confidence than I have in the discretion of committees.

Mr. BURNS. I have great confidence in the chairman, and I have great confidence in any committee that he may appoint.

Senator PROXMIRE. I have great confidence in Chairman Patman, too.

As I say, Chairman Martin has said that the Federal Reserve has no responsibility for allocating a supply of credit among various sectors of the economy such as housing. In Chairman Martin's view the Fed had only one responsibility, and that is developing the adequate supply of credit. What is your view on this?

Mr. BURNS. I have stated my view in earlier testimony before the House Ways and Means and the House Banking and Currency Committees. I think the Federal Reserve Board has a great responsibility to deal with a major social problem; namely, the protection of the integrity of the dollar and the promotion of stable prosperity in our country. That, I think, is the function that the Congress assigned to the Board. That is a function that the Board, by virtue of its constitution, I think is able to perform.

Finding solutions for other social problems is a responsibility, as I see it, that the Congress has reserved to itself, and rightly so.

Senator PROXMIRE. Let we give you an example, Dr. Burns, of how the Congress has given to the Federal Reserve Board the responsibility for getting into this area. In 1966 Congress gave the Federal Reserve the authority to buy Federal agency issues in addition to Treasury securities in the conduct of open market operations. And looking at the figures for 1969, I note that the Fed increased its holdings of Treasury issues by $4.4 billion, but it did not increase its holding of agency issues by a single penny. Now, is there some reason why the Fed has ignored the intent of Congress to buy agency issues? As long as the Fed was buying over $4 billion in Treasury issues, why could it not have spent a billion or two on Home Loan Bank issues in order to channel money into the mortgage market where it is so desperately needed and where we know we have the most serious situation in the whole economy, that is, in housing? Purchases of a billion or $2 billion could easily be offset by reduced purchases of Treasury issues.

Mr. BURNS. I cannot answer your question fully, because there is a history here that I do not know as well as I should. But let me say this. I think your question implies that if the Federal Reserve Board had bought agency securities, large benefits would have accrued to the housing market. I do not think that is true at all. Because if the Federal Reserve had bought agency securities it would have bought fewer—or it might have had to sell—Treasury securities. So that the effect on interest rates would have been in the overall market quite small.

The effect on the interest rate or the yield of agency issues, I think would have been marginal at best.

Senator PROXMIRE. Even if they are marginal they could not help but be helpful.

Mr. BURNS. I know. I am just addressing myself to what I thought was an implication of your question. This would be of benefit, but I think it would be very marginal.

Senator PROXMIRE. That is one specific and concrete thing that the Fed could do to help housing to a limited extent, and they have not done it.

Mr. BURNS. Let me say first, I have to review the early history. I am not able to speak with authority on this point. My judgment is that the effect on housing issues would be very marginal. Indeed, there may be some injury to the market for agency issues if the Fed became a large buyer.

In that event the private buyers might become less interested in that security, feeling that the Fed can manipulate that market.

Senator PROXMIRE. You could say that about Treasury obligations.

Mr. BURNS. No. The market is far too large and far too broad. It is a worldwide market.

Senator PROXMIRE. It is a big market in housing too.

Mr. BURNS. It is becoming larger, you are right. And the point that I am making, I think, has less validity today than it would have had a year ago. And as these agencies grow it will have still less validity.

Let me say that I want to look into this issue. I do not want to give you a categorical answer, but I have done the best I can at the present time.

Senator PROXMIRE. Let me give you another example of how the Fed could help out. Why couldn't the Fed as an incentive reduce the reserve requirements on these banks who increase their investments in low- and middle-income mortgages and offset any increase in bank reserves through open market operations in order to maintain the same aggregate monetary effect? This would stimulate the flow of funds into housing without adding to inflation.

Mr. BURNS. This question I am not qualified to deal with, Senator. It raises questions of law that I am not familiar with. But I shall look into that question and give you my answer at a later time.

Senator PROXMIRE. My time is up. But I suggest we can always change the law. That is a matter of policy that Congress can always do.

Chairman PATMAN. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Dr. Burns, I would like to reiterate all the pleasant things that have been said to you today about your being the head of the Federal Reserve System. And I would also like to repeat my comments when you came before the House Banking and Currency Committee recently. It is very refreshing to have a witness before us who admits at some point that he does not know the answer right then. This is rather unusual, I think, in testimony before a congressional committee.

Mr. BURNS. I was a university professor. I have had a lot of experience along that line, Mr. Widnall.

Representative WIDNALL. We are delighted that you have the job that you have. And I am sure we all have great confidence in the way you will run the Federal Reserve.

Dr. Burns, there are now only $3 billion in U.S. Government securities due in over 5 years, less than half the 1968 holdings. While monetary restraint is no doubt responsible for much of this, do you believe this might signal a permanent change in bank investment policies, possibly stimulated by the recent change in the tax treatment of the gains on the securities?

Mr. BURNS. That again is a question that I do not feel I can discuss with the feeling of assurance that this committee ought to have. There certainly has been a shift in the attitude of the banks toward Government securities. And I think the bear market that we have had in Government bonds undoubtedly bears some responsibility for this. Now, as for the tax features, I hesitate to try to answer that.

The fact that there is a great bear market in bonds—I think we have had the greatest bear market in history—is probably largely responsible for the reluctance of banks to hold on to or to acquire long-dated Government bonds.

Representative WIDNALL. Do you believe that long-term Government bonds will gain in favor once interest rates decline and reach their normal prominence in bank portfolios?

Mr. BURNS. I would expect that once inflationary expectations change, yes, the attitude toward bonds in general, Government bonds, corporate bonds, by banks and by financial institutions, will change.

Representative WIDNALL. Agencies such as the Federal Home Loan System and FNMA are Government sponsored but not controlled by the Government as we all know. Last year these agencies borrowed $9.1 billion of the money in capital markets, which in turn was loaned out mostly to support residential and farm mortgages.

To what extent does heavy borrowing by these Government-sponsored agencies reveal a budget policy of reducing Federal demand on the credit market?

Mr. BURNS. Well, these agencies are outside of the budget. But they are still under the influence of the Government. I think that we sometimes take the new unified budget a little too literally. If we were to look at the lending the Government-sponsored financial institutions last year, and if we were to include that in the Federal budget, as we once did, we would find that the budgetary picture for last year does not look as good as we perhaps believe.

Now, these issues have had a large effect on other markets. In thinking of the budget—yes; let us stay with the unified budget. But when we examine it and think about it, let us also consider the lending that is being done by the Government-sponsored financial corporations. That was the thrust, you see, of some remarks I made toward the close of my testimony.

In a fundamental sense all this is a part of governmental activity. We ought to consider it, and you in the Congress should consider it.

Representative WIDNALL. To what extent did the 1969 security issues of these sponsored agencies for the purpose of supporting mortgages compete with private sources which normally supply the mortgages?

Mr. BURNS. I cannot say to what extent, but certainly these agencies went into the market with huge issues with high interest rates. Then people over the country who had their money in savings banks and savings and loans began withdrawing their money, or instead of putting their money into these thrift institutions, they bought agency issues. So that benefits to the residential market that came from these agency issues can easily be exaggerated.

Taken as a gross figure the benefit is enormous, but when you allow for the depletion of the resources of the thrift institutions, the benefit was certainly very much smaller.

Representative WIDNALL. As monetary policy is eased, what role should these agencies play in insuring that the credit made available is allocated to these sectors such as homebuilding that need it most?

Mr. BURNS. Well, these agencies have a vital role to play. Certainly the Executive and the Congress should try at a time such as this, when funds flowing into homebuilding from private sources are very limited, to shore up the ability of FNMA and the Federal home loan banks to continue to engage in a sizable lending program. But we should do it with our eyes open, remembering that if there is a flood of such agency issues, money may flow out of the thrift institutions. It is not all net gain, not by a long shot. Still there is great service to be performed by the Federal home loan banks and FNMA and GNMA, hopefully, at the present time.

GNMA is coming up with a new issue, and it is a useful beginning. I think a new issue will be out in 2 weeks. It is small, only about $2 million.

Representative WIDNALL. Just one more question, Dr. Burns. In 1969 FNMA and the Federal home loan bank supported residential mortgages tripled their 1968 level, representing 47 percent of the total supply of noncommercial mortgages in the 1969 third quarter compared to 17 percent in 1968, in other words, a rise from 17 to 47 percent. Can these agencies continue to provide comparable support in the year ahead?

Mr. BURNS. Well, that is not an easy question. Much is going to depend on the market, and much is also going to depend on what support to these agencies will come from the Executive or the Congress. We may need some new legislation.

Representative WIDNALL. Will support by these agencies be required in 1970 in your opinion?

Mr. BURNS. In my opinion strong support by these agencies will be required in the first half of this year.

Representative WIDNALL. Thank you very much.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

As you can see, Dr. Burns, you enjoy the good will of this committee. And I think it is well deserved, and I certainly share in it. Welcome here. And may I congratulate you on your fine statement.

You had a first meeting of the Open Market Committee last week, didn't you?

Mr. BURNS. February 10, I believe.

Representative REUSS. Being of an inquisitive nature, I would like to ask you what you said and what you decided, but in the light of the answer you made to a question by Senator Proxmire, I take it that you prefer that the question be asked only in executive session?

Mr. BURNS. That is correct.

Representative REUSS. So I will not ask it.

I note a very frank statement you made in your presentation here this morning. In your statement you said:

> I wish I could assure this committee that the disconcerting advance of the consumer price level will soon come to an end. Unfortunately such optimism is not warranted.

I think that is no less than a frank, honest statement which we would expect you to make.

You have also said that you of course are interested in any ways that present themselves for bringing that disconcerting inflation to an end. I would like your reaction to a couple of propositions I have recently advanced. First, I think the time has come, so intractable is inflation proving, for the Government to impose an across-the-board ceiling on prices for a period long enough, say, 6 months, so that the public and the economy would know that we mean business. And just last night I asked Chairman Patman of the Banking and Currency Committee in the House whether he would be willing, should the administration ask for any legal authority which it might feel it might need, whether he would be willing to have prompt hearings. And he said, yes, he would go into immediate hearings, stay in session night and day, and see that such legislation was promptly reported out if needed. What is your view? Would it be a good idea to have an across-the-board freeze on prices for the next 6 months?

Mr. BURNS. Well, my view is that if any such hearings were announced prices would begin going up in all kinds of places where they otherwise would not go up.

Representative REUSS. You could make, of course, your freeze retroactive.

Mr. BURNS. You could make it retroactive, but how would you make it effective?

Congressman Reuss, bear this in mind. The sharpest advances in consumer prices have occurred in two areas: the prices of foods and the prices of services. Food and services are handled through hundreds of thousands of very small establishments. Now, there is no way of policing prices in the very small shops in the country that handle services and foodstuffs. You would need an army of inspectors, and even then I do not think you would be successful.

We have got to use more constructive devices at the present time. And there is another fact that I think is quite important. To the average man—and never mind whether he is right or wrong about this—the inflation that we are having is attributable to the war in Vietnam. And that war in Vietnam, never mind again whether that is right or wrong, is not a popular war. During World War II people were willing for patriotic reasons by and large to abide by price controls. I doubt very much whether we would have any such public response at the present time. I do not think the psychological or political conditions exist for a price freeze, though I have every sympathy with the motives that lead you to make that suggestion.

Representative REUSS. Let me turn, then, to another possibility. You pointed out in your statement that the Federal Reserve in the last year held the growth of the money supply in very tight rein, I think you said 2½ percent of last year. Time deposits at commercial banks were projected to increase from 1 to 5 percent, and time deposits actually went down by 5 percent. Now, I note on page 31 of the current Economic Indicators that commercial and industrial loans by large, commercial banks, despite this tight money, were going up tremendously again in 1969, from $72.9 billion outstanding in January of 1969 they were up at the year's end to $81.6 billion. That is about 12-percent increase.

This indicates to me that the Fed was in effect pushing on a loose string very largely, that the ability of the large banks—I think there are some 160 of them in this index—to buy their way out of tight money by repatriating Euro-dollars, selling municipals and governments from their portfolios, and grabbing everything they can through the Federal fund market, the sale of certificates of deposit, and through sales of promissory notes by holding company subsidiaries. All of these things enabled them to embark on a real lending spree in this one area, commercial and industrial loans. While some of those loans, particularly to utilities, make good economic sense, because expansion there is necessary, the great majority of these commercial and industrial loans they were just plain inflationary. They were in areas where the industrial capacity is only being used at about 83 percent nowadays.

Mr. BURNS. I do not agree with that.

Representative REUSS. And therefore——

Mr. BURNS. Sorry.

Representative REUSS. So that I may put the question to you, sir, therefore, wouldn't it be a good idea to do what we did in Korea in 1966, and what France and the United Kingdom and many other countries do today, to impose qualitative controls on commercial and industrial loans by the large commercial banks? Commercial and industrial spending have been causing much of the inflation in this country. And if we impose qualitative controls there, a little money would be released for housing and State and local governments and other worthier objects.

Mr. BURNS. Yes. But you might also bankrupt many small businesses throughout this land, and cause financial trouble for many large firms as well. These loans go to business firms that cater to the needs of our people, and that provide jobs for working people. If you had not had this expansion of loans, our industrial production index at the present time might look very sorry indeed. And I would not want to look any longer at bankruptcy statistics.

Representative REUSS. It means, though, that tight money is largely nullified as regards the most inflationary sector of the economy, capital expenditure. Here you have the money supply pushed almost to zero, and yet the commercial and industrial loans by large commercial banks go up 12 percent.

Mr. BURNS. But you are identifying the category commercial and industrial loans with lending for new plant and equipment. No such identification, I feel, is permissible.

Representative REUSS. That is part of it. And part of it is for inventory and part of it is for conglomerate takeover. What I am suggesting is that if the Fed is going to follow the advice of the President and the Secretary of the Treasury, and loosen money a bit, even though I, as you know, am generally sympathetic to easy money, I would not view this money loosening with any great joy. If that is all you do, the large commercial banks that grabbed up all the money supply last year are going to grab it this year. They can make their loans to lenders who can charge off half of the high interest rates they have to pay to Uncle Sam. And I see no reason why the same understandable acquisitive practices by the large commercial banks through CD's, promissory notes, Euro-dollars, Federal funds—the whole gamut—are not going to continue. Thus your easing of money is not going to help housing and small business and State and local governments, but instead is going to add to the inflation in a very inflationary area. That is the problem.

Mr. BURNS. I see your problem. But I believe I am right in saying that these devices that commercial banks have used have helped individual banks here and there, but have not increased credit availability.

Now, these large banks to which you refer lend very substantial sums to small businesses. And we have got to keep that in mind.

I am not in favor of telling bankers just to whom to lend. I do not think—and I say this with great respect, Congressman Reuss—that you or I really could do this job any better than our market does it.

Representative REUSS. I am not suggesting that anybody tell the banks, "Loan to Dick, don't lend to Harry." I am suggesting that in this category of commercial and industrial loans by large commercial banks—these are not my pejorative terms, this is the Federal method of reporting—these banks are showing an ability to pay out money, and therefore if we are serious about monetary restraint, we ought to apply it to the large commercial and industrial category. These borrowers have been able to shake tight money off so far. If this means that some small businesses will be hurt as well as larger businesses, so be it, let us take care of that problem through the Small Business Administration.

In other words, I am with you in your generalized approach. But with all due respect, you have not satisfied me that that monetary policy cannot be frustrated by the ability of the large commercial banks to get their hands on everything not nailed down by way of incoming lendable funds.

Mr. BURNS. I think it is entirely clear that monetary policy is having a restrictive effect at the present time.

The effects have been uneven. So it was last year, and so it has been throughout our history. I think what we should do is try to develop new institutions, new mechanisms, whereby the uneven impact of a policy of monetary restraint may be rectified to some or to a very large degree. We ought to strive for that, rather than try to move toward a regulated economy. If we really knew how to regulate, I might be with you. But I see no evidence of that in this country, and I see no evidence of it abroad. And I do see free markets as the greatest economic asset that this country possesses. Let us therefore try to improve our institutions so that the uneven impact that troubles you—and I assure you it also troubles me—on homebuilding and State and local governments, and on small business for that matter, can be rectified.

Representative REUSS. Thank you very much.

Senator PROXMIRE (now presiding). Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

Dr. Burns, I too want to add my voice in bidding you welcome before this committee. You are not a stranger to us, nor we to you.

You have made a very fine statement, and I think you should be congratulated on that, because you have not tried to gild the lily, you have not tried to lead us astray into believing that things are good now and likely to get better immediately. You have said, and I repeat from your statement, that the availability of mortage credit declined substantially in the past year, and housing starts fell, and local governments are in distress because of the tightness of the money market, many businesses have been unable to raise funds, the bond and stock markets have fallen off substantially, industrial production has begun to decline, and the labor market again to ease, and so on. But regrettably, you say, these evidences of cooling in the economy have not been reflected in the moderation of prices.

Now, Dr. Burns, given hindsight of a year on the economic firing line during this tour of your duty, is there anything we might have done differently to forestall this condition?

Mr. Burns. I would be very glad to deal with your question, Senator. Do you want me to confine my answer to 1969 or go back?

Senator Jordan. Give us enough prelude to 1969 insofar as it affects your answer for 1969.

Mr. Burns. Well, the inflation that we are now experiencing, the first signs of that inflation came as early as the fall of 1963, when prices of raw materials began rising on a broad scale. By mid-1964 the entire wholesale price level began rising; it rose 3 percent between mid-1964 and mid-1965. So that an inflationary process was already underway before Vietnam became a significant factor.

And then in 1965 we pulled all stops. In 1965 we had the second installment of the reduction in the personal income tax, we had the second installment in the reduction of the corporate income tax, we had a substantial reduction in excise taxes, we had massive increases in expenditures for Great Society programs, we had new war expenditures because of Vietnam, and we had a very easy monetary policy. We did everything possible to whip up inflation during that year.

That was the fatal mistake. And we still have not gotten over the consequences of that serious error of judgment on the part of very well-intentioned and very capable people in government.

Since then, we have been struggling with this problem, and in the process inflationary expectations have been built up. And I must say to you, turning now to 1969, that the strength of inflationary expectations was underestimated by Government officials this year, just as it had been understimated by the previous administration.

I think the unified budget caused some difficulty. We felt we were being more conservative on the fiscal side than we were in fact.

Then I think we talked a little too much about a gradualist approach. It is one thing to pursue a gradualist approach, and it is another thing to talk about it. And in the process of talking about it we helped to sustain—unwittingly, of course—these strong inflationary expectations. In short, many mistakes were made within the Congress and within the executive branch. The deepest mistakes were made by the preceding administration, but some mistakes were also made by the new administration.

Senator Jordan. And you have said, and it is quite apparent. the battle against inflation is not yet over, further adjustments must be made to regain the path to sustain noninflationary growth.

How much momentum do you think there is built into this inflation, and how long is it going to take to get prices back down to a level that is tolerable?

Mr. Burns. Well, I think that by now we have eliminated the excess demand for goods and services. That is now accomplished. By now there is a widespread feeling within the financial and business community that this Government has the will and capacity to carry on the fight against inflation. We are not going to turn back.

I think that as this year progresses we will find that while prices continue rising, the price advances will be substantially smaller.

Senator JORDAN. How much lag is there in the reporting of retail prices as compared to what they are today, for instance? You open the paper today, and everyone seems to be having a sale. But when will that be reflected in the prices that we get from the reporting services?

Mr. BURNS. The average lag is about 6 to 7 weeks.

Senator JORDAN. We have heard a great deal recently about the link between inflation and high interest rates. I read a statement by a well-known economist not long ago where he indicated that in his view interest rates would not come down until inflation was reduced. Is not inflation a substantial component of interest rates?

Mr. BURNS. Well, I think it most decidedly is. An inflation premium is built into the interest rates that we have been having. The lenders quite naturally, anticipating as they generally have a continuing rise in the price level, have been reluctant to lend at the going rate, and therefore have expected and have been able to get a higher rate. And as far as borrowers are concerned, expecting to pay back in cheaper dollars, they have been willing to borrow more heavily and pay higher interest rates.

If you take interest rates that we had last year, when they were the highest, I think, in our recorded history, and if you allow also for the advance in the price level, you will find that the real rate of interest was down to something like 3 percent. So an inflation premium is undoubtedly built into the interest rates that we have been having.

But there are already some signs—they are faint as yet—that that inflation premium may be coming down as expectations change.

Senator JORDAN. A lender, in addition to rental for the use of his money, and a factor covering the possibility of a loss on his loan, must also take into account the purchasing power of that dollar when his loan payment comes back to him so that the constant dollar value of his loan is not substantially reduced?

Mr. BURNS. That is entirely correct.

Senator JORDAN. So it is a little wishful thinking to talk about 4 and 5 percent money when we have got a 5 or 6 percent rate of inflation, is it not?

Mr. BURNS. I agree entirely.

Senator JORDAN. Thank you, sir.

Senator PROXMIRE (presiding). Senator Symington?

Senator SYMINGTON. Thank you, Mr. Chairman.

Chairman Burns, it is good to see you.

I noticed your comments with respect to the balance of payments. I also note that in 1969 the deficit was $6.9 billion, the largest deficit in our history; in fact that is $3 billion more than the previous record deficit of 1960. I know that one of the reasons why the fourth quarter was better was the last minute transactions by corporations to meet the Federal line for limiting direct investment in foreign subsidiaries, otherwise the deficit would have been even greater.

I also notice that whereas in 1964 we had a trade surplus of $6.7 billion, that dropped last year to $674 million. As perhaps you know I have been interested in this particular financial problem for some time. And with a deficit of that character—and I notice you say it is important to give consideration to it—you say that the condition of our balance of payments still remains very unsatisfactory, the need to restore reasonable surplus in our trade with other countries reenforces the domestic reasons for making sure that inflation subsides. I have done my best to try to understand this problem, and it seems to me that in any corporation you have assets on one side and liabilities on the other. But everybody says when it comes to the national debt, it is clearly understood that if you do not have any assets you just have a debt; and this debt, in fact, represents great assets of this country, such as the Defense Department, The Interstate Highway System, dams, or other Federal facilities. Therefore people say, why worry about it, because you really owe the debt to yourself.

On the other hand, it is a fact that we have put over a hundred billion dollars into Europe since World War II, and we have put over a hundred billion dollars into Vietnam in the last 5 years. That I do not think is quite fair to say you owe yourself. Win, lose, or draw, we never get back, for example, the billion and a half that we have invested in Camranh Bay, the greatest harbor in the Far East—in the rice fields of Thailand, and so forth.

With those premises it seems to me that the reason for a continuing unfavorable balance, aside from our trade negotiations, and nontariff extras put on by foreign countries, is the amount of money that we are putting out of the United States in support of our worldwide commitments. That you cannot say we owe to ourselves. It seems to me that if we do not curtail in major fashion this continuing deficit in the balance of payments, regardless of the success in the SDR program, it could really affect the future value of the dollar in a much more serious way than it has been affected so far.

Would you please comment on that?

Mr. Burns. Well, I certainly agree with you, Senator, that our continuing large military expenditures abroad are a very serious drain on our balance of payments. And I agree further with the implication of your question, that if we succeeded in reducing those military expenditures a very constructive contribution to our balance of payments would follow.

Senator Symington. Thank you. It seems to me that it is the core of this problem. And we are headed for some trouble, which I think it is fair to say you imply yourself, unless we put a stop to it.

The other subject that I would like to bring up is the question of wages incident to prices. You say in your statement:

> Eventually, however, list prices too will begin to give way under the pressure of increased competition; and as the easing in prices at the wholesale level carries through to the consumer level, the prospects for more moderate wage settlements are enhanced.

That means, does it not, that as additional unemployment develops the workers' negotiating position is not as strong as it would be if there was a demand market as against a supply market in labor?

Mr. Burns. Well, I think that is true. The point that I was emphasizing was simply that once the cost of living stops rising as fast as it has been rising, you would have some modernization in wage demands. Of course, with profits also shrinking, as they are in process of doing, there would be more resistance on the part of employers to large wage increases.

Senator SYMINGTON. Would you care to say what the rate of unemployment will be 6 months from now?

Mr. BURNS. I am not a prophet, Senator Symington.

Senator SYMINGTON. Well, you are a better prophet than I am, and more experienced in the field.

Mr. BURNS. I want to thank you for the compliment.

But let me say this. I do not expect unemployment to be high in this country. There has been in the last few weeks or few days very loose talk about recession. We do not have a recession, and I do not think we are going to have one.

Senator SYMINGTON. What is your definition of high?

Mr. BURNS. Of unemployment?

Senator SYMINGTON. Yes.

Mr. BURNS. Well, anything that gets above 4 percent I feel uncomfortable about, I would not call it high, but I feel uncomfortable about it.

Senator SYMINGTON. Thank you, Mr. Chairman.

In your statement you say "Workers will be striving to obtain wage increases large enough to permit some improvement in their standard of living besides making up for the erosion in real earnings caused by inflation during recent years."

Doesn't to a certain extent that read against your first statement about the weakening position of labor in the present market?

Mr. BURNS. Well, that effort will go on. But the degree of success will diminish. And that effort itself later on in the year will weaken, once evidence accumulates that prices are no longer rising at the earlier pace.

Senator SYMINGTON. This is my final question. Some of my colleagues say, we don't have a recession in our area, we have a depression coming up, with heavy unemployment. In my State we have the three major problems: high interest rates, continuing inflation, and growing unemployment to the point where the living standards are being affected. Small business is being affected, as is housing; and, of course, some people are out of work. It is hard to explain a situation to them because of the overall GNP of this country. I find more and more people, regardless of their position in the economy talking about price and wage control. Are you still fully opposed to price and wage controls?

Mr. BURNS. I am afraid my answer has to be "Yes," Senator, I am. But let me add that I am not an ideological economist. I will always reassess my position.

Senator SYMINGTON. Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). Senator Percy?

Senator PERCY. Mr. Chairman, while Senator Symington is here, with whom I share views on many subjects, I would like to pursue your thinking on military expenditures abroad. In NATO, for instance, we now have roughly a $15 billion annual expense for our share of the common defense, and a billion and a half dollar balance-of-payments deficit. Solutions have been suggested, from Senator Symington's resolution to reduce U.S. troops to 50,000 to the administration's position to keep the level exactly where it is. But I am delighted that in the President's state of the world message today—and as long as we are not on live radio I can read one sentence: "In dealing with NATO the balance of burdens and responsibilities must gradually be adjusted to reflect the economic and political realities of European progress."

Considering this $7 billion deficit last year in the balance of payments, don't you feel that the NATO countries of Europe are endangering our ability to stay there at the present force level? There are 310,000 American troops plus dependents for a total of about 560,000 in Europe, which is more Americans than we have got in Vietnam. European countries should really pick up and start to share the burden of the costs we are now bearing, such as paying 70,000 German civilians in dollars, building buildings and using dollars to do it, buying supplies, paying the German Government to transport our troops, for electrical power, and so forth. These expenses are for the common defense.

Why should we be paying those expenses? Why shouldn't they be paying them? In light of what the President now says, aren't we endangering our ability to say there in force unless they realistically pick up that burden quickly?

Mr. BURNS. Your statement is eloquent, and it is also thoroughly sound. I have felt that way for many, many years. And I hope that we do it.

Senator PERCY. Can I ask about one aspect of offset arrangements that I consider the most ludicrous of the finger-in-the-dike type of arrangement that have been made recently to cover up this real NATO balance-of-payments problem. The United States borrows money from Germany, pays Germany market rates of interest on negotiated loans which have totaled a billion dollars. These loans just temporarily ease the pain. But further, just 2 weeks ago the Bundesbank called a half billion dollars of those loans without even prior notification, either to us or to Chancellor Willy Brandt. He told me he did not have any prior knowledge of this action, and certainly the German Ambassador here did not. I was shocked at it. And I think it exemplifies what happens when you borrow to temporarily ease the pain but do not face up to the fact that someday the price has to be paid.

Mr. BURNS. Senator, I am an economist by profession, and now a central banker. I am not an expert on foreign policy. But I have been shaking my head about these agreements with Germany for some years. And I wonder what kind of thinking goes on that makes this sort of thing possible.

Senator PERCY. I thank you very much. You share my concern and almost anger.

I would like to talk about price controls and wage controls from something of a different standpoint, and particularly while my former business colleague, Congressman Brown, is here.

It is my feeling that there is as much art as science in monetary and fiscal policy, and perhaps more psychology than almost anything else. You said in your statement that during a period of cooling in the economy many business firms shave their list prices through discounts which are not fully reflected in the price indexes. My feeling is that so long as Congress continues to talk about and offer the panacea of price and wage controls—and generally speaking, to businessmen they talk about wage controls and to labor they talk about price controls—and the administration firmly says it does not intend to impose such controls, and the President has said publicly I am sure—I know he has privately—that you cannot enforce wage and price controls, don't we really endanger the whole situation by offering this panacea? Isn't there a tendency on the part of business to protect itself? Business could reduce prices, but is not inclined to do so as long as they think there might be price controls. And in fact I think some of the price increases that are going on now are just a hedge against Government controls. These indexes might be wrong, then, and not truly reflective of the big discounts being given over the retail counter.

Mr. BURNS. I agree with your statement, Senator Percy.

Senator PERCY. In other words, talking about price and wage controls may even hurt the situation, and add to the inflation psychology of rising prices.

I would like to ask about housing. We have discussed many aspects of it this morning. Are there any specific suggestions that you might be prepared to make, or that we might look to from the Fed as to how we can channel more money into housing?

Mr. BURNS. I made two suggestions before the House Banking and Currency Committee when I testified on February 7. One was to make it possible to borrow on mortgages at the discount window, something banks cannot do at the present time without paying a penalty rate. And the other was to expand the authority of our national banks to lend on mortgages by changing the terms now specified in law.

I also indicated when I testified before that committee that we need to develop a secondary market for conventional mortgages, so that the mortgage instrument could become attractive to pension funds, and for that matter to other financial intermediaries.

I think GNMA has possibilities that should be exploited fully. And I am pleased that a small issue at least will be forthcoming. However, it is mighty small, it is limited to $2 million.

Now, I fear that our Federal home loan banks may be in difficulty in the months immediately ahead. Some constructive thinking on this is going on within the executive branch. I have just attended one such meeting, and I will be attending another one. I hesitate to speak on the subject until the administration is ready with a program. My own feeling is that we should be inclined to look favorably on a subsidy for a very limited period—I would restrict it to about 6 months—to the home loan banks, so that they could lend at an interest rate below the market. I think it is highly important that we restrict that authority to a very brief period. If we do not do that we may get into the habit of subsidizing, and stay with it. And if we are going to subsidize housing on a larger scale than we do, we would want to concentrate, of course, on the very low-income groups. That is where the subsidy makes good sense socially.

But there is a temporary problem that the home loan banks will have in coming to the assistance of the saving and loan associations. And I have given you my tentative thinking on that.

Senator PERCY. Thank you. Dr. Burns.

In your statement you talk about resource utilization in the years ahead. I presume you support the President's decision to appoint a Presidential Commission to study the financial structure of the country. Do you have any feelings as to what the scope of the commission should be? Should it be a study of the market structure, the regulatory machinery, or broader?

Mr. BURNS. Well, I think it should be broader than the regulatory machinery. I think also that the mandate of that commission should be spelled out with some specificity, otherwise this commission would be all over the map.

There have been profound changes in the banking world. Take the commercial paper market which has recently grown by leaps and bounds. It is a new banking system. We do not understand it. I think that a very basic study of that is needed, and needed promptly.

Whether the commission is the best device or not one may debate. And certainly we in the Federal Reserve Board are not going to wait for a commission; we will go ahead with our own studies.

Senator PERCY. Dr. Burns, what sort of accord does the Federal Reserve have with central banks as to the converting of dollars into gold? I believe you have such an arrangement with the Bundesbank in Germany that the Germans will not convert dollars into gold. Are there others?

Mr. BURNS. I am not sufficiently informed to answer that question. But I will try to inform myself very promptly on this.

Senator PERCY. Thank you very much.

Mr. Chairman, I think it is rather interesting to note that there was only one question, a highly technical one, on which the chairman was not fully informed. And there is not a single adviser alongside him; no one flanking him on the left and the right as there usually is. I think it is a wonderful tribute to the President's appointment that we do have the most experienced man that has ever been appointed to this high post, and one that enjoys without any question the confidence of the executive and the legislative branches of Government, and both parties.

I certainly will enjoy working with you in the years ahead.

Mr. BURNS. Thank you very much.

Senator PROXMIRE (presiding). Congressman Conable?

Representative CONABLE. I am not well acquainted with you, Dr. Burns, but that is not surprising, in view of my very recent and comparatively modest involvement in the field of economics. I know the enormous respect in which you are held. Actually your predecessor was also held in great respect, I think not only by the community at large but by you. And so I am not looking for any invidious comparisons when I ask you, in the light of your commanding position at the Federal Reserve, whether there are any substantial points of dispute between you and your predecessor as to the manner of implementing the monetary policy of the country, and whether we can expect any changes of emphasis as a result of your primarily academic background in contrast to his primarily business background?

I assume you have very fine contacts with the business community as he did, and that your background does not work to the detriment of the policy formulation in that respect. I assume, however, that you would have closer ties to the academic economists than he would. Can we draw any generalizations, again abhorring invidious comparison, about changes in the direction of the Federal Reserve as a result of this?

Mr. BURNS. Well, this is something that time will supply the answer to. Let me say only this in reply to your question. I think that I am perhaps inclined to attach a little more emphasis to monetary aggregates, such as the money supply and bank credit, and a little less to interest rates than my predecessor did. I may be wrong in that statement, but I am answering your question to the best of my ability.

If there is a major difference between us, this might be it. But then again I may be stating my predecessor's views inaccurately.

I will, being an economist, work more closely with economists on the research staff than my predecessor did. There is not the slightest doubt about that. And I will be drawing on the thinking of academic economists, but for that matter also on business economists and bank economists, very extensively.

This may surprise you, Congressman Conable. My predecessor used to call it academic consultants. Well, I am going to change the format of such meetings. I will have academic economists and also some business economists at these meetings, and hopefully I will also have a trade union economist there. And I think that the discussion will be a little more realistic when you have these men coming from very different backgrounds.

I have found in the past that when academic economists gather and talk to Government officials they sometimes forget that the Government officials are there. They will fix their gaze on some other economist and try to impress or influence him. By having a different kind of grouping we may get better results. Time alone will tell. A year from now I will be able to give you a very much fuller answer and a more dependable answer than I can now to your question.

Representative CONABLE. Thank you, sir.

Do you feel that the close relationship and obvious mutual respect that you and the President have will work to the detriment of an independent monetary policy?

Mr. BURNS. Well, I think it was the President himself who said that I am the most or one of the most independent men he knows. And I will say no more than that.

Representative CONABLE. All right, sir.

In your statement I notice the statement: "Our balance-of-payments accounts on the official settlements basis will also be affected adversely if—as now seems likely—a large inflow of Euro-dollars to U.S. banks that occurred last year is reversed or even reduced." In response to questioning by Mr. Reuss, I believe it was, you said that this affected individual banks but did not affect the aggregate—credit supplies—is that correct; do I correctly interpret you, sir?

Mr. BURNS. That was the essence of my statement.

Representative CONABLE. Didn't the flow of Euro-dollars operate to frustrate to a certain extent monetary restraint during 1969?

Mr. BURNS. I believe not. It improved the position of individual banks, but not really the banking system as a whole. On balance, by virtue of improving the position of individual banks, there may have been some effect in the direction that you indicated. But I do not believe it was large.

Representative CONABLE. By the same token, then, would you feel that any outflow of Euro-dollars, as a result of a change in the interest rate situation generally, would not frustrate any easing of our monetary situation here; is that correct?

Mr. BURNS. Yes.

Representative CONABLE. In other words, it would not tend to work against an easing of our monetary situation?

Mr. BURNS. Yes. But our balance-of-payments statistics could look frightening for a time. And that was the point I was getting at in my statement.

Representative CONABLE. But in terms of the total supply of credit you think the inflow or outflow of Euro-dollars is not going to be a significant factor in monetary policy in 1970, just as you think it was not in 1969?

Mr. BURNS. That is my judgment at the present time.

Representative CONABLE. Now, because of the situation in the bond market, haven't we had quite a bit of unloading of bonds at a loss by banks following the first of the year?

Mr. BURNS. Yes. Banks have taken losses on their bond portfolios.

Representative CONABLE. Doesn't that make it probable that the net taxable revenue of banks this year will be off substantially?

Mr. BURNS. I do not think I had better try to answer that question. It would require a knowledge of profit-and-loss statements of banks that I do not have. The loss on bonds would be a force working in the direction of your statement, but what the overall picture may be I am not able to say.

Representative CONABLE. I am wondering, sir, this is part of a larger question. We tend to focus on the thin potential budget surplus almost entirely from the viewpoint of the probability of our being able to maintain the control of Government expenditures.

Mr. BURNS. Right.

Representative CONABLE. Isn't it entirely possible that with the economic conditions you have described to us that we will have a substantial falling off of Government revenues this year as a result of reduced profits, not just among banks, but among business corporations generally, and with some resulting secondary impact on personal income?

Mr. BURNS. Yes. And also, after all, the decline in the stock market has resulted in all kinds of capital losses for individuals. I put that question to the Treasury Department during the past year, and they tell me it is very difficult to estimate, and I know it is. We may be in for some surprises this year.

Representative CONABLE. Some surprises on the revenue side?

Mr. BURNS. We may be in for some surprises. But I am not able to give you a considered judgment on this. The Treasury has tried to take this factor of capital losses into account. How well they have done it in this instance is a matter on which I have no opinion.

Representative CONABLE. This does not mean that we should change our fiscal policy, but that the net effect of our fiscal policy could be different than we expect?

Mr. BURNS. You are entirely right. I am a little nervous about those revenue figures.

Representative CONABLE. My time is up. Thank you, Mr. Chairman.

Senator PROXMIRE (presiding). Congressman Brown?

Representative BROWN. I am very glad to see you, Dr. Burns, not only here but in the position you occupy.

I would to continue right along with the line of questioning that Mr. Conable was pursuing.

Given this apprehension which you and he apparently share, and I share with you, do you think that the budget for fiscal year 1971 may be too delicately balanced?

Mr. BURNS. Well, I do not quite know what to say. To me what the country needs at this time is a balanced budget. Now, it would have been very easy for the Executive to come in with a budget that showed a large surplus. I for one did not take warmly to that concept, speaking of my earlier incarnation. I did not take warmly to that concept because I feared that if the budget showed a large surplus, then the expenditures would go up sharply. Large surpluses are always a temptation to Members of the Congress, and for that matter they are also a temptation to Cabinet officers and heads of agencies generally. And if that large budget surplus were a result of new tax recommendations, I also had doubts, again referring to my earlier incarnation. I believe that Congress and the country are not in a mood now for higher taxes. Therefore, if the budget had shown a large surplus, I felt that it would lead to a sharp increase in expenditures, but no additional taxes.

Representative BROWN. What you are telling me, then, is that the administration not only psychoanalyzed the business and the economic community, but the Congress?

Mr. BURNS. Yes. We all do that to one another, Congressman.

Representative BROWN. Let me pursue that just a little bit further. Since this committee will be issuing a report on the new budget and the current economic situation, what do you think the committee's advice to the Congress on new programs should be? Since the administration can refuse to spend appropriated funds—unless the Congress forces them to by the language of the appropriation—what is your advice on authorizations for both new and old programs and on appropriations for fiscal year 1971, or, for that matter, the appropriation that was left out of fiscal year 1971, that knotty HEW appropriation?

Mr. BURNS. My advice to this committee would be to follow Senator Proxmire's eternal—it is becoming eternal, Senator—dictim; namely, keep expenditures down and try to get them below the budget. My next advice to this committee and to the Congress would be to fix an expenditure ceiling, and this time leave no escape hatches.

Representative BROWN. You think that we did last time?

Mr. BURNS. I think that the Congress has been experimenting with a fascinating and most promising device. You did it first in 1968, when you really had a legislative budget, and fixed a ceiling. But you left escape hatches. You did it again last year. These escape hatches were of a different sort, but you still left escape hatches.

Now, I hope the day will come, and will come soon, when the Congress will legislate a ceiling on expenditures, and this time let it be a rigid ceiling. Of course, as you know, we live in a time when the Congress is in session the year around. If there were some national emergency, the President would go to the Congress and the Congress would attend to any such request promptly. So I would not be afraid of an emergency, not one bit. In short, I think that a fixed budget ceiling would do our economy, our country a great deal of good.

Representative BROWN. You would lay much significance, then, on the role of the Congress in fighting inflation?

Mr. BURNS. Oh, yes, very much so.

Representative BROWN. Let me pursue the question of the delicate balance in which we now find ourselves. Your testimony indicates to me that we may be on the razor's edge—that continued restraint could result in inflation and a recession, and that easing of restraints too quickly would bring about more inflation. I gather that it is not just a question of when, but also of how much, to do in this whole area.

Do you feel that the change in the psychology has put a damper on the situation? It seems to me that when inflation is rampant, as it was a year ago, and there are no signs of an easing of the economy, businessmen tend to over-order and plan plant expansion because they are frightened by the prospect that the price will go much higher later. So they want to do all they can right now, over-order for inventory, and so forth. Assuming that we can get some degree of price stability in the near future, that psychology will quickly drop out of the picture. Now, if we have a balanced Federal budget in addition to that—taking the Federal Government out of the market for borrowing money—we would have a sharply decreased demand, and possibly an increased supply as a result of the action of the Federal Reserve System. Where does that leave us? Are we likely to see a quick decrease in the interest-rate level in this country?

Mr. BURNS. I do not think I should try to predict that.

Representative BROWN. Then let me ask you this: Do you think that the psychology of the situation is, in fact, changing—as reflected by the market, for instance?

Mr. BURNS. I think the psychology is definitely changing. And more than psychology is involved here. Businessmen are now feeling a profit pinch. And therefore, though some of them would like to continue to expand their capital equipment on a larger scale, the downturn in profits will make that more and more difficult. I think economic events will make business conduct more rational than it recently has been.

Representative BROWN. One other area. As you have indicated, we are anticipating some inflationary pressures from spending increases at various levels of our economy—that is, a social security increase, tax relief for the poor, the tax reform measure, and so forth. Increased income at these levels usually goes into basic expenditures: food, housing, and clothing. Is it possible that prices will continue to rise in these areas even after they level off in, say, the heavy goods and the durable goods fields? And is there any way this disparity might be balanced by government action?

Mr. BURNS. I would expect the moderation in prices to cut across industry, and to be economywide.

Representative BROWN. So you don't think there will be as sharp a balance as there has been in the housing field?

Mr. BURNS. I do not anticipate any, no.

Representative BROWN. My time is up. Thank you very much.

Senator PROXMIRE (presiding). I would like to ask you, Dr. Burns, to verify for me your very interesting specific suggestions that you would approve the principle of permitting mortages to be discounted at the Federal Reserve discount window. I think this has great promise. Would you, for example, have in mind the notion that these might be discounted at 6 percent, which is the present discount rate, I presume?

Mr. BURNS. I would have the notion that they would be discounted at the prescribed rate. I would not have a preferential——

Senator PROXMIRE. You do not have a preferential?

Mr. BURNS. No.

Senator PROXMIRE. And would you think it would be wise to apply it to any limitation on the use of those funds so that the banks discounting mortgages would put the funds they get into mortgages?

Mr. BURNS. No, I do not think so. I would rely with great confidence on business judgment. It is business judgment that has made this country so great in the economic sphere.

Senator PROXMIRE. But it is the free market plus our monetary policy that has put housing in such a disastrous position.

Mr. BURNS. Well, it is a matter of our institutions; we have not been ingenious. We do not need more controls. What we need is more ingenuity in devising institutions. Once we get a standardized conventional mortgage, then I think a huge new demand for mortgages is likely to arise from financial institutions. We have got to be a little more inventive about this entire problem.

Senator PROXMIRE. I am very interested, because I am expecting to draft legislation in the next few days or so to provide for this discounting. But it seems to me that we have to do our best to try to get this money into the homebuilding that has suffered so greatly. What has happened is that we have had a 33-percent cutback in housing starts this year. However, we have had a 23-percent increase in the sales of homes over $35,000. What happens is that the lower priced homes are in great difficulty, the people just cannot afford to build them or to get them.

Mr. BURNS. That is basically correct, though there is a footnote to that; namely, we manufactured 400,000 movable homes last year. This has helped our people in low-income categories. And there is a second footnote; namely that while tight credit bears a very large share of the responsibility for the decline in homebuilding, this is by no means the only factor that has been at work. Construction costs have gone up very sharply. I am a little afraid that if the kind of increase that we have been having in the cost of building homes continues, that many people even in the middle-income group may find themselves just priced out of the market.

Senator PROXMIRE. In other words, the big cost of building today is the money cost. For a $20,000 home at 8 percent interest on a 30-year mortgage, the cost of the home, everything increased, site, labor, and lumber, is $20,000, and the cost of the money is $33,000. So that if we get the cost of the money down that can go a long way toward making it possible for people of low incomes or moderate incomes, I should say, to buy homes.

Mr. BURNS. What you say is basically true. I do not fancy the way in which you put the matter statistically, butI will not go into that.

Let me add only this point. The way things have been going, a $20,000 home today may well cost $22,000 or more next year.

Senator PROXMIRE. I would like to ask you this. The Douglas Commission study on urban problems, and particularly housing, recommended that whenever there was a major change in economic policy affecting industries, affecting the discount rate, that the Treasury and the Federal Reserve Board should be mandated and required to explain what in their judgment, what effect this would have on housing. What do you think of that, if we put that into law?

Mr. BURNS. Your question is, What effect——

Senator PROXMIRE. If you provide for an increase, announce an increase in the discount rate, or if you take other steps indicating a significant and major change in policy, would you explain what effect in your judgment that will have on the housing market?

Mr. BURNS. I would not quarrel with that, no. Because when we embark on a policy we should try to understand it. And all that you are asking is that we, within the Federal Reserve, or the Treasury, or elsewhere in the Government, try to explain the effects of the policy to the Congress. It is a very modest and very decent request. I go along entirely.

Senator PROXMIRE. I am delighted to hear that. You are certainly welcome.

Congressman Reuss has asked something about this. I would like to ask about it more specifically. Last year the Congress passed a bill that gave the President a complete arsenal of credit controls, he can do almost anything he wants in restraining credit based on the bill he signed at the end of the year. It is a very, very comprehensive bill. The purpose of the authority was to try to allocate credit to our most essential need such as housing, without sending interest rates sky high. Would you favor the exercise of this authority in helping bring down interest rates and provide funds for housing, for example, and for State and local governments?

Mr. BURNS. The exercise of this authority by the President to bring down interest rates? I do not know.

Senator PROXMIRE. No, the exercise of this authority by the President in order to make funds available that are now going into some areas, such as the expansion of plant and equipment, and so forth, in order to make those funds more available for other purposes?

Mr. BURNS. Well, at the present time our economy is in a state of transition. A few months ago, for example, all of us might have been worried about the rapid growth of instalment credit and the high rate of purchase of new automobiles. That is not today's problem. Our economy is in a state of transition. As of this moment, Senator, I do not think that I would want to see controls. On the other hand, I will follow the evidence. I have an open mind on the issue. I have some prejudices, and I think you should know them. I very strongly prefer a free economy, and I believe you do. But now and then controls are necessary. This is a new instrument that has been given to the President. The Congress will be asking questions, such as you put to me, from time to time. It is an entirely proper question. I have an open mind, and I will examine the evidence as it comes in.

Senator PROXMIRE. You see, this bill passed with only four dissenting votes in the House of Representatives, it passed overwhelmingly. And there is a very strong sentiment in the Congress and the country for trying to help in the housing area. We have a housing situation where in the last quarter of the year, according to the Economic Report, in the last quarter the utilization rate for the manufacturing output was only 81.8 percent, far below optimum capacity. And yet we do have the ironic contrary fact that industry plans to expand plant and equipment at the rate of 10 percent in this coming year. Meanwhile housing starts are down below 1.2 million, and going further. And you testified today, you had in your statement the expectation that housing is going to be retarded for some time.

Mr. BURNS. But I expect these markets to change. As I indicated in my testimony. I expect retail sales to pick up and I expect the expansion in business outlays on plant and equipment to taper off. That being my judgment, I do not think I would go the control route as of today.

Senator PROXMIRE. Let me very quickly review what you have told me as far as housing is concerned.

You say, No. 1, you want to rely primarily on the free market. And we agree with that.

But you admit that we do need new mechanisms and new institutional adjustment.

You are opposed to a 6-month wage-price freeze, as you understand it.

You say as to selective credit controls, not at this time.

You say the variable reserve requirements which I have suggested is a way of blocking the incentive to move, and you want to study it further.

Purchases of Home Loan Bank Board issues by the Federal Reserve you feel would not help very much.

You feel that use of the discount window has promise, but you confine that to simply permitting mortgages to be discounted without any direction that the money be put into housing.

It seems to me that altogether we do not have very much in specific terms to give much encouragement to housing. I know how deeply you feel about this. You have talked to me privately about it, and you have publicly said that housing should be given more consideration. But I do not see that we really have a program here that is going to do the job.

Mr. BURNS. I do not come here with a program. However, your summary, while very good as far as it went, did not go far enough.

Now, I also indicated that I favored in my testimony before the House Banking and Currency Committee a change in the laws governing national banks as far as housing loans are concerned. That would encourage more mortgage lending by national banks.

I indicated also that I have some sympathy with the thought of permitting the home loan banks to make loans to the savings and loan associations at a subsidy rate for a limited period, say 6 months, in the interest of helping us tide over this present difficulty.

I also indicated that I would like to see GNMA issues stepped up if at all possible.

And I further indicated that I am very much in favor of developing a secondary market for conventional mortgages. I see great promise in that, though unfortunately that will not help us over the critical period in the months immediately ahead.

Senator PROXMIRE. I appreciate very much the correction.

Mr. BURNS. No; it was not a correction, just a supplement to your comments.

Senator PROXMIRE (presiding). Congressman Reuss?

Representative REUSS. Dr. Burns, in your statement, particularly when you looked toward the future, you placed great emphasis, reading from your statement, on future economic growth, new products, new processes, a growing stock of machines, and industrial plants, a labor force that will grow even more rapidly in the 1970's than in the 1960's, and growth in demand for goods and services supported by an every-increasing population. You can probably guess what I am about to ask.

The environmentalists are now telling us that more is not necessarily better. And I am wondering whether you in your growth-oriented discussion here are willing to concede something to environmental values.

What I mean is this. Some of the new products which have been developed in recent years have been nonreturnable bottles, for example, which clutter up the landscape. Another old product made in increased amounts has been the internal combustion engine automobile, which has added to the city smog. You are, of course, familiar with these problems. Do you think, Dr. Burns, that we need to modify our general philosophical attachment to the concept of maximum production and maximum growth in the light of environmental conditions as we now perceive them to be?

Mr. BURNS. Well, I am old fashioned enough to stay with the concept of maximum production. But I certainly join the new generation in its emphasis on the need to improve our environment. And I look forward to the day when our statisticians, when they cast up the national income accounts, will take account of depreciation in our environment in addition to depreciation of plant and equipment.

Now, once they learn how to do that—there will always be a subjective factor here, of course, but that is no reason for not trying to do intelligent work along these lines—once they learn how to do that, we will discover that the gross national product, which has been deceiving us all along, is a good deal lower than we think it is. The figure we should have been looking at is the net national product.

Representative REUSS. What you put in less what you take out?

Mr. BURNS. Yes. Let us work toward a proper recording of the minuses as well as the pluses. But let us try to maximize that net amount.

That, I think, is the link that I see between the old thinking and the new thinking. And the new thinking is very much in the right direction. We have surely tended to neglect our environment. And it is high time that we strive to correct this, and that this committee hold hearings and develop programs for bringing back to America clean air and clear water.

Representative REUSS. Thank you very much. And I hope you will spend some of your spare time on this problem. We need your help.

I just have one other question. I am much moved by and in agreement with your general attachment to free markets. For 5 years now we have had controls on capital outflows from this country, both bank lending and business investment. I think the time has come to remove them and to order our balance of payments by expanding our trade balance, and particularly by reducing the outrageous deficit caused by our military posture abroad. And I think specifically that the time has come to end those capital controls. Would you join me in striking a blow for freedom?

Mr. BURNS. I was sure you would put an embarrassing question to me before the end, but I can only answer honestly, there is no other way. Early last year in the new administration I was one of those who fought hardest for moving toward a removal of the restrictions on foreign lending and investment. I was not in favor of complete removal, but of making a strong move in that direction. Now, this question came up again toward the end of last year. I am now telling tales out of court, and I ought not to, probably. But the hour is late. And I relax as the hours go along and become increasingly indiscreet——

Representative REUSS. Thank you very much. I appreciate your answer.

Mr. BURNS. You do not want me to finish?

Representative REUSS. If you want to. I do not want to lead you into indiscretion. The hour is late.

Mr. BURNS. No, I will not be that indiscreet.

I saw the way the figures were coming out on the balance of payments. There was a time there when it looked as if we might have a balance-of-payments deficit, not of $6.9 billion if that is the figure, but $10 billion approximately. And then, as we were discussing relaxation of investment controls, I thought if we did it at that time it would be terribly confusing and worrisome to financial people, here and more so abroad.

At that time I opposed it. But I certainly look forward to the day when the principle of freedom which you so eloquently espoused a few moments ago will be again respected in this field.

Representative REUSS. Thank you.

Senator PROXMIRE (presiding). Congressman Brown?

Representative BROWN. Dr. Burns, if you are moved to indiscretion, I am almost moved to miss a quorum call that is now going on in the House. I would not want to do that, however, so I will ask you a couple of very brief questions.

First an observation with reference to the housing market. Some steps have been taken, in addition to those which have been mentioned, to make available Federal financing for trailer housing and lower cost housing.

It seems to me that this is also a time to take some Federal steps to bust the building codes around the country so that we could make housing producible at a lower cost.

How can market borrowing by independent agencies, such as FNMA, be coordinated so it will not have a deleterious effect on interest rates in times of inflationary spiral? The statistics developed by the House Government Operations Committee show that interest rates on participation certificates and agency borrowings are higher even though they are given the cloak of sanctity of the Federal Government. But there is a great danger, when FNMA and the Treasury go into the market at the same time, and money is short, that interest rates can come under unusual pressure at that time and create problems. The decision may be made to raise the interest rates; and it is difficult to get them back down after that step has been taken. Would you comment on that?

Mr. BURNS. I do not know how exactly this is done, but my understanding is that heads of agencies involved in issues of this type will confer with the Treasury, and the Treasury plays a very significant role in the timing, and also for that matter in the amount of agency issues at any particular time. So there is coordination. How effective it is I simply do not know.

Representative BROWN. So when we are talking about the independence of FNMA and GNMA doesn't prevent such coordination?

Mr. BURNS. Oh, no; that coordination does go on all the time.

Representative BROWN. Let me ask one other question, prompted by your comment on candor and indiscretion, and because you discussed it briefly in response to earlier questions. You talked about the steps taken by the Federal Government to ease the money supply in 1968 and you said that it was well-intentoned, although you implied it was ill-advised. If that is the case why would those steps have been taken? Did not we have available statistics that would have shown such steps to be ill-advised; and, if so, wouldn't they have been avoided? What I am asking is really twofold. What was the reason that the steps were taken, in your judgment; and, second, is there a statistical problem here? Don't we have available statistics on a current enough basis to really know what is happening to the economy and that some economic judgments are poorly made?

Mr. BURNS. No, I do not think there was a statistical problem at the time. You may recall that in 1968 Congress passed legislation limiting Federal expenditures. And Congress simultaneously passed legislation imposing a 10-percent income tax surcharge.

Now, economists within the Government became fearful that this fiscal policy was unduly restrictive, and that this fiscal policy might bring on a recession. I believe that such thinking took place not only within the executive branch but also at the Federal Reserve Board, and that it played a part in the easing of policy that took place.

There is more to it than that. I believe that the Federal Reserve Board, or its Chairman at the time, suggested, or he was so interpreted as suggesting, that once the Congress took steps on the fiscal front, some easing in credit could be expected. So a psychological and political foundation was laid for some easing of credit.

Now, there was a great deal of talk at that time about overkill. I thought it was a lot of nonsense then. And the reason for the error is a very simple one, and it is one that with your permission I might take a minute or two to nail down. In our thinking at the time we failed to draw a distinction between the effects of a permanent increase in taxes and the effects of a temporary increase in taxes. And we attributed to this temporary increase in taxes the effects that we normally associate with a permanent increase.

Take the simplest case of all, business spending on plant and equipment. Congress comes along and raises taxes by 10 percent for something like 1 year. Now, businessmen in making their plans for plant equipment look 10 years or a generation ahead. In making their research plans, they again look to the long future. Businessmen are not going to change their capital expenditure plans merely because they have to pay 10 percent more in income taxes for a short period.

Now, the same is true of personal outlays by wealthy individuals and many in the middle-income groups. It is only the very poor, those who are living at the margin, who will tend to respond promptly to this pocketbook phenomenon.

In thinking of tax policy in the future, let us be very sensitive to this distinction. It has nothing to do with all kinds of controversy about what is Keynesianism or non-Keynesianism. It is simply good economic sense, or if you prefer, good Keynesianism, to take into account the time factor in the tax package whether it is on the upside or the downside.

I have stated in some of my writing that if you have very frequent tax changes, fiscal policy will be dead, it would have no effect virtually. And therefore if the Congress wants a substantial effect through tax changes, do not, put a short-time tag on the legislation. If you do put a short-time tag on it, bear in mind that the effect may be small, but that may also be all that you want.

I think that neglect of the time factor was a major reason for the mistaken economic diagnosis that was made in 1968 which led to this easing in credit as an offset to the tight fiscal policy.

Representative BROWN. And we are still suffering from it, aren't we?

Mr. BURNS. Yes, I think so. But we are getting over it.

Representative BROWN. Thank you.

Senator PROXMIRE (presiding). Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

It is nice to see you, Dr. Burns.

Mr. BURNS. Thank you, Mr. Miller.

Senator MILLER. Would you say that the single greatest factor in high interest rates would be inflation?

Mr. BURNS. If I were confined to a very brief statement, yes.

Senator MILLER. And would you say further that the single greatest factor in inflation is the fiscal policy adopted by the Federal Government?

Mr. BURNS. No, there I would have to dissent. Sometimes it is fiscal policy, and sometimes it is monetary policy, and sometimes it is just the excessive exuberance of the private economic community.

Senator MILLER. So the factor would vary according to certain circumstances?

Mr. BURNS. I think so.

Senator MILLER. What about the present circumstances?

Mr. BURNS. At the present time the Federal Government finally has expenditures under pretty decent control. I think excess demand has vanished in our economy. What we are having is an afterglow. Demand pull is no longer a very significant factor in the inflation, but a cost push is having its effect. Wages are still being adjusted. And I cannot blame workingmen who are insisting on wage increases of 6, 7, or 8 percent, when the cost of living goes up, as it did last year, by 6 percent. Of course, when that happens businessman try to raise their prices. And with demand still moderately strong, here and there these price increases will stick. But I believe that as the year moves on, businessmen will find it more difficult to pass on higher costs to their customers. Profits will be badly squeezed, and the capital expenditure expansion will tend to taper off.

With prices no longer rising as fast, and with unemployment a shade higher, wage demands will not be as extravagant—well, put extravagant in quotation marks if you will—as they have recently been. So that the strength of the cost push will progessively diminish.

That is my expectation. And let me add, though I cannot be sure about these things, that there is a good chance that things will work out in this fashion year.

Senator MILLER. Does this afterglow include a certain amount of inflationary psychology?

Senator MILLER. So you think we still have some inflationary psychology in this country?

Mr. BURNS. Yes, we do. But I think that a change is taking place. And a distinction needs to be drawn now between expectations for the short run on the part of the business community and expectations for the long run. There are very many people in the business and financial community who think that sentiment in this country, in Congress and the administration, being what it is, or what they judge it to be, that they are doing to live in an inflationary age. And yet many of these same people feel that the inflationary push has run its course for the time being.

Senator MILLER. Do you think the inflationary psychology would dampen down, possibly go out the window, if the Congress, those in control of the Congress, adhere to the President's spending budget?

Mr. BURNS. I think that would help tremendously. And rightly or wrongly, I rather think this Congress will be an economy-minded Congress this year. That is my present judgment. And I certainly hope I am right.

Senator MILLER. Now, if the Congress does not adhere to that budget, and exceeds the President's request by a few billion dollars, then would it be your assessment that inflationary psychology would be increased?

Mr. BURNS. My assessment would be that inflationary expectations would be enhanced, yes.

Senator MILLER. Now, suppose that as a tradeoff to such action on the part of those in control of the Congress there should be an offsetting increase in taxes, by a surtax, or postponement of tax relief under the Tax Act of 1969, so that we ended up with a surplus or relatively balance budget, would that achieve the same result as if the Congress adhered to the spending side of the budget?

Mr. BURNS. I do not think so. I think that if the Congress goes on a spending spree, and if taxes are raised to finance this, there will still be a residual enhancement of inflationary psychology.

Senator MILLER. And is this because the impact to control inflation is greater by curtailment on the spending side rather than the delayed impact of taxes?

Mr. BURNS. Well, I think it is because once there is a sharp increase in spending people expect that increase to be permanent, whereas they will feel that even if Congress did raise taxes this year, it might lower them next year. In the meantime, we would get committed to a bigger Government, to more spending by Government. I think that will be the typical thinking.

Senator MILLER. And especially if the tax imposed would be a temporary tax?

Mr. BURNS. Oh, yes, decidedly so.

Senator MILLER. Now, I am sure you stated the case as you saw it, even though I am sure you did not like to state it. But you expect housing starts to decline even further—noting, however, that in the long-range outlays for housing will have to be substantially raised to make up for deficits. How would be the best way to achieve the availability of money needed for these housing starts? Would it, for example, be through a Federal surplus?

Mr. BURNS. I am doubtful about that. I think really that the fundamental answer to the housing problem is an end to inflation and easier credit conditions. That, combined with some other measures that will be taken, will still leave the problem of construction costs. Money is not the only factor in the housing problem. I think it is the major factor at the present time, but by no means the only significant factor.

Now, although specific measures that the Congress may take on the credit side are not likely to be decisive, that is no reason for not taking them. But I do think that the major answer will have to come from the monetary side, and that can only come on a sufficient scale once inflationary factors subside more than they have.

Senator MILLER. Would not a surplus in the Federal budget be a way of taking care of two problems at the sime time; one, helping put an end to inflation, and two, providing another source of money?

Mr. BURNS. Well, it would provide another source of money. How much would go into housing I could not be sure. My main difficulty with the surplus is that I see no good, practical way of achieving a surplus. In my judgment if the President recommended to this Congress a large surplus to be realized through some additional taxes, then two results would follow. First, members of the Congress would be tempted to spend more, and they would do so. Members of the Executive would do the same. Second, the recommended tax increases probably would not be adopted by the Congress, and therefore the recommended surplus would turn out to be counter-productive.

Now, that is my judgment. If I saw a way of realizing a real surplus, if I thought we could actually get it, I would be for it. But I do not think we will.

Senator MILLER. Thank you.

My last question. There have been suggestions made that the ceiling on various interest rates of thrift institutions, banks, and other agencies be raised. There has been criticism that certain types of thrift institutions are losing their deposits, and that the present structure favors other thirft institutions. Do you have any comments on that?

Mr. BURNS. Well, the Federal Reserve, and also the FDIC and the Federal Home Loan Bank Board, recently carried through an increase in ceiling interest rates that the depository institutes can pay. And I believe that was a good thing to do. Now, as far as I can judge at the moment, this has not led to an inflow of funds to thrift institutions, but it has played a significant role, it appears, in stopping or checking the outflow. So I think this recent move by the three agencies was constructive.

Senator MILLER. Thank you.

Mr. BURNS. And will help housing.

Senator MILLER. Thank you.

Senator PROXMIRE (presiding). In talking about the surplus, Dr. Burns, it is a very small surplus, and the reason it is a surplus is because the administration is selling $3.6 billion net of mortgages, et cetera. And it has been pointed out to me that in doing that they will tend to drive up interest rates and absorb the money that would go into mortgages otherwise, unless the Federal Reserve Board avts. Isn't that likely to be the case unless you ease money somewhat, you will have the effect of having a higher interest rate which would in turn retard the economy further and have a depressing effect on profits, and therefore on revenues and, therefore give you a deficit by that route?

Mr. BURNS. Senator, you have traced this fragile and very thin surplus to one factor. You could trace it to a dozen or a hundred factors.

Senator PROXMIRE. Of course, the factor I am bringing in is the one that has the most direct relationship to the Federal Reserve Board and your actions.

Mr. BURNS. That was my first observation.

My second observation is that, as you all know, these budgetary projections of how much will be sold in the way of governmental paper have never been very good. Last year's experience was instructive on that. I regard this item in the budget as an expression of hope. Whether it will be realized or not I do not know. Therefore, I am not willing at this time, history being what it is, to assume that these loans will be sold off in the indicated volume. In fact, this may not happen. And possibly it may happen at a time when conditions have eased, and therefore the awful effects that you now visualize may not take place at all.

Senator PROXMIRE. I hope they will not. But this is something that it would seem to me would require action by the Federal Reserve Board that would be most unfortunate for housing.

Let me ask you about something that troubles me in your statement. You seemed to be concerned about the projection by the staff of the

Federal Reserve Board, their projections at least on money flows for 1969, projections made at the end of last year. This is a result of a report by this committee in which we asked the Federal Reserve Board to give us annually the outlook for money flows that parallel the President's Economic Report, just as the Council of Economic Advisers estimates the gross national product, and so forth, we thought the Federal Reserve Board would be in the most authoritative position to give us a picture of the outlook on monetary policy. Now, we did not get what we asked for from Mr. Martin. He was most unhappy about having the Board of Governors go on record saying this was their prediction. He compromised by giving us something less, the staff report. But even the staff report seems to you to be apparently ill-advised and to have an adverse effect. Isn't it true that to the extent that it had some adverse effect it was the result of just poor prediction? Why do we have to assume that the Federal Reserve Board staff, which you agree is a good staff, and a very competent staff, cannot give us this? Otherwise we are at the mercy of relative amateurs who will make estimates, they are going to make them. The big banks have their letters in which they tell us what they expect. The newspaper reporters do the same thing, and they may be very competent people. But the staff of the Federal Reserve Board ought to be the most authoritative.

Mr. BURNS. I think the members of the Federal Reserve staff are very able analysts. I do not think that the quality of research that is done in the Federal Reserve Board can be matched anywhere in this country or in the world.

Senator PROXMIRE. Why shouldn't we have the benefit of it?

Mr. BURNS. I think you are having the benefit of it. And one of the benefits of that research is that those men know and advise me, and through me advise you, that they are very poor prophets.

Senator PROXMIRE. Is that a complaint that they cannot predict?

Mr. BURNS. Let me tell you something that may or may not have come to your attention. Let us turn to a sister agency, the Council of Economic Advisers. I have been interested in that agency for many years. The Council of Economic Advisers has made projections of the gross national product, which is an easier magnitude to estimate in fact than are monetary aggregates. It has made those predictions, year by year, before your committee since 1961. The Council of Economic Advisers, recognizing its fallibility, presents its predictions or projections within a $10 billion range. Now, if you go back and study the historical record, that is to say, if you compare what was predicted with what actually happened, you will find that in only 1 year during the past decade projected did the actual GNP fall within the $10 billion range projected by the Council. If you will, this is a measure of the fallibility of the economists.

Senator PROXMIRE. It just convinces that in the land of the blind the one-eyed man is king. We know very little about this. But with the experts that we do have it seems to me we have a little bit of guidance. They might be off, and as you indicated they have been off. But the fact that they have been off more than $10 billion most of the time on GNP estimates does not impress me as meaning that we should not have some estimate by them. At least their direction has generally been right. And I do not know how much they have been off, but $10 billion is pretty close in a trillion-dollar economy, that is 1 percent.

Mr. BURNS. As far as the Federal Reserve Board is concerned, there was another factor that I spoke of before. I can only reiterate, any projections we make about monetary aggregates will go on the wire, all over the world. And they may rock one way or another the financial market. And money may be made by the millions by people who have no right to make it. And what worries me more, innocent people may lose.

Senator PROXMIRE. We were very careful to say that what we wanted was not their prediction as to what would happen, but their explanation of the effect on monetary policy if the President's economic projections are correct, the President's projections on GNP and so forth are correct. That is all we want.

Mr. BURNS. You were very careful, of course you were. And you will always be careful. But now think of the marketplace. And note how the market interpreted those projections and the damage that this did. I would not like to see that damage repeated, and I doubt that you would—well, I know you would not.

Senator PROXMIRE. Let me ask you two more questions. That was a rollcall, and I have not missed one in 4 years, and I do not want to miss this one. So you are lucky that we will have to leave.

Mr. BURNS. You will have another crack at me, Senator.

Senator PROXMIRE. Let me ask about something that you said a couple of years ago.

In a Moskowitz lecture you gave at New York University in 1967 you stated that the size of the defense budget does not indicate the full financial cost of defense activities, and I thought that was a brilliant speech, one of the best I ever heard from you, and I put it in the Congressional Record. You then said that expenditures for international programs and space technology were pursued mainly in the interests of national security; and that the interest on the national debt was mostly a payment for past wars, while veterans' benefits were entirely a legacy of past wars. Adding up what you termed defense-related expenditures, you concluded that they would total over $100 billion in that year.

Can you estimate the total for defense-related expenditures in 1969 and 1970?

Mr. BURNS. I cannot do it at the moment, but I will be glad to supply estimates of that kind for you.

(The following material was subsequently submitted for the record:)

As I indicated in the Moskowitz lecture that I gave in November 1967, Federal spending pursued in the interests of national security substantially exceeds direct outlays by national defense agencies, such as the Department of Defense and the Atomic Energy Commission. In this lecture, I pointed out that Federal outlays for international programs and for space research and technology were mainly undertaken in the interest of national security. Moreover, payments for interest on the public debt to a large extent represent the legacy of past wars and outlays for veterans benefits result entirely from past wars or defense activities.

The size of these budget outlays for fiscal years 1967, 1968, and 1969, and the estimated outlays for fiscal years 1970 and 1971 are shown in the table below:

OUTLAYS GENERATED BY NATIONAL SECURITY NEEDS FISCAL YEARS 1967–71[1]

[In billions of dollars]

	1967	1968	1969	1970	1971
Direct national defense outlays	70.1	80.5	81.2	79.4	73.6
1. Department of Defense	67.5	77.4	77.9	76.5	71.2
2. Military assistance	.9	.7	.8	.5	.6
3. Atomic energy	2.3	2.5	2.5	2.5	2.4
4. Other	−.5	(2)	.1	(2)	−.6
Other major outlays in the interest of national security	10.0	9.3	8.0	8.0	7.0
1. International affairs and finance	4.5	4.6	3.8	4.1	3.6
2. Space research and technology	5.4	4.7	4.2	3.9	3.4
Outlays mainly resulting from past wars	19.6	20.6	23.4	26.5	26.3
1. Interest on public debt	12.6	13.7	15.8	17.8	17.8
2. Veterans benefits	6.9	6.9	7.6	8.7	8.5
Grand total	99.5	110.5	112.7	113.9	106.8

[1] As estimated in the budget for fiscal year 1971.
[2] Less than $50,000,000.

Note: Details may not add to totals due to rounding.

Senator PROXMIRE. That would be very helpful. We would like to have that for the record.

Do you think it would be helpful for the budget document to more clearly indicate all the defense-related expenditures contained in civilian outlays such as subsidies to the maritime industry, the cost of the oil import quota program, and others that are justified on the grounds of national security?

Mr. BURNS. I think so. The more you can get out of those people the better.

Senator PROXMIRE. The more you can get out of those people the better, is that correct?

The last quotation is from your latest debate with Paul Samuelson, which many of us have enjoyed. You said in the course of that debate: "I have no quarrel with the sort of guidelines that were set forth in 1962"—according to Wage and Price Guidelines—"if they would only say that way, and if we were also realistic enough not to expect very much from them."

Do you still have that view that guidelines would be useful, at least you have no quarrel with them, and do you see any useful role for guidelines in 1970, in view of the large number of workers involved in wage negotiations this year?

Mr. BURNS. I have no quarrel with the guidelines as formulated in 1962. My quarrel refers to later years. I have to stand on that, yes.

Now, as for the present time, there is one part of the President's budget that I attached a great deal of importance to. It is not a numerical guideline, it is nothing of the sort. It is not jawboning of the usual type, it is nothing of that sort. But I think it is terribly important. The President has called for a postponement by 6 months of the wage increase for Government employees.

Now, why did the President do that?

No, I will not speculate on the President's thinking, but I shall indicate the merits of that proposal as I see them.

They are two. First, it cuts down the budget by $1.2 billion. And that is of some significance.

But far more important than that, it is an example to the country. It is a way of telling employers, telling working people, and telling trade union leaders that something like moderation, if not a full moratorium on wage increases, would be a very healthy thing at this time.

Senator PROXMIRE. I would be much more enthusiastic about that, Dr. Burns, if this affected those of us who make the policy. We have increased our salaries by 40 percent last year, and we increased the salary of Cabinet officers by about 60 percent, and the President's a hundred percent. And now the general workers around the country, who have nothing to say about policy, because that is up to us to decide, are going to be the victims and are going to have to wait another 6 months and suffer and pay for inflation. That is not a very persuasive argument when I go back to Wisconsin and say, "look, we are not increasing the salaries of Federal workers by 5 or 6 percent because we are anxious to fight inflation." And their response is pretty predictable.

Mr. BURNS. There is a great force in what you say, Senator. But Congress made a mistake in granting that increase to high officials in the executive branch and to itself. And actually I would love it if the Congress passed legislation now cutting your salary and mine, and we will include our good colleagues, by let us say, 10 percent.

Senator PROXMIRE. I think that would be good policy, but I do not think it is very likely to be enacted in the Senate and the House.

Thank you very much, Dr. Burns. You are not only a very expert witness, but you are about the most responsive and entertaining witness we could have.

Mr. BURNS. Thank you very much.

(Whereupon, at 1:10 p.m., the committee recessed, to reconvene the following day, at 10 a.m., Thursday, February 19, 1970.)

APPENDIX

(The following additional questions asked by members of the committee and answers thereto were subsequently supplied for the record by Mr. Burns:)

Question 1. On page three of your statement, you say, "Many businesses, including even some very large firms, were unable to raise the funds on which they had counted."

Can you document this at all? I have the impression established large business firms receive all the money they need.

Answer. Restrictive monetary policy may affect business borrowers in one or all of several ways. It limits the volume of funds available, raises the cost of borrowing, and can alter the choice and timing of the issuance of debt instruments. Some of these effects are evident upon examination of the changing pattern of corporate sources of funds in 1969.

The relative importance of short-term corporate borrowing, especially through open market paper, rose significantly in 1969. Private placements, measured either by new commitments or actual takedowns, on the other hand, dropped off sharply. The SEC private placements series, which represents mainly takedowns, fell below the $500 million level in each of the last 5 months of 1969 for which data are available. It appears, too, that the cost of private placements rose significantly because most institutional lenders are now requiring equity participation in the ventures they finance. Contact with underwriters suggests that several of the large industrial firms which have recently announced bond offerings are turning to public capital markets because of the difficulty and high cost of obtaining private placements.

Declining earnings and liquidity and the slower expansion of bank credit during a period when both production costs and capital outlays were rising undoubtedly put severe pressure on business financial resources. The level of public bond offerings did increase from 1968 to 1969, yet it was still less than the record 1967 volume. The market was able to absorb the 1969 volume of corporate borrowing only with sharp increases in yields on new issues. A number of companies cancelled, postponed, or reduced straight-debt offerings, among them such large firms as Monsanto,[1] Food Fair Fair,[2] Freuhauf Corporation,[3] and Beck Industries.[4] In addition, indefinite postponements of another $300 mil-

[1] Monsanto withdrew $150 million of proposed bonds on September 15, 1969.
[2] Food Fair first rescheduled and then postponed indefinitely $25.0 million of convertible debentures in late 1969.
[3] Freuhauf Corporation reduced a $75 million offering to $60 million on May 13, 1969.
[4] Beck Industries postponed a $56 million stock offering on February 2, 1970 because of market condition.

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lion of issues by smaller firms were announced since May 1969.[5] Rescheduling of convertible debt offerings was frequent, especially in late 1969 and early 1970, as indicated by postponements by such firms as Greyhound and Eastern Air Lines. These public announcements understate the effects of market conditions, however. Discussions with firms which provide financial advice to industrial borrowers indicate that, in view of the market conditions in 1969, many firms simply chose not to initiate debt offerings.

Question 2. The business and financial community seems to have found many ingenous ways to find funds. According to Federal Reserve figures, nonfinancial corporate business expanded its credit market liabilities by $37. billion in 1969, $6 billion more than in 1968. Miscellaneous loans, including business loans, expanded by $17.6 billion in 1969 compared with $13.2 billion in 1968—this in the "tightest" money market in history. Can you explain this? The accelerated increase comes in a category called "other loans;" which went up by over $9 billion last year, compared with $3.6 billion in 1968. Can you give some ideas of what kind of loans these are?

Answer. Loans to business from nonbank sources were indeed very large in 1969. This source of funds—essentially short-term in character—was the only major category of credit to any nonfinancial sector that increased significantly over 1968, apart from net issues of corporate stocks. The explanation for its dramatic rise lies essentially in the burgeoning role of the commercial paper market during recent years as a source of short-term business credit and as a form of liquid asset holding acceptable to investors. For 1969 the explanation can be summarized as follows:

(1) Business needs for outside financing became unusually large during the year when a $9 billion increase over 1968 in capital outlays was juxtaposed against a declining profit trend and no rise from 1968 in gross internal funds. The rise in outlays was entirely in plant and equipment, a form of spending not easily reversible in the short run. Spending for fixed capital tends ordinarly to generate long-term financing, mainly in security markets, and 1969 corporate net issues were in fact high—$3 billion more than 1968. They were not as high as in the record year 1967, however, and it appears that much of the 1969 capital financing requirement was postponed temporarily in the face of unprecedented interest costs on new bond issues, a declining stock market, and an expectation that pressures in security markets would ease off in the foreseeable future. A large part of this postponed long-term financing was thus shifted into heavy demands on the short-term credit markets.

(2) Banks are normally the dominant supplier of short-term credits to business, so that most of the enlarged demand for such credit in 1969 could be expected to fall directly on banks in the first instance. The banks did manage to provide a sizeable amount of net new business credit during the year—about $8½ billion to nonfinancial corporations—even though the total supply of bank credit was severely constricted.

(3) Some of the short-term demand that banks could not absorb directly was shifted by the banks over to various kinds of financial business affiliated with the banks. This was a major financial-market innovation during 1969 and an important part of the explanation for the sharp rise in "other loans" owed by

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[5] These firms were:

Name of firm:	*Millions of Dollars*
Neon Products of Canada	20.0
Long Island Lighting	30.0
Colorado Interstate Corp	30.0
Washington Gas Light	20.0
Computer Investors Group, Inc	12.5
General Interior Corp	21.0
Anodyne, Inc	4.5
Russell Mills, Inc	12.0
Beneficial Standard Corp	10.0
Publisher Co	5.5
Stanray Corp	10.0
New York State Electric & Gas	30.0
Zurn Industries	18.0
Washington Natural Gas	10.0
Credit Thrift Financial Corp	20.0
Vernitron	15.0
International Bank	30.0

corporations. The bank affiliates could borrow in the money markets at going rates, since they were free of the interest rate ceilings imposed on time deposits, and in effect recapture some of the funds that left the banks during 1969 because of the noncompetitive rate ceilings on time deposits of banks. Last year the bank affiliates floated about $4 billion of commercial paper and used about $2½ billion of the funds to hold business loans that could not be carried by the banks themselves. This $2½ billion of business credit is one component of the $9 billion growth in "other loans" referred to in the question.

(4) Business raised another part of their short-term funds from commercial finance companies that are separate from banks. These finance companies obtain their funds in a variety of markets, but in 1969 they relied heavily, like the bank affiliates, on the commercial paper market and found the supply forthcoming at a price. Their commercial paper borrowing during the year was very large, about $4.6 billion, net, and their short-term lending to corporations was comparably large—$4 billion, which is a second component of the $9 billion "other loans".

(5) In addition to loans from bank affiliates and from finance companies—both sources relying heavily on commercial paper—nonfinancial corporations also issued about $2½ billion of paper themselves, the third major component of "other loans." This was the largest volume of paper ever issued in a single year by nonfinancial corporations, and included in it are issues by many companies who had never used the commercial paper market before—particularly public utility firms. There are reports that some of those companies were surprised at the efficiency of the commercial paper market—the speed and simplicity of procedures and the volume of funds forthcoming—and there can be little doubt that the new issuers now will expect to use this market on a regular basis.

Through three different channels, then—bank affiliates, finance companies, and direct issues—corporations were able to raise a large volume of short-term funds from the commercial paper market in 1969 when bank credit, mortgage markets, and security markets all came under increasing restraints resulting from shortage of supply. The volume of credit flow that the paper market could handle was quite unexpected and of course could not have occurred without an equally unprecedented growth in demand for paper as a liquidity instrument. Patently the demand was there, and to a large extent it came from funds moving out of bank CD's into the open market.

Question 3. Can you supply an estimate of the amount of intra-corporate lending and borrowing—those with some spare cash lending to those short of cash?

Do you think intra-corporate lending is healthy? Does it not suggest that business is perhaps financing long term needs through short term borrowing? If so, won't refinancing mean continuing pressure on long term credit markets for some time to come?

Answer. So far as I know, there are no statistics on the type of intra-corporate lending I assume you have in mind—i.e. direct loans by one corporation to another. As a general rule, I would consider such transactions between ostensibly unaffiliated companies to be of doubtful merit because they could so easily subject the borrower to reciprocal trading agreements and to other anticompetitive arrangements.

Corporations typically ease the financing requirements of other businesses in two major ways, neither of which involves the direct transfer of cash. One of these ways—through extension of trade credit—is an accepted selling device, often undertaken for competitive reasons. While the presumption is that stronger suppliers try to accommodate their weaker customers by liberalizing their selling terms when credit is tight, it is not clear that the record expansion in trade credit last year was any larger than would have been expected, given the increase in the book value of inventories and in activity generally. Perhaps stronger customers also tried to accommodate weaker suppliers by paying for goods more promptly than usual.

The second way in which credit may be channeled from one corporation to another is through acquisition of commercial paper. Paper issued by nonfinancial corporations, however, is purchased through a market intermediary, since these companies do not place their paper directly with investors. Moreover, a substantial part of the open-market paper that nonfinancial corporations purchase is issued by finance companies and bank affiliates, which relend the proceeds to corporations and to others. Other investor groups, of course, also purchase open-market paper and, although no cross-classification by type of issuer and type of investor is available, it is possible that these other groups absorbed the increase in the volume of paper issued by nonfinancial corporations last year.

I think the evidence is clear that corporations financed a large amount of long-term needs with short-term funds in 1969 and that other corporations provided a significant share of these funds—but indirectly and in response to market forces. What is not so clear is the timing and intensity of borrowers' efforts to redress their balance sheets in the period ahead. A number of corporations have already repaid short-term loans out of the proceeds of long-term financing, but the greatly expanded commercial paper market (for financial as well as nonfinancial corporate issues) has enabled others to roll-over their short-term debt without difficulty and to postpone the funding of that debt until a more advantageous time.

Question 4. Would you describe monetary policy last year as one which aimed at little or no increase in the money supply? I stress policy rather than results. The money supply increased for the year as a whole, but wasn't this largely the result of revised numbers? Before the revisions were known, the policy makers were pointing to very slow growth in the money supply. After the revision no expansion took place.

Answer. During 1969 monetary policy did not aim explicitly at any given target rate of desired growth in the money supply, but the money supply was one of the financial variables considered—along with many others such as interest rates, mortgage market conditions, bank credit, bank liquidity, etc.—in evaluating the objectives of monetary policy actions.

Published data on the money supply for the first half of 1969 were revised upward substantially in the summer to adjust for distortions that had been created by sharply increased U.S. bank borrowing of Euro-dollars. This revision resulted not from any redefinition in the money supply concept as such, but rather from an adjustment for a downward bias that had crept into the figures reported earlier as a result of increasing use of the Euro-dollar market by banks and the generation in the process of cash items in the process of collection (which are deducted from gross private demand deposits in obtaining the demand deposit component of the money supply).

On balance, when 1969 is viewed in full perspective, it is clear that policy makers were perfectly aware their actions were resulting in a slowing of money supply growth in the first half of the year even through these actions were not aimed at any explicit target rate of growth and even though there was some upward revision in the numbers. In the second half of the year, as interest rates rose markedly further and the public's liquidity was under severe strain so that corporations and others economized on cash, money supply growth was extremely small. This was a result of the cumulative effects of the policy of monetary restraint as it affected financial market conditions; it was not in itself a direct target of policy. Nor was it related to the earlier revision of the money supply numbers. Without that revision, money would still have grown much less in the second half of 1969 than the first half. For the year as a whole, money growth might have been about 1½ to 2 percent without any correction of the money supply series at any point during the year for downward bias, instead of the 2½ percent that actually developed.

Question 5. Could you please state your opinion regarding the desirability of maintaining controls over the export of capital by banks, other financial institutions, and corporations? Can you estimate when these controls will finally be eliminated and how the process of removing them might be phased? Also, are you favorably disposed towards the suggestions recently offered by Governor Andrew Brimmer regarding modification of the Voluntary Credit Restraint Program?

Answer. Given the present state of the U.S. balance of payments, I favor maintenance in the immediate future of the existing restrains on the outflow of capital. Although the dollar has been strong in foreign exchange markets over the past two years, this strength was the result primarily of a large inflow of short-term capital induced by severe credit restraint in the United States. A relaxation of this restraint could bring on a reversal of the short-term capital flow. In fact a mere cessation of this inflow is enough to let the underlying balance of payments deficit show through in both measures of the U.S. balance of payments.

In these circumstances, a significant easing of the restrictions on capital outflow should await some improvement in the underlying balance of payments. The major requirement here is to put an end to inflation in the United States. Without this, it is difficult to see how we can restore a healthy surplus in the U.S. trade balance.

As long as balance of payments restrictions are required to protect the international position of the dollar, there is something to be said for a form of restriction that is market oriented and involves a minimum of administration. This is what Governor Brimmer had in mind in putting forward his recent suggestions. However, I have no comments at this time on the merits of his suggestions.

(The following exchange of letters between Senator Proxmire and Mr. Burns were subsequently supplied for the record:)

U.S. Senate,
Washington, D.C. February 25, 1970.

Hon. Arthur F. Burns,
Chairman, Board of Governors of the Federal Reserve System,
Washington, D.C.

Dear Mr. Chairman: This is to follow up on our personal conversation as well as our discussion during your recent appearance before the Joint Economic Committee on the projection of financial developments for 1970.

In the Committee's report on Standards for Guiding Monetary Action, issued in August of 1968, on page 20 under subsection 4, there is a recommendation that the Federal Reserve set forth at the beginning of each year as specifically as possible "their notion of what kind of monetary policy the expected state of the economy calls for."

The report went on to explain that the Federal Reserve should supplement in the monetary field the review of the Federal government's economic programs which the President is required to set forth in the Economic Report. The language goes on to specify that the projection should indicate the money supply, flows through financial intermediaries, and the appropriate course of interest rates that might be expected to parallel the projections of national income.

This was a matter of some dispute with your predecessor, Chairman William McChesney Martin, and finally compromised by providing the staff report which you discussed in your statement before the Joint Economic Committee.

In that statement, as well as in response to questions and in our personal conversations, you have raised some understandable objections to the requirement that the Fed set forth a specific road map that might imply the kind of monetary policy the country could expect for the next twelve months.

I fully appreciate and understand the difficulties that such a series of projections provide for a flexible monetary policy which is so essential.

At the same time, I do hope you could perhaps give us a series of three or four alternative possibilities which would let us know what might happen to money supply and interest rates under several possible circumstances.

In doing this you would certainly not be committing the Federal Reserve even in the minds of those most dimly informed to a specific policy. But you would be giving us a valuable understanding of some of the alternaive possibilities that might develop. If you could do this, particularly as a Board rather than simply as a staff exercise, it seems to me it would contribute greatly to the enlightenment of the Congress without any commitment to rigidity by the Board.

Sincerely,

William Proxmire,
U.S. Senator.

Chairman of the Board of Governors,
Federal Reserve System,
Washington, D.C., March 17, 1970.

Hon. William Proxmire,
U.S. Senate, Washington, D.C.

Dear Senator Proxmire: I have been giving very careful thought to your request for a specification of a series of possible alternative paths that monetary policy and financial developments might follow in 1970, contained in your letter of February 25. We certainly want to be responsive to the Congress in providing the information it needs in order to plan its domestic economic legislative program and to help it evaluate the performance of monetary policy. And yet I cannot help but be impressed by the many difficulties that surround such an exercise.

A problem in laying out alternative possible courses for monetary and financial developments in 1970 is that much will depend on the specific pattern and character of changes in the performance of the economy as it evolves. A particular dollar estimate for the total value of the national output of goods and services over an arbitrary time period such as a year does not tell us much about the expected state of the economy. How will that output be distributed over the course of the year? What will its composition be, and how will it accord with our notions of economic balance? To what extent will the estimated GNP reflect changes in the real volume of output as against markups in prices of goods and services? What new forces may emerge that will alter expectations for the economy into 1971 and beyond?

These are always important issues, and they are crucially so in the present environment, when all of us are working to reestablish the conditions necessary to a resumption of sustainable, noninflationary economic growth. Monetary policy—and public economic stabilization policy generally—will have to tread a narrow path in the months immediately ahead. We have made real progress over the last year or so in laying the base for an abatement of inflationary pressures. Excess demand has now been generally eliminated from the economy, and I am confident that inflation will gradually subside.

We must now be especially alert to signs that the process that was necessary to the elimination of excess demand pressures in the economy does not spiral on downward into significant recession tendencies, with consequent social and economic costs. Prompt remedial action would be required should it appear that a recession is developing, with the intensity of the action scaled to the indicated magnitude of the problem. But we must also guard against actions that would contribuite to an overly sharp rebound in output and spending later on. Expectations of inflation over the longer run are still widely held and business confidence appears to remain strong. If incautious public policies should precipitate a strong resurgence in demand, therefore, there could be a real danger that inflationary patterns would again be set in motion.

The economic projection for 1970 prepared by the Council of Economic Advisers early this year as a basis for its annual report, as I understand it, traced a path that promised to minimize these possible difficulties. The GNP for the year was estimated in a range of $980–$990 billion, with a period of little or no real growth to be followed by resumption of a relatively moderate rate of expansion beginning in the spring. The price component of the GNP expansion was viewed as declining gradually as the year progresses, and the acceleration in demand growth in the latter part of the year was not seen as large enough to restimulate inflationary expectations. The increase in unemployment accompanying the flatter performance of the economy was expected to be moderate, on average, and recovery in the depressed housing industry was projected to be underway again before too long.

Now if it turns out that this projection is an accurate description of the course of the economy's development in 1970—and I have no basis for disputing its general outlines—then it is not too difficult to visualize how financial conditions might evolve. First, with progress occurring on the inflation front and aggregate demand well within the economy's capabilities, it would seem reasonable to assume that the monetary variables could gradually return to a more normal growth rate—say, 3-4 percent for the narrowly defined money supply and perhaps 6-8 percent for total bank credit. But while one can put such numbers on paper as reasonable expectations, these are by no means the only ones consistent with the GNP projection. Much will depend on the public's preferences as to holdings of financial assets, on the strength of desire by banks and others to rebuild liquidity, and on how aggressive banks prove to be in attempting to regain their earlier market positions.

Next, one might anticipate that interest rates would move generally downward in the year, reflecting not only relaxation of some of the pressures in the financial markets but also investor response to reduced rates of inflation as they in fact began to materialize. Rates could be expected to decline more in short-term than in long-term markets, partly because of the apparent continuing strength in demands for long-term funds. Net savings inflows to the banks and other depositary institutions should also recover as the relative attraction of high market rates to savers tended to diminish. Once again, however, these are speculations based on specific assumptions concerning the development of the economy in 1970.

Finally, would be logical to expect on the basis of these assumptions that the total flow of credit—through institutions and markets combined—would expand somewhat from the relatively low levels reached in the second half of 1969. This would reflect mainly an increase in the availability of funds to those who were rationed out of the market in the restrictive credit environment of 1969, and also the gradual increase in savings flows consistent with expansion in current dollar GNP and aggregate incomes. A large increase in credit flows would not be expected in the short-run, however, since it takes time to get the process of credit generation going again in some sectors, such as mortgage finance.

I want to emphasize, however, that one can readily imagine important variations in this path of money and credit market developments, if the course of the economy does not evolve as specified above. The resurgence in economic activity, when it comes, could prove substantially stronger than anticipated, in which case rates of money and credit expansion would need to be restrained. Or the upturn could come more slowly and without the force anticipated, suggesting the need for additional encouragement to private spending through higher rates of expansion in the monetary factors and associated sharper short-run declines in interest rates. Total bank credit expansion could well run higher relative to growth in the money supply in these circumstances.

Economic developments in the weeks and months immediately ahead, of course, will be fundamental in shaping the course of monetary policy, including changes in interest rates and credit availability that actually emerge. Some major business indicators recently have shown recessive tendencies. If these deepen and intensify, the arguments for corrective action will become more forceful, and I would expect monetary policy to be modified accordingly. If, on the other hand, more positive signs appear on the economic scene, this will have to be taken into account in policy formulation. As I stated at the outset, the problem of economic stabilization policy for the time being is to walk the narrow path between the threats of recession, on the one hand, and restimulation of inflationary expectations, on the other.

As we move toward a more stable economic environment once again, I would expect the monetary aggregates to resume a more normal rate of growth and interest rates to decline to more viable levels. But I can not assure you that this will in fact develop. Patterns of economic change can readily be imagined that would call for either unusual monetary stimulus or continued monetary restraint, the results of which would be reflected not only in the rates of change in monetary aggregates but also in the level and pattern of interest rates and overall credit flows. Monetary policy is by nature one of the most adaptable instruments of economic stabilization, and it is my intention to do everything within my power to keep it flexible and responsively attuned to unexpected variations in the performance of the economy as they occur or come into prospect.

Sincerely,

ARTHUR F. BURNS.

THE 1970 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 19, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:05 a.m., in room G–308, New Senate Office Building, Hon. Wright Patman (chairman of the joint committee) presiding.

Present: Representatives Patman, Reuss, Widnall, Brock, and Moorhead; and Senators Proxmire, Sparkman, Symington, Javits, Miller, Jordan, and Percy.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; and Douglas C. Frechtling and George D. Krumbhaar, economists for the minority.

Chairman PATMAN. The committee will please come to order.

Today we will continue our hearings on the President's Economic Report and the State of the Economy.

Our witness this morning is Mr. David Kennedy, Secretary of the Treasury, accompanied by Mr. Paul Volcker, Under Secretary for Monetary Affairs.

Mr. Secretary it was brought out earlier in these hearings that the projected budget surplus for the next fiscal year is a very uncertain thing. There have been first of all certain recommended tax actions and expenditure actions. Moreover, it depends on the correctness of our revenue projections.

It also depends largely on interest rates that the Treasury and the administration consider uncontrollable. If you will touch on that subject some time during your discussion we will appreciate it.

We will be very interested in hearing what you have to say here today, Mr. Kennedy.

You are welcome to our committee. We are glad to have you. And you may proceed in your own way.

STATEMENT OF HON. DAVID M. KENNEDY, SECRETARY OF THE TREASURY; ACCOMPANIED BY PAUL H. VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS; AND MURRAY WEIDENBAUM, ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY

Secretary KENNEDY. Thank you very much, Mr. Chairman and members of the committee.

It gives me great pleasure to appear again before your distinguished committee——

Chairman PATMAN. I notice you have another witness here, Mr. Volcker. Will not your testimony be his testimony?

Secretary KENNEDY. I would propose that on some international matters that Mr. Volcker would make a statement——

Chairman PATMAN. You think it would be best, then, to have your statements separate?

Secretary KENNEDY. I think it would be.

Chairman PATMAN. That will be done, Mr. Kennedy. You may proceed, sir.

Secretary KENNEDY. Thank you, Mr. Chairman.

You have heard testimony earlier this week from the Council of Economic Advisers, the Bureau of the Budget, and the Federal Reserve. There is no need, therefore, for me to review the past year's developments in great detail. My prepared statement is relatively brief. It gives my own general appraisal of the current situation and the prospects for the future.

We are now entering a crucial period in the domestic economic adjustment. There are multiplying signs that the policy of restraint has taken hold. But final success in the form of a much better price performance is yet to come. Too sharp a turn toward expansion could cancel the progress made to date. Our policies must not feed a resurgence of demand or of inflationary expectations.

A close watch must be kept on this adjustment process. There are risks on both sides, and we must remain alert to them.

Monetary and fiscal restraint have successfully moderated the growth of total spending. Gross national product in current prices rose at a rate in excess of 9 percent in 1968. By mid-1969, the rate was down to 7 percent. In the final quarter of the year, total spending was rising at only a 4-percent rate.

We begin this year against the background of a slower pace of total spending in the economy. The reduction in the growth of total spending is a necessary precondition for the control of inflation. It creates an economic environment within which cost and price increases will not continually feed upon themselves.

There can be little doubt, however, that inflationary pressures are still very strong. Present price statistics make that fact uncomfortably clear. And, the coming calendar of wage negotiations may keep the pressures on costs. To this point, restraint has had its major effect upon output. A further period of comparative stability in real output—extending perhaps through the first half of the year—is to be expected.

During the course of the year, more tangible results on the price front should appear. But this relief from rising prices has certainly been slow in coming.

We must still work our way through a period this year in which increases in gross national product will, to a considerable extent, reflect higher prices. Then, as the rate of inflation drops, real output can safely resume a moderate rise. Even by the end of the year, however, price increases may make up as much as half or more of the rise in the value of national output. But if all goes according to our expectations, we should by then be firmly on a path where growth in real output can rise toward its longer range potential while prices move toward stability.

I see no substitute in an inflationary situation for working to restrain total spending. Detailed intervention into the wage-price decisionmaking process was tried but abandoned by the previous administration as the economy overheated. Nor can direct controls do the job when there are heavy strains on labor and product markets. There is no quick or easy cure for the cost imbalances and distortions that follow in the wake of inflation. But we can look forward this year to some gradual improvement.

Last year the productivity gain on a national basis was well below normal and productivity may actually have declined a bit during the first half of the year. Money wages, on the other hand, rose rapidly, partly in response to the rising cost of living. The combination of little growth in productivity and a strong rise in hourly compensation resulted in more than a 6-percent increase in labor costs per unit of output.

Resumption of productivity growth would permit a much better overall record. Gradually a better balance can and must be restored between productivity, costs, and prices. This better balance is essential for our domestic stability and our international competitive position.

In its essentials, the administration's economic strategy remains unchanged. Maximum reliance will be placed upon the established stabilization tools—fiscal and monetary policy. In the long run, this course is most compatible with the maintenance of a strong free enterprise system.

We do recognize that the burden of restraint can fall unevenly and cause real hardship. Therefore, we have taken steps to alleviate some effects of the adjustment now underway. The proposed Manpower Training Act will forge a new link between manpower programs and economic conditions by linking appropriations to the unemployment rate. Federal agencies have pumped large sums of money into housing and other measures are under consideration. Social security benefits are to be increased substantially. Special legislation has been introduced to liberalize unemployment benefits.

Some change in the relative contributions of fiscal and monetary policy may be required. In this respect, this year's budget planning has been particularly important. Close restraint on Federal expenditures was essential to insure the effectiveness and credibility of the anti-inflationary program. After rising by an average 13 percent annually during the past 5 years, Federal outlays are projected to rise by only about 1½ percent in fiscal 1971. Hard decisions have been made, and they are reflected in the current budget.

The rise of a destabilizing shift toward fiscal ease, further complicating the already difficult task of the monetary authorities, has been avoided, for now at least. When there is a need for some modest lifting of restraint, there is a strong case for its coming on the monetary side, which has been stretched so tight.

If, in the months to come, the economy should begin to slide off too far, a degree of fiscal support would, of course, be supplied automatically through the operation of the so-called built-in stabilizers. There is also a range of discretionary steps which could be taken if and when they are clearly required.

On the domestic financial side, we have to recognize that, directly or indirectly, some of the programs of the Federal Government—whether aimed at housing, or public facilities, or small business, result in heavy demands on the credit markets.

This will remain true in the next fiscal year. We must make sure that these necessary demands are not further increased by a budget deficit. Fortunately, the Treasury is not currently in that position.

Private demands for long-term credit continue to be strong. The potential demand for mortgage credit far exceeds the supply. There is a large backlog of State and local borrowing temporarily postponed during the period of rapidly rising interest rates and, in some cases, reflecting the operation of legal ceilings at the State level now raised or removed.

All told, prospective demands on the capital markets are not likely to diminish, although some shading down of business requirements might be expected as the pace of economic expansion moderates.

The size of these prospective demands suggests that we may have to live with relatively high interest rates during the period just ahead. But some beginnings of an easing trend are appearing. A somewhat lower level of interest rates was, in fact, assumed in drawing up the estimate for interest on the public debt in fiscal 1971. It will take a shift away from inflationary expectations—in keeping with the underlying realities of the economic situation—for this to materialize and to bring lasting relief from high interest rates and credit shortages.

In our own refunding operations, under present circumstances and at current interest rate levels, we could not contemplate any massive reshaping of the debt structure. But the existing 4¼ percent interest rate ceiling has the effect of confining the Treasury entirely to 7-year maturities and under.

This has contributed in recent years to an excessive pile-up of debt at the shorter end of the maturity range, a trend that has tended to aggravate the problems associated with disintermediation and made us excessively vulnerable to higher interest costs.

Our debt management operations could be harmonized much more effectively with general economic objectives if the 4¼ interest rate ceiling were removed or further modified.

Despite the small projected reduction in Federal debt held by the public in 1970 and 1971, an increase in the debt ceiling will be required by the end of this fiscal year. This reflects the expansion in debt obligations held by the trust funds, as well as the need to accommodate seasonal swings between receipts and expenditures. A decision on the amount of the increase in the debt ceiling will not be made until we see the actual figures on budget receipts and expenditures over the next few months. I might add that the current congressional ceiling on budget expenditures tends to reduce whatever rationale the public debt ceiling may have had in the past as a deterrent to spending.

A year ago your committee's report urged that a longer-range look be taken at our national goals and priorities, along with the implications in terms of the Federal fiscal position. Your report pointed out that, "Too often public policy has been formed in an ad hoc fashion because of an absence of clearly stated national objectives and priorities." A forward look has been taken in both the economic report and the budget. Broad projections are made for the economy and the budget out to 1975.

This implements another of the recommendations of the 1967 Presidential Commission on Budget Concepts of which I had the honor to be Chairman. Quite aside from any feelings of personal satisfaction, the provision of these forward estimates seems useful and long overdue.

In and of themselves, the projections cannot do much to insure that better decisions are made. And the specific arithmetic is open to revision and modification. But such estimates do provide a more informed and objective basis for discussion of our national priorities and goals. Too often in the past we have stumbled into the future without a clear idea of where we were going or how much it would cost over a period of time. Now at least we have made a beginning toward a more rational appraisal of future prospects.

The clear lesson that emerges from the 5-year forward projections is the very limited degree of fiscal freedom that is, in fact, available. On the basis of present estimates, there is little, if any, margin available in fiscal 1972 for new Federal budgetary programs. And even by 1975, when new initiatives of about 1 percent of GNP might be accommodated, the overwhelming impression is the lack of budgetary resources relative to potential claims.

While the present period of Federal expenditure restraint is a particularly difficult one, there will be a continuing need for efficient direction and control of Federal expenditures.

There is also a need to make a comprehensive forward looking appraisal of our financial structure and its regulation. The past decade brought profound changes and created new problems. As we look forward in this decade, the volume of potential demand for savings is impressive. It will be increasingly important to insure that our financial structure can adapt flexibly and efficiently. Therefore, the President will shortly be appointing a commission of distinguished citizens to study those matters.

As Mr. Volcker will review more fully, our balance-of-payments position continues to be a cause for concern. On the other hand, the strength of the dollar abroad, despite our large balance-of-payments deficit on the liquidity basis, has been well maintained. On the official settlements basis, we actually ran a large surplus last year—the largest in many years. But this reflected some temporary factors and a degree of monetary tightness here that we would not expect to continue indefinitely.

While some improvement has recently been registered, our trade balance remains far too small. Over the longer run, we must restore a much stronger current account position if we are to reach a satisfactory payments equilibrium. This requires the early establishment of a reasonable degree of cost-price stability in this country—the same stability which our domestic situation requires.

But elimination of domestic inflation is not all we need to do to strengthen our balance-of-payments position. We are seeking a more equitable distribution of the burden of mutual defense expenditures. We are seeking the reduction abroad of nontariff barriers which shut out many U.S. exports. We are trying to heighten the export consciousness of our business community, and to back their efforts with adequate export credit. And we are investigating tax avenues which might help equalize our competitive position relative to exports from other countries.

This past year has seen progress toward relieving the domestic economy and the balance of payments from inflationary strains and distortions. Certainly that progress is incomplete, and some difficult times may still be ahead. But we are moving in the right direction and using the correct policy tools, in my opinion.

The task this year will be to keep the economy moving at a a moderate pace while the current inflation is brought more securely under control. This will provide the essential foundation for gradual resumption of growth along a noninflationary path in the years ahead.

Mr. Chairman, that completes my formal statement. But in response to a letter I received from a member of this committee I have prepared answers for the record to three questions. They deal with the relationships between the Employment Act and the current concern over the issues of pollution and of the quality of our environment. And I am pleased to submit for the record at this time those three answers to the questions.

Chairman PATMAN. That will be satisfactory. It is customary to do that when you examine your transcript for approval, so that will fit in all right.

(The answers to questions posed to Secretary Kennedy for inclusion in the record at this point follow:)

Question 1. Does the goal of "maximum production" as stated in the Employment Act of 1946 adequately protect our dwindling natural resources and the quality of our environment?

Answer. This is an example of why we must not interpret the mandate of the Act too narrowly. The declaration of policy in that Act is quite broad. For example, the Federal Government—"with the assistance and cooperation of industry, agriculture, labor, and state and local governments"—is "to foster and promote free competitive enterprise and the general welfare", and to "promote maximum employment, production and purchasing power."

The Act was, of course, not primarily concerned with conservation or the prevention of pollution. But, I do not see that it conflicts with the pursuit of those goals. Indeed, we are most likely to be able to afford to improve the quality of our environment if we first insure that the economy is strong and productive.

Question 2. Does it [goal of "maximum production"] offer guidance for a rational judgment as to the relative role to be assigned to consumer and investment goods on the one hand, and to public goods such as education, health and environmental protection on the other hand?

Answer. As such, the goal may not offer direct guidance. However, many activities carried out under the broad mandate of the Act do help us see these choices more clearly. Certainly the 5-year forward projections contained in this year's Economic Report and Budget are valuable. They provide the basis for a more informed discussion of the economic and budgetary resources that are likely to be available.

Also, I suppose that achievement of the goal of maximum production points up these problems of choice more clearly. When production is maximized, if we want more of something, say public goods, we have to give up something else.

Question 3. Should the goal ["maximum production"] be modified?

Answer. Over the years, we have found the general language of the Employment Act to be adequate for guiding economic policy. It has proved to be an adaptable instrument. For example, although not explicitly stated, the goal of price stability generally has been subsumed under the section of the preamble referring to "maximum . . . purchasing power."

In view of the many developments since the passage of this landmark legislation in 1946, an examination along the lines suggested in these questions might possibly be fruitful.

Chairman PATMAN. Now, Mr. Volcker, members of the committee have expressed a desire, and I so desire, that you summarize your entire statement and place it in the record. And then the members may question as they desire to question.

Will that be satisfactory?

Mr. VOLCKER. Yes, sir.

Chairman PATMAN. Without objection we will place your entire statement in the record. And then you may proceed to summarize it.

Mr. VOLCKER. The statement I think spells out in somewhat more detail some of the comments that the Secretary was making about our balance-of-payments position primarily, Mr. Chairman. He did emphasize that our underlying balance-of-payments position is unsatisfactory. And while the dollar has been strong in exchange markets and in people's minds, I am sure, in the past year, we have to be aware of the fact that this strength partly reflected some more temporary factors.

The tightness of money in the United States did pull in a very large amount of short-term capital from abroad last year. I am sure that people in other countries too were encouraged by the firm and forceful kind of actions that were taken to deal with the inflationary problem here through monetary and fiscal policies.

They felt that these were essentially the kinds of actions that would in the end deal effectively with our inflationary problem, and therefore had favorable repercussions on foreign attitudes toward the dollar.

As a result primarily of the short-term capital increase we did have a sizeable surplus on the official settlements account. Our own reserves increased and foreign dollar holding decreased. And that is why the dollar was so strong in the exchange markets.

There is no mystery about it. There tended to be a depletion of foreign dollar holdings and a build-up in American assets.

At the same time we had this confusing $7 billion deficit on the liquidity basis. I do not think that itself is a very meaningful measure. It does exclude all these short-term capital inflows. And perhaps there is some justification for that in the sense that they may be erratic.

Certainly they cannot be sustained at last year's level.

But even apart from that analytic point, there were some confusing distortions in the liquidity definition last year. There was a large volume of funds deposited in the Euro-dollar market by Americans that might otherwise have come directly into the United States or stayed right in the United States. The American banks forwarded it back, but because of the peculiarities of the balance-of-payments accounting it appears as an outflow but not as an inflow.

In addition, we had some changes in some foreign official holdings of securities between nominally nonliquid form and nominally liquid form. There is not much real economic distinction. This statistically worsened our deficit. These factors probably added at least two and a half to three billion dollars to the deficit.

We do have a serious problem. The thrust of my statement is to emphasize that it is essential, I think, that we make some progress on the trade account and other current account items if the United States over a period of time is going to fulfill as it should its role in the world as a capital lender and provider.

Over a period of time that implies a good and healthy balance in goods and services and current account. This is where we have fallen down in recent years, primarily due to domestic inflationary pressures. The emphasis in this statement is that we surely need to do a better job in that respect if we are going to fulfill our international responsibilities as well as our domestic responsibilities.

If that is being done I do not think we need to be concerned about short-range fluctuations in our balance-of-payments picture. We do not expect this favorable showing on the official settlements basis to necessarily continue forever. We have to be prepared for fluctuations there.

What is important is that we make progress on the fundamentals.

I think the committee is aware generally of some of the progress that has been made in the international monetary system in the past year, which is touched upon in this statement. And I think you are also aware of the fact that studies are now underway in the International Monetary Fund on one piece of unfinished business, so to speak. And that is examining what ways and means there might be of easing exchange rate adjustments when and if they become necessary. But this is not a matter on which I think I can forecast any results on today.

There are a good many problems, and some very mixed views among governments. But it is an area that we are following with the closest attention. And we feel that it should be pursued actively during this period when we are happily in a favorable position in the international monetary system generally.

I do think a good deal of progress has been made structurally in the international monetary situation, particularly through SDR's. But I think more progress needs to be made, and I think we need to continue to pursue progress in that direction.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, sir.

At this point we will place your prepared statement in the record.

(The prepared statement of Mr. Volcker follows:)

PREPARED STATEMENT OF PAUL A. VOLCKER

We meet at a time when the atmosphere in world currency markets is happily free of the strains and tensions that characterized much of the late 1960's.

In part, this reflects solid progress during the past year toward reshaping our basic monetary arrangements. The collective decision to create Special Drawing Rights in sizeable amounts was a step of fundamental importance. It points the way toward the provision of adequate amounts of world reserves in the years ahead, without relying either on the vicissitudes of the gold market or upon unsustainable growth in reserve currencies. The two-tier gold market arrangements—a logical complement to the era of internationally managed reserve creation implicit in SDR's—has proved its strength and value in practice. With the question of the treatment of new production now resolved, the two-tier system is becoming embedded in the operating practices and policies of our monetary institutions.

The calmer atmosphere can also be traced to effective policies by several large European countries. The exchange rate adjustments by France and Germany removed two of the principal focuses of speculative pressure. The progress of the British trade and payments positioned during the course of 1969 supports confidence in one of the most important world currencies. The process of balance of payments adjustment in France also appears to be advancing in an orderly way.

Finally, as always, developments in this country have been a critical ingredient in the international monetary scene. There is no question, as Secretary Kennedy has already suggested, that our underlying balance of payments position remains unsatisfactory. We must not be lulled by the tranquility of current monetary developments into ignoring this basic problem. The dollar has been demonstrably strong over the past year. But this strength has rested in part on some transient factors.

Most immediately, the tightness of money in the United States has induced American banks and other borrowers to comb the world for dollars to use in the United States. There was an enormous short-term capital inflow—mostly through the Eur-dollar market—running to some $9 billion in 1969. These pressures of demand have kept the dollar relatively scarce in the exchange markets, just as it has seemed scarce to potential borrowers within the United States.

As a result, foreign official dollar holdings actually declined in 1969, and U.S. official reserves rose by $1.3 billion. Those realities were reflected in a record *surplus* of $2.8 billion in our over-all external accounts, as measured on the official settlements basis.

A second factor supporting the position of the dollar—and this looks toward the longer run—is the fact that a new Administration was visibly and directly grappling with our serious inflationary problem through the fundamentals of fiscal and monetary restraint. This supported confidence that the process of inflation and overheating would be brought under control, laying the needed groundwork for improvement in our basic payments position.

Helpful as these factors were last year, we plainly cannot count on tight money and good intentions as a lasting solution for our balance of payments problem. Instead, it is vitally important that we make visible progress on the more fundamental elements.

The $7 billion payments deficit, calculated on a liquidity basis, recorded last year is not, by itself, a meaningful measure of our basic position. Conceptually, that figure does not take into account the huge inflow of private short-term capital. Because those flows can be erratic and certainly cannot be sustained at last year's level, their exclusion can be useful for analytical purposes. But we should recognize that, with the use of the dollar as a transactions currency still increasing, some rise in liquid dollar holdings by private foreigners can be anticipated over time.

Apart from the matter of definition, there were evident distortions in the so-called liquidity calculation last year. These grew out of the diversion into the Euro-dollar market of a sizeable, but unidentified, amount of funds that otherwise might have been employed directly in the United States—funds that eventually were reborrowed by United States banks. In addition, there were shifts of official dollar holdings from the "nonliquid" to the "liquid" side of an arbitrary statistical line that had no economic significance. Together, these factors probably added at least $2½ to $3 billion to the recorded liquidity deficit.

Even with these mental adjustments, it is clear that our external accounts reflect a serious problem. I would suggest the dimensions of that problem can best be appraised by analysis of the trend in our trade balance and other current items. Only by achieving a sizeable surplus in these accounts can we sustain over time our propensity to lend or invest abroad and to provide aid without, at the time, feeding out more dollars into the rest of the world than other countries want to hold.

The attached table illustrates what has been happening during the past five years of inflation. Our trade balance, largely because of a surge in imports, declined from an average of nearly $5½ billion per year in the early 1960's to between $600 million and $700 million in 1968 and 1969. Meanwhile, high interest rates and the increased volume of short-term borrowings have driven up external interest and profit payments to foreigners over recent years almost as fast as the growth in profits and interest remitted to the United States. Other service accounts have changed little on balance. Consequently, a healthy balance on goods and services averaging about $6 billion from 1960 to 1964 dwindled to an estimated $2½ billion in 1969.

It would be an illusion to think that we can, in the course of a year or two, repair the damage of five years of inflation. Moreover, as the extreme pressures in our domestic money markets recede, the short-term capital inflow will presumably be curtailed and could even, for a time, be reversed. The consequence would be to produce a reflow of dollars into official reserves abroad and a deficit in our official settlement balance.

This should not, in itself, be an alarming prospect. Time and again in recent years, individual countries have experienced massive shifts of short-term money, responding to interest rate differentials as well as speculative movements. As economies become more closely integrated, as the total volume of international transactions by the United States alone reaches well beyond $100 billion a year, and as official inhibitions to capital flows are reduced, we must be prepared for recurrent large short-term swings in payments positions. It is a prime function of the international monetary system to finance those short-term swings, and I believe we are better equipped to do so than ever before.

Moreover, a moderate easing of pressures in U.S. credit markets may not be reflected in a massive net reflux of short-term money abroad. Indeed, the high rates here and the pull of funds into the United States has produced unwelcome pressures in some European markets. Given the close linkages among international markets, an easing in U.S. rates could well be accompanied by an easing in European money markets, and especially in Euro-dollar rates. I believe, at the proper point, such a general downward movement in interest rates would be welcomed by most foreign countries, as well as by the United States. In these circumstances, American banks may well retain a relatively large borrowing position in foreign markets.

We have had a cumulative official settlements surplus of $4.4 billion over the past two years. We would certainly be prepared to see that favorable balance reversed for a time, as a by-product of a welcome easing of domestic monetary tensions. What is essential is that, over this same period ahead, we make visible progress in our basic trade and service accounts. Failure to achieve this result would be deeply disturbing.

Until the outburst of inflation since 1965, the United States' record of internal price stability stood very favorably among industrialized countries. Even the recent deterioration in our trade position has been fairly concentrated among a relative handful of countries—especially Germany, Japan, Italy, and Canada. In other words, the deterioration in our trade position with most countries has been moderate, and, in some instances where the balance has been sharply adverse, some corrective forces already seem to be developing. While domestic overheating has swelled our imports, important export markets for manufactured goods have been reasonably well maintained.

Improvement will not come without sustained effort. This primarily means a much better price performance than in recent years and the avoidance of excessive demand pressures.

But we must also be concerned, as must other countries, to improve the processes of international balance of payments adjustment generally. The provision of more adequate international liquidity should itself help. When reserves are inadequate, there is a tendency by individual countries to strive for surpluses or resist deficits simply to achieve adequate reserve growth over time. Unless the global supply of reserves is great enough to satisfy these desires, these tendencies are apt to be mutually frustrating and impede adjustment. Reserve asset creation is aimed at this problem.

In addition, the experience of the 1960's has led to more questioning of whether improvements are not also necessary in the means and methods by which exchange rates might be altered, in those instances when changes are appropriate, through gradual and limited adjustments. This matter is now under intensive discussion in the International Monetary Fund, including such familiar proposals as "crawling pegs" or "wider bands."

I cannot forecast the results of this discussion today. Certainly, views of national governments remain widely mixed and important issues are unresolved.

I would emphasize, too, that, in accord with the reserve currency role of the dollar, our mechanical role in exchange rate adjustments tends to be passive; the initiative for change lies in other hands.

Obviously, we do have a close interest in the outcome of these discussions. We want to take full advantage of this period of calm to examine, fully and sympathetically, those areas where improvement may be needed.

The international monetary system is in a phase of transition. In the area of liquidity, it is clearly moving steadily away from dependence on gold to managed reserve creation. We are in a much earlier stage in considering how exchange rate changes, when appropriate and necessary, can be achieved with less disturbance. The events of the past year in international money markets also emphasize that we must face frankly the need for still more effective policy cooperation and coordination among nations in the period ahead.

The alternatives to evolutionary change are not inviting. We would find ourselves faced again with too many of the problems of the 1960's. Pressures to retreat into a world of controls and restriction would be strong—a world in which each nation, in an effort to preserve an unrealistic autonomy, builds walls around its industry and its money markets. That is the path we must resist—in the interests of the United States and the world as a whole.

U.S. BALANCE OF PAYMENTS ON GOODS AND SERVICES ACCOUNT

[In billions of dollars]

	Goods and services balance	Trade balance	Income from U.S. investment abroad [1]		Payments of investment income to foreigners [1]		Military expenditures	Other items [2]
			Total	(Interest)	Total	(Interest)		
1960	4.1	4.9	3.3		−1.1		−3.1	0.1
1961	5.6	5.6	3.9		−1.0		−3.0	.1
1962	5.1	4.6	4.4		−1.1		−3.1	.3
1963	6.0	5.2	4.6		−1.3		−3.0	.5
1964	8.6	6.8	5.4		−1.5		−2.9	.8
1965	7.1	5.0	5.9		−1.7		−3.0	.9
1966	5.3	3.9	6.3	(2.3)	−2.1	(−1.4)	−3.8	1.0
1967	5.2	3.9	6.9	(2.5)	−2.4	(−1.6)	−4.4	1.2
1968	2.5	.6	7.7	(2.9)	−2.9	(−2.1)	−4.5	1.6
1969 (3 quarters, annual rate)	1.9	[3] .3	8.8	(3.4)	−4.3	(−3.3)	−4.8	1.9

[1] Interest, dividends, and branch profits.
[2] Travel, transportation, fees and royalties, deliveries under military sales contracts, and miscellaneous services.
[3] Actual for 1969 was $674,000,000.

Source: Department of Commerce.

U.S. TRADE BALANCE, OVERALL AND WITH CERTAIN MAJOR COUNTRIES; AND LATTER'S OVERALL TRADE BALANCE WITH WORLD

[Billions of dollars; f.o.b. basis]

	1964	1968	Deterioration (−) or improvement 1964–68	1969
U.S. trade balance with—[1] World	7.01	0.84	(−6.17)	1.26
Germany	.44	−1.01	(−1.45)	−.48
Japan	.24	−1.10	(−1.34)	−1.40
Canada	.68	−.94	(−1.62)	−1.25
Italy	.42	.02	(−.40)	.06
All other countries	5.23	3.87	(−1.36)	4.33
Trade balances of certain foreign countries with world—[2]				
Germany	2.40	5.68	(3.28)	
Japan	.17	2.53	(2.36)	
Canada	.65	1.27	(.62)	
Italy	−.64	1.05	(1.69)	

[1] Census data differs from balance-of-payments data, largely through inclusion of DOD military export sales.
[2] Country sources.

Chairman PATMAN. I would like to question Mr. Kennedy just briefly.

Mr. Kennedy, I am impressed by your attitudes, as far as I know it, in connection with the Swiss secret number accounts. You have demonstrated to me in your correspondence that you will make sure that everything is done that should be done in the direction of stopping some of these loopholes and doing what is necessary to prevent our people from being defrauded, our own Treasury being defrauded, and our own boys in Vietnam being defrauded, with inferior equipment caused by contractors who are out to get the money. They have been convicted for it and sent to the penetentiary.

I think our investigation has disclosed already that these secret foreign bank accounts are the largest single tax loophole used by Americans.

And I would like to place in the record at this point—and without objection I will—an article from the Evening Star in Washington, "U.S. Government Victimized; Swiss Bankers Tied to Fraud." It says:

> Federal authorities have evidence that Swiss banks supplied hundreds of false documents from a string of shadow companies which became the backbone of a multimillion dollar swindle of the U.S. Government. With the aid of the bankers, the evidence says, a group of Americans was able to channel more than $4 million into secret Swiss bank accounts, before the fraud was exposed and stopped.

And many other instances are referred to in this same article. That was February 10, 1970.

(The article referred to by Chairman Patman for inclusion in the record follows:)

U.S. GOVERNMENT VICTIMIZED—SWISS BANKERS TIED TO FRAUD

(By Jean Heller)

Federal authorities have evidence that two Swiss bankers supplied hundreds of false documents from a string of shadow companies which became the backbone of a multimillion-dollar swindle of the U.S. government.

With the aid of the bankers, the evidence says, a group of Americans was able to channel more than $4 million into secret Swiss bank accounts before the fraud was exposed and stopped.

ALL FOUR SENTENCED

The Americans, who pleaded guilty to their parts in the fraud, were sentenced today in U.S. District Court here.

They are Francis N. Rosenbaum, a Washington attorney; Andrew L. Stone, a wealthy St. Louis businessman; Evelyn Price of St. Louis, Stone's executive secretary; Robert B. Bregman, president of Bregman Electronics, Inc., of New York; the Chromcraft Corp. of St. Louis and Alsco Inc. of Akron, Ohio.

Stone and Rosenbaum each received 10 years, and Mrs. Price and Bregman 5 years.

Judge Oliver Gasch sentenced them all to 5 years for conspiracy. Stone and Rosenbaum, in addition, received concurrent five-year terms on each of eight counts of making false statements and claims to the government.

DUMMY FIRMS ESTABLISHED

The two Swiss bankers were named as co-conspirators but not defendants in the case.

The fraud has received much publicity but the evidence detailing the role of the Swiss bankers has remained in government files.

Simplified, the case worked this way: Stone and Rosenbaum were officers of a company which was the prime contractor on millions of dollars in Navy defense business.

They set up two dummy companies in the United States and fraudulently represented them as subcontractors on the Navy work. The Swiss bankers supplied those subcontractors with fradulent bills from other dummy European firms for materials which were never ordered or shipped. The dummy subcontractors then "sold" the nonexistent material to the prime contractor, which charged the Navy for it.

SENT TO SWISS BANKS

In paying off the phony Swiss bills, Stone and Rosenbaum were able to siphon the fraudulent overcharges obtained on the denfense contracts out of the country.

The money went to the Swiss bankers who routed it into the Americans' secret accounts in Switzerland.

The case was broken by Asst. U.S. Atty. Seymour Glanzer, chief of the Frauds Prosecutions Unit of the U.S. attorney's office here. He was able, through court action, to force Swiss banks to open their books and files.

A 30-count indictment was returned in August 1968 against the six defendants involved in the case. Stone and Rosenbaum pleaded guilty last October to nine counts each and the other defendants to one count each. Each count carried a maximum penalty of five years in prison and $10,000 in fines.

The indictment named as co-conspirators Hans Senn, an officer and director of the Bank Fur Handel und Effekten of Zurich; that bank, and Walter A. Lips, vice director of the Union Bank of Switzerland branch at Aarau, Switzerland. Lips has since left the Union Bank and opened his own finance and business advisory service. Senn still is employed by the Bank Fur Handel.

Swiss authorities say no charges have been filed against anyone there, but Justice Department sources here say evidence is being turned over to Swiss authorities at their request. Swiss officials refused to comment when asked if an investigation is under way.

Between February 1962 and January 1967, the Navy awarded more than $47 million in contracts for 2.75-inch rocket launchers for air-to-air ground missiles widely used in Vietnam.

The contracts were awarded on a sole-source basis, that is, to one company without competitive bidding. In the beginning, that company was Chromcraft.

In June 1966, Chromcraft and Alsco merged, and the St. Louis rocket launcher operation changed its name to the Techfab Division of Alsco. Nothing else changed, however, and the Navy continued awarding the contracts to Techfab.

Rosenbaum was a director and special counsel first for Chromcraft and then for Alsco-Techfab from January 1963 through the time the fraud was discovered and stopped in early 1967. During this period, Stone was the principal stockholder and chief executive officer of the companies.

FAKE OFFICE SET UP

Stone and Rosenbaum created a dummy company in Beverly Hills, Calif., and called it Scientific Electronics, Ltd. The company was nothing more than a desk and a chair and piles of letterhead stationery. It never did any business with or for anyone.

Part way through the four-year fraud, Scientific was dropped and Rosenbaum and Stone replaced it with Bregman Electronics, another dummy company.

Scientific and Bregman were the American front companies for the fraud.

There were five more front companies in Europe: Geag; Elpag, A.G.; Alwatra, A.G.; Infina, A.G. and Etablissement Macoba.

During the four-year fraud, as Chromcraft and Alsco received the Navy rocket launcher contracts, the companies assigned some of the work on the weapons to legitimate subcontractors. Those subcontractors submitted bills to Chromcraft and Techfab.

Under honest practices, these bills would have been submitted to the Navy by Chromcraft and Techfab as part of the total cost of manufacturing the launchers.

Instead, Chromcraft and Techfab submitted false invoices from the two dummy American firms, Scientific Electronics and Bregman Electronics, stating that these were the subcontractors. These bills were substantially higher than the true charges by the real subcontractors. The Navy paid the higher costs.

The Swiss bankers' complicity in the fraud can best be shown by following through one typical transaction with the Americans.

DOCUMENTS SEIZED

Among the thousands of documents seized by the Justice Department in connection with the case was an invoice from Macoba, one of the dummy European companies, dated Dec. 1, 1964. It purported to show that Macoba had sold to Scientific Electronics three pieces of equipment at a total price of $10,565.

Three Chromcraft purchase forms, dated Dec. 7, 1964, showed that Chromcraft had ordered the same three pieces of equipment from Scientific Electronics. And there were three Scientific Electronics invoices dated Dec. 14, 1964, billing Chromcraft for the three pieces of equipment at a total cost of $11,000.

But Macoba never shipped anything to Scientific Electronics and Scientific Electronics never shipped anything to Chromcraft.

What did happen was that Rosenbaum wrote to Senn requesting only bills for the three items. The fraudulent Macoba invoices were sent to Scientific Electronics from Europe and Scientific Electronics billed Chromcraft for the items—bills which Chromcraft represented to the Navy as legitimate costs.

Leon Schwartz, the president of Scientific Electronics, sent an air mail letter to Senn on Feb. 16, 1965. It listed 21 bills to Scientific Electronics from Macoba and Alwatra, including one for the three items, and said checks covering the bills were enclosed.

The letter to Senn said the checks, which were made out to Macoba and Alwatra, were to be "applied to your invoices."

The total of the checks referred to in the letter was $160,235.

MONEY SENT TO BANKERS

Each bill listed in that letter and in many similar letters to Senn and the other Swiss banker, Lips, represented a fraudulent invoice. Each payment, in which the checks were made out to one of the five foreign front companies, was sent not to the companies, but to the Swiss bankers or their agents.

And each payment was routed into secret Swiss bank accounts for the use of Stone and Rosenbaum.

By having fraudulent invoices from Europe sent to their two dummy American subcontractors, and by "paying" those bills, Stone and Rosenbaum were able to channel more than $2.2 million into secret Swiss accounts through Scientific Electronics and nearly $1.2 million through Bregman Electronics.

In addition, fraudulent invoices were sent from foreign companies to Western Molded Fibre Products Inc., of Gardena, Calif., a legitimate subcontractor for Chromcraft and Alsco. Western Molded paid the bills although the materials listed on the invoices never were sent.

In that manner, Western Molded paid $663,481 in kickbacks to Stone and Rosenbaum. That money, too, was routed into their Swiss accounts.

A source within Western Molded first tipped off the Navy to the possibility of kickbacks. That alone would have been a violation of the law. The Navy relayed the information to the Justice Department and eventually the whole scheme was uncovered.

Chairman PATMAN. And from the Bridgeport (Conn.) Post article, December 24, 1969, headed "Pentagon Has Evidence of Swiss Bank Payoffs: Foreign numbered accounts pose a security threat to the U.S. Department of Defense in that they may be used to support foreign agents targeted against the military establishment, or they may be used to conceal payments of U.S. personnel recruited by foreign intelligence services, the testimony said."

(The article referred to by Chairman Patman for inclusion in the record follows:)

Pentagon Has Evidence of Swiss Bank Payoffs

(By Jean Heller)

Washington.—The Defense Department has evidence that secret Swiss bank accounts have been used to cloak payoffs to American military personnel who supplied U.S. intelligence information to foreign powers.

Defense Department representatives, it was learned, were to testify to that fact at a House Banking Committee hearing Dec. 12 on a bill aimed at halting the illegal use of secret foreign bank accounts by U.S. citizens.

The hearing was postponed until sometime next year, but committee members received an advance copy of the formal department testimony before the postponement. The testimony said, among other things, that the Defense Department was in "complete accord" with the secret foreign bank account bill.

Pose Security Threat

"Foreign numbered accounts pose a security threat to the Department of Defense in that they may be used to support foreign agents targeted against the military establishment or they may be used to conceal payments to U.S. personnel recruited by foreign intelligence services," the testimony said.

A Defense spokesman cited one example of Soviet intelligence officials depositing $25,000 in a secret Swiss account for a U.S. Army sergeant who supplied them with classified information. The sergeant, who was not named, is now serving a prison term for espionage, the testimony said.

The Defense Department representative testified further that the Pentagon officials would cooperate fully with the Treasury Department in enforcing the secret foreign bank account bill after its enactment.

They may never get the chance.

Regime Backed Down

Even as the Defense Department testimony was being drafted, the Nixon administration, led by the Treasury Department, was backing down from its support for the bill. It was under pressure from domestic and foreign banking leaders who objected to the stringent new record-keeping practices provided for in the measure.

The House Banking Committee, chaired by Rep. Wright Patman, D-Tex., held a day of hearings on secret foreign bank accounts late last year. It was disclosed at that time that the accounts are used to cloak hundreds of millions of dollars in tax evasions and frauds every year.

Patman and other committee members began drafting legislation—with the help of Nixon administration officials—to curb the practice.

Their bill called for tighter record keeping on domestic bank account transactions and the identities of persons dealing with those accounts, as well as reporting by persons transporting U.S. currency abroad and those doing business with foreign financial institutions.

Patman Began Hearings

Assured of administration support for the measure, Patman began hearings Dec. 4. His two witnesses that day were Will Wilson, assistant attorney general in charge of the criminal division, and Robert M. Morgenthau, U.S. attorney for the southern district of New York, a man who broke several foreign bank account fraud cases.

Both testified in favor of the bill, with Wilson stating unequivocally, "That is correct," when asked point-blank if the Justice Department wanted enactment of the bill.

But at the same time they were testifying, subsequent interviews disclosed, the State Department was receiving a barrage of protests from foreign banks and domestic banks with foreign branches, and high-level Treasury Department officials were meeting with representatives of some of the largest banks in the United States.

Among the banks represented at the Dec. 4 Treasury Department meeting, sources said, were the Bank of America, Chase Manhattan, First National City and Chemical Bank New York Trust Co. Several days later they returned, with their attorneys, to argue against passage of the bill.

MET WITH OFFICIALS

They met on both occasions with Internal Revenue Service enforcement officials and Eugene T. Rossides, assistant treasury secretary for enforcement and operations.

Rossides was one of the Nixon administration officials who helped write the secret foreign bank account bill. He was the lead-off witness when Patman convened the second day of hearings Dec. 10 and Rossides came to testify fresh from the two sessions with the bankers.

He testified that he supported the intent of the bill but said he could not support the measure as written because it went too far. IRS Commissioner Randolph W. Thrower followed Rossides and also testified that the bill was too strict.

In addition, Rossides tried to blunt Wilson's endorsement of the bill by saying Wilson actually meant he supported the bill's objectives but not necessarily the bill itself, although those at both hearings knew that was not what Wilson said.

Patman obviously was surprised. He noted that Rossides and Thrower had both helped write the bill and were consulted extensively on it. Why, he asked, hadn't they voiced any objections sooner?

PROBE BY TASK FORCE

Rossides testified later that day that the problem of illegal use of secret foreign bank accounts had been turned over to a special Treasury Department task force which would report its findings to the Patman committee in two or three months. Rossides is head of the task force.

Both congressional and administration officials agree that the flip-flop in administration position on the bill has seriously endangered it.

At the hearings, Rossides raised the possibility that the problem could be handled administratively with no need at all for new legislation. Other administration officials say privately, however, that legislation will be necessary to stop the tax evasions and fraud.

But, they say, if the bill is rewritten to suit the bankers, it may be too weak to do much good.

Chairman PATMAN. There are many instances here where secret accounts are used for payoffs, kickbacks, and things like that which involve our own Government. It is a serious matter. And it is my considered opinion that the exposés by Members of the Congress and by the Department of Justice of the United States—have performed a good service in this connection. In addition, the courts throughout our country and in foreign countries have disclosed the probability of the existence of a scandal equal in importance if not greater than the Teapot Dome scandal of the early thirties.

Now, that statement is made after carefully going over what we have. The situation looks terrible. Whenever hundreds and thousands of people are drawing money through fraud and fradulent activities from the Treasury of the United States or from the Defense Department, money which has been contributed by the taxpayers of this country, I think we should probably stop a lot of other things and take a look at this situation because it is really serious.

Furthermore, they have used secret accounts to purify illegal income and bring it back to the United States and invest it in the stock market without conforming to the laws of margin requirements. Where you would have to put up 70 or 80 percent to buy stocks, they would put up, say, 10 percent, or in some cases nothing.

Now, that has been going on, not for weeks and months but for years. And I think it is time that the people in authority should put it on top of their "must" list and do something about it.

In this connection the House Banking and Currency Committee is considering legislation to combat these practices through the use of secret accounts.

Incidentally, has that bill been considered by your Department, and do you approve the bill for introduction and for support?

Senator KENNEDY. This presents a very difficult matter. We are looking into this very very carefully, because there are some very serious problems here. It is a difficult matter to handle. We have had attorneys doing a good deal of factfinding, so that we can move in this field. And we shall support legislation that we think would be necessary or helpful in this effort, so there is no difference between us with respect to having something done in this field, Mr. Chairman.

Chairman PATMAN. All right, sir.

Senator PROXMIRE. Would the chairman yield on that point?

Chairman PATMAN. Yes, sir.

Senator PROXMIRE. I want to compliment the chairman on his initiative here. I think he has performed a great public serivce. And I want to announce that I intend to introduce legislation in the Senate as companion legislation to the legislation he has introduced in this area in the House. I think it is most important to get it on the docket.

Secretary KENNEDY. It is important. And as I look back over the records of others in the office, a good deal of work has been done in the past. And I think it has to be kept moving.

Chairman PATMAN. The House Members are handicapped today, as they were yesterday. We had a caucus of Democrats yesterday and all of us could not be here all the time. And today we have a meeting of the House at 11 o'clock. And Mr. Reuss will be asked to preside at this session.

I would like to ask him to preside.

Representative REUSS (now presiding). Senator Javits, if you are ready, you may begin your questions.

Senator JAVITS. Mr. Secretary, I think that the thing that is squeezing us the most with respect to anti-inflationary policy is this question of high interest rates. Everything zeroes in on that, and I would like to ask you, Mr. Secretary, what you see ahead in that field, and what you believe could be done to alleviate the pressure which is especially severe on housing, State and city governments, and small business?

Secretary KENNEDY. Senator Javits, there is no question but that the control of inflation, with our combination policy of fiscal monetary restraint, has placed a severe strain in a number of areas. Fortunately now we are seeing signs, as the economic indicators show, that this restraint is taking hold and becoming effective. It is very important that we have a budget surplus, a credible budget surplus, by paring Government expenditures.

This has been done. And as the economy moves on a sidewise basis and the aggregate demand is brought within control, the easing demand for credit will have some effect, as well as the supply factors.

I was interested with respect to the nature of credit demands in the future. And as you indicate, they are very large for housing, and they are for municipalities. Some have been deferred because of the unavailability of money, or because their inflexible rate structure would not permit them to go in and get money if it were available, because of their ceilings.

Rates of interest are currently near alltime high levels. And I would expect that this has placed undue burden in some areas. That is to be expected in any kind of an inflation control period.

Now, the question of monetary policy is implied in your question. And I was interested in reading Dr. Burns' testimony before this committee yesterday, because that is within the province of the Federal Reserve. And they do look at all the factors in the economy—the supply-demand factor, the changes that we are having not only in actual indexes, but in the inflationary expectations that have been very strong.

We have had these expectations. And I was interested—Dr. Burns says in relation to that question: "For some time this year, our monetary and credit policies are therefore likely to tread a narrow path"—he did not say a straight and narrow, so it is going to wind a little, I guess—"between too much restraint and too much ease, as we go through the transition from an overheated economy to a path of noninflationary growth."

That does not give a timing or an indication of when the changes might take place. But we would expect that the first signs that we see will be when the public will recognize that inflation is under control, and that again fixed income securities have some value.

Senator JAVITS. In other words, you really have nothing of a special character in mind for these applicants for credit who are having such grave difficulty now?

Secretary KENNEDY. Well, in the housing field a number of considerations have taken place. And that is one area that has been held back by the restraint policies that have been pursued.

Actually, if you look at what has happened the total amount of housing credit last year was at a very high level, particularly if you consider mobile houses. But when you look at the pattern of it you can see the impact of the policies on the last part of the period, and what effect it will have with respect to this year.

So as a result, we moved very strongly last year to support the public housing sector. And a very large share of the total went in through FNMA and the home loan bank system. That in itself may have caused some problems, and so on, with the interest rates that were paid on the obligations that were sold to the public to accommodate this financing.

Now, as we look further ahead, we may have to do something more in the way of subsidy there through these agencies. And there may be other avenues that we will have to take with respect to housing.

Senator JAVITS. What would you say about the possibility of some subsidization of interest rates as we did in an emergenccy with the college student loan program?

Secretary KENNEDY. Well, I think that may well be part of any program, not just in the way of the student loan program. It is quite clear that at least the home loan bank system, or possibly the FNMA, if they are going to function in this period, may have to have some subsidy. We are also developing under the authority we already have in the Housing Act a security that can have marketability, and might attract funds from other sources that are not now coming into the mortgage market. There are many things we are working on actively.

Senator JAVITS. A different type of mortgage security that would have U.S. Government backing, is that the idea?

Secretary KENNEDY. That is right. And that would perhaps be adaptable to a secondary market use.

Senator JAVITS. And that would ease up——

Secretary KENNEDY. That would bring in a new group of investors, yes, Senator.

Senator JAVITS. Bearing in mind that the Fed controls monetary policy, and the Treasury has the major voice in fiscal policy, subject to Congress, of course, do you join with the new Chairman of the Federal Reserve Board in the determination—he almost made it a pledge—that our Government would respond with affirmative, positive means to avoid a recession?

Secretary KENNEDY. There is no question about that. I join with him. And we have had many discussions. Our whole policy is to slow down without causing that kind of a problem. I think we are seeing the results of that. And we are in a period now where the results of our efforts are showing. As they do, we have the delicate balance here of monetary and fiscal policy. And Dr. Burns is very much aware of this.

Senator JAVITS. Is that determination which you have expressed of the administration also joined by the fact that you are not doctrinaire about the increase in the price level? Now, the price level has on the whole had a normal rate of increase which is inflationary for many years. But is the administration's objective merely to abate the sensational increases in the 5 to 6 percent area, or is the administration determined to have complete halt to increases in the price level, that is, not to stop with the measures which are being adopted now until there is no price increase whatever?

Secretary KENNEDY. No. Our program, Senator, is designed to slow down the rate of price increases. And implicit in the Council's estimates, the documents that have been submitted here in testimony, is a slowing down of the rate of price increases this year. And that will continue into the following year on a gradual basis.

Senator JAVITS. So that we are willing to accept a stability in the price level, and even some increases in the price level so long as they are not of the runaway inflationary character?

Secretary KENNEDY. What we are trying to bring is stability into the economy, and to get a sustainable rate of growth after a 5-year period of excess government expenditures, and so on, with a built-in psychology of inflation. That is what we have been trying to countermand and bring down so that we can stabilize on a plateau and start with a flat rate of growth with reasonable price expectations.

Senator JAVITS. Mr. Secretary, we have at least a two-part government in this field, the executive and the legislative. What high priority measures do you want Congress to pass which will assist in bringing about a realization of this policy so that the repressive character of the administration's handling of the situation may be released?

I notice, just by way of specificity of my question, in your statement you speak of a Manpower Training Act——

Secretary KENNEDY. That is right.

Senator JAVITS (continuing). And liberalizing unemployment compensation benefits. Now, I wish you would repeat those yourself. I was just keying you to the way you have spoken about it. But tell us what measure as the Secretary of the Treasury you feel the Congress should give the highest priority to in order to bring nearer the day when we can have better interest rates and not run as great a danger of recession, and not have a bulge in unemployment, et cetera?

Secretary KENNEDY. Before I answer specifically on the program, Senator, I think perhaps the most important thing is to hold the line on expenditures and keep them within bounds, rather than if the Congress approve expenditures in excess of those that would be implied in the President's messages.

But over and above that, on the revenue side we do have some proposals for revenue to help bring a balance in the budget, as you know. It consists of \$1.6 billion of recommended revenue, which is comprised of \$700 million of user charges, more than half of which will come from aviation. And that has passed the House, and, I believe, is now awaiting action in the Senate.

There are also \$600 million that we are proposing in extension of the automobile and telephone excise taxes which have been extended from time to time. We have already had discussion with the House Ways and Means Committee leadership on this. And we will have recommendations for hearings on that fairly soon.

Now, those rates have been extended in the past, so I see no real problem there.

There is also a couple of hundred million dollars from social security, which is necesary from our standpoint, by bringing the base up from the \$7,800 to the \$9,000 level. And I think an additional hundred million dollars from railroad retirement would make it consistent.

Now, when we get over into the other areas we would like action on the question of the manpower training and the unemployment insurance and the family security program that the President has recommended. All of those would be helpful in this period.

Senator JAVITS. Thank you, Mr. Chairman. My time is up.

Representative REUSS (presiding). Senator Proxmire?

Senator PROXMIRE. Following up Senator Javits' questioning, Mr. Secretary, I get quite a different impression than Senator Javits did from the witnesses we have had so far. Chairman McCracken, Director Mayo, and Chairman Burns have all been, I think, very, very vague. There has been almost a complete lack of specificity. I can understand this with regard to Mr. Burns. I disagree with it. I think he ought to give us a little clearer notion of at least how monetary flows are going to accompany the expansion of the economy projected in the President's Economic Report or the course of the economy. At any rate, he felt that he should not disclose that. But I see no specifications in terms of providing jobs, no shelf of programs available in the event unemployment increases above, say, 4½ or 5 percent; can you give us any such assurance that there is an effort on the part of the administration to work out such a program, to have it available, to be ready to move in the event that unemployment does increase?

Secretary KENNEDY. Well, there is no question but what the administration has looked at many areas in case there should be an increase in the amount of reaction or adjustment in this process. One of the areas that we quickly could move in to help in the labor cost area end of the budget is the construction area. We cut back substantially, as you know. That could be reversed very quickly.

Senator PROXMIRE. Many people argue that that is a very light cutback, a $300 million cutback last year in a trillion dollar economy. And the complementary action, if you restore that, would be a tiny and relatively insignificant stimulus for provision of jobs.

Secretary KENNEDY. It is not massive, that is perfectly true, Senator, as you have indicated. But it is marginal. And it does have considerable impact.

Also there are the automatic items in the budget and already in the law that will quickly come into play, which would be joined, of course, on the revenue side.

And also you have to bear in mind that we have very large social security increases that are already in the law and will be forthcoming as part of this whole picture, and the end of the surtax of 5 percent. That will be a reduction.

And then, of course, there is the monetary policy that would very quickly be reversed in such a situation as you are talking about. The backlog of demand is very large in many areas of our economy, particularly housing and particularly, as the Senator indicated, in the municipal area.

Senator PROXMIRE. That is exactly right. Maybe you can help me to disabuse myself of my impression that we could have a period of rising prices, continuing high interest rates, and increasing unemployment. This is what concerns me, and I am sure it concerns you and the President very, very much. Now, the difficulty is that you see the likelihood that inflation will ease, interest rates will begin to fall somewhat, credit will ease, toward the end of this coming year, and the economy will then move ahead. It seems to me that we could be easily locked in, however, to high interest rates. It is one thing for bankers to increase interest rates, it is something else, as you know as a distinguished and successful banker, to bring those rates down and to bring them down to a point where we can expect housing to move ahead, and expect those projects that are unable to move in the local and State area because of high interest rates to move ahead.

What prospect do you see of interest rates falling, of a moderate easing? Dr. Burns was careful to say it would be a moderate increase, it would be in terms of a 2 to 6 percent in the money supply, which would not be a great stimulation. How do you answer those of us who are fearful that we are going to have a depression and high unemployment this way.

Secretary KENNEDY. You have to keep in mind that the time of moving is always a delicate one in the monetary field, and that there are anticipatory moves, psychological moves of money rates even ahead of and in addition to the actual forces that are being brought to bear. But as the demand on the total economy is leveled off, as it is now, the demand factors themselves come into play. At the same time the supply increases through monetary policy changes. And so you do get large changes, if you look at the history of the changes on both sides, either up or down, sometimes almost out of proportion to the basic factors. But rates do show very large declines at times on that basis.

But in this period I would not expect major reductions in interest rates, because of the heavy underlying demands that we have in our total economy.

Senator PROXMIRE. I have gotten that impression from others. Mr. Burns has testified that credit might be used somewhat. We do not see a really big reduction. And without that it seems to me that we could be forestalled from this kind of economy activity that we hope we will get in the last half of the year.

I would like to ask you a specific question, Mr. Secretary. In 1969 Congress passed by an overwhelming vote—I think there were only four dissenting votes in the House of Representatives—legislation increasing the Treasury borrowing authority of the Federal Home Loan Bank Board from $1 billion to $4 billion. The purpose was to channel more funds, of course, into housing.

Does the Treasury plan to use this new authority this year?

Secretary KENNEDY. I would like to turn, if I may, to Mr. Volcker, who has been doing a lot of work in this field, because it is one that we are very much concerned with. And then I may add to his comment.

Would you like to say something?

Mr. VOLCKER. I think we respect, Senator, that particular authority. We certainly would use it if the need arose in the sense that the home loan banks could not finance themselves in an orderly way in the market.

Now, that has not been the case. And I do not anticipate that that will be the case. But the authority is there, as I understand it, to take care of the unexpected situation in which the home loan banks by an inability to borrow in the market in an orderly way, could not raise funds.

Senator PROXMIRE. We are certainly not satisfied now with the present situation where housing starts went down to 1.16 million a year, a real depression in the industry. Under those circumstances wouldn't it be logical to provide these funds beginning now so that this industry could be helped?

Mr. VOLCKER. The housing industry has problems. I do not think those problems are related to an inability on the part of the home loan banks to borrow. They have borrowed a very large amount of funds successfully.

Senator PROXMIRE. But it is a matter of the rate they have to pay, it is a matter of the rate the homeowners have to pay.

Mr. VOLCKER. But the borrowing authority from the Treasury is also tied to market rates.

Senator PROXMIRE. Of course it is. But you are about one point below what the Home Loan Bank Board has to pay now. This would be 1 percent saving, which would be about $15 a month on a $20,000 home, just enough to make a difference for a young couple.

Mr. VOLCKER. It would be a small saving on a marginal amount of borrowing by the Home Loan Bank Board. It would have nothing like that effect on interest cost on a mortgage.

Senator PROXMIRE. Why not?

Mr. VOLCKER. It is not at all clear that the net cost of funds even to the home loan banks would be reduced by as much as the implicit subsidy from the Treasury borrowing, which is small——

Senator PROXMIRE. There is a difference, is there not?

Mr. VOLCKER. I might just complete that point—because by exhausting their residual borrowing authority, this affects the value that the marketplace will put on their outstanding securities in the market. And that is far larger than the amount they could borrow from the Treasury.

Senator PROXMIRE. It is one thing to exhaust a residual authority, it is something else not to use it. How much have you used it so far as the home loan banks are concerned?

Mr. VOLCKER. None.

Senator PROXMIRE. Zero. So it would seem to me that you could begin to loan a few hundred million dollars. And the fact is that Treasury pays about 1 percent less, is that correct or incorrect, than the Federal Home Loan Bank Board? Under these circumstances if you could make these funds available at 1 percent less it would make a big difference.

Mr. VOLCKER. Near a half percent less, I would say, Senator. This varies from time to time. So if we passed that saving directly through to the Home Loan Bank Board, it would be a half percent less on some limited fraction of their borrowing, which in turn would be loaned to the savings and loans. And what effect that would have on the final rate paid by the home buyer I do not think would be distinguishable.

Senator PROXMIRE. How serious does the housing situation have to get before you feel that you would loan just a little bit of this $4 billion amount that the Congress felt so strongly should be made available on the basis of the vote?

Mr. VOLCKER. The housing situation is serious, Senator. And as the Secretary suggested, a number of measures are under intensive review in that connection. We have not felt that the use of this particular authority at this particular time could make a helpful and significant contribution to what is admittedly an extremely difficult and serious problem. We are revising a variety of techniques.

Senator PROXMIRE. I hope you get from the study stage to the action stage as soon as possible.

Mr. VOLCKER. We have indicated right along, as we did when this legislation was under consideration, that we consider this borrowing authority most useful in the sense of a fallback for the Home Loan Bank should they get into difficulties with the very large volume of borrowing that happily they have been able to conduct in the market.

Senator PROXMIRE. My time is up. But it is like a taxi company saying that instead of having just one cab at the stand they will have four cabs, but they will always have those four cabs sitting on the stand, they will never go into action. It may be reassuring to see four cabs there. But it doesn't really help anyone.

Mr. VOLCKER. There is a certain analogy between the taxicabs and the amount of Home Loan Bank securities in the market. And I think it is increasing rapidly with full administration support and effort and sympathy.

Representative REUSS (presiding). Senator Jordan?

Senator JORDAN. I would like to pursue this matter a little further about housing.

We have estimates that some 26 million new housing units are going to be required in the next 10 years, which, divided by 10, would require about 2.6 million housing units a year, which is down to less than half of that now. What in your opinion, Mr. Secretary, or Mr. Volcker, would be the amount of the subsidy required to get this house building program on schedule?

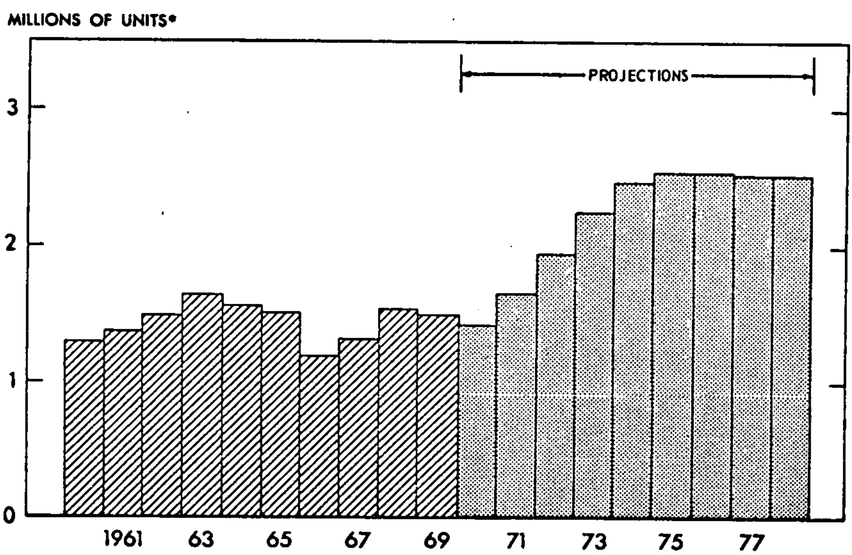
Secretary KENNEDY. Senator, in this economic climate that we are in I do not think it would be possible in the time frame of this year or perhaps next to get onto that schedule. I think our main problem would be to get housing starts back up and to move in the direction of that total in the foreseeable future. Otherwise you would have to pump in large sums of money and by so doing, exclude other segments of our economy. To this extent, it would be upsetting to the control of inflation.

You have a schedule in the Economic Report showing the housing starts, and some discussion of this very problem of the claims. It is on page 89 of the report of the Council. I would like, perhaps, to put that in the record.

Representative REUSS (presiding). Without objection it may be put in the record.

(The chart referred to by Secretary Kennedy for inclusion in the record follows:)

Housing Starts



*TOTAL PRIVATE AND PUBLIC. DATA EXCLUDE MOBILE HOME SHIPMENTS.
SOURCES: DEPARTMENT OF COMMERCE AND DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT.

Senator JORDAN. Are you satisfied that the gradualism policy of the administration is adequate to meet the needs not only in housing but in other areas where substantial inflation exists?

Secretary KENNEDY. In any period of adjustment there are areas of the economy that have difficulty. One is housing, another is municipalities, and there may be others that develop. There is no way to make a correction that I see without having to cut back the overall demand on the economy. And that is the program we have been going through. Once we stabilize the economy—and it is stabilizing—then we can return to a more normal rate of growth. And as the interest rates come down, and credit is more freely available, many of these problems we are talking about will take care of themselves.

Senator JORDAN. There are many factors beginning to indicate that the economy is turning around, except for the increase in prices and wages. And I know that in your testimony in prior appearances before this committee you have always been opposed to wage and price controls as direct controls. And I presume you have not changed in that regard at all?

Secretary KENNEDY. No, not at all. And it seems to me that in this stage where we are winning the battle it would be the wrong time.

Senator JORDAN. Given the value of hindsight and being on the firing line, if you had it to do over again would you have considered wage and price controls a year ago?

Secretary KENNEDY. I did consider them and did not recommend them. And I think that I would not again in the same circumstances. If I had the benefit of 20/20 hindsight, I might have pushed harder on the Government expenditure side, and if we had succeeded in that, I might also have pushed harder on the tax side, and tried to hold the fort in terms of keeping the tax reform bill from becoming a tax reduction bill.

Senator JORDAN. Do I detect that you are saying that perhaps because we have not observed the disciplines that we might have observed in the fiscal restraint area we have had to overcompensate in monetary restraint?

Secretary KENNEDY. Precisely. And this has been of long standing. Our principal problem is that of successive budget deficits of substantial size, even without the Vietnam war, reflecting social programs which are necessary and desirable, but not paid for through the tax mechanism. And so we were running very large Federal deficits. Now, we will have three budget surpluses in a row.

Senator JORDAN. Back through the years—for instance, in the fiscal year 1968—if we could have come through with a reasonably balanced budget instead of the $25 billion deficit it would have made a tremendous difference in the inflationary climate today would it not?

Secretary KENNEDY. Precisely. I am sure of that.

Senator JORDAN. Mr. Secretary, I notice that some place in your statement you warn us that an increase in the debt ceiling will be required by the end of the fiscal year. Now, I have a hard time explaining to my constituents why, with a forecast of a budget surplus for the fiscal year 1970, and another surplus forecast for 1971, why we must increase the ceiling on the Federal debt?

Secretary KENNEDY. Well, the answer might be very complicated, and yet it is very simple. The unified budget takes into account the trust funds, as you know. Where we have a surplus in the trust funds of over and above the Federal funds deficit, the privately held debt goes down, but the total of the debt will go up. The budget is a measure of the impact on the economy of all of the Government's programs including the trust accounts as well as the director Federal expenditure side.

So, in the budget document you have the Federal funds in the special analysis, I think beginning on page 19. And there it shows that if you take the old administrative budget correspondingly you would have, I think, a deficit of $7.3 billion.

Senator JORDAN. Are you as enthusiastic about the unified budget planning now as you were a year ago or 2 years ago, Mr. Secretary?

Secretary KENNEDY. Even more so, Senator. I think the question of this matter deserves a lot of thought and attention as to how we pull out and make clear the differences. I do not think we have done a very good job of spelling that out. I think that something further could be done there. And we are giving consideration to what can or should be done. But we have to measure the total. Whether it is through a trust fund or through regular Govrenment expenditures—many are almost interchangeable—it should be taken into account.

I think one of the areas that we want to take a look at also in this connection in the Federal lending as well as those credit programs that are really outside the budget now and growing in amount. And I think we ought to have some overall look. We have been giving a lot of thought to that and to Government agency accounts.

Senator JORDAN. But you are subject to wide fluctuations in social security surpluses and other special fund surpluses, are you not?

Secretary KENNEDY. We are. And they have an effect on the economy, and they have an effect on the costs of running the Government, whether you go through the trust fund area as in the highway program or go through the regular budget. It is hard to distinguish where you should go.

Senator JORDAN. Mr. Volcker, one question of you. Can you give an estimate of the balance-of-payments costs attributable to the Vietnam war? How does that affect the balance of payments, and what is the magnitude of that effect?

Mr. VOLCKER. There certainly is an effect on the balance of payments. The figure for some years roughly was estimated at a billion and a half or a little more. I do not think there has been any appreciable change in that. But I have not got a figure for this year for you.

Senator JORDAN. There is no immediate prospect of it being changed until we finally get out of there?

Mr. VOLCKER. It is clearly related to the whole prospect for the Vietnam war.

Senator JORDAN. Thank you.

Thank you, Mr. Chairman.

Representative REUSS (presiding). Mr. Secretary, I gather from your testimony that it is your view on our international balance of payments that if we pursue unsound policies and let our balance-of-payments deficits get out of control, this could harm the security of the United States, is that a fair statement?

Secretary KENNEDY. Without any question, Mr. Reuss. One of the strong factors in talking to the ministers of finance and the central bankers abroad over the past year has been an explanation to them of the policies that we are pursuing to bring our own economy into equilibrium. And there is no answer that I know of in the international picture that will take care of having sustained our large inflation in any major country, because it does present problems.

Representative REUSS. In your testimony, Mr. Volcker, while you mentioned some aspects of our balance of payments, such as our trade balance and the results of our restrictions on U.S. investment abroad, there was so far as I could ascertain, no mention of the biggest single item in our balance-of-payments deficit—our military expenditures abroad. And I call your attention to the table attached to your testimony which clearly bears that out. It shows that in 1964, for example, our military expenditures abroad deficit was $2.9 billion, and that it has gone up year by your to $3 billion, to $3.8 billion, to $4.4 billion in 1967, to $4.5 billion in 1968, and last year, in 1969, despite the supposed diminution of the Vietnam war, it went up to an all-time horrifying high of $4.8 billion. That amount is sufficient to account for our entire balance-of-payments deficit all by itself, is it not?

Mr. VOLCKER. I think one comment has to be made in response to that piece of arithmetic. This does not include some offsetting receipts that we have in the military area.

Representative REUSS. With good reason, since we have learned, and Senator Percy particularly has learned, how fleeting, evanescent and chimerical are these offsets, they really do not exist.

Mr. VOLCKER. In part, I think those adjectives are justified. There is military procurement here which is not fleeting and ephemeral.

Representative REUSS. And then there were these nice little loans at 4½ percent, but they converted those into cash——

Mr. VOLCKER. I understand your point. But I did not want you to be misled by these figures. I should point out that the Secretary did have a comment about this in his statement where he noted the importance of working on this particular item.

Representative REUSS. That is what I wanted to talk about. Now, you do a valiant job, I think too valiant, on restricting American investment abroad, in order to preserve our balance of payments. You also do a good deal of very constructive worrying about our trade balance, a concern shared by me, that it is not larger and it is dwindling. But whose job is it to ride herd on the Penatgon? Who, for example, takes note of the vast amounts of foreign exchange flowing out through U.S. headquarters abroad, general falling over general without very much to do? Who takes note of the fact that, so far as I know, though our balance of payments deficit in Germany alone is more than a billion dollars a year, we have never asked the Germans to pick up that deficit?

Surely our troop payments there do them some good. They cost us taxpayers $5 billion a year to keep them there. Surely one-fifth of that benefits the Germans. Who does guard the guardians, who does watch the Pentagon on military expenditures abroad?

Secretary KENNEDY. In the national security process we have, in the Military and State Department and others, experts in each of these areas who consider balance of payments. And we have from the Treasury strong input into those matters.

Representative REUSS. Through what organization?

Secretary KENNEDY. Through the National Security Council, and directly then through the President.

Representative REUSS. The National Security Council—you sit on it?

Secretary KENNEDY. Not as a regular member, but I sit on it from time to time, and particularly when these matters are under consideration, or when any matter affecting financial operations is under consideration.

Representative REUSS. Whose day-to-day job is it to review the Pentagon—which as far as I could see couldn't care less about how they damage our financial security around the world—whose job is it?

Secretary KENNEDY. That is Mr. Volcker's department. I am going to put the bee on him, because I have been watching this very carefully——

Representative REUSS. Who takes the national security interest into account?

Mr. VOLCKER. Obviously the national security interest is relevant here, and has to be balanced out in these considerations. We do attempt to——

Representative REUSS. Do you take the Pentagon's word for it that all their activities overseas are essential and they should not be questioned?

Mr. VOLCKER. I think this is in the end a judgment that the President has to make and does make on the basis of all the information available to him. And as part of that information process certainly the balance-of-payments cost of this should be noted and emphasized.

Representative REUSS. My question, though, was: Can we expect the overburdened President to do this job in the field, as I have pointed out, of American business investment abroad, or American bank lending aboard? We have in the Department of Commerce and in the Federal Reserve an elaborate bureaucratic setup to screen every item. And they do, I think, a good job. But isn't it ironic that when the sinner is not private business or banking but the Government itself, that, so far as I know, nobody is watching this? You say the President does it?

Mr. VOLCKER. He has to make the final judgment in balancing out the national security considerations with all the other security considerations involved.

Representative REUSS. But who outside the Pentagon, which, of course, is not going to do anything about it, who outside the Pentagon has the assignment of riding herd on our terribly aggravated military expenditures abroad, and whose job is it to see that the Pentagon stops damaging our national security?

Mr. VOLCKER. These expenditures are assessed regularly within the procedures of the executive branch, including the Bureau of the Budget, that has a special responsibility here. I assure you that a defense witness would not think that these considerations had been entirely absent from their planning, because they have not been. What you see here is the final figure, after the pros and cons have been reconciled. But that does not mean——

Representative REUSS. I see it going up year after year.

Mr. VOLCKER. Indeed it did go up, it went up as you can see by these figures—it was relatively steady for a number of years, and despite cost increases, salary increases, and all the other cost increases that took place. It jumped up with the Vietnam war. And that is where we have been. We have been on a plateau, and then it jumped up with the Vietnam war.

Representative REUSS. What worries me is that now that the Vietnam war is alleged to be tapering off military expenditures abroad keep rising, just as Senator Proxmire has pointed out. Someone has hijacked the peace dividend at home in our domestic budget; it looks as if the Pentagon has hijacked the Vietnam balance-of-payments dividend. Instead of getting better the foreign exchange cost is growing.

Mr. VOLCKER. Certainly the Vietnam war has had an impact on these expenditures. That cannot be denied. But there are other factors going on here too. Increases in salaries, as I mentioned, in recent years have been substantial. And they affect our overseas payments as well as our domestic payments.

Now, the Defense Department—and we also work closely with the Defense Department in developing what measures we have been able to develop to offset these. They are not fully satisfactory, and no one pretends that they are.

Representative REUSS. Who, if anybody, in the Treasury has the responsibility of riding herd on the Pentagon to see that the foreign exchange cost of our international military posture is kept to a minimum?

Secretary KENNEDY. We have a national security office in the Treasury whose particular responsibilities include keeping track of this particular item, and discussing it with the Defense Department.

Representative REUSS. Would you file at this point in the record the table of organization of that department in the Treasury, and also a list of their accomplishments, or failures, in recent years in attempting to limit the Pentagon's balance-of-payments impact?

Mr. VOLCKER. We would be glad to supply that.

(The information follows:)

Under the over-all direction of Secretary Kennedy, the Under Secretary for Monetary Affairs, Paul A. Volcker provides policy guidance to the Office of the Special Assistant for National Security Affairs on all matters pertaining to balance of payments and other international economic and financial relations which the responsibility of this Office may entail with respect to considerations of national security.

The following is the organization of the Office of the Special Assistant to the Secretary for National Security Affairs. In addition to those appointed professional positions listed there are suporting secretaries and a Staff Assistant:

Special Assistant to the Secretary, Anthony J. Jurich
Deputy Special Assistant to the Secretary, John J. McGinnis
Financial Adviser, Robert W. Bean
National Security Affairs Adviser, William N. Turpin
National Security Affairs Adviser, Clyde C. Crosswhite
National Security Affairs Adviser, William H. Bray

After the National Security Council was established by the National Security Act of 1947, and the Secretary of the Treasury was invited from time to time to participate, Treasury staff were assigned to advise the Secretary on matters being considered by the Council. In 1961 a Special Assistant to the Secretary was appointed to head this small staff.

During 1961–68 the National Security Council was relatively inactive, and Treasury views on defense spending and abroad were expressed mainly through a Cabinet Committee on the Balance of Payments, chaired by the Secretary of the Treasury. As a result of positions taken by that Cabinet Committee and approved by the President, the Department of Defense initiated a series of programs designed both to reduce our defense spending overseas and to increase our foreign exchange receipts by shifting from military grant aid to military sales to foreign governments.

Under these programs a number of foreign bases were closed, U.S. personnel and foreign employees overseas were reduced, and defense procurement policies were tightened to favor procurement from U.S. sources. A summary of these actions is contained in a Treasury Department Report, *Maintaining the Strength of the U.S. Dollar in a Strong Free World Economy*, published in January 1968. (Pages 133–148). The Cabinet Committee on Balance of Payments has been discontinued and international monetary and balance of payments policy is coordinated by other means including an interagency committee chaired by the Treasury Under Secretary for Monetary Affairs and composed of Federal Reserve, State, CEA and NSC representation. On an ad hoc basis related issues, for example, the German offset, may be chaired by another agency.

The most recent of these expenditure-reduction programs was ordered by the President on July 9, 1969. This order called for a 10 per cent reduction in certain U.S. military forces overseas and in American direct-hire civilian personnel serving abroad, to be accomplished during FY 1970. This program is separate from troop reductions in Vietnam. Implementation of this program is supervised by the Under Secretary's Committee of the National Security Council, chaired by the Under Secretary of State.

In addition to the shift from military grant aid to military sales, previous Administrations made other arrangements with certain foreign governments to neutralize or postpone the balance-of-payments impact of our defense spending abroad.

In July 1969 a new agreement was reached with Germany which was intended to improve on arrangements for the preceding two years mainly by including items which had greater direct benefit to the U.S. for longer terms and at lower cost. This agreement was negotiated after consideration of the issues in the National Security Council and decision by the President.

Currently we are participating in a Task Force with the State and Defense Departments which is reviewing various techniques to help reduce both our balance of payments and budget costs of our overseas military commitments. In this context, the Treasury has been working toward some improved arrangement that will have a direct financial benefit to the U.S. Treasury has also been consulting with Senator Percy in his extremely valuable effort on this same matter in a different forum.

The Secretary of the Treasury's Special Assistant for National Security Affairs and his staff have been directly involved in the programs mentioned above. The Treasury view is that basic policy decisions regarding U.S. troop deployment overseas should take into account the budget and balance-of-payments consequences and that, so far as possible, the means for dealing with those consequences should be determined at the time when the deployment decisions are made.

Representative Reuss. Let me now turn to an issue on which this committee respectfully differs from the Treasury, the yearend South African gold agreement. As I read the agreement you furnished to me, under that agreement it is possible for the gold speculators—who were, of course, very concerned when the price of gold started to go below $35 an ounce—to put their speculative gold on the market in amounts just sufficient to keep the price of gold in the free market at $35 an ounce or below. And if that situation occurs under the agreement, the IMF is obligated to buy from South Africa all the currently mined production of South Africa, limited by the amounts of South Africa's foreign exchange needs. And, since, without the help of gold, the foreign exchange needs of South Africa tend to be about a billion dollars a year; and, since its gold production is worth about a billion dollars a year, that could, if all the parties to this genial little agreement do their bit, that could mean that the IMF would have to buy about a billion dollars' worth of gold a year. And we, being the only country which has an open-ended commitment to buy gold, would be obligated to take it off their hands to the tune of as much as a billion dollars a year. Isn't that an accurate account of what the agreement makes possible?

Mr. VOLCKER. I think, in general, your statements follow the agreement. I do not want to accept the quantitative implications necessarily.

One thing that you did not mention is that there is a steady and very sizable industrial demand for gold. And if all the new production, all South African new production at least, is going to the IMF, that industrial demand over a period of time is not going to be satisfied, except to the extent that speculators are selling at a price of less than $35. And nobody knows just how long that might be.

Representative REUSS. The industrial demand is something like $700 or $800 million a year, is it not?

Mr. VOLCKER. That depends upon what you call industrial demand. There are no very good figures in this area. I think it would be generally felt that a kind of hard-core industrial demand would be at least that large. There are other estimates that probably have a broader definition of industrial demand that would be considerably larger. And where the truth lies no one knows. There have been estimates made up to the full amount of the current production.

Representative REUSS. Which would be a billion, or a billion point three.

Mr. VOLCKER. A billion-four, say, for the world.

Representative REUSS. There is enough gold in speculators' hands, if it were forthcoming, to take care of industrial needs for some years to come.

Mr. VOLCKER. I do not know whether it would for some years to come.

Representative REUSS. Three billion went into speculators' hands, hoarders' hands, in the London gold rush of March 1968 in 1 month alone, didn't it?

Mr. VOLCKER. A large amount. I do not remember the exact figures. There is unquestionably a large amount of gold held for speculative, or that was held for speculative or investment purposes, undoubtedly a large number of these people would now like to get out. Just how many of them want to get out and how quickly is one of the enigmas in this whole situation.

Clearly the speculative fervor in the gold market has been completely depleted. And people worry about the price declining, not rising. The effect of this agreement is unquestionably to keep some degree of support under the gold market when the price has declined down to $35. It is not a precise floor. It is not a technical floor at all. But it does provide some support for the market, there is no question about that.

Representative REUSS. Also by taking gold and putting it in monetary stocks it gives the speculators some comfort, does it not? That gold is not likely to interfere on the down side of the speculation?

Mr. VOLCKER. In my opinion the agreement has not given the speculators much comfort, Mr. Reuss. I think they rather take it as a sign that the two-tier system is here to stay, the gold price is here to stay, and it is now part of the institutional arrangements of the world monetary system. Gold is no longer an issue. And that is not a very happy thing for a gold speculator.

Representative REUSS (presiding). My time is up.

Mr. Brock?

Representative BROCK. Thank you.

No. 1, in coming back to Senator Jordan's comment on the military budget, Mr. Secretary, if we were under the administrative budget, what would be the size of the administrative cuts?

Secretary KENNEDY. About a $7.3 billion deficit for the fiscal year 1971.

Representative BROCK. Isn't that of some concern to the administration, not in the sense that it has fiscal impact, but the unitary budget probably is a bitter measure of that, but in terms of the willingness of the Government to accept responsibility not to have an adverse fiscal impact?

Secretary KENNEDY. There is no question but what all Federal expenditures are a concern. And we have gone over those very carefully with the idea of paring them down as much as feasible in the climate we have. That will continue. One of the areas that I mentioned, in answer to Senator Jordan, was that under the pressures that we have under a tight budget policy of holding the line, many want to find a way out and get in some kind of a program outside of the budgetary control process. That is the area that I am more concerned about than this area, because the budgetary process does take care of going through specific expenditures item by item, department by department.

In this climate I think the most helpful thing that we did do and the most helpful thing that we can continue to do is to work for further reduction in expenditures.

Representative BROCK. I think the thing that concerns me, though, is that, by allowing the unitary budget figure to become the one that is accepted by the press and the general public, there tends to be a distortion in the actual situation insofar as the acceptance of responsibility on the part of the Congress is concerned. There is a tendency for Members to consider the excess of receipts over expenditures and trust fund as a fiscal dividend which they can spend for their own reelection, and do so.

Secretary KENNEDY. To the extent that that takes place, it is bad.

Representative BROCK. My point is that I would like to see a little more emphasis on the fact that, even as it is presented, this budget does, insofar as the expenditures in the public sectors outside of trust fund, it does envision a $7-plus billion deficit.

Secretary KENNEDY. In the Federal accounts.

Representative BROCK. Which is hardly acceptable under our current economic situation. I am not sure that the Congress itself is aware of that.

To switch to another area, in this colloquy with the gentleman from Wisconsin, you were discussing the impact of military expenditures on the balance of payments. The fact of the matter is that it is going to be very difficult to have any reduction in adverse balance-of-payments impact for Vietnam, because the major portion of the adverse effect is due to logistical and economic support, is it not, as far as Vietnam is concerned?

Secretary KENNEDY. I do not know what the breakdown is, Mr. Brock. But that is a significant amount.

Representative BROCK. So I think it would be somewhat misleading to anticipate an increased dividend in terms of the balance of payments. I think we are getting our increased dividends in terms of the overall expenditures—last year of $7-plus billions, and this year in excess of $5 billion. So in the first 13 months of this administration we are talking about $13 billion, which is quite a dramatic reversal from the past administration, when it was increased at the rate of a billion dollars a month, and now it is decreasing a billion dollars a month, which I think is a rather significant accomplishment on the part of the administration.

Secretary KENNEDY. There is no question but what defense cuts have been very large.

Representative BROCK. Let me wander to an entirely different field. Earlier we were discussing housing, and the authority of the Treasury to provide us with $4 billion in direct funds to the Federal Home Loan Bank System. To what degree have you studied, and are you willing to consider now the possibility of Treasury support for, a program allowing the Home Loan Bank Board and/or other agencies to become involved in the secondary market for conventional home mortgages?

Secretary KENNEDY. That is very much in the program that we are looking at now. We want to determine how that can be developed, and to what extent.

Representative BROCK. Would it not be better economic policy in terms of—let us take the savings and loan institutions—rather than increasing the debt of those institutions to, in effect, going over a hundred percent, wouldn't it be better policy to refinance their existing paper and give them enough so that they would have funds to go into new market areas?

Secretary KENNEDY. That also is being considered and may well become part of the program.

Representative BROCK. I would encourage you to seriously consider it, because I do not believe the provisions for the utilization of this $4 billion authority is the answer. I think it has an enormous inflationary effect. I think it does not respond to the problem itself, it is a palliative. And I would rather see us address ourselves to the root of the problem, which is an inadequacy of the funds within the institution, within the market itself. And to address ourselves to that problem we must talk about national priorities and where we are going to place our emphasis. And I think housing needs greater emphasis than it has had in the past.

That is all.

Senator PROXMIRE (now presiding). Senator Sparkman?

Senator SPARKMAN. Mr. Secretary. I have enjoyed your testimony very much. There are a few questions I want to ask you.

First, let we ask you this question on behalf of Senator Fulbright. I was in the Foreign Relations Committee just before coming here, and when I told him I was coming here he said, "Well, ask him one question for me. Ask him how will the interest rates fall as long as the Vietnam war continues."

Secretary KENNEDY. I am sorry Senator Fulbright is not here to hear this very profound answer.

Senator SPARKMAN. I am sure he will ask me to repeat it.

Secretary KENNEDY. Yes, he will.

The interest rate level does not relate to any particular item or any particular area. It is determined by the overall demand for credit and supply. And, of course, the earlier we get a reduction through the end of the Vietnam war the less pressure we will have on the economy. And so that would be very helpful as a measure helping to control inflation.

But we have to look at the overall demand and the overall supply. And I think that the important thing is that the budget is in balance, and that we are seeing signs now that a turnaround can take place at some point in this year.

Senator SPARKMAN. In your statement you say that it is not proposed that the Government will take—here it is: "Detailed intervention into the wage-price decisionmaking process was tried and abandoned by the previous administration as the economy overheated."

Does that mean that this administration is going to keep its hands off completely of this wage-price decisionmaking?

Secretary KENNEDY. In specific cases—for example, the lumber situation—we did take a look because of the unusual circumstances there. But as far as getting into specific areas and fixing a specific guidepost, and then the next day finding that it is violated, and then having to get into specific action on a specific case, we have no intention of doing so. We feel that those guideposts in any period of heavy inflationary demand will not work. It was demonstrated that they lost their effect in the sixties when the wage settlements got out of line under pressure.

Senator SPARKMAN. Almost every day we read reports and hear reports of some industry or some company announcing a price increase in its product. How are we ever going to bring inflation under control as long as they keep raising the prices? I am not arguing for controls. It is true we did give the President the right, the power to use voluntary controls or mandatory controls in certain fields. I am not urging anything like wage and price controls. I hope we never have to come to that again. But it does seem to me that the Government ought to use what I call moral suasion to try to get some restraint of price increases, wage increases, when the negotiations come to a head.

Secretary KENNEDY. In that connection, Senator, I have had a series of discussions with business people over this country, and with bankers and others on the fundamentals, showing what the program is, what we are trying to do to control inflation, so that they can have the picture and understand our determination to reduce Government expenditure, hold the line, and actually bring inflation under control.

And then they in their own best interest can work into their decision-making process, at least, the public policy standpoint of the executive branch. And I think those discussions have been helpful, and I expect to continue them. I think the same thing holds true with the labor people. As our policies are effective, the corporations will be less inclined to make a quick settlement, because they cannot pass on wages in the form of increased prices. Some of that may be taking place at the present time, because you do not have in the indexes a true measure of some of the actual prices. They will have list prices and then make sales in this kind of a period under the list price.

I have seen that in the past, and I see it now in a few cases. These things work through the economy.

Senator SPARKMAN. Your position, then, is not one of a looseness; the administration will be concerned with these things, is that right?

Secretary KENNEDY. Well, we are concerned. And I think it is important that we keep in mind the pressures. Because it is a disturbing fact, when you get demands for wages above the areas where you can sustain them over a period of time—and probably the same thing holds for prices—it is hard to get them down once they get up.

Senator SPARKMAN. Let me ask you two or three fast questions, if I may. You said something a few minutes ago about the fact that you are considering the secondary market operations. Chairman Burns yesterday, in answer to a question, supported legislation to permit FNMA to establish a secondary mortgage market for conventional mortgages. I have a bill pending to that effect. Does the Treasury support this idea?

Secretary KENNEDY. We are looking at that at the moment, Senator. And we are interested in establishing a secondary market. Whether it should be done just through the home loan bank system or through something else is another question.

Senator SPARKMAN. I was going to ask you the same question on the Home Loan Bank Board.

Secretary KENNEDY. I am sure in one case it should be done. Whether it would help or not I am not sure yet.

Senator SPARKMAN. That is what I was going to ask.

Secretary KENNEDY. I would like to discuss that with you in more detail some time, because I know your interest, and I have a tremendous interest in it.

Senator SPARKMAN. I am for either or both myself, because I think it ought to be established.

Secretary KENNEDY. Yes; I do too.

Senator SPARKMAN. Another question that Chairman Patman has asked each one of our witnesses before today—I understand he did not ask it today, but I want to ask it because I am concerned too—and that is the question on the One-Bank Holding Act. Both Chairman McCracken and Chairman Burns said that they were in favor of early action on the One-Bank Holding Act, in accordance with the statement that has previously been made by President Nixon. And the answer was in the affirmative. Do you have a position on that?

Secretary KENNEDY. I have a very strong position on this, Senator. We recommended earlier—in fact before becoming Secretary of the Treasury I felt action was needed in this field, and I talked to the

Treasury and to the Federal Reserve about appropriate and reasonable action to have it well defined as to what should take place. And we came up in the new administration with a recommendation, and followed through on it. I am not in favor of the legislation passed by the House. I do not think it is good legislation, and it should be changed. I think that it is not what we recommended, it is not what Chairman Patman himself recommended, and not what the committee itself reported out. And I think it takes away from the banks a number of traditional and effective services that are necessary and desirable in the kind of economic climate we have today and have had for years.

Some of the services they have had for many, many years, going back before our lifetimes, are taken out because of that.

Now, we do have a recommendation for a Presidential commission to study broad aspects of many fields here. I think there is a great need for this, because we need to study the flow of savings, the savings institutions, the questions of fixed rates, and what that has done to hurt us in some of these fields that are so important, such as easy housing, for example. We need to look at the competitive factors. So this would be a broad study.

The President, I would hope, will be able to have this commission appointed promptly. And I should think one area that they could look at could very well be their competitive factors.

I know Senator Proxmire has a bill on this as well. And I know that we have strong views on it. I would like to see their study.

I think that they can move promptly, and that legislation can be forthcoming even if it goes through that commission. If the Senate wants to move separately on it we will be prepared. But I should think that what we want in the end is very good legislation.

Now, with respect to what is happening in the interim, we have watched very closely to see whether there have been any instances where banks have moved into fields that would be prohibited by the House bill as it now is passed. We have seen none. We actually have seen cases where commitments were made before legislation was started. Yet the transaction was stopped because of possible pending legislation.

So I think there is an effective control awaiting action by the Congress of the United States in their field.

Senator SPARKMAN. I assure you I am very much in favor of that study. How soon will that commission be set up, do you know?

Secretary KENNEDY. I should hope within the next few weeks, 2 or 3 weeks at least. We will move promptly on this one, because it is timely and there are many areas that we should be taking a look at that might be helpful, and get some early answers on part of the problem rather than delaying to the end.

Senator SPARKMAN. There is one other thing that I feel I can assure you of, and I know Senator Proxmire will join me in it, that when we do take up Bank Holding Act legislation before the Senate Banking and Currency Committee we will go thoroughly into all of the facets and give it our own individual attention. And we are not wedded to any particular version, although I introduced—I believe I introduced a Treasury bill, the administration bill, and Senator Proxmire introduced one. And we may have others, I am not sure. But we will go into all facets of it.

Secretary KENNEDY. It deserves that kind of consideration.

Senator SPARKMAN. I would like to ask you just one more question. Recently President Nixon had a conference with representatives, officials of the National Association of Home Builders. I believe they came here from the convention that they were holding in Houston, Tex., and had a meeting with him. They came out of that meeting and went away quite reassured, quite optimistic. And, in fact, I believe he gave out a statement at that time that said that he was going to see to it—I am not quoting him word for word—he was going to see to it that the housing situation did improve. And, I believe, he indicated that he was going to see that more credit would be available for the home mortgage business. Now, you may have answered this already, I do not know. But just how does he propose to make more credit available to the mortgage market?

Secretary KENNEDY. I cannot give you the precise answer, Senator, on this matter at this time. The President has directed that we come up with a program to assist in the housing field. Part of it, of course, has already been covered here with respect to the Government side and the home loan banks, the FNMA, and the secondary markets. The other areas may require some legislation. But we will be forthcoming on that.

Senator SPARKMAN. I am glad to hear you say it. And I hope that everything that can be done will be done, because it is suffering. We are less than half of our anticipated goal, as Senator Jordan brought up, and not only our anticipated goal, but a goal that is written into the law, a national goal. I believe last month's housing starts were down to a longtime low of 1.1 million.

Secretary KENNEDY. 1,166,000.

Senator SPARKMAN. We ought to build more than 2 million this year. I realize the difficulty of reaching that goal, but certainly we ought to keep aiming for it.

Secretary KENNEDY. We should move in that direction. And even with our period of tight money and period of inflation control we can do something to move in that direction.

Senator SPARKMAN. We will not solve the problem that recurs every time that we have a money crunch unless we do something that will assure a better allocation of available credit to housing, to small business, to municipal and State governments, and to the farmers, the people who have to have credit in order to carry on.

I thank you very much.

Senator PROXMIRE (presiding). Congressman Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Secretary, this commission that you have described to Senator Sparkman, is that going to be just a one-bank holding company study?

Secretary KENNEDY. Oh, no. That is a very broad study, covering the whole savings flow of funds and administrative setup of the supervisory agencies, getting at some of the questions Senator Sparkman was directing on how we go through this. But we have to bear in mind that you cannot control inflation without slowing down some demands. Otherwise, if you put the money out for all uses you will not have a reduction. So somebody has to slow down in an inflation control period.

Representative MOORHEAD. Would it be possible. Mr. Secretary, to have the commission break out the one-bank holding company issue and issue a report on that as chapter I before a complete study is made? I am afraid this is going to be delayed too long if we wait for a complete study.

Secretary KENNEDY. We have not defined the metes and bounds in terms of reference to the commission precisely. That will take some doing once we get the chairman of the commission. But it makes some sense, in my judgment, just thinking aloud with you for a moment, Congressman Moorhead. There are some areas we would like their judgment on as early as possible to see if there is anything that can be done now in some of the areas of savings flows, rate structures, plus the one-bank holding company matter. We would like to get action as soon as we can on that, and then have the commission devote its attention in the second phase to the broader, longer range, which might take a year or a year and a half. But in this calendar year there are many thing that I would like to have their judgment on as soon as possible, if we can get it.

Representative MOORHEAD. Have you asked Senator Proxmire or Senator Sparkman to postpone action on the one-bank holding company legislation until the completion of this study?

Secretary KENNEDY. I have not.

Representative MOORHEAD. Do you recommend it?

Secretary KENNEDY. There have been discussions with them telling them about the commission. I have not participated personally. We have not asked them to withhold. It makes sense to me that they know about what we are doing and take that into account in the time frame of their judgment as to what should be done.

Representative MOORHEAD. Mr. Secretary, in your testimony you talk about the heavy strains on the labor and product markets. I know that total industrial production has been declining each month since July, that the utilization rate, according to the Council of Economic Advisers, is down to about 81 percent now. This leads me to come back to what Senator Sparkman was saying, that maybe you have actually broken the back of this inflation thing, but that you should be going out and preaching from the rooftops, persuading both the unions and the businessmen not to ask for increases in anticipation of further inflation, you persuading them that they will benefit by holding the line, and that there is no need for increase because of future inflation.

Secretary KENNEDY. I think that it is important now that we make very clear what is happening in the economy, so all can see what these indices are doing, so that they can take this into account. And I have been trying in a number of public addresses and in private discussions with small groups to cover this very clearly. That is as far as I have gone. And, I think, if we could get this message across clearly, that the policies are working—that the various indices are showing the direction that we have been working for over this long period of time, as a result, now is the time for them to take a look at their own best interest. Many I have talked to are taking a look and revising their plans, and changing them. Because in the end if they made decisions that are the basis of continuing inflation at an escalating rate, we can have some serious problems.

Representative MOORHEAD. I urge the administration to do a good portion of that.

In your testimony you talk about investigating tax avenues which might help equalize our competitive position relative to exports with other countries. Is this a value-added tax, or something else that you have in mind?

Secretary KENNEDY. Well, this is not an immediate action. We are studying the various ways in which we can make our tax system reflect a position that will give us competitive quality with other nations. Value added is one way in which to do that. I think in the immediate time frame there is not much likelihood for much of a change there. But that is an important thing that has to be done. And through our tax efforts we are doing it. There are some technical ends that we have been working on that we might be able to help a little with, but these would not be major changes.

Representative MOORHEAD. Do you want to comment, Mr. Volcker?

Mr. VOLCKER. This question of value-added taxes, of course, has been in the background for a long time. But apart from that there is a question of whether the actions of our tax system, which provides the earnings of a foreign subsidiary which are deferred in terms of tax payments to the United States, present a really equal and equitable situation as compared with the American exporter that pays his taxes right away. If he goes to manufacturing abroad, he gets them deferred. And this is one area that we have been looking at quite intensively.

Representative MOORHEAD. This encourages him to employ foreign labor.

Mr. VOLCKER. Precisely, and produce exports from some foreign country other than the United States. And so this is an area we have been looking at very intensively, and it may even reach the stage where we can report a recommendation to the Congress.

Representative MOORHEAD. I hope so. Because I have been aware of that problem for some time.

Mr. Secretary, I hear rumors that the Treasury is considering increasing the minimum for Treasury bills from $1,000 to $5,000. Since the ability to purchase bills at 7½ and 8 percent is one of the prime ways that the small savers have been able to protect themselves against inflation, wouldn't this be a very discriminatory thing against the small person for the Treasury to do?

Secretary KENNEDY. This presents somewhat of a problem for us, Congressman Moorhead. A Treasury bill is not a very good savings instrument. It is a 90-day or a 6 months' bill that has to be rolled over. There is a very large cost involved in this, either to the holder or the buyer—that is, the saver—if he goes through the market mechanism, because they are charging a service fee. In many cases it reduces the effective yield substantially. It also increases the cost to the Treasury by a substantial amount.

But the Treasury bill is a flexible instrument. It is a money market instrument per se, and one for a large major use of funds. We have not made any conclusions on this as to what should be done. It reflects largely the higher interest rates, and the fact that they can come in and get these bills each week, or on maturity a new issue, at the average price.

We have looked at it very carefully, and we are getting more figures to analyze to see what the real effect is. The amounts are not very large, actually, in total. It is a question of the large numbers of items, and it has been growing. But as Treasury bills have moved down in yield recently, this might be an academic question.

Mr. VOLCKER. It has moved down about 1 percent in a month or so.

Secretary KENNEDY. About 1 percent.

We are studying this. And I recognize the problem you are talking about. There is no intention to discriminate against the small saver. One of the problems, of course, is that the savings institutions are bound and fixed by artificial rates, and so savings tend to go into other areas.

There is a market risk in some of these securities which the saver is buying. We decided in the last financing operation of the Treasury on marketable securities other than bills not to change the denomination at that time. The pressure for change is coming from the savings institutions that can see that disintermediation is affecting the housing business whereby savers are pulling their money out of the savings and loans, the savings banks, and commercial-bank savings accounts and going into this kind of an instrument.

And that is putting more pressure in these other fields. We are looking at it.

Representative MOORHEAD. Mr. Volcker, in your testimony, you talk about the diversion into the Eurodollar market of a sizable, but unidentified, amount of funds that might have been employed in the United States. You say you cannot identify them. Is a large portion of that from the United States flowing out of the United States to the Eurodollar market, or is it foreign money going into the Eurodollar market? Can you identify it?

Mr. VOLCKER. I think this can take a variety of forms, Mr. Moorhead. And I cannot give you a very good answer, because you can't identify it. There unquestionably was some money which went out of the United States, was deposited in the Eurodollar market, and then was in effect reborrowed by American banks.

Now, most of this outflow unquestionably took place in forms that are not picked up by our reporting network. And the best evidence we have for it quantitatively is a very indirect form of evidence, that the errors and omissions item in the balance of payments is very unusual and unprecedented negative item in it.

And on the basis largely of analysis and trends in that figure, as well as the other evidence which is available, the estimates are that perhaps as much as $2 billion might have been involved from the United States. I do not know whether that is a fair figure or not.

All the evidence is indirect.

I think unquestionably that apart from this money from the United States abroad, there has been some short-circuiting or shortstopping of flows that might otherwise have come to the United States in another form.

Just out of the operations, for instance, of a large international company, they keep higher balances in London, let us say, in the Eurodollar market than they normally would because the rates are very attractive, and that money otherwise might have been lodged in

New York and appeared in another account in the balance of payments.

Well, instead it stayed in London, and the American banks got it through that channel. And some money that otherwise might have come into the American stocks, for example, is attracted by the higher rates in Eurodollar market.

Representative MOORHEAD. What are the rates in the Eurodollar market?

Mr. VOLCKER. Well, they have come down. In the past month or two they are roughly 9½ percent, as I recall now. But during most of last year, I guess, they were above 10 percent, and hit 11 or even 12 percent in some mature areas for a time last year.

So this was a highly attractive place for people to put their money.

Representative MOORHEAD. Is it true that some U.S. banks are borrowing in the Eurodollar market to satisfy their demands for loans in the American market?

Mr. VOLCKER. Yes, we do have figures on that. That is very clear.

Representative MOORHEAD. I would be interested in those figures.

Mr. VOLCKER. Well, as I recall the figures, they increased their borrowing in the Eurodollar market for use in the United States, apart from what they borrowed for use abroad, by roughly $7 million, as I recall it, over the first half of the year. Since then it has been fluctuating up and down at a very high level in the general range of $14 billion in the form of these borrowings of their own branches from the Eurodollar market abroad.

So it has been maintained at a very high level in recent months. But most of the increase was in the first half of the year.

Representative MOORHEAD. The rapid increase—the rate of increase has slowed down or stopped now; is that it?

Mr. VOLCKER. It has bounded up and down considerably from week to week or month to month; it came down at the yearend, went up again a little, and then came down. But it has fluctuated between $13 and $15 billion roughly since the middle of last year.

Representative MOORHEAD. This device circumvents some of the impact of our restrictive monetary policy, does it not—I understand we have no legal control over this activity—should we change the law so as to retain control?

Mr. VOLCKER. The Federal Reserve did change the regulation during the course of last year so that at least the marginal borrowings in this market had a reserve requirement, which increased the cost of this money. You can get into very rarified theoretical discussions of just what impact this has on the supply of credit to the United States as a whole. My own judgment would be that it does not really hamper the ability of the Federal Reserve to maintain an overall control on the credit supply in the United States. What it does is affect the allocation of this credit to some extent. The banks that are large and aggressive and have access to this market can attract in a sense a larger piece of the pie than they otherwise would have been able to.

Secretary KENNEDY. At a cost.

Mr. VOLCKER. It so happens that these are the same banks that tended to lose the most in the reduction in CD's. And it is an extremely high cost that they paid to attract these Eurodollars, largely in replacement.

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Now, whether this is good or bad in the context of overall credit policy depends a lot upon circumstances at the time, and what those particular banks were doing with the money. And one's perspective on this shifts, depending upon just what you are trying to accomplish at a particular time.

Representative MOORHEAD. My time has expired. Thank you.

Representative REUSS (now presiding). Senator Proxmire?

Senator PROXMIRE. Secretary Kennedy, in connection with the one-bank holding company legislation I just wanted to make sure I understood. You said that you have made no recommendation on action on legislation. To the best of my knowledge that is correct; no recommendation has been made to me, at least by you or any member of the Treasury Department. You are leaving this up to the Senate committee to act without recommendation at this point in terms of whether we act or not?

Secretary KENNEDY. We wanted you to know, and the Senate to know, that there is a commission, and they we will be looking into it further. We will be willing and able and ready to proceed with it whenever it is appropriate to do so.

Senator PROXMIRE. Last March you had made a very vigorous and forthright statement about the great necessity for this legislation. You also said, "I strongly recommend prompt and effective action."

Do you still feel that prompt action is a desirable thing in the light of the commission proposal?

Secretary KENNEDY. I think my definition of promptly would extend into this calendar year. I think that——

Senator PROXMIRE. Then the legislation dies.

Secretary KENNEDY (continuing). I mean effective—well, sometime during the year we could move on it. I am more interested in good legislation that bad legislation and, as I indicated, I think that the bill passed by the House is not good legislation.

Senator PROXMIRE. I understand you oppose that?

Secretary KENNEDY. Right.

Senator PROXMIRE. And certainly it is a highly controversial bill. But the difficulty is that if we do not act this calendar year, and then the legislation dies, and we start all over again next year, there is a feeling that we are postponing something which you properly characterize as being urgent?

Secretary KENNEDY. Well, the urgency of the thing, as I indicated in answer to a question by Senator Sparkman, was that we wanted to get the action started on this to preclude holding companies from moving into unrelated banking activities. And this has been effectively stopped.

Senator PROXMIRE. Of course it has been stopped, because the whole bill is pending.

Secretary KENNEDY. Right.

Senator PROXMIRE. If the House bill dies you could have a different situation.

Now, let me ask if you will correct my impression if it is incorrect. I get the impression from you and from the other witnesses we have had before us that the administration feels that housing will generally just have to wait for relief until we can turn around inflation.

that the only really significant way to help housing is to stop inflation so that interest rates can begin to come down. I do not hear any big and specific program for helping housing short of that.

Secretary KENNEDY. That is precisely right. We can improve and help, but we cannot get back to the level that would be implied by the national housing goal.

Senator PROXMIRE. This does represent a difference between the Congress and the administration, because, on the basis of the legislation we have passed, providing $4 billion more for the Home Loan Bank Board, and more in many other areas, I think it is clear that the Congress is very anxious not to have to wait for that. We recognize that somebody has to suffer for inflation. So that somebody seems to be housing in a big way.

You are familiar with the study by Governor Maisell showing the credit crunch in 1966—that although housing represented 3½ percent of the GNP, it suffered 70 percent of the total national economic cutback emanating from that credit crunch?

Secretary KENNEDY. Disproportionately; right.

Senator PROXMIRE. It seems highly disproportionate now, so we ought to see if we can do something to get resources moving out of these other areas which are inflationary and into housing, and not have to wait for years.

Secretary KENNEDY. Also it is a question of the amount. And we have to turn the corner and improve the general housing picture.

Senator PROXMIRE. We have been trying all week to get some response from administration spokesmen on the question of the budget, the size of the budget surplus. It seems to me that all of a sudden a $1.3 billion surplus is a responsible fiscal action, an action which will tend to abate inflationary pressure. Is this more responsible than the actual budget surplus in 1969 of $3.6 billion?

Secretary KENNEDY. It is on top of that surplus. It is a continuation of surpluses now for the 3-year period, which turns from very large deficits. And I think in that light that it does have some effect. I would not say that it is more.

Senator PROXMIRE. You are, I think, the outstanding expert in the country on the unified budget; you are more responsible for it than anybody else; you headed the Commission. If you had not done that you would be coming up with a $7.3 billion deficit and the whole country would be talking about the fact that we have a deficit, because we operated on the administrative budget, and as you point out now that is in excess of $7 billion on the whole. Now, this unified surplus does seem to be one that is about as tenuous as a surplus can get. In the first place, you have indicated that you expect and you assume that interest rates are going to fall in the coming year, and that therefore the cost to the Treasury of interest will be not as great. The budget contains a series of cuts that would seem to me to have little chance of passage, such as cuts in impacted-aid areas—which I agree with, but which I do not think is going to have much support in Congress—a cut in the school milk programs, with which I strongly disagree, and which I hope will not have much support.

Secretary KENNEDY. You wouldn't be from Wisconsin, would you?

Senator PROXMIRE. So with the conservation payment, and the 6 months' delay on Federal pay, it seems to me that all these things are pretty unlikely to come to pass.

Furthermore, on the sale of mortgages, et cetera, we had from Mr. Burns the notion yesterday that this sale might not take place if interest rates continue to be high, and if this would aggravate the situation. Of course, he does not have control over it, but that was the opinion.

Mr. Mayo said pretty much the same thing. And he pointed out that the reason we have this sale of mortgage assets this year is because last year it was felt that if the mortgage assets were sold in large amounts that it would aggravate the tight credit situation. So that this could very possibly be postponed.

And then, of course, if the economy fails to pick up as you anticipate in the second half you are going to lose your revenue, especially from corporation income taxes.

So that it would seem to me that all these considerations would suggest that you need a much bigger cut than $5 billion in the military budget if you are going to have a balanced budget.

Secretary KENNEDY. I think we have to continue our efforts on the military and the other budget items. We accept the efforts that have been made in the President's budget. And that seems to be all that could be done in the time frame that we had. But it is a continuing process, and an everlasting process.

The budget totals always are subject to question on both sides. The revenue side is difficult to estimate. You have fluctuations when you have a change of the economy as we have now. We think our revenue estimates are good, credible. But in a budget of this size you are entitled to some margin of error in this kind of an estimating process.

First, you have to go to the GNP estimate, and then you have to make a lot of assumptions. And there are tax bill changes and everything else to work into this revenue estimate.

On the expenditure side we do have a number of items. The budget is always a planning document, a document that would show the President's programs priced out so that you could see them. And that will not necessarily turn out precisely, the same as a corporation's budget, when you start to relate that to actual expenditure in a given time frame.

Now, we have made substantial cuts. We have cut not only in defense but elsewhere through the budget—in space, for example, and in many of the other programs, even some of the Treasury programs, which are very difficult to cut, because they are an operating department. But we have done that. And we will have to continue in that effort, because it does not stop. It is a continuous thing.

Senator PROXMIRE. I wonder if you could address yourself to another item, Mr. Secretary. A number of highly competent people have called my attention to the fact that uncontrollable spending has increased sharply. And when Mr. Mayo appeared he showed us that we had another breakdown, indicating that we have an unusual proportion of uncontrollable expenditures. The administration has recommended contract authority for mass transit, which is an excellent program and one we all support, but once again this would take it out of our control in the future if the contract authority is agreed to.

And it seems to me that, while it is a good program, it has less priorities than, say, housing, which we attempted to put under the housing authority.

What can we do to get this uncontrollable spending under control so that we can have an effective fiscal program?

Secretary KENNEDY. The long-range projections in the budget in part were for that purpose, Senator. But we have to take a look at these programs that are already on the books and see if we can work through some of them. And they are not easy to reduce.

Senator PROXMIRE. Is there anybody in the Government who is working on this particular problem?

Secretary KENNEDY. Yes, there is. There is a whole group in the Treasury and at the Budget Bureau trying to come up with some answers here.

Senator PROXMIRE. Are they going to make a report?

Secretary KENNEDY. But most of these, when you say uncontrollable, are in the legislation. And you can do nothing about specific items, because they are already set there. But you can keep the process from increasing.

Senator PROXMIRE. Exactly. And you in the executive are the principal initiator of legislation; we rely so heavily on your recommendations.

Secretary KENNEDY. Yes.

Senator PROXMIRE. I would hope that you could give us some indication of how we can act to reverse this situation to prevent uncontrollable expenditures from increasing as they are.

Secretary KENNEDY. Every advocate of a program would like to have it so that the Congress does not have to take a look at it from time to time and go through the difficult process of justifying it. And they would like to get it outside of the budget completely if they could. We are trying to find ways to prevent this.

I think that this is a task that we will have to continue. And we are very much aware of this. This is one that we are working on.

Senator PROXMIRE. Thank you. My time is up.

Representative REUSS (presiding). Senator Percy?

Senator PERCY. I understand, Mr. Secretary, that Congressman Reuss has already mentioned, and I appreciate very much his thoughtful comment, the work that I have done on the military balance-of-payments problem.

Secretary KENNEDY. Yes.

Senator PERCY. I would like to state unequivocally that the cooperation, support, and help that I have had from the Treasury Department, from you personally, and from Under Secretary Volcker, has been deeply appreciated. Whatever progress I have made in this effort at NATO, and particularly with the German Government, has been largely attributable to the technical advice and counsel and encouragement that I have had from the Treasury.

It is encouraging to note that in your statement you say: "We are seeking a more equitable distribution of the burden of mutual defense expenditures." Yesterday Dr. Burns called for an adjustment in the military balance-of-payments burden between the United States and our NATO allies.

I am happy to report that all three German political parties in a conference 2 or 3 weeks ago seemed totally in accord that something was going to have to be done to accept burden sharing. So that now it is not just a question of balance-of-payments adjustment and offsets. Chairman Burns yesterday mentioned how unsatisfactory the loans have been. Real burden sharing must now be accepted as a principle.

My questions are two. There is a job of coordination within the administration itself, because there are differing points of view about NATO costs. What one agency will have the responsibility for coordination of the administration policy that Congress can look to?

Second, I am not wedded to any particular plan or scheme. I just am wedded to the principle that Europe must start to pay more of the cost of NATO defenses which are for the mutual defense of all of us. Will the Treasury continue to try to devise a better plan, or do you feel that the plan that I have presented with your support is the best plan?

Secretary KENNEDY. As you know, we are very much interested, and are working closely with you and others on this. We are having discussions with the various interested parties in the Government, State, and Defense. And I pursued it abroad when I attended meetings of NATO myself. We have talked about it in our bilateral discussions with the nations involved, particularly Germany. We have not a specific plan, as you have not, to where we have metes and bounds and complete definitions. I do not think we have reached that stage. But we are getting an awareness of this problem, and it is improving. And I think the discussions we have had helped with that.

Senator PERCY. Would it be logical to begin burden sharing, maybe having the German Government assume the cost of the hiring of German nationals by us to help man our bases and offer the kind of services to our forces that are needed? I understand that cost is about a quarter of a billion dollars. Shouldn't the Germans assume the cost of construction of buildings that are going to remain in Germany; to assume the burden of cost for supplies that are purchased and used in Germany; for transportation costs that we really pay to the German Government; for public utilities costs that we pay again to German Government-owned public utilities companies? It seems that those costs can be most readily assumed and taken over by the German defense budget, which is less than half of our own. This is not an undue burden, considering the defense that they receive through mutual cooperation with the United States.

Would those be the beginning points, at least the easiest items for them to assume the cost of? Those items would have great appeal here.

Secretary KENNEDY. There are many items that are identifiable. You have named some that are significant. The broad problem is to get an acceptance of the principle, and to get budgetary acceptance of that by the Federal Republic. Then I think it would not be difficult to pull out a number we can document.

Senator PERCY. As I understand it you would concur that the offset loans, about a billion dollars worth, half of which have been called now, and the others are due and payable sometime, are not a satisfactory arrangement for having an offset? Isn't this a temporary situation, just simply delaying facing up to a real cost that must somehow be met?

Secretary KENNEDY. It has more balance-of-payments implications. And that varies the timing. When it is withdrawn it is just the other way. It does not affect the cost. The burden of the cost is not taken into account there.

Senator PERCY. I would like your comment on productivity in industry. I have been concerned about Congress taking away the investment tax credit. That seemed to be the only way that industry could really, by investing in capital equipment, increase productivity and meet some of the wage demands that have been imposed on industry. Otherwise industry has to meet such demands by simply passing them on in higher prices. I just hope the result is not going to be too severe. Is the Treasury working on proposals, however, to increase productivity; namely, by revised faster depreciation schedules which will more realistically take into account the cost of replacing equipment?

Secretary KENNEDY. We are taking a look at the whole corporate area. We will not have, perhaps this year, recommendations in that field. We went through the effort last year successfully of getting tax legislation through. I have had a number of discussions with the House Ways and Means Committee. It seems to me that this would not be the year to do it. But this is a problem in the corporation tax field. I highlighted it at the time, and I felt strongly that the investment tax credit should be ended, for various reasons which I will not go into here now.

But I recognize at the same time that there are other things that should and must be done to offset that in part. The question, of course, of productivity goes much deeper than just the tax question. And that is one that could help us very much as we go through this adjustment period, if we can get more productivity per unit of labor in our various companies, as you well know from your experience in your own company. This is one area that is being looked at and studied to see if anything can be done.

Senator PERCY. Do I understand correctly that this is being worked on, but that there is no schedule or time schedule yet established for the release of any revised schedules?

Secretary KENNEDY. That is right. There is no time schedule. The staff, as you know, has devoted itself entirely to the tax reform bill. And we are now writing regulations and interpretations, and so on. But they have started actual work in this field.

Senator PERCY. Is there any kind of target that you are working toward by which time you would like to have a revised schedule that would be more realistic?

Secretary KENNEDY. This year sometime. But not for legislation. I do not think it would be possible.

Senator PERCY. Does it necessarily involve legislation? Are there things that could be done within the jurisdiction of the executive branch without further legislation?

Secretary KENNEDY. Yes, there are. Whether they should be done is a question of what we can recommend. And that has to be looked at.

Senator PERCY. In your statement you state that the public debt ceiling does not really have much rationale as a deterrent to spending. Yesterday Chairman Arthur Burns testified that he favors a tight, rigid, congressionally imposed expenditure ceiling. Do you favor a rigid expenditure ceiling without escape hatches, and do you feel that the work that we did in the Congress a year or so ago requiring a $6 billion cut, coupled with the tax bill, was a constructive, helpful thing to this administration in keeping a tight budget as you have?

Secretary KENNEDY. Well, if I can give my personal opinion on this, I think that we need discipline somehow through the congressional process which will take into account the receipts and expenditures side. One of the methods that was used was the expenditure ceiling.

I think there are imperfections in it, in that uncontrollable items always present a problem. If you put controls on the Congress and not on the part of the executive you have difficulties. I know the problems that Mr. Mayo runs into. But I think we must have a consciousness in this field. I believe the ceiling should be continued in some form or another.

Senator PERCY. Lastly, we know that we need to stimulate exports. It is certainly in the national interest to do so. And one of the best ways to do that will be to get inflation down in this country and get our prices competitive abroad. But, while we are working on that, I believe that simultaneously Assistant Secretary Cohen is working on tax incentives. I am reluctant to always use the tax system for every social and economic end. But on the other hand it does motivate people to do things.

Do you foresee any changes in the foreseeable future that would provide adequate tax incentives to stimulate exports, and if so, is there any insight that you could give us as to what form those might take?

Secretary KENNEDY. That is an important area. We are looking into it in both the long run and short run to see what can and should be done. Mr. Volcker referred to one area where we may be able to come up with something fairly soon which will help the exports from this country rather than having the corporations use their funds abroad to produce and expand abroad.

We have not come up with a full incentive program on tax preferences for this purpose. I would not know what form that would take at this time. I think the most fundamental thing, and the one that worries me most of all, would be to have our tax system where it would be competitive with the now almost uniform Common Market tax system which uses the value-added tax. This gives them a great advantage over us. This is a longer run thing, and it will take a lot of communication and a lot of work on the part of our staff. I would be in hopes again that we could have a pretty clear-cut position on this and work toward legislation next year.

Senator PERCY. Thank you.

Mr. Chairman, I would just like to express once again my pride in a fellow Chicagoan coming onto the scene in Washington and making such a fine contribution to the Government. I think an outstanding job has been done in the area of budgeting. I am particularly encouraged with the efforts that are being made now to realistically say this is what we can do to help in the world, but not take it over. We have got a big job to do here at home, and we have to reassert that our No. 1 priority is nationbuilding at home. We must solve some of the pressing problems that we have here, our racial problems, our problems of urban life, and the whole quality of life in America, and I think your contribution to this with fiscal responsibility, yet with a high emphasis on humanitarian programs, is in the best tradition of everything I have known concerning you in private life. You are certainly carrying that tradition on in public life.

Secretary KENNEDY. Thank you.

Representative REUSS (presiding). I would say that the best way to keep our leadership in the United States of America is to maintain our credibility at home, govern ourselves well, set our national priorities right, and create a society of true equality and true justice right within the confines of our continental limits. That will give us the right to lead in the free world.

Mr. Secretary, I will not detain you and your associates very long. I do have a few more questions. I wanted to clear up in my mind your position on the one-bank holding company bill you responded to Senator Proxmire's question on.

As I understand your position, it is that you still believe, as you did last year, that prompt action on one-bank holding company legislation is necessary and desirable, but that you construe the word "prompt" as meaning sometime in this current calendar year of 1970. Did I hear right?

Secretary KENNEDY. I think that is right. I would be in hopes that if the Senate wants the Commission to take a look at this specifically they can do so within a relatively short time. Because a lot of work has been done, and there are a lot of facts available in the supervisory agencies, and we have a tremendous input to the Commission that would be helpful. I think it can be done.

Representative REUSS. I am glad to hear you say that, because I too think that the Congress ought to fish or cut bait on the one-bank holding companies this year.

When you say that promptness means this year 1970, that means that you do not consider it necessary to wait around for the deliberations of the Commission on Financial Institutions—obviously the members are not even appointed yet and they cannot complete their deliberations in time for Congress to consider them this year.

Secretary KENNEDY. I would not agree to that. I headed a commission that did complete a report and finish it in 6 months. If you take one facet of this, they could probably do it in 2 months. So I do not think it is an impossible task. This Commission will be appointed promptly. And if in this discussion and in their studies they should find some great difficulties in this, I would not have any hesitancy in having it go over to another year, in the interest of good legislation in this field. I am not pushing that way. I want good legislation in the end, not just within a short time frame.

Senator PERCY. I would like to indicate that I think it is most important that we have the right legislation.

Secretary KENNEDY. So do I.

Senator PERCY. And when we have as much confusion about it as we have right now, and we are not sure what the implications of it might be, I think there should be prompt appointment of those who are to study financial institutions, and that they should be told that there is a sense of urgency. They are all going to be honorable people.

They do not have to be educated as to the nature of our institutions. We should put them to work as a highest priority on this particular problem to see what they can determine will be the impact, so that they can give us some sense of guidance better than we now have. I would hope that we could get that Commission underway very promptly.

Secretary KENNEDY. I think within the next 2 or 3 weeks.

Representative REUSS (presiding). That would be close to the end of March. Do you really believe that this Commission can be appointed, take office, hire a staff, and make its preliminary reconnaissance? Bear in mind that the President's terms of reference are as broad as our whole financial structure, all financial institutions, all regulatory matter.

Do you think it could report back in time for the U.S. Senate to start its consideration of bank holding company legislation and get it out and passed and on the Senate floor, and in a conference with the House, and then each body act on this, in a Congress which, because it is an election year, is inevitably going to adjourn sometime in late summer or early fall. Does this really seem realistic?

Secretary KENNEDY. Based on my experience at the Budget Commission, we could do it. I think it can be done.

But I again want to emphasize that I think it is far more important to have good legislation than just to have a bill passed.

Representative REUSS. Except that last year you were before the Banking and Currency Committee saying that it was imperative—and I agreed with you—that we do something about one-bank holding company legislation.

Secretary KENNEDY. I feel that way, and it is so stated in my testimony.

Representative REUSS. I cannot understand why you are willing to see the issue hang on beyond this Congress when it would have to start anew in the next.

Secretary KENNEDY. I said, Congressman, that, we would like to have action taken promptly. And by "promptly" I meant this year. I think the Commission could act. It does not require basic research or a great deal of additional provision of facts. It takes analysis and study and determination. The issues are pretty well identified. It might even take them a long time to run through the past confusion of the thing, but it is not important now to do that.

Representative REUSS. I guess what I heard was that you think there should be one-bank holding company legislation this year, and that is what I should get from this colloquy.

On the subject of the gold agreement, Mr. Volcker, how much South African gold has been purchased through the International Monetary Fund since the agreement was signed last December?

Mr. VOLCKER. Approximately 100 million in the month of January. I do not think anything had been published since then.

Representative REUSS. What part of that IMF gold purchase, if any, has palmed off on the United States?

Mr. VOLCKER. None.

Representative REUSS. So far?

Mr. VOLCKER. So far.

Representative REUSS. On whom have they palmed it off?

Mr. VOLCKER. The IMF is just holding it. The procedures by which this might be redistributed have not yet been determined. And just when it might be done—presumably at some point they might want it to be distributed.

Representative REUSS. Somebody said that the December 30 South African agreement was entered into because somehow or other it reinforced and made stronger the commitments of the various countries to the two-tier gold agreement of March 1968. I do not know whether you said that, but somebody did. I have searched the wording of the December 30, 1969, South African gold agreement, and I cannot find a word in it which imposes any obligation on the part of any country to abide by the two-tier agreement of March 1968.

I have a copy of it here.

Mr. VOLCKER. I think you probably did not find the kind of wording you were looking for, because the IMF decision itself was directed toward the very specific problem of handling South African gold in these circumstances. But I think it is quite clear from the context of that decision, and the undertaking of the members of the Fund, to not deal directly with South Africa, that the whole decision is based upon and developed in the context of the two-tier system, and what it means, in my judgment, is that the two-tier system, which grew out of a crisis one weekend in March 1968 with very wise action taken by a limited group of central banks——

Representative REUSS. A group, however, which was very large, as your predecessor Demming used to report to us, so that almost all the major countries—except France and South Africa—were adhering to it, some 30 countries, I think he said, on the dotted line.

Mr. VOLCKER. Precisely. The decision made at that time was communicated to other countries, and with very rare exceptions other countries conducted themselves in accordance with that general policy. I think at that time the question of what to do with newly produced gold was not on the top of people's minds, and it had not been fully resolved. So we had a two-tier system established in a fairly informal kind of way, and it operated very effectively over a period of time. And we came to the point where the question of the disposition of the newly mined had to be handled one way or other.

The kind of an arrangement that was made with South Africa seemed to fit in with general desires. That was not a decision for the United States alone, although we obviously had an important interest in it. But we were looking for an arrangement that other people could accept and feel comfortable with too. And this decision does represent the first time that the IMF itself has not only acknowledged but incorporated into their practices and policies the two-tier system.

And I think that this—maybe it is only a symbol, but sometimes symbols are important too in the evolution of the system—I think that the two-tier system is now accepted as the normal operating basis for the gold market; it is legitimatized in all of the panoply of an IMF decision.

Representative REUSS. You say this is all accepted in the context of the December 30, 1969, South African gold agreement. Where is this set forth? And specifically, what country about to jump traces on the March 1968 two-tier agreement has been brought into line by the two-tier agreement?

Would you list those countries and refer me to language from their competent authorities which bind them? I do not think you can, frankly, but I would welcome some reassurance on that.

Mr. VOLCKER. What you have here, among other things, is a clear expression by the executive directors of the International Monetary Fund that in handling this particular problem they do not intend to deal directly with South Africa, that they have chosen to handle the problem of new gold production——

Representative REUSS. New gold production. But that is a drop in the bucket. What about all the gold that the speculators and hoarders have?

Mr. VOLCKER. That is why you do not see this language in the decision and in the related documents. This decision is directed toward new production.

Representative REUSS. Therefore, if there were defects in the March 1968 two-tier agreement, those defects still exist?

Mr. VOLCKER. The defect is not in the March 1968 agreement. The March 1968 agreement did not tie up this particular loose end.

Representative REUSS. It said that from now on there are going to be two types of gold, the 43 billion that is in the international monetary system, and all other gold. And so it was advertised and proclaimed to all the world that there was going to be blue-painted gold and all other gold. And now we suddenly find that this is not so, that we are going to let additional gold in—it could be a billion dollars of South African gold a year for 5 years.

I do not see any additional assurance by the 170 member nations that they did not give before.

Mr. VOLCKER. I can assure you that these other nations do not have the same view of it as you do. And perhaps the best evidence I can give you of that is that the one nation which did abstain from this agreement did so apparently on the ground, as they released to their press, that they resisted institutionalizing the two-tier system. I think they were quite right in their presumption as to the result of their decision.

Representative REUSS. So you got nothing. Before December 30, 1969, France was thumbing its nose at the two-tier agreement, and after December 30, 1969, France continued to thumb its nose at the two-tier agreement. What is so unusual about that?

Mr. VOLCKER. What we have is an IMF decision from which France has abstained. We had no IMF decision before.

Representative REUSS. I know. But what good is an IMF decision if France was not going to abide by the two-tier agreement before, and it is not going to abide by it now?

Mr. VOLCKER. A good many of our international monetary arrangements are based upon the impression that IMF agreements mean something.

Representative REUSS. I do not see anything in the IMF decision that says that a country has to abide by the two-tier gold agreement. I have got a copy of it here. Will you show the U.S. Congress where it says that?

Mr. VOLCKER. As I said before, and I will have to repeat, this decision does not pretend to encompass the entirety of the two-tier gold market, it is a decision related to the treatment of the new production within the context of the two-tier system.

Representative REUSS. It is a fact, is it not, that the signing of this agreement produced no new commitments from any country as to what it was going to do about the addition to monetary reserves of gold held by speculators?

Mr. VOLCKER. I am not sure I understand the question.

Representative REUSS. The two-tier agreement of March 1968 in effect tried to isolate the free market in gold by saying that central bankers would not become panicky, they would not get worried about the free market in gold if it went up or down, that would not concern them. And I think that is an excellent agreement, and an excellent decision.

Now, there is nothing that I can see in the December 30, 1969, South African gold agreement which causes any adherence to the March 1968 two-tier agreement that did not exist prior to December 30, 1969.

Mr. VOLCKER. This whole question and the whole need to deal with new gold production would not have arisen in the absence of the two-tier system, there is no question about this.

The question left open in March of 1968 was how to deal with new gold production. I do not think there is any question in any monetary authority's mind about this, that this question arose in the context of the two-tier system, and it got disposed of in this manner because this is the manner that seemed to be, as we made quite clear—and it is clear in my letter to the Fund—that we considered this consistent with the two-tier system, and that is why we felt that we could support this understanding.

Now, the only part of the decision itself which directly, I think, perhaps impinges upon or reflects the operations of the two-tier system in black and white is the part that as a matter of policy—and not as a matter of legal necessity—members generally do not intend to initiate gold purchases directly from South Africa.

Now, that is a characteristic of the two-tier system. This is not an understanding that countries would take outside that context.

Representative REUSS. That is chickenfeed, though. The big danger is the $15 or $20 billion in gold that is now in speculative hoarders' hands—or however much it is.

Mr. VOLCKER. The implication of this question is that they will buy from the speculators? They just agreed not to buy from South Africa?

Representative REUSS. Yes. So that they have a few words there about South African gold. But what about all the other gold in the world?

Mr. VOLCKER. All the other gold in the world is sitting there on its own, without central bank buying.

Representative REUSS. It is a fact, is it not, that the December 30, 1969, agreement, the text of which you have before you, does not in any way reinforce any commitments that the financial and monetary authorities of foreign countries may have made in the March 1968 two-tier agreement?

Mr. VOLCKER. No, we do not accept that. I think it does affect them, other than South African gold. Because this is based upon the premise, and that is clearly understood, that the other elements of the two-tier system are in place.

Representative REUSS. Where does it say that?

Mr. VOLCKER. It does not say that. You would prefer if we had started out, or the Fund had started out, with point 1, that all the rest of this is based upon the premise of the two-tier system.

Maybe we should have put that clause in there. We did not. But I assure you that it was a clear understanding in the executive board in considering this that this was the context in which the decision was taken.

Representative REUSS. The reason I find this whole business somewhat Kafkaesque is that here there was a perfectly good clear March 1968 agreement saying, because we will shortly have SDR's, we do not need to buy and sell any gold outside the international monetary system. It is perfectly clear, everybody understood it, except possibly the U.S. Treasury.

Now, having been unhappy with that, you suddenly are in seventh heaven about nothing, an agreement which does not have any language on this at all——

Mr. VOLCKER. Seventh heaven is not exactly my current status, for a number of reasons, Mr. Reuss. But when you tell me the March 1968 agreement was perfectly clear, that is simply contrary to the fact so far as to disposition of new gold production is concerned.

Representative REUSS. Everybody has his view. But the world generally, I put it to you, thought that the central bankers in March 1968, in the two-tier agreement, were saying there are two types of gold—there is blue-painted gold, which is the gold we have now got in the international monetary system, and there is all other gold, old mined, new mined, from the mattress, the sheiks of Araby, from the French, all types.

Mr. VOLCKER. I can assure you, as soon as I took office one of the first things the central bankers brought to my attention was, do not forget, we have not found out how to handle newly mined gold. But you do not have to trust me on this. You can go back to the September 1968 IMF meetings where there were discussions among central banks, and and with South Africa, as to how to properly handle South African gold in the context of the two-tier system.

You did not need these discussions, if it was all settled in March of 1968. It was not settled in March of 1968, so they had another discussion in September of 1968, which failed to settle the matter.

Representative REUSS. The mere fact that some central bankers suddenly realized that their March 1968 blue gold and all other gold agreement might hurt some of their nationals who had been speculating in gold, and they suddenly crawfished on that, and began to raise the question in banking circles, does not mean that the March 1968 agreement—and it is there for all to read—did not say from now on there are two types of gold.

Mr. VOLCKER. No. The March 1968 agreement did not say that. It said words to the effect that these central banks did not feel it necessary in the light of coming into being of SDR's to add to their gold stocks. That was true then, and it is true now. Nobody—certainly not the United States entered into this agreement with any feeling that the monetary system was going to fall apart if there were not any additions to the gold stock.

The gold in the IMF could be held in the IMF forever and ever as far as we are concerned. That was not the point of the agreement. And it is not at all inconsistent with the March 1968 understanding.

What it did was deal with a problem that had not been fully resolved in those 2 days that this matter was under discussion in March of 1968, and a matter that had been the subject of continuing discussion after March of 1968, which led to some formal discussions in September of 1968, which was brought to my attention shortly after I took office, and had been unresolved through the ensuing year until this decision finally resolved it.

Representative REUSS (presiding). Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Secretary Kennedy, yesterday Dr. Burns said that he favored a limited Treasury subsidy for 6 months in the Federal home loan banks to allow them to reduce interest rates on advances to member savings and loan associations as an aid to housing. This morning's Wall Street Journal has an article quoting the administration saying that a total of a 100 to 200 million was being discussed. How soon do you believe such a subsidy could be activated?

Secretary KENNEDY. I would hope that in connection with the housing problem we could have prompt—and by that I mean fast—action by the Congress in various areas. I think next Tuesday there will be some hearings before the Banking and Currency Committee. And I would be in hopes that at that time some of these proposals could be placed before the committee.

Representative WIDNALL. I hope it will be at that time, because this is a very important part of our economy and throughout the entire United States. By how much do you think that this type of subsidy could reduce interest rates to the banks currently running about 3.7 percent?

Secretary KENNEDY. I think it is more the matter of the availability of credit than the question of interest rate that we are trying to attack. And interest rates, of course, come into the question. But it is more a matter of finding ways to open up credit facilities and make credit available to the housing market.

Mr. VOLCKER. If I may add one point on that, in conection with this subsidy, Mr. Widnall, you mentioned their current lending rates. Part of the difficulty here is that as they continue to refund their outstanding securities, and given their need to cover their average cost of money, that the lending rates which you cited apparently will continue to be on the uptrend for some time. And any subsidy problem has to be considered in that context, and not only the current rate, but the increases that might be in store in the absence of a subsidy.

Representative WIDNALL. I understand that the government is exploring ways to gain better control of the financing of the Federal home loan banks and FNMA. What would be the objectives of such control?

Mr. VOLCKER. Would you repeat the first part of that question?

Representative WIDNALL. The Government is exploring ways to gain better control over the financing of Federal home loan banks and FNMA. What would be the objectives of such control?

Secretary KENNEDY. The question of control is the thing that worried me there. What we are doing is trying to work with the home loan banks and FNMA in the timing and the framing of their issues, so that from the market impact standpoint we can carry forward. I think in a very tight and difficult money market last year we were able to finance a large volume of their paper—at high rates, of course. But we were able to do that by the cooperation, not control, of the Treasury with that grouping. Because we have large financings of our own, we do not want the impact to hit all at one particular time. We have been working very closely with them.

Is there a question of control?

Mr. VOLCKER. No, that is why I had a question, because in the context of control, if that means limitation, I do not think it is correct. We are certainly interested in coordination. And we think that that is indispensable, or all of these agencies are going to be self-defeating in the market.

Secretary KENNEDY. And they can damage our own markets.

Representative WIDNALL. There is an article in the Wall Street Journal of February 19, 1970, that says:

> The heavy volume of borrowing by the Home Loan Banks in the Federal national market has helped keep funds flowing into housing, Mr. Burns testified. But the Nixon aide disclosed that the Administration is exploring ways to gain better control of financing of these agencies. This could take the form of an Administrative timing on their debt as well as a clear provision of statistics.

Wouldn't restrictions on their outstanding debt reduce the flow of funds into housing?

Secretary KENNEDY. I am not sure just what that statement is referring to. I made a comment here earlier that we are concerned in the Government and the Treasury with the financing of all the public facilities so that there is a coordination and handling of that in the best way.

Representative WIDNALL. The reason I was late in coming to this hearing today is because the Banking and Currency Committee in the House had several witnesses nearly to the same subject matter as we are discussing right now. And it was pointed out to us that the housing starts are going down to the lowest point in many years. How can we get some funds stimulated into new housing?

One other series of questions. Since mid-1965 the average maturity of the public debt has fallen about 1½ years, and now stands at only 3 years and 8 months. This means, of course, the Treasury must seek money in capital markets much more often even when the budget is balanced. Furthermore, short-term debt securities are much more liquid than long-term issues, and any increase in the liquidity would aggravate inflationary pressures.

I think we are all aware of that.

Why has the average maturity of the debt declined so drastically?

Secretary KENNEDY. Congressman Widnall, I have a chart here which shows the average length of the marketable debt of the United States. It shows the 3 years and 8 months to which you refer at the present time. And the line, if you could see it, is just down. It started to decline after actually reaching a peak in June of 1965. At that time it was 5 years and 9 months.

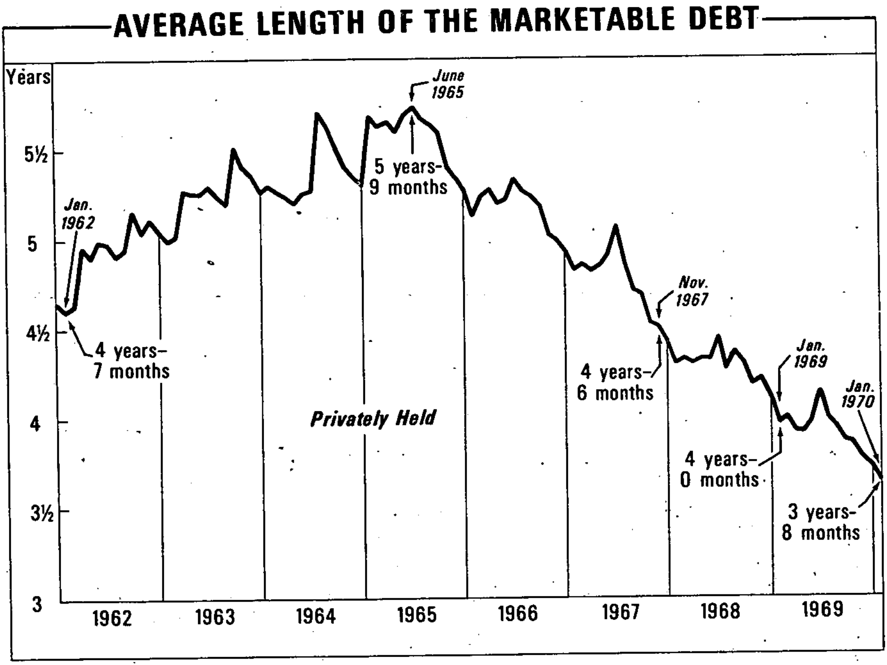
So it went on a roller coaster downward since that period. In large measure the problem in the early period was the 4¼ percent interest rate ceiling when most of the rollover maturities were put in very short term securities.

We paid the price of the fiddler on that in this period of inflation and credit restriction, because we have been held in the short term area by difficulties of the market. At the same time I think we have done all that we could do to extend the maturity of the debt within this period in each financing. We have offered a 7-year obligation, which we could do. Otherwise it would go down to where we would have the debt almost in a cash position.

It does add to liquidity and does cause problems. And I would like to put this in the record if I may.

Representative REUSS (presiding). Without objection it will be so ordered.

(The chart referred to for inclusion in the record at this point follows:)



Office of the Secretary of the Treasury
Office of Debt Analysis

January 27, 1970-6

Representative WIDNALL. How do the more frequent offerings of Treasury obligations affect the market? Do they unduly restrain the Federal Reserve in reaching its stabilization objectives? Of course, the Fed has to support the market at the time of large Treasury issues.

Secretary KENNEDY. There is no question but what frequent Treasury offerings have an impact on the market. And there is some market reaction even in anticipation of major Treasury issues, because dealers and holders of securities have to adjust positions in the contemplation and anticipation of the issue.

Now, last year we had a very heavy maturity schedule. At the same time we had cash needs, and did the largest volume of Treasury financing that has been done. And at the same time we had a large volume of the agency issues which are going to the market. In that period we are successful in finding buyers for the securities, various groups of buyers, without having the Fed come in and support the market because they were in a period of restraint and reducing reserves. We are fortunate in this. If we had gotten into real trouble in the market it might have caused an abrupt reversal of policy of the Fed.

I think it worked very well. Our efforts now would be to do our financing of the Treasury, plus the financing of the agencies, in a market that will permit the Federal Reserve to pursue the kind of policies that they contemplate for this kind of an economy.

Representative WIDNALL. I have two questions for Mr. Volcker.

World monetary reserves as a fraction of the annual world imports have dropped from 55 percent a decade ago to about 35 percent now. This fact alone indicates the need which SDR's are intended to satisfy for renewing the national reserve assets. However, the magnitude of the need implies that the present rates of SDR creation is rather low. For example, the amount of SDR's which will be allocated over the next 3 years is $9.5 billion. There is only about 10 percent of projected world imports over the next 3 years.

Gold transactions affecting the level of world reserves cannot be expected to make up the difference between their 15 percent and the healthy level of world deserves relative to the amount of world trade.

Do you believe that the rate of SDR creation is sufficient to meet world liquidity needs?

Mr. VOLCKER. I am much happier with it than I am without it, Mr. Widnall. You raised the question that we looked at very closely and exhaustively during the negotiations, on what the amount of SDR's should be. There are no precise or easy answers. This is a new area for everyone, in trying to make some judgments about what is adequate and what is not adequate.

I think we ended up with an amount of SDR's—and it was very desirable that we did so—that was far in excess of what the previous thinking had been, even at the beginning of 1969, let us say, where people were talking about 1 billion, and a few far thinkers were talking about 2; well, we ended up with a 3½ to 3 range, which represented a very considerable advance in thinking based primarily on the kind of considerations that you raise.

I think it is also fair to say that in arriving at that decision of 3 to 3½ billion of SDR's, there was a general feeling that the total need for reserves would be greater than that, or desirably should be larger than that.

And there was, I think, a conviction that most people share coming out of this exercise that the total need for world reserves would be larger than this 3 to 3½ billion.

On the other hand, there was a feeling, a natural feeling that you want to proceed prudently, cautiously and conservatively with the new reserve instrument, and that there may be some increase in other reserves assets, including reserve currencies.

So in this sense this was a compromise between different considerations. I think it is much more satisfactory compromise, and it is indeed a satisfactory compromise relative to the earlier discussion that would have led to a much smaller figure.

I think in terms of the whole history of this thing that has to be considered a bold decision, to move ahead with SDR's, and not in an experimental way, but in a way that is somewhat commensurate with needs, even though I would agree with you that the likelihood is that the world could usefully use a somewhat larger increase in reserves over a period of time.

It may well get it from a combination of sources.

Representative WIDNALL. Do you believe there is any such thing as an optimum level of reserves given a specified level of world trade?

Mr. VOLCKER. I think it depends upon more than that indicated. World trade is used as a kind of symbol of increasing international tranasactions of all types. I think there probably is an optimum level of world reserves, but identifying just what that is is the difficulty. We are groping here in a new area. I think there are definitely signs that during the late sixties we had a developing shortage. Hopefully, we will turn this around and at least assure growth more or less in line with the increase in world transactions, and fluctuations in the balance-of-payments positions, and all of the other considerations that bear upon this matter. But I cannot give you an exact answer. I wish I could. That would make the job very easy, determining how many of these were——

Representative WIDNALL. What I had in mind was, what implications does the final issuance of SDR's carry for the U.S. balance-of-payments policy?

Mr. VOLCKER. I think it has got a number of indirect implications. One of the difficulties with not having enough reserves, I think, is that you tend to get a competition for reserves among countries that is mutually frustrating. Everybody feels, as their own economy expands and as their external trade and investment expands, that they feel more comfortable with more reserves.

But you are not creating more reserves. You can only get them from each other. And this tends to lead to an effort to retain surpluses, to resist deficits, to bias your own accounts toward a surplus.

The United States tends to stand in a fairly passive residual position in this respect. And if everybody else is striving intently for surpluses in order to increase their reserves, it comes out of our hides, so to speak. And we feel very strongly that unless the increase in world reserves is reasonably adequate in terms of different nations' collective desires, the United States would find it very difficult to achieve the improvement in our reserve position that we need, or to end the deficit in our balance of payments.

And very frequently, of course, the increasing amount of SDR's in the world and their allocation to various countries provides us with an opportunity over the course of time to improve our reserve position

And like other countries, I think our reserve position should improve over time. And without an adequate new supply of world reserve, specifically in the form of SDR's, the prospect for us achieving the kind of improvement that we want in our reserves is not good.

Representative WIDNALL. Thank you, Mr. Volcker.

And thank you, Mr. Secretary.

Representative REUSS (presiding). I note that it is 10 after 1. And you have been very patient, Mr. Secretary, and your associates.

Senator Miller has a question or two. But I think we can finish up quite fast.

Is it agreeable to you to stay a few more minutes?

Senator KENNEDY. Very good.

Representative REUSS (presiding). Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Volcker, in your statement you said: "The dollar has been demonstrably strong over the past year. But this strength has rested in part on some transient factors."

And then the first transient factor you refer to is the demand for the Eurodollar. And then you say: "A second factor * * * is the fact that a new administration was visibly and directly grappling with our serious inflationary problem through the fundamentals of fiscal and monetary restraints."

I trust you did not imply that that would be a transient policy?

Mr. VOLCKER. No, sir. But all I meant to imply was that during a period in which prices were visibly still increasing, I think that it was clear to everyone what our intent was. They do not have to rely upon our intent when they see the fruit of these policies, which I think we will begin seeing this year in terms of a better performance on the price side, and the beginning of improvement in our competitive position.

Senator MILLER. But is it not true that the fruits of the policy are dependent not only on the nice policies developed at the other end of Pennsylvania Avenue, but on the implementation of those policies by those in control of the Congress.

Mr. VOLCKER. There is no question about that, Senator Miller.

Senator MILLER. So that if Congress should go along with the President's recommendations on Federal spending and taxation as contained in the budget, would it be your judgment that the strength of the dollar would continue?

Mr. VOLCKER. I think we will begin to see, on the basis of the kind of policies we have in place, some improvement in our trade position next year, and our general current account position. I think that is what we saw we needed, and I expect that is what will happen. And it is primarily a byproduct of the anti-inflationary effort. I do not say that is all we need to do. There are a number of other measures that we need to take that the Secretary referred to in this area. But the fundamental one is, we are beginning to see the effect of the end of the inflationary period and the resultant deterioration that we have had in this respect.

Senator MILLER. I hope this does not happen, but suppose that the Congress exceeds rather substantially the President's recommended spending levels for fiscal 1971, how do you think this would impact on the strength of the American dollar?

Mr. VOLCKER. It would be a minus factor.

Senator MILLER. Suppose that the Congress finally exceeded the President's spending recommendations but did enact some tax increases, or postpone some tax relief scheduled to go into effect under current law in order to balance out the budget, would you think that that would be still a minus factor?

Mr. VOLCKER. I think probably still a minus, but a smaller minus.

Senator MILLER. A minus nonetheless?

Mr. VOLCKER. I would have to look at all your arithmetic. Assuming the same tax increase and the same expenditure increase; yes, my judgment would be a smaller minus.

Senator MILLER. Then it seemed to me that the Secretary was emphasizing in his statement that at this point in time restraint has had its major impact on output, and that unless that is matched by restraint on spending, Federal spending, which directly would be a restraint on demand, that we are going to have a minus factor, that we are going to have more trouble with inflation.

Mr. VOLCKER. The primary characteristic of this budget seems to me to be expenditure control. That is the heart of the budget, and that is the message we want to give, and we think it is essential.

Senator MILLER. Now, in your statement you referred to deterioration of our trade position with respect to Germany, Japan, Italy, and Canada. Has the inflation that we have been going through had much of an impact on that deteriorating position?

Mr. VOLCKER. I am sure it has. Those countries by and large did exceptionally well on price stability and the inflationary rate. And we see the results in their trade balances and in our trade balances with them.

Senator MILLER. Do you have the comparative inflation rate for 1969 for those countries versus the United States?

Mr. VOLCKER. I do not have them with me, Senator. We could certainly supply that for the record. In the case of Italy and Germany, they were very substantially better.

In Japan you have got a peculiar situation where their internal prices go up fairly fast, but their prices of export do not go up at all. And you have to look a little bit beyond their internal price levels.

The Canadian situation is a little special. There were some specific factors in that situation, such as the auto-agreement, that has changed our trade balance around.

(The following table was subsequently supplied for the record by Mr. Volcker:)

RATES OF INFLATION COMPARED

[Percentage change]

	Implicit GNP price deflator 1967 to 1968	Implicit GNP price deflator 1968 to 1969	Consumer price index 1967 to 1968	Consumer price index 1968 to 1969
United States	4.0	4.7	4.2	5.4
Canada	4.0	4.2	4.2	4.5
Germany	1.5	3.4	1.8	2.7
Italy	1.5	3.8	1.4	2.6
Japan	4.0	4.5	5.4	5.2

Source: OECD.

Senator MILLER. I did not quite understand this Japanese situation.

Mr. VOLCKER. I wish I understood it better. I cannot tell you fully why it happens, I can only tell you what happens. They have a rate of increase, as I recall, of roughly 5 percent a year in their consumer price index. But their export prices have been very stable for a long period of time. And they have actually declined during some of this period. And this partly reflects the fact, I think, that they have an exceptionally fast rate of productivity increase in their big export industry, they have got a fast rate of productivity increase every place. But their price increases tend to be concentrated in food and services, that are not internationally traded.

And, of course, in that case their domestic market is not as open to external competition as might be desirable.

Senator MILLER. Is there a worsening or an improvement in the wage rate differentials between the United States and these countries in connection with trade, foreign trade?

Mr. VOLCKER. I do not think you can answer that specifically with respect to foreign trade. The situation in Europe has certainly been in a state of some flux in recent years, and it is hard to answer that at any particular point in time. There have been some very large wage increases in Germany, Italy, and a little bit earlier in France recently that exceed in percentage terms our own wage increases by a substantial amount.

Senator MILLER. Yes; I so understand. But I am wondering how the actual wage increases look, because as I understand it——

Mr. VOLCKER. In dollar terms.

Senator MILLER. In dollar terms because that to me is really what counts when it comes to imports and exports, because if they start out with a lower wage base and they have a higher percentage increase, and we have a higher wage base and a lower percentage increase, in actual dollar terms we may be falling further behind.

Mr. VOLCKER. Certainly with rare exceptions the dollar increases in our wages are bigger than the dollar equivalent in their wages.

Senator MILLER. Would you be able to supply for the record the picture of the comparative wages for these countries and the United States for, let us say, 1967, 1968, and 1969, so that we can see where we are going with that?

Mr. VOLCKER. I am sure we can give you some representative figures.

Senator MILLER. Would that be all right with the chairman to have that done?

Representative REUSS (presiding). Without objection.

Senator MILLER. Thank you.

(The material to be furnished for the record at this point follows:)

HOURLY EARNINGS OF WAGE EARNERS IN MANUFACTURING INDUSTRY, 1967 AND 1968[1]

[In U.S. dollars]

	1967	1968
Belgium	1.03	1.06
France	.85	.88
West Germany	1.15	1.20
Italy	.68	.71
Netherlands	.98	1.02
Sweden	2.02	2.14
United Kingdom:		
Males	1.35	1.24
Females	.78	.71
Japan	.65	.76
Canada	2.22	2.39
United States	2.83	3.01

[1] 1969 data not yet available.

Source: Department of Labor, Bureau of Labor Statistics.

Senator MILLER. Mr. Secretary, in your statement you made a passing reference to the fact that we are investigating tax avenues which might help equalize our competitive position relative to the exports from other countries. Would you care to give us some idea of what kind of tax avenues you are referring to there?

Secretary KENNEDY. Senator, we are taking a look at the competitive tax programs of the Common Market countries.

Senator MILLER. The incentive type?

Secretary KENNEDY. Well, the value added that they have, or else looking at incentive tax, or anything else. But this is a rather long-range study, as you well know. There are no easy answers. A good deal of public understanding has to be given to this. I would be in hopes that this calendar year we could at least come up with definitive ideas of what could or could not be done. And I will be talking with you and others on this some time during this calendar year.

Senator MILLER. Of course, I know that Treasury has been looking into the value added tax.

Secretary KENNEDY. Yes.

Senator MILLER. And I was wondering if there were any other approaches that were being looked into, because I have not heard them, except possibly some kind of a tax reduction or tax rate reduction to exporting individuals and corporations with respect to the amount attributable to exports.

Secretary KENNEDY. There are all kinds of proposals. There is the one that we might come up with fairly soon to help the American exporters versus those that produce abroad and sell abroad, where they can hold or withhold the income therefrom. But we have not a definitive recommendation on that.

Senator MILLER. I have just one last question. And that is whether or not you are considering requesting Congress for any standby authority under which the President could raise or lower tax rates or impose or end a tax for purposes of short-range economic stabilization?

Secretary KENNEDY. We have no specific recommendations at this time. That is one area that in the past has been considered very carefully, as you know, and which has had a mixed history. It could well be that we could come up with some fraction or percentage proposal at least for increasing or reducing taxes. Whether Congress would go along with that I am not sure.

Senator MILLER. Before you do so, I would respectfully invite your attention to comments I made in the May 27, 1966, report of the subcommittee on fiscal policy on the subject of tax changes for short-run stabilization on pages 22 and 23.

Secretary KENNEDY. I would be very much interested, and I would like to sit down and talk with you at length on this. We have no proposal.

Senator MILLER. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Representative REUSS (presiding). Senator Proxmire?

Senator PROXMIRE. I see the hour is very late. You must be tired and hungry, so I will be as quick as I can.

We recommended, the Subcommittee on Economy in Government, consisting of 10 members of this committee, House and Senate members, Republican and Democratic, with only one dissent, repeal in effect of the highway trust fund as one way of getting control of uncontrollable spending. I hope that you will take a good hard look at that, because I think this represents a pretty good cross section of the Congress, and it is certainly an area where we do not really have control over our priorities, and we do not subject highway spending to the kind of cost/benefit analysis that we do elsewhere. What is your reaction?

Secretary KENNEDY. We should take a careful look.

Senator PROXMIRE. I would appreciate it.

Now, in your statement you say:

> A forward look has been taken at both the Economic Report and the Budget. Broad projections are made for the economy and the budget out to 1975.

You point out that this implements the recommendations of the Commission on Budget Concepts, and is useful and long overdue. Well, I think if you made real projections I would say it was useful, but I just wonder if these projections are worth very much. We have gone over these projections with Director Mayo, and there just does not seem to be any detail here, it is just a generalization. You just seem to have the trend of what has happened in the past and told us that we are likely to get the same kind of expenditure in the future. Can you break it down to tell us what the military expenditures are going to be over the next 5 years? Director Mayo could not do that.

Secretary KENNEDY. I am sorry that I cannot either. But I think the purpose here is not to give the detail, but to show the mode or the problem really of our receipts and expenditure pattern over this period of time. And I think as we go into discussions of this, we can find ways of improving it. But as far as giving precise details. I do not think any President would want to be locked into specifics.

Senator PROXMIRE. There are tentative plans which should be given so that we would have a good solid basis for debate.

Secretary KENNEDY. We were never able to get the previous President to accept this part of the Budget Commission Report because of some of the problems. But President Nixon was willing to put this into the report, which I think will give over the period of a year or so some additional information as well as give the students of government finance, Congress, and so on, a chance to come up with better ideas of priorities, and so on.

Senator PROXMIRE. Let me find out specifically if I can determine what assumptions went into this projection. You say, for example, that there is little if any margin available for new Federal budgetary programs. Do the forward projections like the $1,600 family allowance figure, does that include $1,600 in 1975, $1,600 plus——

Secretary KENNEDY. It would be a costing out of the programs at the levels or rates that would be in effect at that time—the existing programs and those that the President has proposed and announced. It does not include programs that are on the drawing board or a glint in somebody's eye.

Senator PROXMIRE. Let me ask again specifically, on the $1,600 family allowance, the welfare program the President spoke of last August, that presumably will go into effect, if the administration prevails, will go into effect this coming year, is it assumed that the President's proposals of $1,600 per family plus food stamps—is this the basis for the expectation in regard to this program?

Secretary KENNEDY. Mr. Weidenbaum is closer to the actual estimates than I am on this.

Mr. WEIDENBAUM. My understanding is that the estimates of new initiative are based on the future full year effect of the legislation recommended by the administration. For example, the 1971 budget shows revenue sharing at $250 million, or one-sixth of 1 percent of the personal tax base. We have it rising to almost 1 percent of the personal tax base, and over $4 billion by 1975. There is a very substantial future expenditure cost in here of existing legislation, that is, existing commitments, plus the new initiatives recommended by the President.

Senator PROXMIRE. That is very, very helpful on revenue sharing. That is the first specific revelation that I have had. How about the family allowance? Is it assumed that that will continue at the same level?

Mr. WEIDENBAUM. Revenue sharing is a responsibility of the Treasury Department, and that is why I cited that one. The other program is the responsibility of another department.

Senator PROXMIRE. I will just have to ask the other departments on what they have provided to their budget director.

Secretary KENNEDY. The budget director should be able to give that to you.

Senator PROXMIRE. Let me ask, on education do you project merely a percentage growth on existing programs, or do you project some increase in the quantity of the education programs or do you project some increase over the past few years, which has exploded?

Secretary KENNEDY. My feeling would be that it would be the best estimate they could have of what the costs would be based on the present legislation.

Senator PROXMIRE. What projections did you make on social security, that is, will it increase at some rate per year according to how the economy goes, or is this on some other basis? We have had those big increases——

Secretary KENNEDY. I am afraid, Senator, that I am not familiar with the details. It was my understanding that you costed out the existing programs based on the analysis of the growth in the gross national product and population.

Senator PROXMIRE. There is no program to re-order priorities. You take existing programs and make assumptions of projecting them. You say that there will be little left, or almost nothing for new programs. And it would seem to me that it would be helpful if we could examine programs and determine if they could not be done better by private enterprise, examine them to see if some other alternative program could not do it better. We have not done that.

We just had a very extensive report by the Joint Economic Committee pointing out that that has not been done.

Secretary KENNEDY. You have the figures in the budget on all of these programs on an individual basis program by program. The purpose here was not to analyze individual programs. It was to show the metes and bounds of our revenues and sources of revenues and expenditures on some projected basis. If you are interested in taking a look at each program, the budget document gives more than ample detail to look at these.

Senator PROXMIRE. I just want to be sure that this projection does not mean that you mean to freeze these things, that they are concrete, that they cannot be reviewed, that they cannot be cancelled, that they cannot be cut. Those things can still be changed.

Secretary KENNEDY. That would be part of this exercise. We have to look at these programs if we are going to do the things we need in environment and the cities themselves.

Senator PROXMIRE. That is a very helpful disclaimer, because the impression comes from this that this is the expectation of this administration, and that this is what you would try to do.

Let me ask you one final lighter question. I wonder if you might strike a blow against gobbledegook and bureaucratic language and the use of jargon by hiring some consultants from English departments or from the working press to give you a better word than "disintermediation." By working night and day they came up with a satire on long words in a popular song, "Supercalifragilistic-expialidocious," but "disintermediation" is almost as bad. Few people know what it means, though it is used all the time. It is a very important term. And the Treasury Department seems to be in the best position, I think, of suggesting, if not four-letter word, a word that would be better than this unfortunate jargon.

Secretary KENNEDY. It took me a long time to learn that word. It is a long one. We will see what we can do.

Senator PROXMIRE (now presiding). I would appreciate it very much.

Thank you very much, Mr. Secretary and gentlemen. You have been most helpful.

(Secretary of Labor George P. Shultz was invited to participate in these hearings but was unable to do so. He subsequently submitted the following statement for the record:)

STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF LABOR

Secretary SHULTZ. In my testimony before your committee last year, I mentioned two questions which must be listed high on the agenda of anyone concerned with the future of this country. The first had to do with the problem of bringing inflation under control without an appreciable rise in unemployment, and the second dealt with the need to broaden economic opportunities and contribute toward an end to poverty. During the ensuing year these problems were given constant attention by the administration, and the efforts have borne some fruit. As a consequence, the character of these questions has changed even though both problems retain a position of prominence. The key questions to which I will address my remarks today are:

1. What progress has been made against inflation during the last year and what can be done to smooth unemployment and other disruptions that may arise during the current period of transition from an inflationary economy to one with stable prices and sustained real economic growth?

2. In addition to keeping the reins on inflation and promoting greater economic growth in the 1970's, what can be done in the new decade to broaden economic opportunities and assure that the poor and disadvantaged break the shackles of poverty and participate more fully in the Nation's economic prosperity?

While these have been stated as separate questions, they are actually closely interconnected problems for economic policy. The decade of the 1970's will be one of enormous demand. The total population of the United States will grow by 12 to 16 percent by 1980, and the population growth in certain critical age groups will be even more dramatic. From 1970 to 1980 the population between 20 and 24 years of age will grow by over 25 percent and that from 25 to 44 will grow by as much as one-third. These are important consuming years in a person's life—they are the years when formal education has been completed and substantial income gains are realized; they are the years of family formation and childbearing (the population under 5 years of age will grow 25 percent by 1980), and they are the years when housing and similar major purchases are made. If our Nation is to meet this surge of demand and at the same time avoid serious inflation, it is essential that all of its resources are used efficiently and fully. This means that policies to develop the productivity and employability of all workers—especially the disadvantaged—are urgently needed. And it is by bringing more people into the mainstream of economic activity that the problems of poverty can best be ended.

In viewing the economy from the perspective of the decade of the 1970's, there is a tendency to lose sight of the significance of our current economic problems. We must guard against this, however, since the successful resolution of the current inflation is essential if we are to get on with the work of meeting the challenge that lies ahead.

PROGRESS IN THE BATTLE AGAINST INFLATION

Ever since this administration took office, it has worked steadfastly to see that inflation is controlled without serious unemployment repercussions. Avoiding serious unemployment is not entirely costless, however, since it requires a gradual approach to cooling inflation, and gradualism means that you don't see instantaneous results on a day-to-day or even month-to-month basis.

As I indicated in last year's testimony, the first priority in the battle against inflation was to get the inflation "topped off." By that I mean putting an end to the increasing rate of increase in prices that has occurred since the inflation got underway. After that, the objective was slowly to bring the rate of increase down to noninflationary levels.

Present evidence suggests that we have achieved our first priority of topping out the increasing rate of growth in prices. As you are well aware, month-to-month data are often too variable to be very useful in finding trends or general directions of movement, whereas annual figures typically move too slowly to pick up current developments. Changes over 6-month intervals balance off these two extremes, although they too leave something to be desired. Chart I (p. 276) shows the rate of CPI increase calculated over 6-month spans for every month from 1965 to 1969. As you can see from the chart, the rate of increase in the CPI has generally been increasing since around the middle of 1967, but appears to have topped out around August 1969. Our next objective is to establish a general downward trend in this line in 1970 and beyond, until reasonable stability is attained.

A convenient summary table of this chart, which indicates the general overall movement of the CPI rate of increase, is the following:

CPI rate of increase (compounded annual rate)

	Percent
1967:	
1st half	2.3
2d half	3.8
1968:	
1st half	4.6
2d half	4.7
1969:	
1st half	6.4
2d half	5.9

The chart shows that the movement has been more erratic than the table suggests, but it is noteworthy that the second half of 1969 is the first time that the rate of increase has dropped since 1967. A roughly similar but somewhat more variable pattern emerges from an examination of the quarterly rates of increase in the GNP price deflator with the topping out occurring in the third or fourth quarter of 1969. The third quarter is pushed up by the Federal pay increase that went into effect in July 1969.

ANNUAL RATE OF INCREASE IN THE GNP DEFLATOR (COMPOUNDED)

[In percent]

	Quarter			
	I	II	III	IV
1967	3.5	2.4	4.2	4.5
1968	3.7	4.0	4.0	4.3
1969	4.9	5.2	5.4	4.7

The topping out and subsequent decrease in the rate of increase of prices occurred earlier and is somewhat more pronounced for commodities other than food and for services as chart II (p. 277) shows. Food prices have not yet topped out and appear to have contributed significantly to the inflation in 1969. If the top in food price increases occurs in the next few months, and the subsequent decrease is anything like that which occurred in 1966 and early 1967, we can hope for some appreciable improvement by mid-1970 in the behavior of the overall Consumer Price Index.

The fiscal and monetary policies pursued in 1969 have set the stage for further progress in the inflationary battle during 1970. The excessive demand pressures which have fed the inflation in recent years have now been cooled. Since this cooling of demand pressure is now fairly well recognized, there is no need for elaborate documentation at this time. I would, however, like to point briefly to a number of indications of what has happened in this area. The broadest measure of the cooling in demand pressure has been the slowdown in the growth of real gross national product during 1969—real GNP grew at an annual rate of about 2.4 percent from fourth quarter 1968 to first quarter 1969, and had stopped increasing by the fourth quarter of 1969. The composite index of twelve leading indicators compiled by the National Bureau of Economic Research reached its peak in September. Private nonfarm housing starts, which are directly affected by restrictive monetary policy, were one-third below the January peak by December of 1969. The index of industrial production has been dropping since July 1969 and, despite price increases, dollar sales of retail stores leveled off or declined slightly in the last half of 1969. This list could be extended, but the general picture that emerges is the same—demand pressures cooled appreciably in 1969.

The administration's strategy in bringing about this cooling, which is expected to achieve further and more dramatic results on the price front in 1970, has been based on moderating fiscal and monetary policies. The reason for relying on fiscal and monetary policy is that such policies are fundamental determinants of inflation and economic activity. This conclusion is strongly supported by both economic theory and the real world facts of economic history. Despite the impressive evidence of the power of fiscal and monetary policy in fighting inflation, many people have urged the administration to take other steps ranging from outright wage and price controls to more formal techniques such as "jawboning" by the President or other officials of the administration. The administration has rejected such techniques. I would like to take this opportunity to make more clear the reasons for not taking such steps.

JAWBONING

I will restrict my comments to jawboning since many people who feel wage and price controls are unacceptable do urge jawboning.

Jawboning is usually taken to mean the practice of calling people into the White House or somewhere else in Washington and having the administration apply various pressures ranging from simple oral persuasion to threats of political, economic and other reprisals in an effort to prevent or moderate price increases. The last administration jawboned both openly and covertly and, in a number of instances, directed public attention to the success of these efforts. Recently, Arthur Okun, the last Chairman of the Council of Economic Advisers, made public his statistical analysis of the effect of jawboning on various industries whose prices are included in the Wholesale Price Index.

Okun examined changes in the wholesale prices of 22 selected industrial commodities which he believed were responsive to White House persuasion from 1966 to 1968. In the "jawboning" period (1966–68), these prices rose 1.7 percent compared to a price rise of 2.3 percent for all other industrials. In contrast, the prices of the "responsive" products rose 6.9 percent, and the prices of other industrials rose 3.5 percent in 1969 when there was no jawboning. Okun concludes his analysis with an estimate that the cost of not jawboning in 1969 was an increase of from 0.5 to 1.0 percent in wholesale prices of industrial commodities.

I question the validity of this estimate and urge caution in attributing these differences mainly to jawboning. Numerous other factors are at work.

Four of the twenty-two selected prices; i.e., more than 18 percent; either decreased or increased less in 1969 than during the 1966–68 jawboning period. For example, sulphur prices decreased by a third in 1969 following a rise of over 18 percent in the 1966–68 years apparently because of increased supplies. Similar changes in the supply and demand factors are obviously always occurring and, without a more detailed analysis than Okun's overall comparison provides, it is difficult to determine with any precision the actual impact of jawboning. The following summaries indicate the multitude of factors affecting prices and suggest that in many cases such as steel, copper, and aluminum, jawboning in 1969 would have had limited success at best. In other cases such as tires and tubes and sulphur, it is difficult to identify the impact of jawboning during the 1966–68 period.

SELECTED STEEL PRODUCTS

Steel price increases during the Kennedy and Johnson administrations took place in an environment of relatively stable domestic and world steel markets, making it most difficult to disentangle relative effects of jawboning and other forces. During 1969, any possible impact of jawboning probably would have had little influence on steel price increases, primarily because of three factors: Reduced foreign competition, actual and potential, in the domestic market as a result of informal import quotas; a substantial increase in world demand which enabled the industry to increase exports considerably, especially of semifinished steel products, and the nickel strike in Canada, which directly caused significant increases in prices for steel alloy products. The import controls, though informal, appear to be highly effective, at least in the context of strong world demand. According to an article in the Journal of Commerce of August 22, 1968, "Steel imports have risen each year since 1961 with an annual tonnage increase averaging more than 40 percent." In sharp contrast, latest AISI figures indicate that in the first 11 months of 1969, imports of steel mill products to the United States were off by 22 percent.

SELECTED NONFERROUS METALS

Jawboning apparently had some effect on attempted price increases for both aluminum and copper in the past. However, it is unlikely that it would have had much effect on copper prices in 1969, since several significant influences were at work. Production of domestic copper was lower than anticipated. This forced U.S. users to seek additional copper supplies from higher priced sources including imported, secondary and copper scrap. Prices of these copper raw materials followed the free market where prices rose by more than 40 percent in 1969. Moreover, jawboning can be applied only to producer prices and these amount to only about a half of all copper sales. The remainder—dealer and scrap sales—are free market prices and both are currently above producer prices. The current supply shortage of copper may in part be attributed to jawboning and the resulting increases in dealer and scrap copper prices are an interesting example of spillover effects.

SELECTED PETROLEUM PRODUCTS

The petroleum industry is always under close scrutiny by the Federal Government because of petroleum's importance in terms of national security and foreign policy. Since 1959, imports have been regulated by the Federal Government and these controls determine in large part the level of domestic prices. Insofar as the Government already occupies a central role in the determination and maintenance of domestic petroleum prices at high levels, analysis of the additional influence that jawboning may have seems somewhat pointless.

NEW PASSENGER CARS

Using the October to October over-the-year comparisons, which has been the first month after new car introduction in recent years, affords a more realistic comparison than December to December when rebates for some models have already begun to appear:

	October to October	December to December
1967	1.9	1.9
1968	1.5	1.2
1969	1.6	1.9

In 1968, rebates in December were significantly greater than in 1969, thus, distorting the December to December comparison. Rebates, of course, reflect directly market competition. Jawboning resulted in rollbacks of announced price increases by Chrysler and Ford in 1966 on 1967 models and by Chrysler in 1968 on 1969 models, and GM was said to have been persuaded to reduce the amount of increase they had anticipated making in January 1968, when shoulder belts were added to 1969 models as required by a Federal safety standard. Note, however, that the net increase of 1.6 percent from October 1968 to October 1969 was less than the average of 1.7 percent the 2 previous years. Quite probably, failure to raise prices more than 1.6 percent on 1970 models reflected manufacturers' uncertainty about demand and continued, perhaps accelerated, competition from foreign producers.

SULFUR AND SULFURIC ACID

One commodity expert during these years was not aware until he read the article that "jawboning" was ever used in connection with sulfur and sulfuric acid prices. Certainly it had no appreciable effect during the 1966–68 period, as prices of crude sulfur and sulfuric acid rose more than 18 percent. During 1969, sulfur prices declined by about one-third.

TIRES AND TUBES

Price weakness shown by tires and tubes during the first half of the 1960 decade was a continuation of a longer term declining trend which began in 1959. Since demand remained strong, these decreases reflected lower unit costs achieved by high productivity and the effect of competition for market share, particularly between private-label tires and major manufacturers' brands. Price recovery in the second half of the 1969 decade reflected the industry's ability to pass through the market price structures current increases in cost without impairing demand which remained strong. However, in the final quarter of 1969, prices were still below levels prevailing in the 1956–58 period.

PAPERBOARD

Price decreases over the period 1960–68, but particularly in the year 1966–68, were due to overcapacity in the industry. Overcapacity has been a problem since 1957–59. The increase in 1969 has followed a reduction in the rate of additions to capacity with the consequent catching up of demand. Limited additional capacity slated for the next 2 years will assure firm prices during that period. As indicated above, the price level in December 1969 was significantly below the 1957–59 base period.

GLASS CONTAINERS

Prices of glass containers have been characterized by relatively long periods of stability. Such was the case in the years through 1967. A strike lasting nearly 2 months which occurred in the first part of 1968, depleted manufacturers' stocks and resulted in higher wages. Prices were adjusted upward immediately. Further increases occurred at the end of the year and particularly in January 1969, in the industry's words, "to adjust to higher costs."

CIGARETTES

Cost pressures for a general price increase were building for about 2 years before the increase that occurred in June 1969. "Jawboning" may have delayed the increase which otherwise might have taken the form of two separate increases in the 2 years rather than one big increase. However, "jawboning" probably had little to do with net price behavior since wholesale price changes are infrequent for cigarettes and manufacturers may simply have waited as long as possible before raising prices, especially in the face of declining sales and greatly increased taxes at retail.

NEWSPRINT

Prices of newsprint were held down in the period 1960–68 by increases in capacity in both Canada and the United States. Capacity increases were particularly important in the southern States and were reflected in stable prices in the years 1966–68. Reasons given for the January, 1969 increase, were higher pulpwood and manufacturing costs.

PHOTOGRAPHIC SUPPLIES

Since the industry is dominated by one firm, Eastman Kodak, it would be an easy industry in which to attempt "jawboning" techniques. There are, however, three factors that might explain the differences in the annual rates of changes for prices aside from any "jawboning" pressures. Film prices and prices of photo papers using silver halides have risen in the past 2 years due to higher silver prices. Film manufacturers blamed silver for increases in both years, but the majority of film produced was color types which use only a small fraction of the silver salts consumed by black and white films. Mounting labor and transportation costs had a lot to do with the increase and these cost pressures were stronger in 1969 than in 1968. In addition, the initial price increases for film were not met by any consumer resistance which encouraged manufacturers to announce further increases. Finally, a price war of sorts in the photocopy field caused some reductions in prices of photocopy paper in 1968.

LAUNDRY EQUIPMENT

In laundry equipment, the 1961–65 change of −1.3 percent and the 1966 change of −.1 percent appear to support the thesis that jawboning did work in this industry; but the contrast of 1967 and 1968 increases of 2.4 percent and 2.8 percent with the 1969 increase of 1.2 percent would not support the contention. Supply and demand tend to dominate this competitive industry.

It is significant that Okun's analysis contains no discussion of attempts at jawboning in the areas where really large price increases have occurred such as construction, food, and medical care. Equally significant is the absence of any discussion of jawboning with respect to wage increases. The reason for these conspicuous gaps is quite obvious—jawboning simply would not work in these areas. In 1968, the consumer price index rose 4.7 percent and in 1969 it increased about 6.1 percent. The difference of 1.4 percent is explained entirely by more rapid increases in prices of food, housing, and private transportation during 1969—prices which, by and large, cannot be "jawboned."

In view of these considerations it is difficult to assess just how successful "jawboning" really is. At the same time, I do not mean to imply that jawboning has absolutely no effect. It is clearly possible to intimidate producers in selected cases and thereby alter prices. However, it does not follow from these particular instances that jawboning is really useful in stopping the overall inflation, which is, by definition, a widespread phenomenon.

An even greater danger is the tendency to view "jawboning" as an activity which, at worst, is ineffective and innocuous. In fact, there are many undesirable effects of jawboning, and these add up to too high a price to pay for the spotty and limited success that jawboning has. There are at least the following five undesirable aspects of jawboning:

(a) *Jawboning directs attention away from the fundamentals.*—The use of jawboning in a few highly visible situations may lead to the impression that something is being done about inflation, when, in actuality, the problem is getting worse because fundamental causes are ignored or at least relegated to a less prominent position. This is something like plugging a thermometer to stop a patient's fever instead of attacking the underlying illness. As the previous tables on price increases show, the rate of price increase generally accelerated during the jawboning years and appears to have stopped accelerating when jawboning was abandoned in favor of fiscal and monetary restraint.

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(*b*) *Jawboning is highly selective and inequitable.*—Jawboning is applied to those who it is easy to jawbone and not necessarily to such exceptionally high price-increase industries as food, medicine, and construction. This is an inequitable allocation of the responsibility for halting inflation which is widely spread throughout all sectors of the economy.

(*c*) *Jawboning is regulation without representation.*—Jawboning provides no representation to those "jawboned" but is otherwise very similar to formal Government regulation in setting standards, selecting targets, and applying pressures. No standards are set for the selection of organizations to be regulated by jawbone and no open process of appeal or representation is established. The target is dictated by the procedure as is the regulatory result to be sought.

(*d*) *Jawboning is a misuse of executive power.*—The President does not have any direct legal sanction for jawboning and, as a principle of Government, it is not desirable to use powers that have been granted for other purposes to intervene in areas where specific authority has not been given. Indeed, in some cases meetings held under Government auspices to discuss prices amount to official encouragement for violation of anti-trust laws.

(*e*) *Jawboning interfers with, and may seriously disrupt the operation of the price system which is essential to the allocation of resources in a free society.*—By dealing with selected prices rather than the movement of the overall price level, jawboning can lead to undesirable shortages or surpluses in certain markets. A related example is the effect of interest rate ceilings on time deposits and savings and loan shares, ceilings which have tended to keep badly needed funds out of the home mortgage market in recent months.

It has been argued that there is an appreciable range of discretion in the determination of many important prices and wages and that the Government should act to keep any such decisions at the lower end of this range especially in periods of inflation. Even if such discretion exists (and the extent of it is far from clear) this does not provide a justification for jawboning. In addition to the disadvantages of jawboning listed above, no formal attempt appears to have been made in case of the jawboned industries to determine the nature of the wage-price structure or the multitude of factors that affect wage and price decisions. Such analyses are important in order to provide well-informed public judgment on what is happening in key wage and price areas and to provide a monitor on the functioning of the free price system. The administration undertook such an analysis of the sharp lumber price increases last year and was able to identify certain factors which, when rectified, would help ease the upward pressure on prices in that industry. These factors involved certain Government controllable supply constraints and demand influences which could be modified without recourse to jawboning. In this case there was no interference with the price decision process per se, but it was possible to correct some of the factors influencing these price decisions.

The administration is now considering proposals for establishing such evaluative and analytical capabilities on a more formal basis, not with the intention of intervening in the wage and price decisions of the market but to provide information on what underlies these decisions. Such analysis may suggest modification in Government activities and practices or other factors that could ease those problems that are uncovered. The sudden and sharp increase in 1969 of the spread between farm and retail beef prices is an example of the type of problem that bears investigation. The influence of Government on the market is discussed in greater detail in chapter 4 of the 1970 Economic Report of the Council of Economic Advisers.

MANPOWER AND ECONOMIC POLICY

Manpower programs can contribute to the solution of both of the questions raised at the start of this testimony. The first chapter of the forthcoming manpower report examines in some detail the relationship of manpower programs to economic policy, and I would like to take this opportunity to present a review of that material to this committee.

Fiscal and monetary policies represent the fundamental means of achieving our Nation's economic goals. Nonetheless, economists and policymakers are now coming to realize that overall economic policy should, and does, depend on more than these traditional tools. It should involve more because we recognize that while fiscal and monetary policies have helped us avoid economic stagnation or severe depressions, problems such as inflation, unemployment, and instability continue to affect the economy. It does involve more because other Government policies such as manpower programs have grown to a size where they have nationwide economic as well as social impacts. For both of these reasons, it is becoming increasingly necessary to think of manpower activities in their role as partner, albeit a junior partner, to fiscal and monetary policy.

In viewing manpower programs as a companion to the traditional tools of monetary and fiscal policy, it is helpful to draw some broad distinctions. The first distinction is that manpower programs tend to be specific in nature whereas monetary and fiscal policies tend to have broad undifferentiated impacts. The second distinction is that monetary and fiscal policies tend to operate on the demand side of the economy whereas manpower programs tend to affect the supply side.

As these comparisons suggest, manpower programs can be a promising complement to the traditional tools of economic policy. This is especially true when manpower policy is broadly defined to include not only training programs and employment services but also unemployment insurance, programs to reduce seasonality, those aimed at easing the school-to-work transition, and related activities including the military draft. Given this broad perspective, it is impossible, in a few pages, to detail or even touch on all of the possible ways in which manpower efforts can supplement economic policy. Consequently, the discussion is limited to a few of the more obvious and important linkages.

The central discussion is organized around the relationship of manpower programs to two critical problems of economic policy—how to achieve full employment, economic growth and price stability, and how to mitigate the effects of unemployment upcreep.

FULL EMPLOYMENT AND PRICE STABILITY

A fundamental objective of economic policy is to assure satisfactory employment opportunities for all workers. The labor force continues to grow as the population expands, and this means that fiscal and monetary policies must provide for continued economic growth. It is widely recognized, however, that expansionary economic policies frequently lead to undesirable upward pressure on prices. The problem is especially acute when the economy nears its capacity level of output.

Even in very prosperous circumstances, some unemployment exists. Part of this unemployment does not necessarily reflect any serious economic hardship. This part results from adjustments which occur in an economy characterized by rapid growth, technological change, and a mobile labor force. Unemployment of this type takes place when persons moving from one job to another in search of better wages or more desirable working and living conditions, and those who have just entered the labor force and are in the process of finding suitable employment. The other part represents a more serious problem. It includes people who are unemployed for an extended period of time because their skill levels are too low to meet the requirements for the available job opportunities.

In a relatively full employment economy, fiscal and monetary policy can do little to alleviate these unemployment problems without causing inflation. Expansionary policy creates demand for goods which will drive up prices and wages as people bid for additional output which is not forthcoming.

In such a situation, manpower and related programs can provide some help by contributing to improvements in labor supply conditions.

REDUCING FRICTIONAL UNEMPLOYMENT AND INCREASING LABOR MARKET EFFECTIVENESS

In 1969 more than 60 percent of the unemployed were people who had voluntarily left their last job or were "entrants"—those who had been out of the labor force before they began to look for work. An important cause of this unemployment—though by no means the only one—is the time it takes for these people to search out job opportunities and, on the other hand, the time it takes for employers with job vacancies to find people who are available for work. This suggests that efforts which would facilitate the flow of information in the job market can make a very useful contribution to the reduction of unemployment during periods of high level economic activity.

An important means of facilitating the flow of information in the labor market is through improving the effectiveness of the Public Employment Service system by computerization and other means. The use of computer job banks, like the one now operated by the Employment Service in Baltimore, provides job searchers with up-to-date records on job openings and valuable information about the nature of the jobs. Computerization of job information offers many advantages. It allows all of the employment service offices in a given labor market to have essentially the same information about job openings, and it becomes possible to update this information on a daily basis. Even more important the data handling capabilities of the computer permit Employment Service officials to collect and analyze information relating to the overall behavior of the local labor market and to maintain an audit of the operations of the Employment Service that highlights its strengths and weaknesses. The success of existing job banks, especially in increasing the employment of the disadvantaged, has led to plans to expand this service to 76 cities by the end of 1970.

THE TRANSITION FROM SCHOOL TO WORK

Steps which facilitate the transition from school to work help to reduce frictional unemployment and improve the long-run employability prospects for many young people. In addition to improvements in the Employment Service, there are a number of manpower and other policies that can be of aid in this area.

An important problem in the school-to-work transition is the tendency for youth to leave school, for economic and other reasons, before they have acquired enough education to perform successfully in the job market. The Neighborhood Youth Corps seeks to remedy this problem by making it easier for youth to remain in school. The in-school program provides part-time work, thereby offering financial assistance and job experience which increases the employability of the individual upon graduation. The out-of-school program encourages high school dropouts to resume their education on a full or part-time basis, while preparing them for employment through vocational training and other services. The summer NYC program provides work experience and financial aid, with the intent that the participants will find it easier to return to school in the fall.

Cooperative education programs are a particularly promising approach to the school-to-work transition problem. Cooperative education programs establish a formal relationship between employers and public schools which permits students who participate in the program to divide their time between work and classroom study in a meaningful, coordinated manner. The jobs they hold are designed, much like internships to introduce students to careers. These jobs often offer specific training while their classroom studies provide the broader educational inputs needed for their work.

In recent years, one of the most important causes of unemployment among young men just leaving school has been a military draft policy that created a significant period of uncertainty about the individual's availability for permanent employment. Uncertainty about when, if ever, a recent high school or college graduate will be drafted makes many employers wary about hiring these job applicants, even when they possess needed skills and abilities. This same uncertainty on the part of job applicants also means that many are reluctant to actively seek work, thereby contributing to "hidden" unemployment.

Recently, there have been important changes in the Nation's military draft policy which have the effect of reducing this uncertainty and will consequently reduce the unfavorable employment impact of the military draft. The 1969 amendments to the Military Selective Service Act of 1967 reduced the period of maximum draft vulnerability to 1 year and instituted a random system of selection which identifies, at an early point in the year, those young men who are most likely to be drafted. While such changes go far to solve these problems, this is a policy area in which even more can be done. In recognition of this, further changes in military draft policy are currently under consideration, including the alternative of an all-volunteer armed force which would eliminate the draft entirely except in periods of national emergency.

Other factors that may contribute to youth unemployment are being examined by the Department of Labor. These include the effects on youth unemployment of legal restrictions on hours of work, working conditions, and wages. The Bureau of Statistics will soon release a study of the effects of minimum wages and other influences on the unemployment problems of youth.

MANPOWER PROGRAMS AND JOB LOSERS

Even during 1969, which was a year when labor markets were generally regarded as "tight," more than 35 percent of the unemployed had lost their last job. This group has employment problems that are generally much more serious than those considered in the last section. Often the loss of a job is caused by events beyond the worker's control, such as business failure, decreased workload, technological change, seasonal work, or forced retirement due to injury, disability, and other factors.

While there are many factors underlying job loss, it is significant that job losers had about a year-and-a-half less schooling than those who were jobless for other reasons in 1968.

This indicates a need for training and education to improve the employment record of the job loser. The kinds of educational services required, however, are likely to be quite varied, given the many reasons for job loss. Many job losers need basic and remedial education to broaden their employment opportunities and to prepare them for vocational education. Job loss is also caused by a lack of vocational skills and by technological innovation which renders former skills obsolete. At present, these diverse educational needs are met by a variety of categorical programs, such as those conducted under the Manpower Development and Training Act, the Neighborhood Youth Corps, the JOBS (Job Opportunities in the Business Sector) program, the adult basic education program, and Operation Mainstream. The proposed Manpower Training Act would eliminate much of this categorization and streamline the manpower programs, so that educational and other services could be more directly tailored to the needs of individual participants.

SEASONALITY AND INTERMITTENCY

Certain occupations and industries are characterized by a high degree of seasonality in their employment patterns. This problem is particularly acute in education, agriculture, and contract construction. Indeed, historical factors led to the offsetting of seasonality in education and agriculture. When the economy was largely agricultural, the school year was chosen so that children would be available for farmwork during the summer months and in school in those months when there was less agricultural activity. Although the economy has become more industrialized and the relative size of the agricultural sector has declined, the traditional seasonal pattern in education persists and results in some serious labor market problems. The most important of these is the large summer influx of teenagers into the labor market in search of both regular and temporary employment. For example, in 1968, the civilian labor force of 16–19 year olds averaged 8.7 million in June, July, and August compared to an average of only 6 million for the other 9 months—a differential of 45 percent. Part of this problem is addressed by NYC and other manpower programs, but a longer range solution would probably involve changes in the usual academic year. It is interesting to note that plans for a full year academic calendar might be meshed advantageously with an expanded cooperative education program.

There is pronounced seasonality in both employment and unemployment in contract construction. From 1947 to 1968, February employment averaged about 85 percent of annual average employment in this industry. Over the same period, August employment averaged about 111 percent of annual average employment. There is a similar seasonality in unemployment. From 1964 to 1968 the February unemployment rate in construction was two-and-a-half to three times greater than the August unemployment rate. Moreover, on an annual basis, the unemployment rate in construction is typically about twice as large as it is in nonagricultural industries as a whole.

Both the loss of productive services and the unemployment attributable to seasonality in construction make this a serious problem. In December 1969, the Departments of Labor and Commerce reported the results of a joint study of this problem to the Congress and suggested measures to lessen construction seasonality. Included in the recommendations of this study are some suggestions for relating national manpower policy to stabilization of construction industry employment:

An expansion of apprenticeship training, skill enrichment, and minority employment programs to provide the range of skills needed by a more stable construction workforce;

The development of new financial incentives to encourage winter employment, perhaps by combining taxation of peak quarter payrolls with rebates to contractors against existing payroll taxes for winter quarter payrolls; and

The development of a local construction labor market information system by cooperative action of contractors, building trade unions, and the Department of Labor, in conjunction with computer job-matching programs.

The additional manpower achieved from a reduction in seasonality is very much needed in the next decade to help reach the Nation's housing goal of an additional 26 million units.

Intermittency of employment in construction would persist even if seasonality could be eliminated. There is a significant loss in productive manpower because construction workers have to move to new projects and regions as work is completed on present jobs. This problem is more difficult than seasonality, but its solution cannot be neglected as a long-range goal. This is another area in which a nationwide job bank may provide some significant improvements. It also raises the many issues involved in increased portability of pension and health and welfare rights.

MANPOWER POLICIES DURING PERIODS OF INCREASING UNEMPLOYMENT

The previous discussion deals with the role of manpower policies during periods of economic prosperity and increasing employment. It is equally important to ask what manpower policies can contribute when unemployment increases.

There are a number of ways in which manpower efforts can cushion the impact of unemployment in periods of economic slowdown. Unemployment insurance is a most important contributor to this goal, and its value as an economic stabilizer has long been recognized. In 1969, the administration proposed legislation to strengthen the unemployment insurance system in a number of ways:

Extending coverage to many workers not covered (at present, almost 17 million jobs are not covered by unemployment insurance);

Allowing unemployed workers who enroll in retraining programs to continue to receive benefit payments:

Improving responsiveness to economic conditions by providing for an automatic extension of the maximum period for which benefits may be paid; this would be triggered when the insured unemployment rate equals or exceeds 4.5 percent for 3 consecutive months;

Increasing the taxable wage base for the Unemployment Insurance Tax.

While it is true that there would be an increase in the number of unemployed persons who already have skills and work experience during an economic slowdown, it is also likely that there would be a much greater increase in unemployment among those with lower skill and education levels. For the latter group the loss of a job could act as a powerful motivation to seek additional skill training especially at a time when the opportunity cost is low. Even if there was not an immediate job waiting for them at the end of the training period, the training would serve to enhance the employability and earnings of participants over the longer run, and our studies of experience of MDTA enrollees bring this fact out strongly.

In recognition of these advantages, the proposed Manpower Training Act includes a provision that would automatically trigger a 10-percent increase in the appropriated manpower funds when the national unemployment rate reaches 4.5 percent for 3 consecutive months. This trigger has a number of desirable features:

It increases the effectiveness of manpower programs as economic stabilizers by strengthening their counter-cyclical characteristics. Since training efforts cushion the impact of unemployment while reducing inflationary pressures, this counter-cyclical effect can be an especially useful aid to monetary and fiscal policy when the problem is one of fighting inflation and recession at the same time.

The automatic increase in funds means that expanded manpower efforts can be put into operation fairly quickly and directly, thereby providing needed relief in the early stages of an economic slowdown.

The trigger would provide an increase in the supply of training at the time when there is likely to be an increased cost to trainees of foregone opportunities for income are low. It is complemented in this respect by the trigger device for extension of benefits proposed in the Unemployment Insurance legislation and by the provision that allows participation in training programs without loss of unemployment insurance benefits.

THE PROMISE OF MANPOWER PROGRAMS

Evaluation and research are needed to guide the future direction of manpower programs, but I feel confident that these programs have made and will continue to make important contributions to the solution of the Nation's social and economic problems. The experience with manpower efforts in the United States and other countries provides a strong basis for an optimistic assessment of what can be expected from these programs in the future. The Nation's economic goals in the 1970's combine a high level of economic growth with a greater degree of stability than has been experienced in the past, and the promotion of economic stability is a primary characteristic of manpower activities. In addition to reducing inflationary pressures and increasing productivity and employment, manpower programs can be focused intensively on the problems of those individuals and groups that do not receive their full share of the Nation's prosperity. The very recognition that economic policy encompasses more than the traditional fiscal and monetary devices is an important step in the realization of the broad promise of manpower programs.

CHART I.—Rate of change in consumer price index

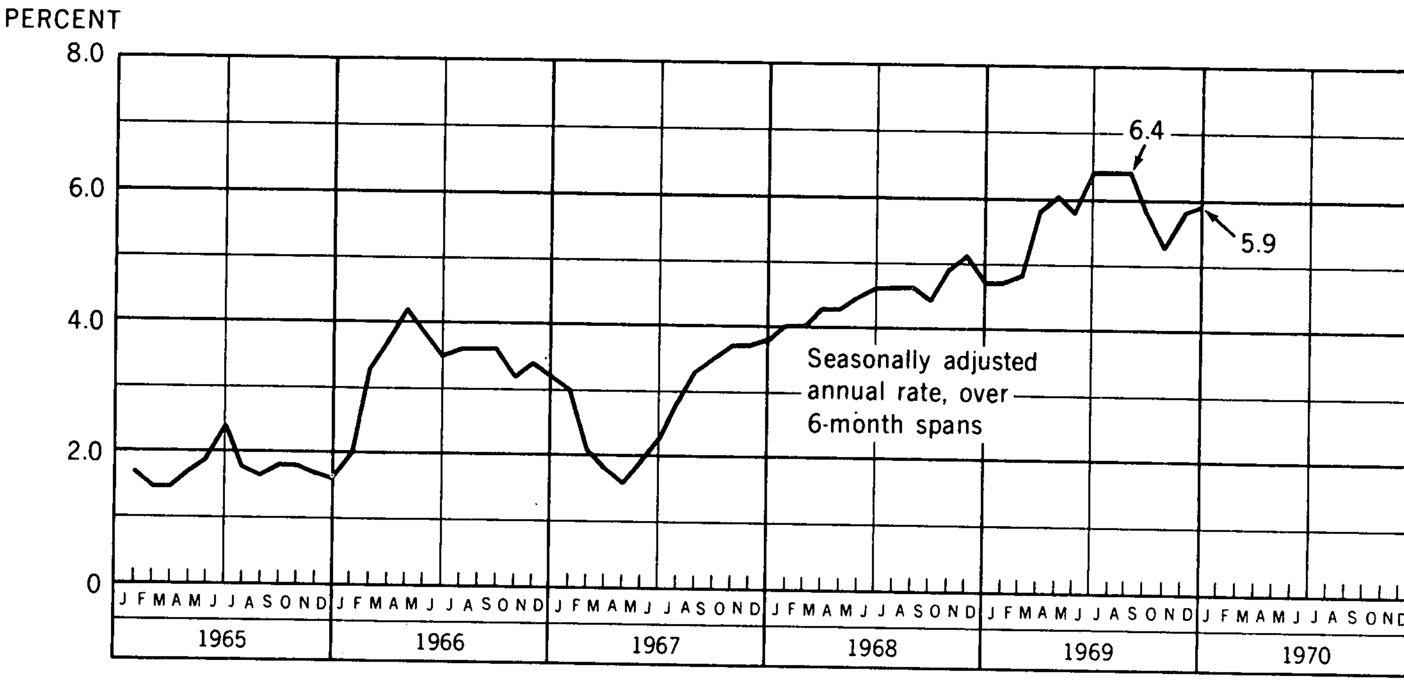
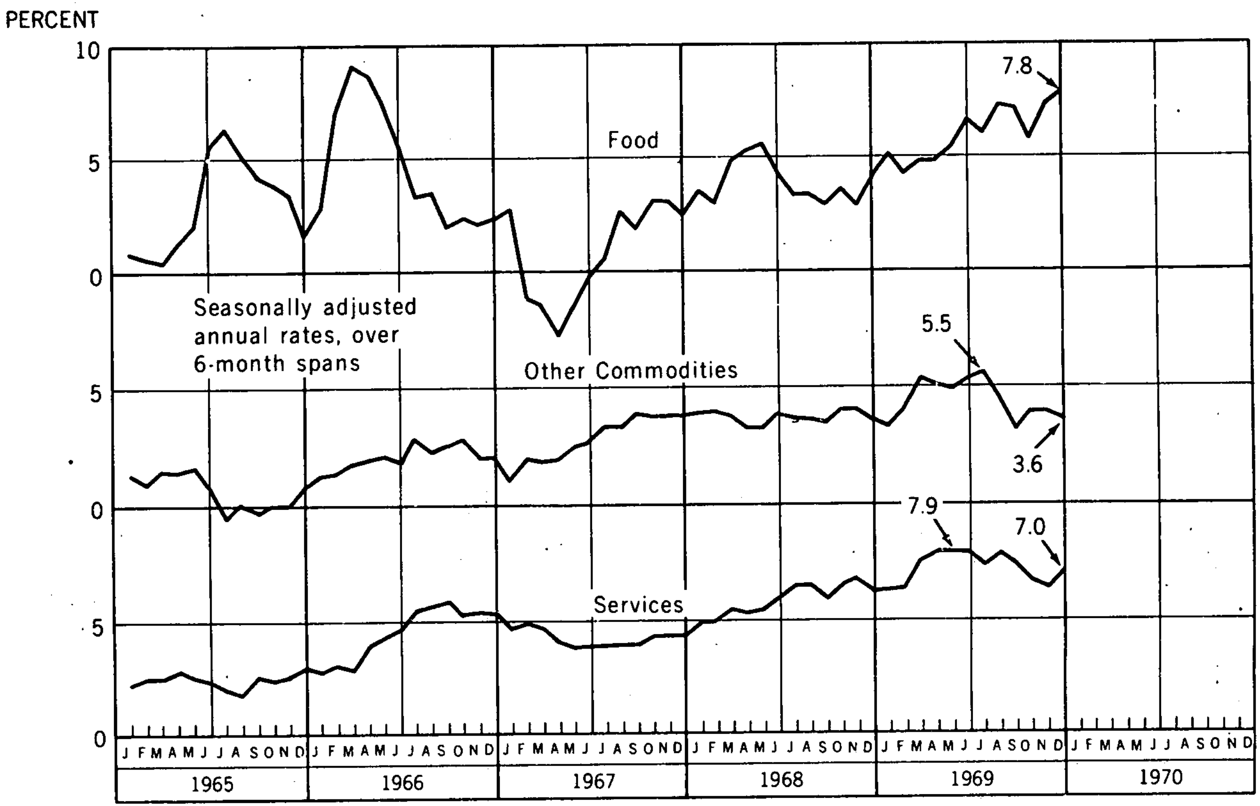


CHART II.— Rate of change in components of the consumer price index



Senator PROXMIRE (presiding). The committee will stand in recess until February 23, when we reconvene in this room to hear a panel of experts on the economic outlook.

(Whereupon, at 1:30 p.m., the committee adjourned, to reconvene at 10 a.m., Monday, February 23, 1970.)

APPENDIX

(The following additional questions asked by members of the committee and answers thereto were subsequently supplied for the record by Secretary Kennedy:)

Question 1. During his campaign for the Presidency, Mr. Nixon committed himself to abolition of the restrictions and controls limiting the export of capital from the United States and in his balance-of-payments statement of April 4, last year, he reaffirmed this commitment. Why are we still retaining these limitations on capital exports and when will they finally be removed?

Answer. Last April 4, the President took a number of steps to reduce or modify existing controls on outflows of U.S. capital. At the same time, he reaffirmed the intention of his Administration to dismantle the controls as soon as possible, having due regard for the realities of the foreseeable impact of such action on the U.S. balance of payments situation.

The Administration's efforts to make further reductions in the present selective restraints on capital outflows will be greatly facilitated by the corrections now underway in the domestic economy. The distortions created by more than three years of inflation have had major adverse effects on our international payments position. Achievement of balanced non-inflationary growth in the domestic economy is a necessary precondition to the reestablishment of a strong international trade and current account position for the U.S. However, it takes time to remove these distortions and to achieve the mix of domestic and international conditions which would permit a substantial further relaxation in the capital controls.

In the past several years, while the U.S. has continued to export sizable amounts of capital, its current account balance has shifted from a surplus of almost $6 billion in 1964 to a deficit of nearly $1 billion (annual rate) during the first three quarters of 1969. Although the U.S. continues to be a large potential exporter of capital, such financial capital exports must be sustained over time by a sizable current account surplus which makes possible an equivalent transfer of real resources. In the absence of such a surplus, long term financial exports are mainly swapped for increased foreign financial holdings in the U.S.

Our propensity to export financial capital cannot, therefore, be effectively balanced by the export of goods and services until we again achieve a sizable current account surplus. The magnitude and difficulty of this problem could also be affected by the extent to which improvement in our current account is accompanied by an increased two-way flow of international investment capital vis-a-vis our major partners.

Question 2. Recently, the major steel companies throughout the United States increased their prices on certain products. Subsequent to this price increase, it became apparent that the Japanese had marginally exceeded in 1969 "voluntary" limitations on steel exports to the United States. The Administration's reaction was to assert that the excess of 1969 Japanese steel exports to the United States over the quota limit would be deducted from that country's 1970 allotment. Is this administrative decision really consistent with a serious and credible attack on domestic inflation? Is any across-the-board reexamination of import quotas under way to determine whether the abolition of these quantitative limitations would reduce domestic prices or at least retard further increases?

Answer. As the Committee may recall, the Chairman of the Japan Iron and Steel Exporters' Association sent a memorandum to the Secretary of State in December of 1968 which stated the intention of the Japanese steel industry to limit their shipment of steel mill products to the United States during 1969 to 5.75 million net tons with shipments in 1970 not to exceed 105% of that amount.[1]

[1] Joint Release, Committee on Ways and Means, House of Representatives: Senate Finance Committee, United States Senate, January 14, 1969.

I understand that the Chairman of the Japan Iron and Steel Exporters' Association has now advised the Department of State that the 1969 limit was exceeded by 110,000 tons. The Chairman further informed the State Department that this over-shipment would be applied to reduce the 1970 limit accordingly.

As I have already indicated to the Committee, the Administration's economic strategy for controlling inflation places maximum reliance upon the established stabilization tools—fiscal and monetary policy. In order to succeed in our efforts, continued monetary and fiscal restraint is necessary. This policy is important for the international as well as the domestic economy. By reducing inflationary pressures, the deterioration in our trade balance will be arrested, and restoration of a satisfactory payments equilibrium facilitated. This policy does not rely on trade restrictions or interference with the market mechanism.

The Administration recognizes the valuable contribution trade makes to our economic well-being and the dangers involved in a policy of restricting imports. Early in his Administration, President Nixon stated:

> 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.

This support for a liberal trade policy has been frequently reiterated, most recently in the President's trade message and his statement on U.S. foreign policy for the 1970's. At the same time, it must be recognized that there may be limited exceptional cases requiring special temporary measures.

Question 3. The Administration has proposed an environmental financing authority which would lend money to State and local governments only for anti-pollution purposes. If we make funds more readily available to States and localities for some purposes than for others, doesn't this restrict the freedom of local governments to order their own prioities? Isn't this the kind of restrictive approach which this Administration is trying to move away from?

Has the Administration studied the possibility of a comprehensive Federal financing authority which would lend to State and local governments for all the purposes for which they now issue tax exempt bonds? If so, what conclusions were reached?

Answer. The Environmental Financing Authority, which would be established by the Environmental Financing Act of 1970 submitted to the Congress on February 10 by the Secretary of the Treasury, would not restrict the freedom of local governments to order their own priorities. Section 3 of the bill states:

> The purpose of this Act is to assure that inability to borrow at reasonable rates necessary funds does not prevent any State or local public body from carrying out any project for construction of waste treatment works authorized and financed with the aid of grants provided by the Secretary of the Interior (33 U.S.C. 466, C–1, 466e).

Accordingly, EFA would purchase only obligations which are issued to finance the non-Federal share of the costs of a waste treatment facility receiving a construction grant from the Secretary of the Interior and which cannot oherwise be marketed on reasonable tems. EFA purchases will not involve the Federal Government in any local projects that it is not already involved in through the underlying Federal grant program. Borrowing from EFA will not be a condition for the Federal construction grant. The local public body will continue to have the option to borrow in the private market.

While the Administration is clearly moving in the direction of a less restrictive approach to Federal financial assistance to States and localities, as evidenced by the Administration's broad revenue sharing proposal, there are still many specific areas of high national priority, such as the construction of local waste treatment facilities for the control of water pollution, which warrant additional Federal aid.

It is quite another matter, however, to establish a comprehensive Federal financing authority which would lend to State and local governments for all the purposes for which they now issue tax-exempt bonds. Our review of such proposals leaves a number of unanswered questions regarding overall tax equity, capital market structure, and the extent to which board Federal aid measures should be related to State and local borrowing or to capital facilities as opposed to current operating expenses. Also, there has been much concern that a comprehensive Federal financing authority, unlike EFA, might lead to increased

Federal involvement or control over municipal projects which are not now directly assisted by the Federal Government.

Question 4. The 1971 budget surplus depends on sales of mortgage-type assets of $3.6 billion. Can these assets be sold (assuming they should) unless interest rates fall substantially? How much must interest rates fall before they can be sold? What effect would these sales have on the mortgage market?

Answer. The 1971 budget contemplates a general improvement in financial conditions and a reduction in market rates of interest, which will facilitate the asset sales program. In fact, market interest rates have already declined significantly since the 1971 budget was transmitted to the Congress. It should be noted, however, that most of the loans to be sold involve significant interest rate subsidies so that the rates paid to the purchasers by the Federal lending agencies will in any event be significantly higher than the rates paid by the borrowers. The actual volume of sales in 1971 will depend upon the general financial situation and the demand for these obligations at interest rates which are reasonable in light of current market conditions.

The effect of asset sales on the mortgage market is difficult to measure. On the one hand, the proceeds of asset sales in 1971 are to be used largely for assistance to the mortgage market by the Farmers Home Administration, the Veterans Administration, and the Department of Housing and Urban Development. On the other hand, any expansion in the volume of Federal mortgage assistance—whether financed through asset sales or in the form of direct Treasury or Federal agency obligations, such as FNMA and home loan bank issues, or through guaranteed loans originated and financed through private lenders—will add to overall credit demands and to some extent divert funds which might otherwise have flowed to unassisted mortgages. While any adverse effects on the flow of private mortgage credit resulting from Federal asset sales and direct Federal agency borrowings might be ameliorated somewhat by careful design of the denominations, maturities, and other terms of the specific instruments being sold, the fundamental corrective must be to reduce overall credit demands so as to restore the normal flow of mortage credit through institutional lenders.

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