498

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

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CONGRESS OF THE UNITED STATES

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THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

MONDAY, JULY 13, 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 S-407, the Capitol Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, Widnall, and Brown; and Senators Proxmire, Fulbright, and Miller.

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

Chairman PATMAN. The committee will please come to order.

Mr. Eaton, I want to thank you very much for taking the time from your busy schedule to appear before this committee of Congress, the Joint Economic Committee, composed of 10 U.S. Senators and 10 Representatives.

I have always regarded you as one of the real original thinkers of the American free enterprise system. You are the type of big businessman who has provided the fresh thinking necessary to keep our economic system moving forward. You have not been afraid of new or controversial ideas, and this fact has made you invaluable to the Nation. Personally, I have benefited greatly from the counsel and ideas that I have received from you through the years.

Mr. Eaton's career is so varied and illustrious that many have forgotten that he comes from quite a famous and well-known family.

I was reminded of this last week when I saw some news stories on the 25th anniversary of the signing of the United Nations Charter. Some of my colleagues may have forgotten that another well known Eaton, Charles Aubrey Eaton, was a major participant in that San Francisco conference which launched the United Nations. Charles Aubrey Eaton was the uncle of Cyrus Eaton who is here today.

Mr. Eaton, I knew your uncle very well, and I have fond memories of my long service in the Congress with him. He was an outstanding expert in foreign affairs and, of course, served at one time for a long time as chairman of the House Foreign Affairs Committee.

Like Cyrus Eaton, the interests of Chairman Eaton were varied and, at one time, he was active in the ministry, serving as pastor of several churches, including the First Baptist Church, of Natick, Mass.

I bring this up just to remind you that I have known the Eatons over many, many years.

We welcome your wonderful, lovely, and charming wife to this hearing. We are glad that she is present, too.

Mr. Eaton, you may proceed in your own way, sir. You have a prepared statement, I believe.

Mr. EATON. Yes, sir.

Chairman PATMAN. Go ahead, you may proceed.

STATEMENT OF CYRUS EATON, CHAIRMAN OF THE BOARD, THE CHESAPEAKE & OHIO RAILWAY CO.

Mr. EATON. Yes, thank you, Mr. Chairman. You have been one of my heroes for many years.

My name is Cyrus Eaton. I am chairman of the board of the Chesapeake & Ohio Railway Co. I welcome the opportunity afforded by your invitation to express my views on the state of the economy.

In my opinion, we are already in the midst of a full-scale recession. Moreover, no amount of explanatory telecasts by the President or other members of the administration will save us from a devastating depression unless the war in Southeast Asia is brought to a quick and complete conclusion.

My business career, starting almost at the beginning of this century, has included active participation in industry, public utilities, banking, railroads, and farming, both in the United States and abroad. I have known the giants of industry—Rockefeller, Ford, Firestone, Edison, and many others. I have been a reader of "The Economist," of London, for 70 years and of "The Wall Street Journal" for 65 years.

I have considered it an urgent duty, consistent with my stake in America and capitalism, to know and maintain close contact with the heads of state of the Communist and Socialist nations, as well as in the capitalistic countries.

As a businessman, I have experienced firsthand all of the economic depressions and panics of this century, including those of 1907, 1914, 1921 and the prolonged worldwide collapse that started in 1929. The panic in 1921 all but toppled Ford Motor Co. and Goodyear Tire & Rubber. The 1929 crash wiped out many banks. In my hometown of Cleveland, alone, two of the largest closed forever, and the double liability that shareholders were forced to pay on their stock crippled the community for years to come.

Whatever is to follow in the current economic crisis, we have already witnessed the bankruptcy of the Penn Central, the Nation's largest railroad system. The full repercussions of that disaster remain to be felt. One immediately measurable effect is the stock market loss to a widespread family of shareholders. The value of their holdings has shrunk 92 percent, from the postmerger high of slightly more than $2 billion to approximately $157 million. The similar declines which have occurred in many other corporations have caused painful losses to millions of American investors.

The abrupt resignation of seven Penn Central directors because of conflicts of interest arising from their affiliations with financial institutions holding Penn Central loans points to the necessity for legislative reform. Officers of banks and insurance companies should not be permitted to be directors of corporations to which they lend money. Not involved in the Penn Central case, but relating to the conflict

of interest problem, is the reprehensible practice of bank officers perpetuating themselves in office by voting the stock of their own bank held in a fiduciary capacity. This abuse should be prohibited by law.

Because the undeclared war in Vietnam is so inextricably involved in our business and financial crises, affecting the money markets and credits, I must refer to it in this discussion. Congress supplies the money for war and has an equally grave responsibility for the Nation's economic health.

The Nixon administration was elected on the strength of a purported but still undisclosed plan to terminate the war in Vietnam. Three of the key figures in the administration, the President, the Secretary of State, and the Attorney General, are Wall Street lawyers who have been closely associated with the problems of corporate and municipal finance. Their failure to recognize the portents of impending economic doom and to conclude the rash military adventure responsible for these portents, even after 18 months in office is incredible. Instead we have been treated to the spectacle of escalation in desperation, accompanied by economic chaos, if not collapse.

As a concerned capitalist, I have communicated my misgivings to the administration. Last November, when Bell Telephone bonds were sold at the, up to then, highest interest rates in American corporate history, I called this to President Nixon's attention by telegram.

My message to the President stated:

> Our government's massive expenditures on world-wide military commitments threaten the greatest crisis in our financial markets and the very soundness of the dollar. Unless there are immediate and drastic changes in our foreign policies I feel we are headed for a panic that could destroy the Nixon Administration even as the financial debacle of 1929 destroyed the political career of Herbert Hoover.

That was probably an understatement since there was no war in 1929.

The chaos in the bond market still exists, but has more recently been overshadowed by the stock market collapse. At the beginning of June, I felt impelled to wire the President as follows:

> Businessmen are watching your Administration with increasing anxiety for signs that you will come to grips with the nation's grave economic problems. Unemployment increases. The squeeze on credit and money supply tightens: Operating profits are disappearing. Several large corporations are in serious trouble. Wall Street is in a panic. The international payments deficit threatens the dollar. Mammoth military expenditures make it impossible to restrain inflation. Those of us who witnessed inflation in World War I can testify to its causes and hazards. The business community beseeches you to act before the financial storm breaks into full fury.

If the President will not act, then the Congress must. Under the Constitution, the Congress is charged with controlling the public purse and determining how much of the estimates submitted by the Executive will be funded. This Nation simply cannot afford to continue spending $80 billion a year for military purposes. The $25 billion included in that budget for the Vietnam adventure is money completely down the drain, while much of the remainder goes for the development and production of weapons that would extinguish the human race if ever used.

It is sobering to consider that we have Vietnam-style commitments to 43 foreign countries. If we should be obliged to live up to all of them, we could find ourselves in 43 wars at one time, even though we are going broke on just the one in Vietnam.

One-half the world is Communist. Many of the Communist nations are anxious to purchase the products of our factories and our farms. We should trade with them and extend credit to them as do all the nations that are our allies and friends.

The astronomical sums we are spending annually to kill people could better be spent to improve their standard of living.

Less than a week ago I received a letter from Viscount Montgomery written at his home in England. The great general, a student of warfare throughout the ages, makes this judment on President Nixon's conduct of the war in Vietnam:

> He (Nixon) should realize that a political end to the war in Vietnam is the only possible way to end that war.

Holders of American securities abroad were disturbed by the extension of the war into Cambodia. It is harmful to the Nation and its credit in world financial markets for the President to commit the Nation and its Armed Forces to warfare in a situation where the President's authority to do so is doubtful. Steps ought to be taken to clarify the matter of jurisdiction and power, and they ought to be taken not only with respect to Vietnam, Cambodia, and Laos, but with respect to anything that may arise in the future.

In other words, whether by legislation or by constitutional amendment or by judicial decision, there ought to be a firm definition of when, if ever, the President of the United States can involve our Armed Forces in warfare outside the boundaries of the United States without getting prior congressional approval.

In conclusion, let me offer a few specific steps that I believe should be taken without delay to stave off complete economic calamity.

1. First, and foremost, the war in Southeast Asia must be terminated with a negotiated settlement.

2. Astronomical Federal expenditures for such abhorrent military projects as ABM, for military aid to other nations, for the so-called intelligence activities of the Pentagon and the State Department and such unproductive agencies as the CIA and the FBI should be pared to the bone.

3. Money rates should be substantially reduced, and funds should be made available for housing and other essential American needs.

4. Margin requirements on stock purchases should be lowered to 33 percent.

5. A strong Federal corporation on the pattern of the old Reconstruction Finance Corp. should be created immediately to make funds available for business concerns, industrial corporations, railroads, banks, and insurance, and loan companies.

I repeat that the war in Southeast Asia must be terminated immediately. I have recently visited Hanoi, Cambodia, and Laos and have conferred with their statesmen. I have also talked to spokesmen for Great Britain, Soviet Union, Japan, Canada, Poland, and France.

The example of France's ending the war in Algeria is the one we should follow. After years of killing and endless negotiations, de Gaulle decided to end the war. He stopped the fighting and withdrew 500,000 soldiers and a million French civilians, and France is none the worse for it. Not one more American life is worth spending on a war we cannot win; a war in which the only thing we seem to be salvaging is foolish pride.

The allegation that North Vietnam and the Provisional Revolutionary Government of South Vietnam will not negotiate is not in accord with the facts. I suggest for the Congress' consideration that a small committee of the Senate and House meet informally in Canada or in France with a similar group from North Vietnam and the Provisional Revolutionary Government. By so doing they would learn at first hand, as I did, the terms on which this expensive and economically disruptive war may be ended.

Chairman PATMAN. Thank you, sir. Your statement is very interesting and very timely. I do not know of anyone we could invite before this committee whose testimony would fit into today's hearings in a more timely and constructive way than your testimony does, by reason of your age, experience, intelligence, and sincere desire to be of help to your country.

I notice that you mention reviving a corporation along the lines of the old Reconstruction Finance Corporation. That appeals to me because none of us want to see the Penn Central go through bankruptcy but we were faced with a situation where the people who would benefit the most, the 77 banks holding hundreds of millions of dollars of their paper, would not put up a dime of that $200 million that they wanted the Government to provide to help save Penn Central. So we just didn't think it was right, many people didn't, but the Penn Central should be saved, and it can be saved through just what you suggested here.

In 1932 when President Hoover was President, he initiated the original Reconstruction Finance Corporation. It was for banks, railroads, and insurance companies only. It was later expanded to include any worthy enterprise that could not receive financing from local sources at reasonable rates of interest. The Reconstruction Finance Corporation would not even accept or consider an application for funds unless it was accompanied by a statement from the local bankers that they could not finance it or would not finance it. Then the Reconstruction Finance Corporation would consider it and, of course, that saved the railroads and the banks and insurance companies, too. It saved them all, and it saved many other worthy and deserving projects.

The original Reconstruction Finance Corporation had a capital structure of $500 million provided by the U.S. Treasury. They were permitted to expand about 17½ to 1 on that capital structure, and that was sufficient for 22 years, and during that time the RFC never lost money, it made many profits which, of course, went into the U.S. Treasury, and everybody was benefited. It saved billions of dollars, billions of dollars in companies that would have been lost. It refinanced the school bonds in many different States where their schools were actually closed. The RFC refinanced these school bonds making the payments lower and the terms longer. The schoolhouses were opened, and we had no more trouble about that.

This suggestion would take care of the Penn Central, but more important, it would help many deserving enterprises. We shouldn't just pick out the biggest railroad in the country or the biggest bank in the country and provide Government funds for them, but we should make it possible for all worthy and deserving projects to be benefited in a similar way. I believe that is the thinking of many Members of Congress.

I shall not ask all the questions that I would like to ask because Mr. Proxmire, who is with us, is the ranking member of the Senate Banking and Currency Committee. They have a meeting and they are waiting on him and I persuaded him to come by. Senator Miller, would it be all right to let him use his time now and you next?

Senator MILLER. He would do the same for me.

Chairman PATMAN. Thank you, sir. Unanimous consent is granted. Go ahead.

Senator PROXMIRE. I did come by because I have such great respect and admiration for Mr. Eaton. I should be in the other committee, but I am delighted I did.

This is a most impressive statement, Mr. Eaton, and also I wanted to pay tribute to my good friend and former colleague, Senator Lausche, who is with you this morning.

Mr. Eaton, one of the great things about you, I have often disagreed with you, as many people have, but you are one of the rare people who have the courage to say unpopular things and say them loudly and strongly when they should be said and a number of times I have found that I have been wrong and you have been right.

With respect to the point the chairman brought up, the RFC, Reconstruction Finance Corporation, I am afraid maybe I disagree with you here. I am not so sure it wasn't good for the Penn Central going into bankruptcy. What is wrong with bankruptcy? After all it seems if we are going to have a federal bail out procedure which is going to prevent these firms from having a shakeup in poor management, and I think if we learned one thing about Penn Central it was very poor management and it would seem to me that would be a mistake. Why shouldn't we have the court move in when you have a situation such as the Penn Central had and have a new kind of management? We have had bankruptcy and receiverships operate railroads very efficiently in the past and with improvement in the kind of quality of management. So under these circumstances why do you think something like the RFC to move in to prop up these firms that have not done well is an answer.

Chairman PATMAN. May I suggest, Senator Proxmire, that I didn't say one thing I should have. In order for Penn Central or any other concern to get a loan they would have to put up adequate collateral. You see the RFC didn't lose money on these things. They made money. Borrowers would still have to put up the collateral. I think that is the important thing.

Mr. EATON. I am a dedicated capitalist both in theory and practice. At the same time, I think we here in America must have closer cooperation between private capital and government, Federal, State, and municipal.

Take the collapse of 1930. The country became terrified. Many who had bank deposits were drawing out their money. Many who held insurance policies were cashing them in. I came to Washington to see President Hoover. I told him that the Government must guarantee bank deposits to reassure the public.

When the President took that up with his advisers, especially with some of his friends in New York, they asserted that such a step would be completely contrary to the principles on which this Nation had been developed. In their opinion, banks that had been badly managed would have to close and go through bankruptcy.

So the depression deepened, until every bank in America was closed. Runs on every bank, no matter how sound, continued at a terrible pace. There was continued liquidation of stocks and bonds. Everyone wanted to sell and nobody to buy, so that even the highest credit securities sold at unbelievably low prices.

One of the first steps Franklin Roosevelt took was to guarantee bank deposits, after telling the Nation, in his inaugural address:

The only thing we have to fear is fear itself.

I supported this action, even though I belonged to the other party at that time, along with my uncle, Charles Eaton.

We are in a comparable condition now. We have 32,000 banks in America, but none of them is really big enough to handle an adequate share of the immense credit requirements of this vast country and its mammoth corporations.

While the management of Penn Central may have made some mistakes, it is a marvelous property, one of the greatest in the world, in fact. In my judgment, it ought not to have gone into receivership, even though insufficient private capital was available to save it. In view of the present American predicament, at home as well as abroad, there is great uneasiness in all capitalist countries over the economy and the finances of America. That is true in England, it is true in Germany, it is true in France, it is true in Holland and Belgium, it is true in Canada. There is great uneasiness around the world, and foreign investors are no longer buying the stocks and bonds of American corporations.

Chairman PATMAN. I recognize that; yes, sir.

Mr. EATON. I am sorry to be so long. But in this time of uneasiness, when private capital is not able to cope with the crisis, I think some means must be found by which Federal and perhaps also State governments can collaborate and cooperate with private capital.

Senator PROXMIRE. Yes. You see, as I understand it, the Federal Deposit Insurance Corp., was to protect depositors, not stockholders but depositors, depositors who could gain nothing from the profits of a bank but could get only a fixed return.

On the other hand, the stockholders in corporations like the Penn Central are taking a risk and they stand to gain a great deal if the corporation does well, and if the risk means anything it means if the corporation does not do well they lose. If the people they elect as directors and who in turn elect their corporate executives are not competent the management fails and the stockholders have to pay the price.

Along that line, and since I have just a couple of more minutes, let me ask you this, Mr. Eaton: You have indicated that you feel strongly that banks should not be empowered to vote the trust funds and accounts that they have under their control.

I noticed in this Penn Central case one very large New York bank, a major holder, has been in a position to vote a great deal of the stock in the Penn Central. That same New York bank is also a creditor of Penn Central and, of course, there is a conflict of interest involved here. I know that for a long time you have been talking with some of us on the Banking Committees of the House and Senate about legislation that would not permit bankers to keep themselves in authority and in power by simply voting the stock in that bank that is in trust, and in turn voting for the directors who will keep them in authority.

Would you like to give us your opinions on this now, because I don't think you have had a chance to testify publicly on this matter.

Mr. EATON. The pressure of public opinion, I think, ought to be enough to discourage the practice of banks accumulating their own stock in their trust departments, and voting it for the election of directors who, in turn, keep the officers of the bank in power. Nor should banks collect and maintain large blocks of stock of outside corporations for long periods of time in their trust departments, and put the banks' own officers on the boards of those companies.

Since public opinion is not powerful enough, the alternative must be legislation to prevent these unwise policies. There are a good many State banks in the United States that are not subject to Federal regulations against these practices. These banks nevertheless enjoy the benefit of the guarantee of their deposits by the Federal Deposit Insurance Corp., as well as the privilege of borrowing money from the Federal Reserve bank.

As the magnitude of the Penn Central collapse becomes fully felt, the impact on public opinion and on statesmen will be so strong, I am sure, that the result will be constructive legislation in the interest of the banks, themselves, as well as the country.

Senator PROXMIRE. Just one more question, because it is sort of startling. Your last recommendation is that margin requirements be reduced, one of your recommendations is that margin requirements be reduced, to 33 and a third percent. The Federal Reserve Board recently cut them from 80 to 65 percent and many people have critized that. If we have 33 percent margin requirements don't we encourage a great deal of speculation, don't we encourage people to get in over their head by borrowing and investing in the stock market? It may be a temporary palliative, although incidentally the cut in margin requirements from 80 to 65 percent didn't result in a significant rise in the stock market. Why do you think a 33 percent margin will do it?

Mr. EATON. I don't think that is necessarily the percentage that ought to prevail at all times. I do think that it would be desirable now, however, when stocks are down to almost a low point in history and there are few buyers. The collapse of the stock market spreads uneasiness. The holders of our securities abroad are selling. The shrinkage in the market value of stocks has been terrific. So if you needed, let us say, a 70-percent protection when a stock was selling at $150, a 33-percent margin would seem reasonable if it is now down to $30. Even though it can't go much lower, there are few buyers. People are scared to buy stocks, but this is the time when there are very great bargains. As I say this, I also feel impelled to state that I think this market is going to slide further, if the war goes on, because of uneasiness about it around the world. The prudent, careful investors in France, in Switzerland, in England, are quietly selling their American stocks, and they are no longer buying any American securities, either bonds or stocks.

So we have reached the point where stocks are cheap. While they will probably go lower, I still think this is the time to buy stocks. In the case of a stock selling at $30 a share that not long ago sold at $150, you can obviously justify less margin now than you could when it was at the peak.

Senator PROXMIRE. Thank you very much. My time is up.

Chairman PATMAN. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Eaton, it is a pleasure to have you before the committee. It is also a pleasure to see you accompanied by my friend and colleague, Senator Lausche, whom I personally think is the most courageous and one of the outstanding Senators with whom it has been my privilege to serve.

I also know that you have been quite active in trying to develop better relationships with the countries behind the Iron and Bamboo Curtains and in that respect you have ventured some opinions which I am sure were sincere, with which some people, including myself, have disagreed from time to time but you share the distinguished company of one of my fellow Iowans in Roswell Garst who has tried to do in agriculture what you have tried to do in the areas of industry.

First of all, you keep harking back to 1929. Do you really believe that with all of the built-in safeguards we have, insured bank deposits, social security and many other Federal Government programs, that there is much chance of getting back into a situation such as we had in this country back in 1929 and in the 1930's?

Mr. EATON. It is almost as bad now as it was in 1930 and 1931. Corporations that need to borrow money are having very great difficulty in doing so.

If a man wants to build a house today and if he has proper connections, he may get a loan at 15-percent when all of the compensating balances are added on. Most people can't get the money, though. We are today in a position verging on what happened in the 1930's.

We are better off in this respect: The Federal Reserve bank today can discount commercial paper for banks. At that earlier time they could only loan a bank on Government bonds or 90-day liquid paper. Today the banks can borrow from the Fed on almost any kind of security or no security at all. In that respect we are very much better off.

On the other hand, there has never been a time in the history of this Nation when credit has been so difficult and scarce as it is now.

There are thousands of corporations that need money today and can't get it. The predicament is much more difficult than meets the eye.

The collapse of the Penn Central has called attention in a very dramatic way to conditions in this country.

The Penn Central is one of the greatest properties in the world. I could go into detail on that. It is my competitor, but I am still willing to concede that it is a marvelous property. It has sufficient assets, if well handled, to justify any kind of credit. Yet Penn Central couldn't get the money it needed, even though it had many leading banks of the United States behind it.

Now when that happens to a corporation of such distinction and size, what happens to a small company in Iowa or in Ohio that needs money urgently and can't get it?

Senator MILLER. Well, possibly you have a different concept of this recession or depression than I do. I recognize we have a tight money market and I recognize interest rates are very high. But to many of us when we look at a recession one of the first indicators is unemployment and when you compare the unemployment rate of 5 percent today, especially as we are phasing from a war-time to a peace-time economy and compare that to what we had in the 1930's, I suggest to

you that we have a long, long way to go, and especially when you take into account the fact that the unemployment rate for 4 or 5 years during the Kennedy and Johnson administrations until the war heated up was higher than it is today. I just don't think that we should lose our perspective on that point.

Mr. EATON. Senator, if this depression continues, it is going to go deeper than 1929 did, and there will be unemployment on a vast scale, unless Government expenditures for foreign wars are immediately curtailed. The war is the main cause of our financial difficulties. We are not ending the conflict. We are extending it in the vain hope that we can win.

Again, take the Penn Central. I would predict that at least 20,000 to 25,000 people will have to be eliminated from its payroll. That is what happens in only one company. In industry everywhere, when business disappears and money is scarce, there is no alternative but to let people out. You are going to find the unemployment rate accelerating sharply unless the Nation mends its international ways. I think there is still time to save the situation, but I don't believe we can go on spending money the lavish way we do abroad, without moving into a depression that will be at least as devastating as 1930 and 1931.

Senator MILLER. Well, thank you, I think you have answered my question, but incidental to that are you suggesting that Penn Central is not suffering under mismanagement?

Mr. EATON. We always look for a victim and a goat. The management of Penn Central made mistakes, but I doubt that you could have gotten abler executives than Saunders and some of his associates. They are extremely able men. They are under a cloud now, and they will get a lot of kicking around, but I think they are better men than they will be made out by their critics. What went on in a corporation of that size is also going on in hundreds of others, big and small. There have been other large corporations just on the verge of bankruptcy. Some of them have been rescued only in the past 10 days, because the banking fraternity has felt that it would be under severe criticism if this spread further. Even so, there are companies of fine credit standing, with thousands of employees, that are in terribly tight shape today.

Senator MILLER. Do you think we are in danger of having other Penn Central situations involving others of our railroads?

Mr. EATON. I don't think there is any other railroad of great size to which that will happen, but there are other huge corporations, with thousands of stockholders, in a very hazardous position.

I have strong sympathy for stockholders. There are some 30 million stockholders in the United States, and I think that is the very heart of capitalism. If we are to avoid socialism I think more people must become stockholders. I want to see every employee of every corporation a stockholder, so there will be a mutual interest between owners and employees.

But what has happened to the American stockholder in these great companies? Take American Telephone & Telegraph, which has been regarded as probably our greatest corporation. Its stock has shrunk nearly $10 billion in market value. That means that widows and orphans have seen a sizable shrink in the value of their holdings, even in that great and well-managed corporation.

I don't want to do it publicly, but I could cite you hundreds of corporations that are in very precarious position today.

Senator MILLER. Well, as chairman of the board of C. & O., you certainly have some familiarity with the railroad industry as a whole, and there are rumors going around that there are other railroads besides Penn Central that are in trouble, not as large as Penn Central but substantial with their investors, and my question to you is whether or not, in your view of the present situation, other railroad corporations are in trouble somewhat analogous to Penn Central although on a smaller scale because they are smaller railroads.

Mr. EATON. Every railroad in America today is suffering acutely because of the high cost of money or inability to get money. Our railroads, the Chesapeake & Ohio and Baltimore & Ohio, have been more fortunate, in that we have great coal deposits on our lines. What is stimulating our business, and enabling us to make more money this year than we did in 1969, is the demand for coal all over the world, not only in America, but also in Europe, Asia, and South America. We are running full, because we happen to be in the fortunate position of serving these great coal reserves, at a time when every part of the world needs coal. If it wasn't for the worldwide demand, we would also be uncomfortable, but that is our good luck.

Some of the smaller railroads are in a tight position, but I am hoping the banking community and the Government itself will prevent any of them from going into receivership. There are many other great American corporations that urgently need money, and can't get it, because it just isn't available. We are spending it abroad.

Senator MILLER. Thank you. My time is up.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Welcome, Mr. Eaton, to what I understand is your first appearance before the Joint Economic Committee. Your many qualifications to advise us, beyond one that struck me in your testimony, the fact that you had been reading the Economist for 70 years, that entitles you to be called an old subscriber. I am very much impressed by your central analysis, the fact that you point to our military expenditures in general and our Southeast Asian preoccupation in particular as the source of our economic troubles of inflation, high interest rates, unemployment, the liquidity squeeze, and so on.

It was interesting the other day we had two very fine witnesses, one a leading businessman, the other a leader in labor, and both of them talked extensively about the economy without mentioning military expenditures and the war, so much so that our colleague, Senator Fulbright, remarked on it.

Here we may leave economists and get into psychology, but why is it that so many economists, so many businessmen, and so many labor leaders in talking about the economy fail to mention what I agree with you is the central force that is producing our economic troubles, namely, wars, threats of wars, and preoccupation with wars? Why is that? You have been around for a long time and maybe you have observed something about human nature that we would like to hear. Were you able to hear that question?

Would you rather I repeat it?

Why is this so?

Mr. EATON. We have a longstanding prejudice here against communism. I am as little of a Communist as there is in the world. Half the world has embraced it but our people are still feeling that anything that has a Communist touch is evil, and I think the leading example of that is our President. From the time he was in Congress here, then as Vice President and now as President, he has looked upon communism as the greatest threat to the world.

When I went to Hanoi and said that I thought our President wanted to end the war, the leaders there didn't tell me I was naive, but implied it very strongly. I found that, while I had known the President since he was in Congress, they had studied his record more accurately and closely than I had. They took me to their museum and showed me pictures of Vice President Nixon when he came to Hanoi in 1953 to urge the French to continue their fight against the Vietnamese attempt for independence.

There, as you see, you get deeply into human nature. For 300 years, our ancestors felt the world couldn't exist half Christian and half Mohammedan. After fighting for 300 years, they just decided on peaceful coexistence. There are now about as many Mohammedans as there are Christians.

The parallel today is America's rabid anticommunism which drives us into all kinds of extravagant undertakings, even going to war. The prospect of a war between major nations today is terrifying because the Soviet Union possesses, as we do, the implements of war to destroy the whole world. We regrettably seem to be blinded to those hazards at times by our prejudices. Under restrained leadership, I am sure the American people would never entertain the notion of bombing Communists or Socialists. They could come to feel that the way to change opposing systems is not to drop bombs on them, but with patience and education, and by trading with them. That is my great and fundamental doctrine.

When Soviet Deputy Premier Mikoyan came to Cleveland to see me in 1959, he wanted to meet the leading industrialists. I assembled 75 of them and Mikoyan told them:

> I want to place the largest order for steel in the history of the world. We need tremendous amounts for our pipelines and automobiles and other things. You ought to extend us credit, as other nations will, but we will use our gold and we will pay cash on the barrelhead.

When Mikoyan got through, the president of every company was up to sign an order with him. He said to me afterward:

> This is the happiest day of my life, to be received in this gracious way by these industrialists.

When he came to Washington to get export permits, the Department of Commerce said:

> No, we will not permit the export of steel from America to you.

Mikoyan thought that the State Department would take the opposite view. When he went to them, however, they said:

> We realize that the buying of this steel will not help you in a military way, but it will strengthen your commerce, and we will not permit anything to happen that will strengthen your commerce.

If America won't trade with a country, even though it would be profitable to do so, it means that we have a deadly hatred of the country and its system. I think that is something that we must overcome. Frankly, I don't think the present administration subscribes to that doctrine. I think they still feel that the course to pursue is to arouse every bit of antagonism we can against the Communists nations.

I don't subscribe to their system, but I am hoping that this antagonism will not last so long as to get us into a war. If we do, we are all through.

Representative REUSS. One other question, Mr. Eaton. In your analysis the war is largely responsible for our inflation. The inflation is largely responsible for the so-called liquidity squeeze, this because as long as prices are rising corporate managers have felt it necessary to take all the cash they have in their cash flow and all the money they can borrow from the banks and the market and elsewhere, and put it into fixed assets, those that will be somewhat inflation-proof. Would that be a fair statement of why we are in the cash liquidity fiasco we are experiencing?

Mr. EATON. I think all economists would say that the chief thing we have to contend with is inflation. What is inflation? The chief producer of inflation today is our war, and I go back to my experience with earlier wars. At the time of World War I, I was interested in the utilities in Senator Miller's State. Coal for a gas plant or a powerplant went up to $25 a ton. When the war was over, coal went back to $4 a ton. But a lot of our utilities were on the verge of bankruptcy during the war, because coal for the production of gas and electricity was costing us $25 a ton. This was just one example of the inflation caused by that war.

In World War II we avoided that by establishing strict price controls that applied to everything. This time, the Vietnam war has been going on for years without any controls. Of course, if we had price controls, they would apply not only to labor and commodities, but also to bank rates.

Let us look again at today's cost of money. If a man who is going to build a house must pay 15 percent for money, there is something seriously wrong. When that exists, we urgently need to determine the fundamental cause and cure it.

Representative REUSS. My time has expired. Thank you, Mr. Chairman.

Chairman PATMAN. Mr. Brown?

Representative BROWN. Mr. Eaton, first let me welcome you here as a fellow Ohioan and also tell you how glad I am to see your distinguished counsel and our former Senator and Governor, Mr. Lausche. It has been my pleasure to know him for many years, although the first opportunity, I think, to visit with you.

In your testimony, you observe that it is sobering to consider that we have commitments to 43 foreign countries. Would it not be desirable for the U.S. Senate which confirmed those commitments, to review some of them with officials of this administration to see whether they might be altered or in some way modified?

Mr. EATON. They ought to be reviewed. I don't see the point of the United States alone undertaking these vast expenditures without the help of other nations. We won't go through the United Nations, although I think it would be the logical place.

We have what we regard as a very valuable ally in Great Britain. I have discussed our Vietnam problems with the leading statesmen of all three parties in Britain. They all say practically the same thing, namely, that Great Britain has never had an alliance that meant so much to them, but cost them so little. They call attention to the fact that they have never put up the first dollar toward the war in Vietnam and never sent a single soldier, but they get credit for being our ally and friend and, for that reason, get tremendous rewards from us in our economic and other collaboration with them.

We have a lot of these commitments that are entirely one-sided, many of them engendered because of hatred of communism. You will find that a good many of our allies respond as Great Britain does: We love you and publicly support you, but we won't put up a dollar.

They save their money, and they are all improving their financial position.

This is true of France. De Gaulle showed great wisdom when he ended the war that had been going on in Algeria for years. Prolonged negotiations had been in vain. The French could cite all of the same reasons for their inability to stop that conflict that we are giving now to justify our prolongation of the war in Vietnam. "Commitment" and "honor" were the sacred catchwords. Then, overnight, De Gaulle decided to end it and he withdrew 500,000 troops and a million civilians. Cutting off the bloodshed and its vast expense has done nothing but improve France financially and in world opinion.

These commitments of ours are extremely dangerous and expensive. We are in no financial position to carry them out. We must remember that our allies right now are selling their American securities. While it is true that in the last 2 years American corporations were doing important financing in Europe, any security of an American corporation offered in Europe today meets with the polite response. "Come back in 6 months or a year, and we'll see."

Representative BROWN. Most of those commitments, like the war in Vietnam itself, were effected prior to the present administration coming to power. It seems perhaps our time might be more profitably spent reviewing the commitments which might involve us in another Vietnam rather than trying to second guess the President's method of withdrawal from this current involvement.

President Nixon came into office facing an already full scale conflict in Vietnam. He has taken some fairly concerted steps to terminate that war by withdrawing personnel, by entering into negotiations with Hanoi, and expressing the desire to negotiate, most recently, by naming Ambassador Bruce.

In your contacts with Hanoi did you find a willingness on the part of the North Vietnamese to bring the war to an equitable conclusion or only to bring it to a conclusion on terms dictated by Hanoi?

Mr. EATON. Everyone I talked to in North Vietnam wants to end the war, and on terms that I think are quite reasonable. While you say Mr. Nixon inherited this war——

Representative BROWN. Could you indicate what the terms would be?

Mr. EATON. Yes.

For instance, take the question of withdrawal of troops. North Vietnam would regard 18 months as a reasonable period for that, so that there would be no chance of slaughter of civilians or of our forces.

Representative BROWN. That is troops of both sides?

Mr. EATON. Pardon me.

Representative BROWN. Will troops of both sides be withdrawn?

Mr. EATON. When you say both sides, I should like to call your attention to the attitude of the French, the best informed people on the problem in Vietnam. I have discussed this subject at great length with the French Foreign Office, with French bankers and with French statesmen. They say to you immediately:

> We don't differentiate between North and South Vietnam. It is all one country, with everybody speaking one language. We drew an arbitrary line there, so we could move our troops in and out. The United States has made two nations where there was only one before.

Representative BROWN. More properly the Geneva settlement.

Mr. EATON. Pardon me.

Representative BROWN. The Geneva settlement separated the two, did it not?

Mr. EATON. No, that was a temporary agreement between the French and the Vietnamese for the convenience of the French troops. On the subject of government, which I discussed at length, Hanoi said:

> We want to see a coalition government there. We don't want more than we control.

They take this view, which I think is probably accurate, that about 20 percent of the people of South Vietnam are for the Saigon government, another 20 percent are in the National Liberation Front. That leaves 60 percent who aren't concerned with communism or capitalism. They would like to be left alone on their farms and in their homes.

Representative BROWN. This is Hanoi's view, is that correct?

Mr. EATON. That is Hanoi's view, and my view, after the most careful investigation. Hanoi realizes that any government there ought to represent all the people. They would accept any member of the present Saigon cabinet except the three tops. The objection to the three tops is they were all generals of the French army, and all fought against their own country.

Representative BROWN. Apparently they would not care for internationally supervised free elections in Hanoi, is that right?

Mr. EATON. They would favor free elections. If you are going to conduct free elections, you must have some group to supervise it. You certainly can't have the present government in Saigon do it.

Representative BROWN. Would they tolerate United Nations supervision of free elections?

Mr. EATON. That needs to be explored. They would not go along with any supervision under the control of the United States. Remember, the United States is their great enemy. We have bombed their churches and hospitals and schools, and we have supported the regime in South Vietnam. They would accept a truly impartial group. They are confident of what would happen with an honest vote.

Representative BROWN. My time is up, but I want to be sure that I understood what you said. The 18 months' withdrawal would be 18 months for withdrawal of American forces but not any North Vietnamese forces, is that correct?

Mr. EATON. There would be no North Vietnamese soldiers in the South at the end of that time. They would all be back home. That could easily be worked out. Reasonable terms could readily be obtained, once they thought that Mr. Nixon really wanted to end the war.

Representative BROWN. Again, my time is up, but the President has indicated in every public way that he wants to end the war. He is withdrawing troops now. Isn't that a sufficient indication? What would they take as an indication that we really wanted to terminate the war?

Mr. EATON. I believed that until I came back from Hanoi with what I considered fair terms. You only have to go back over the past 2 weeks to know the attitude of the United States. Secretary Rogers has been in Southeast Asia, in Japan, and in London. What was he mainly trying to do there? To stimulate Southeast Asia to get into the war, to get Japan in and to get help from Great Britain; not to end the war, but to continue it. That is what you face.

Chairman PATMAN. Senator Fulbright?

Senator FULBRIGHT. Thank you, Mr. Chairman.

First, I would like to say, Mr. Eaton, that I think you are one of the best qualified men I can think of to address yourself to this question. Your appearance here does bring back memories of your uncle in the House of Representatives. He was there on the Foreign Affairs Committee when I first came there some 27 years ago. I believe he was your uncle, Charles Eaton was your uncle, and I know he was a very broadminded, extremely perceptive and intelligent man. He also was a Republican, I may say, he was the ranking Republican of the Committee on Foreign Affairs.

I also am glad to note that you are accompanied this morning by our old colleague and friend, Frank Lausche, whom we miss very much. He was on the Foreign Relations Committee for a number of years; the first time I have seen him at a committee meeting, I think, since he left us. He also has very good credentials in matters that you have been discussing this morning with a long experience. I don't mean to say that he agrees with everything you have said but anyway he has very positive opinions about it.

You yourself have been participating in the business life of this world and this country, I guess, as long or longer than any present business leader that I know of. How old are you, Mr. Eaton, you don't mind saying that, do you?

Mr. EATON. Eight-six and a half. [Laughter.]

Senator FULBRIGHT. And you have been in business for how long, you have been in business, I guess, 50 years longer?

Mr. EATON. Actively since 1906, and even before that, when I was working for Mr. John D. Rockefeller, Sr., as a student.

Senator FULBRIGHT. And you have learned your lessons very well. The common rumor is that you have been quite successful in business, that is what I have heard. It has been so reported in the press. So that as, speaking as, a capitalist, as you have done several times, reiterated this morning, that you believe in capitalism, it seems to me your views ought to carry a great weight with this country which still professes a devotion to both democracy and capitalism.

If I understand your position is that you are devoted and dedicated, as you have said this morning several times, to capitalism and de-

mocracy. I am speaking into the mike, I don't think they have turned it on, Mr. Lausche, because they don't want to hear what I have got to say.

My mike doesn't. It is not operating. I can't get any closer to it than I am.

I think that the fact that your record is so clear on this, and you have been such a success, if I understand your position correctly is, while you are dedicated to capitalism and to democracy you believe the policies followed by this country are undermining democracy and capitalism and that is what you object to, that these policies that this Government has been following are not in support of our professed objectives, being the preservation of capitalism, private enterprise, and democracy.

If I understand you correctly that is your position. I regret that I cannot have a microphone——

Mr. EATON. The great threat to the capitalistic system comes from unwise policies in a democracy. The great threat to our American capitalism today is our vast expenditures abroad that are crippling us financially.

When I was in Laos and Cambodia, I was absolutely shocked at the evidence of the spending of American money there to influence people in those countries. Here we would call it bribery. Over there we call it efforts in behalf of democracy. Actually, we are just trying to buy people by the thousands, with vast expenditures of our taxpayers' money, to get adherents and followers. That is no way to get people to adhere to a political system, by trying to buy them.

So I think the criticism, if any might be made, of the great Congress of the United States, for which I have deep respect, is that it is in somewhat the same position as the board of directors of the Penn Central. It hasn't been observing as carefully as it might the expenditure of money for military purposes and so-called foreign aid. That is something that needs to be taken more seriously. It is not good to be a defender of democracy if you go bust in the process.

Senator FULBRIGHT. I think I understand you correctly. In other words our policies are discrediting our judgment around the world, and when not only have you already described the internal difficulties, the bankruptcy, of a great corporation, and the difficulties of others but in addition to that, I believe I gather from your testimony that the other countries that you mentioned do not really have confidence in our judgment, they are not really following us, that they are taking our money but they have great doubts about the validity of our own system because of the way we operate it.

Mr. EATON. Yes, that is right.

Senator FULBRIGHT. Do you agree with that? Do I interpret your meaning properly?

Mr. EATON. Yes. A great illustration of that is in dear old Great Britain, of which we are all very fond. John Bull is pretty canny; he lets us spend our dough, but doesn't part with a pound of his own.

France, of course, feels a special responsibility for Vietnam, Cambodia, and Laos, because those countries were a proud part of the French empire for many years. Therefore, the French are more openly critical of our policy. The French love those people and they know them well. The people speak French and are steeped in French tradi-

tions. France has been rather outspoken in calling our attention to our mistakes. What I believe our statesmen could advantageously do is to ask the French to tell us frankly what they, as long time rulers of that area, think we ought to do to end this war.

I have gone into this at great length with the French Foreign Office and with French bankers and businessmen. I would urge Americans who are seriously interested in getting the final answer to talk to the French.

Senator FULBRIGHT. If I understood you correctly, the French recommend, in effect, an approach similar to that which they took to their involvement in Algeria and in Indochina; the pattern of their disengagement in Indochina still applies to our engagements, if we were willing to take it, is that not correct, isn't that what you have been saying?

Mr. EATON. Yes, the French say very openly that the only solution to Vietnam is the one they finally adopted in Algeria.

Senator FULBRIGHT. Yes.

Mr. EATON. They had to contend with all these questions about the possible slaughter of the people and honoring their own commitments.

Senator FULBRIGHT. They also adopted it in Vietnam. I mean in 1954 they were in a very similar position to our own. They had a Vietnamization plan going. They advocated it. It didn't work. They were training the local people to defend themselves. It didn't work, but they were finally faced with a decision. They had to either expand it or they had to liquidate it and they liquidated it in 1954 within the space of a couple of months in Geneva.

Now, let me come to the line of questions of the Congressman from Ohio on this method. It seems to me you and the administration, and the administration says it wants to end the war, the difference is the means that they have adopted as opposed to what you recommend and the French recommend and many others recommend.

The French, as I understand it correctly, and you and I do not believe that Vietnamization as a concept is properly or appropriately adapted to achieve that end, and neither do the people of North Vietnam, is that correct?

Mr. EATON. Yes. You see, the President said during the election campaign that he had a plan to end the war.

Senator FULBRIGHT. Yes.

Mr. EATON. I have been trying to find out what that plan is, and I don't think anyone in the State Department knows what it is.

Senator FULBRIGHT. Well, Vietnamization is the professed alleged plan.

Mr. EATON. That is not to end the war though.

Senator FULBRIGHT. Well, but they——

Mr. EATON. That is to continue it and to bring in other allies.

Senator FULBRIGHT. But this is the crux of the matter. They say it is the way to end it. They say it. You say it is not. I agree with you. I don't think either it is the way to end it. It is a way to prolong it.

Mr. EATON. I don't believe the President intends to end it.

Senator FULBRIGHT. That is what I am getting at.

Mr. EATON. Unless Congress tells him he must.

Senator FULBRIGHT. Well, that is a very difficult thing for Congress to do. You know what has happened in the last 2 months both in the

Senate and in the House, but this is the crux of the matter. I am trying to isolate what is the real issue in this whole debate.

Mr. EATON. Obviously you can't end the war by extending it. For instance, the President said, on going into Cambodia, that he wanted to bring our troops home quicker. You don't bring your troops home quicker by starting a new war in a new country. Prince Sihanouk, who has been expelled from Cambodia, is a smart man, with a great following there. He is going to influence a lot of Cambodians before he is through. So instead of bringing the troops home faster, the President is going to have to leave them in Southeast Asia much longer, because we now have a new country involved in the war. No one knows how divided Cambodia is, but Prince Sihanouk is very popular there in certain circles, and was the head of the government for many years. Now he is going all out to arouse Cambodia to participate in this war.

Senator FULBRIGHT. Mr. Eaton, I can't overemphasize I have been, and others of us who share your attitude on how to end the war, are condemned daily most vigorously because we don't back the President. If you back the President in Vietnamization do you think it would bring about an end—I have had letters saying "if you backed the President the war would be over," the assumption apparently being that Hanoi would surrender if they thought the country was united. Do you believe this is true, you have been in Hanoi, do you think there is anything to indicate if we were determined to go through to victory that Hanoi would surrender or come to an agreement?

Mr. EATON. No. I have never in any part of the world in my long life seen people that are so devoted to nationalism and to their country. The French statesmen will tell you that the great mistake the French made was not to give these people their independence when they demonstrated that they would fight to the end for it. They will continue to fight until they get their independence, of that I am convinced.

Beyond that, it is terrifying to contemplate the massive support which that little country gets, first from Red China, with which it shares 500 miles of common border, and, of course, from the Soviet Union, which is helping somewhat reluctantly but on a rather liberal scale.

We are foolhardy to underestimate the spirit and determination of the people of Hanoi, especially backed as they are by two immense nations.

Just looking at it from the practical angle, Field Marshal Montgomery once said to me that, never in the long history of warfare has a campaign been undertaken with less chance of success from a military standpoint. We are sending our men 9,000 miles to Asia to fight, on unfamiliar terrain, people of different race, color and religion, backed by the massive support of Red China and the Soviet Union.

Montgomery points out that most wars are hard to understand. There is only one with an easily recognizable cause, the 10-year war in Troy, and that was over a beautiful woman. After his long life of military experience, Montgomery professes to be terrified by war. He says that, from the practical standpoint of a general, there never was anything so lacking in wisdom as sending our troops to Southeast Asia. They are brave soldiers, who fight magnificently, but have no chance of winning. To answer your question, there isn't anything we can do

to win the war. Let's say we went all out to win. That would bring Russia and China in, and that could mean the end of the human race.

Senator FULBRIGHT. My time is up, Mr. Eaton. I think you have made a fine witness.

Is it fair to summarize it by saying if we continue this war we are undermining the integrity of our capitalistic democratic system?

Mr. EATON. We are doing more to make capitalism unpopular in the world by this war than anything else we could possibly do. The way to sell the world on our capitalistic system is to have success and harmony in our own country. We can't do it by engaging in wars 9,000 miles from Washington. We must do it in this country, by the example of our prosperity, our harmony and our devotion to our institutions, and not by undertaking wars all over the world.

Senator FULBRIGHT. Thank you very much.

Chairman PATMAN. Please bear with me just a minute, Mr. Eaton.

We have two other distinguished witnesses and we must give them an opportunity to present their statements. If you will keep your seat, if you would like to do so, and let us bring in these witnesses, Mr. Eckstein, please come around, sir, and Mr. Daniel Brill, and then we will ask them questions along with you, Mr. Eaton. They are on our agenda for this morning and we must give them an opportunity.

Please proceed, Mr. Eckstein.

STATEMENT OF OTTO ECKSTEIN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. ECKSTEIN. As it has so many times before, your committee holds it hearings at the very moment when people are most concerned with our economy.

I am sure we have all benefited from Mr. Eaton's remarks. He has had an opportunity to observe this world a lot longer than we have.

Unemployment is hovering at 5 percent. Profits are down 10 percent. The equity value of American business has been marked down 35 percent. Interest rates are at historic levels. Large corporations are edging into bankruptcy in a fashion not remembered since the depression.

How could all this have happened to us so soon after we seemed to have uncovered the secrets of sustainable growth and high employment? And how soon will our troubles end? My testimony today will argue that our economic performance will fall short of reasonable goals for at least another year, even if, in a narrow sense, the low point of the "stretched recession" may be behind us. The economy will not soar into the early 1970's any more than it did into the early 1960's.

AN EARLY END TO THE INFLATION?

The worst inflation since Korea appears to have passed its peak. The consumer price index is rising slightly less than the 6.2 percent average of the last 12 months. The more sensitive wholesale price index, which rose by 5.6 percent from December 1968 to December 1969, has slowed to a 2.8 percent rate over the last 6 months, 1.2 percent since March. Sensitive industrial material prices are actually falling, and were 4 percent lower in June than at their February peak. What's more, the

broad indexes probably understate the extent of improvement. In periods of economic softening, transaction prices weaken before the list prices which are reported in the Government's indexes.

While this improvement is most welcome, we must be careful not to raise our hopes too high. Virtually all economists have been too sanguine in looking for improvement in the inflation. They have based their conclusions on the postwar experience, when every major economic slowdown or recession resulted, frequently after a few months of delay, in an end to inflation. The question is whether the known historical relationships will stand up in the face of a number of special conditions.

The disinflation process this time is made particularly difficult by the following factors:

The duration and extent of the recent inflation in consumer prices is resulting in wage claims that are still accelerating. Even substantial unemployment for a year or two is not likely to bring the big negotiated settlements to the productivity trend. Last year's average negotiated settlement was 8.2 percent, a pattern that seemed to hold outside of construction this year, until the recent 12-percent Teamster settlement. While the unorganized workers, whose wages rose more quickly, will not fully match the settlements, their wages will not be on a completely different trend. Our wage structure is tied together through spillovers.

Prices in the metal and metal product industries particularly picked up speed in 1969 and are still advancing. Nonferrous metal prices appear to have peaked out, but the average of metals and metal product prices continues to advance and to impose cost and price pressures on the machinery and equipment industries, office furniture, hardware, fabricated metal products, etc.

Prosperity in other advanced industrial countries will keep world material prices high. Coal is the most dramatic current example.

The rise of protectionism, particularly the quotas on meat, steel, and textiles, reduces the price restraining influence of world competition.

The absence of an incomes policy has worsened inflation in the labor and product markets where discretionary power exists. I hope that the President's new Commission on Productivity and the Council of Economic Advisers' Inflation Alert reports will be used effectively as incomes policy measures.

The $3 billion increase of employer social security taxes on January 1, 1971, will raise unit labor costs by an extra six-tenths of a percent.

The costs of meeting consumer protection, social, and environmental objectives will lead to higher nominal prices although it may be money well spent.

The inflation record of the broad price indexes is likely to show very substantial improvement over the 12 months, though satisfactory price stability is not likely to be reached. The trouble is that the cost-push elements will continue at a rapid rate beneath the surface, partly hidden by the declines of sensitive material prices. With price performance never quite satisfactory, and the risk of renewed acceleration of inflation always close at hand, fiscal and monetary policies are likely to continue to give weight to the price objective.

THE STRETCHED RECESSION

When the economic historians look back on the years 1969–71, they may chronicle it as the stretched recession. Most of the things that usually go wrong in recession are going wrong, but not all at once. The timing and sequence of economic processes is different from the normal cycle. Some sequences are worse than normal:

Housing starts, which normally turn down during the boom and then help recovery, were declining during the slide.

Defense spending is falling through the period of decline and recovery, though it is not the dominant factor that it was in the 1953–54 recession.

The rise of State and local spending, the old faithful of demands, is departing substantially below its trend.

Other elements are right on track:

Consumer durable outlays fell precisely with the economy.

Inventory decumulation is mild and coincident.

The most striking departures of the current episode from normal are these:

Business fixed investment is still rising, though its correction remains ahead.

Federal taxes were cut during the decline and will be cut repeatedly thereafter.

A stretched recession requires a changed perspective. The discovery of the lower turning point is not the crucial question. The economy bottoming out in May (or June or August) is not the signal for anything in particular. Product markets which have not fallen sharply will not recovery dramatically. Profits, having fallen less than the traditional 18 to 30 percent of recession (or the 100 percent decline of depression), will not experience a sharp cyclical upswing.

TRANSITION TO A LOWER DEFENSE BUDGET

The defense budget is slated to fall by 10 percent despite rising wages and prices, and the size of the Armed Forces is to decline by close to a million men. Prime contracts let to American business are down from an annual rate of $42.3 billion in 1968 to $34.1 billion in the first quarter of this year, and to a rate of $28.4 billion in April and May. If the scheduled reductions in manpower and the recent volume of prime contracts are any indication, the process of transition from a wartime to a peacetime economy has much further to go. The reductions already made have created economic distress in Southern California, Seattle, and elsewhere. They have created financial difficulties for some of the big defense contracting companies. Despite the studies and reports of two administrations, little of substance has been done. The unemployment insurance program remains to be improved. Special programs to ease the transition still need to be devised.

MANAGING THE MONEY SUPPLY

Adoption of the new approach to monetary policy is one of the signal changes of this period. In February, the Federal Reserve let the money supply resume its growth after 9 months of freeze. In the first 6 months of this year the rate of increase of the money supply

has averaged 4 percent. Considering the severity of the inflation, this left no increased money for real growth; but compared to past behavior of the money supply in recessions, the current experience compares favorably. (See table 1.)

TABLE 1.—MONEY SUPPLY IN RECESSIONS AND NOW (ANNUAL RATE OF CHANGE)

Cycle dates	Peak to trough	12 months after trough
November 1948 to October 1949	0.7	4.3
July 1953 to August 1954	1.5	3.1
July 1957 to April 1958	0	4.2
May 1960 to February 1961	1.3	2.9
September 1969 to May 1970	3.9	(1)

1 Not available.

The new approach will produce a more stable and more planned growth of the money supply. There are technical problems in selecting the proper rate of growth and the proper concepts for monetary aggregates. But modern quantitative analysis should be able to solve them. Interest rates will no longer be as cyclically predictable as in the past and will be more volatile in response to various shocks that shift the public's liquidity preference.

Under the new approach, the Government would face the financial consequences of its foreign policy more quickly, since the Federal Reserve would not automatically accommodate the Government by attempting to keep the tone of the money market unchanged. A Cambodian episode drives up interest rates right away, rather than later on through inflation.

Given the deepseated nature of the cost-push inflation, a policy of moderate growth of the money supply will result in continued scarce liquidity. Even with slow real growth, GNP in current dollars rises by 5 to 7 percent. With the money supply not keeping pace with the GNP, interest rates will decline very slowly even when the inflation expectations wear off.

SOME EARLY PERSPECTIVES ON 1971

Economic growth this year will be virtually nil, the second year of below-normal growth. On present indications, 1971 will be another year of slow growth, with unemployment likely to remain over 5 percent and probably drifting higher.

Table 2 reports on three simulation studies conducted with the aid of the data resources econometric model of 260 equations. The forecast figures represent the best-judgment solution. OPTIM-71 resolves some uncertainties on the high side. Investment is up somewhat and Federal spending, especially on grants to States, is a little higher. The recession picture would result if the plant and equipment markdowns are deeper, consumers maintain a saving rate over 6½ percent, and the high-interest rates result in a weak recovery for housing.

If the model is a realistic representation of the economy, the simulations contain some significant implications for policy. First, the basic outlook is for a third year of slow growth—the recession is stretched flatly over 3 years.

TABLE 2.—A FORECAST AND SOME ALTERNATIVES FOR THE ECONOMY IN 1971

[Dollar amounts in billions]

	1970 DRI forecast	DRI forecast	Optim-71	Recession
GNP	$982	$1,045	$1,054	$1,022
GNP in 1958 dollars	$730	$751	$758	$735
Growth of real GNP (percent)	.3	2.9	3.8	1.8
GNP price deflator (percent change)	5.0	3.5	3.6	3.3
Total consumption	$617	$662	$665	$650
Consumer durables	$92	$100	$101	$94
Consumer nondurables	$261	$277	$278	$272
Consumer services	$264	$285	$286	$284
Business fixed investment	$105	$103	$108	$96
Residential construction	$31	$37	$37	$34
Inventory investment	$2	$5	$6	$2
Net exports	$4	$4	$4	$6
Federal Government	$100	$99	$100	$99
State and local	$123	$135	$136	$135
Profits after tax	$47	$50	$52	$47
Personal income	$799	$846	$851	$832
Money supply	$204	$213	$214	$210
Interest rate on seasoned Aaa bonds	8.0	7.8	7.9	7.6
Government surplus or deficit	$-3	$-6	$-4	$-13
Housing starts (thousands)	1,340	1,630	1,630	1,520

Note: These projections were prepared with the 260-equation Data Resources econometric model, June 24, 1970.

This gray economic outlook is created by these forces.

Defense spending falls substantially, but the offsetting tax reductions are already largely behind us.

Plant and equipment spending will either show a small decline or at best a small increase, given this year's extraordinarily high spending, squeezed cash flow, continued high interest rates, and a depressed stock market.

The rate of increase of State and local spending has slowed down as communities are unable to borrow, despite large local needs.

On the other hand, the negative forces do not produce genuine recession because:

There is some further tax reduction;

Monetary policy is at least moderately accommodating under the new regime of managing monetary aggregates;

Business fixed investment cannot fall precipitously even if manufacturing experiences a substantial decline: the enormous jump in the reported appropriations—NICB—of the utility industry is insurance against a major investment decline.

The housing industry is likely to be in a recovery phase despite the high interest rates as the demand for housing continues to strengthen and the general slack in the economy will release both financial and real resources.

The financial position of consumers is improving with the very high saving rate of 1970, and by 1971 consumers are likely to move toward a more normal saving rate.

A review and comparison of the three simulations provides some additional information. First, the range of unemployment is from 5 to 6 percent. While these are all uncomfortable figures, there is a big difference between them. Table 3 shows the structure of unemployment under the three alternatives. The recession pattern is substantially worse for the vulnerable groups.

TABLE 3.—UNEMPLOYMENT AND ITS STRUCTURE

	1970 DRI forecast	DRI forecast	OPTIM-71	Recession
Unemployment rate	4.8	5.5	5.1	6.0
Black adult male	5.3	5.8	5.6	6.7
Black adult female	8.2	9.1	8.8	10.1
Black youth	28.4	30.6	30.1	32.5
White adult male	2.9	3.4	3.2	4.0
White adult female	4.5	5.0	4.8	5.6
White youth	14.9	16.9	16.7	17.9

Note: These projections were prepared with the 260-equation Data Resources econometric model, June 24, 1970.

Second, prices improve under all three alternatives, but there is not much difference in the rate of improvement. Over a 3-year span one would see that the higher unemployment rate restores price stability, but, in 1971, the extra 1 percent of unemployment does not buy much extra price stability.

Third, long term interest rates stay very high. The cumulative effects of past inflation and of the liquidity squeeze keep rates high. A more rapid increase in the money supply would not produce a drastic reduction of interest rates, though it would permit a more orderly restoration of the economy's financial position.[1]

Fourth, the Federal budget is highly vulnerable to the economy. The $6 billion deficit—NIA basis—in the forecast would rise to $13 billion in recession.

THE FINANCIAL SYSTEM IN A PERIOD OF STRESS

The highly visible problems of the financial system are largely the result of general economic developments. With business expectations too high, some companies find their cash flow worse than expected and their credit facilities inadequate to their commitments. With the liquidity of the financial sector itself depleted, lenders do not rush to meet the surprising needs. The cash squeeze is also proving a major force to cut costs and raise productivity.

The overall financial stringency plays a contributory role to the more dramatic of recent company debacles. But it would be a mistake to weave the separate cases into a story of general financial disaster. Let me review the major recent cases.

(1) The Penn Central case and the disturbance in the commercial paper market are partly the result of disintermediation and recent monetary policy. During the period of frozen money last year, the Federal Reserve attempted to control the growth of bank loans through regulation Q ceilings. As a result, the banking system was bypassed and many companies switched their short term financing into commercial paper. Unfortunately, the commercial paper market does not possess as good a screening process for credit soundness as the bank process. The paper is issued on the good names of the companies and little else. As a result, internal company difficulties go undiscovered longer, and there is the new-found risk that a company will lose overnight its ability to sell commercial paper.

[1] All these simulations assume an increase of nonborrowed reserves at a 5 percent rate during the rest of this year, a 4 percent rate thereafter. The different money supply projections result from the higher demand for money in a higher economy.

(2) The financial problems of aerospace companies are related to the cutbacks in defense spending, to the difficulty of businesses accustomed to the cost-plus world to adjust to a changed environment, and to the Defense Department's cost consciousness partly induced by this committee. The financial stringency makes it more difficult for aerospace companies to carry on despite temporary obstacles, but it also serves to confront the companies and the Government with the reality of their changed circumstances.

(3) The financial problems of Wall Street firms are partly related to structural and management problems of the industry, and to expansions of staff based on high stock prices and rising volume. It took several years for the inflation to be fully reflected in interest rates and stock yields.

(4) The financial problems of a few conglomerates have their roots in stock prices and in policy. Mergers were facilitated by high stock prices, tax considerations, and available credit. With all three of these factors changed, only those conglomerates whose success rests on the strengths of their products and managements can continue to thrive.

The cited cases highlight that our financial system has not fully performed its function of allocating capital rationally and reducing lenders' risk through intermediation. The system should protect us against this still-lengthening list of unhappy surprises. I hope that the President's new Commission on Financial Institutions will make major recommendations that not only strengthen the financial system, but allow it to better perform its functions for the economy.

ECONOMIC POLICY TO SPEED THE CORRECTION AND SOFTEN ITS IMPACT

What is desirable policy under the postulated conditions of low prospective economic growth, rising unemployment to show an improvement of inflation and economy-wide illiquidity? Let me outline my conclusions.

(1) *Income policy*: The most immediate need is to improve the time profile of the disinflation process. Cost-push inflation keeps unemployment high by tilting demand policies in the direction of restraint, by keeping interest rates high regardless of monetary policy, and by encouraging business to invest heavily in laborsaving capital. It will take a forceful, energetic incomes policy, including numerical guidepost standards and explicit congressional support, to convince business and labor that the period of laissez faire on prices and wages is over.

(2) *Monetary policy:* Should aim at an increase in the money supply moderately above the 4-percent normal target in order to facilitate expansion and permit a gradual improvement of the economy's liquidity position.

(3) *Fiscal policy:* Should aim for a rough balance in the full employment budget, not in the actual budget. Under the forecast of 1971 economic conditions, a balanced full employment budget would imply an actual deficit—NIA—of close to $10 billion. Until the economy gives clear signs of sufficient growth to reduce the gap between potential and actual GNP, it would be premature to call for tax increases.

(4) *Income maintenance programs:* Should be strengthened through lengthened unemployment insurance benefits. While the main rationale for the family assistance program is social reform, it would also strengthen the stability of purchasing power, and soften the blow of the disinflation policy on those least able to bear it.

(5) *Redefining goals:* As we look into the 1970's we should broaden our definitions of general economic performance beyond high employment, price stability and economic growth. But that is a topic for another day.

Chairman PATMAN. Mr. Brill, you can proceed.

STATEMENT OF DANIEL H. BRILL, SENIOR VICE PRESIDENT, COMMERCIAL CREDIT CO.

Mr. BRILL. Thank you, Mr. Chairman.

I am privileged to be able to participate in this committee's deliberations on the economic problems facing the country, particularly in the financial area. I should note at the outset that the views I am expressing are entirely personal, and do not necessarily reflect those of my business associates. I can summarize my concern about current and prospective developments briefly:

a. We are beginning to see the first faint signs of victory in the battle to contain inflation. For this we must be grateful.

b. We must recognize, however, that progress in this battle has been inordinately slow and, to date, slight.

c. We must also recognize that the country has paid dearly—in terms of unemployment, lost output, and disrupted financial markets—for even these small achievements in reducing inflationary pressures.

d. In my judgment, the exorbitant price paid for minimal progress results from the inadequate—and often inappropriate—use of the economic stabilization tools available to the Government. We have been subject to over-reliance on monetary policy, inadequate use of fiscal policy, an insufficiency of selective policies to channel restraint efficiently, and, in the past year, an unfortunate failure to advance forcibly the public's interest in private wage and price decisions.

e. Further progress in reducing inflation will be made in coming months, but this progress will continue to be slow and continue to be excessively costly to the economy unless we utilize more fully the powers available to the President and to the Congress.

Let me cite some evidence supporting these contentions. As to progress in containing inflation, there has definitely been a slower pace to the rise in wholesale industrial commodity prices this year, an increase of about 3½ percent per annum from December to June, compared with 4¼ percent in the last half of 1969. Moreover, there are increasing reports of price-shaving that are not as yet reflected in the official indexes. And farm prices have tended slightly down this year, compared with a slight upturn the second half of last year, and a very sharp rise in the first half of 1969. If previous patterns can be taken as a guide, this slowing of the price advance at wholesale should be followed by slowing in the pace at the consumer level.

Even more significant in terms of the push of costs on prices has been the sharp change in trend of unit labor costs in manufacturing, which have shown little change so far this year compared with an

increase at an 8-percent annual rate in the second half of 1969. Thus, there is now evidence of some reduction in cost pressures from both the material and labor sides, and we should rightfully expect some abatement of inflation at the consumer level.

It is high time we were seeing results, considering that we have been running the economy below its capacity for almost a year; the gap between real GNP and the potential rate of growth our resources would permit has widened markedly this winter and spring. So far in 1970, we have lost over $20 billion of potential output, and idled over one and a quarter million workers, in the effort to contain inflation through the conventional tools of economic stabilization. And in the process, financial markets have been brought to an almost unbearable degree of tension. Some costs for disinflating the economy were inevitable; one cannot expect to reverse a 4-year inflationary buildup painlessly. But we have managed to choose a stabilization policy mix almost guaranteed to create the most pain for the most people.

This is the background against which I approach my assignment today, to comment on the state of credit and money markets. The state is far from tranquil. These markets continue under exceptional pressure despite the slowing in real growth. Many businesses are scrambling for credit to fill the gap between previously planned capital outlays and unexpectedly poor earnings. Many are scrambling for longer-term funds to rebuild the liquidity they ran down during the monetary pinch of 1968 and 1969. And the plunge in stock prices prevents some of the pressure for long-term funds from being diverted from bond markets to equity financing. These pressures carry over to the mortgage and municipal markets, holding back a recovery in home construction and in construction of sorely needed community facilities.

Many of the recent developments in financial markets are characteristic of the tail end of a boom. Stock prices, most sensitive of the financial indicators of cyclical developments, turned down early in the cycle, when cost pressures began to press against profits, then plunged as the boom crested. Suddenly, yesterday's "smart money" operator in the stock market became today's "goat." More than ephemeral reputations were at stake, however. The decline in stock prices seemed to cast a pall on consumer as well as business spending plans. Businessmen whose capital spending plans were formulated in the euphoria of the upswing, found current cash flows inadequate to meet scheduled outlays, while long-term credit was still unavailable or available only at exorbitant rates. Increasingly, resort was made to short-term financing of long-term needs, on the hope that resurgent inflation would bail out any venture, or on the hope for a break in long-term rates that always seemed just around the corner.

This is an all too common sequence, with an all too common ending. Somewhere along the line, one of the gambles doesn't work out; someone trips, investors rediscover that there are risk elements in debt instruments as well as in equities and flee to the haven of super-liquid investments, such as Treasury bills. And when investor sentiment shifts rapidly, the innocent borrower suffers along with the guilty.

We have recently seen just such developments in the commercial paper market, subsequent to the Penn Central failure. Investors who

for decades found this financial instrument a highly desirable liquid vehicle for temporary placement of surplus funds, began to shy away from the market, or to shorten the maturity of their investments. Market difficulties were exacerbated by the action taken by the Federal Reserve permitting banks greater freedom to compete for short-term corporate funds. The ingredients were present for cumulating financial trouble.

Fortunately, our financial system is proving to be sufficiently sound and resilient to avert widespread reverberations. Newspaper reports last week indicated that the commercial banking system is coming to the aid of fundamentally sound companies unfortunately caught up in a sudden temporary swing in investor preference. And the Federal Reserve appears to have remembered its primary obligation as a central bank, that of providing adequate credit facilities to prevent these temporary shifts in investment preference from turning into financial panic.

The Fed's recent action is causing a bulge in bank credit, and there are some who contend that the Federal Reserve is pumping too much credit into the financial system. Indeed, some observers claim that the Federal Reserve rushed into a posture of excessive ease far too early in the cycle. For this view, they cite numbers of alarming magnitude with respect to money supply growth over particular selected periods this spring. I find it hard to accept this assessment of monetary policy posture in light of the behavior of either the monetary aggregates or of interest rates.

To be sure, many short-term interest rates have declined, as well they might in periods of great economic uncertainty when investors seek the most liquid havens available. But the long-term rates most relevant to investment decisions have continued to climb until very recently, and are far above earlier peaks. As for the monetary aggregates, or flows of credit and money, I do not judge them to have grown excessively over the first half of 1970; indeed, I think their growth has been somewhat too small in light of the unfolding economic situation. For example, bank credit—as measured by the adjusted credit proxy—increased at only about a 3 percent annual rate from mid-December to mid-June, or at less than half the rate historically regarded as on the moderate side.

Moreover, most of this first half growth occurred in a brief burst in late March and early April. To illustrate the point, the following chart, prepared by the Federal Reserve Bank of St. Louis, showing the course of the adjusted bank credit proxy (a concept of bank credit that measures the total funds available to member banks, from both deposit and nondeposit sources, for lending and investing). You will observe that bank credit fluctuated around a plateau early in the year, jumped at the end of the first quarter, and since then fluctuated around the higher level reached in early April. Roughly the same pattern is observable in most of the other monetary aggregates—the monetary base, total reserves, etc.

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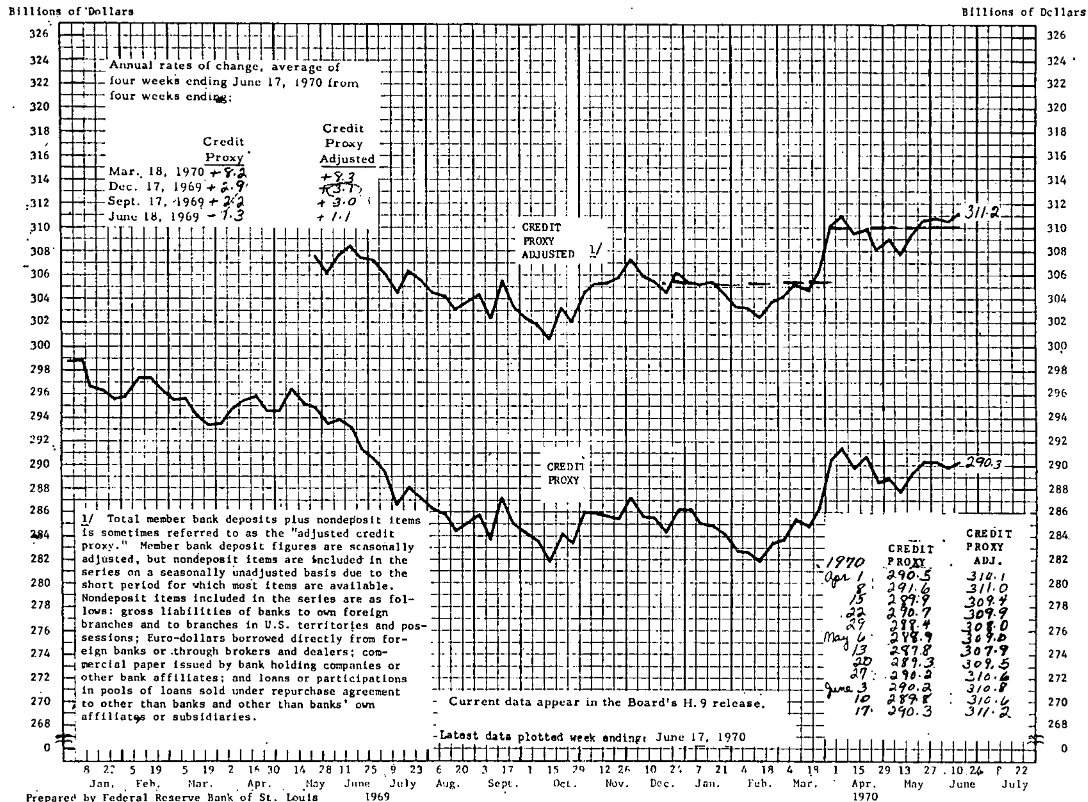
MEMBER BANK DEPOSITS SUBJECT TO RESERVE REQUIREMENTS
(CREDIT PROXY)
AVERAGES OF DAILY FIGURES SEASONALLY ADJUSTED



This is hardly a pattern of monetary largesse. One interpretation of the pattern is that credit was kept under tight rein earlier in the year, that the burst in credit expansion in late March was inadvertent and would have been erased had not the plunge in the stock market and a poorly received Treasury financing stayed the hands of the monetary authorities. The most the Fed could probably do under the circumstances was to hold the level of credit from rising unduly further. But whether this is indeed the proper interpretation—whether the late March burst in credit was deliberate or inadvertent—is less important than the fact that so far in 1970, bank credit expansion has been modest. Even those who index monetary policy by growth in the narrowly defined money stock must admit that the 4-percent growth rate over the first half of the year does not seem excessive in light of the liquidity-starved condition of the economy.

Certainly, the Fed has had reason to be cautious in any move toward monetary ease. Burned before by premature easing, with little evidence available earlier in the year of any lessening in business spending plans, with the extent of fiscal restraint in doubt as Government pay raises were being enlarged and accelerated, and with the administration pursuing a "hands-off" policy in private wage and price decisions, the monetary authorities had justification for moving slowly in rebuilding the economy's liquidity.

But this caution has proceeded too long. The economic evidence unfolding this spring has provided a surer base for monetary easing, and it is well known that the lag in effects of monetary policy shifts is long. The Fed cannot wait until the end of inflation is certified in the official price indexes; it must move in anticipation of events. And most forecasts are for continued sluggish economic growth far below our potential, with unemployment rising and industrial capacity utilization declining.

Obviously, the Fed could move to ease with more assurance and speed if the process of disinflating were to be hastened by administration espousal of a vigorous income policy. I do not suggest wage or price controls; perhaps these should have been employed at an earlier stage of the inflation, but at this juncture they seem to me unnecessary. Distasteful as such controls are to all of us, they should not be employed until other approaches have been exhausted.

We haven't really given other approaches a fair try. Indeed, we moved in the reverse direction last year; the task of curbing inflation was made more difficult by unseemly haste in promising tax relief long before there were any signs of reduced price pressures. And abandonment of wage-price guidelines removed at least a psychological deterrent to inflationary increases. Campaign rhetoric sometimes leads to poor economic policies.

While it may be too late at this juncture to impose controls, or wage-price freezes, it is never too late to turn the spotlight of public attention on key wage and price decisions, to develop measures of appropriate or acceptable increases, and to measure in public each bargaining decision or price increase against the standards of what is in the public's interest. Is the recent trucking settlement appropriate or acceptable? Are the consequent rate increases going to be justified? I don't know. But we should know, and we should be told, and the information should be widely disseminated from the most authoritative and influential source in Government.

Perhaps publicizing is not a strong enough weapon to contain an inflation that has gathered momentum for so long. There are other alternatives to consider, such as a wage-price board with authority to hold hearings before major wage and price decisions become effective. I do not favor stand-by controls, fearing that they might encourage positioning in anticipation of their implementation. If we reach the point of needing controls, let us impose them swiftly and remove them promptly.

My conviction is that the need for controls has passed. I am convinced, however, that credit flows can be increased, market tension relieved, and interest rates reduced much more rapidly by measures far short of direct controls. These measures would reduce the price we have to pay for returning to reasonable price stability.

Chairman PATMAN. Mr. Brill, you are senior vice president of Commercial Credit Corp., and not so long ago one of the chief economic advisers of the Board of Governors of the Federal Reserve. Mr. Eckstein is now a professor of economics at Harvard, but also a learned practitioner in the art of public policy formulation as a member of the Council of Economic Advisers.

Mr. Widnall has not asked any questions, and I did not finish my time, but I want Mr. Widnall to take his time since he has not had the opportunity to question any of you gentlemen.

I assume it will be all right with you gentlemen to submit for the record answers to additional questions that members of this committee desire to ask you. Is that satisfactory?

Mr. BRILL. Yes.

Mr. ECKSTEIN. Yes.

Chairman PATMAN. Fine. Go ahead, Mr. Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

I want to join in welcoming the three witnesses before us this morning and certainly giving us valuable testimony to consider in arriving at some recommendations with respect to our hearings.

Mr. Eaton, I have a couple of questions for you. Mr. Eaton, you link continuation of the war in Southeast Asia with the devastating depression in this country. Would you elaborate in this connection or may I amplify that by asking this question: How is it that the Vietnam conflict will produce depression here at the same time that military spending is declining, efforts are under way to reduce our troops and spending participation in the war, and the expenditures on the war itself account for only about 1.5 percent of our gross national product?

Mr. EATON. In my estimation, 1.5 percent of our gross national product is an astronomical amount, and its expenditure on the war in Vietnam is utter and complete waste. Moreover, I should hate to see the cost of war geared to gross national product, so that the military budget would automatically increase as the gross national product rose. Let's take a look at our total annual military expenditures. A great deal of this money is spent, for instance, in Japan where we are getting supplies and using their shipping. We spend vast amounts of money in Japan. Thailand is also flourishing beyond belief with American money. Our war in Vietnam calls for expenditures on a vast scale for many things other than the strictly military.

Then no one knows how much money the CIA spends or where they spend it. If you go to Cambodia and Laos, and look around, however, you will see that the American dollar is everywhere in use, to buy people, and influence people. This goes on and on.

In the meantime, the shortage of capital in this country is crippling every American business institution. There isn't one that isn't suffering from the lack of credit. Inflation, of course, is taking a heavy toll. My own experience is that war is the great creator of inflation. Continuation of this war whether directly or by proxy, is extremely hazardous to our already floundering economy.

Representative WIDNALL. Mr. Eaton, my questions were set up this way: that while the military spending is declining and efforts are under way to reduce our troops and spending participation in that war, still at that same time the expenditures total and account for only about 1.5 percent of our gross national product.

Why is it when they are declining at this time it is going to lead to a depression?

Mr. EATON. I don't think our military spending actually is declining. We go into this war in Cambodia and that puts on us the responsibility of financing armies in Cambodia. You go over into Laos, and the entire army of that country is being secretly financed by the United States. As I see the present plans, and I think they are illustrated by Secretary Rogers' travels of the past two weeks, we are trying desperately to get other nations to come in to support us. If we make a little saving in one direction, we will spend more in some other, and we will keep on doing it until the war is over.

Representative WIDNALL. Let me ask a question in another direction, Mr. Eaton: I believe you stated we are already in a full scale recession and that we are possibly headed for a depression similar to 1929. In your conclusion you recommend the reduction of the margin rate for stock purchases to 33-percent lower than any previous rate since the depression. Now wouldn't the lowering of the margin rate only induce a credit expansion within the stock market at the expense of other sectors such as housing?

Mr. EATON. Those matters are relative. Certainly we can't abandon our present institutions. I think an American ought to have a right to have ownership in our corporations.

You don't need a wide margin when stocks are selling far below their intrinsic value. You do need a high margin when stock prices are inflated. The great catastrophe of the present situation is the collapse of the stock markets and the Dow-Jones averages. There are 30 million stockholders in the U.S., and every one of them has been suffering acutely from the shrinkage in stock values.

Representative WIDNALL. I just can't see putting more credit into the stock market at a time when credit is so urgently needed in other sectors of the economy and particularly in the housing field and also with respect to things we are trying to do for the inner cities. It seems to me this is just encouraging gambling at a time when we have been trying to tighten our belts and spend what dollars we have in directions that are more wholesome for the general public.

As a person who has purchased stocks and owned stocks and knows something about the stock market, I just don't see how encouraging further stock purchases by a much lower margin requirement is going to do the trick today.

Mr. Eaton. That is a minor point, but I can't agree that investing in the stocks of our corporations is gambling. Occasionally there may be some buying of that nature, but most of it is sound, long-term investment. Most people buy stocks for dividend income and appreciation, many with a thought for more comfortable old age.

Don't forget that there actually are 30 million stockholders in American corporations. That is one-sixth of our population. Those are not gamblers, but thrifty people who have invested their savings and are prepared to buy more now. It would be better, of course, if they could pay a hundred percent without borrowing. But I also believe there is a place for those with the courage and belief in the future of our country, to buy stocks now, on credit, if necessary.

Representative Widnall. I don't think this has priority at this time. That is my only quarrel with you. That is all.

Mr. Eaton. It is a question of priority, Congressman. There is nothing more urgent than the supplying of funds to our corporations, of which there are many, many hundreds of thousands. The investment I want to see, as I have said, is the laboring man putting some of his money into the company for which he works, so there will be a mutual interest there. We must develop that on a vast scale. It will give the man who works for a company, whether he is white collar or a laborer, an interest in his own institution, and a reason for sustaining it. Concededly, it is a minor point in this whole situation.

Most urgent at the moment is the dire need of corporations for funds. That is far more widespread than is generally known. It is not a very good thing to talk about in a public meeting, because it only spreads fear and anxiety.

Chairman Patman. Mr. Reuss?

Representative Reuss. Thank you, Mr. Chairman.

Mr. Eckstein and Mr. Brill, welcome. I share the chairman's regret that you had to be rushed in the presentation of your papers. I have read both your papers in full, and they are solid and excellent. We are very grateful to you.

Both Mr. Eckstein and Mr. Brill agree, it seems to me, that there is one important omission in the present economic policies of the administration, namely, the we don't have sufficient quantitative wage-price guideposts and some congressional support for that kind of an income policy. That is a fair statement of both your positions, is it not?

Mr. Brill. Certainly mine, sir.

Mr. Eckstein. It is, sir.

Representative Reuss. I am alarmed at what Mr. Eckstein tells us will be the result of continued failure by the administration to employ responsible economic policies. In his statement occur some estimates of what is going to happen in 1971, and I will just take the most optimistic, favorable rosy colored estimate, and there, table 3, under column 4, the predicted unemployment on the optimistic view for black youth is 30.1 percent for next year, and for white youth, for that matter, 16.7 percent. This is an optimistic view and I would ask you, Mr. Eckstein, if this is not social and political dynamite, and if the issue of economics is not to be upgraded out of the area of the dreary specialty and into the top national priority which I think it deserves.

Mr. Eckstein. We may be settling too easily into the view that 5-percent unemployment is inevitable, and that it will take a considerable period of it to get the inflation under control.

The top priority of economic policy should be to bring and end to the inflation or to bring it down to a tolerable rate, and the Government should do what it can to avoid this really very pessimistic situation.

Youth unemployment rates are too high even in good times but we do forget that they do respond along with the adult male rates, and that a period of 5-percent unemployment is a very different economy than the kind we have become accustomed to in the last 5 years.

Representative REUSS. Well, how ridiculous it is to talk about peace in our city ghettos and a new harmony between the generations if your most optimistic view is that of 30-plus-percent unemployment among black young people and 16-plus-percent unemployment among white young people.

Mr. ECKSTEIN. Well——

Representative REUSS. Is that not so?

Mr. ECKSTEIN. Yes.

Representative REUSS. Aren't we living in a dream world and wouldn't it be a good idea if the Government came to its senses and did something about inflation and unemployment?

Mr. ECKSTEIN. We see this summer that the opportunities for youth just are not there the way they were in recent years.

Or coming to grips with the wage-price problem, the problem, of course, is that a genuine control apparatus requires a kind of public support which is far removed at this time given the unpopularity of the war.

Representative REUSS. May I interrupt you there, while it is surely true that the public is deeply upset about the war, and wishes it would go away, it is also true, I believe, from the opinion polls I have seen, that the public is quite prepared or a vigorous wage-price policy of the kind that you and Mr. Brill are advocating. In my district, like 8 or 10 to 1, and I think this is true nationally.

Mr. ECKSTEIN. Yes, both the public and even the business community, and perhaps even some labor leadership, are looking for some kind of Presidential leadership and some kind of firm action, and there are lots of measures between a complete World War II control operation and just sort of keeping your fingers crossed.

Representative REUSS. I think you made a valuable point in your statement, Mr. Eckstein, where you point out that cost-push inflation, which is the kind we are primarily suffering from at present, actually causes unemployment. You point out that it causes unemployment because it tends to make our economic rulers pursue mistaken antidemand inflation policies, and by keeping interest rates high and by encouraging business to invest heavily in laborsaving capital. Isn't that last thing very largely the cause of the present liquidity squeeze, the fact that corporate treasurers, anxious to fend off future high-wage costs and anxious to put equipment into place before its costs go up, have so overinvested that today our use of present plants and equipment are something like 78 or 79 percent, and hasn't that dried up the ready cash in this country and contributed to the liquidity squeeze?

Mr. ECKSTEIN. Given the reality of the inflation it was sensible for business to increase investment, to try to keep the cost increases down.

The increase in wages is genuine, increase in material costs is genuine, and this certainly is an additional stimulus to investment. What is more, even though the interest rates are very high in a period of inflation, people realize it is going to be repaid in depreciated dollars.

The central problem remains. This is now cost-push inflation very late in the game, it didn't start out as cost-push inflation, but the unhappy aspect of it is that once the entire price-wage structure gets into motion, it just takes a long time for it to wear off, and the Government should do whatever it can to speed it up.

Could I make one other point——

Representative REUSS. And before you do that, and the Government is not, in your judgment, doing what it should and can do?

Mr. ECKSTEIN. They have just begun a new set of initiatives, which if pursued actively and vigorously could amount to something of an incomes policy. It just remains to be seen if they really do what could be done with the institutions created.

Representative REUSS. But haven't they said explicitly that they are not going to do what you think ought to be done; namely—and I am quoting from you—"a forceful, energetic incomes policy including numerical guidepost standards and explicit congressional support?" Aren't those the three things they have said are works of the devil and they will never have anything to do with them?

Mr. ECKSTEIN. They are very much against browbeating.

Representative REUSS. They are against numerical guideposts, aren't they?

Mr. ECKSTEIN. Well, I would say it is still possible the Commission on Productivity could come up with numerical guideposts.

Representative REUSS. Well, it could come up with a great number of sensible policies, but hasn't the likelihood of its coming up with sensible policies been in effect ruled out by President Nixon when he said no numerical guidepost standards and no congressional laws?

Mr. ECKSTEIN. I am not sure that his speech actually ruled out a number altogether. They certainly have given no indication that they are headed for a numerical guidepost. I don't just remember the text precisely, whether the opening did not remain.

Representative REUSS. You had an additional thought which I interfered with.

Thank you, Mr. Chairman.

Chairman PATMAN. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Eaton, I will have a couple of questions that I would like to have you answer for the record, but I do think that I should make a couple of observations about your statement. For one thing, you say the astronomical sums we are spending annually to kill people could better be spent to improve their standard of living. I don't know of a soul on Capitol Hill—any of the 535 Members of Congress—who would disagree with that, and I doubt very much if there would be a single person over in the Pentagon or in the White House who would disagree with that, and that is what the SALT talks are all about. I am sure that the same thing could be said to the leaders in the Soviet Union and elsewhere, and they would probably agree, and that is why they are engaging in the SALT talks.

But we must have two sides to reach an agreement in the SALT talks, and I know you share the hopes of all of us that those will be fruitful.

Another point I would make is that while I very much agree with your suggestions about doing away with some of the present abuses which are outlined in your statement having to do with banks and corporations, I do suggest to you that the former Attorney General of the United States, Nicholas Katzenbach would part company with you when you refer to an undeclared war in Vietnam.

It is true that it is not formally declared, but that was not what the Constitution requires. The Constitution requires a manifestation of congressional intent, and that congressional intent is set forth in the Gulf of Tonkin resolution and the legislative history accompanying it, particularly the colloquy between Senator Cooper of Kentucky and the floor manager of the resolution, Senator Fulbright.

Also your statement refers to a still undisclosed plan of the President to terminate the war in Vietnam. But that is what the program of Vietnamization is all about, and I suggest to you that the plan is clearly evidenced in the sharp drop in the numbers of our troops over there, 115,000 fewer than a year ago, and another 150,000 scheduled out by next spring, and the sharp drop in the cost of this war, down from $30 billion at one time to an estimated $13 billion for the year just concluded, in fact former Budget Director Schultze estimated it at $17 billion, and an anticipated expenditure of $13 billion for the current year, which while it is a lot of money, represents a drop of over 50 percent.

Then, particularly, another factor is the drop in the number of our casualties, half the number for the same period a year ago, a third of the number of 2 years ago, and while no one wants casualties, the trend is very much downward. I suggest to you that all those demonstrate that this plan is moving us in the right direction, although I don't know of anyone who wouldn't like to see it move faster.

But you advocate this East-West trade, and that we extend credit to some of the countries behind the Iron Curtain, let me ask you this. My position on that point has been to extend commercial credit to them when they pay up their delinquencies before the United Nations. Now what is wrong with that position?

Mr. EATON. That would be fine, but I don't believe it is realistic. If we refused to trade with anyone with whose philosophy or religion we disagreed, we would become a fifth-rate nation.

I don't for a moment want to give the impression that I am advocating communism or suggesting that the people of Communist countries are saints in any sense. They have all of the limitations of humanity, of which I also have plenty, but let me give you an illustration, Senator. You are from the great State of Iowa, the most wonderful farming community anywhere in the world. The Soviets have a territory two and a half times the size of the United States, with great undeveloped land, but they greatly need meat.

The Soviet Union could place an order in the United States tomorrow for, let's say, $20 million worth of foundation livestock for beef—shorthorns, Herefords, and Angus. The State of Iowa would be one of the biggest suppliers. Other countries will extend the Soviet Union credit for such purchases. If we would make $20 million in

credits available to them through some agency, that would be instantly stimulating to our agriculture, and no State would profit more than Iowa, where you produce some of the finest cattle in the world.

Senator MILLER. I could agree with you on that. The only problem I have is this. I think it gets down to how much or how deeply one believes in the United Nations and believes that it should be a viable international force for peace. I suggest to you that that organization cannot serve that role if the members do not pay their dues and assessments, and I am deeply troubled by the fact that the Soviet Union and other Iron Curtain countries are very far behind in the payment of their dues and assessments as validly determined by the United Nations.

Now, why should they receive credit from us on the same terms as some other country which is paying up its dues and assessments to the United Nations? It seems to me that we have some obligation to the United Nations in that respect, and that if we treat them both alike, we can discourage the payment of the dues and assessments to the United Nations.

Mr. EATON. I have no doubt that with vigorous research we can find great defects of character in the people of practically every country in the world, including the Communist nations. But there is an old saying that you should forgive a man not only once but 70 times, if necessary, in view of human weakness and human limitations. I think we would be better off, and the world would have a better chance to survive, if we began to trade with these people. I don't think we accomplish anything by our opposition to them.

It is true that we annoy them and it seems to be human nature to get some satisfaction out of inflicting punishment on someone we disagree with, but I don't believe it is constructive policy in the long run.

Senator MILLER. I wasn't referring to an embargo on trade with them. My thought is to go ahead and trade with them, but I am concerned about extending them this same credit that we extend to other countries which are paying their dues and assessments to the United Nations. That is my point.

Mr. EATON. That is a good point. Still I believe the Communist nations are smart enough to realize that they have to keep their word, and that they will, if we make credit available to them.

Let me refer to farming again for a minute. When I was dining with the Prime Minister of North Vietnam, he said:

> When this war is over, there is one thing I want you to help us with, and that is to get a good supply of beef cattle and dairy cattle. We need milk urgently for our babies. We need beef for our people. Will you help us to do that?

I said of course I would.

My point is this. Instead of spending $30 billion a year to try to lick them, what if we took a chance and supplied them with dairy cattle and beef cattle. We might say, "We believe your system is wrong, and we don't agree with you, but we will give you some time to make your own mistakes and to improve. In the meantime we will try to help you." Now my philosophy may be all wrong, but I at least want to put it forward for your consideration.

Senator MILLER. Well, may I say your philosophy sounds a lot like some of the philosophy expressed by farmer Roswell Garst of Iowa, and there is much to commend it. My only point to you is that I am concerned about the commercial credit terms and that I do believe

very deeply that the United Nations cannot survive if it does not receive the payment of its dues and assessments from its members, and that some of these prospective trading partners of ours are quite able to pay. It is not a matter of inability. It is a matter of refusal and I would hope that we could utilize the trade feature perhaps as a lever to getting them to support the United Nations as they should.

Mr. Chairman, I have two quick questions for Mr. Eckstein but could I yield just a half a second for Congressman Brown who wants to make a consent request.

Representative BROWN. Mr. Chairman, I have to depart for a luncheon engagement and I would like to ask unanimous consent to submit written questions for response by Mr. Brill and Mr. Eckstein.

Representative REUSS (presiding). Without objection so ordered.

(The following answers were subsequently supplied for the record by Mr. Eckstein:)

OTTO ECKSTEIN'S REPLIES TO THE QUESTIONS POSED BY REPRESENTATIVE BROWN

Question 1. At the beginning of your statement, you predict, "The economy will not soar into the early 70's any more than it did into the early 60's." Do you think it should be our principal economic objective to stimulate the economy to "soar"? Shouldn't we take measures to insure that the economy doesn't "soar" again as it did in the late 60's, with such unfortunate results? Is it possible there have been significant changes in both the economic and social environments that make single-minded pursuit of "maximum economic growth" largely irrelevant to current needs, such as improving our natural environment?

Answer. The economy should not soar beyond its productive potential. The opening of the 1960's was disappointing and the period of excessive unemployment was too prolonged.

Of course, maximum economic growth should not be pursued at the expense of everything else, but growth still creates the resources that help solve the environmental and social problems.

Question 2. You say special programs are needed to ease the transition in areas where defense industries account for substantial employment. Could you elaborate for us what some approaches to regional transition might be?

Answer. There have been studies, such as the Ackley report by the Johnson Administration and the Stein report by the present Administration, which made recommendations for a transition problem. These proposals should be reexamined and measures should be taken. At the moment, it appears to the outsider that the main transition measure has been to accelerate a few defense contracts in the areas of greatest distress.

Question 3. You outline some of the unfortunate effects of controlling bank loans through Regulation "Q" ceilings on bank deposit interest rates. In your opinion, did the use of Regulation "Q" ceilings in this manner directly promote the growth of the commercial paper market? What effect will the recent suspension of the ceilings on one category of certificate of deposits have on the commercial paper market? And those who often borrow in it? Would you advocate removing Regulation "Q" ceilings on all forms of bank deposits?

Answer. There is no question that Regulation Q promoted the growth of the commercial paper market. The recent temporary suspension of the ceilings on large CD's will rechannel some of the short-term credit through the banks.

Removing Regulation Q ceilings altogether should be preceded by careful study of its impact on thrift institutions and the housing industry.

Senator MILLER. Mr. Eckstein, you can answer this quickly, would you say we have a mix between demand-pull and cost-push inflation today? A lot of people are talking about how in one period we have demand-pull and another period we have cost-push. Wouldn't it be a fair assessment to say we have both?

Mr. ECKSTEIN. You always have a bit of the two because the higher prices and wages generate the higher incomes which help validate those higher prices and wages within the next period so you cannot

really draw a line and one period is only one and one period is all the other.

Senator MILLER. One other question. What would you say would be a minimal time—I know this would be an estimate—that you would expect the unemployment arising from a shift from defense industry employment and a shift from the armed services—into civilian occupations or civilian activities—for the number of people who have already been involved in this change as a result of winding down involvement in the war in Vietnam to dissipate?

As I understand it, the total is around 700,000 involved.

Mr. ECKSTEIN. The rise in unemployment so far is not mainly due to direct demands of the defense budget on the economy or the release of people from the armed services. For example, total employment in durable goods industries is down 700,000. Of that 65,000 is in ordnance, 120,000 in electrical equipment, 200,000 in all kinds of transportation, including automobiles. The unemployment is up from the very, very low levels, at the peak of the war, to 5 percent, due to the necessity to bring the inflation under control, due to the austere monetary policies undertaken for that reason, and the surcharge which after a long and weary delay finally did have some impact on consumer spending.

Actually the transition from this war is so stretched out over such a long period, that it in itself is no reason to have a real recession.

Even after Korea when the decline was many times sharper than it is this time, the 1953–54 recession was avoidable.

Whether recession is now avoidable or unavoidable really comes back to the inflation question. Is there any way of getting out of inflation, is there any way that you could let demand grow, that you could let the money supply expand, that you could leave the budget mildly stimulating in the next year or two and still make sufficient progress on inflation?

Senator MILLER. Well, I understood that in the President's economic message recently something was said to the effect that there were some 300,000 or 400,000 fewer in the defense-related jobs directly or indirectly attributable to the war. Would you take issue with that?

Mr. ECKSTEIN. Total employment is down over 900,000. Now, if you take all direct and indirect effects, there is a very skillful study by BLS which has shown you do get some 300,000-plus related to the defense industry or defense production.

The point I want to emphasize is this: If it were only a question of reemploying the resources that went into the military budget, our system could easily handle that.

Senator MILLER. What would be the time estimate you would give on something like that?

Mr. ECKSTEIN. If everything else were going right, if we did not have the inflation hangover problem, which is also partly a reconversion from the war, you could have absorbed those hundreds of thousands of workers and hundreds of thousands of men released from the armed services with not a significant increase in unemployment. They are coming out so slowly over several years that it is a minor element in the unemployment now. The major element is the need to sit on total demand, less auto sales, less housing, less soft goods sales, that is what is really keeping the economy from moving.

Senator MILLER. Thank you.

Representative REUSS. Senator Fulbright?

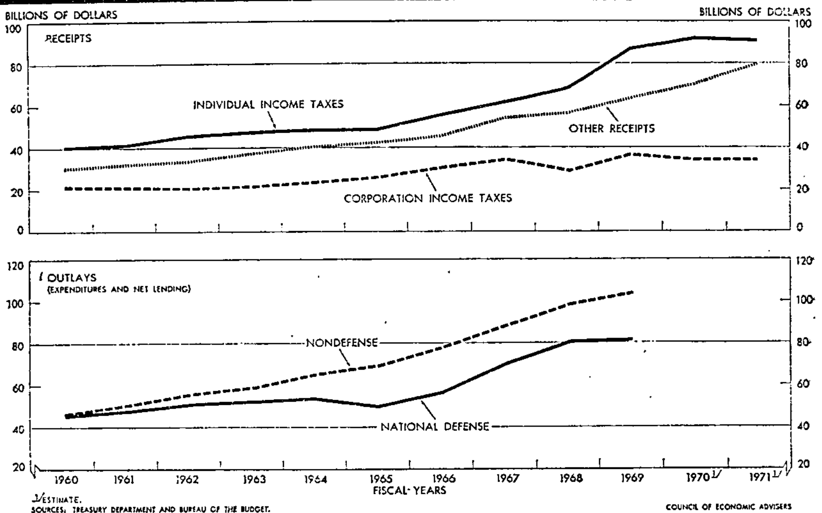
Senator FULBRIGHT. Thank you, Mr. Chairman. I wanted to put in the record, in view of some questions that have been asked by members of the committee, a page from the Economic Indicators of June 1970, source is the Treasury and the Bureau of the Budget, which indicates that the first 10 months of fiscal year 1969 was slightly less, the Department of Defense military expenditures, than the first 10 months of 1970, $64.2 billion, versus $64.3 billion which would not indicate any substantial decrease in military expenditures.

Another ominous figure in this same indicator, this is all on the same page, is that corporate income taxes have declined from $27.3 billion in 1969, first 10 months, to $24.8 billion, a very substantial decline in corporate income taxes, which ought to, would certainly cause concern, I think, to anyone.

(The information follows:)

FEDERAL BUDGET RECEIPTS BY SOURCE AND OUTLAYS BY FUNCTION

In the first 10 months of fiscal 1970, receipts were up $6.5 billion over a year earlier and outlays were up $9.5 billion.



[Billions of dollars]

Period	Receipts				Outlays						
						National defense					
	Total	Individual income taxes	Corporation income taxes	Other	Total	Total	Department of Defense, military [1]	International affairs and finance	Health and income security	Interest	Other
Fiscal year:											
1960	92.5	40.7	21.5	30.3	92.2	45.9	41.5	3.1	18.7	8.3	16.2
1961	94.4	41.3	21.0	32.1	97.8	47.4	43.3	3.4	21.8	8.1	17.1
1962	99.7	45.6	20.5	33.6	106.8	51.1	46.9	4.5	23.3	8.3	19.6
1963	106.6	47.6	21.6	37.4	111.3	52.3	48.1	4.1	25.2	9.2	20.5
1964	112.7	48.7	23.5	40.5	118.6	53.6	49.6	4.1	26.6	9.8	24.5
1965	116.8	48.8	25.5	42.6	118.4	49.6	46.0	4.3	27.2	10.4	27.0
1966	130.9	55.4	30.1	45.3	134.7	56.8	54.2	4.5	31.3	11.3	30.8
1967	149.6	61.5	34.0	54.1	158.3	70.1	67.5	4.5	37.6	12.6	33.4
1968	153.7	68.7	28.7	56.3	178.8	80.5	77.4	4.6	43.5	13.7	36.4
1969	187.8	87.2	36.7	63.9	184.6	81.2	77.9	3.8	49.1	15.8	34.6
1970 [2]	196.4	92.2	34.0	70.2	198.2	(3)	76.5	(3)	(3)	(3)	(3)
1971 [2]	204.3	90.5	34.0	79.8	205.6	(3)	71.2	(3)	(3)	(3)	(3)
Cumulative totals for first 10 months:											
Fiscal year 1969	150.7	72.4	27.3	51.0	155.3	66.9	64.2	3.2	40.8	13.3	31.1
Fiscal year 1970	157.2	75.8	24.8	56.6	164.8	66.9	64.3	3.0	46.3	15.3	33.3

[1] Expenditure account.
[2] Estimates.
[3] Not available.

Sources: Treasury Department and Bureau of the Budget.

Senator FULBRIGHT. I don't know that I can belabor this matter or should belabor it any further, but the question about this assertion that we are on the road to ending the war, and that the decline in the numbers of troops, that is our own, that is the withdrawal of 115,000, as a part of Vietnamization should persuade Hanoi that we are serious about ending the war, this may be true in the minds of some of our Americans.

I thought I might ask Mr. Eaton, simply because he has had a rather unique opportunity to discuss these matters with the Communists, whether they be in North Vietnam or in, their representatives in, Paris and elsewhere, many of whom he has discussed these matters with in recent months, whether or not it is a fact that many people in Hanoi and representing them as well, as here do not believe that Vietnamization is designed to end the war in the foreseeable future. That on the contrary they believe it is designed to continue the war by hopefully making it tolerable to the American people.

Mr. EATON. When I went to Hanoi, I believed devoutly, that we wanted to end the war. I have reluctantly changed my view, and I now think we are endeavoring to win the war cleverly and secretly. I have no doubt that Mr. Rogers' activity the past 2 weeks, to try to get more support from the nations of Asia, and from Japan and England, was designed not to end the war, but to continue it. And I have very reluctantly reached the conclusion that our Vietnam policy is made almost exclusively by the President, who feels well qualified to do so. I don't think the State Department or others have any real influence on his overall policy. I think Mr. Nixon is obsessed with the idea that, in some way, with some break of luck, he can win this war and go down in history as having achieved a victory. He is doing his best to tranquilize American public opinion. At the same time, the activity behind the scenes is very great to continue the war and to bring in others, whom we will finance, as is illustrated in Cambodia.

Senator FULBRIGHT. That is your view, Mr. Eaton. Is this the view you find among the representatives of the enemy; is this the view of the representatives of Hanoi in Hanoi or elsewhere?

Mr. EATON. Yes. When I reached Hanoi, and said everyone in America wants to end this war on terms that will be honorable, they said, "We disagree with you." They are convinced that Mr. Nixon has no intention of ending it. On the contrary, they believe he is trying to continue it by many rather subtle and clever methods. They would like to see the war ended, so that they could turn their efforts to the possibilities for progress in many fields, but they will continue to concentrate on the war to its conclusion. They are being supported magnificently by Red China, which has large embassies not only in Hanoi, but also in Cambodia and Laos. While the Russians give every appearance of wanting to see the war ended, North Vietnam is their ally, and they have no alternative but to continue their support as long as the fighting continues.

Senator FULBRIGHT. You said a good deal about the importance of trade and its effect not only on the economy but reconciling the animosities which motivate both sides and to try to bring about an amelioration of the antagonism which led to this vast arms race.

This morning's paper had an article which indicated the reiteration of our determined opposition to improving our relations with Cuba. In other words, we are not to trade with them, we are encouraging all Latin American countries who show a disposition to trade with them not to trade with them. This seems to me to be indicative of an attitude which we found, you have already stated, with regard to the Far East and it is now reported this morning to be the latest move on our Government's part with regard to Cuba.

Would you comment on that? Do you think we ought to trade with Cuba and try to reestablish more normal relations or not?

Mr. EATON. I feel that we should. I consider myself somewhat of an authority on this subject, because I had large interests in Cuba that were confiscated. I realize the circumstances under which that happened. But we keep kidding ourselves by assuming that an attitude of hostility against these people will bring them around to our point of view. Unfortunately it has the very opposite effect; it just strengthens their resolution. Cuba is an island right near us, and we ought to trade with the Cubans, and get along with them.

Senator FULBRIGHT. This may not be——

Mr. EATON. Our attitude of hostility binds the people together, in support of their government and against us.

Senator FULBRIGHT. It seems to me that this is not wholly irrelevant to the idea you had with regard to our problems with Russia and China and Vietnam. I mean this is a factor which I can imagine Hanoi and others take into consideration as to the possibilities of our making any progress toward a settlement of the war.

I wonder if I might ask Mr. Eckstein just two very short questions.

Mr. Eckstein, do I understand you to believe that the military expenditures are minor or a major contributor to the high interest rates and inflation.

Mr. ECKSTEIN. The rise of the expenditures from 1965 to 1967 was a major factor in the inflation which drove up the interest rates.

Senator FULBRIGHT. To interest rates and inflation, that is the two.

Mr. ECKSTEIN. Yes.

Senator FULBRIGHT. It is a major factor.

What do you think, Mr. Eckstein, would be the effect upon our economy with the ending of the war? Let's assume that within the foreseeable future we repeated the experience of France in 1954, what do you think would be the effect on our economy?

Mr. ECKSTEIN. On that point I cannot come to the sanguine conclusion that the inflation problem would substantially disappear with the end of the war.

Senator FULBRIGHT. Are you familiar with what happened in France when they ended the war?

Mr. ECKSTEIN. Well, in France there was a time of the Pinay plan, they had a very tough, austere stabilization program, and they did solve the inflation problem for the moment.

Senator FULBRIGHT. But you think the French are more astute and more sophisticated than we are and we couldn't do it. Is that what you mean by that?

Mr. ECKSTEIN. Well, I am not sure we are prepared to go through the kind of extreme policies that the French did at that time. They didn't last very long; they got back into inflation.

My concern on this topic is that we will believe this set of problems, the imperfections of our markets, protectionism on textiles and steel and meat and so on, that somehow these problems will look much less important once some kind of peace is concluded in Vietnam. These things will still be with us and they will be nagging. It would make a major difference not having the war factor in the inflation.

Senator FULBRIGHT. We are becoming, according to previous witnesses, noncompetitive in international trade. We had some testimony I believe to that effect but I wouldn't want to attribute it to someone who is not able to defend himself. Do you think we are competitive vis-a-vis Germany, Japan, and other countries?

Mr. ECKSTEIN. The progressive industries of America are more than competitive.

Senator FULBRIGHT. More than competitive. Is our balance of trade now favorable, as favorable now as it was 5 years ago?

Mr. ECKSTEIN. Our balance of trade is inadequate to support our foreign policy.

Senator FULBRIGHT. Is it?

Mr. ECKSTEIN. It is inadequate even probably apart from that, but, in any event, our present problem mainly is vis-a-vis Japan, our trade and capital policies with Japan are out of balance. You are more familiar with it than I am. We should examine our relationship with Japan.

Senator FULBRIGHT. Do you favor the quota systems being proposed?

Mr. ECKSTEIN. No, I oppose all those quota systems because I have been so concerned both during my period of service in the Government and as a scholar with the inflation, and it is just a simple fact that the quotas drive up prices at home.

Senator FULBRIGHT. My time is up, Mr. Eckstein. Thank you very much.

Representative REUSS. I would have one question of all three gentlemen. In your discussion of the liquidity squeeze there was no specific mention of the brokerage industry. Do any of the three of you have any fears or concerns about the possible effects of illiquidity on our brokerage establishments? Start with Mr. Brill.

Mr. BRILL. Sir, I think that situation was one of legitimate concern perhaps 6 to 9 months ago. I think brokers have just worked their way through a good share of the problem. Mergers among a number of the firms have been a result of the liquidity squeeze; perhaps we are now at the stage where, barring a necessity for resumption of very tight credit conditions, the industry is likely to work its way through.

It was certainly a serious problem but I think we have passed the crest of it.

Representative REUSS. Mr. Eckstein?

Mr. ECKSTEIN. I think the process of consolidation in the brokerage industry has a long way to go. It was a classic case of overexpansion of staff and sales in a period of tremendous stock market rise, and the indications I get are that it will take a considerable additional period before Wall Street is back as a reasonably efficient industry.

Representative REUSS. Mr. Eaton, would you care to comment on this point?

Mr. EATON. No; I think not.

Representative REUSS. Are there any further questions?
Senator Miller?

Senator MILLER. I just have one last question. The war has been involved in considerable degree in our discussions this morning, and my question has a bearing on this. Mr. Eaton, you emphasized on several occasions that the leaders in Hanoi and other Communist countries think that President Nixon wants to win the war. What do they mean when they say win the war? What are they talking about?

Mr. EATON. They believe that, in one form or another, he will continue the war, until they themselves grow weary and give up, and until their allies for one reason or another withdraw their support. They think that Mr. Nixon is a very clever man, and that he is very cleverly and subtly giving the American people the impression that he is ending the war by token withdrawal of troops. Behind the scenes, they are convinced that he and his representatives are extremely busy organizing methods of continuing the war by bringing other people in to do the fighting. I must say they are intelligent and well informed. I was amazed at their knowledge of what goes on in America. The Prime Minister carried on the negotiations with Roosevelt and took his people into the war to expel the Japanese. He has had contacts with all the world's statesmen from that time. The statement is constantly made that they won't negotiate. That is not true. If you want to go over and talk to them yourself, you will find that they will talk to you, they will tell you their position, and they will speak authoritatively.

Senator MILLER. Well, of course, when you talk about winning you are talking about attaining an objective, winning an objective, and what do they think is the objective? Now, wearing them down is one way to attain the objective, but I am curious in what they think our objective is or Mr. Nixon's objective is as a result of his attaining, which as a result of his attaining, would represent a winning of the war. What is the objective that they see that he is trying to attain?

Mr. EATON. They take you to their museum and show you pictures of Mr. Nixon as Vice President, visiting Hanoi in 1953 and conferring with the French generals. Mr. Nixon exhorted the generals to continue the war and promised to work his head off to give them every kind of support. Hanoi feels that Mr. Nixon's personal pride is wrapped up in this, that his whole career has been built around antagonism to communism and that he does not intend to be the one to quit the war.

In Hanoi's view, it is a matter more of personal pride with the President and of his long commitment to anticommunism than anything else. They feel that he has a tremendous personal commitment to this war and that his pride, his ambition, and everything he has stood for during his life are involved.

Senator MILLER. But did they ever tell you what he is trying to do, what objective he is trying to attain over there?

For example, does he want, do they think he wants, to invade North Vietnam or take over control of the Government of North Vietnam or do they think that he wants to merely see to it that the North Vietnamese troops leave South Vietnam?

I am trying to get at what objective do they see he has in mind as a result of which he would win the war.

Mr. EATON. They feel that he eventually wants to have in South Vietnam, Cambodia, and Laos, as well as Thailand and the rest of

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Southeast Asia, governments and forces that are completely antagonistic to the Communists.

Now, the North Vietnamese actually are not dedicated to communism. I think, if we had left them alone, they probably would have departed from communism as a principle, at least to the extent that Yugoslavia did. What they were most interested in was the independence of their own country. But they think that Mr. Nixon, as a part of his worldwide plans, is interested in the superiority of the United States and that he doesn't want to be a President who compromised on these problems. They show you their churches, pagodas, hospitals, and schools that have been bombed by our planes, with the loss of thousands of their women and children. They are surprisingly free of antagonism on that point. They nevertheless feel that a nation that would go that far must have very deep-seated ambitions and purposes. Therefore, they will fight to the last man, and all of our threats to them will have no effect except to strengthen their resolve to go on fighting. As long as China, with its immense army right beside them, supports them, and the Soviet Union continues to aid them, they have every reason to keep on fighting.

This morning in an interview, Mr. Rogers said he didn't think this was a time to negotiate, because he thought the people of North Vietnam would not want to negotiate from weakness after the great defeat we had imposed on them in Cambodia. That is sophistry of the worst kind. What it means is that he found that the nations of Southeast Asia, Japan, and England were not willing to give him the backing that he hoped to get.

Senator MILLER. Do you think that if, they fear in Hanoi that if, internationally supervised free elections in South Vietnam were held that these elections would result in a government which would be antagonistic to their Communist government and that that is the reason why they do not want to have internationally supervised free elections in South Vietnam or do you think they are willing to take their chances?

Mr. EATON. They will take their chances providing it is an election that is not under the gun of the present three heads of government in South Vietnam, or of the United States, using vast sums of money to influence the vote. If you could get an absolutely honest expression of opinion, I think you would find 20 percent of the people of South Vietnam devoted to Saigon, 20 percent to the Provisional Revolutionary Government, and the remaining 60 percent not caring whether they are Communists or capitalists. They would like to be left alone and in peace, and they would take their chances completely on that.

Senator MILLER. Well, then, what would be wrong with having the United Nations supervise those elections; what objection would North Vietnam have to that?

Mr. EATON. You can't have a free election under any supervision while our Army, Navy, and Air Force are there. I think they would probably accept the United Nations if we did not have our military, naval, and air forces there to intimidate people, and provided also we were not pouring out astronomical sums of our taxpayers' money to influence people and buy them up. That is what we are now doing on a vast scale.

Senator MILLER. That I would assume would be the ground rules for any international supervision by the United Nations that that would not happen.

Mr. EATON. If the United States makes up its mind that it wants to end the war, both directly and by proxy, I believe there would be no difficulty whatever in working out all the details and all of the conditions for the future and for elections. They are human beings. They have been in this war for many years, and they would like to have peace. They are not warlike people. All of the details could be worked out overnight. I reported to President Nixon that, if he would offer to meet with the Prime Minister of North Vietnam, the two heads of state could settle all of these problems in one session. The bosses need to talk to each other rather than through representatives who have no authority.

Senator MILLER. Thank you, my time is up.

Senator FULBRIGHT (presiding). Mr. Eaton, I must say you are a very refreshing witness. Your candor about some of our public statements is most unusual. We rarely encounter that in these parts.

There is one last question. I know you have been here a long time and it is getting, everyone is getting, a little weary with this but you were asked just a minute ago but you didn't pursue it right here at the end, exactly the question the Senator from Iowa has brought up. I don't know whether you can go any further than you have about this position regarding negotiations.

If I understood some of your former statements their conditions are not the prior withdrawal but the agreement to completely withdraw our forces, and some kind of an election or mechanism for settlement which would not be subject either to our domination or the Thieu-Ky government, perhaps I should say, or necessarily their own, but some device for objective non-North Vietnamese and non-Americans could be developed, this would be a matter of negotiation, that you believe these are the two essentials.

Some people have put it this way. That the Thieu-Ky government is the real crux of the matter. If we could agree to circumstances in which the Thieu-Ky government was removed, not necessarily that any other specific government be created but the Thieu-Ky government is the crux to the matter, and then the conditions for an election would have to be determined by negotiations. Is this an adequate way to describe it? I don't want to prolong this but I am just trying to clarify what you have already said.

Mr. EATON. I am sure those conditions would be accepted.

Senator FULBRIGHT. Do you think, from your information you believe, that if we offered that Hanoi would accept it?

Mr. EATON. Yes.

Senator FULBRIGHT. If Mr. Bruce, in other words, in Paris, he is going there soon, if he were authorized to make such an offer you believe it would be accepted?

Mr. EATON. Yes.

Senator FULBRIGHT. I was only trying to clarify as fully as I could just the concepts you have with regard to what is standing in the way of the ending of the war in Saigon and I don't want to misstate it or put words in your mouth.

Well, you have been a very helpful witness, I believe. I don't know as anyone with your business background, together with your experience and interest in the political international relations, I don't believe there is anyone else who has that combination of your credentials as a capitalist, may I say, together with the long interest in reconciling political differences among countries. You are, if I may say that, rather a citizen of the world rather than just a U.S. citizen.

I believe you really were born in Canada, weren't you; your people came from Canada, did they not?

Mr. EATON. Yes, I was born in Canada.

Senator FULBRIGHT. You were; that is what I thought.

Mr. EATON. I came to Cleveland when I was 16.

Senator FULBRIGHT. That is what I thought and, of course, I have great admiration for the Canadians.

Mr. EATON. About 70 years ago.

Senator FULBRIGHT. Seventy years ago. Well, but I have great admiration today for the wisdom and the knowledge of the Canadians.

I have been watching with much interest what they have been doing recently in their attitude toward international relations and I thoroughly approve of it. I think they have a very great Prime Minister at the moment, and I think we can learn a great deal from the Canadians both from the government and elsewhere.

I have been asked, and I am sorry, Mr. Eckstein and Mr. Brill, that we didn't get more time on yours. I hope you will understand that the circumstances, I mean I am not responsible for it, but the chairman has already explained that.

I have been asked to make this statement by the chairman of certain changes in the schedule for the hearings on July 14, tomorrow, and July 15. Tomorrow on prices-wages, Mr. Gardiner C. Means, consultant; Charles E. Rockwood, professor of economics, Florida State University; and Mr. John M. Blair, consultant, will be the witnesses.

On July 15 on international affairs, Mr. Hale Boggs, U.S. Representative, State of Louisiana, and Mr. Jacob K. Javits, U.S. Senator, State of New York.

Just if I may be allowed to say so, I think the testimony this morning is very relevant to the hearing on July 15. It ought to be made a part of the record.

Thank you very much, gentlemen. I appreciate very much, I know the committee does, your taking your time to come here and giving us the benefit of your thoughts on these matters.

Thank you very much; the committee is adjourned.

(Whereupon, at 12:45 p.m., the committee was adjourned, to reconvene, at 10 a.m., Tuesday, July 14, 1970.)

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

TUESDAY, JULY 14, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10 a.m., in room S-407, the Capitol Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representative Patman and Senator Proxmire.

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

Chairman PATMAN. The committee will please come to order.

Today we continue our hearings on the state of the economy and our focus this morning will be on prices.

As I pointed out earlier in these hearings, we are suffering from increased unemployment and inflation at the same time. We are told that unemployment may well reach 5½ percent and prices have been increasing at the rate of 6 percent. Meanwhile the economy will continue to operate well below its potential. We cannot afford to tolerate losses in output and increase in human misery. Obviously we must have better means of dealing with inflation and unemployment than the administration put forth so far.

We have three first-class economists with us today who have devoted their professional lives to the study of the structural aspects of our economy.

Dr. Gardiner Means is, perhaps, best known for his pioneer work "The Modern Corporation and Private Property," coauthored with A. A. Berle, but he has been in the forefront of a long fight over the years to bring a little more competition into the business world.

Dr. John Blair has spent most of his working life in Government, both in executive agencies and on the Hill, fighting for a fair shake for small business in its competition with the giants of industry.

Prof. Charles Rockwood has recently written an excellent book on the subject which is to be discussed today, "National Incomes Policy for Inflation Control."

We welcome you gentlemen and thank you for your efforts. I hope you can keep your opening remarks to what we have discussed, say, 1 hour for the three of you with the understanding that your complete statements will appear in the record.

Dr. Means, you may proceed first.

STATEMENT OF GARDINER C. MEANS, CONSULTANT

Mr. MEANS. Mr. Chairman and members of the committee, I very much appreciate this opportunity to testify before you on the problem of inflation combined with excessive unemployment.

The main thrust of my testimony will be that the reason we have inflation and recession at the same time is that in our modern economy we have two quite different types of price behavior which operate on quite different principles. One type can properly be called market prices. The other I have called administered prices. I will show that, so far as macroeconomic policies are concerned, the policies having to do with inflation and unemployment, the conventional wisdom is built around market prices and their behavior. It takes little or no account of the quite different behavior of administered prices. I will show how different the types of behavior can be. I will point to major mistakes in macroeconomic policy which have arisen from the failure to distinguish between them. I will examine the Nixon game plan and show why it is bound to fail unless it is radically altered. I will show the basic flaw in the Kennedy game plan which caused it to break down and also why its guidepost program was remarkably successful in spite of its bad design. And finally I will sketch the elements in a game plan which I believe could in the near future bring us sustained full employment and price stability.

THE CONVENTIONAL WISDOM

The man in the street knows that it is not possible to have inflation and recession at the same time. He is relying on the conventional wisdom which has been built up by professional economists over a long period of years. And he is right about the conventional wisdom. This wisdom is based on the behavior of market prices and, according to both the theory and our experience with market price behavior, inflation and recession at the same time are simply impossible. But the professional economists who developed the conventional wisdom took no account of the quite different behavior of administered prices and the high economic concentration which produces them.

Consider Alfred Marshall, the greatest of the traditional economists. He likened each industry to a forest with individual trees sprouting, growing or dying but with the forest as a whole surviving. In his first edition he said:

> And as with the growth of trees, so it is with the growth of businesses.

But by the eighth edition 30 years later he had changed this to read:

> And as with the growth of trees, so was it with the growth of businesses as a general rule before the recent development of vast joint-stock companies, which often stagnate but do not die.

But his principles were never revised to take account of this momentous change. His principles could not apply to an economy of concentrated enterprise and administered prices.

Or take Keynes' general theory. His analysis of macroeconomic theory and policy rests on the assumption that prices will behave like

market prices and conform to the theory of marginal cost. He recognizes the existence of administered prices, saying:

> Apart from "administered" or monopoly prices, the price level will only change in the short period in response to the extent that changes in the volume of employment affect marginal costs.

But nowhere does he build into his theory the particular behavior of administered prices.

Or take Samuelson's economics, the most widely used economic text in this country. There he recognizes the existence of administered prices but he devotes four chapters to the determination of market prices by the forces of supply and demand in the classical fashion, followed by a chapter on monopoly and a final weak chapter on "Imperfect Competition." But the great bulk of product prices are administered prices and nowhere in his macroeconomic analysis does he introduce the macroeffect of the fact that administered prices behave quite differently from market prices. There is no suggestion that the traditional conclusion is at fault and that simultaneous inflation and recession are possible.

And now we have that archclassicist, Professor Stigler, saying that the reason the wholesale price index has continued to rise in the last 6 or 8 months, when according to his thinking it should have been falling, is because the index is badly compiled. The index undoubtedly could be improved. But a perfect index would still show the behavior of administered prices quite different in the short run from that of market prices.

Here I want to depart from my written text because a new book has just been released by the National Bureau of Economic Research which studies industrial prices. It is written by Professor Stigler and an associate. In this the aim is to test the theory of administered prices and to test Stigler's own theory that the BLS wholesale price index is a bad index because it does not take account of discounts given for quantity and for various other reasons.

Actually the book presents some excellent new data on pricing derived from the buyers of commodities rather than the sellers, a very interesting and valuable approach.

But the data themselves are wrapped up in such a misleading context that the actual findings do not appear. Actually, when account is taken of the reasons the BLS and the National Bureau indexes could be expected to differ, the new data strongly support the validity of the BLS indexes with certain minor exceptions.

On steel the report says:

> The BLS and NB prices of steel products moved together so closely that a description of one is a description of the other.

The same applies almost equally well to nonferrous metal products, nonmetallic mineral products, electric machinery and equipment except for one major price change in which the BLS seems to be the more reliable, lumber and wood products, and pharmaceutical preparations. These group indexes combined cover almost half of all the items covered by the NB study. They constitute a strong confirmation of the general validity of the BLS index.

Some differences are to be expected between the two sets of indexes because of the partial coverage of the NB series. They are not concerned with the total market for the commodities covered but with that part in which big corporations and governments are the buyers.

Another noteworthy thing about this report is that the empirical evidence amply confirms the administered-price hypothesis. One of the major features of this hypothesis is that where prices are administered in the concentrated industries, prices tend to be insensitive to fluctuations in business activity, something that is quite contrary to the classical thinking.

Buried in the National Bureau report is the statement concerning the commodities studied that "the prices of most of these commodities were insensitive to general business fluctuations"—exactly what the administered-price theory maintains.

I have taken the time to call your attention to these aspects of this study because the framework within which the data are presented is so misleading. It gives the impression that the data call into question the validity of the BLS index and the administered-price theory, whereas in fact they strongly support the validity of both.

Now coming back to my text, the man in the street is amply justified to react in terms of the conventional wisdom. However, this 19th century wisdom does not apply to the modern economy of concentrated enterprise as has repeatedly been brought out in studies over the last 35 years. Yet the Nixon game plan is designed in terms of the conventional wisdom and on the assumption that the great bulk of prices will behave like market prices. For this there is no excuse.

THE EMPIRICAL EVIDENCE OF A DIFFERENT BEHAVIOR

I present two charts in my prepared statement to show the quite different behavior of market prices and administered prices in the more concentrated industries.

Chart I, in my prepared statement, which was published by the National Resources Committee in 1939——

Chairman PATMAN. Without objection the charts will be inserted in the record, too, Dr. Means.

Mr. MEANS. I appreciate that. I will just call your attention to this one (chart I, my prepared statement) which, as you can see, represents five groups of items classed according to frequency of price change, on the assumption that prices that change every month are obviously market prices. Prices which change infrequently in the BLS index are prices which tend to be inflexible, tend to be administered, and tend to be prices made in the concentrated industries.

The intermediates are of an intermediate character.

In the great depression the market prices dropped 60 percent. The more administered prices dropped relatively little. They undoubtedly dropped more than the chart indicates because the BLS frequency count is not a perfect index of concentration, but, if you correct for all of the weaknesses in the BLS index, you would come to the same conclusion, confirmed by Stigler's book, that the administered prices are relatively insensitive to business fluctuations.

The second chart, in my prepared statement, I want to show you was presented in hearings before the Senate Antitrust and Monopoly

Committee in 1959. It covers the inflation which took place from 1953 to October 1958. In this 5-year period unemployment increased irregularly from 2.9 percent in 1953 to 6.8 percent in 1958 and yet the wholesale price index rose over 8 percent. We had a period of substantial unemployment and a rise in wholesale price index.

In certain respects this period was similar to the present period. It introduced the paradox of inflation and recession at the same time. And the immediate explanation is to be found in the different macroeconomic behavior of market and administered prices.

Chart 2, in my prepared statement, here represents the change in price during the period 1953 to 1958 for each of the 16 industry groups which make up the BLS wholesale price index, with the steel industry group divided between steel production and steel fabrication.

Each group was classified according to the importance of market prices or administered prices in the group. Market dominated groups such as farm products, textiles, lumber, and leather products were given a light shading. Administration-dominated groups were represented in black. And mixed groups where market and administered prices played a more equal part were shaded in gray. Unfortunately the chart does not make a clear enough distinction between black and gray but you can see the stippling in the case of the middle group.

Then the industry groups were arranged in order of declining price increase. For each industry the height of the bar represents the rise in the price index for the group while the width of the bar shows the weight the group index carries in the wholesale index.

Even a swift glance at the chart shows the group indexes which rose most from 1953 to 1958 were black, the administration-dominated indexes. All but one of the market-dominated indexes are at the right and with two exceptions show an actual price drop in the period. The mixed industries fall in the center. And I should add here parenthetically that no amount of tinkering with the BLS price index would substantially alter this picture.

From this chart it can be seen that it was the administration-dominated index which accounted for most of the rise in the wholesale index. Subsequent analysis has shown that if all prices in the index had behaved like market prices there would have been no inflation in that period. On the other hand, if all prices had behaved like the administered prices in the concentrated industries the wholesale index, instead of increasing 8 percent, would have increased by twice this amount.

That period had much in common with the present since there was high unemployment and unused industrial capacity along with rising prices. And as chart IV, in my prepared statement, shows, the price rises today are again in the administered-price industries, while market prices are leveling off or falling.

Certainly, with increasing unemployment and much idle industrial capacity, this inflation of 1953–58, like that since the end of 1969, could not have been a product of excess demand which generates the traditional demand inflation. Because administered prices were the primary source of inflation in this period, I have called it an administrative inflation.

Its causes could not be found in a lag in prices since, in 1953, market and administered prices were in very close to the same relation they had held in 1942, in 1926 to 1929, and in 1914. There seems to be a balanced condition here. Most of the lag of administered prices or the rise in administered prices in the postwar inflation have been overcome.

Theoretically this administrative inflation could have been caused either by labor pushing prices up faster than productivity and living costs or by management seeking to widen profit margins. The weight of the evidence seems to make management responsible with steel playing the role of the bellwether. In this period of administrative inflation, wage rates tended to lag behind, though not by much.

This is developed in my own book, "Pricing Power and the Public Interest," which is based on a study of the steel industry.

RECENT POLICY ERRORS

In recent years there have been serious errors in macroeconomic policy which have arisen from a failure to take account of the differences in behavior between market and administered prices. I will mention only two.

In 1957, the Federal Reserve Board caused the 1957–58 recession by applying the conventional wisdom to the inflation which was underway. The conventional wisdom only knew of demand inflation and prescribed a contraction in the money stock as a means of bringing it to a halt. The Fed applied this prescription, contracting the money supply quite sharply. As we have just seen, the inflation in that period was not demand inflation but administrative inflation, and the effect of the money contraction was to cause a recession, easily predicted if you understood the behavior of administrative prices. The decline in aggregate demand caused market prices to decline but administered prices as a group kept on rising.

Shortly after this episode and the reversal of the contraction policy, a chief economist at the Fed, Woodlief Thomas, publicly acknowledged that this type of inflation could not be handled by contracting aggregate demand. In a letter to the Washington Post on March 12, 1959, he wrote:

> Recent discussion of the influence of administered prices stimulated by [hearings before the Senate Antitrust and Monopoly Committee], has made a significant contribution to a better understanding of the problems of inflation and fluctuations in economic activity and unemployment. This contribution is in pointing out that there are unstabilizing forces in pricing actions of the private economy—on the part of both management and labor—that cannot be effectively controlled or corrected by governmental actions in the area of fiscal and monetary policy.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Means follows:)

PREPARED STATEMENT OF GARDINER C. MEANS

INFLATION AND UNEMPLOYMENT

Mr. Chairman and members of the Committee, I very much appreciate this opportunity to testify before you on the problem of inflation combined with excessive unemployment.

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Consider Alfred Marshall, the greatest of the traditional economists. He likened each industry to a forest with individual trees sprouting, growing or dying but with the forest as a whole surviving. In his first edition he said "And as with the growth of trees, so it is with the growth of businesses." But by the eighth edition thirty years later he had changed this to read "And as with the growth of trees, so was it with the growth of businesses as a general rule before the recent development of vast joint-stock companies, which often stagnate but do not die."[1] But his *Principals* were never revised to take account of this momentous change. His principles could not apply to an economy of concentrated enterprise and administered prices.

Or take Keynes' *General Theory*. His analysis of macro-economic theory and policy rests on the assumption that prices will behave like market prices and conform to the theory of marginal cost. He recognizes the existence of administered prices, saying "Apart from 'administered' or monopoly prices, the price level will only change in the short period in response to the extent that changes in the volume of employment affect marginal costs."[2] But nowhere does he build into his theory the particular behavior of administered prices.

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[1] *Principle of Economics*, Eighth Edition, Macmillan and Co., London, 1930, p. 316.
[2] John Maynard Keynes, *The General Theory of Employment, Interest and Money*, New York, 1936, p. 270.
[3] Paul A. Samuelson, *Economics*, Fourth Edition, New York, 1958, pp. 367–498.

There is thus plenty of justification for the man in the street to react in terms of the conventional wisdom. However this 19th century wisdom does not apply to the modern economy of concentrated enterprise as has repeatedly been brought out in studies over the last 35 years. Yet the Nixon game plan is designed in terms of the conventional wisdom and on the assumption that the great bulk of prices will behave like market prices. For this there is no excuse.

THE EMPIRICAL EVIDENCE OF A DIFFERENT BEHAVIOR

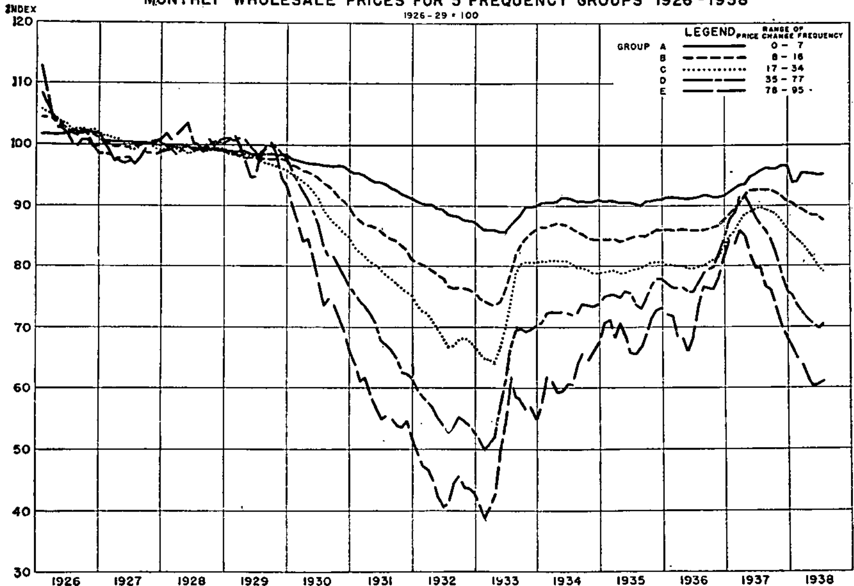
I will present two charts to show the quite different behavior of market prices and administered prices in the more concentrated industries.

Chart I, which was publishd by the National Resources Committee in 1939, shows the behavior of five different price indexes in the depression and recovery of the 1930's. All the items in the BLS wholesale price index of that day were divided into five approximately equal groups according to the frequency of price change. This was done on the assumption that market prices which were determined by supply and demand would change practically every month with identical prices in successive months a matter of pure chance. Thus market prices would show a high frequency of price change. On the other hand, in concentrated industries where prices like those of steel or automobiles were administered and kept constant for considerable periods of time, the frequency of price change would be low. Where industries were less concentrated but not made up of a forest of enterprises or where changes in raw material prices dominated the prices of finished products the way cattle prices dominate the price of beef, prices would tend to show an intermediate frequency of change. Frequency of price change is, of course, a very crude index of the market power exercised in concentrated markets but the clear cut pattern it shows suggests its validity and other investigations such as those on which Dr. Blair will report confirm this.

CHART I

MONTHLY WHOLESALE PRICES FOR 5 FREQUENCY GROUPS 1926-1938

1926-29 = 100



The five indexes of chart I are based on 1926 to 1929 as 100 and run from 1926 to mid 1938.[4] As you can see, the five indexes are almost on top of each other in the 4 years of relatively high employment from 1926 to 1929. Then with deepening depression, the index for market prices, represented by the lowest

[4] The Structure of the American Economy, National Resources Committee, Washington, 1939, p. 147.

line, dropped 60 percent while the index for administered prices in the more concentrated industries dropped only 15 percent. The intermediate indexes behaved in an intermediate fashion.

In the recovery period, the five indexes all rose with those that had dropped most recovering most until they were fairly close together in 1937. With the recession in 1937–38 they splayed out again as in 1930 to 1932.

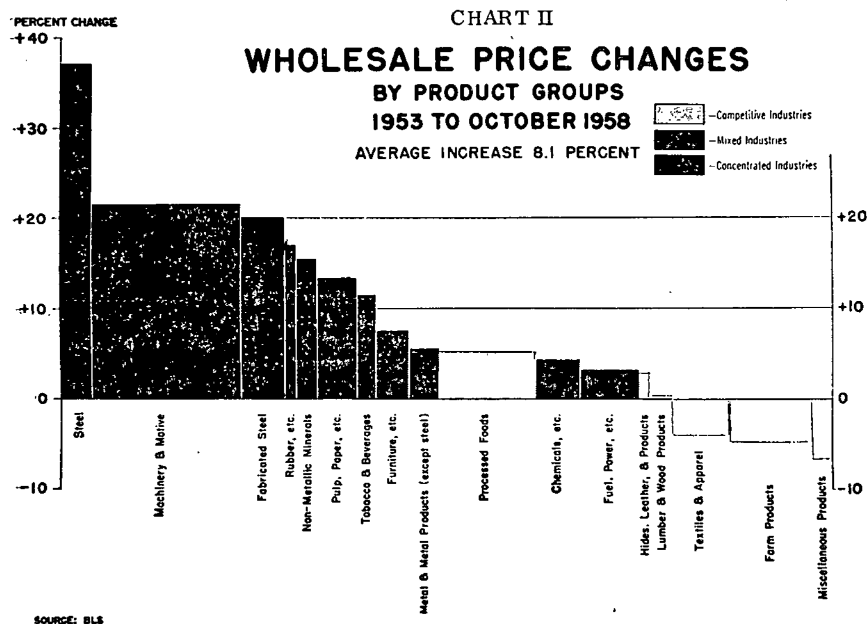
My chart came to an end in 1938 but a continuation of the same five indexes would show them rising and coming together so that by March of 1942 when the OPA froze the price structure, the indexes were as nearly on top of each other as in 1926 to 1929 and averaged close to 100.

There are three things to notice for this period. First you should notice that market prices as a group are much more sensitive to changes in aggregate demand than administered prices. Second you should notice the tendency for the market price index and for the administered price index for the most concentrated industries to come into approximately the same balance at high employment in 1942 as in the high employment of 1926–29. Also they held almost exactly to this same relation though at a much lower level at the high employment of 1914. There thus seems to be a close long run relation at full employment between market prices as a group and administered prices as a group but none in the short run as business fluctuates. Finally I should point out that production and employment dropped little in the depression for the market-priced commodities while it tended to drop most where administered-prices dropped least. Clearly the macroeconomic behavior of administered prices is significantly different from the traditional behavior of market prices.

The second chart I want to show you was presented in hearings before the Senate Anti-Trust and Monopoly Committee in 1959.[5] It covers the inflation which took place from 1953 to October 1958. In this five year period unemployment increased irregularly from 2.9 percent in 1953 to 6.8 percent in 1958 and yet the wholesale price index rose over 8 per cent. In certain respects it was similar to the present situation. It introduced the paradox of inflation and recession at the same time. And the immediate explanation is to be found in the different macroeconomic behavior of market and administered prices.

This difference is shown in chart II. It represents the change in price during the period for each of the 16 industry groups which made up the BLS wholesale price index with the steel industry group divided between steel production and

CHART II



[5] Hearings on Administered Prices, Part 9, p. 4754, January 24, 1959.

steel fabrication. Each group was classified according to the importance of market prices or administered prices in the group. Market dominated groups such as farm products, textiles, lumber and leather products were given a light shading. Administration dominated groups were represented in black. And mixed groups where market and administered prices played a more equal part were shaded in gray. Then the industry groups were arranged in order of declining price increase. For each industry the height of the bar represents the rise in the price index for the group while the width of the bar shows the weight the group index carries in the wholesale index.

Even a swift glance at the chart shows that the group indexes which rose most from 1953 to 1958 were black, the administration-dominated indexes. All but one of the market-dominated indexes are at the right and with two exceptions show an actual price drop in the period. The mixed industries fall in the center. And I should add here parenthetically that no amount of tinkering with the BLS price index would substantially alter this picture.

From this chart it can be seen that it was the administration-dominated index which accounted for most of the rise in the wholesale index. Subsequent analysis has shown that if all prices in the index had behaved like market prices there would have been no inflation in that period. On the other hand, if all prices had behaved like the administered prices in the concentrated industries the wholesale index, instead of increasing 8 per cent would have increased by twice this amount.

Certainly, with increasing unemployment and much idle industrial capacity this inflation could not have been a product of excess demand which generates the traditional demand inflation. Because administered prices were the primary source of the inflation in this period, I have called it an administrative inflation.

Its causes could not be found in a lag in prices since in 1953, market and administered prices were in very close to the same relation they had held in 1942, in 1926 to 1929 and in 1914. The lag of administered prices in the post-war inflation had been overcome.

Theoretically this administrative inflation could have been caused either by labor pushing prices up faster than productivity and living costs or by management seeking to widen profit margins. The weight of the evidence seems to make management responsible with steel playing the role of the bell-wether. In this period of administrative inflation, wage rates tended to lag behind, though not by much.

What is immediately important is that market prices and administered prices played quite different roles in this inflation as they did in the great depression and there is nothing in Marshall's *Principles* or Keynes' *General Theory* or Samuelson's *Economics* or Stigler's argument which would lead one to expect this different macro-economic behavior of administering prices or the simultaneous occurrence of both inflation and recession.

RECENT POLICY ERRORS

In recent years there have been serious errors in macro-economic policy which have arisen from a failure to take account of the difference in behavior between market and administered prices. I will mention only two.

In 1957, the Federal Reserve Board caused the 1957–58 recession by applying the conventional wisdom to the inflation which was underway. The conventional wisdom only knew of demand inflation and prescribed a contraction in the money stock as a means of bringing it to a halt. The Fed applied this prescription contracting the money supply quite sharply. As we have just seen, the inflation in that period was not demand inflation but administrative inflation and the effect of the money contraction was to cause a recession. The decline in aggregate demand caused market prices to decline but administered prices as a group kept on rising.

Shortly after this episode and the reversal of the contraction policy a chief economist at the Fed, Woodlief Thomas, publicly acknowledged that this type of inflation could not be handled by contracting aggregate demand. In a letter to the Washington Post on March 12, 1959 he wrote:

"Recent discussion of the influence of administered prices, stimulated by [hearings before the Senate Anti-trust and Monopoly Committee], has made a significant contribution to a better understanding of the problems of inflation and fluctuations in economic activity and unemployment. This contribution is in pointing out that there are unstabilizing forces in pricing actions of the private

economy—on the part of both management and labor—that cannot be effectively controlled or corrected by governmental actions in the area of fiscal and monetary policies."

A second major error was made in the Kennedy Game Plan. That plan took account of the problem of administrative inflation through introducing a Guidepost Program but strangely took no account of the expectable behavior of market prices. As a result the Guideposts were poorly designed and the Guidepost program broke down. I will show why this happened after I have considered the Nixon Game Plan.

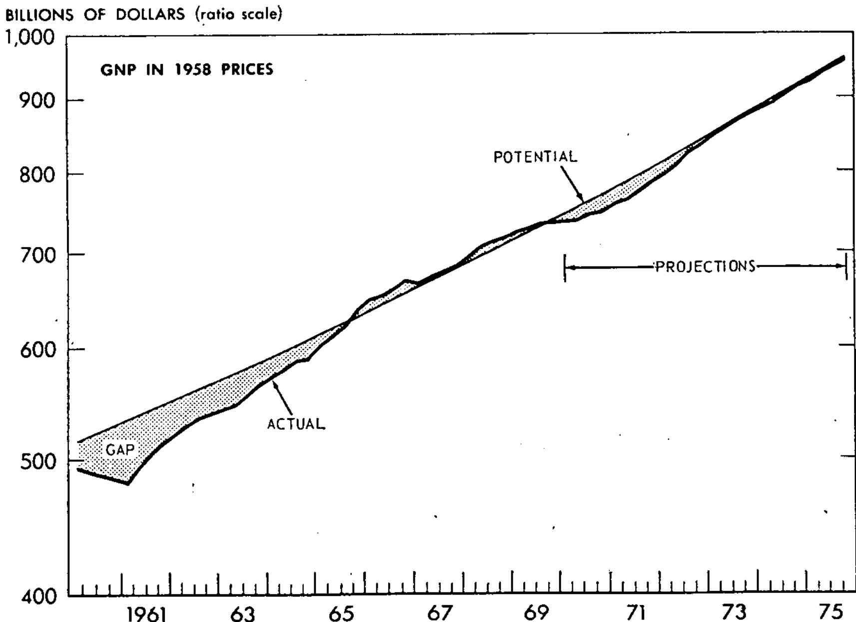
THE NIXON GAME PLAN

It is the announced purpose of the Nixon Game Plan to bring about full employment with stable prices.

The basic strategy is to take the heat out of the inflationary process by depressing the economy significantly below its full employment potential, holding it in a depressed condition long enough for the inflationary forces to burn themselves out and then reflecting the economy to full employment. The essential character of this plan is reflected in Chart III, taken from the President's Economic Report for 1970 [6] It shows in the smooth upward rising line, the past and expected real GNP for this country if unemployment were kept to 3.8 per cent. This is treated in the Nixon plan as corresponding to full employment. The fluctuating line represents the actual GNP through 1969 and the planned GNP in subsequent years. The shaded area represents the extent to which the actual or planned GNP falls below or exceeds the Nixon-defined potential.

CHART III

Gross National Product, Actual and Potential



[6] Page 85.

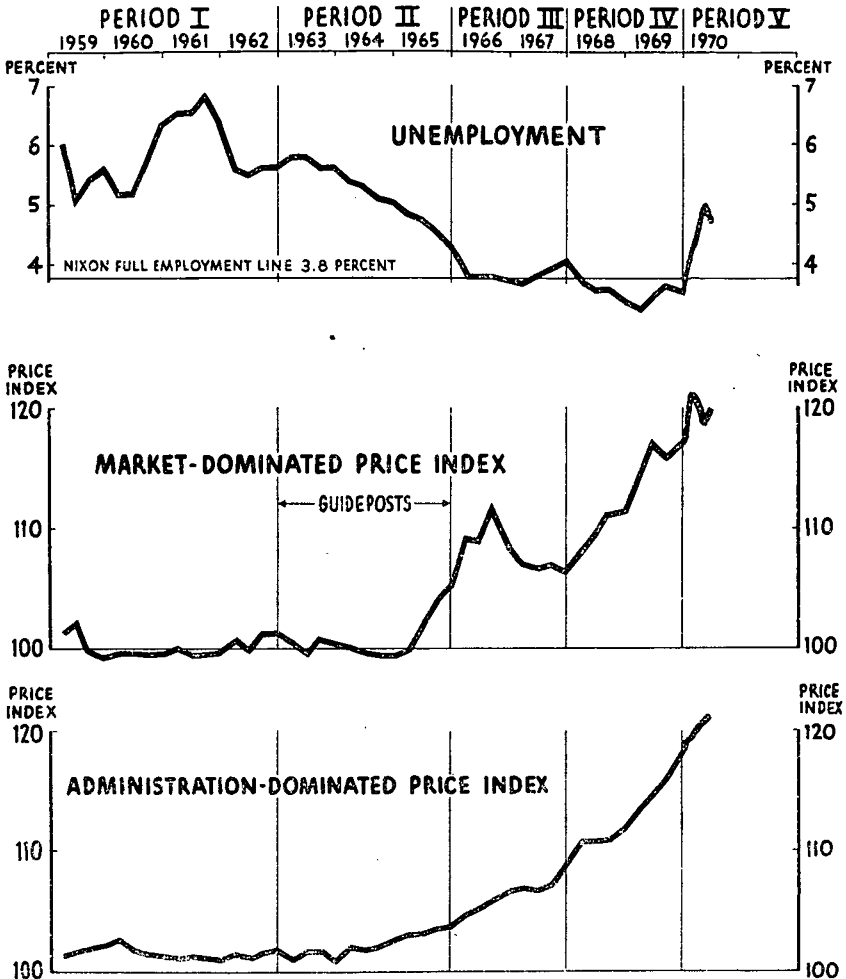
As can be seen from the chart the plan falls roughly into three periods. The plan for the first period calls for stopping the growth in real aggregate demand so as to depress the economy and create a substantial gap between actual and potential GNP. According to the chart this might amount to a loss of potential production at the annual rate of around $15 billion and unemployment of around 5 per cent. Then, for two years, aggregate demand would be held to a level which would maintain the economy in a depressed condition, perhaps even increasing the gap. In the third period aggregate demand would be increased faster than the growth in the economy's potential, reflating the economy to full employment in early 1973.

I will not go into the *planned* cost of this program—something like $40 billion and 4 million man years of excessive unemployment and corresponding human suffering. Rather, I will suggest that this game plan is built on the basis of the conventional wisdom and takes no account of the macro-behavior of administered prices or administrative inflation. I will show the faulty assumptions underlying this game-plan and then the reasons why it will fail unless radically altered.

THE ASSUMPTION OF PROLONGED EXCESS DEMAND

The most basic error underlying the Nixon game-plan is the failure to recognize the reality of administered prices and the consequent reliance on the conventional wisdom which says that the inflation of the last five or six years must have been the product of excess demand. The 1970 Economic Report refers to 1965-1969 as a period "when the economy operated under excessive demand pressure." [7] And the President speaks of "the growth of total spending, public and private, which was the driving force of the inflation." [8] Actually, there is no evidence of excessive demand before 1968.

[7] Economic Report of the President, 1970, p. 84.
[8] Ibid., p. 6.



This can be shown by examining Chart IV. The chart runs from 1959 to the present. The top line indicates the per cent of the civilian labor force unemployed with the 3.8 per cent Nixon full employment line drawn in. The data are quarterly averages of seasonally adjusted data except for the last six monthly observations.

The second line represents an index of market-dominated prices. It is made up of the group price indexes for farm products, foods, lumber and leather. These group indexes are largely made up of market prices but contain some administered prices such as fluid milk.

The third line represents a comparable index for administration-dominated prices made up of major industry groups in which production is highly concentrated such as steel and automobiles but contains some market prices such as steel scrap and lead.

I have divided the total period into five periods for convenience in analysis. Period I, the four years from 1959 to 1962 is one of low employment and great stability in both the price indexes. Period II from 1963 to 1965 is the period

in which the Kennedy Game Plan was operating and in which market prices rose. Period III is one of administrative inflation during 1966 and 67. Period IV shows the demand inflation of 1968 and 1969. Period V covers this year to date a period in which there appears to have been no excess in demand. Only in 1968 and 1969 is there evidence of excess demand.

The rise in prices in the second period was clearly not a product of excess demand. At the beginning of 1963 when the Kennedy Game Plan was put into effect, unemployment was at 5.8 per cent of the civilian labor force. The purpose of the plan was to increase aggregate demand through tax and other measures so as to increase employment. This program was slow in getting into operation but by the end of 1965, unemployment, seasonally adjusted, was down to the interim goal of 4 per cent.

In this period, the wholesale price index rose 4 per cent but this came mostly from a rise in market prices. The market-dominated index rose over 9 per cent while the index for administration-dominated prices rose only 2 per cent and part of this latter must be attributed to the rise in market-priced raw materials. The rise in market prices was not a product of excess demand but was a natural result of the process of expanding demand which was necessary to absorb unemployed in the industries in which administered prices prevailed. Since demand rose only just enough to support the interim goal of 4 per cent unemployed, it cannot have been excessive and the inflation of the period was a benign inflation essential to this goal of reflation.

There are also no signs of a general excess of demand in 1966 and 1967. The market-dominated price index where excessive demand should have been reflected was lower at the end of 1967 than at the beginning of 1966. After the rise in general demand in 1965, market prices continued to rise for a short period, as is usually the case at the end of a sharp rise in market prices when user-demand ceases to rise and speculative demand is still strong. Then the index dropped back to the level at the beginning of the year or below.

On the other hand, the administration-dominated index rose fairly steadily through 1966 and 1967, showing a 4 per cent increase. How much this was a matter of lag and how much it was administrative inflation will be discussed later. But it is clear that it was not a product of a general excess in demand since market prices as a group did not rise.

It is only in 1968 that signs of excessive demand appear. From the last quarter of 1967 to the last quarter of 1969, the market-dominated index rose 10 per cent. Since employment was already high, this was clearly the product of excessive demand.

In the same two years, the administrative-dominated index rose by just over 7 per cent. How much this was a result of excess demand and how much it was a continuation of the administrative inflation of the preceding two years needs to be investigated.

When the present administration took office at the beginning of 1969, there appears to have been only one year of excessive demand, not four. Any momentum the demand inflation carried at that time was only from a year's duration.

Even more important, by the beginning of 1970 when the Nixon Game Plan was formally announced, there was no longer an excess in demand. During 1969 the excess in demand was gradually dissipated by three developments. The Federal economic budget was brought into balance in the last half of 1968 by the surtax which also allowed a substantial surplus throughout 1969. The rapid growth in the stock of money was slowed down and then brought to a halt in the last half of 1969. And most important of all, the 7 per cent rise in prices had very substantially reduced the real buying-power of the money stock.

The rapid rise in unemployment this year shown in Chart IV clearly indicates the fact that there has been no excess in demand since the turn of the year. Since January there has not even been enough demand to support full employment.

That excess demand had already come to an end before 1970 is also suggested by the steady decline in industrial production from its peak in the summer of 1969. At the end of the year manufacturing industry was operating at less than 82 per cent of capacity compared to 85 in the first half of 1968.

Market prices also confirm the end of excess demand. In early 1970 market prices were still going up, presumably the speculative rise which usually occurs at the end of a rise in market prices. But since March, market prices have declined.

It is a truly remarkable thought that the Nixon Game Plan calls for three years of under-production and excessive unemployment to cure a two year period of excess demand, an excess that was rapidly disappearing in the latter part of the period and was gone at the time the game plan was announced. If all prices behaved like market prices it would be enough that aggregate demand had ceased to be in excess. Any sustained speculative demand for a further rise would be short lived and no period of under-production would be needed.

It is this error in assumption which has led to an over-contraction in aggregate demand. Because it was assumed that the inflation was from five years of excess in demand and a strong momentum which this created, action was instituted which has already raised unemployment more than was planned and has substantially reduced manufacturing when it was planned simply to stop growth.

THE ASSUMPTION OF MOMENTUM

The second major error in assumption underlying the Nixon Game Plan grows out of the first. It is that, once excess demand is eliminated, the basic inflation problem is one of momentum and that, if the momentum can be killed by a prolonged period of depressed operation, there can be a return to full employment without inflation.

I think no one would deny that with market prices, inflation generates a speculative momentum. We have seen it in the tendency of market prices to over-shoot when market prices rise rapidly. But this is relatively short-lived and corrects itself when excess demand is avoided or eliminated.

The case of administrative inflation is quite a different matter. It does not arise from the extra demand from customers or speculators. What can look like momentum to a classicist is' not primarly momentum but is something vastly more complex and does not grow out of an excess of demand by speculators or a sustained rise in prices. And it can occur at levels of demand well below those required for full employment.

The reason administrative inflation can occur in the absence of excess demand and at less than full employment is quite simply explained. In our modern highly concentrated economy, management has significant discretionary power over prices and labor has significant bargaining power over wages. In the more concentrated industries, market forces do not *determine* prices, they only limit the range within which prices and wages are set. How far this keeps prices in reasonable relation to costs is a micro-economic problem which I will not discuss.

But at the macro-economic level with which we are concerned, the power to affect prices or wage rates a few percentage points is vital. In the more concentrated industries price administrators usually have the power to raise prices a few percentage points when there is no change in demand or costs. Likewise organized labor often has the power to push wage increases a few percentage points beyond the level justified by increases in national productivity and living costs. These powers provide the basis for administrative inflation. And as we saw in Chart II, between 1953 and mid-1958 this market power produced administrative inflation when there was no initial inflationary momentum, when there was no excess in demand, when there was less than full employment and when manufacturing industry had ample capacity.

The tendency toward administrative inflation results from the arbitrary exercise of market power and is closely associated with the process by which the gains from increased productivity are divided between labor and capital. Management is well aware that labor is constantly demanding and often forcing wage increases greater than economic conditions warrant. Labor is well aware that management often does more than pass on increases in labor costs per unit and tacks on something to boot. These steps in the increase of prices can properly be thought of as "natural" uses of market power as each side seeks a larger share of the gains from increasing productivity to which both contribute. And there is nothing in short-run market forces which can be expected to control this process of price escalation except a high degree of underemployment of workers and equipment.

It is wholly appropriate that both labor and capital should share in the increase in productivity but the form in which the shares are obtained is quite different. For example, if improved technology makes it possible for a given amount of labor and capital, is combination, to produce progressively more and more extra units of output, each should gain. But with a stable general price level, the gain to labor should come from increased wage *rates* while the gain to

capital should come not from widened profit margins but from the extra profits which come from selling the *extra units of output*. In this way an industry with average increases in productivity would divide the gains without price increases and both total wages and total profits would go up.

There are two conditions which complicate and contribute to the escalating process. The first is that productivity does not go up at the same rate in all industries. As a result, administrative inflation may come partly because prices are not reduced in industries in which productivity increases faster than average while prices rise in industries in which productivity increases at less than the average rate. The second complicating factor is that, at any given time, there are bound to be inequities in both wage rates and profit rates. These can be serious and need to be corrected. This need can often confuse the process of dividing the gains from increased productivity but is primarily a problem of micro-economic policy.

What is immediately important for macro-policy is that what looks like inflationary momentum is not primarily a matter of momentum but is a natural behavior to be expected where there is a substantial degree of economic concentration. Undoubtedly an administrative inflation does generate momentum. With an expectation of further inflation both management and labor seek to beat the gun. But with no inflationary momentum, the natural use of market power could be expected to produce administrative inflation except under heavily depressed conditions.

This conclusion is reinforced by recent studies. In all four of the biggest industrial countries of the free world, England, Germany, Japan and this country, administrative inflation at full employment is becoming recognized as a fact associated with more concentrated industries. It is reflected in the Phillips Curve developed for England which shows not only that general price increases are associated with high employment as is to be expected but also, and more important, price stability is associated with relatively high unemployment. This finding was confirmed for the United States in the President's Economic Report for 1969. There it was shown that price stability tended to be associated with between 6 and 7 percent unemployment.

One simply cannot accept the Nixon Game Plan assumption that the continued infiation this year in the absence of excess demand has been primarily a matter of momentum, or that if all inflationary momentum were eliminated by depressing the economy for three years, aggregate demand could then be increased as planned to the point necessary to support full employment as the Nixon Plan proposed without generating inflation.

THE SUCCESS AND FAILURE OF THE KENNEDY GUIDEPOSTS

The third major error in the assumptions underlying the Nixon Game Plan concerns the use of Guideposts. The Council of Economic Advisers said, "The results of our own experience and numerous trials in other countries over the preceding 20 years did not justify confidence that such efforts would help solve the inflation problem in 1969". To support this position, it cites the breakdown of the Kennedy Guideposts.[9]

This attitude is understandable if one is steeped in the conventional wisdom. If one looks at the Guidepost Program from the point of view of 19th Century theory and the assumption that most prices behave like market prices with the level of each determined by marginal cost, the effort to restrain a demand inflation by a Guidepost program is bound to break down. It will be overrun by the forces of excess demand. This is an easy way to explain the breakdown of the Kennedy program.

But there are four errors in such reasoning. First, there was no excess demand in the 1953–55 period; second, the bulk of prices are not market prices; third the break down arose from a major flaw in the design of the Guideposts; and fourth, in spite of the flaw in the design it was remarkably successful in influencing the behavior of both labor and management.

[9] *Economic Report of the President, 1970*, p. 23.

The aim of the Guidepost Program was to prevent administrative inflation. It was recognized that when fiscal and monetary measures are used to increase aggregate demand faster than normal growth and thus reduce unemployment there is danger that prices will be raised arbitrarily "in those sectors where both companies and unions possess substantial market power" and "where the interplay of price and wage decisions could set off a movement toward a higher price level," [10] thus defeating the aim of the reflation.

The flaw in the actual design of the Guideposts arose from the reverse of that in the Nixon plan. While the Nixon plan fails to take account of the natural behavior of administered prices, the Kennedy plan failed to take account of the natural behavior of market prices. The Guideposts allowed companies to increase prices where market-priced raw materials had risen or labor costs had increased. They allowed wage increases for increases in national productivity. But they made not provision for any wage increase because of a rise in living costs. Yet it was a reasonable expectation that living costs would go up when the increase in aggregate demand caused a natural rise in market prices, particularly in foods.

Undoubtedly, the failure to include a cost of living adjustment in the wage guidepost arose from a fear of generating a never ending, constantly rising price-wage spiral. But this fear grows out of a failure to understand the interrelation between the movement of market prices and that of administered prices. The inclusion of a living cost factor in the guideposts could be expected to produce a price-wage spiral, but under the conditions of reflation the spiral would tend to be self-damping and cease to be significant after a very few rounds.

This self-damping character of the spiral is so important that I will give a simplified example. Suppose that half the prices in the economy were market prices and half were administered. To keep the example simple, leave out changes in productivity but assume that aggregate demand is expanded and guideposts including a cost-of-living adjustment are precisely followed. Then, if market prices rose, say, 8 percent and administered prices remained constant, the cost of living could be expected to go up say 4 percent. This would allow a 4 percent increase in wage rates, causing a 4 percent increase in labor costs per unit of output. Because of this increase in labor cost, management would be allowed to raise its prices but labor represents only part of the cost of the product and with the expansion in output, overhead costs per unit would go down so that business could be expected to raise prices by much less than in proportion to the wage increase. If management raised prices 2 percent because of the 4 percent rise in wages, this would mean only a 1 percent rise in the cost of living, since administered prices affect only part of living costs and market prices would not rise because of the rise in wage rates. They have *already* risen sufficiently to allow the payment of the higher wage rates. Thus in the first round of the spiral, the initial 4 percent increase in living costs would produce only, say, a 1 percent further rise in living costs. If in the second turn of the spiral wage rates were raised another 1 percent, the effect on living costs would be only ¼ of one percent. In the third turn of the spiral, the further cost-of-living increase would be only 1/16 of one percent and hardly significant.

While this is only a mathematical example, the principle is clear and would apply to a reflation in our economy where prices are partly market and partly administered. The inclusion of a cost-of-living factor in the guideposts should not produce a serious spiral if the guideposts are well designed.

In spite of the fact that the actual guideposts were quite unfair to labor, there was a remarkable degree of adherence by labor until nearly half of the increases in wage rates justified by productivity increases had been nullified by cost-of-living increases. This is clearly shown in chart V, which indicates that the labor cost per unit of production for the total of all nonfinancial corporations was remarkably stable from 1963 to 1965. Indeed, if anything, labor costs per unit of production were slightly lower in the last quarter of 1965 than in the first quarter of 1963. Thus on the whole, the nonfinancial corporations which account for more than half of our total production, labor in the aggregate clearly adhered to the guideposts up to the end of 1965.

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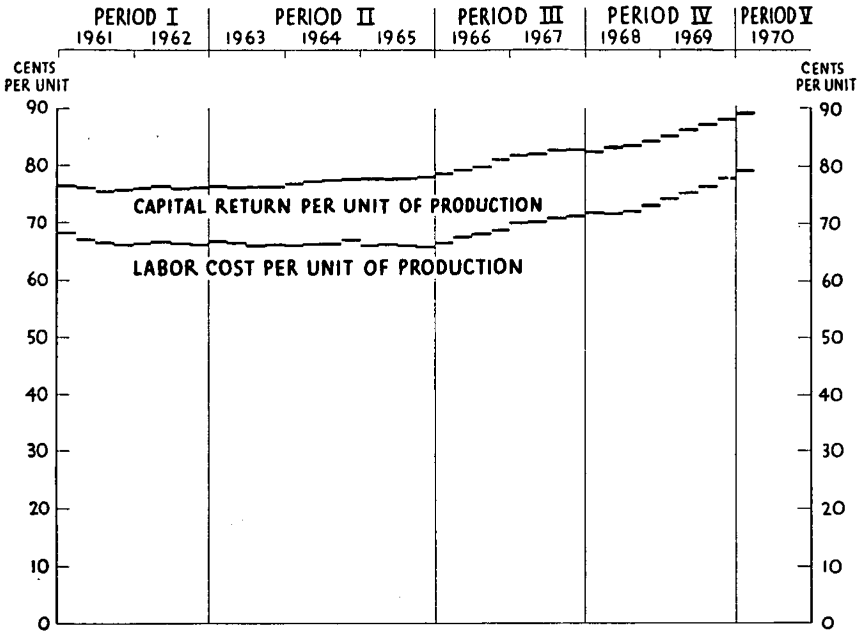
[10] *Economic Report of the President, 1962*, p. 16.

CHART V



It is more difficult to say how closely management adhered to the guideposts but up to the end of 1965 any departure did not contribute much to inflation. The price deflator for the value added by all nonfinancial corporations went up only 1.7 percent from the first quarter of 1963 to the last quarter of 1965. This figure for value added does not represent the prices charged for corporation products which have to cover raw materials and business services. It is, however, quite consistent with the rise of 2.0 percent in the index of administration-dominated prices which do reflect the rise in market-priced raw materials.

However, in this Guidepost period, the proportionate returns to capital rose substantially. This is reflected in that share in the pie divided between capital and labor which went to capital. Capital's share consists of interest, dividends and undistributed profits after taxes and excluding inventory profits. Labor's share consists of wages, salaries and fringe benefits.

For all nonfinancial corporations, capital's share in the first part of 1963 amounted to only 12.5 percent of the total pie, just about what it had averaged over the preceding ten years of relatively low employment. But in the three years of the Kennedy Game Plan, capital's share increased to 15.6 percent of the pie.

There were several sources which contributed to this increase in capital's share, some legitimate and some in conflict with the guideposts. Part came from a rise in interest rates. Part came from the 7 percent investment credit which meant smaller tax payments for a given volume of business, part came from the small reduction in labor cost per unit of output, part from spreading overhead costs over a somewhat larger volume of output and part from price increases in excess of those justified by the guideposts or, where costs were lower, failure to reduce prices to the extent required by the guideposts. This rise in margins contributed to labor's final rejection of the guideposts, but it is doubtful if it contributed much to an excessive rise in administered prices in that period. The price indexes make this clear.

By the end of 1965, the unfairness to labor of the particular wage guidepost had been so clear that labor ceased to play ball. Labor became increasingly aware that it had lost nearly half of the gains from productivity in the three years of effective guideposts and saw some widening of profit margins. As a result it forced wage contracts which substantially exceeded the guidepost based only on productivity. The result is the rapidly rising line of labor cost per unit from

1966 as shown on Chart V. In Period III, the two years of administrative inflation, wage rates went up a little faster than the combination of productivity and living costs. Management passed on most of the increases in labor costs but absorbed a small amount so that by the end of 1967 capital was getting 14.1 percent of the pie and profit margins per dollar of value added, somewhat squeezed by high interest rates, were nearly back to the earlier rate. By the end of 1967, labor had recouped some of its loss due to the unfairness of the Kennedy guideposts.

Two things stand out in the guidepost period. The first is the remarkable adherence of labor to the guideposts even though they were unfair to labor and the very substantial adherence by management. The second is that the distortions in the price relationship which caused the breakdown of the program and resulted in the administrative inflation of 1966–67 were not inherent in guideposts as such but in the particular guideposts adopted. If the wage guideposts had contained a suitable cost of living adjustment, wage rates would probably have increased a little more than 4 percent over what they did, all or most of the extra labor cost per unit in the more concentrated industries would have been passed on in prices, market prices would have been little affected, the cost of living would have increased by, perhaps, 2 percent more than it did and close to full employment would have been achieved in early 1966 with both labor and management reasonably satisfied to continue the guideposts, at least for a time. And most important of all, both full employment and a balanced overall price and wage structure could have been obtained without seeds of demand inflation and with reasonable guideposts acting to keep administrative inflation to a minimum.

It is my conclusion that the Nixon Game Plan is aimed at a type of inflation which had already passed when it was made public; that the basic inflation problem today is not one of momentum but one of administrative inflation with which the plan does not attempt to deal; that in spite of its faulty design the earlier Guidepost Program had a substantial effect in curbing the arbitrary use of market power; and that, in spite of the waste and hardships it is creating, the three year plan for depressed activity followed by reflation cannot be expected to bring us to full employment and stable prices.

AN ALTERNATIVE GAME PLAN

Once it is recognized that the real problem of simultaneous recession and inflation is not one of excess demand or momentum but arises from arbitrary use of market power, the outlines of an alternative game plan become clear. Reflate the economy back to full employment as quickly as possible and take measures to minimize the arbitrary use of market power in the concentrated industries.

I do not need to go into the use of monetary and fiscal measures to reflate the economy, except to say two things. First, I would support a budget which is approximately in balance or produces a small surplus at full employment but a deficit when unemployment is at present levels. This is essentially the recommendation which the Committee for Economic Development made in its policy statement twenty-five year ago, and I think it is still sound. Second, I would use monetary expansion as the main instrument for stimulating aggregate demand to the extent needed.

The abuse of market power is a much less well understood matter. Some have suggested that government should adopt price and wage controls as it did in World War II. But this seems to me altogether too drastic. During the War, the problem was to contain a heavy excess in demand while the war was carried on. Today the problem is quite different and price and wage controls would involve much greater interference with industry decisions than is either necessary or desirable.

I have shown the extent to which labor and business adhered to a badly designed set of guideposts. I believe a well-designed set could be reasonably successful in the present circumstances. It would spell out in principle for concentrated industries what wage and price behavior would be legitimate and what behavior would be an abuse of market power. It would not force particular behavior as would price controls. But where pricing power exists it would place the making of wage and price decisions in the larger context of the public interest. The longer-run self interest of the decision makers would then operate to minimize the abuse. I would expect that once such a program was instituted, we could achieve full employment and reasonable price stability within a year.

It is abundantly clear that a refusal to adopt a vigorous program to limit the abuse of market power is a decision to maintain a permanently depressed economy or to accept continuous administrative inflation.

Chairman PATMAN. Dr. Blair, you may proceed.

STATEMENT OF JOHN M. BLAIR, CONSULTANT

Mr. BLAIR. Mr. Chairman and members of the committee, the proposition to be examined here is that the price structure is composed of two different types of prices: one consisting of prices which change frequently, react to an economic downturn by declining and are generally responsive to changes in supply and demand; the other consisting of prices which change only infrequently, react to a downturn by either remaining relatively stable or actually increasing, and in short are not responsive to changes in supply and demand; and further that the former type of behavior is characteristic of unconcentrated products while concentrated industries tend to display the latter type of behavior. Obviously, to the extent that this proposition is valid, measures designed to reduce overall demand, whether monetary—reductions in the money supply, increase in interest rates—or fiscal—increase in taxes, reductions in Government expenditures—can be expected to result in price reductions in the unconcentrated, flexible price areas but not in the concentrated inflexible price fields.

The proposition can be examined by analyzing the price movements of broad groups of commodities and of individual products. Particularly important are differences in price behavior during economic recessions, of which there have been three since World War II—the recessions of 1948–49, of 1953–54, and of 1956–58. The first part of this presentation will examine the movements of groups of commodities, differentiated according to their frequency of price change, over the period 1947–58, which encompasses each of these recessions. The second part consists of an analysis, covering the same period, of pairs of products which are subject to much the same changes in demand but differ markedly in terms of both the level of concentration and the frequency of price change. In the third part an effort will be made to ascertain whether the differences in price behavior, as revealed in the earlier recessions, are repeating themselves in the current year.

THE BLS "QUINTILE" STUDY

Information on the price trends of product groups, classified according to their frequency of price change, is available in a special report prepared by the Bureau of Labor Statistics.[1] In the study each of 1,788 products in the wholesale price index was classified according to the frequency of the products' price changes during the 3-year period, 1954–56; these represented all of the 1,900 products in the index with the exception of certain items whose prices are secured on a confidential basis, certain seasonal products, and a few items for which the price series obtained by the Bureau of Labor Statistics was not suitable for the purpose of the study. The distribution of the products

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[1] U.S. Dept. of Labor, Bureau of Labor Statistics. *Frequency of Change in Wholesale Prices: A Study of Price Flexibility*, by Henry Ernest Riley.

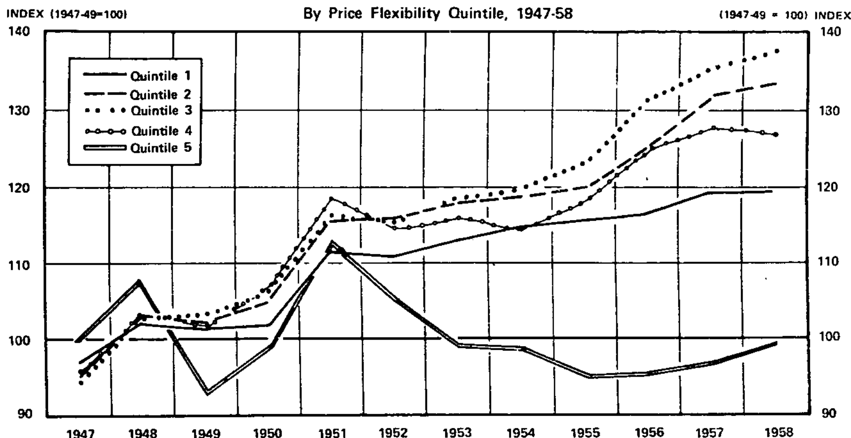
into five categories or "quintiles," according to the frequency of change, was as follows:

Flexibility group (quintile)	Number of price changes	Number of products	Percent of weight
I	0 to 2	370	13.3
II	3 to 4	308	14.3
III	5 to 7	405	19.2
IV	8 to 14	355	16.4
V	15 to 36	350	36.8
Total		1,788	100.0

Since the Bureau of Labor Statistics computes its price series on a monthly basis, the greatest possible frequency of change was 36. As compared to the periods used in similar studies, which embraced both sharp downswings and upturns, the 3-year period used in the Bureau of Labor Statistics study for classifying the products was one of relative stability in the economy as a whole and in the price structure. Hence, it is not surprising that most of the products have a relatively low frequency of change. Only one of the five classes, or quintiles, can properly be rated as "flexible" in the usual and traditional sense of the term. This is quintile 5, which consists of products having 15 or more price changes in the 3-year period. In order to determine whether price trends of flexible products have been different from inflexible-price products the movement of quintile 5 can be compared with the movements of quintiles 1 and 2, the former having 0 to 2 changes, and the latter 2 to 4. By virtually any standard the products in these two quintiles can be regarded as highly inflexible.

Chart 1 shows the trend from 1947 to 1958 for each of these five groupings of the 1,789 commodities. The period encompasses three economic downturns, those of 1948–49, 1953–54, and 1956–58. During the first period the Federal Reserve Board's index of industrial production for manufacturing dropped by about 6 percent; during the latter two, it fell by 7 percent.[2] Under virtually any definition all three would thus qualify as "recessions."

[2] Since the index of industrial production for manufacturing was virtually the same in 1956 and 1957, either year could be taken as the beginning point for the third recession. Except for a sharp decline in automobile production, the 1958 downturn was confined largely to producers' goods, which began to experience a contraction of demand around the middle of 1956. No decrease occurred during 1958 in either real consumer income or the production of non-durable goods. Because it is more relevant to the area of the economy in which economic decline was centered, the year 1956 is used in this analysis as the beginning point for the third recession.



During the first two downswings a comparison of the behavior of the least flexible groups with that of the most flexible is a study in contrasts. During 1948–49 stability in quintiles 1 and 2 contrasted with a pronounced decline in quintile 5. In 1953–54 the flexible group again recorded a noticeable decrease, but this time the two inflexible groups actually moved upward, repeating this anomolous behavior in 1956–58. Although these upward movements were of limited magnitude, any increase in price during a recession is significant. During the last downswing the most flexible group also moved upward, a form of behavior which was in sharp contrast to its movement during the two preceding recessions. The explanation is to be found in the composition of quintile 5, itself. Nearly two-thirds of the weight of this grouping was made up of farm products—35.6 percent—and processed foods—28.8 percent. Apart from marginal operators the farmers who have come to account for the bulk of agricultural production closely resemble in their operations small manufacturers in a typically competitive industry. Both are essentially fabricators; the small manufacturer buys raw materials and semifinished products; the farmer buys fertilizer, fuel, seeds, insecticides, and other supplies. The manufacturer uses tools and machinery of one type or another to fabricate the materials into finished products; the tools of the farmer are agricultural machinery which requires a substantial capital investment. Both employ hired labor forces and for their outside financial requirements both operate largely on the basis of borrowing from commercial banks. But perhaps the most important similarity is that no single enterpriser, or even small group of producers, in either farming or the typical competitive industry has a sufficiently large share of their product's total output to be able to significantly affect the price.

For a short-term period, there is, however, one important difference; the output of the farmer, and thus his price, is more directly and severely affected by influences over which he has no control. Of these

the most important is the weather, which was one of the factors responsible for an increase in farm prices in 1958. According to the Department of Agriculture:

Freeze damage brought smaller supplies and higher prices for vegetables in the first half of the year and for citrus fruits.[3]

It was also a year of reduced supplies of both hogs and cattle:

Prices of hogs and cattle are substantially higher this year [1958] than last, reflecting reduced marketings of meat animals.[4]

Finally, the 1958 downswing had little effect on the demand for food:

Consumer incomes were well maintained, and sales at retail food stores in the first nine months of the year average 6 percent above the same period of 1957.[5]

Another apparent anomaly is the relatively limited magnitude of the increase, both over the entire period and its three stages, by the least flexible group. Again the explanation is to be found in its composition. Nearly half of the weight of quintile 1 was made up of two commodity groups—textile products and apparel (16.6 percent) and chemicals and allied products (22.7 percent). Many apparel items are sold on a "price-lined" basis, with competitive rivalry taking the form of changes in quality rather than price. Although recently improved the price indexes for chemicals have for years been regarded as the weakest series in the BLS wholesale price index. Because of their conspicuous failure to reflect changes shown by "realized" prices, the chemical series have simply been excluded from studies of price flexibility based on the BLS indexes. At the same time it appears that at least some segments of the chemical industry have been experiencing an intensification of price competition, which of course would act as a restraint upon price increases.

An interesting comparison is provided by a contrast of quintile 2 with quintile 4. Although not at the extremes, the difference in flexibility was significant; products in the former experienced only three to four changes during 1954–56 while those in the latter group had from eight to 14. What makes this comparison significant is not only its avoidance of the unusual problems inherent in the farm and food products of quintile 5 and the apparel and chemical products of quintile 1 but the similarity in their composition. Of the total weight of all products in quintile 2 41.8 percent is made up of the two commodity groups: metals and metal products and machinery and motive products; in quintile 4 the proportion represented by these two groups is 43.8 percent. In both, the remainder was widely dispersed among other commodity groups.

As can be seen from chart 1, the relative stability of both quintiles 2 and 4 in 1948–49 had by 1953–54 given way to a divergence in behavior. A clearly discernable decline in the more flexible group was accompanied by a definite upward movement in the less flexible class. Again, during the 1956–58 downturn quintile 2 moved steadily upward, while quintile 4, after rising in 1957 fell back in the following year.

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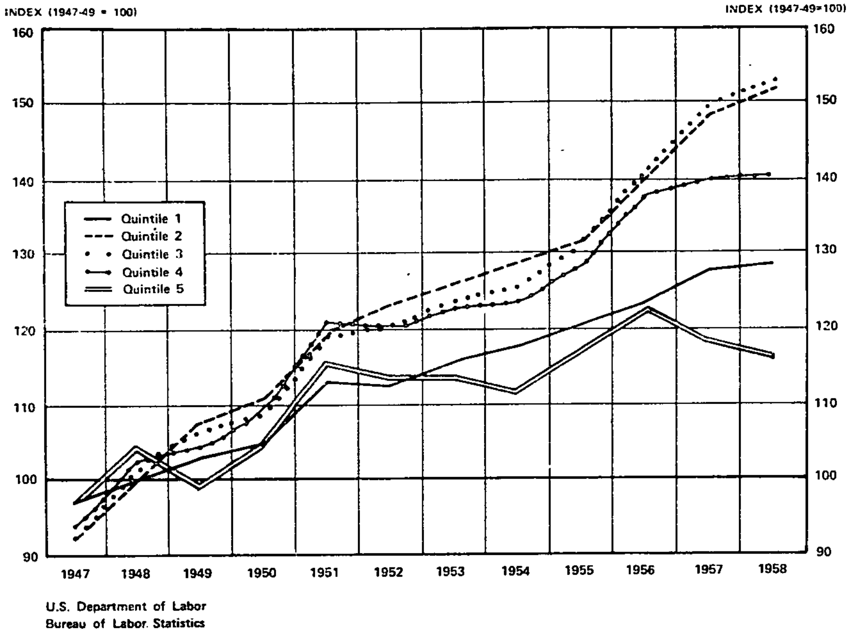
[3] U.S. Dept. of Agriculture, "The Agricultural Outlook for 1959, Nov. 17, 1958.
[4] *Ibid.*
[5] *Ibid.*

As is invariably the case, the brunt of each of the three downswings fell on the durable goods sector. The output of durable goods fell 10 percent in 1948–49, 11 percent in 1953–54, and 14 percent in 1956–58. Because of the greater reduction in demand the trend of the different quintiles within durable goods is of greater significance than their behavior in terms of all commodities.

Chart 2. Annual Average Price Indexes of Durable Manufactured Commodities, By Price Flexibility Quintile, 1947-58



U.S. Department of Labor
Bureau of Labor Statistics

The behavior of the most flexible group in durable goods is consistent. In each of the three downswings quintile 5 registered a noticeable decline. In contrast, the adjustment of the two inflexible groups took the form of a slight upward movement, which was particularly noticeable in the case of quintile 2. Thus, within the sector of the economy most severely affected by a recession the price behavior of the most flexible product grouping, in terms of frequency of change, accorded perfectly with the expectations of classical theory. But the behavior of the least flexible groups was inexplicable under either classical theory or more recent theories of monopolistic competition since under the latter the expectation would be, not that oligopolists would raise prices, but that they would merely abstain from cutting them.

It is recognized that the BLS study contains no data on concentration and therefore cannot be cited as evidence of a relationship between concentration and any particular type of price behavior. Nonetheless, the showings of limited amplitude of change during downswings on the part of products with low frequency of change is in accord with accepted theories of monopolistic competition, which suggest that during periods of falling demand oligopolistic prices will

tend to be rigid in terms of both frequency and amplitude. The reluctance of each oligopolist to make a price reduction because of his expectation that it would immediately be matched would imply that in such industries prices would be changed only infrequently and the amount of the change would be limited. This inhibition, and the ability to implement it through the control of output, would of course not be present in unconcentrated industries where a falling off in demand would presumably be accompanied by falling prices; the price changes, in other words, would be both frequent in number and extensive in amplitude. These theoretical expectations are indirectly reinforced by empirical findings that during the great depression of 1929–32 frequency of change was directly related to amplitude and that amplitude was directly related to the level of concentration.[6]

PRODUCTS WITH COMPARABLE DEMAND

A more direct way of ascertaining the effect of concentration on price behavior is of course to determine the statistical relationship between the two in terms of individual industries. For the Great Depression Means found a "rough relationship" between the share of the industry held by the four largest companies and the amplitude of price change between 1929 and 1932.[7] In arriving at this finding Means had eliminated industries which failed to meet standards that he regarded as necessary for a meaningful analysis: industries such as bakery products sold principally on the basis of local or regional rather than national markets; industries such as meat-packing with a narrow margin between the cost of materials and the value of shipments; and industries, such as chemicals, for which the BLS wholesale price series appeared to be clearly inadequate.

The study has been criticized as statistically inadequate and theoretically irrelevant. The statistical criticism centers on the oft-cited alleged shortcomings in the BLS price data, a matter which is examined at greater length in appendix A. Here it may briefly be noted that comparisons between BLS and Census "realized" prices—which reflect all discounts and concessions—reveal, with some exceptions, a remarkable similarity in the direction and extent of change;[8] that using the BLS data to analyze price inflexibility is invalid only if unreported changes in discounts and concessions are assumed to be relatively more important in industries of high than of low concentration—an assumption which flies in the face of their known prevalence in such unconcentrated fields as apparel and lumber; and that the criticism loses most of its force when prices are being raised, since it taxes credulity to assume that at the very time when producers are increasing their reported prices they are simultaneously granting further discounts and concessions.

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[6] Cf. 74th Congress, 1st Sess., Sen. Document No. 13, *Industrial Prices and Their Relative Inflexibility,* by Gardiner C. Means, Jan. 17, 1935; and National Resources Committee, *The Structure of the American Economy,* Pt. 1, 1939 (prepared under the direction of Gardiner C. Means).

[7] National Resources Committee, *The Structure of the American Economy, op. cit.*

[8] Also part of the statistical criticism is a study by Willard Thorp and Edward Crowder in which no relationship between concentration and depression price flexibility was found to exist (T.N.E.C. Monograph 27, *The Structure of Industry,* 1941). It differed from the Means' study in two respects: the use of the Census realized figures for its price data and its failure to employ standards, such as those used by Means, to eliminate products which are not meaningful for this type of analysis (cf. John M. Blair, "Means, Thorp and Neal on Price Inflexibility", *Review of Economics and Statistics,* Nov. 1956).

The last consideration is of particular relevance at the present time. Prof. George J. Stigler has recently been quoted in the press as saying:

> I am absolutely confident that there has been extensive price cutting during the slowdown of the past six to eight months; but these cuts have not showed up in the government's WPI.[9]

Prof. Stigler's "conviction" would have a considerable measure of plausibility if reported prices were being maintained at relatively stable levels. Under such conditions it is easy to visualize that under a facade of unchanged quoted prices producers are actually scrambling for business by offering greater discounts and concessions. It is much more difficult to visualize that this is taking place when the reported prices are being raised, which, as will be brought out later, is exactly what is happening in many concentrated industries. A more logical assumption would be that producers who are raising their reported prices would accompany this effort to increase revenues by narrowing their discounts and concessions.[10]

The theoretical criticism centers on differences in the postponability of demand. Thus it has been held that the ability of the buyer of an automobile to postpone his purchase results in the adjustment to a downswing taking the form of a reduction of output rather than price. In contrast, it is to be expected that the production of nonpostponable items, such as food, will be maintained, with the adjustment therefor falling on price. But, as Ralph C. Wood observed:

> Two very different points are involved in this argument. To assert—with much justice—that durable goods frequently attain high inelasticities of demand in times of depression is not to explain why the individual producer has to concern himself with what the market as a whole, or any appreciable portion of it, will take . . . Under pure competition the individual seller is not directly concerned with the elasticity of demand of the whole market; at the market price which he views as given and as something over which he has no control, demand for his product is perfectly elastic.

Wood concluded by observing that the argument does:

> Provide a very useful suggestion as to why price policies in certain industries are what they are; but they do not show how it comes about that an individual seller is able to have a price "policy".[11]

The argument can also be met empirically through a comparison of the price behavior of different products which are similarly affected by expansions or contractions in demand but which differ greatly in the control of the market, as reflected by the level of concentration. Such an analysis is presented here for 16 pairs of products. While

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[9] *Washington Evening Star*, June 25, 1970.

[10] Some indications that increases in reported prices are being accompanied by a withdrawal of concessions are provided by the business press. Thus the same news account which described a recent price increase by tire manufacturers stated: "Both Goodyear and Goodrich said they will pay freight allowances only on shipments of 500 pounds or more, compared with the current 400-pound minimum." (*Wall St. Journal*, June 22, 1970) Similarly, an announcement of a price increase for gasoline was accompanied by a withdrawal of price supports to dealers:

"Mobil also announced it is withdrawing all temporary price allowances paid to dealers. This so-called 'price protection,' is a guaranteed minimum margin in cents per gallon for dealers regardless of how low pump prices go. It is used to protect dealers during local gasoline price wars. Over 99% of Mobil's 35,500 service stations are operated by independent dealers who make their own retail pricing decisions. But removal of such allowances would encourage *restoration of normal prices*, since it transfers the burden of local price wars to the dealers from the company." (*Wall St. Journal*, March 26, 1970, emphasis added.)

[11] Ralph C. Wood, "Dr. Tucker's 'Reasons' for Price Rigidity", *American Economic Review*, Dec. 1938, p. 669.

both members of each pair are subject to much the same changes in demand, one member is a concentrated, inflexible-price product; the other is an unconcentrated, flexible-price product. In order to make a comparison between products which differed in terms not only of concentration but also in terms of frequency of change, the products were drawn from the BLS "Quintile" study. Since the only really flexible group in the BLS study is quintile 5, the starting point in drawing the comparisons was the products in that group. Inasmuch as nearly half of its products—accounting for nearly two-thirds its value—are farm products and foods and there are few such products in the other quintiles, this limitation imposed a severe limitation on the numbers of comparisons which would be developed. To this initial limitation certain other restrictions have been added in order to make the analysis more meaningful:

(*a*) Comparisons are made only where the insensitive product had four or fewer changes in the 1954–56 base period—that is products in quintiles 1 and 2.[12]

(*b*) Because of their known past inadequacies, no use has been made of BLS price series for chemical products.

(*c*) No comparisons were made involving products typically sold on a price-lined basis.

The one further step is the determination of which products are subject to reasonably comparable demand forces. Here the test was not whether one product was an exact substitute for another, although in several instances—for example the comparison between pig iron and steel scrap—such was the case.[13] Rather, the concept employed is whether the products used in a given comparison are subject to the same general expansions or contractions in demand.

For a few of the flexible-price products concentration ratios were not available, but it is known that their level is relatively low and in each case well below the inflexible products with which they are compared. The use of copper and brass as market-price products is based on a number of unusual circumstances. While concentration is relatively high for domestic copper refining, the available domestic concentration ratios in the past substantially overstated the actual control of the market. These commodities were sold on the world market during the period surveyed, and their prices were immediately responsive to international developments. Also the available concentration figures ignore the ever-growing role played by secondary metals, which unlike steel scrap, are not subject to rust and thus tend to be a perpetually increasing source of supply. In the case of brass, these competitive factors are reinforced by the activities of custom smelters who, operating on the basis of a fixed margin between the ore price and the refined metal price, are comparatively indifferent to the level of prices.

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[12] Some steel products were reported by the B.L.S. to have had five or six changes during the 35-month period, falling just outside of quintile 2. During this period there were only four changes in the base prices of most steel products. The additional changes represented changes in the so-called extras, some of which are incorporated as price changes by the B.L.S. Since other products have analogous charges, modifications of which are not treated by the B.L.S. as price changes, changes in extras should properly be ignored in comparing the flexibility of different products.

[13] Where substitutability does exist, the expectation would be that if changes in demand were the determinant of price changes, the price of a flexible product would decline less during a downswing than its inflexible-price counterpart. At the outset of a downswing buyers would attempt to shift to the sensitive declining product from the insensitive stable product, thus tending to shore up the demand for the former and weaken it for the latter. If despite this, the price of the flexible product throughout the downswing declines more than that of the inflexible item, changes in demand become even less persuasive as the explanation for changes in price.

The concentration and price data for the 32 products involved in the analysis are shown in the following table. For the most part the figures on concentration are the ratios computed by the Census Bureau based on the 1958 census of manufactures. The principal exceptions are the products of the steel industry for which concentration ratios compiled by the American Iron and Steel Institute accord more closely with the product definitions used by the Bureau of Labor Statistics. Using the first pair as an example, it will be seen that the four largest firms produced 65 percent of the Nation's output of pig iron; that during 1954–56 only three price changes were reported by the BLS, all of which were increases. In contrast, while no precise concentration ratio is available, the collection and handling of steel scrap is known to be an extremely unconcentrated area, the four largest firms probably accounting for less than 5 percent of the collections. But of 36 opportunities, a change in price was reported in 31, of which 12 were decreases and 19 increases.

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16 PAIRS OF PRODUCTS WITH COMPARABLE DEMAND—CONCENTRATION RATIO AND FREQUENCY AND MAGNITUDE OF PRICE CHANGE, 1953-58

Concentration ratio (4 cos.)	Commodity	Frequency of change, 1954-56			Indexes, 1947-49=100					
		Total	Negative	Positive	1953	1954	1955	1956	1957	1958
65	Pig iron, basic	3	0	3	136.5	138.3	141.4	149.9	160.0	163.0
5	Steel scrap, No. 1 heavy melting	31	12	19	115.1	83.6	113.6	149.9	133.5	101.1
75	Steel billets, rerolling, carbon	3	0	3	148.6	160.6	167.7	177.7	198.7	205.7
(1)	Red brass ingot	23	8	15	136.8	141.6	196.6	205.4	158.6	140.9
72	Steel bars, hot rolled, carbon	5	1	4	136.7	145.3	152.1	166.9	183.4	191.9
47	Yellow brass rod	16	7	9	(1)	143.2	159.2	177.0	140.4	123.2
60	Steel sheets, hot rolled, carbon	6	2	4	133.7	139.4	144.8	158.3	175.6	181.0
89	Aluminum sheets	5	0	5	130.0	134.2	142.2	153.1	162.0	163.4
46	Copper sheets	16	5	11	(1)	151.0	174.7	193.2	164.4	156.9
82	Aluminum ingot, primary	6	0	6	131.2	136.9	148.6	163.5	172.9	169.0
28	Aluminum ingot, secondary	32	14	18	123.6	114.2	158.4	149.7	125.5	122.0
65	Steel pipe, black	5	0	5	134.7	141.4	150.7	168.7	185.4	191.6
46	Copper tubing	15	4	11	(1)	144.6	163.9	179.7	158.1	153.6
92	Structural steel shapes	4	1	3	138.2	143.8	151.9	162.9	187.5	195.3

See footnotes at end of table, p. 254.

16 PAIRS OF PRODUCTS WITH COMPARABLE DEMAND—CONCENTRATION RATIO AND FREQUENCY AND MAGNITUDE OF PRICE CHANGE, 1953-58—Continued

Concentration ratio (4 cos.)	Commodity	Frequency of change, 1954-56			Indexes, 1947-49=100					
		Total	Negative	Positive	1953	1954	1955	1956	1957	1958
[2]20	Douglas-fir timbers (construction)	34	12	22	119.9	123.0	142.9	153.5	135.4	125.7
69	Steel bars, concrete reinforcing	7	2	5	141.0	153.7	158.8	169.7	184.1	190.8
[2]20	Douglas-fir dimension (construction)	34	14	20	120.7	121.7	134.0	133.3	122.3	119.4
87	Gypsum wallboard	1	0	1	120.2	121.1	121.1	124.9	124.9	129.4
18	Plywood, Douglas-fir, interior	17	9	8	107.1	103.0	106.1	97.4	88.7	89.6
73	Roofing shingles, asbestos	3	0	3	130.3	133.5	133.5	140.0	150.4	151.9
17	Oak, red, flooring, select	24	8	16	113.5	114.2	128.0	132.2	118.5	118.0
([3])	Crude petroleum, Oklahoma-Kansas	0	0	0	115.7	120.2	120.2	120.2	130.0	130.8
30	Lubricating oil, cylinder stock, Pennsylvania	15	4	11	67.8	40.9	44.1	70.8	76.6	59.4
54	Synthetic rubber, neoprene GN	0	0	0	128.5	131.7	131.7	131.7	131.7	131.7
([1])	Natural rubber, No. 3 r.s.s.[4]	35	12	23	117.8	122.0	202.7	178.3	161.7	141.0
37	Container board, test liner, Cent	1	0	1	117.8	120.9	120.9	124.8	126.1	126.1
([1])	Ponderosa pine box boards [5]	36	16	20	128.1	114.0	125.3	125.1	114.3	110.2
79	Viscose staple, 1.5 d	2	2	0	99.7	96.8	96.3	92.7	88.3	91.0
([1])	Wool tops	36	15	21	114.7	112.5	99.9	95.9	108.8	88.5
78	Viscose filament yarn, 100 d	4	1	3	104.4	104.3	104.7	107.4	113.0	103.4
19	Wool yarn, Bradford, weaving	31	18	13	114.0	111.3	100.5	100.9	109.5	95.1
81	Salt	4	1	3	123.2	145.6	143.4	152.1	157.1	160.1
([1])	Pepper, whole black	36	27	9	179.9	103.4	63.3	44.5	38.2	36.7

[1] Not available.

[2] Holdings of privately owned timberlands on the west coast in the hands of the 4 largest owners are estimated to be less than 20 percent of the amount held by all private ownership.

[3] Supply limited by Government controls.

[4] The producers of natural rubber are numbered in the thousands. The small holdings produce roughly half the world's supply of natural rubber, the balance coming from independently owned estates.

[5] Ponderosa pine No. 3 board used as reasonably equivalent in price movement to boxboard.

Sources: Price data: Bureau of Labor Statistics; concentration ratios: Steel products: American Iron & Steel Institute (U.S. Senate Subcommittee on Antitrust & Monopoly, "Administered Prices: Steel" (S. Rept. 1387, 85th Cong., 2d sess.), p. 70); others: U.S. Senate Subcommittee on Antitrust & Monopoly, "Concentration Ratios in Manufacturing Industry, 1958," pt. I, table 4.

For the concentrated products the four largest companies produced, on the average, 72 percent of the output; for those unconcentrated products for which figures are available the average was 27 percent; if figures were available for the other unconcentrated products, the average would have been even lower. During the 3-year base period the concentrated products averaged 3.3 price changes, or a little over one a year; they averaged 2.8 increases and only .5 decreases. In contrast, the unconcentrated products averaged 27 changes, or three-fourths of the opportunities. Increases and decreases were more evenly distributed, the unconcentrated products averaging 11.6 decreases and 15.4 decreases. These differences between the two sets of products are pervasive. In 14 of the concentrated products the share held by the four largest companies was 60 percent or higher; in seven of the 11 unconcentrated products for which ratios are available the share of the four leaders was 30 percent or less, the three exceptions being the copper and brass products which have been included for the reasons cited above. Among the concentrated products the maximum number of price changes was seven; among the unconcentrated the minimum number was 15.

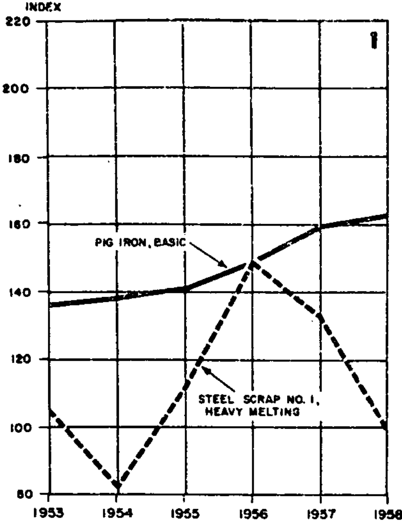
The question at issue here is whether any significant difference existed in the price behavior of these two types of products. The answer can be seen in the following four charts, each of which shows the price movements from 1953–58 for four pairs of commodities.

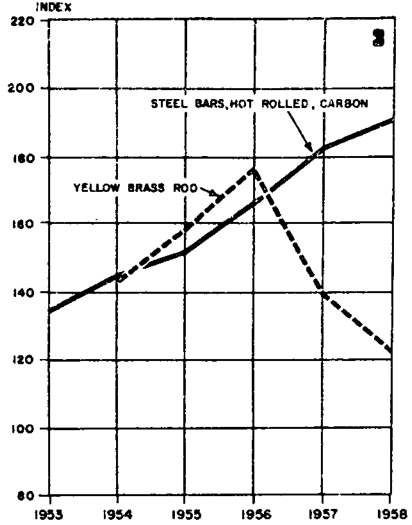
Chart 3

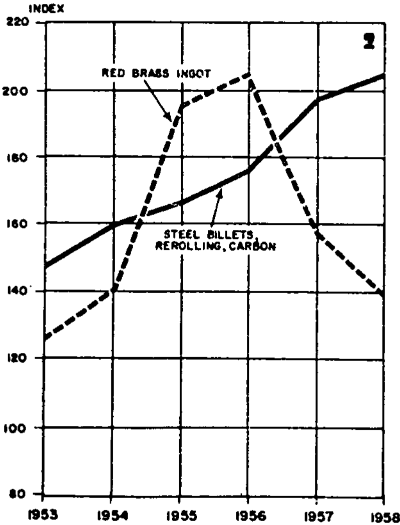
PRICE MOVEMENTS OF INFLEXIBLE[1] VS. FLEXIBLE[2] PRICE PRODUCTS

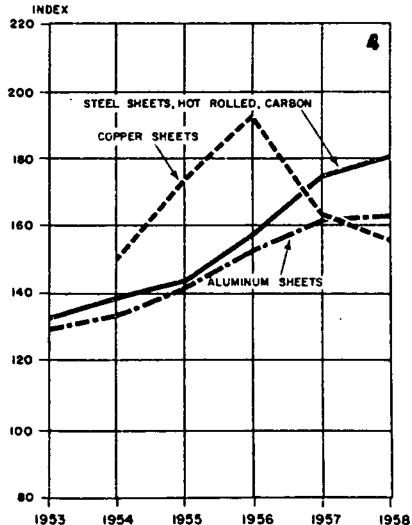
1953-1958

(1947-49=100)









1/ 4 OR FEWER CHANGES IN PRICE DURING 1954-56

2/ 15 OR MORE CHANGES IN PRICE DURING 1954-56

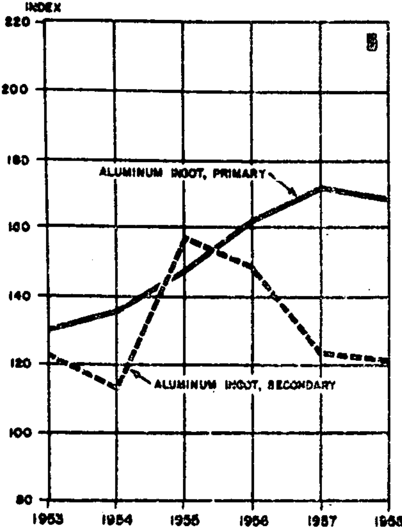
SOURCE: BUREAU OF LABOR STATISTICS

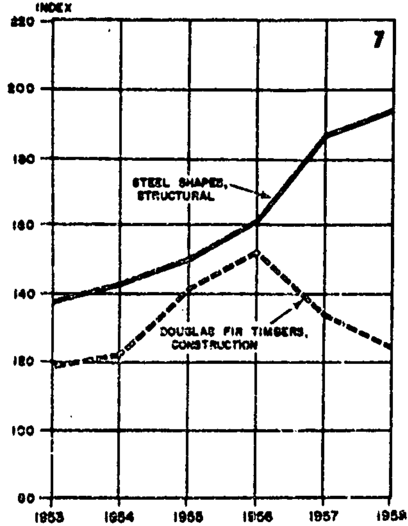
Chart 4

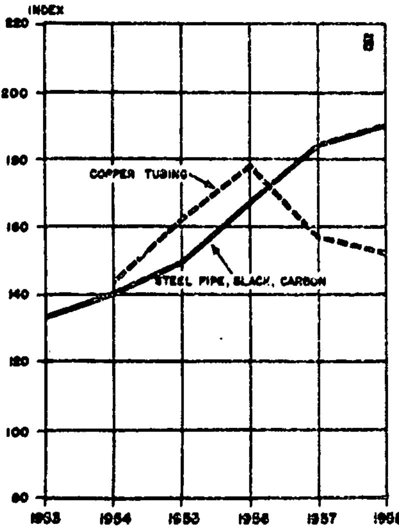
PRICE MOVEMENTS OF INFLEXIBLE[1] VS. FLEXIBLE[2] PRICE PRODUCTS

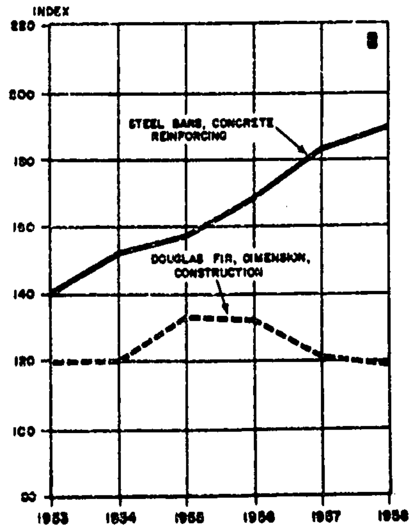
1953-1958

(1947-49=100)









1/ 4 OR FEWER CHANGES IN PRICE DURING 1954-56
2/ 16 OR MORE CHANGES IN PRICE DURING 1954-56

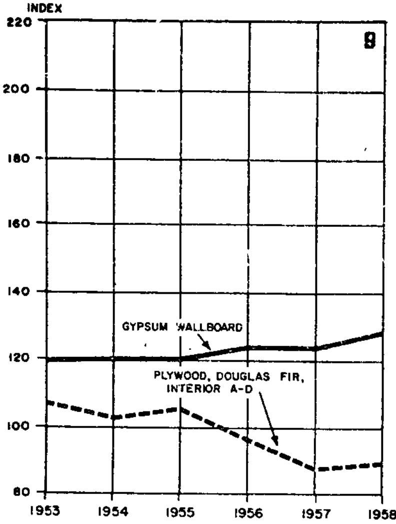
SOURCE: BUREAU OF LABOR STATISTICS

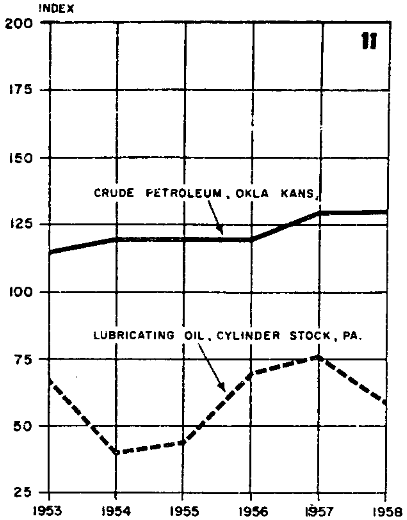
Chart 5

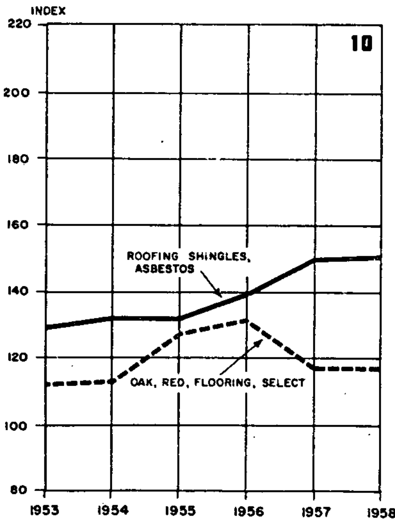
PRICE MOVEMENTS OF INFLEXIBLE[1] VS. FLEXIBLE[2] PRICE PRODUCTS

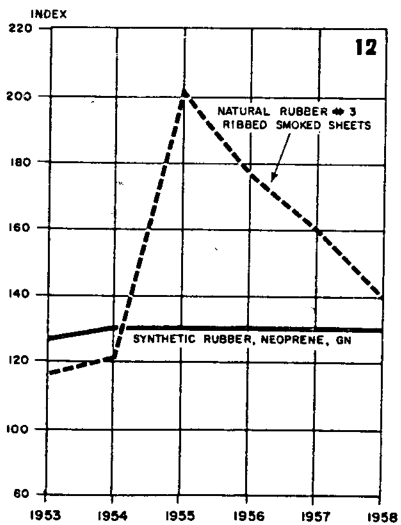
1953–1958

(1947-49 = 100)









1/ 4 OR FEWER CHANGES IN PRICE DURING 1954–56

2/ 15 OR MORE CHANGES IN PRICE DURING 1954–56

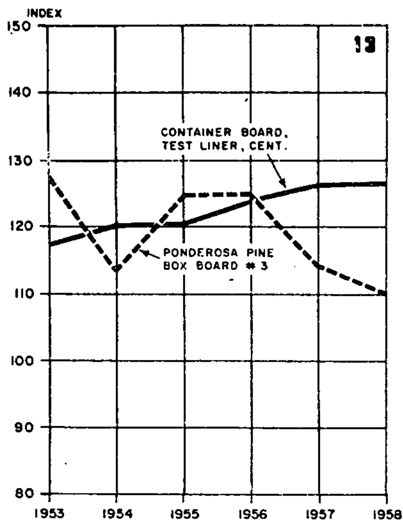
SOURCE: BUREAU OF LABOR STATISTICS

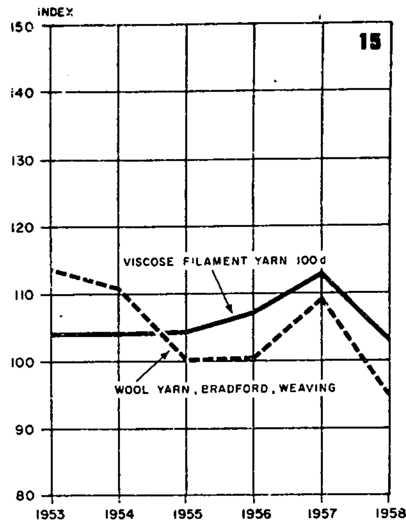
Chart 6

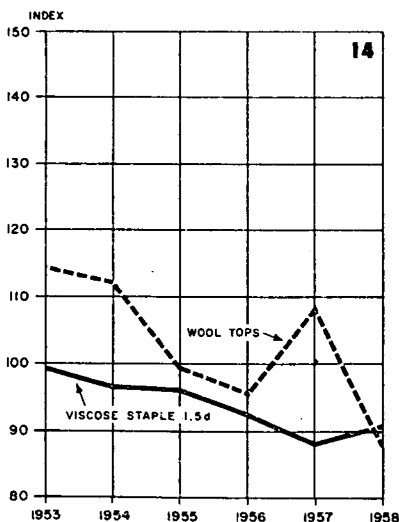
PRICE MOVEMENTS OF INFLEXIBLE[1] VS. FLEXIBLE[2] PRICE PRODUCTS

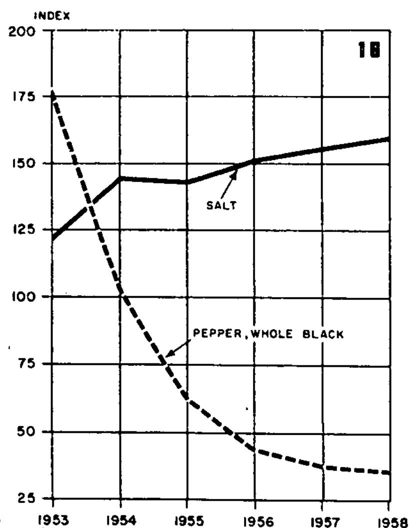
1953 - 1958

(1947-49 = 100)









1/ 4 OR FEWER CHANGES IN PRICE DURING 1954 - 56

2/ 15 OR MORE CHANGES IN PRICE DURING 1954 - 56

SOURCE: BUREAU OF LABOR STATISTICS

The first comparison is between the price of pig iron and of steel scrap. Used as raw materials in the production of steel, the demand for both is governed by the steel operating rate. The behavior of steel scrap is illustrative of the type of price movements typically displayed by flexible-price products. A decline in price during the 1953–54 downswing was followed by an increase during the 1954–56 recovery and then by a further decline in the recession which began during the middle of 1956. In sharp contrast, the price of pig iron moved slowly upward during the 1953–54 downturn, rose at a more rapid rate during the 1954–56 recovery, and continued to advance during the 1956–58 recession.

The next comparison involves two semifinished products, steel billets and brass ingots, both of which are used as materials by semi-integrated producers. As compared to the other steel products which are purchased by the customers of steel producers rather than by their smaller semi-integrated competitors, the price increase for steel billets during the 1953–54 downswing was unusually pronounced, averaging 8 percent. The price continued to rise during the subsequent recovery as well as in the 1958 recession. Reflecting weakness in world copper markets, however, the price of red brass ingots, after peaking in 1956, fell sharply during the next 2 years. The demand for the other products shown on the chart is determined by the general level of metalworking activity. The contrast between steel bars and yellow brass rod is a repetition of the pattern displayed by steel billets and brass ingots. The final comparison on the chart contrasts the price behavior of two inflexible-price products, steel sheets and aluminum sheets with a similar but flexible-price product, copper sheets. Except for the fact that aluminum sheets advanced at a slower rate during the 1958 recession, the trends of the former two products displayed a remarkable symmetry. Whatever the reason, this similarity in behavior reveals that the aluminum producers certainly did not take advantage of the opportunities presented by steel price increases to promote the use of their product as a substitute material. In contrast to the relatively steady upward movement of both steel and aluminum sheets, the price of copper sheets fell sharply during 1956–58.

For two of the sets of products shown on chart 4 demand is largely determined by changes in metalworking activity, while in the other two the principal determinant is the level of construction activity. In the case of the former, both of the flexible-price products, secondary aluminum ingot and copper tubing, exhibited marked declines during both recessions, whereas, with one exception, their inflexible-price counterparts moved upward. This exception was a slight price decline in primary aluminum ingot during 1957–58, attributed in part to the competitive pressure of lower priced foreign supplies. In the case of the latter two products, there was no deviation from the general pattern on the part of the inflexible-price products. Both structural steel shapes and concrete reinforcing bars moved steadily upward throughout the entire period. During the 1956–58 period this was in sharp contrast to market declines in price manifested by their unconcentrated counterparts—Douglas-fir timbers and Douglas-fir dimension.

In the case of two of the products shown on chart 5, the level of con-

struction activity is again the principal determinant of demand. For the other two, it is the use of automobiles, trucks, and related products. Douglas-fir plywood declined noticeably in both downswings; red-oak flooring, although remaining virtually unchanged during the earlier decline, dropped significantly during the latter. Their concentrated counterparts, gypsum wallboard and asbestos roofing shingles, moved irregularly upward throughout the period. Particularly striking is the contrasting behavior of asbestos shingles and oak flooring during the 1956–58 recession. Insofar as market behavior is concerned, concentration ratios for either the production or refining of crude petroleum are largely irrelevant. The controlling factor is a system of government controls over supply. Through market demand proration, particularly in Texas and Louisiana, and through a quota on imports, supply is limited to anticipated demand. No such controls exist in the Pennsylvania lubricating oil industry, which is composed of a substantial number of small producers. The effect of government controls over supply is dramatized by the difference in price behavior. Pennsylvania lubricating oil suffered price decreases during both recessions while in each crude petroleum moved upward. The price of synthetic rubber is the most inflexible of any of the commodities included in this analysis, remaining unchanged throughout the entire period, with the exception of a slight increase of 2.5 percent occurring during the recession of 1953–54. This stability is in striking contrast to the precipitous rise in the price of natural rubber in 1955, when automobile production reached its then alltime high of 7.9 million cars. When automobile output slumped in 1958 to 4.2 million cars, the price of natural rubber moved sharply downward.

The first comparison on chart 6 involves packaging materials—container board versus ponderosa pine box board. Although the extent of their movements was not as pronounced as the case of most other products, in both recessions the flexible product declined while the inflexible-price commodity rose. The two comparisons involving textile products present a number of exceptions to the general pattern typically displayed by the other commodities. Thus, the price of the concentrated product, viscose staple, suffered a slight decline in the first downswing and the ensuing upturn. However, part of the loss was recovered by a price increase in 1957–58, which was accompanied by a decrease in the price of its counterpart, wool tops. The concentrated product, viscose yarn, remained unchanged during the earlier downswing, though declining in 1958. In the final comparison a precipitous and sustained decline in the price of pepper was accompanied by a substantial and, except for 1954–55, uninterrupted increase in the price of its concentrated counterpart, salt.

In the following summary table covering the two recessions, 1953–54 and 1956–58, the industries are distributed in accordance with their price change during both downswings. Generally speaking, the pattern was one of price decreases in the unconcentrated, flexible-price fields and of increases in the concentrated, inflexible-price industries. Thus, in the 1956–58 recession all but three of the 17 concentrated industries had price increases; in two of the three exceptions the decreases were less than 2 percent, while in the third it was only 3.7 percent. In con-

trast, all of the unconcentrated industries had decreases, each of which was 5 percent or more—with nine having decreases of 15 percent or more. During the earlier downswing the contrast, while less pronounced, was still marked. In 15 of the 17 concentrated industries prices moved upward, while in eight of the 13 unconcentrated industries decreases were recorded, and all of the five exceptions were quite small, the largest being an increase of only 3.6 percent.

DISTRIBUTION OF INDUSTRIES, BY PERCENTAGE PRICE CHANGE, 1953-54 AND 1956-58

Number of industries by percentage change	1953-54		1956-58	
	Concentrated	Unconcentrated	Concentrated	Unconcentrated
−15 and over	0	3	0	9
−10 to −14	0	1	0	4
−5 to −9	0	1	0	3
Under −5	2	3	3	0
No change	0	0	1	0
Under +5	10	5	2	0
+5 to +9	3	0	5	0
+10 to +14	1	0	3	0
+15 and over	1	0	3	0
Total	17	13	17	16
Not available		3		

THE 1970 DOWNTURN

Will the divergence of price trends which characterized the recessions of the forties and fifties repeat itself during the current economic downturn? While there has been a definite slowing down in the rate of economic activity—capacity utilization in manufacturing dropping from 84.5 percent to 79.5 percent between the first quarters of 1969 and 1970 [15] the current downturn has not reached the dimensions of the earlier recessions. As compared to its 1969 level, the index of industrial production for manufacturing had by May of this year fallen only 3.2 percent. Furthermore, no distributions of the BLS price series, in terms of either frequency of change or level of concentration, are currently available, and the downturn has not yet affected enough industrial products to permit meaningful comparisons of pairs of products affected by similar demand factors.

Nonetheless, a cursory review of recent price movements suggests the possibility that much the same pattern may again be developing. Since the purpose of the restrictive monetary and fiscal measures taken during the past year and a half has been "to dampen" the pressure of demand, it should be instructive to ascertain which products have responded thus far in 1970 by declining in price. The 2,000-odd individual products in the BLS Wholesale Price Index are classified into 289 product groups. On the basis of a just completed review, I found that price declines—amounting to more than half a percentage point—took place between March and May in 43 of these groups.[16] Their distribution is as follows:

[15] *Federal Reserve Bulletin*, May 1970, p. A–62.
[16] See Appendix B.

Product groups with price decreases,[1] March–May 1970

Farm and food products:	
Livestock and meat products	7
Poultry and eggs	4
Fats and oils	3
Animal feeds	2
Other farm and food products	5
Total	21
Industrial commodities:	
Textile products	5
Hides and leather	3
Lumber and building materials	5
Plastics materials and products	2
Scrap materials	3
Other industrial commodities [2]	4
Total	22

[1] Of more than .5 percentage points.
[2] Anthracite, fertilizer materials, pharmaceutical preparations (ethical), small arms ammunition.

Over nine-tenths of the categories are flexible-price, unconcentrated product groups. This is true of all 21 of the groups in farm and food products; it is true of all five in textile products; of all three of the categories in hides and leather; of all three scrap materials of four of the five groups in lumber and building materials; of the plastics groups; and of anthracite—or a total of 39. The four exceptions are gypsum products—with a concentration ratio of 84 percent—fertilizer materials—particularly potash and superphosphate—small arms and ammunition, and ethical pharmaceutical preparations—most of whose individual products are highly concentrated. In short, the characteristics of the products which have reacted to the current downturn by falling in price are about what would have been assumed on the basis of the recession behavior of Quintile 5 and of the individual unconcentrated products, examined earlier.

The same body of evidence would suggest that at least some of the concentrated industries would react to a general economic slowdown by an increase in price. Except for the few product groups noted above, it is evident that prices in concentrated industries have certainly not declined. Indeed, price increases in such industries have been rather commonplace, as is evident from the price behavior of ten industries shown in the attached table. In each, the four largest firms produced in 1963 more than half of the output;[17] the simple average of their concentration ratios was 70 percent. Moreover, each is an important field, with a value of shipments in 1963 of more than a billion dollars. That the ability to raise prices during a period of economic decline is not a function of the characteristics of the product is indicated by the widespread dispersion among different industry groups. Represented are industries in producer goods and consumer goods, in durable goods and in nondurable goods.

[17] An exception is gasoline, the market for which is controlled through market demand prorationing and import quotas.

CONCENTRATION RATIOS AND PRICE INDEXES OF 10 SELECTED CONCENTRATED PRODUCTS, 1968-69; 1970 (MONTHS)

Industry	Concentration ratio (percent) (1963)	Price indexes (1957-59=100)									Percent increase January to June 1970
		Year		1970—months						
		1968	1969	January	February	March	April	May	June	
Primary metals:										
Steel mill products	51	108.5	113.7	115.5	117.7	118.4	118.7	120.5	122.0	5.6
Primary aluminum	93	102.0	107.9	111.6	111.6	111.6	115.6	115.6	115.6	3.6
Petroleum, chemical, and rubber products:										
Gasoline	(1)	97.2	99.2	96.1	95.7	95.0	95.9	100.4	96.9	.8
Soap and synthetic detergents	68	107.6	109.8	110.6	110.6	110.8	110.8	111.8	111.6	.9
Tires and tubes	72	98.7	98.2	101.7	101.7	101.7	101.7	101.7	[2] 106.7	5.0
Electrical machinery:										
Motors and generators	50	95.4	100.4	104.6	105.7	107.0	107.6	108.2	109.2	4.4
Electric lamps/bulbs	92	114.3	110.5	110.6	110.7	113.5	115.0	115.2	115.1	4.1
Food and related products:										
Biscuits and crackers	71	127.2	129.3	134.0	136.3	138.6	140.9	140.9	140.9	5.1
Distilled spirits	56	97.2	97.2	97.2	98.6	98.6	98.6	100.7	100.7	3.6
Cigarettes	80	115.8	121.8	125.0	125.0	125.0	125.0	125.0	134.8	7.8

[1] Market controlled by government restraints.
[2] Estimate effective July 1.

Sources: Concentration ratios: Bureau of the Census, "Concentration Ratios in Manufacturing Industry, 1963." Price Indexes: Bureau of Labor Statistics.

Of all the industries in the country none has a greater effect on the general price level than steel. Because it is the industrial underpinning of the economy, an increase in the price of steel raises directly or indirectly the cost of doing business in virtually every field of enterprise. Since consumers do not buy steel as such, it is not included in the Consumer Price Index, nor is its true importance reflected in any price index. This is because an increase in the price of steel, by the time it reaches the ultimate consumer, will have "pyramided" until it is a multiple of the steel price increase itself. Pyramiding is the natural consequence of efforts by sellers at each successively higher stage of fabrication and distribution not only to cover the actual higher costs to them but also to preserve their customary percentage margin. The Wall Street Journal, for example, explained how a $6 a ton steel price increase was transformed into a $75 increase in the price of a tractor:

> Immediately after the steel price hike, prices of stampings from a supplier went up 4 percent too. Forgings shops raised prices. Machine shops passed along the increase. Components such as wheels, hydraulic systems, and axles arrived with higher price tags. Where costs of that tractor totaled $1800 on July 1, several months later they were $1875.[18]

Similarly, referring to a $4 a ton increase in the price of steel sheets and strip, Iron Age observed:

> Consideration of all factors has a cumulative effect that swells a $5 material cost increase into $25.[19]

During the 10-year period between the latter 1950's and latter 1960's, the price of steel products remained relatively stable; in 1968 its index was only 8.5 percent above the 1957–59 average, or an average increase during the decade of less than 1 percent a year. But in 1969 the

[18] *Wall Street Journal,* June 23, 1950.
[19] *Iron Age,* April 25, 1963, p. 90. The journal went on to say:
"One automotive steel purchasing agent estimates the increased cost to automakers would be $25 per car for sheet steel in a typical low-price, standard-size auto. This estimate allows a profit for component manufacturers and other suppliers. It doesn't include any added profit for the automaker. For this reason, the average 1964 auto may cost $50 more than 1963 models."

pace was accelerated, the index rising by 5 percent. This has been followed by further increases in 1970; in June the index was 5.6% above the January level. Commenting on this upward movement the Wall Street Journal states:

> Certainly the steel price trend over the past year has given the inflation fighters nothing to cheer. A long series of price boosts over the past 12 months pushed the Government's index of steel-mill product prices in May 6.9% above the year earlier mark and 10.5% above the level at the beginning of 1969. And this doesn't count price boosts averaging nearly 5%, effective June 1, on sheet steels that account for more than a third of the industry's total tonnage. Overall, this year's price increases have covered products accounting for 90% of the industry's volume, and prices on some products have been raised twice this year.[20]

The 1970 increases, it should be noted, have been taking place while steel production was declining. Thus in the first quarter of 1970 steel ingot production was down to 33.6 million tons as compared, for the same period, to 34.4 million in 1969 and 36.5 million in 1968; indeed, first quarter 1970 production was 3.4 million tons, or 9 percent, below the second quarter of 1968.

The aluminum industry has evidenced much the same pattern of behavior. By 1968 its price was only 2 percent above the 1957–59 average. But in 1969 the index moved sharply upward, rising by 5.9 percentage points. Further increases were recorded in 1970, the latest having taken place in April. By June of this year the price of primary aluminum had risen 3.6 percent above the January level.

With supply limited by prorationing and import quotas to, or slightly below, anticipated demand, the major oil companies have been able to raise prices of petroleum products in 1969 and again in 1970.[21] At current levels of gasoline consumption, an increase at retail of 1 cent a gallon costs the consuming public approximately $800,000,000, of which about $500,000,000 is retained by the refining companies, with the remainder going to dealers and distributors. The 1969 advance was accompanied by a price increase to domestic crude producers; no such increase has been made in 1970. Describing the latest price advance, the Wall Street Journal stated:

> Mobil Oil Corp. raised its gasoline prices to service station dealers and wholesale distributors nationwide, except in Oregon and Washington. It is the second successive year in which a major oil company has taken such a previously unprecedented action. In February 1969, Texaco Inc. raised nationwide its wholesale prices for gasoline and the price at which it buys crude oil. That touched off increases of varying amounts by most of the nation's major oil companies.
>
> Mobil boosted its "tankwagon" prices to dealers 0.7 cents a gallon and its prices to distributors 0.55 cents a gallon. Increases in prices to dealers in 1969 averaged about 0.6 cents a gallon and resulted in average retail price boosts to motorists of about 1 cent a gallon.[22]

Contrary to some expectations the 1969 increase did "stick." The fate of the 1970 advance, however, is uncertain. Although the index rose from 95.0 in March to 100.4 in May, much of this gain has apparently been eroded away, as the June quotation has fallen to 96.9.

In 1968 the price of tires and tubes was slightly below the level of 10 years earlier. After remaining almost unchanged in 1969, the price has been increased twice thus far in 1970. After a 4-percent ad-

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[20] *Wall St. Journal*, June 19, 1970.

[21] The relatively low level of the gasoline price index in terms of the 1957–59 base period is traceable in good part to the inflationary conditions in this industry during the first Suez crisis in 1957.

[22] *Wall St. Journal*, March 26, 1970.

vance, which was reflected in the series for January, a further raise was announced, effective July 1, which incidentally is estimated in the accompanying table. The latter advance was of the "raising-prices-to-meet-competition" variety. On June 13 the industry's largest producer, Goodyear Tire & Rubber Co., announced an increase of 5 percent on passenger tires and 6 percent on truck and farm tires. Nine days later these increases were matched by B. F. Goodrich. According to the Wall Street Journal:

> Goodyear and Goodrich were the first two companies to sign new contracts with the United Rubber Workers union. They attributed the price increases to higher costs under that contract and to higher materials and distribution costs. Industry sources expect other major producers to follow the price increases after their labor contracts have been signed and ratified by union members.[23]

Even if the added costs from the new wage contract were the same for each company, they would constitute a justification for raising prices to the same identical level only if the different companies had identical unit costs, which in view of the obvious differences in their profit rates appears to be most unlikely. Adding a constant increment to differing bases does not yield identical totals.

Another large-scale, concentrated industry in this broad grouping is soap and detergents. During the decade ending in 1968 its price had risen at an average rate of 0.7 percent a year. In 1969 the pace advanced to 2 percent a year, which, if the present trend continues, will be matched in 1970.

During the 1957–59 base period prices of electrical machinery had undoubtedly been inflated by the conspiracies disclosed in the celebrated "Philadelphia" price-fixing case. It is therefore not surprising that in 1968 the price of motors and generators was 5 percent lower than 10 years earlier. In 1969, however, the price was raised 5 percent, which has been followed by further advances in 1970. By June 1970 the price was 4.4 percent above the January level.

Of the 10 industries shown in the table, only electric lamps was significantly lower in price in 1969 than in 1968. But as a result of increases in February and April, the price by June of this year was higher than in 1968 and 4.1 percent above the January figure.

Contrary to the trend of farm and food prices generally, a number of concentrated farm-based industries have enjoyed price increases during 1970. An example is biscuits and crackers which by 1968 had risen over a quarter in price during the past decade. Increases in 1970 brought it by June to a level 5.1 percent above the January level.

Two increases in 1970 have raised the price of distilled liquor 3.6 percent above the January quotation.

The cigarette industry provides a striking illustration of declining consumption accompanied by rising prices. In 1969 the price was raised 8 percent, or 35 cents a thousand. Effective June 1, 1970 it has been increased again, this time by 45 cents a thousand, raising the index to 7.8 percent above the January figures. The managing director of the Wholesale Tobacco Distributors of New York is quoted as saying that the increase, amounting to at least 2 cents a pack or 20 cents a carton, would "most definitely" be passed on to retail consumers.[24]

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[23] *Wall St. Journal,* June 22, 1970.
[24] *Wall St. Journal,* May 29, 1970.

As in the case of a number of other industries cited here, leading cigarette manufacturers raised their prices at about the same time, by the same amount to the same level.[25]

CONCLUSION

Over the years a substantial body of knowledge has been gradually developed through empirical studies concerning the actual behavior of prices. A central conclusion is that the price structure is composed of two very different types of prices; one the prices of classical economic theory which are sensitive to changes in demand in relation to supply; the other the prices of concentrated industry which change infrequently and are generally not responsive to short run changes in supply and demand. From the material presented here, it is clear that during downturns the former continue to display the type of behavior expected under economic theory. It would also appear, however, that the latter have been exhibiting a type of behavior which is inexplicable under any body of theory—classical or monopolistic.

Monetary and fiscal restraints designed to arrest increases in the general price level will succeed in their purpose to the extent—but only to the extent—that the price structure is composed of the former types of prices. While constituting only a fifth of the number of products in the Wholesale Price Index, the products in the most flexible category, Quintile 5, accounted for 37 percent of its weight. If to these commodities there are added those products in quintile 4 which, though changing somewhat less frequently, behave in the same general manner, about half of the price structure in terms of weight could be estimated to be composed of products which respond to a reduction in demand with a decline in price.

At the same time it must be recognized that a substantial proportion of the other half is composed of products whose price behavior during downturns can only be regarded as perverse. These include a number of strategically important basic industries, such as steel and aluminum. Because of the pyramiding effect described above, the effect of their price increases is considerably greater than would be indicated by their weight in the overall price index.

Barring a severe depression, the probabilities are that while the effect of price declines in the flexible-price sector will be sufficient to slow down the rate of advance in the general level of prices, the price increases in the concentrated sector will continue to cause it to move upward.

In a paper on this same general subject delivered before the American Economic Association in 1959, I concluded by saying:

> Except in periods of severe depression, the analysis presented above suggests that in oligopolistic industries, other factors being equal or unequal, prices will rise. And unless these increases are offset by price declines in atomistic industries, the result will be a rise in the general price level.[26]

Eleven years later I see no reason to alter that conclusion, except to note an apparent acceleration in the rapidity with which the diver-

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[25] The move was announced initially on May 22 by American, followed on May 24 by Lorillard, on May 25 by Liggett & Myers, and on May 27 by Brown & Williamson (*Wall St. Journal*, May 29, 1970).

[26] "Administered Prices: A Phenomenon in Search of a Theory", *American Economic Review*, May 1959, vol. XLIX, No. 2.

gence between the two types of prices has developed during the current downswing.

Appendix A

The Validity of the B.L.S. Wholesale Price Series

The B.L.S. Wholesale Price Series, it has been charged, understates the true flexibility of prices since they fail to reflect hidden discounts and concessions. This criticism was first made in 1936 and is invariably brought forth again—often as an original discovery—whenever the issue of price policy becomes a matter of public concern.

In the words of Willard Thorp, the original exponent of the criticism:

Frequently a commodity will be quoted at an unchanged price over a period of years and thus to the extent that indexes include this type of quotation they will remain relatively unchanged. Actually, the manufacturers of the product may have shaved or cut the price of the item drastically in periods when business was slow and boosted it as economic conditions improved without the change being recorded in the quoted price.[1]

To illustrate the importance of hidden concessions, Thorp cited the case of a manufacturer of flexible cord, who drastically changed his discount structure between 1933 and 1934. But, as so frequently occurs, after the discount structure had finished its gyrations, the base price itself was lowered and the discount structure returned to practically its original form. Hence, the illustration itself suggests only a lag rather than a failure of the base price to reflect the actual price change. If the price reduction were made before the end of the time period under survey, only frequency and not amplitude of price change would be affected. A recent case in point concerned sheet steel which during the latter part of 1968 became the subject of a price "war", waged with secret discounts and concessions. But apparently growing weary of trying to keep track of which deals had been granted to which customer and of endeavoring to keep their non-favored buyer in ignorance, the steel companies openly announced a reduction in their list price. Speaking of this espisode the *Wall Street Journal* has observed: "That situation prompted Bethlehem to formally cut book prices on hot-rolled steel by 22%, a sort of shock therapy that soon ended the price war as steelmakers realized such deep cuts would have disastrous results."[2]

For the purpose of analyzing the relationship between concentration and price rigidity the B.L.S. series are invalidated only if it is assumed that during a downswing secret discounts become relatively more important in products of high than in products of low concentration. Neither Thorp nor the other critics of Means ever explicitly made this assumption, nor, incidentally, did Means ever call upon them to do so. From common observation concerning, say, the apparel and lumber industries, it is obvious that hidden discounts are not unknown in industries of low concentration, and it is equally obvious that they do not remain unchanged in periods of declining demand.

Nor is it sufficient to dismiss the B.L.S. series with a casual reference to a few horrendous examples, such as sulphuric acid, ammonia, or men's shirts. For every one such illustration, numerous examples could be cited of indexes which move in rather close conformity with what would appear to be the behavior of the actual price.[3] One of the areas often cited to illustrate the inadequacies of the B.L.S. series is the steel industry. Proof is brought forward in the form of a special survey conducted by the Bureau of Labor Statistics for the Office of Price Administration.[4] Yet, if anything, the results of that survey tend to prove the opposite.[5] Of interest here is the extent of the difference between the published base prices (i.e., the B.L.S. Indexes) and the delivered prices actually paid during a period of relatively free supply. Such a period is provided by the third quarter of 1939; steel ingot production was then only 63% of capacity; during the years covered by the survey the deviations were at their

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[1] TNEC Monograph No. 27, *The Structure of Industry*, p. 339. Cf. also Willard Thorp, "Price Theories and Market Realities", *American Economic Review*, Papers and Proceedings, March 1936.

[2] *Wall Street Journal*, June 19, 1970.

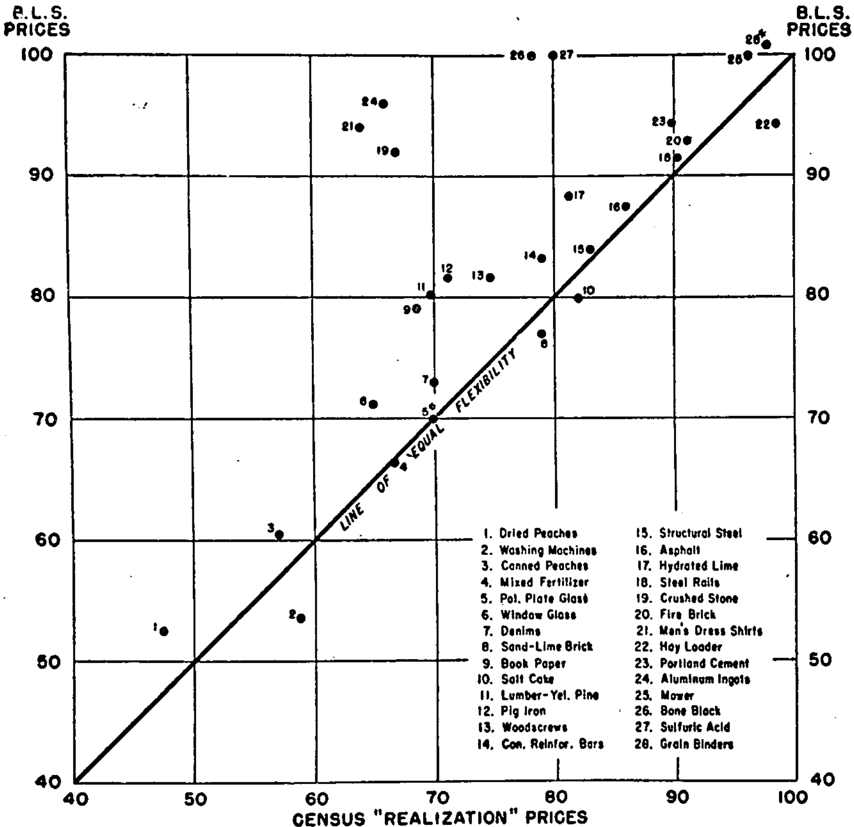
[3] Cf. John M. Blair and Melville J. Ulmer, *Wartime Prices*, Pt. 1, Bureau of Labor Statistics, 1942. his monograph compares the behavior of the real prices, as suggested by contemporary reports in the trade press. With some notable exceptions, the correspondence appears to be quite marked.

[4] The results of the survey were published in *Iron Age*, April 25, 1946. It covered 629 consuming firms which bought approximately 15 percent of all steel produced in 1940.

[5] George W. Stocking, *Basing Point Pricing and Regional Development*, 1954, pp. 119–123.

greatest. The percentage deviations of the actual from the published prices were: merchant bars —2.0%, cold finished bars —2.0%, plages —3.0%, structural shapes —4.0%, hot-rolled sheets —7.4%, cold-rolled sheets —8.0%, hot-rolled strip —9.5%, and cold-rolled strip —11.0%, or a simple average for all 8 products of oniy —5.9%. Even assuming that the published and the actual prices were the same at the beginning of a depression, deviations of this limited magnitude would certainly not invalidate Means' conclusions.

The inference of some of his critics to the contrary notwithstanding, Means was by no means unaware of the bias in the B.L.S. prices. In drawing the relationship between concentration and price change, he attempted to evaluate the series for the various Census industries and eliminate those for which the data appeared to be inadequate. One of the bases used in making this evaluation was a comparison of B.L.S. prices with Census realized prices.[6]



For 28 products most of which are narrowly defined, the price decline during 1929–33 as shown by the B.L.S. price series was compared with that of a comparable Census (or Bureau of Mines) realization figure. For products falling above and to the left of the "Line of Equal Flexibility," the price decline shown by the B.L.S. series was less than that of the Census figure, with the reverse being true of the items falling below and to the right of the line.

The most conspicuous deviations are to be found in the field of chemicals, an area in which the B.L.S. series had long been known to be notoriously unreliable; the B.L.S. prices for sulfuric acid and carbon black, which recorded no change, are obviously "out of line" with the more flexible realization price.

[6] National Resources Committee, *op. cit.*, Appendix 1, "A Consideration of the Validity of Bureau of Labor Statistics Price Indexes", prepared by Saul Nelson.

A number of the remaining deviations, however, are more apparent than real. Thus, in the case of products sold under delivered-price systems, such as cement, hydrated lime, and crushed stone, the realization figures which were on a plant basis fell more than the B.L.S. series which at the time were on a delivered-price basis, a disparity to be expected since the former reflected the increased absorption of freight and the latter did not. The greater decline in the realized price for men's dress shirts obviously reflected the relatively greater sales during the depression of lower-priced shirts.

On the other hand remarkable similarity between the two series was shown by such diverse products as asphalt, steel rails, mixed fertilizer, fire brick, window glass, structural steel, sand-lime brick, salt coke and denims. In 23 of the 28 products the difference in the decrease shown by the two types of prices was less than 10 percentage points. In general, the Census figures declined on the average by only about 7 percent more than the B.L.S. prices. Moreover, there was no relationship between the deviation between the two series and the level of concentration: In about half of the 13 products in which the deviation between the two series exceeded 5 percentage points, concentration was relatively low.

By far the most comprehensive comparison of B.L.S. vs. Census prices has been made by Professor Howard Norman Ross.[7] In a study of 44 industries, divided into 16 "unconcentrated" and 28 "concentrated" groups, Ross contrasted the B.L.S. with the Census price changes for 1929–31.[8] Significant departures of the B.L.S. from the Census prices are conspicuous by their infrequency; and this is true of both the concentrated and unconcentrated groups. Almost equal percentages of prices in both the unconcentrated and the concentrated groups fell below the line of equal change. For the unconcentrated group the B.L.S. price fell on the average almost as much as the Census price; the average difference being only 1.4%. For the concentrated industries the difference was not much greater, averaging only 5.3%. Inasmuch as the Census prices, themselves, tend to overstate the decline in price, it would take differences of far greater magnitude to preclude the use of B.L.S. prices in measuring depression price behavior. In Ross' words:

"Census prices are admittedly grotesqueries: derived as ratios of indexes of Value of Products to indexes of production (the most accessible form of the data), they are average annual values at the industry level of a conglomerate and changing output. Reporting errors, changes in establishment coverage (especially in the meager 1933 Census), and arbitrary intracompany transfer values in vertically integrated firms impede the estimation of a true value. When demand is sharply down, census prices will fall more than transaction prices as they respond to shifts in purchases to lower priced lines and cheaper qualities."[9]

With the re-emergence of interest in oligopolistic prices during the late 1950's and particularly with Means' contention that most of the rise in the wholesale price index between 1953 and 1957 had resulted from increases in the more concentrated industries, this well-known "defect" in the B.L.S. series was once again discovered. Studies by Harry E. McAllister[10] and John Flueck, comparing B.L.S. with "real" prices, were cited by George J. Stigler[11] as constituting an adequate basis for dismissing Means' argument.

The first of the studies on which Stigler relied for his criticism of frequency, by Harry E. McAllister, showed a direct relationship between frequency of change and number of price reporters.[12] Yet his argument that differences in frequency of change are due to the number of price reporters and not to differences in industry structures involves an inherent and inescapable tautology. In the non-concentrated industries with many producers there will inevitably be, *ceteris*

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[7] Howard Norman Ross, *The Theory and Evidence of Price Flexibility;* Dissertation, Columbia University, 1964 (typed).

[8] The unconcentrated industries are those in which the 8 largest producers accounted in 1935 for less than 50% of the value of product and the 4 largest for less than 40% (p. 83). His comparisons were necessarily limited to the Census years, 1931 and 1933; he regarded the former as preferable because during most of 1933 recovery had already set in and prices had begun to rise following the low point in 1932.

[9] *Ibid.*, p. 80.

[10] Cf. 87th Cong. 1st Sess., Joint Economic Committee, Hearings before the Subcommittee on Economic Statistics, 1961, pp. 373.

[11] "Administered Prices and Oligopolistic Inflation", *Journal of Business*, University of Chicago, Jan. 1962.

[12] Joint Economic Committee, Hearings before the Subcommittee on Economic Statistics, *Government Price Statistics* (87th Cong., 1st Sess., 1961), pp. 373 ff.

paribus, a greater number of price reporters than in the highly concentrated industries with few producers. The variable, number of reporters, which is held to be the determinant of frequency of change, is itself a function of the variable which is held not to be the determinant, that is, industry structure.

Referring to the effect of the number of reporters on Means' tabulations Stigler observed caustically:

"We emerge, then, with the finding that Means' tabulations of frequency of price change are unknown mixtures of the actual behavior of quoted prices and the number of firms reporting such prices. By increasing the number of price reporters, the BLS can reduce price inflexibility by the same order of magnitude as the increase in the number of reports. The major development which Means believes to have outmoded neoclassical economic theory is the 'development' of collecting a number of price quotations inappropriate to the measurement of short-run flexibility."

Stigler is simply in error regarding the basic tabulations in which Means distributed all the products in the Wholesale Price Index by frequency of change and related their frequency to their amplitude. Having been granted access to the reports *to the B.L.S.*, Means took either the average of the number of changes reported by each of the reporters or, where the number of reporters was more than three, the number of changes by a single reporter who appeared to be typical of the group.[13] It is also not correct to assume that in oligopolistic industries with a long tradition of price leadership the B.L.S., even if it wanted to, could increase the apparent frequency of change merely by increasing the number of reporters. After the other oligopolists have met the leader's change (either upward or downward), calling for reports from a larger number of oligopolists would only increase the number of responses containing the same information.

As to the question of whether actual prices vary more frequently than published prices, McAllister presents a comparison of the B.L.S. price series with prices paid by a single large buyer for thirty products.[14] It is reinforced by a study, by John Flueck, comparing for thirty-two products the frequency of price change as shown by the B.L.S. with that revealed by government bids.[15] Within the universe of McAllister's "private-buyer" prices, however, the great majority exhibit a rather striking inflexibility. Fifteen, or half, showed four or fewer changes during the three-year period and seven others had from five to nine changes, that is, two-thirds showed less than three changes a year. Interestingly enough, the four products with the greatest frequency of change (platinum, 15; mercury, 22; pig lead, 22; storage batteries, 26) are importantly affected by world markets, which approach the free markets of classical competition. Moreover, the price of pig lead, which would also have an influence upon the price of storage batteries, is affected by the competition of secondary refineries and by the existence of custom smelters who operate on a fixed margin.

The principle underlying Flueck's study that B.L.S. prices can properly be compared with government bid prices is questionable. Sales to the government have certain advantages over the ordinary commercial sales that the B.L.S. series are designed to reflect. Orders tend to be in larger quantities, thus permitting larger production runs and the attainment of economies of scale. Selling and advertising expenses are largely dispensed with. For these and related reasons it has long been recognized that different pricing policies are frequently followed on government purchases than on commercial sales. What is surprising in view of these considerations is that in nine of the thirty-two products the B.L.S. prices showed the same (or a greater) number of changes as the bid prices, and in nine others the B.L.S. recorded at least two-thirds of the changes reflected by the bid prices.

More recently additional comparisons have been made between the B.L.S. prices and the Census "realized" figures, one of which compared for the major carbon steel products the percentage change during 1954–58 shown by the two types of series. Presumably, during this period in which steel prices were rising the Census realized prices would tend to show a somewhat smaller increase, since steel buyers would be expected, where possible, to substitute the less expensive specifications within a given product. Nonetheless, the over-all similarity between the two series is quite striking. The weighted average for the ten products shows

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[13] Since in his presentation for the 1950's Means was not redoing his original tabulations but only using frequency as a secondary basis of classification, there was no occasion to repeat this detailed form of treatment.

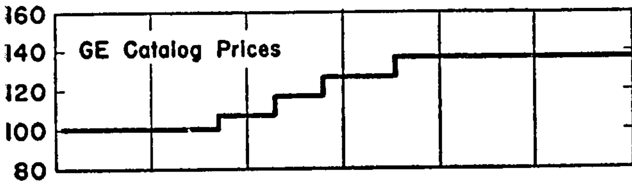
[14] As cited by Stigler, *op. cit.*, p. 267.

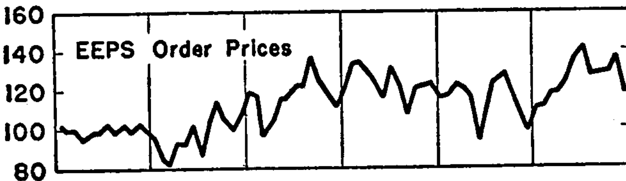
[15] As cited in *Ibid.*, pp. 369–70.

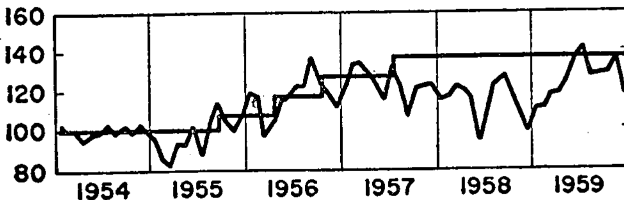
an increase of 28.8 percent for the B.L.S. series and 25.1 percent for the Census figures. As would be anticipated, the divergencies are greatest for the products with the widest Census definitions—structural shapes, hot-rolled sheets—and smallest for those whose definitions most closely approximate the B.L.S. specifications—rails and electrolytic tin plate.

In a study often cited as demonstrating the unreliability of published prices, Charles R. Dean and Horace J. DePodwin compared realized with published prices for two types of electrical equipment—large outdoor circuit breakers and power-switching equipment. As a basis for comparison with a time series, the usefulness of the realized price for the former is questionable inasmuch as no sales were made during about half of each of the years surveyed.[16] In the accompanying chart the two top grids—GE Catalog Prices and EEPS Order Prices—are simply reproductions of the Dean-DePodwin study for power-switching equipment, while the bottom grid has been added to superimpose one index upon the other.

1954=100







General Electric Company Catalog Price Index and Electrical Equipment Price Study Order Price Index, Dean & DePodwin General Electric Co.

It will be observed that both series remained at about the same level throughout 1954, averaged out to about the same level in 1955, and showed roughly similar increases in 1956 and 1957. The divergence in 1958 was due to widespread price-cutting or "white sales". Through the conspiracy, prices of switch

[16] "Product Variations and Price Indexes: A Case Study of Electrical Apparatus." *Proceedings of the Business and Economic Statistical Section of the American Statistical Association* (1961), pp. 271–79.

gear had been raised to such heights by 1958 that the temptation to obtain a larger share of this extremely profitable market by shading prices proved irresistible. Mr. Landon Fuller of Westinghouse testified before the Antitrust Subcommittee that market shares in the government-sealed business for circuit breakers (part or switch gear) were changed after a meeting in 1958 in the Traymore Hotel in Philadelphia in order to accommodate both a newcomer and a smaller producer who demanded and received larger shares. After ITE Circuit Breaker was allocated 4% of the market and Federal Pacific's share was raised from 10 to 15.6 percent, the price-cutting abated and, as shown by the chart, the realized price then moved upward, reaching the level of the published price by the middle of 1959. Had profit margins not been so abnormally inflated by one of the most egregrious conspiracies in history, price-cutting would probably not have broken out and the two series would have displayed much the same similarity that they manifested during the remainder of the period.

The reasons for assuming that the percentage changes in the B.L.S. series can generally be used as a rough indication of changes in "actual" or "realized" prices have been summarized by Walter Adams and Robert F. Lanzilotti in a critique of Stigler: [17]

"In questioning the universal applicability of list of quoted prices . . . Stigler is only repeating a truism; but it is a truism which does not disprove the price doctrines of Means and others. Quoted prices, and their inflexibility in some industries, are still of major significance—for a number of reasons. First, in many industries, quoted prices are the foundation of the price structure—the point of departure for bargaining over premiums and discounts, the takeoff point for price revisions. It is the price structure and the manner in which it is constructed that constitute a major concern of public policy.

"Second, price structures normally provide for various discounts from list, which are made available to different classes of buyers . . . What is really significant is the structure of prices and how it changes over time. The mere fact that some sales are made at discount prices is not relevant to the points at issue.

"Third, if transaction prices are always an understood and invariate discount below quoted prices, then changes in the latter are fully representative of changes in transaction prices. Thus, if circuit breakers usually sell at 20% off book list, the movement of the quoted price is an accurate reflection of changes in the transaction price.

"Fourth, if Stigler is correct about the illusion of quoted prices, why in the spring of 1962 did United States Steel not simply raise its transaction prices to the level of its quoted prices? Why did Roger Blough, who is certainly conversant with the facts of life in the steel industry, insist on raising a fictitious price? Did he not know that a single revision of transaction prices would have served his purpose and also saved him from detection by the B.L.S. (and its henchmen)? In short, given Stigler's model, Mr. Blough was either a fool or a provocateur, hankering for a joust with the President of the United States. Both these interpretations of Mr. Blough's behavior tax credulity."

The most recent and in many respects the most comprehensive study of the issue is a book issued by the National Bureau of Economic Research, *The Behavior of Industrial Prices*, by George J. Stigler and James K. Kindall.[18] Its purpose is to test the validity of the B.L.S. Wholesale Price Series by comparing them against indexes of buyer's prices developed by the National Bureau. Because they are less subject to "elaborate product changes", the study is "heavily biased toward widely used staple individual materials." The period covered is 1957–1966. The buyers from whom prices were obtained consisted of 33 government and governmental agencies—Federal, State and local, 137 industrial, utility and transportation companies and, in the case of drugs, nine hospitals. Since there was an "overwhelming reliance . . . on large companies and institutions" for their sources, the study is biased in the direction of those buyers who are most likely to be the recipients of secret deals and concessions.

In appraising the study it is necessary to draw a distinction between, on the one hand, its introduction and conclusion and, on the other, the actual data which it contains. As is made clear at the outset, the central purpose is to examine the empirical basis of Gardiner Means' "celebrated" doctrine of administered prices, with its "startling" statistics of prices and its "sweeping inferences . . .

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[17] 88th Cong., 1st Sess., Senate Subcommittee on Antitrust and Monopoly, *Administered Prices: A Compendium on Public Policy*, 1963, pp. 6–7.

[18] George J. Stigler and James K. Kindahl, *The Behavior of Industrial Prices*, National Bureau of Economic Research, 1970.

about the role of price rigidity in the economic malaise of the 1930's . . ." Citing a sharp increase in the number of articles on rigid prices appearing in economic journals, the authors remark that Means ". . . had in fact created a new subject:" [19]

"The propostion that in many important industrial markets prices do not respond quickly or fully to changing supply and demand conditions in the way a competitive market had become generally accepted by the late 1930's. It was accepted first by the economists and then increasingly by the general public. Public acceptance is illustrated by the Congressional hearings to which changes in the price of steel products have been subjected since 1948." [20]

Continuing to base his analyses on the B.L.S. price data, it was again Means who in "widely publicized testimony" attributed the inflation of 1953–57 primarily to increases in administered price industries. From this view, which ". . . was endorsed in substantial measure by economists as eminent as Abba Lerner and J. K. Galbraith," there was a "natural evolution to the 'guidelines' of price and wage policy announced by the Council of Economic Advisers in 1962 and applied to steel, aluminum and other products in a series of highly dramatic confrontations of the Presidential office and the industries in question." [21]

The Means' doctrines are subject to criticism on two grounds. The first is the absence of a theoretical rationale: "They have not emerged in response to the development of a coherent, widely accepted theory that industrial prices will display downward rigidity in any meaningful sense." [22] The second is the validity of the B.L.S. price series on which they are based: "The existence of inflexible industrial prices is accepted because it is believed to be an implacable empirical fact. One large purpose of our study is to determine whether it is indeed a fact." [23] The reader can be forgiven for anticipating a demolition of the empirical foundation of doctrines which Prof. Stigler holds in such ill-disguised contempt.

The demolition, however, never comes off, for the very good reason that the new National Bureau (N.B.) indexes, instead of providing a basis for refutation, move substantially in accord with the behavior of the B.L.S. series. This is most clearly evident from the charts which are presented for each of the industry categories examined.[24] In many cases the close correspondence is openly acknowledged. Thus in the case of steel, which is of particular importance in view of the responsibility attributed to it by Means as well as by Eckstein and Fromm [25] for the inflation of the 'fifties, Stigler and Kindall state: "The B.L.S. and N.B. prices of steel products move together so closely that a description of one is a description of the other . . . this finding, it must be confessed, comes as a surprise to us . . . With the exception of three steel products [reinforcing bars, pipe and stainless steel], however, we were unable to learn of any important and continuous departures from quote prices . . . the general picture was one of close adherence to quoted prices even for very large buyers of steel." [26]

In contrast to the pattern shown for steel of stability, interrupted occasionally by stair-step increases, both indexes for nonferrous metals fluctuate widely with changes in demand—in the same direction and about the same extent. Both series show a steep drop in 1957–58, a sharp recovery in 1959–60, a more gradual decline in 1961–63, and a sustained rise thereafter. During the last stage the N.B. index does show a sharper increase which, however, is explained as follows: "The greater rise in the N.B. index in 1964–66 reflects the more rapid rise in transaction prices than in quoted prices, which were under 'guideline' control." [27]

Except for a greater volatility of the B.L.S. series, which is partly attributed to the fact that it is essentially a "spot" price and partly to the stability of transaction prices paid by railroads for diesel oil, ". . . the two indexes [for petroleum and products] show fairly similar cyclical patterns." Noting a sharper

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[19] Ibid., p. 13.
[20] *Ibid.*, p. 13.
[21] *Ibid.*, p. 14.
[22] *Ibid.*, p. 15, While arrived at empirically, Means' findings of price rigidity during the great depression were certainly in harmony with the expectations arising from the theoretical concepts of Chamberlin and Robinson as well as with the earlier theories of duopoly pricing.
[23] *Ibid.*, p. 15.
[24] Cf. Ch. 5, *Ibid.*
[25] 86th Cong., 1st Sess., *Steel and The Postwar Inflation*, Report of the Joint Economic Committee, by Otto Eckstein and Gary Fromm, 1958.
[26] Stigler and Frankel, *op. cit.*, pp. 73–74.
[27] *Ibid.*, p. 75.

increase by the B.L.S. series for 1965–66, the author observe "The more rapid secular fall of the N.B. index is due exclusively to this difference in the last two years." [28]

"The agreement between the B.L.S. and N.B. price indexes for paper and pulp products is broadly satisfactory . . . Neither price index has a strong trend . . ." [29] An examination of the chart reveals only two noteworthy differences. The B.L.S. series showed increases in 1957 and 1960 while the N.B. index continued a moderate decline and the B.L.S. series showed a sharp drop (and recovery) in 1961 which was not displayed by the N.B. index. Such differences, incidentally, contradict the constant criticism of the B.L.S. series as unduly insensitive.

Suggesting a marked improvement during recent years in the quality of the B.L.S. for this group, "The N.B. composite index for all chemicals falls more rapidly than the B.L.S. index, but in other respects the series agree fairly well." [30]

Relatively close correspondence between the two series is also apparent from the charts for three other industry groups for which no textical comment is offered—nonmetalic mineral products, electrical machinery and lumber and wood products.[31] Only in the case of rubber end products do the two series differ significantly in trend and cyclical behavior. But even here the authors observe, "On the average the B.L.S. and N.B. indexes agree tolerably on rubber products. The agreement in tires, which are not shown separately, was done for the decade but not for shorter periods and in synthetic rubber the N.B. index fell more rapidly." [32]

In view of this evidence it is hardly surprising that the study contains no general condemnation, or even criticism, of the B.L.S. indexes as indicators of the movement of prices in individual industry groups. The closest they come is to cite a quotation by Irving Fisher, "All index numbers which are not freakish or biased practically agree with each other." [33] They then go on to state: "Measured by this exacting standard of difference, the N.B. and B.L.S. indexes differ appreciably." [34] In view of the differences in nature and composition, their own findings indicate that the two series, if not "practically", are certainly "remarkably" in agreement.

APPENDIX B

PRODUCT GROUPS IN THE WHOLESALE PRICE INDEX WITH PRICE DECREASES OF MORE THAN 0.5 PERCENT BETWEEN MARCH AND MAY 1950

[1957–59=100 unless otherwise indicated]

Grouping	Year	Month			
		June	May	April	March
FARM AND FOOD PRODUCTS					
Cattle	1970	118.6	119.5	120.6	122.8
	1969	128.4	124.7	114.7	112.0
Hogs	1970	134.2	129.8	136.0	148.0
	1969	135.8	117.9	109.7	112.6
Lambs, choice	1970	131.9	122.0	126.4	128.6
	1969	129.7	132.0	134.2	125.3
Chickens	1970	(1)	(1)	(1)	(1)
	1969	86.8	88.1	84.0	94.4
Turkeys	1970	107.8	106.5	106.5	116.3
	1969	96.7	95.9	(2)	(2)
Milk for fluid use	1970	131.3	131.6	131.3	132.1
	1969	128.3	128.2	127.4	127.4
Eggs	1970	85.3	79.7	94.9	120.1
	1969	85.9	80.6	97.3	110.9

See footnotes at end of table, p. 276.

[28] *Ibid.*, p. 76.
[29] *Ibid.*, p. 77.
[30] *Ibid.*, p. 80.
[31] Cf. pp. 83, 84, 86.
[32] *Ibid.*, p. 77.
[33] Irving Fisher, *The Making of Index Number*, Boston, 1922, p. 350.
[34] Stigler and Kendahl, *op. cit.*, p. 85. It should be noted that the sentence quoted by Stigler and Kendahl appears in the context of a discussion of the technical design of index numbers, as distinguished from the question of the adequacy of sources. After examining a large number of formulae, Fisher narrows the list of acceptable formulae to a handful, of which one, No. 353, seems preferable. The sentence quoted by Stigler and Kendahl immediately precedes this *caveat* by Fisher: "But there is no thought of maintaining that 353 is the 'one and only' formula."

PRODUCT GROUPS IN THE WHOLESALE PRICE INDEX WITH PRICE DECREASES OF MORE THAN 0.5 PERCENT BETWEEN MARCH AND MAY 1950—Continued

[1957-59=100 unless otherwise indicated]

Grouping	Year	Month			
		June	May	April	March
Hay, alfalfa	1970	90.6	90.6	93.1	93.1
	1969	93.1	115.7	115.7	113.2
Hayseeds	1970	146.6	147.6	151.2	150.6
	1969	136.4	138.8		139.4
Beef and veal	1970	122.3	122.0	126.8	125.2
	1969	134.2	129.0	120.4	115.3
Lamb, choice	1970	132.5	123.4	125.0	128.8
	1969	134.7	131.1	132.6	130.1
Pork	1970	125.5	118.7	118.7	125.7
	1969	121.3	110.9	102.7	101.8
Other meats (January 1960=100)	1970	143.4	146.0	148.6	149.9
	1969	141.2	133.1	127.3	124.7
Processed poultry	1970	94.1	99.4	98.9	104.7
	1969	98.4	98.8	92.7	96.1
Fresh and processed fish	1970	154.9	151.1	154.3	155.8
	1969	144.3	146.2	143.3	147.5
Animal fats and oils	1970	111.5	116.8	118.8	133.7
	1969	91.2	89.0	90.8	96.1
Crude vegetable oils	1970	105.3	106.6	114.7	110.7
	1969	81.9	81.0	80.6	83.0
Refined vegetable oils	1970	102.8	106.4	107.7	111.9
	1969	89.4	89.4	89.4	91.6
Processed eggs	1970	95.7	95.9	97.6	116.7
	1969	101.0	101.9	105.8	105.7
Other miscellaneous processed foods	1970	132.3	127.2	130.6	132.0
	1969	117.8	118.1	118.1	118.6
Formula feeds (livestock) (January 1962=100)	1970	111.9	111.2	110.6	111.9
	1969	108.1	106.4	106.9	106.1
Miscellaneous feedstuffs	1970	89.0	89.9	91.3	91.4
	1969	86.3	84.6	86.0	85.2
INDUSTRIAL COMMODITIES					
Cotton yarns	1970	96.2	96.7	97.3	97.9
	1969	100.7	100.8	101.0	101.2
Wool tops	1970	85.9	87.4	89.5	92.2
	1969	96.5	95.6	95.3	94.0
Broadwoven goods	1970	89.3	90.4	91.3	92.5
	1969	98.3	98.1	97.5	97.1
Jute woven goods	1970	125.9	128.2	121.0	129.7
	1969	118.6	114.8	123.3	127.0
Cattle hides	1970	86.6	92.2	99.8	93.1
	1969	99.2	113.6	118.4	91.0
Goatskins	1970	145.5	161.7	161.7	168.8
	1969	167.4	161.7	161.7	161.7
Calf leather, upper	1970	76.4	79.9	83.3	82.2
	1969	95.9	96.6	97.8	94.2
Anthracite	1970	116.5	116.5	118.9	118.9
	1969	103.9	103.9	105.9	107.0
Pharmaceutical preparations (ethical) (January 1961=100)	1970	91.0	91.0	91.0	91.9
	1969	91.1	91.2	91.2	91.4
Fertilizer materials	1970	79.7	79.7	81.1	80.2
	1969	88.8	88.8	88.8	88.8
Plastic resins and materials	1970	80.2	80.2	81.1	81.2
	1969	80.8	80.8	80.9	81.3
Plastic construction products (December 1969=100)	1970	97.4	97.6	98.7	99.1
	1969				
Hardwood lumber	1970	130.7	132.9	133.9	136.8
	1969	138.5	138.7	138.1	135.5
Prefabricated structural members (December 1963=100)	1970	119.2	119.2	119.2	121.1
	1969	122.0	122.3	121.1	116.7
Wooden pallets (December 1966=100)	1970	117.6	117.8	117.8	118.6
	1969	114.8	113.4	113.0	112.4
Wastepaper	1970	99.0	104.2	108.5	108.5
	1969	108.8	107.1	109.1	108.1
Iron and steel scrap	1970	106.6	105.1	101.8	111.3
	1969	79.4	78.6	71.9	73.5
Nonferrous scrap	1970	171.4	187.7	193.9	189.2
	1969	169.3	164.5	164.8	151.4
Soft surface floor coverings	1970	88.0	88.1	88.6	89.0
	1969	89.6	89.5	90.2	90.9
Prepared asphalt roofing	1970	91.8	95.0	95.0	98.8
	1969	102.8	99.8	101.6	101.6
Gypsum products: wallboard	1970	89.0	93.1	95.0	96.9
	1969	100.6	100.6	98.0	98.0
Small arms and ammunition	1970	125.9	124.4	123.6	127.6
	1969	118.2	117.6	117.0	116.4

[1] Index discontinued January 1970.
[2] Seasonal commodity, index not available this month.

Source: U.S. Department of Labor, Bureau of Labor Statistics, July 1970.

Chairman PATMAN. Thank you, Dr. Blair.

Our next witness is Prof. Charles Rockwood. Professor Rockwood, you may proceed in your own way, sir.

STATEMENT OF CHARLES E. ROCKWOOD, ASSOCIATE PROFESSOR OF ECONOMICS, FLORIDA STATE UNIVERSITY

Mr. ROCKWOOD. Thank you, Mr. Chairman, for this opportunity to discuss the state of the economy at mid-year 1970 and to comment upon the advisability of adopting a national income policy for inflation control. My remarks are divided into three main areas.

First, problems of measuring and predicting economic performance; second, hazards of incomes policies as long-term stabilizing measures; and, third, support of a short-term incomes policy to provide immediate relief for the economy and support of a long-term productivity and market structure improvement program aimed at permanently shifting the Nation's Phillips curve.

Because the incomes policy approach does involve undesirable side effects, on economic efficiency particularly, it is important to know whether the current economic situation is bad enough to warrant the change. In this connection, problems of economic forecasting and inadequacies of important indexes that make difficult an appraisal of the true position of the economy are disturbing to us all.

More specifically, discussions of the inevitability of upward price drift may be more a comment on the nature and calculation of our price indexes than upon the economic verities. Equally pertinent, if available price indexes overstate the case, as is thought, then indexes of output per worker are biased downward, and the result is apparently disappointing rates of change in productivity.

Moreover, current productivity trends, while difficult to appraise because of statistical inadequacies of the measure, may be additionally deflated at this time because output recently has grown at a lesser rate than employment. Now that the period of increasing monetary restraint seems ended, some natural resumption of growth in output per worker can be expected as a cyclical development, independent of stimulation by specific policy.

As a further statistical note there is a danger of assuming too rigid a trade-off between inflation and unemployment. In a recent study just published by Brookings, Prof. Robert J. Gordon suggests that, in order to hold annual inflation to the 2.0- to 2.5-percent range, the Nation would have to suffer an unemployment rate of about 4.8 percent. He concludes further that a 1.1-percent price level change would have to be accompanied by about 6-percent unemployment, while measured price level stability would require about 6.8-percent measured unemployment.

But such figures should be used as a guide to the kinds of trade offs that might be expected rather than as firm predictions of coming events. The actual experience might be better or worse than these estimates. The fact is that the Phillips curve relationship between inflation and unemployment is not entirely stable for the economy as a whole, and my own research on the subject indicates that, disaggregated, Phillips curves may not even make sense. That is, my preliminary results indicate that the relationship between rate of change

in wages and unemployment by occupation and by industry classification does not follow any easily predicted pattern.

In addition to the difficulty of measuring the seriousness of tradeoff problems between inflation and unemployment, there is the very real danger that remedies selected could be improperly directed—for other economic ills sometimes are ascribed to wage-price problems. Two examples may serve to illustrate. (1) A significant portion of the rising cost of living about which everyone is complaining, may be less than supposed the consequence of inflation, and more than supposed the effect of population pressure, congestion, pollution, and other factors which make it increasingly expensive to maintain an existing quality of economic life even in the absense of price-level changes. (2) Some of the teenage unemployment cited as one cost of current anti-inflation policies may stem more from the reluctance of employers to pay inexperienced workers the existing minimum wage or from their reluctance to train employees subject to the draft. Again, these are not really wage-price problems.

The worth of an incomes policy for inflation control in the current situation is not entirely clear. In spite of qualifications mentioned, there is a serious and perhaps still growing unemployment problem in this country. At the same time consumer prices are continuing to rise sharply. Although the June figures seem a little more encouraging than those for May, the difference is not large enough to affect the basic conclusion. On the other hand, wage guidepost or national incomes type policies have had a doubtful record of success in this and other countries. Such experience, together with lessons gained from wartime application of direct controls on prices and wages, reveals a number of limitations to incomes policy programs. These limitations suggest the need for caution in adoption.

The most serious disadvantages of an incomes policy, of wage guideposts, are evidenced when economic pressure on prices and wages is great and when the controls have been in effect for an extended period. Under such conditions the policies are inevitably difficult to enforce, tend to distort wage and price levels as well as wage patterns and relative product prices, may make the task of other economic policies more difficult, and sometimes are costly to administer.

The difficulty of enforcement is manifested by upward wage drift. Commonly, there is concurrent upward price drift, sometimes in the form of product quality decline. Our own recent experiences with wage guideposts of course did not involve formal enforcement powers—of which a number of possibilities exist. But past history of the United States and other nations makes it clear that, when wage and price levels are under economic pressure, even strong enforcement measures cannot stop wage-price drift without consequences more serious than the inflation and unemployment which presumably are the alternatives. Wage drift has plagued all national incomes policies in truly challenging situations. Wage drift in particular has been a problem even for totalitarian systems of government, both fascist and Communist.

The lesson most of us draw is that the need for appropriately restrictive monetary and fiscal policy cannot be ignored even if some reliance is to be placed upon national incomes policies. Unfortunately, national incomes policies are going to be least effective where they are most needed.

Tied to the enforcement issue is that of selecting the wage level and wage patterns most appropriate. For selection of a wage level and a wage pattern no really sound criteria exist except those of market need. In spite of the vast theoretical literature on relative shares, production functions, and the like, market need is the most reliable point of departure. The difficulty is that the longer an incomes policy is in effect, and the more remote the unregulated market case thereby becomes, the harder it is to determine wages by analogy. As time passes historical relationships among labor markets become less and less relevant. In these circumstances certain weaknesses of wage determination by governmental regulation become apparent. There is a tendency to approve wage adjustments that are too liberal, and in this respect to do exactly what the market was accused of doing. There is a tendency to narrow wage differentials unduly. There is a tendency to be more permissive in fringe benefits than in wage increases, with the result that employers and employees are forced into a system of wage payments that overemphasizes fringe benefits to a degree preferred by neither. There is a tendency to make all changes gradually, even those urgently needed.

Further, if a national incomes policy includes judgments about relative wages in particular labor markets, the policy requires a detail of administration that can be expensive in money and time. As the policy moves beyond mere exhortation, it becomes increasingly complex and burdensome.

As a final difficulty, a comprehensive national incomes policy can be in conflict with other economic policies rather than in harmony with them. Especially troublesome is the possibility that wage-price policy mistakes will seriously complicate the task of monetary and fiscal policy.

In the current circumstance the case seems strong against a detailed national wage-price policy that involves direct and permanent intervention into all economic markets. But the concept of an incomes policy should not be rejected out of hand. The policies come in many forms, and two variations in particular offer special promise presently. One is a temporary incomes program, 6 months, a year or perhaps 2 years at most, to break the psychology of inflation. A second and complementary type is a selective program to concentrate on economic markets that malfunction and thereby aggravate inflation.

The first of these policies might be the same as what some have called a wage-price freeze. If the historical parallel of the Korean war period is used, the wage freeze at that time was one that held everyone to a maximum 10 percent wage increase, exclusive of fringe benefit changes, which were not included in the total. So if a freeze is defined as a generally uniform change, the policies might be similar. Personally, I prefer to view guidepost policies as a form of freeze—for as typically administered such policies do promote generally uniform change. They tend to freeze the relative shares of capital and labor in other words.

But in any event a freeze that allows for some change would seem to be fully as necessary in 1970 as it was in 1950, for one of the big questions concerning application of a wage-price freeze at this time is how to impose such a policy upon an economy in the midst of fairly severe reaction to recent inflation. Some markets already have

responded through wage and price escalations, while others are approaching such action.

Equitable application of a short-term incomes policy would demand that the generally uniform change encompass two kinds of adjustment, productivity and cost of living. The specific productivity adjustment factor, and the needed cost of living adjustment for wages in industries and areas that have had no recent adjustments would require determination. In view of current productivity figures, the adjustment ought to be more conservative than the 3.2 or 3.5 percent guideline used previously. But some provision for a standard of living adjustment needs to be a part of the program. (1) It would be unfair to labor to deny workers all productivity gain, as an absolute wage freeze would attempt to do. This would mean that, on the absence of a general productivity-prompted price reduction, the benefits of national productivity gain would accrue almost entirely to capital—to business ownership and management. (2) It would be difficult to enforce an anti-inflation policy which failed to provide for a balanced attack on the problem and thus suggested, improperly, that excessive wage changes are solely responsible for the current inflation-unemployment dilemma.

The main stability problem faced by the economy today is that of a pervasive inflation psychology which seems tenaciously rooted. What is needed as a remedy is not an anti-labor policy, nor an anti-business policy, but an anti-inflation policy.

The idea of a short-term incomes policy as opposed to a long-term one is advocated here for several reasons. (1) The problem of wage-price drift is less likely to pose a serious threat to a short-term incomes policy than to a continuing policy. The evidence is that incomes policies are most effective in controlling price and wage adjustments when first implemented. (2) Standards or guides to wage level adjustment are more reliable for short-term than for continuing or long-term policy. Under a short-term policy there is insufficient time for wage level adjustment errors to cumulate to the point where a serious difficulty emerges. (3) Under a short-term policy, wage and price pattern adjustment would be an uncommon rather than a common need. Except for catching up with inflation in selected markets, wage and price pattern adjustment generally could be deferred to the end of the incomes program. (4) Under a short-term policy, economists by admonition, "jawboning" if you will, should have effect. This is because the admonition would operate with the favorable coincidence of individual self-interest and national welfare. Stringent monetary and fiscal policy already implemented satisfies that condition.

The effectiveness of a short-term incomes policy would depend in large measure upon its prompt and vigorous pursuit. Specific overall guidelines for wage level adjustment would need to be established quickly and published widely. Significant wage and price changes would need to be brought to the attention of the public and bear the kind of scrutiny that action brings. Judicial penalties in cases of noncompliance may not be needed, but the policy would require positive, market-directed study and discussion. As things stand now, inflation psychology has reached the point now where individually we are seeking wage and price changes that collectively we find un-

acceptable. It will take a fairly active policy to reverse this psychology. The short-term incomes policy idea seems a step in that direction.

A second anti-inflation proposal of merit calls for improving the functioning of specific economic markets that are suspected of contributing especially to inflation pressure. Some of the theories of inflation cause which are based on structure of industry arguments and which have been presented here today, lead logically to this approach.

The suggestion by Prof. George Perry, and others who have phrased it a little differently, that policy concentrate upon the "visible" industries represents another kind of argument for the specific industry approach.

Certainly if the causes of inflation were well enough understood a long-term incomes policy might make a good deal of sense. This is because the policy would not have to be generally applied, but could be more narrowly directed to inflation's specific cause, which would allow for considerable reduction in the program's cost to society.

Some of the theoretical possibilities for adjustment of national incomes policies to attack cost inflation of a more specific cause than general cost push are treated in my book "National Incomes Policy for Inflation Control"; and for that reason, with the committee's permission, I should like to have included in the record a brief excerpt from the section that bears upon this point. However, development of a structure of industry theory that suggests inflation is narrowly rather than generally rooted in the economy is not something I am anticipating.

(The brief excerpt referred to above follows:)

[From "National Incomes Policy for Inflation Control," by Charles E. Rockwood—Florida State University Press, Tallahassee, 1969]

NATIONAL INCOMES POLICY IN NON WAGE INFLATION SITUATIONS

NATIONAL INCOMES POLICY IN NON WAGE-PUSH SITUATIONS

A rapid survey of national incomes policy operated in anti wage-push ways, but employed to combat non wage-push types of inflation, yields several conclusions.

A national incomes policy program designed primarily to counter wage-push inflation offers the greatest possibility of success when used to combat the type of inflation which it was designed to help control—wage-push inflation. This policy is by no means of equal value in all wage inflation situations, but in general it offers the greatest hope where inflation is of the wage-push type. National incomes policy offers some advantages when applied to other inflation situations, but in these instances the greatest value often comes when the policy is applied in non wage-push ways. Subject to the type of inflation with which the economy is faced, these methods would include: (1) efforts to promote general economic stability through less frequent wage change than presently exists, (2) efforts to repress general inflation through direct controls on wages only, and (3) efforts to limit only inflation due to wage behavior through an incomes policy, and to allow other cost-push pressures to continue and to continue to affect the general price-level.

National incomes policy, if operated in anti wage-push ways, relies heavily on private sources for market information. Consequently, the policy enjoys the strongest guarantees of success if those who supply the raw data are in sympathy with an incomes policy, both in principle and in practice. If those who supply the raw data oppose the wages authority, the incomes policy would be effective in accomplishing its goal only to the extent that the policy was adequately administered and enforced.

As demonstrated in Chapters 9, 10, and 11, adequate administration and enforcement is not beyond the realm of possibility. This is particularly the case where partial application of the policy is a possibility. To be administered and enforced adequately, the policy must result in a less ineffective pattern of resource allocation than would occur in its absence. This amounts to a requirement that the incomes policy adopted be less severe in its impact than the inflation or inflationary pressures that would exist in its absence. This result is entirely possible. It is less probable than the proponents of some sort of national incomes policy claim, but it is possible.

As demonstrated in Chapter 11, a national incomes policy program operated in anti wage-push ways, offiers some chance of success when used to combat general wage inflation. It offers a greater chance of success when used to combat union inflation. This is particularly true if the policy can be directed against the unionized sector only. National incomes policy offers the greatest hope of all when used to control key wage-push inflation, provided the policy can be directed effectively against just the key sectors.

A national incomes policy program also could achieve some successes when used to combat demand inflation, general cost inflation, key cost inflation, or Schultze inflation. The results of application of an incomes policy in these four situations would not be equal. Moreover, it seems clear that, to be effective, the policy ought to be applied in non wage-push ways, and each situation could call for different variations in the policy.

Both the key cost-push and the Schultze hypotheses imply an incomes policy program that is limited to a sector of the economy only. The demand-pull and general cost-push hypotheses imply an incomes policy which is applied to the entire economy. But all four inflation theories imply a need for a policy program that does more than remove wage rigidities and neutralize excessive wage increases. With the exception of the demand-pull case, introduction of wage flexibility and prevention of excessive wage increases would ease the conflict between high employment and price-level stability. In the demand-pull case, elimination of pressures for excessive wage increases would add nothing since no such pressures are presumed to exist; whereas introduction of wage flexibility probably would complicate the task of the monetary and fiscal policy authorities rather that simplify it. But in none of the four cases would introduction of wage flexibility and removal of pressures for excessive wage increases be a complete answer to the postulated problems of inflation.

The establishment of a level and pattern of wages that was both appropriate and appropriately flexible would assist in the reduction of inflationary pressures only to the extent that inappropriate wage behavior was an inflation cause. In the instances just cited wage behavior was not the only reason for inflationary pressures. In all but the demand-pull case, non-wage cost-push forces also would be present. These cost-push forces undoubtedly could be offset by depressing the wage level, if wages were depressed far enough. Depressing the wage level also could assist in the control of demand inflation. But if inflationary pressures are restricted, in part, by placing restraint on the level of wages, two serious problems arise.

Reduction of inflationary pressures by restraining the level of wages would have an effect upon patterns of income distribution and upon patterns of resource allocation. The intensity of this impact would vary depending both upon the cause and upon the relative strength of the inflationary pressure to be contained. But some distortion would exist in every instance.

The proposition that non-wage cost inflation pressures should be offset by an income policy appears doubtful. Seemingly a superior approach would be to use the incomes policy only to control wage inflation, and not to attempt to use wage policy to correct non-wage problems, but administratively it might not be feasible to make a distinction of this kind. If not, a decision would have to be made as to whether the economic inequity of the too low wage level needed to neutralize inflationary pressures, partly non wage-push in origin, would be offset by the economic benefit of eliminating inflationary pressures. Alternatively, if it were possible to make a distinction between non-wage cost inflation and wage inflation, and to use the developed incomes policy to fight only the latter, a decision would have to be made as to whether wage inflation was a significant enough portion of total inflationary pressures to warrant imposition of a program so broad and far reaching.

If national incomes policy were used to fight non-wage inflation, in addition to the allocative effects that would result, reduction of inflation pressures by

restraining the level of wages also would complicate greatly the task of price stabilizing monetary and fiscal policy. Certainly, price-level increases can be repressed through direct controls. But price-level movements are the usual signal for monetary and fiscal policy action. Thus the question—is it wise to attempt to restrict price-level movements if they are the accepted guide to stabilization policy?

As a further problem, given repressed inflation, even the usual alternates to price-level movements as guides to stabilization policy will be distorted. Where repressed inflation exists, individual markets will be characterized by "scrambling," shortages, etc. The presence of these conditions thus becomes usual, rather than unusual, and the appropriateness of monetary and fiscal policy decisions taken, given repressed inflation, would hinge upon ability to determine when the symptoms of suppression were present to a greater (or lesser) extent than they should be.

In the course of the discussion in Chapter 3 the hope was expressed that it might be possible to develop a more universal inflation cure than methods currently employed. Certainly if such a cure could be developed its implementation would render less necessary current debates as to inflation cause.

Investigation indicates that a national incomes policy program could have some universal attributes for inflation control. Provided the policy was properly structured, it should be able to make a contribution to the control of any of the inflations, as classified according to cause, that were discussed in this study. But application of an incomes policy should be adjusted to suit the particular inflation experienced; and in some cases the form the policy ought to take is not certain.

Whenever there is general wage-push inflation, incomes policy ought to attempt to establish the level of wages most compatible with price-level stability continuously maintained. Even if it is union wage inflation or key wage-push inflation that is presumed to exist, instead of general wage-push inflation, the issue of structure of the policy does not get a great deal more complex. In these cases, the means of accomplishing the appropriate wage level may vary slightly in that the policy may be partial or general. But the objective still is clear. Any national incomes policy should be directed toward obtaining that level of wages most compatible with price-level stability.

When the task facing the wage authority is control of any inflation other than wage-push in type, not only may the incomes policy program used be either partial or general depending upon the situation, but the proper goal of the control program is in doubt. Should the incomes policy be employed just to prevent excessive increases in the wage level and to provide adequate flexibility in wages, or should the policy be used to suppress inflation not of the wage-push type?

If national incomes policy is to be used in non wage-push situations, several results can be expected depending upon the type of inflation experienced. Under certain conditions (demand inflation and many types of cost inflation) the impact of policy, if operated in anti wage-push ways,[3] could be slight—i.e., no appreciable distortion in the level or pattern of wages. But the policy would not make much of a contribution of a positive nature either. Under other conditions (general cost inflation and certain varieties of round inflation), the impact of national incomes policy would be such as to enable at least partial control of price increases through some control of the wage bill.

But if an incomes policy is to be effective in controlling price-level increases not of the wage-push type, it should be directed towards the specific kind of inflation in existence. The policy should not be operated in anti wage-push ways. This is not possible unless and until (1) causes of particular inflationary experiences can be diagnosed with greater accuracy, and (2) the appropriate goal of the incomes policy, in each case, can be determined with more certainty.

The above conclusions take on even greater significance when the fact is considered that the various theories as to inflation cause actually are attempts to isolate a significant inflation cause or one that is significant some of the time. This is particularly true of the cost inflation theories, as they assume the possibility of demand inflation some of the time.

In the real world there is evidence to indicate that inflations are not uniquely caused over a period of time or at one time. If this is so, it can be expected that national incomes policy as an anti-inflationary device would have two im-

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[3] National incomes policy operated in such a way that the wage level selected is that most compatible with high level full employment, given price stabilizing monetary and fiscal policy.

portant effects in varying degrees: (1) aberrations in the pattern and level of wages and (2) some inflation control effect.

Mr. Rockwood. The basic idea of the specific industry approach has merit. But I would prefer the policy emphasis be placed upon systems for raising productivity in these industries and upon otherwise improving their economic performance rather than upon a strict incomes policy. If improper wage-price behavior really is confined to a few "visible" industries, a selective incomes policy might help to contain the problem. But if the inflation psychology is more pervasive, a selective policy could be harmful. However, if the policy approach is directed toward productivity improvement and development of more competitive behavior in selected markets by antitrust, tariff, or other policy, the anti-inflation benefits will be felt generally throughout the economy. This will be true even if the cause of the inflation is broader than the productivity and market structure policies employed.

The productivity and structure solutions alluded to do not offer the hope for immediate benefit that a short-term incomes policy might provide. On the other hand, the short-term incomes policy solution does not offer the hope for the permanent and favorable shifting of the nation's Phillips curve that the productivity and structure solutions might effect. Each policy has a contribution to make, and both together are not a complete answer, of course.

Productivity improvement in the long pull is very important. Presumably, this is the objective toward which President Nixon's productivity commission will be directed after it gets underway. If the rate of national productivity improvement can be increased and maintained, the inflation-unemployment trade-off probably can be modified, and that rather than inflation control alone is the really difficult policy objective.

My conclusion is that, if instituted promptly, a short-run incomes policy could help to ease the adjustment from an inflation economy to one somewhat nearer measured price-level stability. The advantage of a longer term incomes policy is less clear and not recommended in the current circumstance. Improvement in market structure and performance, including improvement through advancing technology, should be fostered actively. If the Federal Government would devote to other markets some of the attention that has helped to improve the technology of American agriculture and aviation; for example, the future could be bright indeed.

Chairman Patman. Thank you very much, Professor.

Now we will have the questioning. Senator Proxmire will have to go to the Senate rather soon, and I will yield to him soon.

First, I would like to ask each of you gentlemen this question. How much of a contribution to reducing inflation do you expect from the administration's decisions to establish a productivity commission, and to issue inflation alerts?

Do you feel more rapid progress against inflation could be made if the President, through the Council of Economic Advisers established explicit guideposts so that people would know just what price and income changes would be in the public interest?

Should guideposts be established for all forms of income, profits, professional fees, and so forth, or just for wages and prices in concentrated industries?

Has the time come for some type of mandatory price and wage controls and, if so, what form should these take?

Dr. Means, I will ask you to comment on these questions first.

Mr. MEANS. The whole Nixon game plan is built around the classical conception of inflation. Actually we have not had demand inflation except in the years 1968 and 1969, and the effort to deal with inflation as a demand inflation is bound to break down.

This is why it seems to me essential that there be some kind of price and wage measures to resist the inflation which comes from administered prices not from an excess in demand. Obviously we do not have an excess in demand now. I would be very strongly against trying to introduce price and wage controls in the sense of the wartime controls but I think that the Kennedy program of wage and price guideposts was remarkably successful in the period in which it really operated and suggests possibilities for the present. Now, it operated up to the end of 1965, and in that period labor clearly adhered to the guideposts. The labor cost per unit of output for the sum of all nonfinancial corporations actually went down slightly as can be seen in chart V. That means that employment dropped from 5.6 percent to the interim goal of 4 percent and market prices rose markedly, wage rates did not go up on the average more than productivity.

In this period business abided remarkably well with the guideposts, all things considered. The administered price index shown in chart IV of my prepared statement rose only 2 percent while market prices rose 9 percent.

But the Kennedy guideposts did not include an adjustment for changes in cost of living. With a reflation, that is an expansion in aggregate demand to move the economy from high unemployment to low unemployment, you can expect market prices, such as those for farm products, foods, and the flexible priced raw materials to rise. When that rise takes place it automatically increases the cost of living. The rise in cost of living needs to be accounted for in wage rates, and it wasn't. So that by the end of 1965 labor found nearly half of the productivity gains which it had realized through increased wage rates, had been dissipated in increased cost of living, and at this point labor simply stopped playing ball.

I can show you that in chart V of my prepared statement.

Chairman PATMAN. Of your prepared statement, sir?

Mr. MEANS. Of my prepared statement, yes, chart V.

Chairman PATMAN. Do you think this productivity commission will get the job done, Dr. Means?

Mr. MEANS. No, I do not, for the simple reason that the whole program of the administration is so thoroughly oriented to market prices and the traditional wisdom of price behavior that I do not think that it is likely to come to grips with this problem. I think it is better than nothing.

Chairman PATMAN. You mean the marketplace prices? I would like to ask you a question on these marketplace prices.

Mr. MEANS. Yes.

Chairman PATMAN. Especially on interest rates.

Mr. MEANS. Yes.

Chairman PATMAN. Now they all claim, all the money managers, that interest rate prices are fixed in the marketplace, and they insist on following that for even the most worthy projects.

The way I see that, Dr. Means, and I would like for you to comment on this, the poor homeowner, he must have a low price, he must have a low interest price or he cannot own a home. Today we talk so much about environmental quality and, of course, we recognize that so far as the 50 million families of this Nation are concerned, food, clothing, and decent houses for the family are a part of environmental quality. Now we don't have provisions made for decent housing. We have a goal of 26 million houses to be built in 10 years. We are way behind on that goal. We are not going forward building homes, and today we have an interest rate the market fixed in the marketplace for the homeowners as well as the speculators and the gamblers, they are all fixed in there together. If a person were to buy a $20,000 home today he would have to obligate himself to also pay $38,000 interest in addition to that $20,000 for the home, making the total price $58,000 for a $20,000 home.

Now, that is true by reason of the marketplace fixing the interest rate. In other words, that person who is buying a home is in competition with the biggest banks in the country and the biggest corporations in the country.

Therefore, the homeowner has not been getting any money for housing. It has not been available.

So don't you think that we could well afford to have two interest rates, one for such a vital thing as housing that is fixed by law or regulation, and let the others have the market rate, if it is in the public interest. It is terrible, I think, to have people who want to be homeowners in competition in the marketplace with the gamblers, the speculators, the high-interest moneylenders, and all the rest of them. People can't compete with that. Don't you think there should be a difference, Dr. Means?

Mr. Means. Well, if the policies that I recommend here were carried out, it would involve a very substantial increase in the country's stock of money along with the wage and price guideposts program, and this, I am quite sure, would bring down interest rates.

Now, in this country today, and in recent years, there has been a very high demand for loanable funds and I don't believe that the high rate was in large measure a product of monetary policy. It was a product of a variety of demands for loanable funds, consumers buying on the installment plan, housing, business expansion, the conglomerates borrowing money in huge amounts and buying stocks of companies that they sought to acquire.

Now, the increase in the money supply that could come about through monetary expansion would certainly bring down interest rates, but I think we would still have a very large demand for loanable funds, and to the extent of housing——

Chairman Patman. I know, but that is the point I am making. You have the demand for funds but, of course, this demand includes the gamblers and the speculators and the buyers of stock. You are in competition with them in fixing the interest rate on such worthy projects as residential housing. Don't you think there should be a difference, that the Government should even use a part of the Federal Reserve credit or in some way make provisions for people to get to purchase homes at low rates of interest regardless of the market?

Mr. MEANS. I haven't gone into the problem of rationing the available capital to the point where I would want to take a position on it. I am very sympathetic to the idea, for instance, of eliminating conglomerate borrowing to finance stock purchases.

Chairman PATMAN. All right. My time has expired.

Senator Proxmire?

Senator PROXMIRE. I am delighted to have all three of you gentlemen here this morning, and I think this contrasting testimony is most useful.

Dr. Means and Dr. Blair, your testimony is particularly refreshing following the opinions that we have had from a number of people that wage-price guidelines, income policies, if we get it, it just won't do the job, and the testimony that we had from the principal antitrust officer of the Federal Government, Mr. McLaren, who said that the analysis that his staff people had made shows that prices have risen less in the concentrated industries than in the other industries. I think both of your analyses show where this is so. It shows they are just inflexible prices. They don't change, they are as much on the up side as on the down side. This is understandable.

Mr. BLAIR. No, sir, I wouldn't agree with that interpretation.

Senator PROXMIRE. All right, what is your interpretation?

Mr. BLAIR. My interpretation is there is no conflict between the analysis of inflation presented by Mr. McLaren and prepared for him by Professor Weiss, and the analyses prepared by Dr. Means and myself. The Weiss analysis is really not directed to the present economic condition—an economic downturn.

Senator PROXMIRE. I am not saying, Dr. Blair, that the studies are necessarily wrong. What I am saying is the conclusions that I got from——

Mr. BLAIR. Now——

Senator PROXMIRE (continuing). Mr. McLaren seems to contradict your conclusions.

Mr. BLAIR. His conclusions are simply irrelevant to the present condition, which is an economic decline, an economic recession. The analyses that he presented were directed to a period of general economic stability, and to one of rapidly expanding demand, and for the period 1967–69. In the latter we would certainly anticipate what he found, a more rapid increase in market prices than in the concentrated sectors of the economy.

Mr. MEANS. Yes.

Mr. BLAIR. But in good part, as a result of efforts to dampen demand by restricting the money supply, and allowing interest rates to rise there has been created a situation in which economic activity is declining. There is nothing in Mr. McLaren's statement or in Professor Weiss's analysis which relates to a period of economic decline. But if we may look at the evidence of the postwar years, we find in recessions this relatively new phenomenon, upward flexibility in the administered price or concentrated industries.

Senator PROXMIRE. Let me quote what Mr. McLaren reported on the basis of the Weiss findings. He said:

Even after taking them—that is, other possible factors such as cost and demand—into account prices in 1967–68 rose significantly less the more concentrated the industry. In other words, it appears that rather

than contributing to inflation, concentration probably damped its effect through 1968 and perhaps through 1969."

Mr. BLAIR. That was the part of his analysis which was directed to a period of rapid expansion in economic activity. In all analyses of price movements with which I am familiar, going back to Dr. Means' studies of 35 years ago, it has been well established that in times of rising economic activity prices in unconcentrated areas, the more sensitive prices, tend to rise more rapidly.

Senator PROXMIRE. Right.

Mr. BLAIR. Professor Galbraith has a very interesting article bearing on this exact subject in which he goes into the possible reasons why this phenomenon takes place.

Senator PROXMIRE. So that whereas Mr. McLaren made the implication, at least I felt he was making the implication, that the present game plan of the Nixon administration was about right, you don't need a vigorous incomes policy in 1970 which is quite different in 1967–68, then you had rising economic activity and now you have falling economic activity, your position is, as I understand it is, you need that policy now otherwise you are going to have prices disproportionately rising in the concentrated sector, is that right?

Mr. BLAIR. On this point I think I can speak for both Dr. Means and myself. We feel that at the present time measures designed to hold down demand, whether monetary or fiscal, are not only irrelevant, but dangerous and potentially disastrous to the economy.

Senator PROXMIRE. So that where you have now nearly 5-percent unemployed, and you have unused capacity and you have what seems to be the likelihood, on the basis of economic analyses that I have seen, of perhaps further unemployment if you pursue an anti-inflation policy based on monetary and fiscal restraint, it can be damaging to the economy and it can be perverse; furthermore, it is not going to be effective in coping with inflation, in your view, as I understand it, because so much of the inflation is in the concentrated industries which won't respond to reducing demand.

Mr. BLAIR. Insofar as wholesale prices are concerned, virtually all of the present inflation seems to be centered in the concentrated industries. Whereas in the unconcentrated industries, in farm products, in textiles, in lumber, in scrap material, et cetera, we have declining prices. It is because of the price declines in these sectors of the economy that the wholesale price level can be expected to rise more slowly in the future. But that should not be regarded as anything other than the consequence of the effectiveness of monetary and fiscal restraints on the competitive sectors of the economy. In my judgment these price decreases will be more than offset by continuing price rises in the concentrated sector.

Senator PROXMIRE. I would like to ask Mr. Rockwood. Mr. Rockwood, you have a very interesting statement but I am somewhat confused by it. You seem to spend the first part of your statement flaying incomes policy, and then you come down to the section of your statement and you say the effectiveness of a short term incomes policy would depend in large measure upon its prompt and vigorous pursuit. You say:

> Specific overall guidelines for wage level adjustments would need to be established quickly and published widely. Significant wage and price changes would need to be brought to the attention to the public and bear the kind of scrutiny that action brings.

Does that mean that you now would favor for the short term, at least, a policy in which guidelines or guideposts are established and the President points his finger at a union or points his finger at a corporation which is adopting an inflationary policy and says so and tries to hold down prices that way?

Mr. ROCKWOOD. Well, I think, Senator Proxmire, these policies come in various forms. I wouldn't say necessarily it must come from the President.

Senator PROXMIRE. Only a President can command attention, a Member of Congress can't do it. The Council of Economic Advisers doesn't get that kind of attention really and the President of the United States does.

You talk about effective policy, and you talk about public opinion, using that instrument, I can't think of any other way that we can focus public attention effectively in this area without the President using his own office.

Mr. ROCKWOOD. Well, this is a question which I haven't settled in my own mind. I think that the answer is incomes policies will work if they are pushed vigorously enough that people respond, and exactly how much pressure is needed to do this I don't know.

But the main point I was trying to make is——

Senator PROXMIRE. Let me just interrupt 1 minute to say, because this may be easier for you to answer, because in your prepared statement one of the very few omissions you had in your oral statement, there was a short statement you gave us, 20 minutes, and then you said:

> The short term incomes policy idea seems to be a step in this direction.

You did not say the following sentence, however, "but it will have to be pursued seriously," you just omitted that. I don't mean to imply that you feel it shouldn't be pursued seriously but I just wondered why you omitted that.

Mr. ROCKWOOD. I was conscious of the time pressure that we were under and it was taken out with the thought that that would be understood.

Senator PROXMIRE. I see.

Mr. ROCKWOOD. But the main point that I wanted to make was that if you make national incomes policy a permanent part of your anti-inflation tool kit, I am very skeptical of how well it can continue to work. But I do feel that the experiences of this country and a number of others have indicated that the policies do work for a time, and that——

Senator PROXMIRE. And they for almost 4 years with the Kennedy-Johnson policy did, did they not, or do you feel they did not work, that is, from 1962 to 1965?

Mr. ROCKWOOD. Well, we could see a process of breaking down. There certainly was some residual effect.

Senator PROXMIRE. Certainly wage costs were stable in manufacturing.

Mr. ROCKWOOD. Yes. There are some other consequences, though, that are a little harder to measure that we are not sure about.

Senator PROXMIRE. What is your answer to the Means-Blair findings we have gotten here this morning that monetary and fiscal policies just do not work on concentrated industries which account for so much

of our price increase, and would be particularly perverse to pursue them vigorously now?

Mr. ROCKWOOD. Well, I assume that they might want to qualify that a little bit. I think they are trying to tell us, if I understand it correctly, they are trying to tell us that they work much less well in these areas, and I think we would agree that these concentrated industries do have this problem.

Another place where I disagree with them a little bit, they have attempted to assign some motives to the President's anti-inflation program which I don't see there. The National Incomes Policy remedy which is really about the only one that I know of that might be added to the President's tool kit, for the shortrun, is a controversial policy measure. The President and his advisers might object to the incomes policy measure and yet understand about the market power problem which Dr. Means and Dr. Blair discussed.

Senator PROXMIRE. Let me ask you one other question. I hate to do this because I know Dr. Means would like to respond and perhaps Dr. Blair, but I do have to go and I would like to ask you, Mr. Rockwood, you seem to place so much reliance on the President's productivity council.

I would like to know how that is going to improve productivity especially anything like the period when we can use it say in the next couple of years. I can see in the long run it is fine, we are all for that in all kinds of ways but how is this going to solve our inflation problem?

Mr. ROCKWOOD. Well, I think it is a long term solution rather than short term, and since I am not sure what the Commission will find or how it will operate it is a little speculative at this point to say what effect it will have.

Senator PROXMIRE. My time is up.

Chairman PATMAN. Dr. Means and Dr. Blair, I want you to discuss with me how to hold down the price of money, in other words, interest rates. I submitted a number of questions that I would like for you to answer for the record when you look over your transcript, and one of them was how we should deal with the high interest rates.

It is my theory, Dr. Blair, that high interest caused inflation and has for the last 18 or 19 years. Every time you would raise interest rates you would raise the price of goods on the shelves for sale, you would raise the price of everything as you raised interest rates, and as prices went up that was more inflation, then they raise interest rates again, more inflation, and that has caused our inflation.

I do believe that you can successfully stop inflation or deter it substantially without lower interest rates.

Now, on June 9, 1969, a banker in Wall Street, where they have always been recognized as the ones to raise interest rates, raised the prime rate, and all the other big banks followed very quickly. In that way, without any Government control, just private bankers, they raised the rate from 7½ to 8½ percent. That is the first time in history that even the bankers have raised the prime rate as much as one percent.

In the past it was usually one-fourth of 1 percent, with two exceptions, when it was one-half of 1 percent, but never more than that. At the time of this 1-percent increase, we had debts, public and private,

of $1 trillion 500 billion plus. So that 1 percent increase was a potential rise of $15 billion on our outstanding debts. Of course, that wouldn't mean that it would become effective tomorrow because the debts are not paid off so quickly, long term debts especially. But as debts are refinanced that 1 percent would be taken into consideration and eventually it would be 1 percent clear across the board.

$15 billion is an awfully high cost to impose on the American people by just one stroke of the banker's pen. Nobody else did that, nobody in Government did that.

Now we passed a law, initiated by our Banking and Currency Committee in the House, to give the President of the United States the power to go out on his front porch and just say, "here after the prime rate will be not exceeding 7½ percent instead of 8½," or to roll it back to 6 percent or any other level that the President wanted to.

When the President came in the prime rate was 6 percent, and then within a short time it went up to 8½ percent. That was increasing interest costs to the American people $37½ billion a year. That is more than the cost of the Vietnam war. I am not saying that all the inflation was caused by the Vietnam war, although I know that a substantial part of it was, but a more substantial part was caused by the increase in interest rates.

Would you like to comment on that?

Mr. BLAIR. Mr. Chairman, I must plead ignorance to any really informed, technical knowledge concerning the structure and behavior of interest rates. That is an area in which serious students of the subject recognize that one of the true scholars in the field is yourself. My area of expertise——

Chairman PATMAN. I disclaim.

Mr. BLAIR. Your fund of knowledge and expertise in that area far surpasses mine. My particular field of expertise, to the extent I have one, is the behavior of prices of commodities and the behavior and structure of industry.

The only observations I would like to make concerning interest rates is that they are a price which is being paid as a consequence by a Federal policy designed to hold down the level of aggregate demand. That policy, of course, being implemented by a contraction of the money supply.

An analogy that springs to mind concerns a recent medical news dispatch that I read relating to spinach. It has now been found that spinach is not particularly beneficial to the growing child. Perhaps the generations of children, including myself, who rejected spinach were reacting to an instinct which later scientific findings have demonstrated to have been correct. We could bear high interest rates with greater equanimity if we were convinced that they really were good for us, just as young boys could be induced to eat their spinach if they could be persuaded that it would make them better baseball players. But the purport of the analyses presented here by Dr. Means and myself is that this is a price which we are paying for a remedy which will not work. It is one thing to take a bitter pill in the knowledge that what you are swallowing will remedy the disease. It is something else to be forced to take a bitter pill, or eat spinach, when there is a substantial body of evidence that it won't do any good—that the restrictive monetary policy which result in these high interest rates is

not going to have a significant effect upon the price policies of industries whose output constitutes about half of our total production.

Chairman PATMAN. May I say, Dr. Blair, that, of course, we want to follow these good remedies that are suggested. The spinach is a good illustration, and many others could be found, but one thing we all agree on, if you are going to be operated on, a surgical operation, you would demand that the surgeon who wields the knife should want the patient to live. I don't believe that the American people can depend upon the people who make the money out of high interest rates to set the rate. I believe it should be set in the public interest, don't you agree to that?

Mr. BLAIR. Mr. Chairman, I want to thank you for that question. It does provide me with the opportunity of also replying to the statement made by Professor Rockwood to the effect that Dr. Means and I were implying unworthy motives to the officials of the Federal Government, who are following restrictive monetary and fiscal policies.

Chairman PATMAN. I am talking about the private banker who is not elected by the people.

Mr. BLAIR. Yes.

Chairman PATMAN. He has no obligation to the people other than just make money, and he is given the power, the surgeon who doesn't want the patient to live necessarily. He wants the patient to live if he makes plenty of money out of it.

Mr. BLAIR. Neither in the case of the banker nor in the case of the Federal official are we assuming any motives other than the incentives and motivations which can properly be expected to be followed by honest and objective persons in the positions which they happen to occupy.

Chairman PATMAN. That is right.

Mr. BLAIR. Although officials of the Federal Government, as Dr. Means has pointed out, are now belatedly reversing their policy of restricting the money supply, the deflationary monetary and fiscal policies which they have pursued have been followed in the honest and sincere conviction that they constitute the wise and prudent course of public policy, that these are disagreeable and distasteful remedies which must be swallowed, but that they are the proper means of arresting the increase in the general price level. And behind these convictions have been the assumption that the structure of industry more or less resembles that of the classical model which does respond to such measures.

Chairman PATMAN. Let me get back to your earlier statement that if the people were convinced that it was in the interest of the people to have higher interest, they would be willing to accept it.

Now I have honestly tried to find out some way that people in the middle-income group and the low-income group could possibly accept high interest rates and live and properly educate their children and properly look after their families, and I have reasoned it out this way. Suppose the interest rates get so high, 9 or 10 percent, as it is now, and that the little man could come in on it just like the big man and earn the same rate. As it is now, if you are poor you can only get a 5 percent, return on your savings, if you are rich you can get 7½ or 10 percent. We permitted this under regulation Q for 1 year with the understanding we were in a squeeze, and if we allowed these interest rates to go up on certain financial institutions it would cause their

liquidation. This regulation was intended for 1 year only, during which time the monetary managers could present to Congress a way to give everybody the same rate of interest regardless of the amount of money they put into the market. They wouldn't have any hundred thousand dollar limitation, below which you had to take a certain low rate. If you figure that out the way I did, and you let everybody have the same high rate, I think there would be a great inducement for thrift, and I was looking at it that way, trying to see some way that looked good, because I am a great believer in thrift. I helped organize the credit unions of this country. They now have 23 million depositors and they have $18 billion in assets.

Next to the church I think they do the greatest good to humanity in this country, and I am very proud of them. So, I began to think maybe if we could let the people all get 9 or 10 percent they would be more prudent in their expenditures, we would have less high interest rates, that would be acceptable to them, they would be thrifty, they wouldn't buy things they didn't need, they would want to hold that money and get that high rate of interest on it and it would be a great thing for our country.

But, after all, if we were to do that, and it worked, and people began to save their money and not spend it, to get the high interest, what would happen to our banking system?

You see, the banks do business on other peoples money, and they do business on debts. No debts, no money, that is absolutely true. If everybody paid their debts today we wouldn't have any money to do business with, and so if we had an interest rate like that, that would induce people to save their money, not go into debt, why we would have a bad reaction so far as our great banking system is concerned.

Now I know we have bad practices among certain banks but generally the banking system is mighty good and has served our country well, both in time of peace and in time of war.

But don't you think that you would have more snakes dug up there than you could kill?

Mr. Blair. Mr. Chairman, perhaps the most meaningful thing I can do in response to your question is to suggest that it be answered by Dr. Means——

Chairman Patman. I wanted to ask him, too.

Mr. Blair (continuing). Because he has much greater competence in the field of monetary policy.

Chairman Patman. I was getting to him because I discussed it with him before the hearing.

Mr. Blair. This is a field in which I again say I have no particular expertise. However, the quickest way to bring about a reduction in interest rates would be to follow the type of public policy recommended by Dr. Means.

Chairman Patman. All right, go ahead, Dr. Means. I would like to have your comments there.

Mr. Means. Basically, it seems to me you are proposing an institutional change in our financial system comparable, let us say, to the system of farm banks that were created to deal with the special situation of farmers.

Chairman Patman. Dr. Means, let me get you off that. I am talking about something entirely different. I am talking about people needing

homes and not being able to get homes because they can't get the money at reasonable interest rates. They have to go into competition with all of these speculators and gamblers and everybody else to get their money, and pay 9 or 10 percent or higher. I am talking about having a special interest rate for homeowners, residential construction, through the Federal Reserve, use of pension funds, and RFC or any other way, but we should have two interest rates, one for the homeowner, a fixed rate. We can do that through the Federal Reserve if we want to.

In Mexico right south of the Rio Grande, they have a banking system similar to ours, but they require the banks, for that valuable franchise they give them to manufacture money free of charge, and use other peoples money free and things like that, to do something for the social good, in order words, assume social responsibility. Mexican banks are required to make at least 30 percent of their loans to low-income groups for housing. Now they can do this in Mexico, and every central bank, I think, in the world, except ours, is required to assume a social responsibility of some kind. That is what I am talking about, have a distinction between speculators and gamblers and home construction, because housing should be right at the top of the priority list. Don't you believe it should have some preference, Dr. Means?

Mr. MEANS. I would want to make much more intensive study than I have ever made on this subject. I don't in the least disagree with the suggestion that you are making, but I also wouldn't want to say that I agreed with it for the simple reason that my work has been primarily concerned with maintaining full employment without inflation, and——

Chairman PATMAN. Let me ask you gentlemen about concerns like the Penn Central Railroad. This is a $7 billion concern which, by reason of mismanagement—and I say that because there cannot be any dispute about it—has gotten into difficulty. They can't even pay their electric light bills, and they had to go into bankruptcy. Now there was an effort made to have the Government bail it out, put in $200 million and then several hundred million dollars more when needed. Don't you think it would be a lot fairer to go back to what was done at the time, say, when Mr. Hoover was President in 1932, and the banks, the railroads, insurance companies got in trouble.

An RFC bill was introduced under Mr. Hoover to just bail out the banks, railroads, and insurance companies and that was done then. But soon after that, when there was a change of administration the Reconstruction Finance Corporation was changed to read that not just the three that I have mentioned but all people who had worthy projects to finance and that could not get the money at reasonable rates of interest were allowed to make application to that same concern. The RFC served this country for longer than 21 years on $500 million capital which was expanded by 17½ to 1. This really saved this country and kept our school houses open and our highways under construction. Don't you think we could well afford now to have an improved RFC, say, of a billion dollars capital from the Government, and then to be expanded upon 20 to 1, which would take care of all the banks, railroads, insurance companies, and all the other people who had worthy projects that had to have a reasonable rate of interest? Don't you think that should be considered?

Mr. MEANS. Well, I think there are a great many improvements in our whole monetary and financial system that could be made. These will take time.

Chairman PATMAN. Well, we have been doing it for 194 years, you know, we have been working on it.

Mr. MEANS. We should continue to do it, but I don't think it is essential for getting full employment and reasonable price stability. Instead of a 3-year program of depressed economic operations, which is what the Nixon game plan calls for, I think that an effective policy of monetary expansion and adequate price-wage guideposts program would get us back to high employment and reasonable price stability. Probably it could be accomplished within a year, of starting an effective program.

Chairman PATMAN. Yes; but how are we going to get back to high employment with high interest rates? You know this goes into the structure, too. Whenever the interest rates are high that makes your taxes higher. The worst thing about it, my dear friend, you know, all these utilities, electricity, water, gas, telephone, everything, they are beginning to make applications to sometimes double their rates, just on account of high interest rates, because their interest costs have more than doubled. So whenever you permit high interest rates, unduly high interest rates, you just unbalance the budget of everybody in this Nation from the housewife to the Federal Government. I don't think you can have full employment unless you do have more reasonable interest rates. That is just my own personal opinion and, of course, I admit I do not possess the knowledge and information that you gentlemen possess.

Mr. MEANS. But the program that I am recommending would reduce interest rates somewhat.

Chairman PATMAN. Yes, sir.

Mr. MEANS. It would leave unsettled the major longer run problem of taking the total savings of the country and rationing them to various uses. At the present time, and in the past, with important exceptions, we have used interest rates as the method of rationing. I think a study that took up the whole problem——

Chairman PATMAN. You mean rationing credit?

Mr. MEANS. Rationing the loanable funds, the amount of credit.

Chairman PATMAN. That has been done by private individuals.

Mr. MEANS. It has been done through interest rates.

Chairman PATMAN. Not through the government. It has been done by the individuals who would make the most out of interest rates.

Mr. MEANS. It has been rationed by the market in most part.

Chairman PATMAN. Well, they call it the market.

Mr. MEANS. All right, let's call it the market.

Chairman PATMAN. What chance would you have with a $27 billion bank bidding against you?

Mr. MEANS. The problem of departing from the rationing by the market seems to me primarily a long run problem of modifying our institutions, which Hoover did when he introduced the reconstruction finance, which the farm credit system accomplished, and which the home loan arrangements have accomplished, and I would say that to combine at this time the problem of reconstructing our financial sys-

tem with the problem of getting high employment and reasonable price stability is to combine something which I would regard as a short-run macro-economic problem with the longer run problem of improving our whole system of economic institutions.

Chairman PATMAN. Let me make it just a little bit plainer, Dr. Means, if I may.

Mr. MEANS. Yes.

Chairman PATMAN. In the Bahamas, which is becoming the gambling capital of the world, there is a concern known as Resorts International, Inc. It has gamblers from all over the world.

There is one bank over here that didn't put much money into housing loans, we couldn't get them to put much money into housing, but they put in enough to buy a million shares of Resorts International, Inc., at a pretty good price. They claim they didn't do that out of bank funds, that they did that out of their trust accounts, which makes it very, very bad. Those trust accounts were accounts that loved ones had placed in the bank to be administered properly and prudently.

Now the bank stripped 159 of those accounts to buy a million shares of stock in a gambling institution. That is not caring much for the total responsibility or for the people of this country. That is going on right now in broad daylight, and it is a disgrace to our country. They have got money for everything, gambling of all forms and kinds, speculation, they have got money for everything except housing. There is where we have reached an impasse. We have got to do something about this. We can't go on this way indefinitely. We will have a slump all over the United States. It will just be 50 States composed of cities and counties that are most of them slums.

These houses won't last forever, and we have got to build more houses. We can't do it in competition with these gamblers and these other people that I mentioned.

So I think we have got to find a way to have residential housing construction at reasonable interest rates, and I know you agree with the premise anyway.

You agree on that, don't you, Professor?

Mr. ROCKWOOD. I would say, Mr. Chairman, at the moment I feel a little sympathy for the lender. If we talk about your small lender, for example, who gets 5 percent, and we had 5 percent inflation this year and he pays tax on the interest received, I will have to have a little sympathy for him as well. I think we have got to get our inflation under control as well and that is part of the problem.

Chairman PATMAN. I agree with you, thoroughly agree with you, but you can't get it with high interest costs because it increases inflation.

Mr. ROCKWOOD. I would also like to endorse your view especially that we do need to have special concern about the market for housing.

Chairman PATMAN. That is my point.

What do you think about it Dr. Blair?

Mr. BLAIR. Mr. Chairman, addressing myself to your proposal for the re-establishment of a new RFC, I cannot help but recall that in 1944 I became the chief economist of an agency established by Congress and, at that time headed by a fellow Texan, Mr. Maury Maverick. That agency, as you will remember, was the Small War Plants Corp.

Chairman PATMAN. Smaller War Plants Corp. I was one of the authors of the bill. Senator Murray and I were the authors.

Mr. BLAIR. And it never received stronger support from anyone on the hill than from yourself. As you will recall, a fundamental reason for the establishment of that agency was that the RFC was dispensing most of its loan money to big firms not only in the field of banking insurance and railroads but in manufacturing as well. A small company, even a medium-sized company, had a difficult time getting a loan from the RFC.

If a new RFC is established and it functions as the old RFC operated, we can anticipate a parade of applicants for loans consisting of conglomerates which are now experiencing some of the diseconomies inherent in the slipshod and uneconomic way in which they were put together. For years economists, including myself, had been warning against the creation of conglomerates, partly on the grounds that what was being created consisted of uneconomic and inefficient enterprises. We quoted the remark of Andrew Carnegie when urged to put his eggs in several baskets, that he preferred to put all his eggs in one basket and then watch the basket. Today we can look back at some of the towering edifices represented by huge conglomerate complexes and realize that they have been unable to achieve the vaunted "synergism," and other economies of scale claimed for them. Now that they are experiencing bad and worsening times, if an agency is setup to hand out governmental largesse, to bail out large enterprises, there will be no shortage of applicants. The applicants who, if the RFC experience is any criterion, will walk off with the major share of the loan moneys and guarantee, will very definitely not consist of the type of enterprises and individuals that you particularly have in mind.

Chairman PATMAN. I want to remind you that you are overlooking the experience that we had with Smaller War Plants Corporation. If we do not provide against such an occurrence we are pretty naive, because having had that experience we would establish another Reconstruction Finance Corporation, and we would want to take into consideration our sad experiences in the past and make provisions that the little man would get his share or get a part of it and not let the big ones just come in and gobble it up.

Mr. BLAIR. That is an objective which Congress has repeated over and over again in a multiplicity of acts which unfortunately have been honored more in the breach than in the observance.

Chairman PATMAN. Well, I don't agree with you that it has been a failure.

Mr. BLAIR. No, I don't say it is a failure.

Chairman PATMAN. What it did was helpful.

Mr. BLAIR. But having been in the executive branch for nearly 20 years, I am mindful of the pressures.

Chairman PATMAN. That was to allow the small man to get part of the Government contracts.

Mr. BLAIR. The SWPC did help him get part of them.

Chairman PATMAN. It was a great success.

Mr. BLAIR. Well, we did our best.

Chairman PATMAN. We shall have to go. The House will be in session. I appreciate the attendance of the witnesses. You made wonder-

ful statements. We appreciate your testimony. If you want to enlarge upon your testimony when looking over the transcript you may do so. With the thanks of the committee we will release you.

We will meet again on Thursday, July 16, when we will have Mr. Walter Heller, professor of economics, University of Minnesota; Mr. Raymond J. Saulnier, professor of economics, Barnard College; and Mr. Robert M. Solow, professor of economics, Massachusetts Institute of Technology.

The committee will stand in recess until Thursday, July 16, at 10 a.m., in this room.

(Whereupon, at 12:15 p.m., the committee was adjourned, to reconvene, at 10 a.m., Thursday, July 16, 1970.)

APPENDIX

(The following article was subsequently supplied for the record by Mr. Means:)

THE NATIONAL BUREAU STUDY OF INDUSTRIAL PRICES*

By Gardiner C. Means

The new price data contained in the National Bureau report on *The Behavior of Industrial Prices* is an important contribution to our price information. The idea of testing the validity of the administered price hypothesis and the BLS wholesale price index by collecting price data from buyers is both sound and fruitful.

The introduction, summary and conclusions of the report, however, are thoroughly misleading. The new data strongly support the administered price hypothesis and in large measure confirm the validity of the BLS indexes. Yet the report gives the erroneous impression that the new data negate the administered price hypothesis and discredit the BLS indexes. Findings in the text are in sharp conflict with the "Main Findings" stated in the introduction.

VINDICATION OF THE ADMINISTERED PRICE HYPOTHESIS

The main stated finding of the report is that the data show ". . . a predominant tendency of prices to move in response to the movement of general business" (p. 9). Yet the actual data published in the report overwhelmingly contradict this finding.

The report gives price data for 63 commodities. Of these, 46 offer a fair test of the administered price hypothesis. Among the remainder, eleven [1] are market prices which behave exactly as traditional theory would lead one to expect, falling approximately 7 percent in *each* of the two recessions studied. Another six were dominated by trend factors in one or both recessions, falling more than 25 percent between the beginning of 1960 and the average of 1964, and provide no test of the hypothesis.

Of the 46 which offer a fair test of the hypothesis, 39 or 85 percent either rose in one or both recessions or showed no change in one or both. Thus only seven, or 15 percent, show a tendency to respond in the traditionally expected fashion to a decline in business activity. Even these seven items that do show a decline in both recessions fall on the average only a third as much as the 11 market-dominated prices, supporting the administered price hypothesis of *relative* insensitivity. This is a noteworthy vindication of the administered price hypothesis that administered prices behave quite differently from market prices and tend to be insensitive to decline in business activity.

The figures are summarized below as they relate to the administered price hypothesis.[2]

Rose in both recessions	3
Rose in one recession; no change in other	7
Rose in one recession; declined in other	12
No change in either recession	7

*The Behavior of Industrial Prices by George J. Stigler and James K. Kindahl, National Bureau of Economic Research, New York, 1970.

[1] Bituminous coal, Plywood, Car flooring, Methyl alcohol, AC Electric Motors, Copper (whose price was made in world markets), Copper pipe and tubing, Copper wire and cable—bare, Insulated wire, Magnet wire, Brass bars and rods (all of these being simply fabricated copper products whose price is dominated by the price of copper).

[2] The figure of 40 items decreasing in recession which is cited in the "Main Findings" includes: 11 market prices, 6 trend-dominated prices, 7 prices which declined in both recessions and at least 11 prices which fell in one recession and rose or showed no change in the other. No information is available on 5 items.

Declined in one recession; no change in other	10
Declined in both recessions	7
Total price series valid for test	46
No data	5
Market-dominated prices	11
Dominated by trend	6
Total price series not applicable to test	22

This spectacular confirmation of the administered price hypothesis is in fact acknowledged by the authors, but their statement to that effect is buried in the text of the report in a comparison of the cyclical behavior of prices covered in the study which were paid by public agencies and those paid by private buyers. They found that "... the prices of most of these commodities were insensitive to general business fluctuations ...". I quote below the whole paragraph in which this crucially important finding is embedded:

"One may correctly say that there was no difference on average and hardly any in detail in the degree of conformity of price movements for public and private buyers during the reference cycles (not presented here). It would be disingenuous, however, not to add that the prices of most of these commodities were insensitive to general business fluctuations, so their agreement was to disagree with general business movements (p. 49)."

This finding based on actual transaction prices confirms and reinforces the previous finding of administered price insensitivity derived from the analysis of the BLS data. The disingenuousness comes in failing to include this crucial finding in the summary of the "Main Findings" and in asserting the opposite.

Furthermore, the authors state that "... we find no evidence here to suggest that price rigidity or 'administration' is a significant phenomenon" (p. 9). This is a curious conclusion in view of the fact that all of the relevant prices, including the seven which dropped relatively little, behaved in a manner quite different from that to be expected of market prices and quite different from the way the sample of market prices in the study did in fact behave. Since this different behavior cannot be explained on the basis of traditional theory, it would seem to be a phenomenon of some significance, especially since it provides an explanation of simultaneous inflation and recession, a phenomenon which is impossible according to traditional theory.

VALIDATION OF THE BLS INDEXES

The new data also, to a notable degree, validate the data underlying the BLS indexes, but again the statements supporting this conclusion are scattered through the report and are not reflected in the summary and conclusions. Rather, the "Main Fndings" give the impression that the correspondence between the group indexes based on NB data and those based on BLS data is poor.

In the report, the new price data are combined into nine group indexes and comparable indexes are calculated from the BLS data. These group indexes are then compared.

The best correspondence between the resulting NB and BLS indexes is that for Finished Steel Products. The report states, "The BLS and NB prices of steel products move together so closely that a description of one is a description of the other. The upward trends in price are essentially the same .... Neither index displays a noticeable cyclical movement in either expansion or contraction. Nor are the short-run fluctuations of appreciable size" (p. 72).

Six other paired indexes show a satisfactory correspondence in the circumstances, while not fitting quite as well as steel. Three of these, Non-Ferrous Metal Products, Non-Metallic Mineral Products, Chemical and Allied Products, show a very reasonable fit. Two more, Petroleum Products and Lumber and Wood Products, show an excellent fit when account is taken of the fact that the BLS indexes reflect "spot" fluctuations and the NB indexes cannot. One pair, Electrical Machinery and Equipment, shows a close fit except for a major change in 1964 in 3 HP and 10 HP electric motors which the BLS index properly reflects but the NB index fails to show.

This leaves the indexes for Rubber and Rubber Products and for Paper, Pulp and Allied Products which correspond least well. Of these the NB report says in the text, "On average the BLS and NB indexes agree tolerably on rubber

products" (p. 77) and "The agreement between the BLS and NB price indexes for paper and pulp products is broadly satisfactory but poor in two respects" (p. 77).

The seven group indexes which fit reasonably well account for 82 percent of the commodities covered in the study, while the authors regard the remaining two as in tolerable agreement or broadly satisfactory. This gives a strong validation of the BLS indexes.

The NB study also, in general, confirms the infrequency of price change shown by the data on which the BLS bases the corresponding indexes. The actual transaction data used for the NB report show an average of less than five price changes in four years (Table 5–5, p. 65). If the eleven market prices had been excluded from the count, the average frequency of price change would have been even less.

The relatively high correspondence between the BLS and NB indexes is all the more remarkable when consideration is given to the a priori reasons to expect considerable differences. The NB report gives an impression that there should be an extremely close correspondence between the two sets of indexes. Thus it says:

"It is a traditional characteristic of index numbers which purport to represent broad categories that they are remarkably unresponsive to changes in *coverage and method of computation.* Irving Fisher italicized his conclusion: 'All index numbers which are not freakish or biased practically agree with each other.' Measured by this exacting standard of difference, the NB and BLS indexes differ appreciably." (pp. 84–5. Emphasis added).

This paragraph grossly misrepresents what Fisher said. At the point where this sentence appears in his book on *The Making of Index Numbers*, Fisher was not at all concerned with differences in coverage or method in general but only with formulae for deriving a price index from *a given set of price series* and *a given set of weights.* He had developed formulae which were neither freakish nor biased by his precise definition and was saying that these formulae gave almost identical results. Therefore the quoted sentence does not apply to either "coverage" or "method" other than the application of alternative formulae to identical data. It gives *no* support to the bland assertion that content and method make little difference where broad categories are involved. Irving Fisher would certainly turn in his grave if he could see this distortion of his work. Nor is there anything in the science of index numbers which would lead one to expect a very close fit between indexes derived from different data by different methods. The authors' "exacting standard" is a fiction.

Actually there are significant a priori reasons to expect substantial differences even if both indexes were perfectly accurate in measuring what they specifically set out to measure.

Probably the most important reason to expect differences is the quite different source of the data. Most of the NB's buyer data are obtained from big organizations, but the total user purchases of a commodity in any one month are likely to come partly from big organizations and partly from medium and small organizations. The latter would seem to be much more likely to buy at list price less standard discounts than at a vigorously bargained contract price. To assume that the transaction prices paid by big organizations are identical with, or vary closely with, the transaction prices for all buyers is contrary to experience. The specialized coverage of the NB data could thus be expected to produce appreciably different indexes.

A second a priori reason for difference is the fact that the BLS data are collected as of each month while much of the NB data is made up of prices under long-term contracts, usually annual, in which the price is set but quantities are determined at later dates as the buyer needs supplies. This means that the BLS indexes could be expected to reflect short-run price changes better than the NB indexes, as is shown in the charts for petroleum and lumber products.

Other matters having to do with weighting, differences in the exact specifications of the commodities covered in the respective indexes and similar differences in content and method could also be expected to produce appreciable differences.

In the light of this reasonable expectation of difference, the parallelism between the BLS and NB group indexes is all the more notable and the conclusion that they "differ appreciably" all the more misleading. Because the senior author of this report has led the attack on the BLS price data as failing to reflect actual transactions, he has a special responsibility to report affirmatively that his findings support in large measure the validity of the BLS price data.

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ADDITIONAL MISREPRESENTATIONS

Two additional misrepresentations deserve attention, although they are of secondary importance compared to the conflicts between the conclusions and the data.

The first is the misrepresentation involved in the way in which the nine charts comparing the movement of the NB and BLS group indexes are drawn. Because of the failure to superimpose the respective indexes in a scientific fashion, most of the charts grossly exaggerate the difference in trend between the two indexes. For example, if the indexes for Non-Ferrous Metals were properly superimposed so that half the numerical differences for one index were above and half below the other, the trend differences shown would be cut nearly in half.

The second misrepresentation seeks to discredit the statistical work I have done on administered prices by repeatedly citing the McAllister report which, the authors say, ". . . . effectively destroys the entire body of work resting upon frequency of price change" (p. 20.). The McAllister report makes the false assertion that, in determining frequency, I failed to take account of the number of reporters providing information on each commodity. Actually, in *The Structure of the American Economy*, from which the authors quote, the procedure used was as follows: For composite items, i.e. those involving more than one reporter, the frequency of price change was counted separately for *each* reporter and the frequencies for the several reporters were then averaged to give the the frequency of change for the commodity. This is explained in the Structure Report, p. 187. In my earlier study, essentially the same procedure was followed. In no case was the frequency count cumulated by the number of reporters as McAllister charges. The falseness of the McAllister charge was pointed out by Dr. John Blair in 1964 in his article "Administered Prices and Oligopolistic Inflation: a Reply".[3] This makes the repetition of the charge even more inexcusable.

(At the start of the interrogation period at the hearing on July 14, Chairman Patman posed the following four questions. The following answers were subsequently supplied for the record by Mr. Rockwood:)

Question 1. How much of a contribution to reducing inflation do you expect from the administration's decisions to establish a Productivity Commission, and to issue inflation alerts?

Answer. The Commission and the inflation alerts could be a way of implementing the short-term incomes policy I have recommended. If specific wage-price guidelines are established and if the inflation alerts do point to troublesome areas of the economy, the basic ingredients for an incomes policy are present. From that point it would depend upon how vigorously the policy was pursued.

The degree of success that could be expected from a short-term incomes program is a matter for conjecture. If it is correct that such policies can hold the rate of unit labor cost to 2 per cent below the rate that otherwise would occur, this would trade-off to something like a half a million to a million fewer unemployed. This is probably our most optimistic expectation.

Question 2. Do you feel more rapid progress against inflation could be made if the President, through the Council of Economic Advisors, established explicit guideposts so that people would know just what price and income changes would be in the public interest?

Answer. To be effective, an income policy must be pursued vigorously. It it not certain that the policy has to be pursued through the Council of Economic Advisors, or that the President has to be the one to actually implement the policy. The President's announced support for a policy largely pursued by others might be sufficient.

Question 3. Should guideposts be established for all forms of income, profits, professional fees, etc., or just for wages and prices in concentrated industries?

Answer. Concentrated industries may represent a special problem insofar as getting compliance is concerned. But the guideposts should be for all wages and prices, including professional fees, and should be applied in all areas and industries.

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[3] *Journal of Business*, January, 1964.

Question 4. Has the time come for some type of mandatory price and wage controls and, if so, what form should these take?

Answer. I would be against mandatory controls to deal with the unemployment-inflation dilemma presently before us. Mandatory controls are difficult and expensive to enforce. They seem to me too much policy for the current problem.

(The following additional questions posed by Chairman Patman and answers thereto were subsequently supplied for the record by Mr. Rockwood:)

Question 1. The recent bankruptcy of the $7 billion Pennsylvania Railroad and the reported liquidity problems of many other businesses raises a serious question of whether we should have a special way of providing financial help to businesses that find themselves in trouble by reason of tight money, whether or not these businesses are big or small. I have in mind something generally similar to the old Reconstruction Finance Corporation but not necessarily like it; an institution that would, if credit is not available locally through financial institutions, be able to extend help in the form of loans at reasonable rates of interest. Is it your opinion that we should have such a Federal National Development Bank, or similar institution?

Answer. If, as the Administration has indicated, the period of greatest monetary stringency is behind us, the problem of tightness of credit and high interest rates can be expected to ease considerably. Should high rates and tight money continue unabated, the plight of businesses unable to get credit would merit further consideration.

However, the evidence is that the nation's largest companies have avenues of credit available to them that are not available to smaller firms. This suggests that the Penn-Central and other larger firms, are less in need of the services of a Federal National Development Bank than are smaller businesses and individual borrowers.

I do not find convincing the argument that firms unable to get credit in private markets deserve a favorable rate on the Federal credit they do get.

Question 2. Is it your view that interest rates at the present time are too high? If so, what are your recommendations to lower these rates?

Answer. To some extent interest rates are established under conditions that are quite some distance from the economists concept of perfect competition. Interest rate increases can be a part of the general cost-push phenomenon in other words. At the same time, inflation does reduce the real rate of return on money loaned.

Thus, part of the problem will solve itself if inflation is brought more nearly under control. At the same time, a short-term national incomes policy designed to destroy the prevailing psychology of inflation could not ignore the need for restraint in interest rates.

Question 3. Our housing industry is in a serious state of depression and we are falling far short of our housing goals—goals that a few years ago were set forth as fundamental to our national interest. Under present interest rates, a person who buys a $20,000 home with a traditional mortgage term of 30 years, under present rates of interest, would be compelled to pay not only the $20,000 for the home but $38,000 for the interest, a total of $58,000. It has been proposed that in order to channel more vitally needed funds into housing, some provision be made for utilizing pension funds. I have introduced a proposal in the Congress that would require them to invest a small percentage of their assets in a public bank which in turn would be able to make housing loans. What is your opinion of some such means of using pension funds?

Answer. The housing market is especially depressed presently. If interest rates fall in the near future and mortgage money becomes more readily available this will help. It would seem, however, that the housing market could benefit from additional aid. Government assistance of some sort, perhaps in the form of tax concessions, could do the job.

I do not feel the law should require that pension funds be invested partly in housing if this is contrary to the wishes of those who manage the funds. Further, I question whether a long-term national policy should be established that is based upon the assumption that the housing shortage is permanent. It seems more likely that the housing shortage is not permanent. These things have a way of working themselves out over time.

Question 4. Under present law, Delaware corporations are able to participate in far reaching mergers and formation of conglomerates and to get around state laws on such questions as branch banking and other reasonable limitations. Should not the Congress take some action to restrict the power of such corporations in order to bring them more in conformity with the laws of the states in which they operate?

Answer. The role of conglomerates in the economy is not well understood; but it would seem that the recent and rapid increase of this form of business organization has importantly affected the competitive structure of the economy, sometimes adversely. The part played by banking institutions in the establishment of these conglomerates merits investigation and perhaps control. Also of concern is the trend toward concentration in banking itself through mergers, branching and the formation of bank holding companies.

Question 5. What should be done about the trend toward forming one bank holding companies? Do you believe that this should be restrained? In view of the fact that banks are franchised by public authority to carry out monetary functions that are basic legislative powers, should they not be required to stay exclusively in the banking business and not be permitted to engage in other forms of business and in effect go into competition with their own depositors?

Answer. The current trend towards one bank holding companies should be viewed with considerable apprehension because of the several potential abuses of the privilege that exist and because of the large number of such companies that are now being established. I do not see any particularly noteworthy advantages to permitting the trend to continue.

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

THURSDAY, JULY 16, 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 S-407, the Capitol Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire and Fulbright; and Representatives Griffiths and Conable.

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

Senator PROXMIRE. The committee will come to order. Unfortunately, one of our three panelists is not here yet, but we understand he is on his way and will be here momentarily.

These midyear hearings on the actual and prospective state of the economy have not so far provided any cheer to the American people and the Congress. We are, indeed, in troubled times. It is extremely important that we analyze our problems at this time to develop the proper approach to regaining our economic equilibrium.

Virtually, every economist we have heard so far agrees that the administration's economic policies have been a failure. The business world is in a liquidity squeeze, the cure for which threatens to keep long-term interest rates at extremely high levels. Business will seek long-term capital to replace the short-term borrowing on which they have been depending to an excessive degree.

If this eventuates, it means that housing and pressing needs of States and local governments will continue to be starved for credit.

We are especially concerned because of the evident fact that if the economy is going to pick up, housing must carry some of the activity in the economy, which has been dominated for a considerable extent, at least being so characterized for the last 5 years, by a capital goods boom which may be tailing off.

I hope that the three illustrious economists here today will be able to tell us how to redress the balance which has been distorted by the sole dependence on tight money, and how to deal with the possible affliction of rising prices and rising unemployment.

All three of these gentlemen are well versed in public policy formation.

Dr. Walter Heller and Dr. Raymond Saulnier are former Chairmen of the Council of Economic Advisers, Dr. Heller in the Kennedy

and Johnson administrations, and Dr. Saulnier in President Eisenhower's. Professor Solow also served with Kennedy's Council of Economic Advisers and has been a consultant with the Council.

So we have three of the most eminent economists in the Nation with us this morning.

Gentlemen, I hope you can keep your opening statements to 15 to 20 minutes.

Dr. Saulnier, I understand, has to leave at noon. And we can understand that, and for that reason, as well as the fact that we must proceed rapidly, we will go right ahead, and Dr. Heller can deliver his statement when he comes.

I would hope that you can summarize your statement in 15 to 20 minutes. The full text of your statement will be printed in the record.

Dr. Saulnier, will you proceed?

STATEMENT OF RAYMOND J. SAULNIER, PROFESSOR OF ECONOMICS, BARNARD COLLEGE, COLUMBIA UNIVERSITY

Mr. SAULNIER. Thank you, Mr. Chairman.

I have the impression, from reading press reports, that much of the testimony in these hearings has favored an easing of monetary and fiscal restraints and the adoption of an income policy to bring inflation under control. Let me give you my reasons for thinking it would be a mistake to endorse this line of policy.

First, there is as yet too little evidence that inflation is being overcome to justify a relaxation of restraint. Indeed, there may have been too much relaxation already. Markets for some industrial materials and some manufactured goods have softened noticeably in the past few months, but the overall trend of prices is still strongly up; what is more important, there has been no slowing whatever in the alarming increase in labor costs. On the contrary, these seem to be accelerating.

Actually, we are experiencing a veritable explosion of labor costs. On an annual rate basis, total compensation costs for all workers in the U.S. private economy were up 7.7 percent in the first quarter of 1970, more than twice normal productivity gains, and new labor contracts are being written with pay and benefit increases in the 12 percent zone. Annual increases in the construction trades are over 20 percent.

The fact that a 7- to 8-percent increase in compensation barely suffices to meet living cost increases is what makes the whole process of wage inflation so pathetic. Taken as a group, workers are gaining nothing in current buying power from these inflationary packages and they are losing money every day through the declining value of their savings. Needless to say, the whole system of retirement benefits is threatened. In the interests of the worker as well as the public generally, settlements must be brought more nearly in line with productivity gains. A relaxation of monetary and fiscal policy now would not bring that about; on the contrary, it would almost certainly prevent the necessary adjustment from occurring. Increases in compensation now 7 to 8 percent on the average could become 9 to 10 percent, and new contract settlements would move up from 12 to 15 percent. Is it not obvious that this spiral must be stopped? Somehow we must find

a way back to wage-increase packages in line with productivity gains. You can be sure that if we fail in this, our economy is in for a lot more trouble than it has seen so far, which is already enough.

The situation is made more critical by the fact that a kind of wage explosion is occurring all over the industrialized world. I have just returned from Western Europe and I am appalled by what I find happening there. Like everyone who follows these economies closely, I expected a certain heating-up in 1970. But the heating-up came faster and is more intense than anyone expected. In West Germany, for example, there are labor cost increases, covering many thousands of workers, of 23 percent in 1970. Elsewhere, 15 to 17 percent increases are common—with Italy leading the parade. Moreover, similar increases are forecast for 1971 and 1972, though these expectations may be upset by the economic slowdown that is bound to follow such excesses. Obviously, these trends must be brought under control, both in the United States and in Western Europe. The question of how to do it deserves top priority by this committee and I believe it deserves top priority also at the EEC in Brussels and at the OECD in Paris. Indeed, a joint investigation conducted on a crash basis, in which the U.S Government would join as an independent participant with EEC and OECD, is urgently needed and I suggest this committee use its influence to have one launched at the earliest possible opportunity.

Unfortunately, overcoming inflation inevitably involves a slowdown in economic growth. It also involves the risk of recession. And it is folly to think that credit tightness and high interest rates will not inevitably be a part of the process. This absolutely fundamental fact must be recognized: as long as monetary policy accommodates the transference of higher wage costs into higher prices the spiral of inflation will continue. In the U.S. economy and elsewhere the spiral will not be checked except by credit restraints plus restraints on spending, public and private, which result in a sufficient slowdown of the economy to stiffen the resistance of employers, including public employers, to inflationary labor cost increases. And the employers must have the support of Government in their resistance.

It is not a question of leaping back in one giant step from egregiously inflationary wage settlements to settlements closely in line with productivity improvement. The object should be to work our way back, bit by bit, to a balance between labor cost increases and productivity gains consistent with reasonably stable prices. Inflation having been allowed to gain such momentum, it will take a few years, I fear, to make the adjustment. The process can be speeded considerably, however, if Government can win the support of labor—rank and file as well as leadership—in achieving the needed result.

To date, there has been all too little progress in checking inflation. Indeed, I have had to revise my ideas recently as to how much effect there will be from the downturn in the economy, since activity seems to be bottoming out at about its present rate and could be rising again toward the end of the year. The recovery is likely to be slow and bumpy, but there is a high enough probability that aggregate demand will be increasing in the second half of this year in fairly sizeable quarterly pumps to suggest that we will move into 1971 still with a good deal more inflation than is comfortable—probably around 3½ to 4 percent a year, as measured by the GNP deflator. Moreover, a distinct

possibility exists that, as the momentum of increases in aggregate demand become greater, the momentum of inflation will be similiarly increased. If this is the way things go, it is a sure bet that in the not too distant future it will be necessary to undergo another spell of restraint. It is precisely such an outcome—a U.S. version of stop-go—that is invited by proposals to relax restraints now.

These hearing are designed to develop ways of avoiding such an outcome. Let me outline more specifically the anti-inflation program I believe is needed.

First, although no success in an anti-inflation program is possible if money and credit policies are not right. I do not put money policy in first place as an action measure. On the contrary, I put fiscal policy in first place, and I do so because fiscal policy is directly the business and responsibility of the executive and legislative branches of Government, and there is little chance of success in a program to overcome inflation unless it is built on a foundation of unquestioned fiscal responsibility at the Federal level. The budget is the mirror of Government and the mirror must reflect the right image—the right image in the circumstances is unquestioned fiscal strength.

The Congress has a crucial role to play in this—its task in the present situation should be to see that appropriations bills are enacted that will enable the executive branch to hold spending in fiscal 1971 at the fiscal 1970 level.

Second is the question of taxes. I thought it was a mistake to plan abandonment of the surtax in advance of a significant reduction in the cost of the Vietnam war, and it still looks like a mistake to me. Accordingly, I should like to see the committee support all reasonable steps to increase Federal revenues—hopefully this can be done without another long public debate about "overkill." What we need is a budget surplus and, though it will be a man-sized task to achieve it, at least a start could be made by putting the Post Office on a self-supporting basis through enactment of adequate postal rates. After all, this alone would cut expenditures between $1 and $2 billion a year.

Obviously, it will require more than wiping out the Post Office deficit to solve our Federal fiscal problem. It looks to me as though a beginning should be made with some version of a value-added tax, and I suggest that the committee lend its support to such a move. In my view, we have needs for public services at the Federal, State and local level so enormous and of such high priority that we shall need Federal revenues far beyond any now in sight. If we do not raise the needed revenues by taxation, and by elimination of low-priority spending, we will either fail to meet pressing needs for public services, or we will live for a long, long time in an economy afflicted by the three basic economic evils: inflation, slow growth, and direct controls. This is the syndrome we must avoid.

Third, I have on more than one occasion called attention to things government can do to help overcome inflation by the way it operates its own programs. I have in mind specifically the policies followed in procurement and construction, extension and insurance of credit, setting wage floors under Walsh-Healey and Davis-Bacon, setting rates in regulated industries, et cetera.

In his recent talk on the economy, President Nixon indicated he was establishing a group within the executive branch with the idea of

using such programs to help check inflationary developments. Although the announcement got little press attention, it could, if carried out vigorously and imaginatively, be one of the most important steps taken by government in recent years in the fight against inflation. In any case, the new group will need lots of support. It will need support from the White House, and it will need support of the Congress, as well. I was chairman of a similar group in the second half of the fifties, and I know from my own experience that it will not be easy to persuade all divisions of the Federal bureaucracy so to conduct their affairs as to moderate rather than exacerbate inflation. But they must be persuaded.

Fourth is monetary policy. Considering the present momentum of cost and price inflation and the extreme percariousness of financial markets, and considering the spectacularly unsatisfactory condition of our balance of payments, it is not easy to see that money policy of late has been an outstanding success. Indeed, the attempt to use regulation Q to restrain the use of credit, and the veritable explosion of credit outside the banking system to which this led, must be regarded as one of the least successful experiments in the long history of our Federal Reserve System. What is important now is to deal constructively with the present financial situation. In my view, what we need is a credit policy that will, first, reestablish a viable balance in the financial system between commercial financing done inside the banking system and financing done outside the banks and, second, facilitate the funding on an intermediate and long-term basis of the presently excessive volume of short-term financing.

Simplistic formulas such as a 4-percent per annum growth of the money supply will not help much as a guideline for such a policy, even if we could be sure what is meant, as a practical matter, by the money supply. What is needed is a skillful blending of credit ease and credit restraint, which is necessarily something of an inconsistency, unfortunately, but not as much of an inconsistency as it may sound. If there is a basic rule to be followed by the Federal Reserve at this time it is this: See to it that the U.S. economy has enough access to credit through the banking system to avoid a liquidity crisis and to avoid a spiraling downturn but no more than that until there is solid evidence that wage and price inflation is under control.

Fifth, and finally, I come to the incomes policies that are much in the news nowadays. It is not easy to comment on these because everyone who proposes them seems to have something different in mind—perhaps that is what gives them their charm. I believe myself in strong presidential leadership in pointing out what is appropriate in the relation between wages, productivity, prices and profits, and I have myself, in an earlier age, helped to compose a certain amount of official rhetoric on the subject. All the same I have deep reservations about much that is currently said on incomes policies.

The one comment I would make is this: as is demonstrated beyond peradventure by the wage explosion occurring now in Western Europe, where incomes policies have been in vogue nearly everywhere for 10 years or more, there is no hope at all for controlling inflation through such means in the absence of adequately disinflationary fiscal and monetary measures. The most serious mistake we could make in the United States at this time would be to adopt some version of an in-

comes policy with the thought that it would be a shield behind which we could safely resume expansionist monetary and fiscal policies. Believe me, down that road lies the bankruptcy of economic policy.

Strong presidential leadership on wages, prices, productivity and profits is another matter. On an earlier occasion I put my views on this as follows:

> There is an important role to be played by political leadership at the White House level in clarifying the objects and methods of the administration's anti-inflation effort, especially to the leadership of labor and business. This is accomplished in part through the President's annual economic message. Additional messages are provided for in the Employment Act, and should be issued as circumstances require * * *. A more dramatic and potentially more effective step would be for the White House to convene annually a summit-type conference of the leadership of business and labor to discuss the state of the economy * * *.
>
> It would provide the President and his chief economic aides an opportunity to clarify administration polices and give a frank evaluation of the policies of business and labor * * *. A meeting of this kind is as close, in my judgment, as one should come to government intervention in wage and price decisions, apart of course from interventions mandated in the Taft-Hartley law and related structures. There is no place in the formula * * * for individual arm-twisting or for assaults on individual industries or companies. And I would try to keep arithmetic out of it. What it would provide is presidential leadership in the best American tradition of shared responsibility between the public and private sectors of the economy.

Mr. Chairman, a program such as I have outlined above would, I feel sure, ultimately overcome inflation. Obviously, it should be accompanied by programs designed to offset unwanted side effects. But it is a mistake to believe that disinflation can be entirely painless, and it is a mistake to expect that it can be accomplished quickly. Even with a program of the sort I propose, the struggle against inflation will certainly have to continue into 1971. The point is that, in the absence of such program there is little chance that inflation will be overcome even in 1971.

Thank you very much.

Senator PROXMIRE. Thank you very much, Dr. Saulnier, for a fine statement.

Our next witness is Dr. Solow.

STATEMENT OF ROBERT M. SOLOW, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. SOLOW. Thank you, Mr. Chairman.

I am not going to agree entirely with what Mr. Saulnier has just said. Nonetheless, I am very grateful to the committee for this opportunity to comment on the economic policy problems that the Federal Government and the public now have.

The difficulty is that we have two problems, not one.

There is never any genuine difficulty with one problem. We usually know what to do. The trouble is that there is now more unemployment and more excess capacity than we would like, and they will probably go higher before they go lower and, at the same time, prices are rising faster than we would like. While there are signs that the inflation is slowing, you are still considered an optimist if you believe that the GNP deflator will be rising at an annual rate perceptibly below four percent by the end of the year.

The question suggested by the circumstances is: What set of economic policies would permit the country's economy to combine acceptably high output and unemployment with reasonably stable prices?

There is always a temptation, when you are asked important questions by important people, to prove your gratitude by giving them answers. What honesty compels me to say, however, is not that I do not know what the answer is but that I do not believe there is any satisfactory answer to know.

If what you mean by "acceptably high employment" is an unemployment rate no higher than something like three and three-quarters percent, and if by "reasonably stable prices," you mean a GNP deflator and a consumer price index that are going up at about 2 percent a year, then, I think there is no reason to believe that our sort of economic system can combine those things without long-term structural changes of a sort that I could not specify with confidence—and I am not sure anyone could.

It is worth remembering that nearly every modern industrial country in the world with reasonably free markets for goods and for labor has been suffering from this same pair of problems. There may even be a tendency for the problem to be getting worse not better. In that respect, I agree with what Mr. Saulnier has just said.

Many British economists, for example, fear their country is on the brink of accelerated price and wage increases, even though they have been experiencing high unemployment by their standards for the past 2 or 3 years, and much the same is true elsewhere in Europe.

I think you ought to be terribly suspicious of anyone who has a tidy answer to this problem, because, if there were any such answer, you would think that at least one or two countries somewhere in the world would have stumbled on it by now, if only by dumb luck.

If this view is correct, then Congress and the administration always have to be weighing the consequences of alternative policy moves, simply trying to steer in the safer direction.

Right now, it seems to me, the greater danger is on the downside.

The unemployment rate is already at 5 percent and will probably go higher. (I am going on the assumption, which seems to be made by most observers, that the June figure represents a statistical fluctuation rather than the beginning of a sharp upturn in the economy.) Even the relatively optimistic forecasts that call for real output to begin rising in the second half of the year generally suggest a rate of increase that is too slow to reduce the unemployment rate and probably too slow to keep it from rising further.

If consumption spending should weaken or plant and equipment spending intentions should be revised downward—I do not know how likely these contingencies are, but they seem more likely than their opposite—then the expected upturn might be a quarter later or a bit weaker, or even later and weaker than that. The recessionary loss of output would be greater, and the number of jobs available would be even lower. I think this amount of prolonged slack in the economy, and the accompanying risks of more, are too high a price to pay for the reduction of the rate of inflation that we are likely to get in the course of the next year.

It is not that I do not think that disinflationary policy will work in due course, much as Professor Saulnier outlined; I think it will work but at unfavorable terms of trade.

My conclusion, to put it plainly, is that we ought to accept somewhat more inflation for a longer period of time than the present policy or Professor Saulnier's policy seems to do. The present policy, I think, was simply overoptimistic about what could be accomplished, about how soon it could be accomplished and at what cost in real output and employment. I think the time has come to let the economy expand more freely.

Even if that were agreed, there would remain the question of policy mix, to which these hearings are particularly devoted. Before I come to the conventional alternatives of fiscal and monetary policy and, now, incomes policy, I want to put in an urgent plug on a policy issue to which this committee does not ordinarily address itself.

Everybody seems to be agreed that the current rise in the price level gets much of its steam from inflationary expectations. In markets for commodities and in markets for labor, many sellers are trying to catch up with prices after having been left behind earlier and are trying to anticipate future price increase lest they be left behind again. Buyers who expect the same course of events are disinclined to resist price increases because they fear that to buy later will be to buy dearer. So, this kind of unwinding of the past makes it harder for anyone to believe that the price level will eventually stabilize, and the resulting expectation of inflation makes it harder, actually, to stabilize prices.

Now, in the course of history, war and inflation have been associated in our consciousness probably because war and inflation have been associated, in fact. It does not matter that, in principle, it is possible to finance a war in a noninflationary way. Any textbook tells you how to do that, but we have not done it. As long as the war in Vietnam continues, I think it is going to be difficult to dissipate the widespread belief that prices will continue to rise. And, contrariwise, the single best thing we could do to break the hold of inflationary expectations is to end the war and get out of Vietnam quickly and decisively.

I do not think that is the main reason for doing so, but it is an additional reason, for anyone who needs one.

As between fiscal and monetary policy, a strong case can be made that whatever net expansionary stimulus is applied should come mainly on the monetary side. It is common ground that the country needs a lot of new housing in the next 5 or 10 years, both to improve the stock of housing we have and to make house room for large numbers of newly formed families. A 20 percent reduction rate in the annual rate of housing starts, comparing April 1970, with April 1969, is hardly the way to do that. It would take a general easing of credit conditions and/or some special incentives to direct funds into the mortgage market, if mortgage rates are to fall sufficiently to permit the volume of house construction that the country needs.

Another reason for leaning in the direction of monetary ease is the general liquidity squeeze on business. I am not against squeezing when that is required. It is illogical to believe that you can deflate an inflated economy without anybody hurting, without anybody feeling any pain. But if, as I think, the immediate prospects and the inherent risks call for some relaxation of pressure, and if capital needs, not only in housing but in State and local construction and, perhaps, in some industrial capacity as well, remain urgent and especially vulnerable to downside risks, then, some monetary ease seems to be in order to bring down interest rates.

Since some net stimulus is desirable, this does not mean the fiscal policy needs to be tightened because that would just offset in other areas the good that might come from some monetary ease and would still leave the country paying, as I think, too high a price for its disinflation and running the risk of paying more.

Above all, I hope that this committee, in its role as the guardian of economic rationality in the Congress, will remind everyone that a deficit in the Federal budget in a time of recession is not a sign of inflationary recklessness. I hope by now that most interested people have learned that the current deficit or surplus in the budget reflects the current state of the economy, and if you want a broad measure of the stance of fiscal policy you must turn to the deficit or surplus as it would be at some standard level of economic activity. In statistical practice, ever since 1961 and 1962, that has come to mean the so-called Full Employment Surplus, an estimate of the balance of the Federal budget as it would be if the economy were using its potential fully.

The recent estimates of the full-empolyment surplus seem to say that under present legislation, fiscal policy will be marginally more restrictive in the second half of this year than in the first half, and that the fiscal policy for 1970 as a whole will be much like 1969 and certainly no more expansionary. The prospects for fiscal 1971 are that fiscal policy will be more restrictive than in fiscal 1970 because the normal increment in revenues at full employment, plus the effect of increasing the social security wage ceiling, will outweight the expiration of the surcharge, other tax reliefs, and the projected increase in expenditures.

If the budget goes into deficit it will be primarily because the economy is weak, not because fiscal policy is easy. To raise taxes to eliminate that kind of deficit is like kicking a man when he is down, and the man is ourselves.

Finally, I come to the "in" topic of the day: income policies or guidelines for prices and wages. There has been so much discussion of this subject lately that I will not try to be systematic but merely make a few isolated comments.

In the first place, I would not now favor detailed wage and price controls nor, I think, a uniform freeze. A system of bureaucratic controls with all the inequities that that will inevitably mean is appropriate in a major emergency and would be tolerated by the public if they felt a sense of emergency. I do not think they feel it now, because there is no emergency and controls would be an overreaction.

On the other hand, I think that President Nixon's proposals in his speech a month ago amount to underreaction. Moreover, the proposals themselves were presented in such a way as to minimize whatever impact they might otherwise have had.

When I was a boy, I once tried to sell the Saturday Evening Post from door to door in Brooklyn. I would ring the bell, and when the lady came to the door, I said: "You don't want to buy a Saturday Evening Post, do you?" Not surprisingly, very few of them did. That is roughly the way the President tried to sell us his incomes policy and not surprisingly, he will find few buyers. Of course, I did not much believe in the Saturday Evening Post, and the President does not seem to believe much in his own incomes policy.

Actually the proposed Government Regulations and Purchasing Review Board could do some good if it takes itself seriously and the President backs it up. The other two legs of the policy, I fear, are negligible. The inflation alert seems to consist of Council of Economic Advisers publishing price series deadpan. This has all the potential for action of a notice from the Weather Bureau saying that it rained last Thursday. [Laughter.]

The National Commission on Productivity will find that there is very little it can do about productivity, and even if it could, there is no guarantee that wages and other costs would not go up that much faster, with little effect on the rate of inflation. In any case, the failure of productivity to rise in the past year is not an independent cause of inflation. It is most likely just the standard accompaniment to a slowdown or recession, and, therefore, the consequence, an unavoidable consequence, of disinflationary policy.

Now, the evidence on the effectiveness of incomes policies, when they are tried with a will, is not crystal clear. Still, I think, the preponderance of the evidence is that policies of the guidelines type can and do have a restraining effect on inflation. The effect will be small—I would not promise much at all—but the cost of getting that effect will be small. It does not sound like much to say that an active incomes policy might reduce the rate of inflation by a half of 1 percent or 1 percent a year. But if you remember that the other way to reduce the rate of price increase by a half of 1 percent or 1 percent is to let the unemployment rate rise by about a half of 1 percent or 1 percent, then, the incomes policy begins to sound like a bargain, although, admittedly, an uncertain bargain.

Now, experience suggests that merely preaching restraint is not an adequate guideline. Somebody has to set a norm for prices and wages, and publicize it, and repeat it and make a fuss about it. It is far better, of course, if the actual parties to wage-making and price-making can be induced to agree to the norm and to participate in setting it. It is easier to set such a norm when prices are stable to begin with, but it is not impossible even at a time like the present.

Let me give an extreme example, which I would not propose as a practical matter at all: Suppose the cost of living goes up by 6 percent this year. If labor could be induced to settle for 6 percent wage increases on the average for next year and if productivity were to rise by the normal 3 percent, then labor costs per unit of output would go up by 3 percent next year.

If industry could be induced to hold price increases on the average to the rate of cost increase, then, the price level would only have to rise by 3 percent next year, and labor would have achieved a 3 percent in real wages just matching the productivity gain. The rate of inflation would fall from 6 percent a year to 3 percent.

If the wage increase in the following year could once again be held to the previous rate of price increase, 3 percent in my example, and if productivity were to rise by the normal 3 percent, then unit labor costs would be constant and the stage would be set for price stability in this two-step, 2-year process.

Now, as I have said, and I want to emphasize, I do not mean that as a realistic possibility at the moment. I do not think zero price increase at full employment is in the cards, and even if it is it will not come up

in 2 years unless we can somehow deal it from the bottom of the deck. A more realistic process would aim for something less than stability and aim to achieve it in, say, 3 years.

I am merely trying to show that a sensible norm, or series of norms, can actually be designed. Over a long period of time, I think, a persistent pursuit of such norms might actually have a marginal effect—and I emphasize "marginal effect"—on the intrinsic behavior tendencies of the economy. As a university professor, I have to believe in education.

Unfortunately, a norm, even a sensible norm, even an agreed norm, is unlikely to be enough. Probably some sort of sanction is necessary to make an incomes policy work. Frankly, I do not know what an effective and appropriate sanction would be. I am not hinting at compulsory price control. But there ought to be some way to identify the genuine outrage, the flagrantly antisocial and self-nullifying act, and to make its perpetrator feel unhappy. Maybe publicity applied in the right way can be the sanction. I do not know. I have to leave that to wiser heads.

Thank you.

Senator PROXMIRE. Professor Solow, thank you for a most delightful, interesting, as well as informative statement.

Our last witness this morning is Dr. Walter Heller.

Dr. Heller, you were, unfortunately, detained. The other witnesses were forewarned to hold their statements to 15 minutes and summarize if necessary. The entire statement will be printed in the record.

STATEMENT OF WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. HELLER. Mr. Chairman, thank you.

Looking at my 15-page prepared statement you, obviously, realize that I cannot read it in 15 minutes. If I may, I would like to have it entered in the record and speak then from it——

Senator PROXMIRE. Fine.

Mr. HELLER (continuing). Selectively.

I would like to open by sounding the same note as Professor Solow, because, as we struggle to break out of the shadows of the inflationary recession and back into the sunshine of noninflationary expansion, we are well-advised to remind ourselves, that there are no magic formulas, there are no pat solutions, no easy ways to reconcile full employment and price stability.

No modern free economy has yet found the combination of policies that can deliver sustained high employment and high growth side by side with sustained price stability. This is not meant to be a counsel of despair, inaction, or overreaction.

On the contrary, it is a plea to recognize that there is a tradeoff between jobs and prices. In the last analysis, economic policy involves a conscious choice between the human and social costs of more unemployment on one hand and the inequities and distortions of inflation on the other.

Let me turn directly now to our current economic prospects.

As we take stock of U.S. economy in mid-1970, the dominant facts of economic life are these:

First, even if the economy managed a little uptick in the second quarter or rises a bit in the third and fourth, economic sluggishness and growing economic slack will be the order of the day for the rest of 1970, and our GNP gap will grow sharply. If we average out to a no-growth year, our annual loss in production would reach $40 billion by the end of 1970. If we settle for a snail's-pace recovery in 1971, that loss could rise to a billion dollars a week a year from now.

I noticed in this morning's Wall Street Journal that an official economist is quoted as saying: "Certainly it appears that the economy will not take-off in the second half. It looks like there may be small gains, but economic conditions still will be pretty sluggish throughout the year. There is nothing to get very excited about."

Well, I think a loss of 1 billion a week in output, under the present policies, that may be in the cards for a year from now is something to get very excited about.

Secondly, even if the unemployment rate dropped a bit in June, the employment picture is still weakening, and the human costs of unemployment continue to rise.

If the administration honors its pledges to deescalate in Vietnam, there is a danger under present policies that the resources thus freed may run to waste in continued economic slack instead of finding prompt constructive use in an expanding economy.

This, obviously, is not an argument not to deescalate it is an argument to be sure we have an expansionary economy for the veterans to return to.

And, fourth, even if the cost of living index does not show it yet, inflation is at last on the wane and will take a diminishing toll in economic distortion and inequity as the year progresses.

I would like to take up a moment to back up each of these assertions about our economic prospects.

First, as I assess the contending forces, I see more or less of a standoff for the rest of the year. All in all, we seem to be going through the least severe but most sustained recession (or "recessionary adjustment") of the post-war period.

Now, this picture could change for the better if the consumer unexpectedly casts off his apprehensions and pessimism, snaps out of his lethargy and starts spending a more normal, that is, higher, percentage of his income; or if the Nixon administration and the Federal Reserve unexpectedly move to a distinctly more expansionary monetary-fiscal policy.

What emerges from this brief rundown is that we should become preoccupied with the question of whether the economy moves up a bit, down a bit, or sideways. The much more telling consideration is that if the U.S. economy essentially marks time in 1970, its unused potential—the gap between actual and potential output—will reach $40 billion by the end of the year. And I think that is worth repeating: a continuation, in other words, of unduly restrictive economic policies runs the risk of letting as much as $1 billion a week of American productive potential run to waste by the second half of 1971. That is the key point on which employment and output policy should focus.

Second, going to unemployment: The employment implication of this scenario is self evident: an economy that stagnates for several quarters and then grows sluggishly for a time will simply not gen-

erate job opportunities fast enough to absorb new entrants into the labor force and offset the growth in productivity per man-hour. Without a shift to a more expansionary policy, unemployment will rise substantially in the coming year to a peak of between 5.5 and 6 percent.

Third, with respect to Vietnam deescalation, in this context that I have just mentioned, one should consider the human resources made available by troop pullouts from Vietnam and the associated reductions in military manpower requirements. If economic policy, in effect, continues to dump returning veterans into a soft job market, it would incur not only unnecessary economic costs but grave social risks. Part of the cost would be in the temporary loss of these human resources to the programs that so desperately need them. But beyond this, we would have to count the cost not just in the indignity and hardship of the individual but in the heightened social tension, militancy, and crime which breed in the atmosphere of idleness and injustice labeled "unemployment."

Fourth, what about ebbing inflation?

Since the risks and costs we have been reviewing here are being incurred in the name of conquering inflation, we have to consider two further questions before deciding which way and how far monetary-fiscal policy should move:

Are inflationary pressures ebbing as a result of previous restrictive policy and, if so, how much relief is already in sight?

How big a cost in further loss of jobs and output is the country prepared to suffer to bring the inflation rate down below the rates now in prospect?

With respect to the near-term inflationary prospects, I believe that significant, if still not satisfactory, relief is in sight, based on the following considerations:

Moderately restrictive fiscal policy in 1968–69 and brutally tight money in 1969 and early 1970 have replaced excess demand and drum-tight labor markets with excess capacity and widespread unemployment, an environment in which price competition and price cutting take on new meaning and huge wage increases will eventually be harder to come by.

As output begins to move up again and operating rates rise, increases in productivity will slow down the rise in unit costs of labor.

There's plenty of evidence at hand that basic materials prices are easing, wholesale prices are rising less rapidly than they did, and some key food prices are likely to fall.

In short, we seem to be moving out of the epidemic phase of our current inflation. A 4-percent rate of inflation, in terms of the gross national product deflator, by the end of the year is a reasonably good bet. As a consequence of the slowdown and slack already generated in the U.S. economy, I would expect further improvement in 1971 even if, as I would urge, monetary policy becomes considerably easier.

Let me make clear, however, that I would be the last to dismiss inflation as a tough and stubborn problem in the U.S. economy. In an economy that has a basic bipartisan commitment to high growth and high employment, as I surely hope it has, I continue to see inflation as an endemic problem that must be faced for the longer run. Unless we condemn ourselves to a chronically slack or stagnant economy, I do not see how we can expect to average much less than 3-percent

annual inflation in the next 5 years. Just as current prospects permit a move toward more expansionary monetary policy, so the longer term prospects call for the most serious efforts on the structural policy front.

At the same time, for those who fear that a return to expansionary economic policy spells a quick return to epidemic inflation, one should recall that it took a war in Vietnam, a $25 billion Federal budget deficit and sustained 7- to 8-percent growth in the money supply to generate the Vietnam inflation. I doubt that we are in danger of repeating that set of mistakes.

Perhaps we will have another set, but I think that we have learned enough not to do that again.

Now, turning to policy, we should keep in mind as background that this slowdown or recession we are in is not something that just happened. It is our first consciously induced, managed, and engineered economic downswing. The same tools that were used to engineer the downswing can engineer a renewed expansion.

Let's make no mistake about this: In spite of the President's statistics in his speech a month ago which associated the growth in unemployment with a winding down of war in Vietnam, our present unemployment and slack are the direct outgrowth of a combination of moderate fiscal and harsh monetary restriction, not a result of military cutbacks. With the modern tools of fiscal and monetary policy at its command, the economy as a whole has nothing to fear from military deescalation—in spite of painful adjustments in Seattle and Boeing and a few other areas and industries.

As one looks at the actual unfolding of fiscal-monetary policy for our engineered slowdown, one can discern two distinct stages to date. The first stage was the restrictive stage, begun in 1968 and sharply intensified in 1969. The second stage, initiated early this year, might be called the letup stage. Consciously in the case of monetary policy, semiconsciously in the case of fiscal policy, the monetary and fiscal brakes were somewhat eased.

It is now time to enter stage three, moving from a policy of less restriction to a positive policy for expansion. This requires prompt and decisive action on the monetary front, together with a wary eye cocked on the fiscal policy front lest the automatic growth in revenue potential generate too large a full employment surplus in 1971.

This recommendation will affront those—including my colleague, Professor Saulnier—who demand the unconditional surrender of inflation. Perhaps that is overstating his position. It will affront those who insist on pressing the restrictive monetary-fiscal policy to the point not only of breaking the back of excess demand—as it already has—but of breaking the will of strong unions and strong management through the discipline of unemployment, low profits, and ferociously high interest rates. To this group, one has to counter with two sharp reminders:

First, that discipline involves costs, both economic and social, which range from large to catastrophic. One should not forget that the unconditional surrender of inflation in the late 1950's was bought at the cost of 7 percent unemployment, a GNP gap of $50 billion—which was 10 percent of GNP 10 years ago, as against 5 percent today—and profit plunges of 20 to 30 percent.

Second, these costs are imposed on all segments of the community in order to get at the relatively few with strong market power. Ironically, these few are among the last to be hit by cutbacks in aggregate demand.

I shudder to think what could happen to our human and social fabric if we incurred those kinds of costs again.

Turning now to the fiscal-monetary mix, I have repeatedly in the last year and a half urged greater reliance on fiscal restriction and less reliance on a monetary squeeze. Early in 1969, prompt and full extension of the surcharge, as President Johnson recommended, would have been the right policy medicine for the continued fever of inflation. Again, extension of the surtax this year would have allowed a better policy mix. Indeed, as late as 2 months ago, I was arguing for a Federal tax increase coupled with a flexible and easier monetary policy, not for additional restriction of consumer demand, but (1) to take some of the pressure off of our money and capital markets and reduce the unduly severe policy burden borne by the Federal Reserve System and (2) to meet our aching social needs in a more adequate and responsible way with particular emphasis, in the immediate context, on taking out policy insurance—public policy insurance, if you will—for the victims of our fight against inflation, that is, the unemployed—providing better unemployment compensation, family assistance plans, training programs, and the like.

Now, if such a change in mix had been made, we would have been far better off, both economically and socially. Also, if we could will it into being instantaneously. I would continue to urge it. But in the realistic political and economic context which confronts us today—a reluctant or unwilling White House and Congress on one hand and a sluggish economy on the other—the risks of embarking on that course probably exceed the gains. Yet, in the face of longer run needs of a better policy mix and, more important, of more adequate financing of our huge and pressing social needs, I should make very clear that I would now put this proposal temporarily on the back burner, not take it off the stove.

I agree with Professor Saulnier that we need tax increases in the longer run, but I do not propose to do this through a value-added tax.

Now, in part, my caution on any immediate moves on the tax front is based on a projection of the probable course of the Federal budget surplus in terms of high employment. Although the actual budget bids fair to fall into a deficit of over $10 billion this fiscal year, one has to keep two facts clearly in mind in assessing the budget's impact on the economy:

First, the annual rate of deficit in the actual Federal budget will probably peak in the current quarter. It is likely to run $13 billion to $14 billion this quarter, and then to diminish to perhaps $5 billion by the second quarter of 1971.

Meanwhile, second, the budget surplus in full, or high employment terms—just to put some numbers on what Professor Solow was saying—after reaching a low of perhaps $3 billion in the current quarter, will rise steadily to something like $10 billion in the second quarter of 1971.

Now, as to Federal Reserve policy, given the prospects for a sluggish economy, rising unemployment, waning inflationary pressures,

and a swing toward fiscal restraint during the coming 12 months, one can offer some pointed and positive recommendations for ease in monetary policy. We already have welcome assurances that the Federal Reserve will serve as a lender of last resort. Indeed, the Federal Reserve must feel just a bit shellshocked after its first few months of target practice focusing on the new targets of bank credit and money supply. In the face of a foundering Treasury debt operation and a scramble for liquidity in the private financial markets, the Fed was forced to return to its more traditional targets of money market conditions and interest rates. Without abandoning some broad guidelines with respect to the aggregates, monetary policy would be well advised to continue to emphasize interest rates and money market conditions in its targetry in 1970 and 1971.

There are those who argue that the rapid expansion of the money supply, at a rate of nearly 10 percent for 3 months this spring, requires an offsetting pullback and tightening of monetary policy. This conclusion is wrong from every point of view: First, for the first 6 months of 1970, the growth in money supply averaged out to somewhat less than half the 10 percent spurt of the 3 spring months. Second, when we move from myopic or what Professor Saulnier would call simplistic preoccupation with money supply or fixed rate of increase in the money supply and take into account also the demand for money, it is perfectly clear that the 10 percent jump in the money supply was quickly absorbed in the hunger for liquidity. Looking at interest rates, which reflect both supply and demand, one finds the price of money staying very high during those 3 months of spurting supply. Every indication in the financial and business sector today suggests that the hunger for liquidity is strong and continuing, that it will take an unusual increase in money supply to meet the sharp increase in demand.

Third, putting the money supply picture into still longer perspective, one should remember that the first half of 1969 saw a rate of increase of just about 4 percent; the second half, zero: the first half of 1970, a little over 4 percent. We are still well behind any reasonable schedule in terms of normal requirements for real expansion in the economy even without plugging in an allowance for some of our price inflation. There is still a lot of catching up to do.

Finally, the economic picture sketched early in this paper suggests that the increase in money supply should now be stepped up beyond the requirements of normal real expansion in the economy. Using a fall in interest rates and a rise in liquidity as the appropriate targets in the present economic situation, and taking into account the large risks and costs of failure to turn our sluggish economy back toward expansion, I am confident that the relevant monetary signals call for a significant stepup in the rate of increase in the money supply in the next 6 months.

Now, just one or two comments on wage-price restraints, self-restraints, before I close.

First, echoing Professor Solow, I welcome the in-house price watchdog committee that the President set up. Also, I hope that the Productivity Commission will do some good in the long run, and I am glad that the Council of Economic Advisers is going to give us an inflation alert from time to time. All of this adds up to a recognition

of facets of the inflation problem that the Nixon administration had previously ignored or neglected, and this is all to the good.

But I am concerned that the inflation alert is being administered by economists who are declared disbelievers in Government guidance, leadership, and intervention in the wage-price process. Being first-rate economists and dedicated public servants, they will do their job in a manly way, and, perhaps, even in a "Friedman-ly" way. [Laughter.] But unless the National Commission on Productivity takes it from there and expresses public outrage over things like that 13 percent truckers' settlement or unwarranted price boosts—and the composition of the Commission is almost an ironclad guarantee against such a development—there is simply going to be little or no moral restraint, no effective self-restraint, in the wage-price field.

A considerable part of the trouble stems from the surprisingly domestic, almost theological, Nixonian adherence to a hands-off policy in the wage-price field—a policy that delights labor, pleases business, puzzles the financial community both here and abroad, and short-changes the public. Lest that strikes you as a partisan comment, let me recall that important international observers in the OECD, IMF, Bank for International Settlements, and other bodies, have made pointed statements urging the United States to adopt a meaningful incomes policy. Fortune magazine and more recently Business Week have devoted pointed editorials to the same end: Why should Government intervention in the trucking settlement have been confined to the mediation service, with its approach of "peace at any price level"? One could also add some examples of dissenters within the administration itself.

Direct intervention and leadership—not a straitjacket of mandatory controls—is needed to flank appropriate fiscal and monetary policies for stabilization, with effective wage-price restraints.

I have some comments on the long-run that I will skip.

I make a renewed plea for some discretionary authority to enable faster fiscal policy changes so that we keep a better fiscal-monetary mix in the long run. But I have had some unfortunate experience with proposals along that line with some of the present members of the committee, so I will skip that part in the interests of saving time.

In conclusion, the balance of risks in today's economy has clearly shifted. The pressures of inflation are beginning to subside while the perils of idleness and slack continue to mount. It is high time, Mr. Chairman, for economic policy—especially monetary policy—to respond to this shift with a decisive and sustained move toward expansion. This is not a plea to open the expansionary throttle wide, but to stop "riding the brake" and start using the accelerator again.

(The prepared statement of Mr. Heller follows:)

PREPARED STATEMENT OF WALTER W. HELLER

Mr. Chairman and Members of the Committee: As we struggle to break out of the shadows of inflationary recession and back into the sunlight of non-inflationary expansion, we are well advised to remind ourselves that there are no magic formulas, no pat solutions, no easy ways to reconcile full employment and price stability. No modern, free economy has yet found the combination of policies that can deliver sustained high employment and high growth side by side with sustained price stability. This is not meant to be a counsel of despair, inaction, or overreaction.

On the contrary, it is a plea to recognize that there *is* a tradeoff between jobs and prices. In the last analysis, economic policy involves a conscious choice between the human and social costs of more unemployment on one hand and the inequities and distortions of inflation on the other. In today's terms, this requires the policy maker first, to take stock of our progress in the battle against inflation and prospects, under present policies, of breaking out of our economic slump; and second, in the light of this stock-taking, to adjust policy so as to strike a better balance between the large and growing cost of unemployment and lost production on one hand and the further anti-inflationary payoff of a continued economic squeeze on the other.

I submit that such a review yields some clear and unmistakable signals for the policy maker.

ECONOMIC PROSPECTS TODAY

As we take stock of the U.S. economy in mid-1970, the dominant facts of economic life (skipping qualifications and details for the moment) are these:

- Even if the economy managed a little uptick in the second quarter or rises a bit in the third and fourth, *economic sluggishness and growing economic slack will be the order of the day for the rest of 1970, and our GNP gap will grow sharply.* If we average out to a no-growth year, our annual loss in production would reach $40 billion by the end of 1970. If we settle for a snail's-pace recovery in 1971, that loss could rise to a billion dollars a week a year from now.
- Even if the unemployment rate dropped a bit in June, *the employment picture is still weakening, and the human costs of unemployment continue to rise.*
- If the Administration honors its pledges to de-escalate in Vietnam, *there is a danger under present policies that the resources thus freed may run to waste in continued economic slack* instead of finding prompt constructive use in an expanding economy.
- Even if the cost of living index doesn't show it yet, *inflation is at last on the wane* and will take a diminishing toll in economic distortion and inequity as the year progresses.

Let me take a moment to back up each of these assertions about our economic prospects.

ECONOMIC SLACK

First, as I assess the contending forces—those that would mire us more deeply in recession versus those that would pull us out—I see more or less of a stand-off for the rest of the year. With the steam going out of the boom in plant and equipment investment, with government spending providing no great thrust, with housing just about holding its own at a low level (though not as low as most observers expected), with most surveys showing the consumer in a subdued frame of mind, and with the prospect of serious strikes hanging over the economy, the fires of recovery seem pretty well banked for the rest of 1970. At the same time, there are few signs that the weaknesses in the economy will accumulate into a downward spiral. All in all, we seem to be going through the least severe but most sustained recession (or "recessionary adjustment" if euphemisms are needed) of the post-war period.

This picture could change for the better if the consumer unexpectedly casts off his apprehensions and pessimism, snaps out of his lethargy, and starts spending a more normal (higher) percentage of his income; and if the Nixon Administration and the Federal Reserve unexpectedly move to a distinctly more expansionary monetary-fiscal policy.

What emerges from this brief rundown is that we should not become preoccupied with the question of whether the economy moves up a bit, down a bit, or sideways. The much more telling consideration is that if the U.S. economy essentially marks time in 1970, its unused potential—the gap between actual and potential output—will reach $40 billion by the end of the year.

This projection takes as its point of departure the Council of Economic Advisers' analysis of actual and potential GNP (as shown in Chart 8 on page 85 of the *Economic Report of the President*, February 1970). The Council analysis shows actual and potential GNP coinciding in the fourth quarter of 1969 and projects "about a 4.3% rate of growth of potential real GNP." At prevailing levels of GNP, this means approximately a $10 billion quarterly growth in GNP potential. Little or no real growth throughout 1970 would therefore open the gap to about $40 billion by the end of the year. If one further assumes sluggish

growth at a 2% rate in the first half of 1971, the gap would be roughly $50 billion by mid-year.

To put this in operational terms: a continuation of unduly restrictive economic policies runs the risk of letting as much as $1 billion a week of American productive potential run to waste by the second half of 1971. *That* is the key point on which employment and output policy should focus. Let me drive this point home by noting that this could occur even without experiencing what, by traditional standards, we would call a "recession." Thus, in an economy whose potential growth is 4.3% annually, four quarters of zero real growth in 1970 and two quarters of 2% growth in 1971 would be enough to produce a $50 billion gap.

UNEMPLOYMENT

Second, the employment implication of this picture should, in general terms, be self-evident: an economy that stagnates for several quarters and then grows sluggishly for a time will simply not generate job opportunities fast enough to absorb new entrants into the labor force and offset the growth in productivity per man-hour. Without a shift to a more expansionary policy, unemployment will rise substantially in the coming year, to a peak of between 5.5 and 6%. This percentage does not count those who drop out of the labor market or are discouraged from entering it because of limited job opportunities. Nor does it reflect the great concentration of joblessness in certain groups. On that score, one need only remember that at a 4.7% overall unemployment rate last month, the unemployment rate for blacks was twice as high and for black teenagers was a staggering 34%.

VIETNAM DE-ESCALATION

Third, it is in this context that one should consider the human resources made available by troop pullouts from Vietnam and the associated reductions in military manpower requirements. If economic policy, in effect, continues to dump returning veteran into a soft job market, it would incur not only unnecessary economic costs but grave social risks. Part of the cost would be in the temporary loss of these human resources to the programs that so desperately need them. But beyond this, we would have to count the cost not just in the indignity and hardship of the individual, but in the heightened social tension, militancy, and crime which breed in the atmosphere of idleness and injustice labeled "unemployment."

EBBING INFLATION

Fourth, since the risks and costs we have been reviewing here are being incurred in the name of conquering inflation, we have to consider two further questions before deciding which way and how far monetary-fiscal policy should move:

Are inflationary pressures ebbing as a result of previous restrictive policy and, if so, how much relief is already in sight?

How big a cost in further loss of jobs and output is the country prepared to suffer to bring the inflation rate down below the rates now in prospect?

With respect to the near-term inflationary prospects, I believe that significant, if still not satisfactory, relief is in sight, based on the following considerations:

Moderately restrictive fiscal policy in 1968–69 and brutally tight money in 1969 and early 1970 have replaced excess demand and drum-tight labor markets with excess capacity and wide-spread unemployment, an environment in which price competition and price cutting take on new meaning and huge wage increases will eventually be harder to come by.

As output begins to move up again and operating rates rise, increases in productivity will slow down the rise in unit costs of labor.

There's plenty of evidence at hand that basic materials prices are easing, wholesale prices are rising less rapidly than they did, and some key food prices are likely to fall.

In short, we seem to be moving out of the *epidemic* phase of our current inflation. A 4% rate of inflation (in terms of the GNP deflator) by the end of the year is a reasonably good bet. As a consequence of the slowdown and slack already generated in the U.S. economy, I would expect further improvement in 1971 even if, as I would urge, monetary policy becomes considerably easier.

Let me make clear, however, that in an economy that has a basic bipartisan commitment to high growth and high employment, I continue to see inflation as an *endemic* problem that must be faced for the longer run. Unless we condemn

ourselves to a chronically slack or stagnant economy, I don't see how we can expect to average much less than 3% annual inflation in the next five years. Just as current prospects permit a move toward more expansionary monetary policy, so the long-term prospects call for the most serious efforts on the structural policy front.

At the same time, for those who fear that a return to expansionary economic policy spells a quick return to epidemic inflation, one should recall that it took a $25 billion federal budget deficit and sustained 7% to 8% growth in the money supply—in a economy that was operating at or above its potential—to generate the "Vietnam inflation." I doubt that we are in danger of repeating that mistake.

Stabilization Policy

Short Run

As we turn more explicitly to policy measures and policy mix, we should keep in mind that the 1970 slowdown or recession is not something that "just happened." It is our first consciously induced, managed, and engineered economic downswing. The same tools that were used to engineer the downswing can engineer a renewed expansion.

Let's make no mistake about this: in spite of the President's statistics which associated the growth in unemployment with the winding down of war in Vietnam, our present unemployment and slack are the direct outgrowth of a combination of moderate fiscal and harsh monetary restriction, not a result of military cutbacks. With the modern tools of fiscal and monetary policies at its command, the economy as a whole has nothing to fear from military de-escalation (in spite of painful adjustments in certain areas and industries).

As one looks at the actual unfolding of fiscal-monetary policy for our engineered slowdown, one can discern two distinct stages to date. The first stage was the restrictive stage, begun in 1968 and sharply intensified in 1969. The second stage, initiated early this year, might be called the "let up" stage. Consciously in the case of monetary policy, semi-consciously on the case of fiscal policy, the monetary and fiscal brakes were somewhat eased.

It is now time to enter stage 3, moving from a policy of less restriction to a positive policy for expansion. This requires prompt and decisive action on the monetary front, together with a wary eye cocked on the fiscal policy front lest the automatic growth in revenue potential generate too large a full-employment surplus in 1971.

This recommendation will affront those who demand the unconditional surrender of inflation, those who insist on pressing restrictive monetary-fiscal policy to the point not only of breaking the back of excess demand—as it already has—but of breaking the will of strong unions and strong management through the "discipline" of unemployment, low profits, and ferociously high interest rates. To this group, one should counter with two reminders:

> That "discipline" involves costs, both economic and social, that range from large to catastrophic. One should not forget that the unconditional surrender of inflation in the late 1950's was bought at the cost of 7% unemployment, a GNP gap of $50 billion (which was 10% of GNP ten years ago, as against 5% today), and profit plunges of 20 to 30%.
>
> These costs are imposed on *all* segments of the community in order to get at the relatively few with strong market power. Ironically, these few are among the last to be hit by cut backs in aggregate demand.

With respect to the fiscal-monetary mix, I have repeatedly in the past year and a half urged greater reliance on fiscal restriction and less reliance on excruciatingly tight monetary policy. Early in 1969, prompt and full extension of the surtax as President Johnson recommended would have been the right policy medicine for the continued fever of inflation. Again, extension of the surtax this year would have allowed a better policy mix. Indeed, as late as two months ago, I was arguing for a federal tax increase coupled with a flexible and easier monetary policy, *not for additional restriction of consumer demand,* but to take some of the pressure off of our money and capital markets and reduce the unduly severe policy burden borne by the Federal Reserve System; to meet our aching social needs in a more adequate and responsible way with particular emphasis, in the immediate context, on taking out policy insurance for the victims of our fight against inflation, i.e., the unemployed.

If such a change in mix had been made, we would have been far better off, both economically and socially. Also, if we could will it into being instantaneously, I would continue to urge it. But in the realistic political and economic context

which confronts us today—a reluctant or unwilling White House and Congress on one hand and a sluggish economy on the other—the risks of embarking on that course probably exceed the gains. Yet in the face of longer-run needs of a better policy mix and, more important, of more adequate financing of our huge and pressing social needs, I should make very clear that I would now put this proposal temporarily on the back burner, not take it off the stove.

In part, by caution on any immediate moves on the tax front is based on a projection of the probable course of the federal budget surplus in terms of high employment. Even while the actual unified budget bids fair to develop a deficit of over $10 billion for Fiscal 1971, one has to keep two facts clearly in mind in assessing the budget's impact on the economy:

> The annual rate of deficit in the actual federal budget (NIA basis) will probably peak in the current quarter—at $13 to $14 billion—and then diminish to less than $5 billion by the second quarter of 1971.
>
> Meanwhile, the budget surplus in full, or high employment terms, after reaching a low of perhaps $3 billion in the current quarter, will rise steadily to something like $10 billion in the second quarter of 1971.

In connection with the foregoing numbers, I should emphasize that I'm factoring in judgments concerning the most likely fate of Administration tax and expenditure proposals in Congress this year and am also taking account of the short-fall in revenues owing to economic weakness.

Given the prospects for a sluggish economy, rising unemployment, waning inflationary pressures, and a swing toward fiscal restraint during the coming twelve months, one can offer some pointed and positive recommendations for ease in monetary policy. We already have welcome assurances that the Federal Reserve System is alert to the liquidity needs of the economy, will not leave borrowers in the lurch and will serve as a lender of last resort. Indeed, the Federal Reserve must feel just a bit shell-shocked after its first few months of target practice focussing on the new targets of bank credit and money supply, the monetary aggregates. In the face of a foundering Treasury debt operation and a scramble for liquidity in the private financial markets, the Fed was forced to return to its more traditional targets of money market conditions and interest rates. Without abandoning some broad guidelines with respect to the aggregates, monetary policy would be well advised to continue to emphasize interest rates and money market conditions in its targetry.

There are those who argue that the rapid expansion of the money supply—at a rate of nearly 10% for three months this spring—requires an offsetting pull-back and tightening of monetary policy. This conclusion is wrong from every point of view.

> For the first six months of 1970, the growth in money supply averages out to somewhat less than half the 10% spurt of the three spring months.
>
> When we move from myopic preoccupation with money *supply* and take into account also the *demand* for money, it is perfectly clear that the 10% jump in the money supply was quickly absorbed in the hunger for liquidity. Looking at interest rates, which reflect *both* supply and demand, one finds the price of money staying very high during those three months of spurting supply. Every indication in the financial and business sector today suggests that the hunger for liquidity is strong and continuing, that it will take an unusual increase in money supply to meet the ready demand.
>
> Putting the money supply picture into still longer perspective, one must remember that the first half of 1969 saw a rate of increase of just a little more than 4%, the next six months at a zero rate of increase, and the last six months again a bit above 4%. So we are still well behind schedule in terms of the normal requirements for real expansion in the economy. There is *still* a lot of catching up to do.
>
> Finally, the economic picture sketched early in this paper suggests that the increase in money supply should now be stepped up *beyond* the requirements of normal real expansion in the economy. Using a fall in interest rates and a rise in liquidity as the appropriate targets in the present economic situation, and taking into account the large risks and costs of failure to turn our sluggist economy back toward expansion, I'm confident that the relevant monetary signals call for a significant step-up in the rate of increase in the money supply in the next six months.

Although I understand that my main focus today is to be on fiscal and monetary policy, I cannot resist a comment or two about a favorite subject of mine, namely, voluntary wage-price restraints and government guideposts. By now, I'm afraid that any reption of my general views on this would be monotonous, but I hope that a comment or two about the recent Nixon innovations in anti-inflationary policy might not be amiss.

First, I should note that I welcome the in-house price watch-dog committee that the President has set up. Also, I hope that the Productivity Commission will do some good in the long run, and I am glad that the Council of Economic Advisers is going to give us an inflation alert from time to time. All of this adds up to a recognition of the facets of the inflation problem that the Nixon Administration had previously ignored or neglected, and this is all to the good.

But I am concerned that the inflation alert is being administered by economists who are declared disbelievers in government guidance, leadership, and intervention in the wage-price process. Being first-rate economists and dedicated public servants, they will do their job in a responsible way. But unless the National Commission on Productivity "takes it from there" and expresses public outrage over things like that 13% truckers' settlement or unwarranted price boosts (and the composition of the Commission is almost an irony-clad guarantee against such a development), there is simply going to be little or no moral restraint, no effective self-restraint, in the wage-price field.

A considerable part of the trouble stems from the surprisingly dogmatic, almost theological, Nixonian adherence to a hands-off policy in the wage-price field—a policy that delights labor, pleases business, puzzles the financial community both here and abroad, and shortchanges the public. Lest that strikes you as a partisan comment, let me recall that important international observers in the OECD, IMF, Bank for International Settlements, and other bodies, have made pointed statements urging the United States to adopt a meaningful incomes policy. *Fortune* magazine, and more recently *Business Week*, have devoted pointed editorials to the same end. Why should government intervention in the trucking settlement have been confined to the mediation service, with its approach of "peace at any price level"?

Direct intervention and leadership—not a straightjacket of mandatory controls—is needed to flank appropriate fiscal and monetary policies for stabilization.

LONG-RUN

In pondering the problems of proper policy mix, we should break out of the confines of the 1970 context to consider whether fiscal-monetary policy has been the victim of persistent or recurrent biases or imbalances and what changes might be helpful in striking a better balance in the future. The most conspicuous lesson of recent fiscal history is that failure to act promptly and decisively on the fiscal front in the battle against inflation throws an undue burden on the monetary authorities and, through them, an unbearable burden of tight money on housing, small business, and state and local governments.

Had there been standby authority for temporary income tax increases, subject to Congressional veto, on the books in 1966—in other words, if President Johnson could have activated an anti-inflationary tax increase without a bruising battle in Congress, not only over taxes as such, but over Vietnam—I think the odds are reasonably good that we would have had a surtax in 1966 and a correspondingly less stringent monetary crunch. Or even if such standby authority would have meant that the President could have activated a temporary surtax promptly in August of 1967, rather than going through ten months of fiscal fiddling while the inflationary fires burned, we would have been vastly better off in our battle against inflation.

The reluctance of Congress to give up any part of its fiscal prerogatives is understandable. Its refusal even to consider President Kennedy's request in 1962 to give him limited standby authority to reduce taxes in the face of recession is perhaps even more understandable. But what is more difficult to understand is the unwillingness to consider a carefully circumscribed grant of Congressional authority to Presidents to *increase* taxes temporarily, always subject to Congressional veto, to help subdue inflation.

Indeed, I'm surprised that the Congress is unwilling to put the anti-inflationary tax monkey precisely where it belongs, namely, on the back of the President. Let's face it, we live in an inflation-prone economy. If the President is to deal effectively with recurrent upsurges of inflationary pressure in a responsible way—

i.e., without passing the buck to the Federal Reserve System and forcing it to turn the monetary screw far too tight—he must be given the power to put on the fiscal brakes in a hurry, not just on the budget but on the tax side.

Even with this power in hand, Presidents may be reluctant to use it. But if they are, the responsibility for failure to cope with inflationary pressures will be clear and unmistakable. And if this failure leads to excruciatingly tight money, again, this blame will be placed where it belongs.

Effective policy calls for sharply focussed responsibility. In stabilization policy, that responsibility should be vested in the White House in a clear and unequivocal way. It is not clear how else we are to get the right policy mix and to avoid continued over-reliance on monetary tools to fight inflation—an over-reliance that inevitably hurts home building, the weak and small members of the business community, and the school districts and other state and local governments that find themselves at the far end of the queue in the capital markets.

A direct grant of standby authority to the White House would be the best way to implement the foregoing recommendations. But if the Congress would be less reluctant to lodge the authority in the hands of a special commission or council including, among others, the chairman of the Federal Reserve Board, this route would be more than acceptable.

It is so important to overcome the too-little-too-late syndrome of fiscal policy that one should try one formula after another in the hope of overcoming Congressional reluctance to yield its authority on this front. If it adamantly refuses to do so, there are a couple of other routes that might be tried:

> One would be to have the Congress itself prepare a "pre-cooked" tax increase or tax cut that could be activated quickly by joint Congressional resolution at the request of the President.
>
> Another possibility, suggested by Herbert Stein, would be to have the President each January call for a positive or negative income surtax to be the first order of business for the Congressional taxing committee.

Conclusion

The balance of risks in today's economy has clearly shifted. The pressures of inflation are beginning to subside, Mr. Chairman, while the perils of idleness and slack continue to mount. It is high time, Mr. Chairman, for economic policy—especially monetary policy—to respond to this shift with a decisive and sustained move toward expansion. This is not a plea to open the expansionary throttle wide, but to stop "riding the brake" and start using the accelerator again.

Senator Proxmire. Thank you, Dr. Heller.

And thank you, gentlemen.

This is one of the finest panels, in every way, in balance and in vigor, that I have heard in the years I have been on the committee—which are quite a few now—and I congratulate all of you gentlemen on very clear and vigorous and persuasive statements.

Dr. Saulnier, you did not mention either the Vietnam war or unemployment, to the best of my knowledge, in your statement. There is a clear implication in your statement that there was a price to pay and pains to suffer if we are going to get out of this inflationary situation we are in, and the implication was that we would have to pay that price in higher unemployment.

How much unemployment should we tolerate to get this explosion of labor costs to which you refer under control without an incomes policy?

I might just recall Dr. Heller's words when he pointed out in the late 1950's we went to 7 percent unemployment, and his estimate was that we had a $50 billion gap in gross national product that we could have produced if we had not had to pay that price.

How high a price in unemployment are we going to have to pay in your view in order to break this inflation problem?

Mr. SAULNIER. Let me respond to that, Mr. Chairman, by saying that if the economy moves in 1970 the way I have thought it would move, which has been for it to bottom out here at about its present level or, perhaps, a bit lower than the present level, and, then, to move along through the rest of this year with a very moderate degree of recovery and proceed into 1971 still at a fairly moderate expansion rate, constituting a drop in physical output that would be roughly comparable to what occurred in 1960–1961 which was moderate, my guess is that in that model of an economy the unemployment rate would rise to, I have thought, 5.5 percent. It could go a bit higher than that, but I do not think necessarily so, and my reason for that is this:

It has been more or less characteristic of our recessionary experiences in the post-war period that the unemployment rate rises something like 2 full percentage points during recessions from the level that was prevailing when the recession began.

We went into 1960–1961, for example, from a rate that was around 5 percent in 1958–1959, and unemployment rates rose about 2 full percentage points.

Now, we start this downturn—it is apparently not to be called a recession—with an unemployment rate of about 3.5 percent; 5.5 percent seems to me to be a very likely figure.

Senator PROXMIRE. Of course, in recent years, you are right, I presume. You are a very fine economist, and in the 1950's we had that pattern of recessions rather than depressions. I am very concerned about the possibility, however, that this thing could snowball. It has at times over America's economic history. We have moved into deeper recessions, and we could move into a deep recession if not an economic depression again, and I wonder if you feel that we should draw the line somewhere and say "We will not permit, we will do our best to prevent, unemployment going higher than, say, 5.5 percent and at this point we are going to move ahead in a much more expansionary way of fiscal policy, monetary policy, to say we will do whatever it takes to see that we do not move into a deeper recession?" Do you think that would be a mistake, or is there some justification for that attitude?

Mr. SAULNIER. The trouble I would have with that, Mr. Chairman, is there are so many factors that work on the unemployment rate over which Government has very little direct control that it is imprudent to make any commitment as to just how much unemployment you are going to permit.

Senator PROXMIRE. Let me ask you this——

Mr. SAULNIER. It is just not a practical policy.

Senator PROXMIRE. Yes.

We have had a great deal of testimony in recent days—we had it from the chief antitrust official of our Government, Mr. McLaren; we had it from Chairman Budge; we had it from Dr. Means, and Dr. Blair, all indicating that a very great increase in concentration in American industries, concentrated industries, being on the rise.

We had the thesis being advanced very ably by both Dr. Blair and Dr. Means that the expectation is that much of our inflation—in fact, Dr. Blair said "most of it"—is in the coming year or so going to be in the concentrated industries which cannot be affected very much at least by fiscal and monetary policy.

Under these circumstances, whereas they would agree that an incomes policy or wage-price guideposts, whatever you want to call it, would have a limited influence and would not be a solution but would help hold down inflation and reduce the level of unemployment that you would have to have as a corrective for inflation.

Why do you seem so emphatically to reject this kind of an approach?

Mr. SAULNIER. Responding to your comments about concentration, I know of no facts that show a significant increase in concentration ratios in the U.S. economy in recent years. There is a drift in that direction, but it is not a significantly large movement.

Second——

Senator PROXMIRE. McLaren said that as of 1968, I believe that the 100 largest firms now had the same proportion of all of the assets in the country that the 200 largest firms had in 1950 and that this had been a steady, relentless increase.

Chairman Budge pointed out that we had an increase in mergers between 1966 and 1968 from a rate of $800 million in acquisitions in 1966 to a rate of $14.5 billion in 1968, somewhat moderating in 1969, but, nevertheless, the trend is very definitely on the way up.

Mr. SAULNIER. The statisticians have been working this problem over for a considerable period of time. As they present their evidence to the courts, one judge after another, has looked at it and said "Well, it is all very interesting. I wish you fellows could agree among you as to whether there is or is not an concentration taking place."

One economic expert will say there is, and another economic expert says there is not, and, in any case, as I indicated, the movement, the trend, is a relatively small one.

Now, second, I know no prior reason for believing that an adequate monetary and fiscal policy will not have a disinflationary effect on prices across the board, whether it is in a concentrated industry or a nonconcentrated industry. It will take longer, perhaps—but only "perhaps" to produce these results where you have concentration, heavy concentration, and it certainly does on the side of labor where you have, of course, extreme concentration, and it is a slow process in that case to bring about the result. But I do not know of any way of producing the desired result except through the kind of program I have suggested here.

Now, if Government can do something, as I say, to persuade leadership on the side of business and labor to accept, to follow, more appropriate policies, I say "God bless them." This is exactly the effort they should be making.

Senator PROXMIRE. Your friend and colleague Arthur Burns, the Chairman of the Federal Reserve Board, said last February that excess demand is out of the economy. This conclusion then was that we are moving into a cost-push situation, and he called for an incomes policy. He did not define it very well, very clearly—everything he does, he does well, of course, but he did not specify exactly what he meant by that.

You do seem to be somewhat alone among eminent economists in feeling that an incomes policy would do nothing.

Mr. SAULNIER. Not entirely.

Senator PROXMIRE. I should not say alone. The Administration's economists join you. [Laughter.]

Mr. SAULNIER. I was going to say——

Senator PROXMIRE. Among those who are not appointees of President Nixon.

Mr. SAULNIER. I have a few uneasy companions.

Senator PROXMIRE. Yes. [Laughter.]

Mr. SAULNIER. No, I am not alone in this. And there are those outside the administration who feel, I think, as I do. They are influenced, I think, Mr. Chairman, by the history of the efforts in this country and, particularly, by efforts abroad where, after all, incomes policies have been used in greater variety and more systematically than elsewhere. What they see is that where incomes policies have not been based on a truly noninflationary monetary and fiscal policy they simply do not work. And what is going on in Western Europe today, it seems to me, is a dramatic proof of that.

You have had the Commisariat Du Plan in France, you have had a British Incomes and Prices Board, you have had the Italians twisting arms all over the country, and right now, right now, you have a wage explosion going on in Western Europe. If that does not represent the total bankruptcy of the incomes policy, I do not know how it can be demonstrated.

And they are getting really concerned about this in Europe—I mean people in government, in business, in the banking field, in the banks, and professional economists. They are all deeply concerned about their inability to control wage costs in their economies.

I take a very, very grave view of this, Mr. Chairman. I think we are entering a period, as I have called it, of wage explosion, and it is going to be translated into an acceleration of price inflation far beyond what we have seen.

It will not be, I do not think, the 3 percent that my friend Walter Heller mentions. I am afraid that is well below what we can expect, unless there is a reversal of this trend. And I don't see how an incomes policy can reverse the trend.

Essentially, inflation is caused by a failure to keep money policy on a noninflationary track—without the right kind of money policy there is no hope.

Senator PROXMIRE. My time is up.

Mr. Conable, would you permit Mr. Solow to comment?

Representative CONABLE. Surely.

Mr. SOLOW. I would like to comment on that very briefly, Mr. Chairman.

I think that we are all agreed that you get no action out of an incomes policy in a time of severe excess demand. If you are running the economy drum-tight, then you cannot talk down wages or prices. The little Dutch boy with the finger in the dike was not withstanding a flood; it was just a little crack in the dike; that is all. You do not send Dutch boys to do men's jobs.

We are not talking about that kind of a situation now; we are talking about a situation in which there clearly is no excess demand in the economy. There is no backup of that kind of pressure, but there is a situation in which the past is unwinding itself and in which firms and trade unions that are well-entrenched in their own markets are able to get prices just a little bit higher, get wages just a little bit higher than they might if some external kind of pressure were brought to bear on them.

So, the object here is not to control an excess demand inflation by an incomes policy; it is simply to try, in what is already a disinflationary situation, to get a little less price rise and a little less wage rise than one would otherwise have.

Now, it is simply not true that all the evidence is that this effect cannot be had. We are in this paradoxical situation. Professor Saulnier is a practical man. I am an economic theorist. Most of my work is even mathematical. Yet Professor Saulnier insists on symmetrical, abstract, neat policies. I would tax my grandmother if economic policy could get a little benefit out of it. I like to do whatever little thing you can manage that would help the economy along.

I think there is evidence that in the right circumstances—and I think these are the right circumstances—you get marginal assistance from incomes policy. I think this has been found to be the case even in European countries.

The Dutch, in the course of their recovery from the devastation of the Second World War, maintained an incomes policy, an incomes policy of a rather more detailed kind than anyone seems to have proposed here, over a period of 10 or 15 years. It broke down; it broke down twice in the course of those years, but my understanding is that in the meanwhile it enabled the Dutch to repair a balance of payments, to rebuild a country and to fix up that little hole in the dike.

Senator PROXMIRE. You just lost the Dutch boy's vote, but you got the Dutch vote, which is more important in my state. But you just kissed off the grandmother vote, which we really cannot afford.

Mr. SOLOW. Sir, that is your problem; not my problem. [Laughter.]

Senator PROXMIRE. Could Dr. Heller just take a minute?

Mr. HELLER. Just to add one word that relates to the question, as you asked it, concerning the industries with market power, and administered prices.

The simple fact is that there are industries in which there is a substantial amount of discretion, a substantial band of discretion, in which they can set their prices, and in which wages are set. It seems to me that national leadership focused and pointed—not just general statements inveighing against sin but specifically defining sin and identifying the sinners—can move the decisions from the upper end of that band of discretion to the lower end of that band. I submit that in the period before we had excess demand, from 1962 to about 1966, the incomes policy in the United States, the guideposts, had a distinct influence in moderating both wage and price decisions. In this atmosphere when we are moving down from excess demand could again have that same effect.

Senator PROXMIRE. Again, thank you very much for permitting me to go ahead.

Congressman Conable?

Representative CONABLE. Thank you, Mr. Chairman.

I do not want to overdo this talk about an incomes policy, because I still do not understand what we are talking about. I think this uncertainty afflicts many of us.

John Gardner's book "No Easy Victories" (which sounds as though it ought to be a statement by an economist before this committee) includes reference to an anthropologist friend of his who studied the rain dance of some southwestern tribe and said that it did not bring the rain but it made the tribe feel a lot better.

Now, I suppose the function of the President of the United States includes making the tribe feel a lot better. I suspect that the real justification for an incomes policy has got to be the very substantial psychological ingredient which is involved in an economy which apparently on the private sector was frustrating government restraint last year by being expansionary, and is frustrating some government lack of restraint this year by having lost its confidence. Some amount of jawboning may have some impact on the Nation's economic psychology even though we find it difficult to define what that jawboning is going to be.

Would that be important, Dr. Saulnier?

I take it that you are rather jaundiced about jawboning.

Mr. SAULNIER. If jawboning means that the President ought to be talking frankly to the country about what constitutes an appropriate relationship between labor cost increases and productivity gains, then I am in favor of jawboning. If it means some kind of a system of direct controls or some hastily improvised voluntary program, I am against that because I see no real benefit to come from it. But the President has to exert leadership; he has an educational job to do, and I am for his doing that consistently, vigorously, plainly.

Representative CONABLE. You do not send a Dutch boy to do a man's work, but sometimes you do to paint something. [Laughter.]

Mr. SAULNIER. I am getting lost in these Netherlandic figures of speech. But I have written a certain amount of rhetoric on this subject for official publication, and I have seen a good deal of education accomplished over the years.

I recall very well the first economic report I put together which had an extensive discussion in it, of what we needed to have a better relationship between productivity gains and labor cost increases.

I had a delegation come to see me from the Labor Department to tell me that it was bad economics, and, worse than that, that it was bad politics. I told them that they need not bother about the politics, that there were other people around the city who would concern themselves with that, but that it was good economics, and that it was going to stay in the report, as it did.

Now, that is almost 15 years ago now, when you had to argue to win acceptance of the proposition that if you did not have a close relationship between productivity and labor cost increases you could not hope for stable prices.

Now, we have come a long way from that in part because of the presidential messages—and I do not want anything I am saying to derogate or diminish at all the importance of that. In fact, I would like to see it done more vigorously.

Representative CONABLE. Thank you.

I would like to ask all you gentlemen as economists a question about something which is, prehaps, too close to me at this point as a member of the Ways and Means Committee. I am somewhat unhappy, quite unhappy, about a bill that apparently is going to be drafted and presented sometime within the next couple of weeks embarking on a considerably more restrictive trade policy than we have had previously. My concern about it has been primarly economic, because I do not believe that the price relationship of supply and demand is one of the cliches of the past, as it has been called by some people

high in my committee. I wonder if I could have any comment from you about the probable economic implications of a quota system applying not only apparently to textiles and footwear but also legislatively to oil and to a number of products for which quotas might be triggered by the formula which has been reported in the press.

I think the long term economic implications of this, are something that should be of concern to this committee, since we serve as economic advisers to the Congress as a whole and, therefore, I do not feel that I am necessarily out of order in going behind my committee's back, coming over here and asking you to comment about it. Dr. Heller?

Mr. HELLER. Mr. Conable, I would like to say that your question seems to me entirely pertinent and that, indeed, if President Nixon's Regulations and Purchasing Review Board is on the job, is on the stick, it ought to be up there at your committee saying "For heaven's sake, lay off."

In other words, import quotas, any kind of tariff restrictions, and so forth, are precisely the kind of structural moves that are going to complicate and worsen our long term inflationary problem. Let us just start with that.

Secondly, while I am not a knee-jerk freetrader, most of us economists believe strongly in the basic principles of free trade. To start a round of actions of this kind, import quotas, refusal to get rid of the American selling price criterion, and so forth, is a losing game. There is bound to be retaliation. This is going to mean escalation throughout the world in trade restrictions. That, again, is going to mean less efficiency, and we are going to have to pay the costs in higher prices throughout the world.

It is just very unfortunate, thirdly, that the President did not accept the recommendations of the superb report of the committee chaired by former Secretary Shultz on oil import quotas.

It is high time that we led the world in that direction, and yet, fourth, I am very fearful of exactly the thing that you are pointing to. I am very fearful that a combination of (1) old-fashioned restrictionist philosophy, that is, trade restrictionist philosophy, (2) the return of labor union concern over the employment effects of imports (and what the labor unions ought to understand is what is happening to employment is not the result of the incursion of foreign good; it is the result of fiscal and monetary policy), and (3) our concern over the U.S. balance of payments, may constitute a "critical mass" here that will be substantially in the restrictionist direction. I am deeply concerned about that, and I would simply like to underscore my belief that you are on the right track in questioning the Ways and Means Committee action.

Representative CONABLE. I am questioning you about the economic implications of it at this point. I am not, of course, declaring war on my committee. I have regular courses of conduct open to me, as a member of the minority on the committee.

Dr. Saulnier, do you have any comments about this?

Mr. SAULNIER. Just to say I cannot see how the spread of the quota system, or of restrictions on imports of any kind, can have any other result than to make the problem of bringing inflation under control more difficult.

Representative CONABLE. Do you agree with that?

Mr. Solow. That is quite right. Mr. Heller is certainly right, that a move in the protectionist direction by the U.S. will certainly invite retaliation all over the world. There will be no gain to us. There will be gains to some industries offset by losses to others. This is a business in which nobody wins. It will, in fact, make the control of inflation that much more difficult. Discipline, a certain amount of discipline, on the price level, comes from competition, including competition from imported goods, and that is worth something in the fight against inflation.

From the long-term point of view, it can only mean inefficiency in our economy and inefficiency in the world.

Mr. Heller. Mr. Conable, may I just add that, having said this—and you have gotten a unanimous view here from the three panelists—one should go on to be very conscious of the economic impact of an open-door policy on particular industries and their workers and their stockholders.

Representative Conable. Yes.

Mr. Heller. And I used the term in my testimony this morning of public policy insurance, for example, that we ought to take out against the problem of unemployment, who are the victims of inflation.

I think this concept of public policy insurance for people who are harmed by policies that inflict injury on particular industries or particular segments of the economy, in the national interest, I think that concept is a very important one and that we need to do more along that line.

Representative Conable. I quite agree, sir.

My time is up, but I would like to add one thing, that, of course, this unfortunate action has been triggered by acts of other countries which have been discriminatory and unfair, and we have ample justification for moving into a trade war if we want to do it. But the question should not be whether we are justified in doing it but where our national interest lies, and I think, in economic terms, our national interest must be indicated by your answers here today.

Thank you, Mr. Chairman.

Senator Proxmire. Senator Fulbright?

Senator Fulbright. Mr. Chairman, I am sorry I did not get here earlier, though I have read some of the statements.

I do want to compliment Mr. Solow for two things: (1) that he states on the first page that he does not think he knows all the answers, and nobody else does. It is a very unusual statement before any committee, especially for an economist. [Laughter.]

Mr. Heller. That was gratuitous.

Senator Fulbright. I was prompted in that by Mrs. Griffiths.

Mr. Solow. That was also gratuitous.

Senator Fulbright. Next, in your reference to the war. Previous witnesses tended to ignore the war as having any significant effect on our economy and especially inflation. You do take this into account.

I wonder what would be your answer to, say, assuming as a hypothetical—I do not want to get into an argument of whether it will be or will not, but assuming that this war goes on for 3, 4, 5, 10 years, what do you think will be the effect on our economy?

Mr. Solow. One effect on my economy is that no one will be able to teach in a university anymore, and I will have to come down here and look for a job, I am afraid.

Sir, I always feel a little different on this subject, because I do not want to argue or talk as if the economic effects of the war in Asia are its main effects or the important thing about it. They could, in fact, be managed. They won't be managed, but they could, in principle, be managed. I do think that the fundamental economic effect of a continuation of the war over, 3, 4, or 5 or 10 years is a staggering loss of resources to the domestic economy. There is the labor and services and lives of so many people who are spending their time as soldiers instead of workers in the civilian economy. There are the time and effort of so many men and women who spend their time working in defense industries producing bits of metal to be left in Asia and who might instead be producing something more useful at home.

So, the fundamentally important economic effect of the war is simply that so many billions of dollars a year of valuable resources that could be used in reconstructing our own economy or in helping other economies are instead used for destruction.

A secondary effect of the war is that since it is apparently unpopular to finance wars, and most particularly this war, by sufficient taxation, those expenditures will not be properly tax-financed. Thus, whenever the civilian economy is strong, the war will be adding and creating bits and bursts of excess demand and contributing to inflation in that way.

The third effect of the war is the one that I most specifically mentioned in my statement. There is a general feeling that wars are inflationary periods, that wars go along with price increases. Even if they can in major wars, like the Second World War, be held back by rigorous price controls which the public will stand for because the public feels committed to the war, they burst out afterwards, and the aftermath of the war is a burst of inflation.

In this case I think that the link between war and rising prices just gets hardened into the public's mind, and will be that much harder to break.

Senator FULBRIGHT. Of course, I do not think we can really isolate the war, the cost of the war itself, from the overall military expenditures because they feed upon one another. I mean, one reason why the psychology of the Congress is such that they appropriate money for such ridiculous things as ABM's and Cheyenne helicopter that do not work, and the sensors that the Senator from Wisconsin has talked about, is because of the war.

We have spent, according to the Library of Congress, over $1,000 billion on military—direct military—costs, not including such things as veterans. If you include veterans costs and interest on the war debt, and so on, it runs well over that, about $1,200 billion, and this seems to me a terrible drain upon an economy. If this is not stopped, you cannot control inflation. Therefore, the pressure will be greater on quotas, and the pressure is greater all around. This is a kind of catalyst that sparks the other difficulties.

Mr. SOLOW. It is certainly true that the offshore drain through the Vietnam war on the balance of payments is quite considerable. Much pressure on the dollar could be relieved by an end to those expenditures.

Senator FULBRIGHT. But it is all over the world, you see, because of the fever of war, we have three or four hundred installations of more

or less magnitude, I mean, we have people scattered all over the world. Our intelligence gathering is so ridiculous and, of course, it is all secret. It is against the law to tell you about it, to tell anybody else about it, and in fact it is against the law for the Congress to know about it.

It does not appear in any of our appropriations bills. There are appropriations for many of these activities, so it is very secret, and it is kept that way. They have these installations all over the world, all of which are a great drain upon our economy. They all have men, manpower and expenditures in these installations all around the world.

Mr. SOLOW. That certainly is correct.

Senator FULBRIGHT. The reason we cannot control it is the war. It comes back, the war fever, "Well, you are not supporting the boys if you do not support some gathering installation in Africa," which has nothing to do with it, but this is the psychology that results from the war.

Mr. SOLOW. I think there is a good deal of truth in that, but I think I am not prepared to go the whole way with you, sir. We had a large military establishment and a large military budget before the escalation of the war in Vietnam in 1965.

Senator FULBRIGHT. About half of what we have now, approximately.

Mr. SOLOW. That is right. We buy, or presumably we buy something with peacetime military expenditures. I am trying to hold back from letting you call on my convictions and prejudices. I am trying to speak only as an economist. Presumably we buy something; each citizen has to decide, as each Senator and Congressman has to decide, whether we are buying something that is worth the other things that could be produced with those resources.

Now, as a citizen, I believe that with most of it we are not. I believe we are worse off, not better off, because of a large military budget. I do agree with you wholeheartedly that to the extent that we, ourselves, and the world, see us as committed for a very long period of time, to very large military expenditures and to a continuation of the war, then we ourselves, and the rest of the world, will see us as undercommitted to a strong and prosperous and socially cohesive economy at home.

Senator FULBRIGHT. Mr. Heller, perhaps you do not have his opinions. Do you agree with him as to the effect of the war?

Mr. HELLER. Entirely.

Senator FULBRIGHT. You do.

Mr. HELLER. Indeed, I think it is always worth reminding ourselves that the fundamental cause of today's inflation is the war in Vietnam.

Senator FULBRIGHT. A lot of economists do not bother to do that. Some of the people at previous hearings here never even mentioned it at all.

Mr. HELLER. I think one has to go on to say that if we had faced up to the costs of the war more promptly with taxes and tight, tough monetary policy, and so forth, that we would have less inflation. But it is——

Senator FULBRIGHT. We might have had less war if they had to do that, don't you think? [Laughter.]

I think that is the reason they did not do it. They do not want to arouse the opposition which could result from it.

Mr. HELLER. And that goes to the point that Professor Solow is just making, that you are not likely to finance the expenditures of war in a noninflationary way. It also goes, by the way, to part of my testimony which I did not read this morning, namely, that if Congress were to give up a little of its fiscal prerogative—which it is not about to do, I guess—but if it were willing to give some standby authority to the Chief Executive or to a Commission of some kind to cope with inflationary problems, I think we might get more anti-inflationary action. Not just in case of wars but in case of any outburst of inflation we might get action more promptly on the tax side than we do under our present institutions.

Senator FULBRIGHT. I do not know whether this last question—I know my time is about up, and I am curious about it—and if you do not feel that it is a proper question, I hope you will say so, but what do you think is the economic significance of a program like the SST? You are familiar with it, of course.

Is this really a productive, useful addition to our economy or is it not?

Mr. HELLER. The answer, even as a Boeing stockholder is no, it is not, on any rational cost-benefit calculation I've seen.

Senator FULBRIGHT. I did not know you were a Boeing stockholder. This is a matter that is coming up very soon and just wondered do either of you, Mr. Saulnier or others, have any views about that?

Mr. SAULNIER. I would say there is no question but that programs of this kind do have a certain advantage in the promotion of research and development. This is true throughout the military system, it is true of all kinds of developmental work, of course.

On the other hand, if you ask me where I would put such a program in my scale of priorities at this time——

Senator FULBRIGHT. That is really what I had in mind.

Mr. SAULNIER (continuing). It would not be at the top, Senator. [Laughter.]

Senator FULBRIGHT. That is what I had in mind.

Well, my time is up. Did you wish to say anything?

Mr. SOLOW. I know of no careful analysis of the SST that suggests that it is a sensible use of these funds.

Senator FULBRIGHT. All right.

Mr. HELLER. Senator, may I add that the answer I gave you is one that I have been giving ever since 1962 when I sat on Vice President Johnson's Committee on the SST.

Senator FULBRIGHT. I did not realize that you had that background. I read in the paper, as you know, that we are going to vote on it soon—and I wondered what you gentlemen thought.

Thank you, Mr. Chairman.

Senator PROXMIRE. It is good to get that view from a Boeing stockholder. If you are not unique you are one of the few.

Senator FULBRIGHT. The stock is down a little these days.

Mr. HELLER. That is another painful aspect of my position as a Boeing stockholder.

Senator PROXMIRE. Congresswoman Griffiths?

Representative GRIFFITHS. I, too, sit on the Ways and Means Committee and worry about a trade bill.

Our review in that committee shows that what we are really exporting are the simple jobs.

Senator PROXMIRE. Could I just interrupt to say that Dr. Saulnier is going to have to leave in a few minutes, and he will be excused when he feels he has to go. We just wanted to alert the committee to that.

Representative GRIFFITHS. May I ask, in view of the fact that we have a few million simple, untrained people ourselves who need jobs, what do you propose that we give those people for jobs?

Mr. HELLER. I gather you are addressing that question to me?

Representative GRIFFITHS. To any of you, and to all of you. I would be glad to hear it.

Mr. HELLER. Let me say just two things.

Representative GRIFFITHS. Because I just think it is not an easy answer.

Mr. HELLER. It is not. That is why I added the postscript in the answer to Mr. Conable about what I would call taking out the public policy insurance needed to take care of the victims of various public policies that focus their penalties on a particular group in the economy.

In the industries that are hurt by liberalization of policy in this field or by the maintenance of a current liberal policy. I think we have to have very generous adjustment payments, and so forth.

As far as the broader question which, I believe, you are raising at the end of your inquiry, the broader question of the millions of undertrained and in many cases, hard core unemployed, that is an area in which, in particular, in the light of our war on inflation we should have been taking out this public policy insurance. We should have moved promptly and quickly to broaden and deepen unemployment insurance, to greatly broaden training and retraining programs, to put something like the family assistance program into effect and, finally—the missing link in the Nixon program—to have put some kind of Government employment of last resort or public service employment, into effect at least on a temporary basis for the people who came off the end of the assembly line of training or retraining.

I think we have fallen down very badly on this front.

Representative GRIFFITHS. Would you suggest public works or some such thing as a last resort?

Mr. HELLER. Well, if by public works you mean what I just described as public service employment——

Representative GRIFFITHS. Yes.

Mr. HELLER (continuing). Of last resort or, for that matter, the use of Government subsidies to maintain temporary employment (and this is a much tougher kind of thing) in the private sector, I would say, yes.

I am not thinking of huge public works projects like the 1930's when we had the WPA, and so forth, but many of those programs in the 1930's were lifesavers for the individuals involved.

Representative GRIFFITHS. It seems to me——

Mr. HELLER. There are lots of jobs—excuse me—I was just going to say there are lots of jobs in being that need to be done that are not being done, and that are economically efficient to do. It seems to me that we could set up a program of public service jobs without mounting a vast new public works program.

Representative GRIFFITHS. One of the things that I have always felt is that we do not really spend much time on exporting.

The American market is so large, so good, that those who sell in that market just do not have time enough and energy enough to worry about exporting.

Now, there is to be an incentive for this. For a $600 million tax cut, Mr. Woodworth says we will get about a $300 million increase in exports. Do you think that is a good bargain or not?

Mr. HELLER. For a $600——

Representative GRIFFITHS. $600 million annual tax cut.

Mr. HELLER. That is in the form of an incentive for exporting we only get $300 million?

Representative GRIFFITHS. Yes.

Mr. HELLER. Well, I guess I just have to use arithmetic and not economics to say that is not much of a bargain.

Mr. SAULNIER. I would have to study this arithmetic, but I would be rather skeptical of it.

Representative GRIFFITHS. Let me say the proponents, the administration in proposing it, say we will get billions addition in export. Woodworth said, and Houthakker has stated, that the elasticity of price that will result is about one and a half to one.

Mr. SAULNIER. Well, Western Europe today is swept by a capital goods boom, and as part of that we have had a very strong demand for exports, particularly metals. Steel industry exports, for example, have been phenomenally high in this period.

Now, I will make a forecast. You are going to see in 1971 not only a substantially lower rate of expansion of physical output in Western Europe but, quite possibly, a drop, and in that context I think we have to contemplate a distinct drop in the demand for U.S. exports.

Tax abatement, tax assistance, may help to cushion that, but there is a drop in the making. That is a forecast, and it may prove to be wrong, but I think the probability of its being right is very high.

If I were in the export business this is what I would be concerned about. And let me say that this prospect, this prospect of a decline in economic activity in Western Europe, is traceable to the fact that Europe is swept today by an inflation of wages and prices, especially of wages, which governments at some point are going to have to resist, just as we are resisting them here in this country. And once they start resisting them—and it has begun already—there is going to be what Professor Heller correctly called an engineered slowdown.

Now, that is the prospect I see. For some years, as I have seen the inflationary momentum building up in the United States, I have said before this committee and elsewhere "Let us be careful we do not push our luck too hard. Aggregate demand is being pushed too hard, and this is going to start an inflationary process in the economy. And once it gets started it is going to be very, very hard to stop. What is more, when you try to stop it it is going to involve unemployment."

But people did not want to listen to that when there was an opportunity to do something about it anymore, Senator Fulbright, than people wanted to listen when it was possible to do something about financing the Vietnam war on a noninflationary basis.

I do not agree with those who say that we have an inflation because we are in the Vietnam war. I would modify that to say we have got an inflation because we are in a war that we are unprepared to finance in a noninflationary way, and I have said, when I have been con-

fronted with this fact, to my friends in Government, in the previous administration as well as this one, "If that is the kind of a war we have, we had better get out of it because it is going to sweep the country with inflation, and unless we stop it everybody is going to suffer in a very cruel way."

Representative GRIFFITHS. If you estimate that there will be a lessening of our exports——

Mr. SAULNIER. Yes, right.

Representative GRIFFITHS (continuing). Do you also anticipate that we will buy less abroad or do you anticipate a wider balance of payments problem?

Mr. SAULNIER. Well, what may happen, Mrs. Griffiths, is this: There will be a lessening of demand for our exports, a flattening of our imports, and a narrowing of our present trade surplus. Indeed, we may go back to the point where we have no trade surplus at all.

Representative GRIFFITHS. Yes, it cannot narrow much more.

Mr. SAULNIER. It cannot narrow much more without disappearing, that is correct. As you see, I am not one of the country's outstanding optimists on the subject of the balance of payments and the position of the dollar in the world.

Representative GRIFFITHS. Thank you, Mr. Chairman.

Senator PROXMIRE. Dr. Saulnier, I know you have to go soon. Let me ask you this: I take it you place some reliance on the President's announced program to counter inflation with a productivity commission and inflation alert.

I am skeptical, and I am inclined to buy the characterization offered by Professor Solow who likened it to his sales pitch when he was a boy, "You don't want to buy a Saturday Evening Post, do you?" And not selling many Saturday Evening Posts that way; and an inflation alert which he said has all the potential for getting action of a weather report that last Thursday it rained.

As one who has indicated some support for this, what is your answer to that?

Mr. SAULNIER. I would say, Mr. Chairman, that the portion of that program that seems to me the most promising is the one that got the least attention in press reports, and that is the committee to oversee Federal programs that affect inflation, of which the quotas that Congressman Conable has referred to are an example.

Senator PROXMIRE. Well, now, on that point, I always thought that was the Procurement Commission, and we have been trying to get the Council of Economic Advisors under the Johnson administration—this was after Dr. Heller left and under the Nixon administration to tell us the impact of the Vietnam war on inflation and the impact of military spending on inflation.

Here is the biggest procurement element that you have, about $40 billion of military procurement, and they won't tell us that.

Mr. SAULNIER. The impact is not merely in the amount of money that is spent.

Senator PROXMIRE. Well, yes, exactly.

Mr. SAULNIER. There is impact also in the fact that here you have contracts being let in which, for the buyer, the question as to whether you make a profit is not a consideration, and properly not. The job of the procurement officer is to get the stuff fast, though at the best price he can obtain.

The contractor, on the other hand is anxious to deliver as promptly as possible, so he pays wages and pays prices for supplies that are often a bit above the market. In this way he begins to set the pace of inflationary wage and price increases.

Senator PROXMIRE. It seems to me—go ahead, I am sorry.

Mr. SAULNIER. Somebody has got to ring the gong on this, believe me, and hard.

I was chairman when I was here of a special Cabinet Committee on Governmental Activities Affecting Costs and Prices. Unfortunately, it was one of the least effective ventures in Government in that period.

Senator PROXMIRE. It was the least effective, and now you think it will be the most effective of what the President has proposed?

Mr. SAULNIER. It will be if it gets the kind of support it needs.

Let me be quite specific. The difficulty of bringing the wage problem, the wage inflation problem, under control is multiplied if the Labor Department is going to be setting floors for minimum wages—floors which, incidentally, are well above the statutory minimum wage rate—that are on the front edge of the inflationary trend. They set minimum rates for construction workers, say, in Portsmouth, N.H., or Seattle, and typically they set them at or a bit above the market in that area.

This is the Walsh-Healy, Davis-Bacon problem, and we have been living with it now for many years.

When I tried to do something about it I was to all intents and purposes locked out of the Labor Department.

Now, somebody has got to open the door, and somebody has got to say—"this process of setting wage floors is going to be done in a manner that does not exacerbate inflation." I do not say you can solve the whole inflation problem by a proper management of Federal programs. But you can have a significant impact on it.

Senator PROXMIRE. This committee had asked Secretary Shultz, when he was Secretary of Labor, to give us these facts. We told him we wanted to have them. We did not ask for any specific action following it, but we wanted the information, we wanted to know how inflationary these Federal labor policies were.

But in addition to that, it would seem to me that the one clear action Congress can take is to cut military spending, military procurement, cut the amount; No. 2, insist on more competitive procurement. Now only 11 percent of it is competitive procurement.

And to crack down hard on the kind of sweetheart contracts that we have so frequently in our procurement.

Mr. SAULNIER. The only reservation I would have about that ——

Senator PROXMIRE. At any rate, the administration has opposed us on all these things.

Mr. SAULNIER. The only reservation I would have about that statement is this—it is not really a reservation, but an amendment, Mr. Chairman—is that I am as anxious as anybody else to get military spending down, whether or not it is spending for Vietnam, but as an economist I have to take the military programs as given. That is not an economic question. What is an economic question is: Given a volume of military expenditures, how are you going to pay for them.

Senator PROXMIRE. However, this is the one part of the President's program in which you seem to place some reliance. I take it, that you

also do not feel that the President's Productivity Commission and inflation alert, are of great substance in fighting inflation?

Mr. SAULNIER. I believe, as I have indicated in my statement, Mr. Chairman, that the way to do this, first, is to work on the budget; and, second——

Senator PROXMIRE. How do you work on it?

Mr. SAULNIER. How do you work on it?

Senator PROXMIRE. How do you work on it?

Mr. SAULNIER. Right here in the Congress.

Senator PROXMIRE. Where do you cut—where do you cut spending, where do you cut it? You have passed up military spending. You say the SST is not your top priority—well, you said that is beyond you as an economist.

Mr. SAULNIER. No.

Senator PROXMIRE. You feel that military spending is a given——

Mr. SAULNIER. No; I have not passed up military spending. That is the business of the military committees of the Congress. I gave you one example of how to cut expenditures.

Senator PROXMIRE. You are a citizen of the United States, you outrank us. We are your servants here in Congress. [Laughter.]

Mr. SAULNIER. I gave you one example—it is a small one, the Post Office. Now, it just strikes me——

Senator PROXMIRE. That is the trouble, it is a small one. We would like you to tell us where the big ones are.

Mr. SAULNIER. Well, $1.7 billion is still a substantial amount of money in the United States of America.

What I can claim for it is that it would make a beginning.

Senator PROXMIRE. Well, it is almost as big as the over-run on the C–5A, one weapons system. That is how big it is.

Mr. SAULNIER. Well, if we take a defeatist attitude toward these things, nothing can be done.

Senator PROXMIRE. No, no; I do not mean to demean it at all. I think it is a good suggestion.

Mr. SAULNIER. I think these are dreadful consequences if spending is not brought under better control.

Senator PROXMIRE. Dr. Heller, you made a very eloquent attack, I thought, on the unemployment and what a sad human effect it has, as well as what a serious economic loss it constitutes.

You also indicated that you favored the family assistance program, some form of guaranteed income, perhaps, improved unemployment compensation.

How about the Government as an employer of last resort? This seems to be a kind of thing that more people, in my view, would be willing to buy. They do not like the notion of people getting something for nothing.

At the same time most people feel if a person is willing to work he ought to have a chance to have a job, and if he cannot get a job in the private sector, the Federal Government should have some responsibility for seeing that he can get it.

Mr. HELLER. The way Cal Coolidge put it, for a man to have a job someone has to hire him. This is one of his several rather profound observations on the employment problem. [Laughter.]

It has a certain lesson for us.

When all is said and done on all the other programs, someone has to hire that man who has been knocked out of a job elsewhere or never had a job or is coming off the end of the line in a training program. When we have programs that consciously knock people out of jobs as part of our battle against inflation, I think the Government has a very great responsibility to avoid both the social and the individual tensions and pains that arise from that.

Now, I do not mean to suggest that you should, on the one hand, through restrictive policy take purchasing power away, on the other hand inject it back in in the same degree. One would have to match these programs with some corresponding fiscal restrictions, some additional taxation, but certainly it is far better, far easier, it takes far less fiscal commitment to set up a series of programs for Government service jobs or Government jobs of last resort than to try to reemploy these people by a general injection of purchasing power into the economy by general fiscal and monetary policy.

So that as part of a balanced stabilization policy, Government employment of last resort is an absolute essential.

Mr. SOLOW. Mr. Chairman, could I just support that view? It does seem to me to be a terribly sensible thing to try. There are a lot of jobs that need doing locally in nonprofit organizations of one kind or another which are dignified, not make-work, not a degrading sort of labor, and which do not require very much in the way of skills. It seems to me it would be clearly in the public good to employ these people, those citizens who want to work, but simply are not able to find employment in the private economy.

Now, there will be effects of this beyond simple employment. For example, if there were such a public employment or public service program, presumably it would pay at least the statutory minimum wage. There are a number of people in our economy who work at less than the statutory minimum wage, and presumably the opening up of this sort of public service program would attract people out of the 75-cents-an-hour job that some of them still do. The price of a cheap hamburger might go up a little bit.

I think this is a price that the public ought to be willing to pay. But it is a complicated thing. I think it clearly is worth doing.

What I would plead for is to try it, to try it as an experiment. Not every such program, I would suppose, has to be started at what would be its ultimate scale if it were a roaring success, but it might be possible on a small scale in a couple of localities to try such a thing and see how it works out.

Senator PROXMIRE. You are thinking in terms of places like Seattle and other places where you have very, very heavy unemployment now?

Mr. SOLOW. I think that two things need to be considered: The amount of unemployment and the character of the unemployment. There is some good, but not as much good, in providing a job at the statutory minimum wage for a $6 or $7 an hour machinist who is out of work in Seattle. The sort of job that could be provided under a program like this is more suitable for the unskilled unemployed persons.

So it is both the amount of unemployment in the community and the character of unemployment.

Senator PROXMIRE. It does not mean you could not do this because the ripple effect, the multiplier effect out there, it is true the machinist

is out of work, but the people who service and supply him lose their jobs, too.

Mr. SOLOW. That is quite right. Such a job would be more likely to be taken by some other member of the machinist's family than the machinist himself. But even that would have the kind of multiplier effect you are talking about.

Mr. HELLER. I have a very personal example in Wisconsin, a Milwaukee example, Senator Proxmire. It suggests that this would not necessarily have to be limited to the lowest skill brackets. The example is that of my father in the great depression of the 1930's. He worked for A. O. Smith Corp. as a civil engineer in the depths of the depression, and A. O. Smith had to lay off its civil engineers.

He was employed for a while under the FERA program, Federal Emergency Relief Act, designing plans for an expansion of Milwaukee excellent sewage control plant. He was one of the early fighters in the war on pollution. In other words, here was a man whose capabilities might have had to run to waste for a year during the layoff. You could call it a Government program of employment of last resort. It meant a great deal not only to our family, and I feel that it meant something to the city of Milwaukee and to the country in terms of not letting those resources run to waste.

Senator PROXMIRE. Congressman Conable?

Representative CONABLE. Thank you, Mr. Chairman.

I think it would be difficult to design such a program in a way that you could keep politics out of it, but perhaps politics is not the worst thing in the world that can happen.

Dr. Heller, I do have a question of you. You talked about loss a lot in terms of our expected gross national product, and it was somewhat reminescent of Secretary McNamara who used to talk about great Defense savings by estimating the cost of things low, thus setting the basis for a splendid investigation by this committee over a long period of time of the ultimate cost overruns, and that, incidentally, is only part of the picture. If we are not growing as fast as someone thinks we should grow, I don't feel that necessarily constitutes a loss.

I will acknowledge I may be oversimplifying a little, but I would like to ask you if price stability is not a worthy goal?

I noticed you mentioned at one point a settlement, a wage settlement, that you said was a peace at any price level, and I am sure you are not advocating growth at any price level. I just wonder if a greater price stability than we have had over the past 4 years is not a worthy objective?

What programs would you have implemented in 1969 if you had been the philosopher king back of the decisionmakers or if you were the decisionmaker yourself, to prevent growth in the actual potential gross national product gap that you were mentioning, and promote price stability at the same time?

Mr. HELLER. Well, that is an entirely fair, even though extremely tough, question.

The point is to get the best possible bargain, the best possible tradeoff that you can——

Representative CONABLE. Balance is the word, is it not?

Mr. HELLER. Yes; balance between the loss in jobs and output, on the one hand, and progress in the battle against inflation, on the other.

I have also said a number of times that no administration—a Humphrey administration for example could not have avoided tight monetary and tight fiscal policy in the battle against inflation, could not have avoided cutting down aggregate demand. Unfortunately, when you have gotten into as overheated a situation as this economy has gotten into, and when you had underestimated the power and extent of inflation in 1968, and again unfortunately in 1969, there is no way you could do this job without some pain.

But what I am suggesting is that, first of all, we could have had a better policy mix, a considerably less painful experience for small business, for housing, for State and local governments, if we had relied more heavily on fiscal policy and less on this brutally tight money.

Second, I surely would not have abandoned the attempt to maintain some moral restraint on wages and prices as the President did in his very first press conference. I thought it was gratuitous of him to say in effect, "Fellows, we are not going to, you know, touch a hair on the head of your private wage and price decisions."

I would, in other words, have installed as quickly as possible a meaningful incomes policy, recognizing that side by side with that meaningful incomes policy you had to have this tough fiscal and monetary policy to remove excess demand.

Third, I would have put into place—and again this is something I said well over a year ago, not by 20/20 hindsight—the so-called landing nets or public policy insurance to protect the victims of the battle against inflation, namely, the people who are knocked out of jobs, against some of the worst consequences of that, so that we could have pressed the battle against inflation harder with less cost.

The whole idea that an economist works by is to improve the benefit-cost ratio. I am talking about how we might have increased the benefits in damping down inflation more rapidly, on the one hand, and reduced human costs, on the other, by putting in these programs that would have enabled us to press harder on the aggregate demand side because we were protecting the people who were being knocked off the employment ladder in the process of fighting inflation.

Representative CONABLE. By that I assume you mean you would have supported the Nixon welfare reform program?

Mr. HELLER. Yes, I would have.

Representative CONABLE. And the Nixon unemployment insurance program more readily than Congress seems to have done?

Mr. HELLER. And the training and retraining program, and I certainly would have mounted them before August of 1969. It seems to me——

Representative CONABLE. It has not passed yet in the Congress.

Mr. HELLER. No, but had the Nixon administration properly assessed the severity of the inflation problem I think they might have gotten going a good deal sooner on these programs.

You asked me what I would have recommended as philosopher-king. Well, that is the kind of thing.

Finally, this whole series of long-range programs to increase productivity, to stop some of the Government's price-raising and price-propping operations, including such sensitive areas as fair trade——

Representative CONABLE. Agriculture.

Mr. HELLER. Agricultural subsidies, and so on, and so on, one should have gotten going on that. These are terribly sensitive areas. They step on tremendously sensitive political toes, but that is the kind of program we have got to come to if we want to strike a reasonable balance between full employment and price stability in the long run.

Representative CONABLE. You note the danger that we have an unreasonably restrictive Federal budget, and you have pointed to the full employment budget as an example of what might happen next year.

Haven't we learned that we just cannot take potential growth in revenue for granted? I am referring, for instance, to the tax reform bill which has robbed us of a substantial part of our revenue growth. We have had a remarkably large growth in our Federal nondefense expenditures over the last couple of years. Between fiscal 1969, and 1971 the figures show somewhere around $25 billion in nondefense growth as compared to a shrinkage of $6.5 billion in military expenditures.

Well, I am just wondering if you are not overestimating the danger of an unnecessarily restrictive fiscal policy in the light of these facts?

Mr. HELLER. Well, your concern is one that I share. It goes, in the last analysis, to the proposition that we are not taxing ourselves heavily enough for the long run; that even with the fiscal dividend in the gross sense of $15 billion to $16 billion a year of automatic growth in Federal revenues (with a normal 4.3 percent grown in the economy in real terms) even with that, the claims against that $15 billion to $16 billion are so enormous——

Representative CONABLE. As a member of the Ways and Means Committee, I shouldn't have asked you such a leading question, should I?

Mr. HELLER. That is about right—that in the longer pull I just think we are going to have to face up to it and raise taxes.

You know, people forget. People forget that we cut taxes 20 percent; that their liability in 1970, beginning July 1 with the removal of the surtax, is 20 percent below what it would have been under the rates of 1960. While that tax cut was absolutely the right thing to do at the time, we ought to accept the other side of the coin and be prepared to increase taxes over the longer pull to meet these needs that you are talking about.

Representative CONABLE. I will mention it to my colleagues. [Laughter.]

Mr. HELLER. They will be overjoyed.

Representative CONABLE. That is all, Mr. Chairman. Thank you.

Senator PROXMIRE. I just have a couple of more quick questions. I want to apologize to you gentlemen for having to detain you as long as we have, but this is a very fine panel, as I said before, one of the best that I have had a chance to hear in the time I have been on the committee.

Nobody has asked you, and I think we should ask, about a very important question because it is going to come before the Congress.

I have heard rumors that the Defense Production Act, which I am very happy to say was my bill, and passed the Senate the other day, and had some reforms for defense procurement, that it may be the vehicle for an effort in the House to attach overall comprehensive price and wage controls on a standby basis for the President.

Now, under present circumstances, Dr. Heller and Dr. Solow, do you think it would be wise for the Congress to adopt a standby wage-price control program of this kind?

Mr. HELLER. I will be happy to comment, but I have been rather vocal. Let me defer for a moment to Mr. Solow.

Senator PROXMIRE. Dr. Solow?

Mr. SOLOW. I like to listen to Walter, so I do not feel put upon at all.

Senator PROXMIRE. We all love to listen to you.

Mr. SOLOW. I don't think it is a matter of great importance, and I have two doubts about the wisdom of adding a standby comprehensive price and wage control amendment to the act.

First of all, the President has made it perfectly clear that he won't use it; it therefore, stands as a gesture and I am not much in favor of gestures.

But the second reason is that I do not think that comprehensive wage and price controls are what we need or want or are likely to need or want absent some genuine emergency in the society and the economy which does not now seem to be there.

Wage and price controls were useful things, indeed necessary things, from 1941 or 1942 to 1945. They came in the Korean war a little after the horse had left the barn. You can invoke controls at a time when the society is united in agreeing that there exists an emergency of such magnitude that the inevitable irritations, inequities, bureaucratic interferences here and there, simply must be taken by everybody for the greater good. Should such an occasion arise, the Congress could step in instantly and pass whatever legislation was necessary.

Senator PROXMIRE. The trouble is, though—let me just interrupt to say—the Vietnam war has been dragging on and on and, as Senator Fulbright indicated, it may go on another 3, 4, 5, 10 years, and it is hard to know when to move in, and when Congress begins debate of price and wage controls at a time when they seem imminent, then it could have a perverse effect. Everybody pushes up their wages and prices so they get in before the rush.

Mr. SOLOW. Indeed, that is what happened at the beginning of the Korean war. But in a rather peculiar way—not so much while the Congress was debating the Defense Production Act of 1950, but because the Congress voted a standby sort of thing that the President himself had to call into effect, and President Truman delayed until some time in 1950–51, and everybody, with the Second World War fresh in his memory, was buying sugar and pushing up prices and getting ready to have the ceiling come into effect.

I am afraid, having such a law sitting on the books now might have the same effect. People might keep looking off to the horizon for anything that might induce the President to invoke the controls. They might be inclined to push up prices just in case.

When an emergency does appear of the kind that would convince the public and everyone that wage and price controls are needed, then I think that the Congress could act very quickly, and not delay.

Senator PROXMIRE. The proposed law would enable the President to push back prices to the level they were on May 27, I believe.

Mr. SOLOW. I think that is a terribly difficult thing to do, always a terribly difficult thing to do.

Senator PROXMIRE. Dr. Heller?

Mr. HELLER. Well, Senator, I do not accept the first reason that Bob Solow just mentioned, namely, that you should not even force on a President something he does not want. Did I overstate that?

Mr. SOLOW. Yes; I did not quite say that, but go ahead, Walter, I said I love to hear you talk. [Laughter.]

Senator PROXMIRE. That is the acid test.

Mr. HELLER. Because I think——

Senator PROXMIRE. It is the acid test because he is talking "agin" you.

Mr. HELLER. First of all, I think it was a good idea to put on the books the standby selective credit control power in spite of the President's reluctance or opposition.

Second, I think it would be good, as I implied earlier, to put on the books some sort of standby Presidential temporary tax increase and tax-cutting power whether Mr. Nixon wants it or not, because I think it is an essential part of a long-term policy arsenal for a balanced fiscal monetary policy. So I do not regard that first reason as at all conclusive.

I have more sympathy for the things he was saying under his second heading because I, too, regard wage and price controls of a mandatory type as an absolute last resort, sort of a confession of bankruptcy of our anti-inflationary policy side by side with a high-employment high-growth policy.

Yet at the same time I am strongly impressed with the problems of the delays that occur when there is a need for controls. Let me repeat that my concept of a need for those price-wage controls is one of a very serious kind of involvement in a war, crisis, and so forth. But it is quite true that the ability to invoke those in a hurry, just as the ability to invoke selective credit controls in a hurry or a temporary tax change in a hurry, is worth quite a lot.

So I have rather more mixed feelings about it than Bob Solow does.

Senator PROXMIRE. How about credit controls? You spoke favorably of the action by Congress in putting them into effect. You have also spoken about the housing, serious housing problem we have, and the heart of that seems to be the unavailability of mortgage money, unavailability of capital.

Do you think those credit controls should be used now and, if so, how?

Mr. HELLER. No; I do not think they should be invoked now. I think we missed the period this time. They should have been invoked in 1969 at the height of the inflation. I think we have come to a turn.

Senator PROXMIRE. What are you going to do about housing; how are you going to get money into housing?

Mr. HELLER. I could not agree with you more that we have to find some way better to insulate housing from this cruel impact of our stabilization policy and, particularly, obviously our tight money policy.

There are several ways to do it for the longer run. One is to rely more on fiscal policy, to come back to that unpopular proposition, for more taxes.

Senator PROXMIRE. But this has dragged on and on and on. We have had——

Mr. HELLER. Right.

Senator PROXMIRE (continuing). Housing going from bad to worse. We are now at about a 1.3 million housing starts a year, which is completely unacceptable. We have a depression in the industry, 11 percent unemployment among construction workers, and all we can talk about are long-range solutions.

We have an emergency mortgage credit bill that we are working on, we are having a conference again on Tuesday, and we hope to report that out, and it will help a little in the subsidized area.

But that only helps in about one-quarter to one-third of the total area of housing construction. The rest of housing, conventional housing, depends on what the interest rate for mortgages is, and it is now at a 9-percent rate, and it is so sluggish there is not much indication that it is going to go down. What do we do about it?

Mr. HELLER. Well, for the moment I would say that the kind of monetary policy that I have strongly urged here this morning would do a very considerable amount to relieve the pressures on housing.

For the longer run, I think we have to erect some kind of a system, perhaps, of subsidized interest rates and perhaps also a housing development bank, if you will, that would keep interest rates low, particularly for the lower-income groups one might even have a sliding scale, Senator, moving from, say, a ceiling of 4 percent on mortgage money for people with less than $5,000 a year income to market rates for people with say, $12,000 or perhaps $15,000 of income?

Senator PROXMIRE. Why not coordinate it with monetary policy by giving the Federal Reserve Board the authority to buy some housing obligations? Governor Brimmer has suggested something like this, and I know the economists do not seem to like it. The Federal Reserve, the rest of the Federal Reserve, is very unhappy, indeed, but this would permit a coordinated policy and a direct way of giving monetary policy more strength and muscle.

Now, I think it is seriously inhibited because of what it does to housing.

Mr. HELLER. I would rather build in some other safeguards for the housing market than leaving it in the hands of the Federal Reserve.

Senator PROXMIRE. It was not done very well in the hands of Congress.

Mr. HELLER. A program of this type, that is, with some ceilings on interest rates particularly for the less able to pay, combined with an additional institution to help maintain a flow of money into housing, would keep housing from bearing the full brunt of anti-inflationary policy.

It also would put Congress right up against the gun of tougher tax action.

Senator PROXMIRE. Well, gentlemen, again I want to thank you very, very much. It has been highly stimulating. We are very grateful to you.

The committee will stand adjourned until 10 o'clock tomorrow morning when we will hear from Senator Javits and Congressman Boggs, and Senator Sparkman will chair the committee.

(Whereupon, at 12:35 p.m., the committee was adjourned, to reconvene, at 10 a.m., Friday, July 17, 1970.)

49-774—70—pt. 2——12

APPENDIX

(The following additional questions posed by Chairman Patman and answers thereto were subsequently supplied for the record by Mr. Saulnier:)

Question 1. The recent bankruptcy of the $7 billion Pennsylvania Railroad and the reported high liquidity problems of many other businesses raises a serious question of whether we should have a special way of providing financial help to businesses that find themselves in trouble by reason of tight money, whether or not these businesses are big or small. I have in mind something generally similar to the old Reconstruction Finance Corporation but not necessarily like it; an institution that would if credit is not available locally through financial institutions be able to extend help in the form of loans at reasonable rates of interest. Is it your opinion that we should have such a Federal National Development Bank, or similar institution?

Answer. I have been troubled for more than a year by the phenomenally rapid increase of commercial paper and it has been obvious to me all along that special standby arrangements should be designed to take care of a contingency which I hoped would not happen—that is, inability of issuers to roll over large amounts of outstanding paper—but which all the same was a possibility. It is not at all clear to me, however, that another RFC is the answer; nor am I sure that "Federal National Development Bank" correctly describes what is needed. What is necessary is that the Federal Reserve System should see to it that a shift of financing from the commercial paper market to the commercial banking system, insofar as a shift is needed, takes place without disruptive incidents. There are inflationary risks involved, but they are not as great as the risks entailed by failure to act at all, or by complete reliance on the Federal Reserve Banks to absorb the paper.

Accordingly, my suggestion is that the Federal Reserve System should (i) make a careful survey of issuers and holders, if such a survey has not already been made; (ii) prepare a standby clearinghouse arrangement in each Federal Reserve Bank to assure that commercial bank credits are available if needed by commercial paper issuers unable to obtain a renewal of financing in the commercial paper market; and (iii) stand ready to assist the commercial banks to absorb the needed additional financing. As a last resort, it may be necessary to (iv) activate a program along the lines of 13(b), although I hope its use would be held to an absolute minimum.

Question 2. Is it your view that interest rates at the present time are too high? If so, what are your recommendations to lower these rates?

Answer. Naturally, along with everyone, I would prefer to see interest rates lower, but they are at their present levels because of inflation and the only way to get them down on a constructive and lasting basis is to reduce the inflation rate.

Question 3. Our housing industry is in a serious state of depression and we are falling for short of our housing goals—goals that a few years ago were set forth as fundamental to our national interest. Under present interest rates, a person who buys a $20,000 home with a traditional mortgage term of 30 years under present rates of interest would be compelled to pay not only the $20,000 for the home but $38,000 for the interest, a total of $58,000. It has been proposed that in order to channel more vitally needed funds into housing, some provision be made for utilizing pension funds. I have introduced a proposal in the Congress that would require them to invest a small percentage of their assets in a public bank which in turn would be able to make housing loans. What is your opinion of some such means of using pension funds?

Answer. I had occasion recently to write a paper on ways to maintain an adequate flow of funds into home mortgage markets and I attach a copy as it was published, in slightly abbreviated form.[1] I think it answers fully your question 3.

Question 4. Under present law, Delaware corporations are able to participate in far-reaching mergers and formation of conglomerates and to get around State laws on such questions as branch banking and other reasonable limitations. Should not the Congress take some action to restrict the power of such corporations in order to bring them more in conformity with the laws of the States in which they operate?

Answer. Because this question may come before the Presidential Commission on Financial Structure and Regulation, of which I am a member, it would be premature, I think, for me to comment on it publicly at this time.

Question 5. Unemployments already too high and is in danger of increasing further. Millions of people have been thrown out of work. What in your opinion should be done to alleviate unemployment?

Answer. Although question 5 states that "million of people have been thrown out of work" in the current downturn, the most recent Census Bureau figures show an increase of 426,000 in civilian employment between June 1969 and June 1970. To be sure, unemployment has been rising, but not so much because people are being thrown out of work and are unable to find new jobs as because the numbers entering the labor force are in excess of the increase in jobs. To reduce unemployment, I would rely more heavily on training programs to equip people for jobs currently available but not being filled, of which apparently there are large numbers. Beyond that, it may well be desirable for the Federal Government to launch a program of last-resort employment on useful public undertakings.

Question 6. What should be done about the trend toward forming one bank holding companies? Do you believe that this should be restrained? In view of the fact that banks are franchised by public authority to carry out monetary functions that are basic legislative powers, should they not be required to stay exclusively in the banking business and not be permitted to engage in other forms of business and in effect go into competition with their own depositors?

Answer. Because this question may come before the Presidential Commission on Financial Structure and Regulation, of whch I am a member, it would be premature, I think, for me to comment on it publicly at this time.

Question 7. What do you believe to be the best course of action to deal with the inflation that now afflicts our economy so badly?

Answer. I believe you will find my July 16, 1970, testimony before the Joint Economic Committee adequately states my views on how to overcome inflation.

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[1] See pp. 353–354 for paper referred to.

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MAINTAINING AN ADEQUATE FLOW OF FUNDS INTO HOME MORTGAGE MARKETS

by Raymond J. Saulnier, Professor of Economics
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There has been much discussion recently of what might be done to moderate the impact of tight money on the home mortgage market. A more useful approach to housing problems might be to consider what is needed to maintain at all times an adequate flow of funds into home mortgage markets.

The following ten suggestions are offered as an answer to this more basic question.

1) Overcoming Inflationary Expectations

The absolutely essential element in any program for assisting the home mortgage market on a constructive and lasting basis must be to overcome inflationary expectations. So long as inflation persists, one can only improvise solutions to a continuing shortage of funds for home financing. There are improvisations that will help, even where inflationary expectations persist, but it has to be a losing battle until the struggle against inflation has been won.

2) A Federal Budget Surplus

Next, an anti-inflation policy designed to avoid a harsh impact on the home mortgage market must rely heavily on fiscal restraint. Present policies are having an adverse effect on housing primarily because they rely too much on high interest rates. What is needed is a large budget surplus. Given that, the problem of helping the homebuilding industry would to all intents and purposes be solved.

3) Incentives to Increase Private Savings

Just as saving by the federal government through a budget surplus would help the mortgage market, so would an increase in personal savings. And there are things that could be done to accomplish this, beginning with the tax system. One of the anomalies of federal tax arrangements is that they encourage borrowing for home purchases but do nothing to promote the thrift that is essential if credit is to be made available on a noninflationary basis. Actually, by tightening the rules on taxation of interest income, practices in recent years have moved in the opposite direction.

A powerful stimulus could be given to saving by extending tax exemption to income earned on thrift accounts, subject to a reasonable upper limit. In my judgment there is an urgent need for such a move. Tax deferral would be a lesser but important incentive. Restricted withdrawal savings accounts already enjoy this privilege, but these accounts would almost certainly be more widely used in thrift institutions if the funds could be invested in equities. Although this would draw financing into the homebuilding market only to the extent that the funds were invested in real estate equities, the availability of such a plan at thrift institutions might also attract savings in conventional form, thus aiding the home mortgage market. In any case, a widening of the tax deferral privilege deserves close study.

4) Flexibility in Rate of Return on Mortgage Portfolios

Most problems faced by the home mortgage market would be resolved if earnings on mortgage portfolios could be made sufficiently flexible to keep them broadly in line with alternative investment yields. Basically, the problem is that long maturities and fixed interest rates keep the average yield on mortgage portfolios from rising except slowly as open market yields rise, making it difficult to lift the return paid on savings and thus to hold them against the pull of disintermediation. An obvious way to correct this would be to have a variable division of payments between interest and retirement of principal, with the division perhaps determined automatically in some relation to the cost of savings to the lending institution.

Although it is not clear that a variable yield mortgage would have the same marketability as the fixed-interest, level-payment, long-maturity home mortgage, this possibly should not be dismissed out-of-hand. Obviously, there is work to be done to devise a mortgage instrument that will combine flexibility of return with investment acceptability.

5) Wider Lending, Investing and Other Service-Rendering Authorities

Most discussions of the problem of assisting thrift institutions assume they would be better able to compete for savings if they had wider lending, investing and other service-rendering authorities. But it seems reasonable to believe they would earn a competitively adequate rate of return if the yield on a mortgage investment portfolio were adjusted flexibly under a variable-yield mortgage instrument. Conversely, lacking this flexibility, a widening of the lending and investing authorities of thrift institutions would divert funds from the home mortgage market. What this suggests is that the industry should concentrate mainly on making mortgage investment yields more flexible.

It is conceivable, however, that widening the service-rendering authorities of thrift institutions would help them attract and hold savings. Proposals to this end deserve objective examination, though I would expect better results from an extension of the tax deferral privilege, as proposed under point 3.

6) Flexibility in Rates Payable on Savings

Next, thrift institutions need greater freedom to fix rates on savings according to their own lights. Like all ceilings, limitations on the amount that can be paid for savings – whether imposed by statute or administrative ruling – do not hold interest rates down until they become unrealistic in relation to the market, at which point they suppress rate increases at the cost of diverting funds from home mortgage investment. At the earliest possible moment, the monetary authorities should begin dismantling all present ceilings; steps to this end should be high on the agenda of the new Commission on the Structure and Regulation of Financial Institutions.

7) Branches, Mergers, Conversions and Chartering

Recent studies show that location is crucial in the ability of a thrift institution to attract new savings accounts and to hold old ones. There is need, accordingly, to give institutions greater freedom to establish new offices. Neighborhoods change, new ones are created, and population densities are altered rapidly nowadays, and financial institutions that gather savings in small amounts from large number of individual savers need more freedom to adapt themselves to these facts. Clearly, a fresh look at federal and state regulations regarding the establishment of branches is needed.

At the same time, there is need to reexamine law and administrative practice regarding mergers, conversions and the chartering of financial institutions. These, too, are matters that should be high on the agenda of the new Commission on the Structure and Regulation of Financial Institutions.

8) Removing Obstacles to Flow of Funds into Mortgage Investment

The next requirement for helping the home mortgage market is to remove obstacles to the flow of funds into mortgage investment. State usury statutes that set maximum interest rates below the rate of return available on alternative investment are a case in point. A number of these have been adjusted upward recently, but others remain. In addition, interest rate ceilings imposed on federally-insured, guaranteed mortgages either by statute or administrative edict need to be eliminated. Time after time, a failure to adjust these ceilings to increases in open market yields has starved the home mortgage market of funds. And because this always occurs when credit is most urgently needed, the result cannot help but be awkward. The obvious conclusion is that ceilings should be eliminated. If some type of monitoring is thought necessary to determine whether rates charged are higher than competitive markets require, surely there is enough ingenuity in the world to devise a system that would be effective without relying on fixed ceilings.

9) Increasing Flow of Savings into Mortgage Investment

The economy's institutional structure has changed sufficiently in the past few decades to suggest the need for innovations to help channel funds into the home mortgage market. Specifically, it would be constructive to find ways to attract a larger portion of funds gathered on a contractual basis in pension funds and similar pools of capital. The new mortgage-backed, federally-guaranteed security issued under the Government National Mortgage Association is a promising step in this direction. But not so the proposals that would require financial institutions to invest some stated percentage of their resources in home mortgages. This dirigist approach collides head-on with the philosophy of competition and I would not want to see it gain any support whatever.

10) Direct Federal Support of the Home Mortgage Market

Under this heading, let me first register complete dissent from suggestions that the Federal Reserve System make direct purchases of home mortgages. Similarly, I dissent from proposals for supplemental cash reserves – presumably applicable only to commercial banks – that would vary by type of loan according to norms set by Federal Reserve authorities. Whatever may be the implications of such a proposal for control over the money supply, it would assign to the Federal Reserve responsibilities for national planning and resource allocation so extensive as obviously to require basic reconsideration of the system's political accountability.

Actually, there are many ways for the federal government to supply funds to the homebuilding industry without involving a potentially inflationary creation of bank reserves or without catapulting us into a hastily contrived system of bureaucratically-determined resource allocation. Credit can be extended directly or indirectly to home financing institutions, to builders or to homeowners by government in any one of a variety of ways. Funds can be made available on a subsidy or nonsubsidy basis, and availability can be selective in any manner desired. The crucial question is not how to do it – which is simple enough – but how much aid should be given and how much can be funded, considering other budget priorities.

However, two suggestions for changes in present arrangements under which the federal government makes credit available to the home mortgage market are pertinent. First, the informal arrangements under which the Federal Reserve system can provide liquidity to mutual savings banks should be made formal and explicit. Second, steps should be taken to minimize competition for funds between home financing institutions and federal agencies that sell their securities in open markets. Ironically, this competition oftentimes draws funds out of home financing institutions to make them available, circuitously, to the home mortgage market. Proposals have been made on numerous occasions to end this pointless competition by better coordination of the investment banking operations of federal agencies with the overall needs of the capital markets. All that remains is actually to initiate the need arrangements, presumably under the aegis of the Treasury.

* *

Obviously, there are many possibilities for elaborating or suggesting alternatives to these ten proposals. That is not important: what is important is that their general thrust and substance should be examined by the new Commission on the Structure and Regulation of Financial Institutions.

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

FRIDAY, JULY 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 S–407, the Capitol Building, Hon. John Sparkman (member of the committee) presiding.

Present: Senator Sparkman.

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

Senator SPARKMAN. Let the committee come to order.

I apologize for being late but I got caught on a matter that I just couldn't throw aside.

I understand Senator Javits will be back shortly.

Was there any intention of your proceeding as a panel or each one separately?

Representative BOGGS. Separately, I think, Mr. Chairman.

Senator SPARKMAN. Today we are considering the international trading position of the United States. In response to excess demand, the trade surplus deteriorated sharply in 1968 and has since recovered only slowly. The expected trade surplus this year is about $2 billion, or approximately half the average of the surpluses we were enjoying in the early and mid-1960's. In addition, organized labor and numerous industries are appealing for relief from the injuries they claim to have suffered as a result of import competition.

Two of our members, Representative Hale Boggs from Louisiana and Senator Jacob K. Javits of New York, appear before us today to present their views on the U.S. import and export position and to offer their recommendations on what policies we should follow to deal with these current problems. Representative Boggs is chairman of our Subcommittee on Foreign Economic Policy and is also a member of the House Committee on Ways and Means. His subcommittee is conducting a series of hearings designed to establish a set of foreign economic policy goals for the 1970's. As a member of Ways and Means, he is also participating in the drafting of trade legislation. Both gentlemen, I believe, are concerned that our present difficulties do not prompt an inappropriate overreaction.

You may proceed, Mr. Boggs.

STATEMENT OF HON. HALE BOGGS, A REPRESENTATIVE IN CONGRESS FROM THE SECOND CONGRESSIONAL DISTRICT OF THE STATE OF LOUISIANA

Representative BOGGS. Thank you, Mr. Chairman.

As you know, I am the chairman of the Subcommittee on Foreign Economic Policy.

Senator SPARKMAN. Yes, sir.

Representative BOGGS. And I am very happy to be here and I find myself in the unusual position of being on this side of the aisle.

I am gratified to have this opportunity to present my views on U.S. trade policy.

I might say that during the course of this year we have had extensive hearings on a trade policy for the 1970's, and we have just set four additional days of hearings for the latter part of July. During the House recess Mr. Stark and I plan to go to Brussels and meet with the Common Market people, meet with the new Prime Minister of Great Britain, Mr. Heath, and also with Mr. Pompidou to talk about the direction of the European Community.

A number of current problems and the lack of any well-defined program for the future threaten to alter the course of trade liberalization and international cooperation we have pursued since 1934. At least some of our current difficulties are temporary, and these can be expected to subside now that excess demand has disappeared. A further improvement should occur when the pace of inflation hopefully slows in the coming months. Even so, the validity and utility of our international trade policies are today being questioned with greater skepticism than I can recall in many years. I might add I have been a member of the legislative committee that handles this problem for 24 years.

Following the hard-won Kennedy round agreement to further reduce tariff barriers, the results of these negotiations had to be digested before we could begin to consider seriously further initiatives in trade policy. The last of the phased tariff reductions agreed to during the Kennedy round will be implemented on January 1, 1972. It is therefore appropriate to be thinking now about what the direction of U.S. foreign economic policy should be in the 1970's if we are to continue our efforts of the last decade to expand world trade for the common benefit of all nations.

As part of the process of developing new initiatives, the Subcommittee on Foreign Economic Policy is conducting a series of hearings to establish goals for the 1970's. Our objective is to outline an approach that will appropriately integrate U.S. policies regarding trade, foreign direct investment, and economic development assistance. As you know, the President earlier this year received a report recommending reorganization and reorientation of the foreign aid progam, but he has not yet transmitted to the Congress his own recommendations to restructure foreign aid. A Presidential Commission on World Trade and Investment Policy has also been appointed recently. The report of our subcommittee will be available before the conclusions of this commission are published next year.

During the interim when we are deciding what course to follow in foreign economic policy, the danger arises that current difficulties over

imports of particular products or concern over the deterioration in the total U.S. trade balance might cause us to adopt policies that we may subsequently regret. During the hearings recently concluded by the House Ways and Means Committee, over 70 different industries appealed for quota protection from imports. With the exception of only two of these industries—textiles and shoes—the trade bill shortly to be reported out by the committee leaves the implementation of quotas entirely at the discretion of the President.

We must remember the long-term importance of international trade for the United States. For these reasons, before turning to more specific considerations, I would like to try to put into perspective the role of international trade in the U.S. economy. I will not elaborate on the importance of trade and investment in international political relations and in the conduct of U.S. foreign policy as broadly conceived. These considerations are obviously important—occasionally more important than strictly economic calculations. Instead, I will let the eonomics stand alone.

A projection of the U.S. economy in 1980 compiled by the Bureau of Labor Statistics dramatically indicates the relative roles of purely domestic economic activity and international trade. In 1968 six out of every 10 workers were employed in service-producing occupations. Services are consumed where they are produced, and thus the workers producing them face virtually no competition from imports.

By the end of this decade the proportion of workers engaged in the output of goods will have fallen to three out of every 10 employees. Goods-producing industries include construction, agriculture, mining, and manufacturing. The construction industry does not compete against imports. Moreover, I might note that American construction firms are found all over the world. And most of U.S. agriculture is so highly efficient that it has no fear of foreign producers. Indeed, our farmers need expanding foreign markets to take full advantage of our superior agricultural productivity. I can give you a dramatic example of that in my State of Louisiana. Ten years ago we produced no soybeans. Today we are one of the largest producers of soybeans in the United States, and the market is entirely a foreign market. Imported ores might to some extent substitute for domestic mining production, but mining is the smallest of the goods-producing industries. And in truth many of our manufacturing activities we are almost entirely dependent upon foreign ores. Bauxite is a good example. Manufacturing is the largest of the goods-producing industries and while many manufacturers must be concerned about maintaining a competitive edge vis-a-vis imports, other manufacturers—employing almost as many persons—have an important stake in foreign markets for our exports.

By 1980 approximately eight out of every 10 workers in this country will be producing services or goods that cannot be imported. Eighty percent of the labor force will face no threat of losing their jobs as a consequence of import competition. Instead, the chief economic concern of these workers and their families will be to obtain the goods and services they desire at the lowest possible cost.

Imports cannot provide an abundance of cheap services, but they do offer American consumers goods at lower prices than available from domestic producers and, in addition, help hold down the cost of do-

mestically produced goods by offering the purchaser an alternative to the output of American factories. Both the ability to purchase imports and U.S. industries reactions in the marketplace to import competition benefit the customer. In the future a steadily increasing proportion of the American labor force and their families will be concerned about the availability of goods at the lowest possible prices regardless of whether these products are domestically produced or imported.

What will the United States export in future years? The deterioration of the U.S. trade balance has raised serious questions about the ability of the United States to export in the future, particularly if we are to participate in the continued liberalization of world trade. To put that another way, if we are to continue to participate in the enormous market that is emerging and to provide the world with what it needs. Interestingly enough the greatest amount of trade occurs between the most highly industrialized nations. People talk about cheap foreign imports. Yet the greatest amount of trade between this country and any other country is our trade with Canada, second, with the European community, and third, with Japan. The least amount of trade we have is with the less-developed countries in the world, the poor countries of Africa and Asia.

In the face of the particularly rapid growth of imports during 1968 and the slow recovery from the precipitous deterioraton in our trade balance that year, policymakers and academic economists have expressed concern about what will happen if the United States fails to have a substantial net export surplus in the future. These persons have pointed to the reserve-currency role of the dollar, to our security commitments abroad, and to the desirability of making goods and services available to the developing countries. In each case an export surplus is necessary to support these activities.

To stimulate and insure our capability to export, the bill drafted by the Ways and Means Committee provides for domestic international sales corporations. I might say that Senator Javits and I have been exponents of this idea for a great many years. Companies establishing such corporations will be able to defer taxes on the income from export sales as long as this income is retained by their DISC subsidiaries and used to promote further export expansion. This tax deferral scheme will place the export activities of firms in the United States on an equal footing—in terms of income taxation—with the foreign subsidiaries of American corporations. Thus, in addition to increasing domestic employment in the production of exports, the DISC provision will discourage the transfer of manufacturing operations to other countries.

Over the long run, however, if the United States is to fulfill its international monetary responsibilities, is to carry a substantial international security burden, and is also to provide goods and services for development, other countries must help create an environment in which we can successfully carry out these functions.

The devaluation bias of the existing international monetary system makes it more difficult for this country to play its expected role. Since 1949 the currencies of most other major industrial countries have been devalued one or more times. But only three upward changes in exchange rates have occurred. Therefore, the competitive position of the United States has tended to become gradually undermined.

This devaluation bias has another undesirable effect which I feel we are experiencing at this time. To the individual U.S. exporter or producer competing against imports, the consequences of this bias materializes as a threat to his current market position. Thus, what is actually a general problem of exchange rate misalignment may be perceived in this country as a rash of individual problems giving rise to pleas for protection and intensified demands for the removal of trade restrictions not sanctioned by GATT.

As their difficulties have intensified, American producers and workers have looked around for the source of their plight; it is understandable that they have pointed to "adverse foreign wage differentials," "unfair labor standards abroad," and sophisticated trade barriers used by other countries that violate the spirit, if not the actual letter, of the GATT. Certainly many of these complaints are justified, but I believe we should investigate further when they swell into a general cry for protection. Let us also remember we on our own part employ a good many of these devices.

The criterion we should always keep in mind is the level of world trade and the efficiency with which various productive activities are located around the globe—not the net balance of payments or trade balance of any particular country, not even that of the United States. If the industrial nations of the world cooperate, pursue liberal and openminded policies regarding trade and international investment, and press for continuing international monetary reform, the balance of payments for each country will tend to fluctuate around zero or, allowing for the growth of reserves through special drawing rights, register a small surplus.

I think it important, Mr. Chairman, we emphasize "reciprocity." The late, great Cordel Hull instituted the reciprocal trade policy, and the essence of it is reciprocity. It has been a most successful policy. It has removed from the Congress the unbelievable burden of attempting to write the tariff rate structures. In the Smoot-Hawley tariff act alone there were something like 2,000 specific items considered in the bill. You can imagine what a job that must have been.

But if the U.S. resorts to protectionism and other countries continue to ignore the principle of reciprocity in admitting imports into their markets, the outcome in terms of net balance will not be significantly different.

Each individual nation will end up with approximately the same net position it had initially. The major difference would be a substantial decline in the level of world trade. Remember, Smoot-Hawley was sold on the notion that it would bring about economic recovery. Quite the opposite was the result thereof. Thus, opportunities for efficient specialization would be forgone, and the developing countries particularly would suffer from their inability to find markets abroad. If the industrial countries fall into the trap of protectionism and trade restriction, the real incomes of everyone will be lower than they otherwise would be.

Through the use of monetary and fiscal policies, the United States can—and I am confident will—return to full employment. But the real earning power of American workers, just like those in any other country, depends upon their skills and efficiency—in the simplest possible terms—on their relative ability to produce. By restricting imports and

subsidizing exports, we will tend to anesthetize our productive capabilities.

When Secretary of Commerce Stans appeared before the Ways and Means Committee to announce the failure of the negotiations with the Japanese, Chairman Wilbur Mills made an observation about the export capabilities of the Japanese which no one can dispute. He said, "They must be doing something right." The chairman went on to mention a number of techniques the Japanese have used to increase their capability to export, such as easy access to bank financing and price cutting to maintain capacity output. I would like to mention one technique that he did not.

Japanese businessmen—and my subcommittee has been there several times—and political leaders have understood that they cannot keep an unchanging proportion of their industrial capability in the same industries forever. In the post-war decades, they have continually striven—with the aid of Government planning and assistance—to increase the quality of their output and to move into more sophisticated lines of production. They understood well that if there incomes were to increase, they could not go on producing firecrackers, toys, and cheap textiles. These industries are gradually being phased out in Japan and transferred to other Asian countries where labor is more plentiful, such as Korea and Taiwan.

Similarly the industrial structure of the United States cannnot remain static if the welfare of our workers is to improve. We can initiate such an effort from a much higher base than the Japanese did, and we can achieve our goals without unilaterally resorting to protectionism. Indeed, the needs of our society threaten to swamp its ability to fulfill these needs. I needn't spell that out and think of the things we do need—the cities that have to be rebuilt, pollution that is to be cleaned up, schools that have to be built, hospitals that need to be built. I could enumerate them one after another. Continued improvement in the quality—and I emphasize the word "quality"—of American life demands that we meet these challenges aggressively.

How are we to handle the problems of individual industries, firms, and communities? Individual firms and communities producing a variety of products are today experiencing severe difficulties as a consequence of import expansion. In considering how to respond, it is obviously unfair to take any action easing the hardships of producers in one industry without making the same type of consideration available to firms and workers manufacturing other products. The same standards should be applied throughout the economy, and the same remedies should be available to all enterprises, communities, and groups of workers.

The solution to these difficulties must be found in an appropriate combination of adjustment assistance and import restraint. During the past year the Tariff Commission has adopted a somewhat easier attitude towards eligibility for adjustment assistance, and the trade bill drafted by the Ways and Means Committee includes provisions to further expand the Commission's latitude for action in recommending such assistance. I think this is one of the most important things in this bill. I heartily approve of assistance to firms and communities demonstrably suffering from import competition; liberalization of the criteria that must be satisfied to qualify would bring the operations of

these programs closer to the intent of Congress in the 1962 act. Training the relocation benefits to workers, financial and technical advice for communities to help them attract new industry, and loans to firms for retooling and the development of new product lines must all be considered as possible options.

You know there are so many domestic examples of what I am talking about, Mr. Chairman. We have here in the 50 States of this great country the greatest free trade area on earth, and the great wisdom of our founding fathers was to make it impossible for one state to impose an export-import restriction on another State. So we have seen over the years a tremendous shift of industry in the United States. Take textiles, for example. In the early days of our republic most textiles were produced in New England, and because of the nearness of cotton fibers, which were then the main ones employed in the production of textiles, the industry gradually moved to North Carolina, South Carolina, Georgia, your State. Eventually New England was left without the textile mills. Now they have developed many sophisticated industries, electronics to name one, and many, many others. Well, if we had attempted in America to maintain that industry in that part of the country, it would have been a most uneconomic thing to do it. It makes much better sense to have textiles produced where cotton is grown or where the synthetic fibers are available.

Blanket industrywide assistance must, however, be regarded with caution.

Senator SPARKMAN. If I may interject there, you will recall, though, that the big factor that brought about that change was a correction in the situation that had prevailed in railroad rates.

Representative BOGGS. Freight rates.

Senator SPARKMAN. For a long period of time.

Representative BOGGS. Certainly.

Senator SPARKMAN. That we finally got corrected about 1944 or 1945.

Representative BOGGS. It took 100 years, Mr. Chairman.

Senator SPARKMAN. Right.

Representative BOGGS. That is correct.

Senator SPARKMAN. So while it was illogical for cotton to be hauled from the South to New England and manufactured into goods and shipped back to our area and to other areas of the United States, the logical thing to do was to have the textiles manufactured where the cotton was produced, but we couldn't do it then because of the so-called official rate.

Representative BOGGS. What was the name of the great Georgian who made the speech, the funeral oration describing——

Senator SPARKMAN. That was right after the Civil War.

Representative BOGGS. Right.

Senator SPARKMAN. It was Henry W. Grady.

Representative BOGGS. You know what he said? You remember the speech, though, don't you?

Senator SPARKMAN. Yes, I do. I surely do.

Representative BOGGS. He described everything about it, and about the only thing that was produced in Georgia was a corpse.

I am surprised I don't remember his name.

Senator SPARKMAN. You and I were in Congress when we got the official rate changed and we did it after a good many years of fighting through legislation.

Representative BOGGS. That is the only way we could do it.

Senator SPARKMAN. The Transportation Act of 1940 started it out. That was S. 2009, if you may remember.

The amendment that was inserted in the bill by my long-time colleague, Senator Hill, over in the Senate side asked that the Interstate Commerce Commission conduct a study on those differentials. It was just incidental that at that time two members of the Interstate Commerce Commission were from the good State of Alabama. So we had some help.

Representative BOGGS. I am sure that made no difference, they were totally objective in their approach.

Senator SPARKMAN. They were, although it happened one of them had formerly been with the TVA and had issued that tremendous report on freight rate discriminations. I thought it was well to bring that little history in.

Representative BOGGS. It is always good to hear you reminisce because the many years you have served in both the House and Senate you have made a magnificent contribution to this country.

To grant such aid to an entire industry is likely to raise a protective umbrella over the more efficient firms and permit them to reap excessive profits while other enterprises deserving assistance are attempting to strengthen their competitive positions.

Fundamentally the type of adjustment that workers, firms, and communities must make in response to an increased flow of imports is no different from the type of adjustment they have to make in response to wholly domestic changes in consumer taste, technology, and market structure. Also each year our economy must grow to provide jobs for young workers entering the labor force in numbers several times as large as the number of workers displaced by import competition. Thus the problems arising from international trade are minor in comparison with the challenges of fostering competition domestically and of keeping the U.S. economy growing at a healthy rate without excessive inflation. If we have appropriate domestic economic policies, any additional problems arising from imports will certainly be manageable.

I believe it would be useful to broaden within the GATT the standards under which firms or groups of workers manufacturing selected products may be judged to have been injured to a degree sufficient to warrant the temporary imposition of import restrictions. Currently, article XIX of the GATT permits such relief only when the difficulties stem from a previously negotiated trade concession. But I feel that American producers should be able to obtain temporary relief from import competition on the same basis as the proposed liberalized criteria for extending adjustment assistance. Specifically, the GATT should allow for the temporary restriction of imports that cause severe domestic injury regardless of whether these imports enter as a consequence of tariff reductions or other factors. I might say I think we spell that out specifically in the new act.

These expanded GATT criteria would include limitations over the time during which imports could be curtailed and supplementary ac-

tions required of the Government of any nation curtailing imports. By necessary supplementary actions I am thinking of any type of adjustment assistance needed to eliminate import curbs as soon as possible. Any country whose exports were curtailed as the result of temporary import restrictions could challenge within the GATT the justifiability of these limitations. If the nation imposing the temporary restrictions could not demonstrate their legitimacy according to internationally accepted standards, it would be required either to abolish the restrictions or compensate the injured country.

I believe that the development of such criteria within the GATT and the use of this organization as an international forum to oversee their application would bring important benefits to the United States and to trading nations generally. First, an objective criteria would be established under which we could challenge the actions of other countries. Such challenges have not been raised effectively to date. Multilateral agreement on realistic and up-to-date criteria to determine when nations may legitimately restrict imports would lead to a more equitable application of GATT standards and less tolerance for special exceptions. The United States would then be able to insist with greater force on the removal of trade barriers now maintained by the Japanese and the Common Market nations in violation of the GATT. Second, American industries facing the steady growth of foreign competitive ability would know the rate at which they will be required to adjust and the circumstances under which they can qualify for relief. Third, if each country continues to be the judge of its own actions and restricts imports when it alone sees fit, the risks of a retaliation counter-retaliation cycle are substantial. A restrictionist slugging match would collapse the network of multi-lateral trade that has been built up—and I might say very painfully built up—over more than three decades and impair the real incomes of American workers and consumers.

While problems will continue to afflict selected firms and communities, a number of general issues will also remain with us.

Substantial liberalization of trade in agricultural products must probably await reform of the various schemes governments employ to support the incomes of rural populations. We should nevertheless work towards an economically rational distribution of agricultural production and guard against the introduction of new trade restrictions. Special vigilance is required to insure that any arrangement to admit Britain to the Common Market does not create additional—I emphasize the word "additional" because there already is a great deal—discrimination against exports of U.S. farm products.

The activities of multinational corporations in promoting a more rapid international transfer of technology could conceivably impair the future ability of the United States to export. On the other hand, such firms remit a growing stream of foreign earnings to their head offices here. That is one of the most favorable aspects of our balance of payments. More should be learned about the effects of these organizations before we attempt to influence their decisions. To this end, the Subcommittee on Foreign Economic Policy has scheduled hearings for later this month on the growth of direct investment and the operations of multinational corporations.

The developing countries will continue to plead for expanded access to our markets and, so long as the industrialized nations do not admit their goods on a nondiscriminatory basis, our expressions of concern for their welfare will ring hollow. Moreover, any plan to provide for easier access of imports from developing countries must include all industrial countries on an equal basis rather than under the present preferential arrangements established by the European Common Market.

Although the Common Market nations recently announced their resolve to limit the geographical extent of the additional preferential arrangements they will conclude with nonmember States, the precise extent of these limits has not yet been decided and the existing preferences remain in violation of GATT. Moreover, it is uncertain whether an arrangement to admit Britain, if successfully negotiated, will discriminate against imports of manufactures from the United States and other nonmembers. This is one of the main questions Mr. Stark and I are going to investigate in Brussels and London.

In dealing with these issues, I strongly believe that the United States must maintain the initiative it first evidenced with the passage of the Reciprocal Trade Agreements Act in 1934 and carried forward with the Trade Expansion Act of 1962. If the U.S. initiative is not maintained, none of our major trading partners can be expected to seize it and press forward for continued trade liberalizations. The sad thing to me about the present tendency in the European community is that its recent behavior is entirely contrary to the concept of Jean Monet, the father of the great concept and who envisioned the market as being outward-looking rather than inward-looking. The Common Market has not consistently adopted policies in keeping with free trade, and some of its policies have injured the United States. Likewise, the Japanese use licensing and credit rationing to discriminate against imports. They also prohibit foreign investment in a number of major industries. Thus, a basis does exist for rationalizing a shift in our policies.

But I do not see how the United States can expect its industrial counterparts to perform better than we do in encouraging a continued expansion of multilateral trade. If this country deviates from its previous course of reciprocal trade liberalization, that action will be taken as an excuse for others to do likewise. We cannot be assured that others will readily follow constructive U.S. leadership and, to achieve any success, we must be prepared for persistent hard bargaining. But as the country with the effective authority to push the tenor of world trading relationships in one direction or another, we must accept the responsibilities of our preeminent position.

Thank you very much, Mr. Chairman.

Senator SPARKMAN. Thank you. That is a very fine and clear statement. I want to ask you just a very few questions. This bill that you referred to several times, what is the status of that now?

Representative BOGGS. The bill is being drafted. The committee has reported the bill for all practical purposes.

Senator SPARKMAN. The committee has come to a conclusion but the bill has not been formally reported.

Representative BOGGS. Exactly.

Senator SPARKMAN. And then you go before the Rules Committee?

Representative BOGGS. Exactly. As you know, Mr. Chairman, we

invariably consider trade legislation and tax legislation under closed rule in the House so——

Senator SPARKMAN. The opposition, whichever party it may be, always refers to it as the gag rule.

Representative BOGGS. Exactly.

Senator SPARKMAN. It is the only way to write tax legislation.

Representative BOGGS. It certainly is.

Senator SPARKMAN. I often wish we had that rule in the Senate.

Representative BOGGS. What happens when we go back to conference, and I am on the conference, on the last tax bill we had 400 matters in disagreement all of which were adopted in the Senate and all of which was a Christmas tree for somebody.

Senator SPARKMAN. Well, some of them were very useful as Christmas gifts.

Representative BOGGS. I am not criticizing.

Senator SPARKMAN. You say with the exception of only two of these industries, textiles and shoes, the trade bill leaves the implementation of quotas entirely to the discretion of the President?

Representative BOGGS. That is entirely true.

Senator SPARKMAN. The bill really relates so far as quotas are concerned to only two.

Representative BOGGS. I will say this——

Senator SPARKMAN. And by the way, I heard it by a commentator, are those noncotton textiles?

Representative BOGGS. Yes, sir; Mr. Chairman, because we have a voluntary arrangement with the Japanese on cotton textiles.

Senator SPARKMAN. I knew we did for a good many years. I thought that it had played out.

Representative BOGGS. No, no; it is still very much in existence.

Senator SPARKMAN. But it is only on the noncotton fibers?

Representative BOGGS. That is right.

Senator SPARKMAN. Well, I am interested in both textiles and shoes. We have a very large shoe factory in my hometown. We have a great many textile employees in my State.

In your statement you refer to another feature of the bill, of which I made note, and that was the Domestic International Sales Corp.

Representative BOGGS. Yes, sir.

Senator SPARKMAN. Of course, when the legislation comes up we will know more about it. Why don't you tell in a few words what that does? I have an idea what it does but I would like to hear it.

Representative BOGGS. Well, under certain regulations prescribed by the Treasury Department, Company A can be established. The function of the company would be to manufacture articles for export purposes only. That company will pay no tax until there is a remission of dividends back to this country. Now, what that does, it prevents the migration of industry from this country to other countries in order to get beyond the tariff and nontariff restrictions of other countries.

I will give you an example. A very important chemical company—I don't think I should name the company—had under consideration building a $250 million plant in my congressional district. And because of certain import restrictions that we have, also the fact that they were going to export everything that they manufactured in this

plant, and also because of the fact that they got no tax preference, although it was entirely for export, their board of directors took a look at it and studied it and said, "We are sorry but we are going to build it somewhere else." So they have built it in Germany. That is just one of many, many similar situations. These issues are the subject of our inquiry in the latter part of this month by our subcommittee.

Senator SPARKMAN. I believe I know the chemical company you are talking about. In fact, the president of the company related to me those very facts. As I recall, he said that not only could he get these advantages that you mentioned, but that he would get a grant, I think he said of $40 million, to aid in the building, and then a loan in addition to that on very favorable terms, and if they did export their products, they would get an export subsidy. If they exported back to any other country, they would get an export subsidy. In other words, there were three different types of relief he could get there.

Representative BOGGS. We tried, Mr. Chairman, every way in the world to work it out. We even were able to get a branch of a foreign trade zone, but it just wouldn't work and it was heartbreaking to me because the industry would have employed 500 or 600 people in a community that needed employment. And as you know, these are some of the highest paid workers in the country.

Senator SPARKMAN. And, of course, it does give an incentive for industry to migrate from this——

Representative BOGGS. And reexport back to this country, you see.

Senator SPARKMAN. That is right. Just about a year ago my wife and I were, less than a year ago, last fall, my wife and I were in Copenhagen one day and she bought some material. I believe it is crystal but I am not sure.

Representative BOGGS. Crystal or china.

Senator SPARKMAN. Right. And the clerk asked if it was to be exported to this country. We said it was. So she just automatically entered a discount, which she said was just about equivalent to the duty that we would have to pay on its coming into this country.

Representative BOGGS. Well, it is even more significant in some other items. Wristwatches, for example.

Senator SPARKMAN. Isn't it true that a good many of the European countries, maybe countries in other parts of the world, I don't know, do have some kind of an organization, have an organization somewhat similar to what you are mentioning here?

Representative BOGGS. Mr. Chairman, this will be the most modest one in the world. Germany has it, France has it, England has it.

Senator SPARKMAN. With very high benefits.

Representative BOGGS. Oh, yes.

Senator Javits is intimately acquainted with this subject.

Senator SPARKMAN. Well, I am glad to see you bring it in. I am glad to see you mention the Common Market and Britain's entry and so forth, and we know already from actions that have been taken by the Common Market countries, although we have been, I would say, generally in support of the movement all along. But we do know of actions that have been taken by individual countries that are hurtful to our export of certain commodities.

Last year, about a year ago, I was in Brussels, I believe Senator Javits, I believe it was at a time when the North Atlantic Assembly

was meeting, and I am not sure whether you were with us the day we had lunch with the Common Market people.

Senator JAVITS. No.

Senator SPARKMAN. Well, we did and we had quite a question-and-answer period during the luncheon. And we went after them rather heavily. They were very courteous and I will say this, I think they showed an understanding of the situation and they assured us that what was taking place now was trying to get the countries adjusted to this thing and that certainly as that was done the matter would be corrected.

Representative BOGGS. I am very hopeful, and I don't say this in any spirit of criticism because I think General de Gaulle will go down in history as one of the great men of all times. I think he was one of the great contributors in saving the free world during World War II. But he did have the concept, you know, of grand France, of reconstructing the Empire of Charlemagne. He had the notion that there would be economic and political union in which France would enjoy a predominant position. I think now that the market will be much more open in its approach; I am very, very hopeful.

One of the things in the executive sessions of the Ways and Means Committee that I kept trying to get from our ambassador time and time again was what authority can we give you, Mr. Ambassador, that will help you negotiate these non-tariffs barriers downward? Suppose the Common Market won't take American wheat or some other feed grain product? So what kind of retaliatory action can we take? Only in the industrial field. So we can say to Germany we are not going to take 500,000 Volkswagens. Well, now, this doesn't help anybody. It doesn't help us. It brings on a trade war. It means that they in turn will retaliate. They don't retaliate against our automobiles. So it is a very difficult problem and what I am really trying to say in this statement is that we must not, in view of the fact we have had a decline, in the American exports and have had an increase in imports, we must not because of that abandon the policy we started in 1934. I see it restrictionism as ultimately leading to disaster, and it does not solve the problems of these specific industries.

Senator SPARKMAN. Well, I think you are absolutely right. You mentioned Jean Monet. I had the privilege one time of visiting him in his home.

Representative BOGGS. So did I.

Senator SPARKMAN. This was back in the formative early days and I always admired the determination that he had and his willingness to keep on even against adverse conditions.

Representative BOGGS. I think without him there would not have been the Treaty of Rome, and I don't want to leave a misconception about the Common Market. I think the Common Market has done more to erase the ancient animosities existing in Western Europe than anything that has happened. The very idea that Germany and France after having fought three bloody wars in less than 50 years are now trading parties and their workers move freely from one country to another and they have adopted common tariff and trade policies is an enormous step forward in the freedom of mankind.

Senator SPARKMAN. Not only do their people move freely but even Americans can be driving down the road and they won't even look at their passports, won't stop them at all.

Representative BOGGS. Let's take an Italian living in Southern Italy which a few years ago was one of the poverty areas of the world. He can now migrate to the industrial centers of Germany and France and elsewhere and get himself a good job, send money back home, and his family now lives in a much better condition. He has the same freedom of movement that man from Louisiana has to migrate anywhere in this country and get a job. This is really enormous progress. What I am saying is it must not become inward looking, just as we mustn't.

Senator SPARKMAN. A very fine statement and we are all grateful to you.

Representative BOGGS. Thank you, Mr. Chairman.

Senator SPARKMAN. Senator Javits?

STATEMENT OF HON. JACOB K. JAVITS, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator JAVITS. Mr. Chairman, thank you very much, I shall try to brief my statement to 10 minutes.

First I would like to join the Chair in complimenting Congressman Boggs on a really splendid presentation. It is hard to believe that the subject can be made as fresh and as interesting as Congressman Boggs, who is my long-standing colleague in these efforts, has made it.

Interestingly enough, while he has detailed the vital arguments against protectionism and demonstrated how the technique of reciprocity can be employed in the United States effectively, so that we are not just soft touches for those who export here, he has also shown us, while we can be tough and equip ourselves with the means for hard bargaining, that it isn't necessary to run the trade policy down the drain in order to do that. I would like to quote two statements of Congressman Boggs whose theme fits into the theme I would like to develop.

He says:

> A restrictionist slugging machine would collapse the network of multilateral trade that has been built up over more than three decades and impair the real incomes of American workers and consumers.

I would like to move on from there, if I may, and ask unanimous consent that the whole prepared statement——

Senator SPARKMAN. The entire prepared statement will be printed in the record at the end of your oral statement. You handle it as you see fit.

Senator JAVITS. Thank you.

The international economic picture presently faces a strange and delicate paradox. On one hand, there are grounds for optimism, while on the other, a protectionist tide seems to be sweeping the world which, if allowed to go unchecked, will bring only grief and disaster to the world in the form of an international trade war. For while some optimism in the world's financial affairs is warranted, it is so precariously balanced as to be susceptible of being swept aside easily by the angry tide of a trade war. Such a trade war could wreck the structure of international economic cooperation established since World War II

and the institutions which have grown up under it. It could destroy the hope for political unity in Western Europe, erode the foundations for political cooperation with Latin America, and make the whole world vulerable to a depression, to disorganization and to a resurgence of Communist influence in the affairs of men.

This threat overshadows the following recent optimistic developments. A major new international monetary initiative has become operative early this year and seems to be functioning well in its assigned task of facilitating international liquidity. I refer to the creation of Special Drawing Rights, and I note that the United States has received its initial allocation of $867 million in SDR's. Trade relations between surplus and deficit countries appear to be moving towards correction and adjustment reflecting the West German and Canadian revaluations and the French devaluation. Lessening inflationary pressures in the United States and our declining economy and the increased inflationary pressure facing European economies have resulted in a greater U.S. trade surplus in the first 5 months of this year. This surplus totals $1.13 billion through May of this year or approximately double the 1969 surplus of $638 millions in the first 5 months of 1969. Some Japanese moves towards the liberalization of their onerous trade restrictions in turn should have the gradual effect of reducing the internationally intolerable surplus position of Japan and alleviating the deficit position of other nations such as the United States.

The Eurodollar market has weathered well the immediate crises of the past year in which the repressive monetary policy in the United States caused massive Eurodollar borrowings by U.S. banks and corporations to meet their liquidity needs. The Eurodollar market proved itself up to the task of keeping the all-important flow of international trade and investment moving.

On the negative side, the balance of payments position of the United States remains weak. The main reason for this is that our trade surplus position is not great enough to cover our other foreign commitments which include Vietnam, foreign military and economic assistance, tourism and foreign direct investment, among other items.

But again, the picture is not totally dark since we are withdrawing from Vietnam and hopefully the balance of payments saving that will accrue from this troop withdrawal will not be spent in military action or military support in other Southeast Asian countries. As I mentioned, our trade surplus is improving and I look for it to continue to improve since we are farther advanced in our battle against inflation than other industrialized countries. Also, the Federal Reserve's recent wise decision to lift the interest ceilings on certain categories of CD deposits is likely to encourage dollars to stay at home since they can now earn returns comparable to those that can be earned by Eurodollars.

It is also clear that the world has been willing to bear the balance of payments deficit of the United States assuming it does not get out of hand. Dollar redemptions for U.S. gold have not been running at a high rate. Perhaps this deficit can be viewed as the service charge that the world is willing to bear for the use of the dollar as a reserve currency and the Eurodollar as the international currency.

Mr. Chairman, I make this brief survey solely to indicate that the international economic picture is far from being grim. It appears to

be far healthier than does our own domestic economy. This has resulted in what can be called a transference of anxieties or scapegoatism in which many people who are afraid of losing their jobs because of the domestic showdown and many firms which are caught in a profit squeeze are blaming their very real woes on the foreigner. This is basically irrational and not borne out by the facts. Rather than indulge in such fantasies, let us take the necessary steps to get this economy moving again, to pass the manpower programs needed to train and employ the unemployed, and to provide the Presidential powers and the trade adjustment assistance to help those individuals and firms genuinely hurt by imports, among other matters.

I emphasize that certain American industries have legitimate grievances in the trade area. Certain American industries are being hurt by a sudden impact of imports; and it is the duty of this administration and the Congress to assist such industries. However, given today's general economic conditions, there are many other American firms that are being injured not by the sudden impact of imports but by the sudden impact of restrictive fiscal and monetary policies, by rampant inflation in wages, prices, by record interest rates and by a stagnation in productivity and in the vaunted American competitive spirit. For this, foreign nations are not to blame.

This irrationality, this propensity to look for the worst in one's neighbor's yard because one's own yard is undergoing temporary difficulties, this move into quasi-isolationism in an increasingly interdependent world, could result in bringing down the economic system that has served us so well over the past 25 years.

Before I make a few brief comments, and I will not be long about the specifics, let me just sum up by saying that I agree with everything that Congressman Boggs has said about equipping the President with the necessary power to counter disadvantages at which we are placed because of violations of the rules of GATT by other countries, which go beyond our acceptability. What I don't agree with and what has been done thus far in the other body is to provide for the establishment of quotas—even if it is only for textiles and shoes. Knowing as I do the temper in Europe and Japan, I can see the impending trade war very, very clearly defined. Interestingly enough, Mr. Chairman, I believe that it isn't what we say but how we say it.

I think we have every right to change those rules domestically with respect to proof of injury and to give the President the power to deal in a selective way with these problems and to be armed with the necessary authority to put restraints of a temporary character on imports based upon their unusual emergency impact upon a given area at a given time. In so doing, I think we can get through this period of readjustment toward greater world rationalization; but it is my deep conviction that if we legislate quotas we are going to incite a world trade war which can be far more harmful to us.

I think that is the issue, Mr. Chairman, one which we probably will be fighting out here in the Senate and in the country on the impending trade bill. I am not mawkish and I don't assume high motives on the part of our trading partners either in Europe or Japan, but I only believe as does Congressman Boggs, that when you have the tremendous economic power that we have you don't do everything you are capable of doing just because you are capable of doing it.

On the contrary, you look to the cost benefit ratio and you do what you need to do and can do, which gives more benefit than loss. In my judgment, entering into a new policy after 40 years which will be hailed throughout the world as protectionism, regardless of how we dress it up or how we try to damper its impact, in the many ways which have already been described, we are going to invite, because we are the leader, a trade war, the consequences of which I shutter to contemplate.

I would like to deal with just three specific matters. One is the redirection or revitalization of foreign aid; second, U.S. private investment abroad, and finally, international monetary policy. I have already dealt with the trade policy question. I won't go into that again.

I see a new outlook in both Western Europe and Japan of being willing to share the burdens of international economic development. This is, of course, critical because the gap between the haves and the havenots is widening and as we look ahead the gap will continue to widen if present development progress is no greater than it has been. In the developing world I see looming a tremendous threat of a critical economic upheaval.

Barbara Ward Jackson has pointed that out in the tremendous analysis of the confrontation between the north and the south of the world.

Now, I think that our new techniques make enormous budgetary outlays unnecessary. We have great opportunities in the trade field with the LDC's, and the United States and Europe are now involved in negotiations toward the end of establishing a system of worldwide, nonreciprocal tariff preferences. These negotiations should be driven to a conclusion and then ratified by the Congress. We have great opportunities in the technical assistance field. We have even greater opportunities in combined public and private investment, both through corporations like the ADELA and Private Investment Corp. of Asia, the now impending similar corporation for Africa, and through organizations like the Overseas Private Investment Corp., which I think will be soon organized in our country and which is already authorized by law.

The significant point about these organizations is the willingness of American business to work with American Government toward the end of promoting productive capital flows to the developing world. This is a big element of these organizations, enormously increase the potential for doing what must be done in the underdeveloped world without tremendous budgetary outlays. I would like to pay a tribute to the Chair, Senator Sparkman. Without him this Overseas Private Investment Corp. would never have come into being as it faced the opposition of the Majority Leader and the chairman of our own committee, but he helped enormously, and I know it will justify his confidence.

Now, a word about the multinational corporation which comprises mainly American corporations moving into foreign areas for production and distribution. Again, this is an extremely important development in the world which essentially bypasses national lines and recognizes the fact that this is now a regional, not a national world. I am very pleased that the Ways and Means Committee resisted the

temptation to repeal certain sections of the law which facilitate the operation—sections 806.30 and 807.0 of the tariff code.

Representative BOGGS. I might say there was tremendous pressure to do that.

Senator JAVITS. I know that, and I am sure that Congressman Boggs was a leader in that. I think it was a great victory to prevent on the one hand the repeal of what would have crippled these multinational corporations operating abroad, and on the other hand push forward as they did with the new PISC proposal which Congressman Boggs has described.

The magnitude of our overseas investment is very large and the American people ought to know about it. It has grown from $19 billion in 1950 to over $100 billion in 1968. Additionally, it is reciprocal because private foreign investment in this country has grown from $8 billion to $40 billion in the same period, an annual growth rate of about 10 percent.

Servan-Schreiber forecasts that by the end of 1975 the third biggest industrial power in the world will be United States-owned industry in Europe. This indicates the extent to which the operations of a multinational corporation with worldwide marketing and production concepts are creating an integrated world economy and outdistancing the legal framework which is dwarfed by the rapid growth of the world economy.

Again, I say that what needs to be done is to encourage the best aspects of this operation, rather than to dismantle it and cut it down. The emerging pattern in the world can be seen in the multinational corporation and in what it produces: the highly sophisticated American exports including services, insurance, and other visibles, et cetera, and in what it brings back in the way of interest and profits to the American tax system and to millions of individuals in the United States. This, coupled with the extremely perceptive analysis made by Congressman Boggs' statement, that emphasizes showing that the overwhelming majority of our working personnel in the United States will be in the service industries shows this pattern and distinguishes it from current protectionistic drive in the United States. We have always been an adventurous moving people in breaking new frontiers. We are interested much more in profit than in avoiding loss. This is the spirit which made us and we should not draw our heads back into our shell like some scared turtle.

Finally, Mr. Chairman, I shall speak on the international monetary picture. I would like to make just two observations. One is that while I hail and commend the concept of Special Drawing Rights—this paper gold is again an ingenious and very advanced concept of how to operate the world's financial system—it is still too modest. The estimated needs for additional reserves in the world run about $6 billion a year.

However, the rate of Special Drawing Rights creation, which incidentially is at the discretion of the International Monetary Fund, is running at about $3 billion per year. While Special Drawing Rights are only one form of reserve creation, the gap between reserves being created, as world reserve needs is growing, I think that the world economy is vital and rich enough to stand the creation of the reserves we need.

The other problem that we have is the grave concern about the position of the dollar in the world. In that regard, I would like to recommend to the committee that an effort should be made to formulate some rules on international monetary flows with a view toward a more stable situation until we get some international monetary unit or until the Common Market gets a comparable reserve currency so the EEC doesn't have to be exclusively dependent upon the dollar. I think that we need to cooperate with the other major countries of the world to develop a better grasp of international capital flows and also to find a better system of readjustment, whether the system is the crawling peg or some other similar plan. Furthermore, Mr. Chairman, I think that these are the suggestions that I would like to leave in completing our survey of the economic situation of the United States and the world.

Thank you, Mr. Chairman.

(The prepared statement of Senator Javits follows:)

PREPARED STATEMENT OF SENATOR JACOB K. JAVITS

DANGER OF A TRADE WAR LOOMS OVER U.S. INTERNATIONAL ECONOMIC POLICY

Mr. Boggs and I have been asked to appear this morning to give our impressions as to the overall international economic situation. The Foreign Economic Subcommittee of the Joint Economic Committee, of which Mr. Boggs is the Chairman and I am the ranking minority member has been holding a series of hearings on various aspects of the international economic scene. These hearings will reconvene shortly after concluding the 1970 mid-year economic review to consider the multinational corporation. The purpose of our appearance here today is to outline for the members of the Committee how the international economic situation appears to us.

The international economic picture presently faces a strange and delicate paradox. On one hand, there are grounds for optimism, while on the other, a protectionist tide seems to be sweeping the world which, if allowed to go unchecked, will bring only grief and disaster to the world in the form of an international trade war. For while some optimism in the world's financial affairs is warranted, it is so precariously balanced as to be susceptible of being swept aside easily by the angry tide of a trade war. Such a trade war could wreck the structure of international economic cooperation established since World War II and the institutions which have grown up under it. It could destroy the hope for political unity in Western Europe, erode the foundations for political cooperation with Latin America, and make the whole world vulnerable to a depression, to disorganization and to a resurgence of Communist influence in the affairs of men.

This threat overshadows the following recent optimistic developments. A major new international monetary initiative has become operative early this year and seems to be functioning well in its assigned task of facilitating international liquidity. I refer to the creation of Special Drawing Rights, and I note that the United States has received its initial allocation of $867 million in SDRs. Trade relations between surplus and deficit countries appear to be moving towards correction and adjustment reflecting the West German and Canadian revaluations and the French devaluation. Lessening inflationary pressures in the United States and our declining economy and the increased inflationary pressures facing European economies have resulted in a greater U.S. trade surplus in the first five months of this year. This surplus totals 1.13 billion through May of this year or approximately double the 1969 surplus of $638 millions in the first five months of 1969. Some Japanese moves towards the liberalization of their onerous trade restrictions in turn should have the gradual effect of reducing the internationally intolerable surplus position of Japan and alleviating the deficit position of other nations such as the United States.

The Eurodollar market has weathered well the immediate crises of the past year in which the repressive monetary policy in the United States caused massive Eurodollar borrowings by U.S. banks and corporations to meet thier liquidity needs. The Eurodollar market proved itself up to the task of keeping the all-important flow of international trade and investment moving.

On the negative side, the balance of payments position of the United States remains weak. The main reason for this is that our trade surplus position is not great enough to cover our other foreign commitments which include Vietnam, foreign military and economic assistance, tourism and foreign direct investment among other items.

But again the picture is not totally dark since we are withdrawing from Vietnam and hopefully the balance of payments saving that will accrue from this troop withdrawal will not be spent in military action or military support in other Southeast Asian countries. As I mentioned, our trade surplus is improving and I look for it to continue to improve since we are farther advanced in our battle against inflation than other industrialized countries. Also, the Federal Reserve's recent wise decision to lift the interest ceilings on certain categories of CD deposits is likely to encourage dollars to stay at home since they can now earn returns comparable to those that can be earned by Eurodollars.

It is also clear that the world has been willing to bear the balance of payments deficit of the United States assuming it does not get out of hand. Dollar redemptions for U.S. gold have not been running at a high rate. Perhaps this deficit can be viewed as the service charge that the world is willing to bear for the use of the dollar as a reserve currency and the Eurodollar as the international currency.

Mr. Chairman, I make this brief survey solely to indicate that the international economic picture is far from being grim. It appears to be far healthier than does our own domestic economy. This has resulted in what can be called a transference of anxieties and scapegoatism in which many people who are afraid of losing their jobs because of the domestic showdown and many firms which are caught in a profit squeeze are blaming their very real woes on the foreigner. This is basically irrational and not borne out by the facts. Rather than to indulge in such fantasies, let us rather take the necessary steps to get this economy moving again, to pass the manpower programs needed to train and employ the unemployed, and to provide the Presidential powers and the trade adjustment assistance to help those individuals and firms genuinely hurt by imports, among other matters.

I emphasize that certain American industries have legitimate grievances in the trade area. Certain American industries are being hurt by a sudden impact of imports; and it is the duty of this Administration and the Congress to assist such industries. However, given today's general economic conditions, there are many other American firms that are being injured not by the sudden impact of imports but by the sudden impact of restrictive fiscal and monetary policies, by rampant inflation in wages, prices, by record interest rates and by a stagnation in productivity and in the vaunted American competitive spirit. For this, foreign nations are not to blame.

This irrationality, this propensity to look for the worst in one's neighbor's yard because one's own yard is undergoing temporary difficulties, this move into quasi-isolationism in an increasingly interdependent world, could result in bringing down the economic system that has served us so well over the past 25 years.

I would now like to outline four areas of specific concern:

1. An ill-advised Administration decision to support quota legislation at the behest of the textile industry, followed by tentative House Ways and Means Committee decisions on the trade bill, are threatening to reverse the liberal trade policies which this nation has followed for approximately 40 years. The result is that the world has moved a step closer to a devastating world trade war, all of this triggered by Japan's past persistence in ostrich-like, head-in-the-sand foreign economic policies.

2. An historic opportunity to re-direct and re-vitalize U.S. foreign aid.

3. The urgent need for a review of U.S. private investment abroad, the magnitude of which has stirred resentment but little understanding at home and overseas. This legislation has led to the growing support of punitive, inward-looking legislation, both in the United States and the European Common Market. This, combined with the retention of outmoded anti-trust laws by the United States, results in a policy combination which may be very harmful to not only U.S. business, but our international balance of payments position as well.

4. International monetary policy stands at the crossroads, and the present calm should be a spur to action designed to prevent future and recurring parity crises and balance of payments disequilibirums that could again threaten the smooth functioning of the international monetary system.

TRADE POLICY

While I share Representative Byrnes concern that "political clout" should not be the principal factor which determines which industries secure or do not secure relief from rising imports, I must consider the tentative decision of the Ways and Means Committee to authorize a general restrictive new quota mechanism as unwise and potentially dangerous.

If this indeed does come to pass, the United States will face retaliation—Western Europe and Japan and perhaps other countries already have discussed the specifics of such retaliation—a chain of events that will not redound to the interest of any nation.

Those promoting protectionist legislation are not promoting in my judgment a national interest, but as is their right, of course, a sectional specific business interest.

I must also express my concern about the Ways and Means Committee's tentative decision concerning the American Selling Price (ASP). Repeal of the ASP is a firm commitment made by the Executive Branch of the United States Government. It is widely viewed abroad as the litmus test of the United States' intent as regards non-tariff barriers. The question must be asked how the Congress can even contemplate the opening of general negotiations on non-tariff barriers, if we don't live up to the one commitment we have made to eliminate American non-tariff barriers.

The one ray of light is the announcement that the United States has now agreed to multilateral talks with its main trading partners to discuss the crises in the world's textile markets and that the President's Special Trade Representative and the Under Secretary for Economic Affairs of the Department of State will represent the United States in these talks. These talks perhaps represent the last hope the industrialized nations of the world have to avert a trade war. I urge the representatives of all nations to seek a solution to the difficult problem of textiles in accord with the trade laws that have so well governed the expanding world trade that has benefitted us all over the past 25 years.

FOREIGN ASSISTANCE POLICIES

There is growing international concern that foreign assistance is not a priority concern of this Administration and that the lack of Administration leadership will result in further cuts in the already low levels of our foreign assistance programs. This concern is partially attributable to the fact that the President has not yet submitted to the Congress the Report requested in my amendment to the Foreign Assistance Act of 1968.

At this time, I do not feel that this international concern about the Administration's future policies in the foreign assistance area is warranted and I have been assured by the Administration that the President's Report will be forthcoming in the very near future. Also the Overseas Private Investment Corporation, a significant new instrument designed to better promote our foreign economic policies, has already been authorized by the Congress and will come into being in the very near future.

In my view, because of the growing sense of quasi-isolation in the United States which is related to the Cambodian decision and reflected in the trade decisions now being made, it is very important that the President outline for the nation and the world, positive suggestions for a continuing fruitful and meaningful involvement with the developing world through a continuing developmentally oriented foreign assistance program. I am further convinced that Western Europe and Japan are increasingly willing to share the burdens of such a program which will primarily address itself to the growing gap between the have and have not nations. Thus, in the foreign assistance field the President and the Administration now have a rare opportunity to take positive action which over time would significantly redound by improving the image of the United States in the world.

THE MULTINATIONAL CORPORATION

I suggest that we are lagging in our understanding of the importance of the role of the multinational corporation and the interconnection between American investment overseas and the health of our economy at home. This "lag" in understanding could result in decisions that we could live to regret.

These are not empty words since the Ways and Means Committee seriously considered language which would materially harm the operations of our American subsidiaries overseas without ascertaining the effect this legislation could

have on the health of our own economy. I refer to the proposed repeal of Items 806.30 and 807.0 of the Tariff Schedules of the United States which provide that American articles which are exported for assembly and processing abroad are dutiable on their return to the United States only on the value of foreign costs and charges incurred; the American component of the produce is not presently dutiable. I have been informed that through the use of these sections in our Tariff Laws, American companies have found a way to compete with foreign manufacturers. Assembly abroad of American componets may have saved and increased American jobs and afforded American companies an opportunity to hold a sizable portion of a market that will otherwise go to manufacturers by default.

To give an idea of the magnitude of our business investment overseas, during the period 1950–1968, U.S. private investment abroad grew from $19 billion to $101.9 billion and overseas private investment in the U.S. grew from $8.0 billion to $40.3 billion; annual growth rates of 10%. Servan-Schreiber forecasts that by the end of 1975 the third biggest industrial power in the world will be United States owned industry in Europe.

This indicates the extent to which the operations of the multinational corporations with their world-wide marketing and production concepts are creating an interdeveloped world economy and are outdistancing the legal framework which still is dwarfed by the rapid growth of the world economy.

INTERNATIONAL MONETARY CONSIDERATIONS

Because of the dollar's role as a reserve currency, and the fact that it is the standard of value for virtually all of the free world's currencies, the United States must assume a passive role in the exchange rate adjustment process. This is to say, we cannot devalue or revalue the dollar in order to improve our position vis a vis other currencies. The U.S. economy which might justify an exchange rate adjustment under other circumstances cannot be corrected by the United States through a change in the par value of the dollar.

The Republican members of this Committee, in the JEC Annual Report, stated that any improvements in the situation "must provide for more automatic and less discretionary means for exchange rate adjustment, both upward and downward, in order to harmonize international exchange rates". This is a sound policy.

The need for the growth in global reserves beyond that which could possibly be attained through conventional means is precisely the fact which lay behind the recent ratification and activation of the Special Drawing Rights facility. This Committee can rightfully take credit for helping develop a realization of this fact, and promoting the U.S. position on Special Drawing Rights; I foresee continued leadership by the Committee in this regard in the future. Therefore, I believe the Committee should consider the possible serious consequences of the failure of world reserves to keep pace with accelerating global needs.

One might ask what is the proper level of reserve creation, and what are the consequences of failure to expand world reserves.

The SDR facility marks a breakthrough in reserve creation and in theory should assure us of a means for guaranteeing the growth in world liquidity according to the needs of world trade and payments equilibrium. However, the present rate of SDR creation appears insufficient to do anything more than blunt the further deterioration in this liquidity situation. Estimated needs for additional reserves run as high as $6-billion per year, while the rate of SDR creation is running at an annual rate of slightly over $3-billion. Creation of total new reserves *including* SDRs is also running significantly lower than the need for new reserves.

Perhaps it is expecting too much of SDR's to solve the world's liquidity problems at once, but the demonstrated needs are so great that serious consideration ought to be given to wider use of SDR's when the amounts to be created are next decided upon.

In perhaps a more ominous development, our balance of payments problems now coincide with a growing realization among economists that the U.S. has little control over its balance of payments and that developments in the international monetary scene show a gradual shift away from dependence upon the dollar as a reserve.

What these facts imply is that the world's surplus countries might find it difficult in the future to tolerate continued heavy outflows of U.S. dollars.

The whole area of international capital flows is grossly unregulated, and was never treated thoroughly in the Bretton Woods Agreements. The fact that coun-

tries readily turn to a wide variety of capital controls whenever they feel slightly threatened on the international front attests to the need for greater coordination and knowledge in this important field.

Therefore, I would like to commend to this Committee a proposal by former Treasury Undersecretary Robert Roosa, that the United States call for a systematic attempt to formulate some "rules of the game" on international capital flows. This attempt would supplement work which has already been done in the OECD on the liberalization of capital movements; it would address itself to the modern conditions characterized by the increased amount of international business activity and the uncertainties regarding our payments position.

Representative BOGGS. May I make an observation?

Senator SPARKMAN. Yes, indeed.

Representative BOGGS. First, let me say that I have worked with Senator Javits in this area since he was a member of the House. I consider him the most knowledgeable and most articulate member of this body of the Congress on this subject in the United States. And I think the work he has done has already inured to millions of human beings all over this world

Senator, I would like to ask you one question, if you don't mind.

It seems to me that what we have to do in the developed nations is get over the concept that if we turn to full capacity in Japan, the Common Market, United States, we still couldn't supply the tremendous demand for goods all over the undeveloped world.

Senator JAVITS. There is absolutely no question about that, Mr. Chairman. As a matter of fact, my brother, who has played with these figures and statistics, has computed that to give every person in the undeveloped part of the world one extra shirt would take about all of the production of which we are now capable in terms of increases.

The important thing, which I would like to add by way of supplement, is that we must learn how to use these magic pieces of paper called credit in order that we may induce mankind to use them too. This is the real trick. We have a priceless resource, Mr. Chairman, that no Communist State can compete with. Our people will give their labor today and accept a piece of paper due in 50 years, and that paper is immediately discountable. This is an unbelievable act of genius in the annals of mankind. No communist State can dream of contending with it. It gives us a limitless power and the difficulty is that we have not yet either felt bold enough or learned enough about it to know how to use it. That is the real issue.

Senator SPARKMAN. I appreciate both these statements. I think they are very fine statements.

I am glad that Senator Javits brought in the Ovearseas Private Investment Corporation. That is just one of his, one of the fruits of his keen imagination as to what can be done and I have been pleased to see the progress that has been made.

Well, I know of nothing else. I certainly appreciate it. Thank you very much.

The committee will stand adjourned until 10 o'clock Monday morning, July 20, when we will hear from Paul W. McCracken, Chairman of the Council of Economic Advisers, and George P. Shultz, Director of the Office of Management and Budget.

(Whereupon, at 11:30 a.m., the committee was adjourned, to reconvene, at 10 a.m., Monday, July 20, 1970.)

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