499

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-FIRST CONGRESS

SECOND SESSION

PART 3

JULY 20, 21, 22, 23, AND 24, 1970

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

49-774 WASHINGTON : 1970

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $1.25

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.]

WRIGHT PATMAN, Texas, *Chairman*
WILLIAM PROXMIRE, Wisconsin, *Vice Chairman*

HOUSE OF REPRESENTATIVES

RICHARD BOLLING, Missouri
HALE BOGGS, Louisiana
HENRY S. REUSS, Wisconsin
MARTHA W. GRIFFITHS, Michigan
WILLIAM S. MOORHEAD, Pennsylvania
WILLIAM B. WIDNALL, New Jersey
W. E. BROCK 3D, Tennessee
BARBER B. CONABLE, JR., New York
CLARENCE J. BROWN, Ohio

SENATE

JOHN SPARKMAN, Alabama
J. W. FULBRIGHT, Arkansas
HERMAN E. TALMADGE, Georgia
STUART SYMINGTON, Missouri
ABRAHAM RIBICOFF, Connecticut
JACOB K. JAVITS, New York
JACK MILLER, Iowa
LEN B. JORDAN, Idaho
CHARLES H. PERCY, Illinois

JOHN R. STARK, *Executive Director*
JAMES W. KNOWLES, *Director of Research*

ECONOMISTS

LOUGHLIN F. MCHUGH
JOHN R. KARLIK
COURTENAY M. SLATER
RICHARD F. KAUFMAN

Minority: DOUGLAS C. FRECHTLING
GEORGE D. KRUMBHAAR

CONTENTS

WITNESSES AND STATEMENTS

MONDAY, JULY 20, 1970

Page

McCracken, Paul W., Chairman of the Council of Economic Advisers 380
Shultz, George P., Director of the Office of Management and Budget 397

TUESDAY, JULY 21, 1970

Kennedy, Hon. David M., Secretary of the Treasury, accompanied by Paul Volcker, Under Secretary of the Treasury for Monetary Affairs; and Murray L. Weidenbaum, Assistant Secretary of the Treasury for Economic Policy 448
Hodgson, Hon. James D., Secretary of Labor, accompanied by Geoffrey H. Moore, Commissioner of Labor Statistics, Department of Labor 455

WEDNESDAY, JULY 22, 1970

Ackley, Gardner, professor of economics, University of Michigan 520
Samuelson, Paul, professor of economics, Massachusetts Institute of Technology 528
Wallich, Henry C., professor of economics, Yale University 532

THURSDAY, JULY 23, 1970

Burns, Hon. Arthur F., Chairman, Board of Governors of the Federal Reserve System 576

FRIDAY, JULY 24, 1970

Keyserling, Leon H., former Chairman of the Council of Economic Advisers, consulting economist and attorney, and president, Conference on Economic Progress 617

SUBMISSIONS

MONDAY, JULY 20, 1970

McCracken, Paul W.:
- Prepared statement 387
- Replies to the questions posed by minority members 442
- Reply to the question posed by Representative Brown 444

Shultz, George P.:
- Response to Representative Brown's question whether the President should refuse to spend the additional appropriations if congressional appropriations exceed what the President considers a responsible budget total 420
- Reply to the question posed by Representative Brown 445
- Response to Senator Proxmire's request to supply for the record the total number of budget examiners in the Office of Management and Budget and the number and percent engaged in examining national security programs 446

TUESDAY, JULY 21, 1970

Department of Labor:
Response to Representative Brown's question regarding the range of sampling error of the overall unemployment rate — Page 511
Department of the Treasury:
Tabular response to Representative Brown's question regarding budget outlays on national defense, human resource, and other programs, fiscal years 1968-71 — 489
Response to Senator Proxmire's question regarding what the Department of Defense (military functions) expenditures for fiscal year 1970 were — 496
Response to Senator Proxmire's question regarding the clarification of the defense budget reduction — 506
Tabular response to Representative Brown's question regarding comparisons of the administration's budget proposals as they have been presented and the action which Congress has taken which affects spending, appropriations, or the bills that add to appropriations spending over recent years — 508
Hodgson, Hon. James D.:
Prepared statement — 462

Appendix

Department of the Treasury:
Response to additional questions posed by Chairman Patman — 515

WEDNESDAY, JULY 22, 1970

Ackley, Gardner:
Prepared statement — 523
Reply to the question posed by Chairman Patman regarding the cancellation of the $57 billion of U.S. Government bonds held by the Federal Reserve — 559
Wallich, Henry C.:
Prepared statement — 536
Reply to the question posed by Chairman Patman regarding the cancellation of the $57 billion of U.S. Government bonds held by the Federal Reserve — 559

THURSDAY, JULY 23, 1970

Burns, Hon. Arthur F.:
Response to Chairman Patman's request to supply for the record the legal authority of the Federal Reserve to make loans — 590
Responses to Representative Reuss' questions regarding his qualifications set forth in his supplementary views of the "1968 Joint Economic Report," Joint Economic Committee:
Qualifications:
No. 2 — 597
No. 3 — 597
No. 4 — 598
No. 5 — 598
No. 6 — 598
Response to Chairman Patman's request to supply for the record the feasibility of (1) requiring the Federal Reserve to provide a certain percentage of funds for housing, and (2) a program of investment in mortgages by pension funds — 603
Response to Senator Proxmire's request to supply for the record available information to confirm the substantial reduction that has occurred over the past year in the defense activity — 607

FRIDAY, JULY 24, 1970

Bonniwell, Donald R., Sr., a senior vice president, Walston & Co., Chicago:
Prepared views — 651
Keyserling, Leon H.:
Prepared statement — 628

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

MONDAY, JULY 20, 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. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Widnall, and Brown; and Senators Proxmire and Percy.

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 resume our review of the state of the economy, hearing from two chief economic advisers of the President. I may say that in our hearings so far, which have been taking place since July 8, there have been few words of cheer from our witnesses, who included business executives, a leader of labor, Government regulators, private economists, and last Friday two of our own committee members who are experts on the balance of payments and related problems.

Almost all major aspects of the economic outlook present serious problems to which apparently there are no ready or early solutions, and matters appear to be getting worse rather than better.

The statements submitted for today attempt to show us some rays of hope in the possibility that the recession has bottomed out. But I have yet to be convinced. Our unemployment is at a peak. Of course, I am hoping that it has bottomed out. The rate of price increase is extremely high. We have lost a tremendous amount in national production and, even worse, there is no prospect that I can see that will prevent our losing a vast amount more.

For that reason, we are most anxious to hear from the representatives of the administration, and I want them to know that we are listening attentively to everything they say. It is obvious that in our present troubles we need all the cooperation and ability that we can muster and I want you to know that we intend to work with you in every way that we can.

Our first witness today will be Dr. Paul McCracken, Chairman of the Council of Economic Advisers. Following him, we shall hear from Dr. George Shultz, until just recently Secretary of Labor and currently Director of the new Office of Management and Budget.

Mr. McCracken, your prepared statement will be inserted in the record and you may proceed as you desire. We would appreciate it if you could summarize so we will have more time to ask questions.

STATEMENT OF PAUL W. McCRACKEN, CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

Mr. McCRACKEN. Thank you very much, Mr. Chairman, members of the committee. I appreciate very much the opportunity to appear again before this committee for its midyear review of economic developments and their implications for policy. The past few months since I was last before the committee have been a period of great uncertainty about where the economy was going and of unusual volatility in sentiment. Recent developments and information, however, have made the main elements in our situation somewhat clearer.

First, the economic decline has not cumulated, but appears to be bottoming out and at worst is unlikely to proceed much further. Its maximum dimension will be far short of the experience in any of the postwar recessions

Second, signs of the expected slowdown in the rate of inflation are becoming stronger, and there is little doubt that continuation of economic policy on its planned course will reduce the rate of inflation further. The inflation rate has proved to be more stubborn than was commonly expected, but it has not been immune to changing economic policies and conditions.

Third, attention should now focus on the requirements for assuring that the upturn will carry through steadily to full employment but not so rapidly as to cause inflation to speed up once more.

Mr. Chairman, there follows a rather long section which is a review of economic developments in the first half of my prepared statement which I will not read.

Chairman PATMAN. It will appear in your prepared statement.

Mr. McCRACKEN. I would like to turn now to the topic "Prospects for the Remainder of 1970," which I take up in my prepared statement.

Chairman PATMAN. All right, sir.

Mr. McCRACKEN. In the rather substantial section which I am not bothering to read I have simply outlined economic developments during the first half of the year, both in the domestic economic situation and in our balance of payments.

I turn now to the question of prospects for the remainder of 1970.

We have behind us a moderate decline in the real economy and the first signs of a decline in the rate of inflation.

WHAT LIES AHEAD?

With economic activity bottoming out in the second quarter of 1970, it is reasonable to expect a resumption of growth in real GNP in the second half, also accompanied by a better price performance. As we stated in our economic report, the existence of slack in the economy means that increases in demand can be translated more nearly into output increases rather than price increases. At the same time, we are likely to experience a further moderate rise in unemployment rates over the average level that prevailed in the second quarter. The unemployment rate will start to level out and decline only after the recovery is vigorous enough to diminish the gap between actual and potential output.

At the start of 1970 it was recognized that, in order for the economy to resume its expansion in the second half, it would be necessary to relax monetary policy at the beginning of the year. A change in monetary policy occurred around midwinter. Growth of the money supply from December to June averaged 4.2 percent at an annual rate, as compared with 0.6 percent for the preceding half year.

In capital markets, the change in policy first produced easier credit conditions. Short-term interest rates declined sharply. Although U.S. Government and municipal bond yields also receded, corporate yields only leveled off and in May they began to rise again. With pessimism about profits and with a continuing need to refinance short-term indebtedness incurred in earlier months, corporate demand for long-term credit remained intense. Corporate bond issues, which had totaled $9.3 billion in the first half of 1969 and $9.1 billion in the second, were $14.1 billion in the first half of 1970. However, the early weeks of July brought signs that these pressures have abated, and bond yields have backed down from their peaks of June.

At the turn of the year, deposit flows into savings institutions began to recover dramatically from the severe decline of 1969. The net change in mortgage holdings of all financial institutions, which had fallen sharply after the middle of 1969, reached a low point in March and showed a definite improvement in April and May.

The increase in the money supply and improvement in credit market conditions should be felt throughout the economy but should be most noticeable in the case of homebuilding, and State and local expenditures. There have already been some signs of an upturn in homebuilding; building permits rose in April and May to their best levels in about a year. Housing starts rose sharply in June. A very considerable backlog demand for housing has built up as a result of the low volume of housing starts in the past several years, and the easing of credit ought to find a reasonably prompt response in housing starts.

Fiscal policy also became more expansive in the first half of 1970, and we have by no means felt all of the effects of this stimulus. That is suggested by the unusually high saving rate (7½ percent) in the second quarter, indicating that consumers have not yet fully adjusted outlays to increases in their after-tax incomes. Furthermore, starting in July, there was the complete elimination of the surtax as well as the increases in personal exemptions that were part of the Tax Reform and Relief Act of 1969. These provisions will add an estimated $5 billion to consumer disposable income in the third quarter. Altogether, the elimination of the surtax, the rise in social security benefits, the Federal pay raise, and the reform and relief provisions of the tax law have added over $16 billion to consumer disposable income since the final quarter of 1969. We have already seen some positive results in consumer spending in the first half, and it is reasonable to expect more in the second as consumers adjust more fully to these income changes.

Federal expenditures are not likely to show much change over the current half year. Cutbacks in defense purchases will continue, offset by rising purchases of other types.

Finally, plant and equipment outlays ought to be a little higher in the second half than in the first. This is not inconsistent with a further scaling back of the plans reported in the June Commerce-SEC survey. Inventory accumulation should also rise after the unusually low figures of the past half-year.

When we put these figures together, they add to increases in real GNP of moderate size in the second half. This assumes no interruptions from major strikes, about which I have no special knowledge. We should also see for the first time a slower price rise at the consumer level. Prospects are particularly favorable for retail food prices to change relatively little in the second half because of larger supplies coming to market.

THE PROBLEM OF LIQUIDITY

The chairman of the committee requested that I comment on the liquidity problem. This is an important matter. It is a factor thought by some to cloud the prospect for economic revival and even to hold potential danger that a decline might resume.

A liquidity problem in the sense of disorganized financial markets clearly does not exist. If there were a generalized scramble for funds, interest rates, particularly short-term rates, would be rising sharply. In fact, they have been declining. Our banks are strong. Consumer credit is not out of line with incomes, and delinquency rates are well within the range of normal expectation.

Certain statistical measures of average liquidity have shown substantial declines. For example, the ratio of quick assets (cash and U.S. Government securities) to current liabilities for nonfinancial corporations declined from 0.33 at the end of 1964 to 0.19 at the end of 1969, and to 0.18 in the first quarter of 1970. For manufacturing corporations in this 5-year period, the decline was from 0.43 to 0.23. These declines seemed to have come heavily in two spurts, one from 1964 to 1966 and the other from 1968 to date.

These declining measures of liquidity reflect many things. There has been a long-run trend toward holding smaller reserves of cash and marketable securities, as companies have been attracted by the increased profits obtainable from investing such funds in inventories and other forms of working assets. Modern techniques of short-term financial and portfolio management have also encouraged this development of economizing on resources, essentially cash resources.

In addition to these long-run trends, two further developments seemed to become more evident in recent years. Both were related to the persisting inflation that began to gather momentum in 1966. As the inflation persisted, and after 1967 accelerated, firms began to shift from cash and financial assets to inventories and physical capital assets. This was presumably a preventive measure reflecting, in part, fears about an erosion of the real value of assets from continuing inflation. In their endeavor to minimize these risks some businesses may have come to give inadequate weight to the normal risks and contingencies for which quick assets and a strong current position are a part of prudent financial management.

Moreover, business capital demands were intense in 1969, as projected increases in outlays for plant and equipment rose to the 12–14 percent range, this is an economy capable of increasing real output by not much over four percent per year. There was in many of these capital budgets also a strong component of inflation-mindedness. These developments began to crowd against a flow of internal funds adversely affected by declining profits. Heavy demands were, therefore, thrown into credit markets also under growing pressure from restrictive monetary policies. Financial markets tightened and interest rates rose sharply. In the face of high bond yields and falling equity prices, many companies borrowed short-term funds last year with the intention of converting to long-term financing at a more opportune time later. This year many firms were faced with converting this short-term indebtedness into longer-term maturities. As a result, the demand for long-term funds continued to be intense this year, and the bond market has been forced to handle a tremendous volume of new issues. In the intense competition for funds, some borrowers have inevitably been squeezed out. Mr. Chairman, we are now engaged in a more detailed study of this problem which extended considerably beyond the time period for this testimony, and I think it may be possible to have this report available for the record.

Chairman PATMAN. In connection with your remarks.

Mr. McCRACKEN. Right.

Chairman PATMAN. Yes, sir, that will be satisfactory.

Mr. McCRACKEN. Our study, however, of this problem to date has led us to three main conclusions. First, the financial institutions of the country are in sound condition and financial markets are working effectively. The ability of the banking system to meet demands upon it has been strengthened by accessibility of the Federal Reserve discount window and by the new ability of banks to attract funds through certificates of deposit.

Second, although the liquidity of nonfinancial corporations on the average has declined by almost any measure, it is only in exceptional cases that serious difficulties exist. These cases do not constitute a problem for the economy as a whole. At the same time, we must be alert to these situations, and have the capability and will to handle them decisively, in order to minimize the danger of adverse secondary effects.

Third, the overall supply of liquidity, as measured by the supply of money and the availability of credit, is on the low side of what is needed, especially for a period which we expect to be the beginning of renewed expansion. Assurance of a sustained rise in the economy would be improved by more rapid strengthening of the economy's general liquidity position.

MANAGING A NONINFLATIONARY EXPANSION

There is a strong and increasing basis for confidence that the decline of the economy is about over and that we will soon be seeing the signs of an upturn. While there is, as usual, disagreement about the precise dates and quantities involved, it is timely for us to look beyond the turn as such and explore the problems of managing an orderly recovery to full utilization of our productive capacity.

The word "managing" deserves emphasis. Having come this far along the road of reestablishing the basis for a more stable price level, we must resist the temptations of overly expansionist policies. There is too much viscosity in our economy for it to make an immediate and dramatic rebound, and in trying to achieve this we would court the risk of reactivating inflationary pressures and inflationary fears.

At the same time we can now begin a more expansionist course for the economy and still continue to make progress against the inflation. Price developments in the period ahead will heavily reflect the emergence of slack in earlier quarters. Pricemaking forces move slowly through the economy. We have already incubated disinflationary pressures whose results on the price level are still largely to come into the picture.

Moreover, even when the economy has turned the corner, we cannot assume an automatic return to full employment. In 1958 the economy began a strong recovery from its low point, but that did not continue long enough to eliminate its slack. The 1960–61 recession was the mildest of postwar history, but 4 years after its low point the unemployment rate was still 5 percent, and another year was required to achieve 4 percent. Certainly our goal must be to regain full employment more promptly this time than in those earlier periods.

We must begin now to think in terms of the magnitudes that will be required in the period ahead. These magnitudes are large. Potential real output rises by at least 4 percent per year as a result of the growing labor force and the various factors that increase productivity. In addition to this we now have some arrearages to make up within a reasonable period. Total output was probably running about 4 percent below its potential, in the second quarter of 1970, as conventionally defined; that is, it was about 4 percent below the output we would have produced if unemployment had been 4 percent and productivity had been on its long-term trend. And the price level in the period ahead will have some upward drift even though the inflation continues to decelerate. Therefore, the rates of increase of money GNP required for recovery to full employment will be somewhat higher than the needed rates of increase of real output alone. These figures suggest that, even for the economy to move along an essentially noninflationary growth path, needed rates of growth in the money demand for output will be large.

Such rates of increase of total output would also involve unusually large increases in productivity—in output per man-hour. The possibility of achieving a large increase of productivity is implicit in the estimate that, while unemployment in the second quarter of 1970 was roughly one percentage point below full employment, real output was 4 percent below potential. A rapid increase of productivity has been our normal experience when the economy was in the early stages of recovery from a slowdown, and there is no reason why it should not occur now.

The rapid rise of productivity would, of course, make a substantial contribution to the reduction of inflation, reversing a factor which has been making a major contribution to the continuation of inflation. If productivity should now rise for a time at the rate of 4 or even 5 percent, which is not impossible, the rise of unit labor costs would be dramatically reduced, and so would cost pressures on the price level.

In the management of fiscal and monetary policy it will be essential to keep in mind that a rate of expansion which is appropriate if we are moving along the path of reasonably full employment is not adequate when we begin from a position substantially below that path. This is doubly important when we bear in mind that it is also an economy needing some strengthening of its liquidity condition.

The problem of fiscal management in the period ahead is particularly complex. And since Mr. Shultz is here I have only a very few comments on that. The basic task of fiscal policy is always to assure that we make provision for the most important national needs which should be met through the Federal budget and that resources and finance are left available for those important public and private needs that must be met outside the Federal budget. The overwhelming requirements of this task, and of the political process through which it is performed, leave little room for flexible variation of the budget to meet changing short-run requirements of economic stabilization. In fact, as experience demonstrates, just to keep the budget from being a destabilizing force in the system is difficult enough.

Probably the basic contribution fiscal policy can make to the orderly and expeditious recovery of the economy is that it should not place upon either monetary policy or on private market forces the need to adapt to sharp changes of conditions. We should achieve at least a balance and hopefully a moderate surplus in the budget when the economy regains full employment, because after this present multifaceted transition the demand for capital to finance housing, State and local investments, and business investment will be high, and a strong budget will help to meet those demands. The transition from today's deficit to the desired full-employment balance or surplus should be made smoothly as the economy rises to its potential. Particularly we should avoid falling off this path into significantly larger deficits. One of the most serious consequences of such a development would be to interrupt the emergent recovery of housing.

The recovery of the economy added to its normal growth will greatly increase the revenue-yielding base. But what is truly amazing is the extent to which this increase is already committed, by tax reductions scheduled under the 1969 act and by a seemingly irresistible flood of expenditure increases built into existing legislation. The dominant, persistent budgetary problem of our time will be to hold expenditures in line with what the people are willing to pay for. We cannot afford to be diverted from that task.

The administration relies basically on the combination of fiscal and monetary policy, with the spontaneous adaptive forces of the private economy, to move us along the path to full employment with less inflation. Still we have been anxious, as any administration would be, to find supplementary measures that would really help to speed the disinflationary process. To this purpose we began considering in March 1969 a wide range of possible actions falling within the category loosely called price-wage policy or incomes policy. We have not, of course, lacked suggestions in this area.

Our objective was to isolate those elements of such possible actions that held some promise of success. In this consideration, it was necessary to get behind the labels pinned on policies to discover what they really consisted of and were really likely to perform. The conclusion of considerable study and discussion within the administration was that the following steps would be useful:

1. To mount a major cooperative effort of the private sector and the Government to increase productivity.
2. To provide a forum within which leaders of the private sector and of the Government can discuss the requirements of a stable and growing economy.
3. To provide the public with more information about the consequences for the course of the inflation of private wage and price decisions.
4. To assure that in the exercise of the Federal Government's procurement and regulatory functions more weight be given to the objective of restraining inflation.

The President announced in his address on June 17 that these steps would be taken. Since then we have been engaged in putting them into effect. A National Commission on Productivity has been established. It will hold its first meeting on August 6. At that time the Council of Economic Advisers will submit to the Commission its first inflation alert, outlining the consequences of major price and wage decisions for changes in the price level. A Regulations and Purchasing Review Board has also been established to determine where these Federal activities tend to drive up prices, and this Board is now functioning.

These measures have been carefully chosen. They are an effort to assure that, within the logic of a free economy, we leave nothing undone to assist the country through the difficult transition we must now make. We will pursue this effort as diligently as possible and are hopeful it will make a contribution.

CUSHIONING ADJUSTMENT HARDSHIPS

During this period of transition we need measures to cushion the adverse effects of the adjustment. The unemployment insurance system has been a support to hundreds of thousands of workers during interruptions of employment. Last year the administration proposed legislation that would have extended unemployment insurance coverage to millions of workers now uncovered, and improve the system in other respects. It is to be hoped that this can soon become legislation.

The administration has also proposed an automatic increase of 10 percent in funds allocated to manpower training programs when the unemployment rate rises about 4.5 percent for 3 consecutive months. Had this legislation been enacted, this increase would already have taken effect. Unemployed workers could take advantage of these increased opportunities for training and upgrading of skill levels during interruptions of employment. Higher skill levels of the work force have been an important source of productivity growth, and the increased training opportunities under the Manpower Training Act would enable these workers to obtain better jobs and lay the basis for future improvements in their earning capacity and in national productivity.

Now to summarize my testimony. This review of recent economic developments, evidence about our prospects, and the implications of these for the management of economic policies has led me to four major conclusions.

First, the adjustment of the economy to needed measures of disinflation though painful has produced no cumulative decline in business activity. In overall terms it has established itself as discernibly less severe than the 1960–61 decline, which itself was the mildest recession of the postwar period.

Second, an evaluation of basic forces which will be shaping the course of the economy in the period ahead leads to cautious optimism about an improvement in business conditions during the second half of the year.

Third, in our understandable desire to regain full employment promptly, we must not undo the substantial progress that has been made in establishing the basis for a more stable price level.

Fourth, mindful of the need to move in an orderly way, we must now face up to managing the resumption of an expansion that in a reasonable period can bring the economy back to the zone of full employment. The magnitudes are large because the basic capacity of the economy is growing rapidly, we set out on the return to full employment from a position that is below the basic path, and some strengthening of the economy's liquidity resources commends itself now as a prudent consideration of policy.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, Dr. McCracken.

(The prepared statement of Mr. McCracken follows:)

PREPARED STATEMENT OF PAUL W. McCRACKEN

I appreciate the opportunity to appear again before this Committee for its mid-year review of economic developments and their implications for policy. The past few months since I was last before the Committee have been a period of great uncertainty about where the economy was going and of unusual volatility in sentiment. Recent developments and information, however, have made the main elements in our situation somewhat clearer.

First, the economic decline has not cumulated, but appears to be bottoming out and at worst is unlikely to proceed much further. Its maximum dimensions will be far short of the experience in any of the postwar recessions.

Second, signs of the expected slowdown in the rate of inflation are becoming stronger, and there is little doubt that continuation of economic policy on its planned course will reduce the rate of inflation further. The inflation rate has proved to be more stubborn than was commonly expected, but it has not been immune to changing economic policies and conditions.

Third, attention should now focus on the requirements for assuring that the upturn will carry through steadily to full employment but not so rapidly as to cause inflation to speed up once more.

ECONOMIC DEVELOPMENTS IN THE FIRST HALF OF 1970

Let me now turn to economic developments during the first half of 1970, partly against the background of expectations held at the beginning of the year.

THE SLOWDOWN OF DEMAND

A major factor in the change that has occurred in the economy in the past year has been the reduction in the rate at which total expenditures (private and public) for goods and services increased. Reducing the rate of increase in this money demand for output was one of the key steps in the policy of reducing the rate of inflation. It was obvious at the beginning of 1969 that with the economy crowding capacity and with total output capable of growing by around 4 percent a year, continued increases of expenditure much in excess of that rate inevitably meant continued rapid inflation. The objective of fiscal and monetary restraint was to check the growth of total expenditures for output, but not so sharply as to trip off a downward spiral of incomes and output.

The rate of increase in these total expenditures declined by almost 50 percent from the three quarters ended in July–September 1969 to the three quarters ended in April–June 1970. The dollar amounts of these changes in total expenditures and in its main components are shown in the accompanying table.

CHANGE IN THE ANNUAL RATE OF TOTAL EXPENDITURES (GNP), BY COMPONENTS

[Seasonally adjusted annual rates in billions]

Component	1968–IV to 1969–III	1969–III to 1970–II
Total	$51.2	$27.5
Federal purchases	.6	−2.9
(Defense)	(.6)	(−2.7)
All other	50.6	30.4
Change in business inventories	2.0	−8.7
Final sales (excluding Federal purchases)	48.6	39.1
Consumption expenditures	31.3	32.1
Nonresidential fixed investment	9.9	1.2
Residential construction	−.7	−2.5
Net exports	1.2	1.2
State and local purchases	6.9	7.1

Source: Department of Commerce.

ANNUAL RATE OF INCREASE IN THE MONEY SUPPLY AND TIME DEPOSITS

[Seasonally adjusted]

Period	Money supply (percent)	Money supply plus time deposits (percent)
December 1967–June 1968	7.3	6.4
June 1968–December 1968	7.1	12.5
December 1968–June 1969	4.4	.1
June 1969–December 1969	.6	−.3
December 1969–June 1970	4.2	5.7

Source: Board of Governors of the Federal Reserve System.

The complex interaction among components of GNP makes it impossible to say how much of this slowdown in spending was due to policy actions and how much to spontaneous forces, or to isolate the separate effects of different policy measures. Nevertheless, it seems reasonable to conclude, since it conforms to expectations based on past experience, that the reduction in the rate of monetary expansion had a general and pervasive influence. The money supply, which had grown at highly inflationary rates in 1968 and set the stage for further overheating the economy in 1969, increased only moderately in the first half of last year, and in the second half of 1969 there was virtually no expansion. Indeed, the money supply broadly defined to include time deposits actually declined slightly in that half-year period.

The influence of monetary policy was supplemented and to some extent directed into specific channels by the fiscal actions which accompanied it. The shift from increasing to decreasing defense production has clearly exerted an independent influence, and it was on a larger scale than is indicated by defense purchases alone because some part of the reduction in inventory accumulation was also the result of lower defense production. At the same time budgetary actions—the tax reduction and the social security benefit increase especially—were helping to sustain the increase of consumption expenditures in the face of a much reduced increase of earned personal income. But these budgetary actions helped to shift the budget position, as measured in the national income accounts, from a surplus at the annual rate of about $7 billion in the second half of calendar 1969 to a deficit of about the same size in the first half of calendar 1970. This contributed to the continued tightness of capital markets and to the lag of housing.

Although the increase of total expenditures for output has been markedly less in the past three quarters than earlier, the increase was larger in the second quarter of 1970 than in the previous quarter or in the fourth quarter of 1969. This is part of the evidence of an emergent economic expansion.

That the rate of increase of total spending for output should slow down was, as I have already indicated, both expected and desired, in order to reduce the inflation. The actual increase in the rate of spending from the third quarter of 1969 to the second quarter of 1970 was $6 billion below the increase expected when we made our projection for the year in January. This difference is largely accounted for by an unexpectedly sharp reduction in the rate of inventory accumulation. Final sales, *i.e.*, total expenditures less additions to inventories, have risen about $1 billion more than we had projected.

THE DECLINE OF REAL OUTPUT

A slowdown in the rise of real output was an inevitable part of the disinflationary process. The rate of inflation would not respond immediately to the slower growth of total expenditures, and this lag would adversely affect the rise of real output. Real output would move below its potential, but this would be essential as a part of altering the balance of market pressures against wage and price increases.

It was part of the strategy of policy that a sharp decline of output was to be avoided and that the gap between actual and potential output be kept small. The reason for this was to limit adverse effects on incomes, production, and employment, and to reduce the danger that the slowdown would set off a cumulative downward spiral. It was recognized that caution on that side implied some willingness to accept delay in seeing anti-inflationary results.

In fact, total production, as measured by the gross national product in constant dollars, has declined 0.9 percent from its peak in the third quarter of 1969 to the second quarter of 1970. For perspective, this may be compared with 3.2 percent in the corresponding period after the peak in 1953, 3.4 percent after 1957, and 1.3 percent after 1960.

Industrial production has declined 3.4 percent from its peak in July 1969 to June 1970. Industrial production is typically more variable than total output. The current decline of industrial production has also been smaller than the decline over an equal interval in postwar recessions.

We consider it important to note that real output showed no sign of a cumulative decline. The largest decline came in the first quarter and, according to preliminary estimates, total output was essentially unchanged in the second quarter. Industrial production continued to fall through June, but the percentage decline in June was less than in May or April.

In our Annual Report at the beginning of the year, we indicated our belief that total real output would be approximately level in the first half of 1970. Instead, the decline in the first quarter and leveling in the second quarter left second quarter output about 0.7 percent below the fourth quarter rate.

EMPLOYMENT AND UNEMPLOYMENT

The slowdown in the increases in demand and output have, of course, affected the employment and unemployment picture. By the end of the first half of 1970, total civilian employment, although one-half million greater than a year earlier, was one-half million less than in December 1969. We expected that the demand for labor would be weak in the first half when real output was edging down.

The unemployment rate increased markedly in the first half of 1970, from 3.6 percent in the fourth quarter of 1969 to 4.1 percent in the first quarter and to 4.8 percent in the second. The increase in unemployment during the first quarter was in part a consequence of an unusually rapid growth in the labor force. On a seasonally adjusted basis, the civilian labor force grew at a 5.9 percent annual rate from December to March, far in excess of its normal rate. However, some correction of this extraordinary growth occurred in the second quarter, when the labor force contracted. By June the labor force was only 2.0 percent above its level a year earlier, a growth rate much more in line with normal expectations.

At the beginning of 1970, we expected some increase in unemployment during the year. The greater than expected increase in unemployment was a result of several factors in addition to the very large increase in the labor force in the first part of the year. Output was more sluggish in the first half than we had expected, and employment growth was consequently weaker. In addition, strikes in the trucking industry, particularly in the Midwest, led to widespread temporary layoffs.

Cutbacks in the defense industry also contributed significantly to job loss, particularly among highly specialized workers in certain parts of the country. The extent of this and its economic implications are inadequately recognized. From the last quarter of 1968 to the second quarter of 1970, the annual rate of defense purchases, of goods and services, declined by about $13 billion in real terms (at mid-1970 prices). Further significant decline may be expected during the remainder of this year. As I pointed out earlier, the decline in defense production is undoubtedly larger than the decline in defense purchases because as defense orders fall more and more deliveries are made out of inventories rather than out of production. The armed forces have been reduced 423,000 from their peak, and employment in defense product industries has declined 320,000 over the past 2 years.

The unemployment problem normally associated with such a transition from defense to civilian production and employment comes on top of the unemployment problem associated with the ending of an inflation. In other circumstances, a stronger general demand for labor might have existed or been created, which would have speeded up the absorption of former defense workers into other employment.

The number of persons counted as unemployed increased by 1,137,000 from June 1969 to June 1970. The common picture of this as meaning that 1,137,000 persons once permanently employed are now permanently unemployed is, of course, incorrect. In any year large numbers of people experience some unemployment, most of them for very short periods, such as four or five weeks or less. An increase of unemployment is almost always made up of some increase in the number of people experiencing unemployment and of some increase in the average duration of unemployment before a job is resumed. Although figures for 1970 will not be available until next year, both parts of this process are clearly going on now, and a large part of the increase of unemployment is due to a rather moderate increase in the median duration of unemployment, from 4.4 weeks in June 1969 to 5.1 weeks in June 1970. This is not, however, to belittle the grave problems that these developments have posed for those whose employment has been interrupted. I want to emphasize what I have stated in the past that so long as anyone is unable to find a job, we have unfinished business.

PRICES AND WAGES

At the start of the year we expected that the gap between the economy's actual and potential output would bring about conditions making for a slower price rise. With jobs harder to find, labor would find it more difficult to make the kind of wage bargains it had during periods of low unemployment. Businesses in turn, facing more competitive markets, would be less likely to grant large wage increases if they believed that it would be difficult to recover higher costs in the form of higher prices. Furthermore, business would take more vigorous steps to cut costs by eliminating the inefficiencies that had grown up over the long period of inflation. This change in behavior was not expected to come all at once; we could not expect to root out in a few months problems of an inflation of long standing.

Specific signs of progress in the fight against inflation are not as numerous as we had hoped but they are now emerging. They should increase in number as 1970 progresses because the gap between our actual and potential production will persist.

The most comprehensive measure of price increases, the GNP deflator, showed a clearcut slowdown in the second quarter. The 4.2 percent increase was smaller than in any quarter of 1969 and approximately matched the annual increase from 1967 to 1968. This slowdown is good news for all of us even though the improvement was greatly influenced by changes in the composition of GNP. (Some of the earlier recorded increases in the deflator, of course, also reflected obverse shifts in composition.)

We do have final figures on the wholesale price index and here there is unmistakable evidence of a slower rise in prices in the first half of 1970. From December to June, the WPI rose at a seasonally adjusted annual rate of 2.6 percent, which was well below the average quarterly gain of 1969. In the second quarter, the rise came to only 1 percent. All of the improvement this year as compared with 1969 has occurred in prices of farm products and processed foods. On a seasonally adjusted basis, the rise in industrial commodities is about the same as the quarterly average last year. However, the price rise for both producer and consumer (nonfood) finished goods has been smaller from December to June than it was from June to December, 1969.

Two further points should be made here. The decline in food prices is extremely important and should be reflected with the usual lag at the retail level. Second, there is some reason to believe that some price cutting is going on in industrial markets that is not being picked up in the official prices indexes, which tend to reflect list prices only.

Unfortunately, the declines at the wholesale level have yet to be felt at retail. We have no evidence as yet of a slowdown in the consumer price index. However, with more favorable movements in wholesale food prices and with some slowdown in wholesale prices of other consumer finished goods, some response at retail should be forthcoming.

Data for the first half of 1970 indicate that average wage increases for the whole economy have slowed down somewhat during this period. The annual rate of increase in average hourly earnings in all private industries from the fourth quarter of 1969 to the second quarter of 1970 was only 5.2 percent as compared with an increase of 7.0 percent in the corresponding quarters one year earlier. From the first to the second quarters of 1970, average hourly earnings increased at an annual rate of 6.5 percent, while the increase was 8.4 percent for the same period in 1969. The slowdown in the rate of increase appears to be related to the elimination of overtime and changes in industry mix.

Wage increases negotiated under major collective bargaining agreements have not slowed down in the first half of 1970. The highly publicized large collective bargaining settlements, however, can give a distorted view of overall wage developments. Although the calendar for these collective bargaining negotiations is heavy in 1970, only about 6 percent of the total labor force will be covered by settlements reached under major agreements. Furthermore, most of the extremely high settlements have been in construction and trucking, which partially reflect symptoms of continuing structural problems in these industries. The high settlements in construction, for example, appear to result in part from a combination of the rapid expansion of demand for nonresidential construction in the late 1960's and union limitations on entry to the industry.

The relationship between wages and prices depends heavily on the behavior of productivity, of output per man-hour. It is only when the recent pace of wage increases is combined with the absence of gains in productivity that we can understand the rapid increase of unit labor costs which has contributed to the persistence of inflation. For example, from the fourth quarter of 1968 to the first quarter of 1970, compensation per man-hour in the private nonfarm economy rose at the annual rate of 6.4 percent, but productivity actually declined at the annual rate of 0.8 percent, with the result that labor costs for unit of output rose at an annual rate of 7.2 percent. This, of course, had a great deal to do with the fact that prices of private nonfarm output rose at an annual rate of 4.9 percent in the same period.

Preliminary information for the second quarter of 1970 suggests that productivity began to rise again, and may have increased at the annual rate of as much as 3 percent. This in turn may be related to early evidence suggesting that profits were somewhat better in the second quarter than many had feared earlier. Whether or not that turns out to have been true, all the conditions seem present for a rise of productivity in the future.

49-774—70—pt. 3——2

BALANCE OF PAYMENTS

Our international transactions during the first half of 1970 have shown both favorable and unfavorable developments. On the favorable side there is a significant improvement in our current transactions. Our merchandise trade surplus, in particular, has shown a fairly steady increase from the low figures of late 1968 and early 1969. In 1968 our merchandise balance had declined to a monthly rate of only $70 million. In 1969 it was $105 million. And in the first five months of 1970 it was $226 million (seasonally adjusted).

Taking goods and services (including factor income) together, our exports for the second quarter of 1970 are provisionally estimated at a seasonally adjusted annual rate of $62.5 billion, or 23.5 percent above the average rate for 1968, and 12.6 percent above the average for 1969. Our imports of goods and services in the second quarter are tentatively put at $58.7 billion, or 22.0 percent above 1968 and 9.5 percent above 1969. The surplus on goods and services of $3.8 billion, if confirmed by later estimates, would be the largest since the end of 1967. This improvement is due in part to strong demand for our exports and a continued growth in income on investments abroad, and also to some slowdown in the growth of imports.

Developments have been less reassuring in our capital accounts. Second-quarter estimates will not be available for some months, but in the first quarter U.S. private long-term capital flowed out at a record rate. Despite controls on direct investment of U.S. corporations, there was a net outflow at a seasonallly adjusted annual rate of $5.2 billion. Portfolio investment by U.S. residents was also at a high level, while the net inflow of foreign private capital was much less than in the years 1968 and 1969. There was a small reduction in U.S. Government grants and capital, to an annual rate of $3.3 billion.

The net result of these diverse developments in the current and the capital account was a liquidity deficit at an annual rate of $6.2 billion, including the first allocation of Special Drawing Rights at an annual rate of $0.9 billion. This is a large deficit by historical standards, though it was exceeded in the second and third quarter of 1969. The official settlements balance, again including SDR's, turned from a sizable surplus in 1969 to a large deficit of $11.4 billion in the first quarter of 1970, reflecting primarily the accumulation of dollars in the hands of foreign official institutions. Tentative indications suggest that the liquidity and official settlements deficits continued into the second quarter but at a significantly lower rate.

PROSPECTS FOR THE REMAINDER OF 1970

We have behind us a moderate decline in the real economy and the first signs of a decline in the rate of inflation.

What lies ahead?

With economic activity bottoming out in the second quarter of 1970, it is reasonable to expect a resumption of growth in real GNP in the second half, accompanied by a better price performance. As we stated in our Economic Report, the existence of slack in the economy means that increases in demand can be translated primarily into output increases rather than price increases. At the same time we are likely to experience a further moderate rise in unemployment rates over the average level that prevailed in the second quarter. The unemployment rate will start to level out and decline only after the recovery is vigorous enough to diminish the gap between actual and potential output.

At the start of 1970 it was recognized that in order for the economy to resume its expansion in the second half, it would be necessary to relax monetary policy at the beginning of the year. A change in monetary policy occurred around mid-winter. Growth of the money supply from December to June averaged 4.2 percent at an annual rate, as compared with 0.6 percent for the preceding half year.

In capital markets, the change in policy first produced easier credit conditions. Short-term interest rates declined sharply. Although U.S. Government and municipal bond yields also receded, corporate yields only leveled off and in May they began to rise again. With pessimism about profits and with a continuing need to refinance short-term indebtedness incurred in earlier months, corporate demand for long-term credit remained intense. Corporate bond issues, which had totaled $9.3 billion in the first half of 1969 and $9.1 billion in the second, were $14.1 billion in the first half of 1970. However, the early weeks of July brought signs that these pressures have abated, and bond yields have backed down from the peaks of June.

At the turn of the year, deposit flows into savings institutions recovered dramatically from the severe decline of 1969. The net change in mortgage holdings of all financial institutions, which had fallen sharply after the middle of 1969, reached a low point in March and showed a definite improvement in April and May.

The increase in the money supply and improvement in credit market conditions should be felt throughout the economy but should be most noticeable in the case of homebuilding and State and local expenditures. There have already been some signs of an imminent upturn in homebuilding; building permits rose in April and May to their best levels in about a year. Housing starts rose sharply in June. A very considerable backlog demand for housing has built up as a result of the low volume of housing starts in the past several years, and the easing of credit ought to find a reasonably prompt response in housing starts.

Fiscal policy also became more expansive in the first half of 1970, and we have by no means felt all of the effects of this stimulus. That is suggested by the unusually high savings rate (7½ percent) in the second quarter, indicating that consumers have not yet fully adjusted outlays to increases in their after-tax incomes. Furthermore, starting in July, there was the complete elimination of the surtax as well as the increases in personal exemptions that were part of the Tax Reform and Relief Act of 1969. These provisions will add an estimated $5 billion to consumer disposable income in the third quarter. Altogether, the elimination of the surtax, the rise in Social Security benefits, the Federal pay raise and the reform and relief provisions of the tax law have added over $16 billion to consumer disposable income since the final quarter of 1969. We have already seen some positive results in consumer spending in the first half, and it is reasonable to expect more in the second as consumers adjust more fully to these income changes.

Federal expenditures are not likely to show much change over the current half year. Cutbacks in defense purchases will continue, offset by rising expenditures of other types.

Finally, plant and equipment outlays ought to be a little higher in the second half than in the first. This is not inconsistent with a further scaling back of the plans reported in the June Commerce–SEC survey. Inventory accumulation should also rise after the unusually low figures of the past half-year.

When we put these figures together, they add to increases in real GNP of moderate size in the second half. This assumes no interruptions from major strikes, about which I have no special knowledge. We should also see for the first time a slower price rise at the consumer level. Prospects are particularly favorable for retail food prices to change relatively little in the second half because of larger supplies coming to market.

The Problem of Liquidity

The Chairman of the Committee requested that I comment on the liquidity problem. This is an important matter. It is a factor thought by some to cloud the prospect for economic revival and even to hold potential danger that a decline might resume.

A liquidity problem in the sense of disorganized financial markets clearly does not exist. If there were a generalized scramble for funds, interest rates, particularly short-term rates, would be rising sharply. In fact, they have been declining. Our banks are strong. Consumer credit is not out of line with incomes, and delinquency rates are well within the range of normal expectation.

Certain statistical measures of average liquidity have shown substantial declines. The ratio of quick assets (cash and U.S. Government securities) to current liabilities for nonfinancial corporations declined from 0.33 at the end of 1964 to 0.19 at the end of 1969, and to 0.18 in the first quarter of 1970. For manufacturing corporations in this five-year period, the decline was from 0.43 to 0.23. These declines seemed to come heavily in two spurts, one from 1964 to 1966 and the other from 1968 to date.

These declining measures of liquidity reflect many things. There has been a long-run trend toward holding smaller reserves of cash and marketable securities, as companies have been attracted by the increased profits obtainable from investing such funds in inventories and other forms of working assets. Modern techniques of short-term portfolio management have also encouraged this development.

LIQUIDITY RATIOS OF U.S. CORPORATIONS

End of period	Nonfinancial corporations [1]		Manufacturing corporations	
	Current ratio [2]	Quick ratio [3]	Current ratio [2]	Quick ratio [3]
1964	1.84	0.33	2.39	0.43
1965	1.79	.29	2.27	.37
1966	1.74	.25	2.16	.30
1967	1.75	.24	2.20	.29
1968	1.72	.23	2.14	.28
1969	1.64	.19	2.01	.23
1970: (Ist quarter)	1.63	.18	1.99	.21

[1] Excludes banks, insurance companies, and savings and loan associations.
[2] Total current assets divided by current liabilities.
[3] Cash plus government securities divided by current liabilities.

Sources: Federal Trade Commission and Securities and Exchange Commission (FTC Quarterly Financial Reports for Manufacturing Corporations and SEC. Statistical Bulletin.)

In addition to these long-run trends, two further developments seemed to become more evident in recent years. Both were related to the persisting inflation that began to gather momentum in 1966. As the inflation persisted, and after 1967 accelerated, firms began to shift from cash and financial assets to inventories and physical capital assets. This was presumably a preventive measure reflecting fears about an erosion of the real value of assets from continuing inflation. In their endeavor to minimize this risk, some businesses may have come to give inadequate weight to the normal risks and contingencies for which quick assets and a strong current position are a part of prudent financial management.

Moreover, business capital demands were intense in 1969, as projected increases in outlays for plant and equipment rose to the 12–14 percent range, this is an economy capable of increasing real output by roughly 4 percent per year. There was in many of these capital budgets also a strong component of inflation-mindedness. These developments began to crowd against a flow of internal funds adversely affected by declining profits. Heavy demands were, therefore, thrown into credit markets also undergrowing pressure from restrictive monetary policies. Financial markets tightened and interest rates rose sharply. In the face of high bond yields and falling equity prices, many companies borrowed short-term funds last year with the intention of converting to long-term financing at a more opportune time later. This year many firms were faced with converting this short-term indebtedness into longer-term maturities. As a result, the demand for long-term funds continued to be intense this year, and the bond market has been forced to handle a tremendous volume of new issues. In the intense competition for funds, some borrowers have inevitably been squeezed out.

We are now engaged in a more detailed study of the liquidity problems of corporations and hope to be able to submit its results to this Committee soon. However, our study of this problem to date has led us to three main conclusions.

First, the financial institutions of the country are in sound condition and financial markets are working effectively. The ability of the banking system to meet demands upon it has been strengthened by accessibility of the Federal Reserve discount window and by the new ability of banks to attract funds through certificates of deposit.

Second, although the liquidity of non-financial corporations on the average has declined by almost any measure, it is only in quite exceptional cases that serious difficulties exist. These cases do not constitute a problem for the economy as a whole. At the same time we must be alert to these situations, and have the capability and will to handle them decisively, in order to minimize the danger of adverse secondary effects.

Third, the overall supply of liquidity, as measured by the supply of money and the availability of credit, is on the low side of what is needed, especially for a period which we expect to be the beginning of renewed economic expansion. Assurance of a sustained rise in the economy would be improved by more rapid strengthening of the economy's general liquidity position.

Managing a Noninflationary Expansion

There is strong and increasing basis for confidence that the decline of the economy is about over and that we will soon be seeing the signs of an upturn. While there is, as usual, disagreement about the precise dates and quantities involved, it is timely for us to look beyond the turn as such and explore the problems of managing an orderly recovery to full utilization of our productive capacity.

The word "managing" deserves emphasis. Having come this far along the road of re-establishing the basis for a more stable price level, we must resist the temptations of overly expansionist policies. There is too much viscosity in our economy for an immediate and dramatic rebound, and in trying to achieve this we would court the risk of reactivating inflationary pressures and inflationary fears.

At the same time we can now begin a more expansionist course for the economy and still continue to make progress against the inflation. Price developments in the period ahead will heavily reflect the emergence of slack in recent quarters. Price-making forces move slowly through the economy. We have already incubated disinflationary pressures whose results on the price level are still largely to come into the picture.

Moreover, even when the economy has turned the corner, we cannot assume an automatic return to full employment. In 1958 the economy began a strong recovery from its low point, but that did not continue long enough to eliminate its slack. The 1960-61 recession was the mildest of postwar history, but four years after its low point the unemployment rate was still 5 percent, and another year was required to achieve 4 percent. Certainly our goal must be to regain full employment more promptly this time.

We must begin now to think in terms of the magnitudes that will be required in the period ahead. They are large. Potential real output rises by at least 4 percent per year as a result of the growing labor force and the various factors that increase productivity. In addition to this we now have some arrearages to make up in a reasonable period. Total output was probably running about 4 percent below its potential, in the second quarter of 1970, as conventionally defined; that is, it was about 4 percent below the output we would have produced if unemployment had been 4 percent and productivity had been on its long-term trend. And the price level in the period ahead will have some upward drift even though the inflation continues to decelerate. Therefore, the rates of increase of money GNP required for recovery to full employment will be somewhat higher than the needed rates of increase of real output alone. These figures suggest that even for the economy to move along an essentially noninflationary growth path, needed rates of growth in the money demand for output must be large.

Such rates of increase of total output would also involve unusually large increases in productivity—in output per man hour. The possibility of achieving a large increase of productivity is implicit in the estimate that, while employment in the second quarter of 1970 was roughly 1 percentage point below full employment, real output was 4 percent below potential. A rapid increase of productivity has been our normal experience when the economy was in the early stages of recovery from a slowdown, and there is no reason why it should not occur now.

The rapid rise of productivity would, of course, make a substantial contribution to the reduction of inflation, reversing a factor which has been making a major contribution to the continuation of inflation. If productivity should now rise for a time at the rate of 4 or even 5 percent, which is not impossible, the rise of unit labor costs would be dramatically reduced, and so would cost pressures on the price level.

In the management of fiscal and monetary policy it will be essential to keep in mind that a rate of expansion which is appropriate if we are moving along the path of reasonably full employment is not adequate when we begin from a position substantially below that path. This is doubly important when we bear in mind that it is also an economy needing some strengthening of its liquidity condition.

The problem of fiscal management in the period ahead is particularly complex. The basic task of fiscal policy is always to assure that we make provision for the most important national needs which should be met through the Federal budget and that resources and finance are left available for those important public and private needs that must be met outside the Federal budget. The overwhelming requirements of this task, and of the political process through which it is performed, leave little room for flexible variation of the budget to meet changing requirements of economic stabilization. In fact, as experience demonstrates, just to keep the budget from being a destabilizing force in the system is difficult.

Probably the basic contribution fiscal policy can make to the orderly and expeditious recovery of the economy is that it should not place upon either monetary policy or on private market forces the need to adapt to sharp changes of conditions. We should achieve at least a balance and hopefully a moderate surplus in the budget when the economy regains full employment, because after this present multifaceted transition the demand for capital to finance housing, State and local investments, and business investment will be high, and a strong budget will help to meet those demands. The transition from today's deficit to the desired full-employment balance or surplus should be made smoothly as the economy rises to its potential. Particularly we should avoid falling off this path into signficantly larger deficits. One of the most serious consequences of such a development would be to interrupt the emergent recovery of housing.

The recovery of the economy added to its normal growth will greatly increase the revenue-yielding base. But what is truly amazing is the extent to which this increase is already committed, by tax reductions scheduled under the 1969 Act and by a seemingly irresistible flood of expenditure increases built into existing legislation. The dominant, persistent budgetary problem of our time will be to hold expenditures in line with what the people are willing to pay for. We cannot afford to be diverted from that task.

The Administration relies basically on the combination of fiscal and monetary policy, with the spontaneous adaptive forces of the private economy, to move us along the path to full employment with less inflation. Still we have been anxious, as any Administration would be, to find supplementary measures that would really help to speed the disinflationary process. To this purpose we began considering in March, 1969 a wide range of possible actions falling within the category loosely called price-wage policy or incomes policy. We have not lacked suggestions in this area.

Our objective was to isolate those elements of such possible actions that held promise of success. In this consideration, it was necessary to get behind the labels pinned on policies to discover what they really consisted of and were likely to perform. The conclusion of considerable study and discussion within the Administration was that the following steps would be useful:

1. To mount a major cooperative effort of the private sector and the government to increase productivity.

2. To provide a forum within which leaders of the private sector and of the government can discuss the requirements of a stable and growing economy.

3. To provide the public with more information about the consequences for the course of the inflation of private wage and price decisions.

4. To assure that in the exercise of the Federal Government's procurement and regulatory functions more weight be given to the objective of restraining inflation.

The President announced in his address on June 17 that these steps would be taken. Since then we have been engaged in putting them into effect. A National Commission on Productivity has been established. It will hold its first meeting on August 6. At that time the Council of Economic Advisers will submit to the Commission its first Inflation Alert, outlining the consequences of major price and wage decisions for changes in the price level. A Rgulations and Purchasing Review Board has also been established to determine where these Federal activities tend to drive up prices, and this Board is now also functioning.

These measures have been carefully chosen. They are an effort to assure that, within the logic of a free economy, we leave nothing undone to assist the country through the difficult transition we must now make. We will pursue this effort as diligently as possible and are hopeful it will make a contribution.

CUSHIONING ADJUSTMENT HARDSHIPS

During this period of transition we need measures to cushion the adverse effects of adjustment. The unemployment insurance system has been a support to hundreds of thousands of workers during interruptions of employment. Last year the Administration proposed legislation that would have extended unemployment insurance coverage to millions of workers now uncovered, and improved the system in other respects. It is to be hoped that this can soon become legislation.

The Administration has also proposed an automatic increase of 10 percent in funds allocated to manpower training programs when the unemployment rate rises above 4.5 percent for 3 consecutive months. Had this legislation been enacted, this increase would already have taken effect. Unemployed workers could take advantage of these increased opportunities for training and upgrading of skill levels during interruptions of employment. Higher skill levels of the work force have been an important source of productivity growth, and the increased training opportunities under the Manpower Training Act would enable these workers to obtain better jobs and lay the basis for future improvements in their earning capacity and in national productivity.

CONCLUSIONS

This review of recent economic developments, evidence about our prospects, and the implications of these for the management of economic policies has led me to four major conclusions.

First, the adjustment of the economy to needed measures of disinflation though painful has produced no cumulative decline in business activity. In overall terms it has established itself as discernibly less severe than the 1960–61 decline, which itself was the mildest recession of the postwar period.

Second, an evaluation of basic forces which will be shaping the course of the economy in the period ahead leads to cautious optimism about an improvement in business conditions during the second half of the year.

Third, in our understandable desire to regain full employment promptly, we must not undo the substantial progress that has been made in establishing the basis for a more stable price level.

Fourth, mindful of the need to move in an orderly way, we must now face up to managing the resumption of an expansion that in a reasonable period can bring the economy back to the zone of full employment. The magnitudes are large because the basic capacity of the economy is growing rapidly, we set out on the return to full employment from a position that is below the basic path, and some strengthening of the economy's liquidity resources commends itself now as a prudent consideration of policy.

Chairman PATMAN. Mr. Shultz, suppose you read the part of your prepared statement that you feel like you should read, summarize it if you can without doing injustice to your text, and then we will ask each of you questions after you conclude, sir. You may proceed as you desire.

STATEMENT OF GEORGE P. SHULTZ, DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET

Mr. SHULTZ. Thank you, Mr. Chairman, members of the committee. My first appearance before a congressional committee as Secretary of Labor happened to be in this distinguished forum and this is my first appearance in my new job as Director of the Office of Management and Budget.

As an economist and as an observer and admirer of the work of the Joint Economic Committee over the years, I am honored to participate again in these initiation rites, although I have noticed that the proper meaning of that word as applied to economic affairs, let alone its spelling, has often been in dispute in your discussions.

That is to be expected in such a controversial area. I enter the discussion in the spirit of exchanging ideas and information and in the hope that issues may be clarified, if not resolved, and that what differences there are may be more carefully defined and perhaps narrowed.

The focus of my testimony is the Federal budget, leaving to others, including the various administration witnesses, responsibility for the review of other aspects of the economic scene, including its present contours and probable lines of development. First, Mr. Chairman, I would like to make some general observations.

The President's budget is simultaneously a financial expression of his objectives and priorities, an assessment of the proper role of Federal revenues and expenditures in economic developments, and a detailed and unified accounting of program costs and sources of funds.

The budget process itself must be a continuous one, since there are strong interrelationships among actions appearing at widely separated time periods. Actions in 1970 and 1971 affect developments in 1972 and beyond, just as objectives for future years must be reflected in immediate budgets if these objectives are to be realized effectively. For this reason, in considering our present budget situation, we must look at the year just completed and the years ahead, as well as at the budget of the current year.

Further, the continuing budget process, with its vast financial and economic implications, imposes a continuing obligation to keep the total picture in mind, while working on the many and highly varying parts. As Adam Smith once noted, specialization increases with the size of the market. Both the legislative and executive branches of Government are elaborately organized for such specialization, which encourages a preoccupation with the individual parts of the budget.

But the very creation, let alone the work of this committee, emphasizes the need for a continuing review of what these parts are adding up to in total and what the economic implications of these totals are. This midyear review is certainly appropriate, since it brings attention to the totals at a time when we might otherwise be overly preoccupied with the parts. Let me shift now to the question of shifting priorities.

An overriding and universal objective is the attainment of a stable peace and a return of resources to peacetime and civilian purposes. Budget developments over the past 3 years reflect a dramatic movement in this direction and stand as a statement of Presidential objectives and priorities. Between fiscal years 1968 and 1971, defense expenditures will have declined from 9.7 percent of the gross national product to about 7.5 percent and from 45 percent of budget outlays to a projected 37 percent. By sharp contrast, the budget outlays allocated to human resources programs[1] rose from 32 percent in 1968 to a projected 41 percent in 1971. This dramatic shift in priorities is underscored by recognition that expenditures by State and local governments concentrate on the human resources

[1] Human resources programs are those included in the functional categories: income security, education and manpower, health, and veterans benefits and services. Almost all of the outlays for veterans benefits and services can be identified with the preceding three categories.

area and that, as private individuals and groups, we devote a large proportion of our incomes to these objectives.

This shift in priorities, desirable though it is, does have transition costs, as individuals, industry and labor groups, and particular communities, are directly affected by reductions in military personnel and in defense contracts, with consequent layoffs of employees.

We must recognize our present situation for what it is: a mild slowing of the economy, as Dr. McCracken has brought out, as necessary to curb the inflation, combined with a movement away from defense-related activities. This movement may have a direct impact on as many as 2 million people during the period from early 1969 to mid-1971, with over 700,000 already affected. Of course, many others have been and will be indirectly affected, varying with the dependence of particular communities and industries on defense activity.

If the beginning of wisdom is to recognize the problem, the outcome of our analysis must be action to help people through transition problems. There is no doubt that the problems can be solved and that a healthy economy is our most important program for doing so. But we must apply the further principle that those who bear this cost most directly deserve help from all of us who share the social gains achieved by the transition.

Secretary Hodgson will be discussing this point in some detail, so I will not belabor it further. I must mention, however, two proposals of special relevance to this problem, proposals that were put before the Congress by the President about 1 year ago. Here I am repeating Dr. McCracken, but I think the point is important enough so that we must complete it.

I urge the Congress to complete action to strengthen and extend the system of unemployment insurance and to move on the proposed Manpower Training Act. As you know, both these pieces of legislation contain automatic trigger formulas that would, respectively, extend the period of unemployment compensation and increase appropriations for work and training programs in the event that unemployment reaches specified levels. I might note in connection with the latter point that, in my own thinking as we were working on the Manpower Training Act, discussions in this committee about the interaction of manpower training with changes in employment conditions was one of the factors that helped shape the particular formulation that we have in the Manpower Training Act.

Let me turn now to the budget and the economy.

The President in his statement of July 18, 1970, put forward the general principles that should guide our thinking about revenue and expenditure totals and their meaning for the economy. And now I am quoting from the President's statement:

> In raising the issue of budget deficits, I am not suggesting that the Federal Government should necessarily adhere to a strict pattern of a balanced budget every year. At times the economic situation permits—even calls for—a budget deficit. There is one basic guideline for the budget, however, which we should never violate: except in emergency conditions, expenditures must never be allowed to outrun the revenues that the tax system would produce at reasonably full employment. When the Federal Government's spending actions over an extended period push outlays sharply higher, increased tax rates or inflation inevitably follow. We had such a period in the 1960's. We have been paying the high price—and higher prices—for that recently.

This general rule, while it does not lend itself to precise point estimates for future periods, nevertheless provides a method of crucial importance to the assessment of where we are and where we are going. We know, for example, that revenues fell short of their full-employment potential in fiscal year 1970. A small deficit created thereby does not have a major inflationary potential, and indeed, is part of the automatic and desirable system of fiscal stabilizers. By contrast, the deficit of fiscal year 1968 represented a large expenditure overrun, beyond the revenue-producing capacity of the tax system. It thereby contributed heavily to the inflationary problems we have since been trying to cure. There is a lesson of immediate relevance in these contrasts as we consider the budgets for fiscal years 1971 and 1972.

We know, of course, that fiscal policy is not the full story in the management of economic policy. As this committee has well recognized in the past, monetary policy is also of critical importance. Here it may be noted that, while the President is charged by the Employment Act of 1946 with responsibility for "setting forth * * * a program for carrying out the policy declared in section 2," for high employment he has no authority over the operation of the Federal Reserve, with its statutory and traditional independence. Conversation, yes, but that is as far as it goes.

We know also that wage and price movements in individual industries must be addressed as a part of the overall strategy of economic policy. It was this realization that led the President to create over a year ago a committee on lumber prices and subsequently another on copper prices. Both these efforts have been fruitful. More recently, in this same vein but with a broader and continuing responsibility, the President created a Regulations and Purchasing Review Board to "determine where Federal purchasing and regulations drive up costs and prices." Further, the Council of Economic Advisers, as Dr. McCracken noted, will prepare a periodic inflation alert to "spotlight the significant areas of wage and price increases and objectively analyze their impact on the price level."

A National Commission on Productivity has also been appointed, with an outstanding membership (list below).

(The list referred to follows:)

MEMBERS OF THE NATIONAL COMMISSION ON PRODUCTIVITY

BUSINESS

Harllee Branch, Jr., The Chairman and Chief Executive Officer, The Southern Company
Edward W. Carter, President, Broadway-Hale Stores, Inc.
George E. Keck, President, United Airlines
R. Heath Larry, Vice Chairman of the Board, U.S. Steel Corporation
James Roche, Chairman of the Board, General Motors Corporation
Walter Wriston, Chairman, First National City Bank, New York City

LABOR

I. W. Abel, President, United Steelworkers of America
Joseph A. Beirne, President, Communications Workers of America
George Meany, President, American Federation of Labor and Congress of Industrial Organizations
John H. Lyons, President, International Association of Bridge, Structural and Ornamental Iron Workers

Floyd E. Smith, President, International Association of Machinists and Aerospace Workers
Leonard Woodcock, President, International Union, United Automobile, Aerospace and Agricultural Implement Workers of America

PUBLIC

William T. Coleman, Jr., Partner, Dilworth, Paxson, Kalish, Levy and Coleman
John T. Dunlop, David A. Welles Professor of Political Economy and Dean of the Faculty of Arts and Sciences, Harvard University
Howard W. Johnson, President, Massachusetts Institute of Technology
Edward H. Levi, President, University of Chicago
Arjay Miller, Dean, Graduate School of Business, Stanford University
W. Allen Wallis, Chancellor, University of Rochester

GOVERNMENT

David M. Kennedy, Secretary of the Treasury
Maurice H. Stans, Secretary of Commerce
James D. Hodgson, Secretary of Labor
Paul W. McCracken, Chairman of the Council of Economic Advisers
George P. Shultz, Director of the Office of Management and Budget

Mr. SHULTZ. Its major responsibility will be to develop and recommend new ideas, initiatives, and policies to encourage continued productivity growth both now and in the long run.

Productivity is a key link between wages and prices. Its growth in the United States has been poor in recent years by both historical and international standards. The slow growth of productivity in 1969 and the decrease in the first quarter of 1970 is one important explanation of the long lag between the cooling of demand pressures and the improvement in price performance. The rate of increases in wages in the total economy did not appear to accelerate very much during this period.

Near-term prospects for productivity growth are much better than the 1969 experience. While complete data are not yet available, it appears that the annual rate of growth in productivity in the second quarter of 1970 was at least 3 percent, which is close to its historical level. This and subsequent improvements will contribute significantly to the improved price performance that is expected in the last half of this year.

Now, let me turn to the budget outlook.

Having in mind the linkages in budget flows from one year to the next, the necessity for relating the parts to the totals, and the President's guide to the relation of total revenues and expenditures to economic developments, let us turn to the budgets for fiscal years 1970, 1971, and 1972.

In February the President proposed budgets for fiscal years 1970 and 1971 with surpluses of $1.5 billion and $1.3 billion, respectively. A combination of events since February has, as reported in the May estimates, pushed both budgets from surplus into deficit.

The revised estimates for fiscal year 1970 showed that the shift from a $1.5 billion surplus to a $1.8 billion deficit resulted almost entirely from a shortfall in estimated receipts rather than from an overrun in spending. Preliminary figures for 1970 will be published before the month is out. For this reason, I shall not speculate about what the specific results for the year will be. Data for the first 11 months suggest strongly, however, that outlays have been held within the May estimate of $198.2 billion.

This is despite significant and continued pressure from some uncontrollable costs, the increase over the proposed budget of education and veterans programs, and congressional inaction on postal rate increases.

Any deficit will result from a shortfall in revenues below those that would have been generated at full employment. In May, as you recall, receipts were estimated at $196.4 billion.

The outlook for the current year—1971—is clouded with uncertainty and for the most part the clouds are dark and threatening. It was concern with these threats that prompted the President's statement of July 18th, a statement calling attention to problems when there is ample time to do something about them.

On the revenue side of the budget, problems are of two types. On the one hand, congressional action or inaction has reduced potential revenues. The Tax Reform Act of 1969 reduced estimated receipts below the President's April tax proposals by about $3 billion for 1971 and by about $5½ billion in 1972. Moreover, no action has been taken on the President's proposals for a tax on lead in gasoline, a speedup of estate and gift tax collections, and an increase in postal rates.[1] These three items together would yield revenues of about $4.5 billion in 1971.

On the other hand, though the economy is expected to be expanding throughout fiscal 1971, it will not be operating at a level sufficient to generate revenues to the full potential of the present tax system.

Both potential and actual revenues can be affected by prompt congressional action on the President's revenue proposals. We will need these expanded boundaries if expenditures are to be contained within the revenue-producing capacity of the tax system.

The expenditure side also presents a mixed picture. The May revision showed a rise from the original estimate of $200.8 billion to $205.6 billion, the result in significant part ($2.1 billion) of increased estimates for mandatory payments: interest on the debt, unemployment compensation, public assistance, and a miscellany of other items. These mandatory items may well call for somewhat higher outlays, perhaps by a total of $3.5 billion rather than $2.1 billion. These increases and Presidential and congressional changes identified in the May review are carrying the expenditure total upwards.

The major uncertainty, of course, is the outcome of the appropriations process. This matter deserves our closest attention since it poses problems of great concern and potential damage to the long-term economic outlook.

The two largest appropriations bills—Defense and HEW-Labor-OEO—have not yet cleared the House. But many others have passed both House and Senate and are in conference or awaiting conference. The education bill needs only action by the Senate and it will be on its way to the President. I have a tabulation, Mr. Chairman, of some of the actions that are involved, and this tabulation suggests the nature of the problem. You can run your eye down these columns and see the general nature of what we are talking about. This is not

[1] Technically, postal rate changes are treated in the unified budget as a change in outlays.

a comprehensive listing, but is an effort to aggregate some of these parts together so that you can see what the total picture may be potentially adding up to.

(The tabulation referred to follows:)

[In millions]

	1971 request	Changes from request: House	Senate	Conference
Appropriation bills:				
Education	$3,967	+$320	+$701	+$453
Independent offices and HUD	17,293	−78	+1,187	
Agriculture	7,748	−298	+728	
Labor-HEW-OEO	18,732	+93		
(Deletion of social services limit may add $200 in outlays)				
Foreign assistance	2,977	−756		
Interior	1,840	−230	−5	
Other bills passed by House	16,748	−515		
Defense	68,746			
Major changes from request in substantive bills:				
Social security (H.R. 17550)		+1,500		
Veterans education (Public Law 91–219)		+169	+169	+169
Veterans compensation (S. 3348)		+226	+114	
Employee health benefits (H.R. 16968)		+140		
Emergency home financing (S. 3685)		+1,500	+60	
Food stamp program (S. 2547)			+750	
National service life insurance (permit use to purchase mortgages H.R. 9476)		+750		

Mr. SHULTZ. What will emerge from the appropriations process, of course, remains to be seen. In view of these uncertainities, added to those on the revenue side, we do not offer any further reestimation of the 1971 budget beyond that identified in May.

But the problem is clear, as is the need for care and caution at both ends of Pennsylvania Avenue. Dedication to and fascination with parts of the budget cannot be allowed to obscure the sum-total to which the parts must finally add.

The perspective of the longer run also urges prudence and responsibility by the Congress in acting on fiscal year 1971 appropriations requests and substantive legislation. We have begun to assemble data preparatory to developing a budget for fiscal year 1972. Just as the 1970 actions are now adding to 1971 outlays, legislation currently being considered by the Congress would boost 1972 outlays significantly. In our preliminary look at possible expenditure levels in 1972, we have examined with care these and other factors. We simply cannot accept the result to which the path of least resistance takes us.

We are on the threshold now of getting control of a problem that has proven stubborn and resistant. We know what caused the inflation, we know how difficult it is to rein in inflation once it starts running, and we know the pains that accompany such an effort. We must keep the momentum of Federal expenditures from carrying them again, as in 1967 and 1968, beyond the revenues produced by the tax system at full employment. We would surely pay fully for such expenditures—whether in higher taxes or higher prices.

Thus, the quality of congressional action in the weeks immediately ahead on both the revenue and expenditure side of the budget is of critical importance, not only to this year, but to next year and the years ahead; not only to the Federal budget, but to our continuing effort for a healthy and expanding economy, reaching full employment with reasonable stability of prices.

Now let me turn to an expenditure ceiling.

The Congress passed and the President signed only weeks ago a bill that imposed on him a ceiling on expenditures. The Congress, however, has placed no such limitation on itself. Such a ceiling, with necessary discretion to reallocate funds within the total, can be an important tool in the effort to relate action on parts of the budget to its overall dimension. The President in his July 18th statement reaffirmed his intention to live within that ceiling and he suggested that Congress bind itself to that ceiling as well.

I hope that this committee, with its special concern for economic aggregates and for guidance on economic policy, will want to endorse this suggestion and carry it to your colleagues with a sense of its genuine merit and urgency.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, Mr. Shultz. We will now have questioning by the committee members.

Dr. McCracken and Dr. Shultz, I notice that neither one of you referred to high interest rates as a problem of any kind. In view of the fact that the people are paying today about $120 billion a year interest on all debts, public and private, it occurs to me that this is a very important element in any discussion of inflation.

For 18 or 19 years the Federal Reserve Board fought inflation by raising interest rates, and the interest rates continued to rise during those 18 or 19 years. To my mind that was just as illogical as using gasoline to try to put out a fire instead of water. Every time interest rates were increased, prices were increased, even the prices of goods on the shelves, all prices were increased. When you raise interest rates, you raise prices, you are going toward inflation. If you will look at the interest rate increases over the years and then at inflation, you will find inflation follows the interest rate increases. It cannot do anything else, the way I see it.

You know, when the prime rate was raised by one New York banker on June 9, 1969, from 7½ to 8½ percent, that automatically gave a potential increase in interest rates of 1 percent of all debts, public and private, which aggregated at that time $1,500 billion-plus. So that was a $15 billion increase in interest rates.

Now, we have had a 2½ percent increase in interest rates during the last couple of years which would mean that we have had a $37½ billion increase in interest costs, yet you have not mentioned that in your budget presentation at all. Do you not think interest rates have contributed to the unbalancing of all budgets from the housewife to the Federal Government, and do you not think that that has entered into our economy in a big way and certainly should be discussed as a major point, Dr. McCracken?

Mr. McCRACKEN. Mr. Chairman, I have two of three points that I would like to make. I did discuss, in a part of the prepared statement which I left out, developments in credit markets and interest rates.

Chairman PATMAN. Let me ask you this question, Dr. McCracken. Are interest rates satisfactory to you now; are they just about right or are they too low?

Mr. McCRACKEN. I can certainly start at the end and cross off the last one. I think interest rates are too high. The complex of pressures which produced high interest rates has had a very damaging effect on our economy.

Chairman PATMAN. What are you trying to do to lower interest rates? Now, the President said in his message recently interest rates are too high but he has not proposed anything to do about it.

Now, my recommendation to the President and to you as an adviser of the President is that inflation can be corrected by lowering interest rates.

Now, the President could very well go out on his front porch at the White House and say that prime interest rates hereafter will be, say, 7 or 6 percent, or whatever he wants to. He has that authority under the law, and do you not think if he says interest rates are too high and you say interest rates are too high, that some effective means should be adopted to roll back those rates?

Mr. MCCRACKEN. An effective program to deal with this will have to contain two or three elements.

First, it is closely related to the budget situation and the budget outlook which Mr. Shultz has alluded to in his statement.

Second, the high level of interest rates that we have seen is itself reflecting the inevitable response to inflation and uneasiness about the price level. That is another reason why it has been important to get at this problem.

Chairman PATMAN. Dr. McCracken, I have only 3 minutes to go. You can complete your answer when you look over your transcript.

There are two points I want to cover before I get through, and I am sorry I have not had time to interrogate Dr. Shultz. How can any government ever hope to have a balanced budget and operate prudently when they pay off their bonds and do not cancel the bond and continue to collect interest on the bonds as though they had not been paid?

Now, I refer to the Federal Reserve's own statement over the years—I have watched it over the years—the Federal Reserve Bank of New York in the name of the Open Market Committee now holds according to their unaudited record and self-audited record $57 billion plus in U.S. Government interest-bearing bonds.

Now, those bonds, every one of them were purchased with U.S. Government funds, Government money, a lot of it manufactured over at the Bureau of Engraving and Printing, but they were all paid for, every one of them. They had been paid for once.

Now, then, there is no effort made and you cannot get any consideration of stopping this. It occurs to me if we had a bond burning like churches do sometimes when they pay off their bonds, they are so happy over it, they have a celebration, that we could reduce our national debt immediately by the amount of those bonds that are then paid for once. And would you please elaborate on the reason why the Government is doing that in your statement when you look it over for approval?

Turning to another point, the banks bought 94 percent of all the tax-exempt bonds that were offered for sale in 1968.

Now, they knew that if the interest rates went up, why, their bonds would go lower down in value. Everybody knows that. And so, they did not raise interest rates for a while until they hit us with 1 percent, from 7½ to 8½ percent. It had never been done before. Heretofore only one-quarter of 1 percent raise, twice one-half of 1 percent, but never before 1 percent, but they did it all and, of course, bonds went way down and it occurs to me, Mr. McCracken, that they must have had an understanding with the supervisory authorities that they could carry those bonds at what they cost them or par value for liquidity or asset purposes. Is that correct or is it not?

Mr. McCRACKEN. My understanding is that they can carry the bonds at book value in their financial statements and in their financial reports to the regulatory agencies. This practice applies to investment grade or similar quality bonds and is quite consistent with conservative accounting principles. This operating procedure follows an agreement reached in July of 1938 and revised and reaffirmed in July of 1949.

Chairman PATMAN. In their financial statements for asset and liquidity purposes?

Mr. McCRACKEN. Yes. Although it must be kept in mind that in appraising liquidity and capital adequacy the maturity of the securities held is taken into consideration.

Chairman PATMAN. Well, I think you are correct. I feel reasonably sure, which means that a substantial part of the capital structure of the banks, of course, is weakened now. It is unusual, I would think, for the supervisory authorities to let people have their cake and eat it, too. In other words the ordinary borrower would have to sell those bonds and take his loss but if you let the banks go ahead and carry them at par or what they cost them indefinitely, why, they have got it made.

Now, it is possible that there are good reasons why that should be done. I am not saying that there are not. But why treat one person one way and another person another way? You would not let all people do that, and the banks do not even let their customers do it. They make them sell their bonds and take their loss. But, of course, that adds to the earnings of the banks. I do not want to do anything that would stop them from having money [laughter] but at the same time, I feel like they ought to be treated just like everybody else.

Now, my time has expired and I will yield to the gentleman on my right, Mr. Conable, for 10 minutes' time, sir.

Representative CONABLE. Thank you, Mr. Chairman.

Dr. McCracken, I would like to dedicate my 10 minutes as an opportunity for you to answer such points raised by the chairman as you would like to answer. Do you have any that you would like to respond to? Interest rates or others?

Mr. McCRACKEN. Yes, I would.

Representative CONABLE. If you would prefer to answer in the record, that is all right, too, but I will leave it up to you, sir.

Mr. McCRACKEN. May I make two or three comments, that certainly will not take 10 minutes.

As I indicated in my brief comment earlier, I share the general concern about the high level of interest rates and the impact that this has had on the economy and especially certain sectors of the economy such as housing. State and local borrowing would be another one. The important thing is to deal with the fundamental causes of the problem.

If we ask ourselves why have interest rates risen to these levels, there would be two or three things that I think we would have to cite. One was the growing uncertainty about confidence in the long-run price level that began to emerge with the long inflation that got underway in 1966. One of the most consistent themes in economic literature is that the rate of inflation will ultimately be added to the basic or true rate interest rate so that if the basic rate is 5 percent, and people expect 4 or 5 percent inflation, then we will see interest rates of 9 or 10 percent. So, establishing the basis for a more stable price level is very important.

The second thing causing an adverse effect on interest rates has been uneasiness about the Federal budget. I do not think there is any question about it. We had the large deficits of the late sixties. We see in the press and in the comments by financial people concern about where basic expenditure forces seem to be taking the budget. This unquestionably carries through into an adverse impact on interest rates.

I think all of this is indicated by the fact that we are now, as there begins to be a little more confidence in the basic financial situation, beginning to see some recedence of interest rates from those levels. The important thing is to carry along with them.

Representative CONABLE. Mr. Shultz, are more people working this year now than were working a year ago at this time?

Mr. SHULTZ. I believe so, yes.

Representative CONABLE. Do we have any figures on that or for——

Mr. SHULTZ. Yes.

Representative CONABLE (continuing). Recent months?

Mr. SHULTZ. We have monthly figures, and I do not have them here.

Representative CONABLE. And would you explain the apparent disparity between this and the rise in the unemployment rate?

Mr. SHULTZ. Well, the unemployment rate is a combination of what is happening to the labor force and what happens to employment. Unemployment is the difference between the two. The labor force continually rises and employment has to rise at least as rapidly if the unemployment rate is to remain constant. And what has happened, in effect, over the last 6 or 7 months is that the labor force has risen fairly rapidly. Actually, considerably more in the first 5 months of 1970 than in the first 5 months of 1969. And this is one reason why we see the rise in the unemployment rate.

Representative CONABLE. Would it be accurate to say that employment is up by about 1.1 million, judging from the May figures?

Mr. SHULTZ. Well, we have published figures. Whatever they are exactly——

Representative CONABLE. I am sorry.

Mr. SHULTZ. I say, there are published figures. Whatever they are, they represent our best estimates. I do not have them exactly in mind. You want to compare a year ago with now?

Representative CONABLE. Yes.

Mr. SHULTZ. Well, a year ago employees in nonagricultural roles, 70,347,000. Our June estimate is 70,666,000. So, that is up slightly.

Representative CONABLE. Now——

Mr. SHULTZ. That is just the flat figure. That is not a seasonally adjusted figure. I am sure you know that there are strong seasonal swings in these figures. Of course, in comparing like months of the year we tend to wash that out.

Representative CONABLE. It is likely that productivity will rise substantially before the rate of employment will go up appreciably?

Mr. SHULTZ. What tends to happen as output starts to move upward is that employment will move up less rapidly, and so you get an increase in productivity, in output per man-hour, and that is what appeared to happen in the second quarter of 1970 and what seems likely in the last half of the year. When that happens and, given the rather stable behavior of the rate of increase in wages looking across the whole economy, when productivity starts to rise as compared with its poor performance in 1969 and the first quarter of 1970, the rate of change in labor cost increases will become much smaller. And, as we see the price picture improving, as the rate of increase in prices starts to lessen, these two factors will interact with each other and it is that, I think, that represents the light at the end of the tunnel in working on inflation.

Through 1969 it was working exactly in the opposite direction. The rate of increase in prices was high and the productivity was poor, so that all of the wage increases in effect became cost increases and these things were interacting in the opposite direction.

Representative CONABLE. As you point out in your statement, Congress has not rushed to enact the administration's requests for additional revenues. Suppose the 91st Congress comes to an end without action in these areas, or at least in substantial parts of them. What course will the administration follow with respect to the fiscal problems which result? Will we likely get new tax requests next year? Will there be a real austerity type expenditure budget? How can we avoid moving toward very substantial deficits and all the inflationary and other problems that they create?

Mr. SHULTZ. Well, we avoid it by seeing the problem in time to do something about it and by adjusting our expenditures to keep them within the revenue-producing capacity of the tax system. If we cannot adjust our expenditures to that, we either wind up paying the price in higher taxes or higher prices.

But the point is, and I think this is a point of the President's statement of Saturday, that this is the time to focus on these questions and to see the relationship about these individual actions on pieces of the budget that are now flowing along, their relationship both on the revenue side and on the expenditure side, to this overall picture, and it was this that led me to feel, since that is one of the special objectives of this committee, that this is a particularly good forum for discussion of that problem.

Representative CONABLE. I take it, you would feel that Congress has an obligation if it is not willing to accept the President's recommendations for increased revenue, either to cut the pattern to fit the cloth or to come up with its own proposals for increased revenue, is that correct?

Mr. SHULTZ. That is certainly correct.

Representative CONABLE. Dr. McCracken, can you tell me to what extent is there a tradeoff between money available for real estate mortgage investment and the Federal deficit? A substantial deficit inevitably, of course, involves borrowing of money which might otherwise be available for other purposes within the economy. Is it logical to assume that mortgage investment is going to be the hardest hit of those credit markets that are affected by substantial deficits?

Mr. McCRACKEN. Yes, I think it is. That is suggested both by the logic of the problem and by history. In other periods we have seen that housing has been particularly adversely affected by stringent conditions in the credit market. It is true that the dollars which the Treasury has to divert from the saving stream to finance the deficit are not there for private borrowers. As I examine the data, it seems to me the major victims tend to be housing and, to some extent, State and local borrowing.

Representative CONABLE. My time is up, Mr. Chairman. Thank you very much.

Chairman PATMAN. Yes, sir.

Senator Proxmire?

Senator PROXMIRE. I want to thank both of you gentlemen for most articulate and persuasive statements. You can do a lot with, I think, a fairly weak case. [Laughter.]

No. 1, I would like to zero in on the support that you give the President's statement of Saturday in which he criticized the Congress very severely for increasing spending and you supported the President's criticism in your statements.

It seems to me that the President is just not telling the whole truth by a long shot. In fact, if we take the President's recommendations and lay them beside what Congress has done, it is the Congress that is reducing spending, not the President. It is true that we are trying to shift priorities more than he is, but, from the standpoint of overall spending, it seems to me, our record is very clear.

Last year we did cut the President's budget $5½ billion below what he requested and this year—you take the Shultz table in his statement, and if you add up the results, it seems to me, you come close to a washout.

When you recognize the fact we have not even begun to deal with Defense and Congress has indicated in the past and has indicated this year, it seems to me, we are going to go below the President once again in Defense, it is Congress that is cutting spending, not the President.

Now, how can you justify the President's charge that Congress was the spendthrift and not the President?

Mr. SHULTZ. As I noted in my statement, the appropriations process has not unfolded as yet, although we are into the fiscal year.

Senator PROXMIRE. The Presidential rhetoric indeed has.

Mr. SHULTZ. The President's statement referred to the kind of appropriations that seem to be shaping up. Now, I think if you look down the table in my statement, it is certainly correct that when you look down the column labeled House, the picture is sharply different from the one labeled Senate, but we have to look at the total picture and we do not know how this is going to come out.

The whole purpose was to call to the attention of the Congress where we are heading and the problem we may be getting back into unless we look at these individual pieces of action. This is not a table that has any special thing to say about any individual piece. But, rather, it is saying let us be sure that in considering any individual piece we are also thinking about the total picture and what all of these things are adding up to because if we do not do that, we are going to get right back into the situation that was produced by the kind of deficits that were run in 1967 and 1968.

Senator PROXMIRE. Now, the Senate is just about to take up in the next few days the military procurement bill, the biggest authorization bill we have. The Senate Armed Services has already cut $1.3 billion below the House and I think about the same below the Presidential request. I do hope the President will help us make a sharper cut. If he will, it seems to me we can have an effective reduction in spending in an area which is particularly inflationary. I doubt if we are going to get that from the President. The President can also help us when we come to the supersonic transport. He has requested $290 million for that project. And there is not any indication the President is going to give us any help there.

Earlier this year a number of us tried hard to cut the space budget and we got no support at all from the administration. So, it is not a matter of overall expenditures, it seems to me. It is a matter of priorities.

Mr. SHULTZ. Well, that is exactly what the President has done. He has reviewed the total budget picture and I think that the shift in priorities during President Nixon's administration as between Defense and human resources is absolutely startling. It is a totally different picture than the one that was present when the President took office.

Senator PROXMIRE. Not so startling when you take a look at what it really does, though, Mr. Shultz. What the President's shift in priorities is, and he deserves a great deal of credit for reversing this escalation in the Vietnam War. He has done that. He has withdrawn some troops and cut back on expenditures in Vietnam by several billion dollars. Everything we can get, however, indicates that, if you leave the Vietnam deescalation out of account, the military budget is higher and substantially higher than it was last year. The entire reduction and then some is in the Vietnam cutback.

So, from the standpoint of shifting priorities out of military, it is true that we have an overwhelming national conviction, it seems to me, that the Vietnam War was a mistake. The McCarthy and Kennedy campaigns had a lot to do with that. The President has recognized this, I think, and the result is that we are cutting back in military spending and the President deserves credit for part of that.

We want to cut it back farther, however.

Let me get into another area. Mr. McCracken, we had testimony by two witnesses, Dr. Heller and Dr. Solow, the other day, and they were anything but in support of the President's proposal to attack inflation by the three methods that he has suggested. In fact, Dr. Solow, I thought, put it very well when he indicated that the President's inflation alert was the equivalent of an announcement by the Weather Bureau that last Thursday it rained. In other words, it is simply a historic recognition of what has happened in the past and every witness we have had so far has indicated that they believe the President will not call attention to a specific wage demand by a particular union or a specific price increase by a particular industry and if that is not done, it seems to me, you simply cannot have any really effective anti-inflationary policy, certainly in the short run at that time when the excess demand has gone out of the economy according to virtually every economist, including Dr. Burns and others.

Mr. McCRACKEN. I obviously do not accept that metaphor as a fair characterization of this program. I think this program can lift the level of visibility about developments in wages and prices in the economy and can make an important contribution to this process.

I have said repeatedly before this committee that I know of no situation where the kind of problem that we have has ever been countered except through the use of stern fiscal and monetary policy. Moreover, I have also indicated in testimony here and before other committees that when one looks at the hard empirical evidence about the effectiveness of incomes policies or guidelines, even of a more stringent type, both here or abroad, the empirical evidence is at least inconclusive about the contribution that these things can create. Nonetheless, I think anything which can help to lift the level of visibility here can make some contribution. We are going to give it all we have got.

Senator PROXMIRE. We have had testimony by Chairman Budge, by Assistant Attorney General McLaren about the tremendous increase in concentration in industry. Mr. McLaren's testimony indicated that the 100 biggest corporations have as many assets in proportion to the total holdings in our country as the 200 biggest corporations had in 1950. Mr. Budge indicated a tremendous increase in conglomerate mergers and concentrations just in the past 3 years. The testimony of Dr. Blair and Dr. Means indicated that in the coming months virtually all of the inflation is going to be in the concentrated sector of the economy and it makes sense as long as we have excess labor available, unemployment running as high as it is, and as long as we have capacity which is available, it seems to me that what pushes up prices is the capacity of the concentrated industries to do so.

We have evidence, of course, that they have been able to do so at times when they were operating far below capacity and manpower was readily available. We have in the construction industry 11 percent unemployment but the highest wage settlements are in that industry. We are just not going to crack inflation by a stiff restraining policy of tight money and stringent fiscal policy, it seems to me, all by itself. When you have this concentration and the clear evidence that this is where, in coming months, we can expect price increases to concentrate——

Mr. McCRACKEN. But Dr. McLaren's testimony also analyzed some statistical evidence about where the price inflation had occurred.

Senator PROXMIRE. Exactly, and when I followed that up with Dr. Blair he pointed out that is exactly the point. In the period we have just had where we did have excessive demand, and you did have that kind of inflation resulting from excess demand, then the prices are relatively stable in the concentrated sector; but, when you move into the period in which demand is no longer excessive, then it is the concentrated industries where you get your inflation, concentrated both from the labor standpoint and from the industrial standpoint. And they were able to document that on the basis of our experience in every recession in the 1950's.

Mr. McCRACKEN. I want to make one or two comments here.

Mr. SHULTZ. I would like to make some, too. I can hardly restrain my enthusiasm for commenting on your assertions in your questions.

Mr. MCCRACKEN. Go right ahead.

Chairman PATMAN. The Senator's time has expired but each one of you may summarize your views.

Mr. SHULTZ. Do you consider construction to be a concentrated industry? You mentioned that.

Senator PROXMIRE. No. I certainly do not consider construction to be concentrated industry, but I do for——

Mr. SHULTZ. If there is one industry where we are having trouble with wage rates, it is construction. There was another recent wage settlement in trucking. Do you consider trucking a concentrated industry?

Senator PROXMIRE. I certainly consider the labor in trucking to be as concentrated as it can go in any industry.

Representative BROWN. I would like to make the point that the time has expired and, if the witness responds, he should not do it with a question.

Chairman PATMAN. You make a good point.

Senator PROXMIRE. I thank "Chairman" Brown for reminding me that my time is up.

Representative BROWN. Would it be possible to get an answer to the questions raised?

Chairman PATMAN. The gentleman will be reached very soon. After Senator Percy, of course, Representative Reuss, then the gentleman from Ohio, Mr. Brown.

Senator Percy?

Senator PERCY. I would like to yield my time to answer that question but I will not. [Laughter.]

I have enough questions of my own but I am sure we will be around long enough this morning to come back to this one.

Dr. Shultz, this is the midyear review and serves a useful purpose. When I first came on this committee I was shocked to find we did not periodically review the budget. But I am equally shocked this morning that we do not have a reestimate of the fiscal 1971 budget from the administration. The history is that, on February 2nd, the President submitted a budget surplus estimate of $1.3 billion. On the 19th of May, he revised that to a deficit of $1.3 billion. Shortly after that, figuring with a stub pencil on the back of a brown envelope, I came up with about a $6.1 billion deficit that I could estimate with the limited resources I had to check with.

A few days ago the Joint Committee on Reduction of Federal Expenditures came up with their estimate of a $10.3 billion deficit. Can you tell us this morning which one is closest and when will we get an official revision of this estimate to resolve this tremendous disparity? How can we operate as a Congress without knowing what you really feel that deficit is going to be and how tough we have to be about decreasing the expenditures or getting more revenue?

Mr. SHULTZ. Senator, as I understand the tradition of the midyear review, it was something like this, that in the early part of the year the President submitted his budget to the Congress. The Congress then took action on the budget and then we could come back at the midyear review and see where we stood and that seems to be like a very desirable process. I wish we could follow it.

We are now into the fiscal year. We do not have any idea—I mean, we can speculate as we all do—about the actions of the House and the Senate, and so on, but there has not been any substantial action on the President's budget by the Congress. We hope that the Congress will take action along the lines suggested by the President's budget and we continue to have that hope. But the situation that was presumed by the theory of the midyear review does not come to pass.

Now, we can do the same arithmetic on the back of an envelope that you spoke of and we can speculate as to whether the Congress will really increase all these expenditures by this much or not, and we can make estimates of that, and we can speculate as to whether the Congress will pass the tax legislation. You can speculate about all of that, and depending upon your assumptions, you can come up with a wide variety of figures.

Our effort is to stick to the President's budget and keep the spending within the ball park of the revenues generated by the tax system.

Senator PERCY. Mr. Shultz, certainly the Office of Management and Budget knows more than it knew on February 2. It knows more than it knew when it gave a revised estimate on May 19. It has greater resources than the Joint Committee or one Senator's office. I really feel we must insist that we get a revised figure, imperfect as it may be. You never will have all the information you need. Senator Mansfield has said we are probably going to be eating Christmas dinner here. The same line of reasoning could mean that we would not have a revised budget by December.

I think we must insist on getting the Budget Bureau's and the President's revised figure as to what in their best judgment, taking into account every condition that you need to consider, are the budget figures for fiscal 1971. We need your best estimate before we can really be aware of the magnitude of the problem. I think the problem is serious. I think it is critical and I think we need to be shocked by having an official figure to guide us as to what we do in the next few months, before it is too late.

Mr. SHULTZ. The uncontrollable costs, so-called—interest on the debt, unemployment compensation payments, public assistance, things like that—we, of course, continually appraise and reappraise, and I have in my statement suggested a change in the estimate for that number from the May review. I think that, when we have the results of fiscal 1970 and the revenues produced, we will then be in a better position than we were in May to estimate revenues for 1971. However, we will not know by then, I suppose, whether the Congress will or will not pass the tax legislation proposed. How far we will be in the appropriations process by that time I do not know. You gentlemen know better than I do.

Of course, I cannot help but recall that as Secretary of Labor, during my first full year as Secretary of Labor, we did not have our budget until 8 months of the fiscal year had gone by and that made for very severe management problems within the Department. I consider this to be a great problem.

Senator PERCY. The sins of one branch of the Government do not make up for the sins of the other, and I really will press on this in every conceivable way I can, on the floor of the Senate and telephone calls to you, to put all the heat I can on getting a figure. I happen to feel that when we see that figure it is going to help those of us who feel we must cut expenses and must raise revenue with our work. I think it is unconscionable that this Congress has raised postal pay and not faced up to the problem of raising rates—we raised pay and we did not raise the rates.

Mr. SHULTZ. I completely agree.

Senator PERCY. We apparently just did not have the guts to do it in an election year and I think it is a terrible thing that we did. We have a perfectly feasible proposal for increasing the gas tax on leaded gas. We would get $1.6 billion and help fight the pollution problems. We have not faced up to that one. But I think when we get this figure of yours it will help us a great deal before we go home to do the kind of things we should as a Congress and not just look at politics all the time. I hope I say the same thing when I am up in 1972. [Laughter.] I would like very much to commend the administration for the change in spending priorities. I think what has gone on in the Defense Department, the Space Agency, and other cuts in Government have been admirable and the emphasis on humanitarian programs has been exceedingly good. I think the President's message on Saturday was called for. We had it coming to us and, if anything, it should have even been tougher, and I think we ought to accept the expenditure ceiling. We have imposed a ceiling on the President. We ought to accept a ceiling on ourselves.

Can you suggest practical ways that we can implement that ceiling on the Congress, giving us flexibility that is required, but also putting a ceiling on our actions in spending so that we can be just as effective as we ask the administration to be?

Mr. SHULTZ. Well, we would like very much to work with the Congress, the appropriate committees, on practical ways of doing that. A problem is posed both for the President and the Congress and I think your note of flexibility is a key to it. If you are going to operate within some ceiling, some number, you cannot have the major parts of that number all pinned down. You have to have flexibility to move across the board to a certain extent. And I suppose also what this sharpens is the desirability of collapsing the appropriations process to a greater degree so that you really do have a chance to see as you are acting on all the individual parts what they are adding up to.

Senator PERCY. I would be very happy to work with you on the introduction of legislation that would impose the same kind of ceiling on the Congress that we have imposed on the administration and the President.

In going after the budget figure, the final figure for fiscal 1970, you have 11 months certain and 1 month to go. Thinking back on my own experience in Government some years ago during World War II, that last month everyone spent like crazy so they did not lose the money. Is that process still going on and in your new responsibility is there any way you can get away from the 12th month, June, being a frantic month to spend the money?

Mr. SHULTZ. I am sure it is still going on, but I think it is something that should be looked at. I think that is quite desirable. I should note that it is a universal trait. People cram for exams at the last minute. No doubt even Bell & Howell had its biggest shipment day on the last day of every month and——

Senator PERCY. Well, the only reason we did that was because we had only quarterly pushes before and then we changed it to a monthly push. Maybe you could close it out at the end of every month in the Federal Government and equalize it. There ought to be some way to get around that practice which I am sure goes on in many, many agencies.

Thank you, Mr. Chairman.

Chairman PATMAN. Representative Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Mr. McCracken, on this vital question of inflation and the cost of living, you expressed some optimism and some pleasure that the second quarter cost-of-living statistics look better than the first. I have just spent the weekend with my constituents in Wisconsin and they are certainly as concerned as everybody about increases in the cost of living and I, therefore, want to put it to you that you may be a little too cheery in your optimistic analysis. A good man, but cheery. And I want to point out a couple of ways in which I think your optimism may have overcome you.

In the first place, you talked about the better showing of the second quarter inflation figures than the first quarter inflation figures. Leaving aside the effect of the Government pay raise on those two figures, the second quarter looked as if it were about 1¼ percent better, less inflationary, than the first quarter. However, I notice that the Department of Commerce, the people who get out these figures, in its press release dated last Friday, July 17, page 3, accounts for the large part of that change thus: "This was due to changes in weights rather than a deceleration in the rate of price inflation." In other words, what they are saying is that because, due to high interest rate policies, the construction industry is on its back, therefore the sharp rises in the prices of construction had less of an effect. This is like saying, if we do not like the noise made down at the saloon on Saturday night, shoot the piano player and things will be better.

Now, is it not a fact that really there was not any marked deceleration in the rate of inflation, when you put to one side these weights? Is not the Department of Commerce right and, therefore, is it not true that there really is not much room to be cheery?

Mr. MCCRACKEN. Mr. Reuss, I did not read about half of my testimony and if——

Representative REUSS. You did mention the weights in your——

Mr. MCCRACKEN. Yes, I mentioned specifically that changes in the composition of GNP were a very important part of the change in the price level and in the rates of increase in the GNP deflator during the second quarter.

Representative REUSS. Should not that diminish the wan little smile we have about the rate of inflation? It seems to me it should. I do not think things are much better.

Mr. MCCRACKEN. I merely mention this because my own optimism about substantive changes did not arise out of overlooking that point. I mentioned that point explicitly in my own prepared statement and

I did not, I think, allude to any deceleration of the costs of living. I did say that there were certain factors—as we look ahead—supplies of food, for example—that provide some hope that we may see essentially a stable trend of food prices for the rest of the year. The main evidence that we have on the price front is being found in those areas where you usually see it first. We are seeing it in the wholesale price index of raw materials. The wholesale price index itself has been doing a little better. The wholesale price index at the industrial level has still not responded.

The Consumer Price Index has shown no visible deceleration, though at least acceleration has stopped.

The sequence that one would normally expect would be to see it first in raw materials, next to see it at the wholesale price level, and later in the Consumer Price Index. Now, one further point about composition. It is also true on the way up that a part of the increase in the GNP deflator, particularly in certain quarters, was reflecting not so much accelerated increases in the price level as these same shifts in composition which in some quarters went the other way.

Representative REUSS. Let me now turn to another aspect of inflation in which I think, respectfully, you may be guilty of excessive cheeriness. In the money supply, of your excellent prepared statement, you point out that the money supply increased at highly inflationary rates in 1968 and then you list those rates which work out at about 7.2 percent. And you suggest that the recent increases in the money supply of 4.2 percent in the last 1967 months are within the ball park.

Now, I call your attention to a release, again of last Friday, July 17, by the Federal Reserve Bank of St. Louis which is to the effect that from February to the present time the money supply has increased at a 6.6 percent annual rate.

Now, the Federal Reserve Bank of St. Louis goes on to indicate that in its judgment, starting things with last February is a fair way to do it because that was the least skewed base period that they could find. Assuming the Federal Reserve Bank in St. Louis is in possession of its senses, which I think they are, is not that a rather alarming and un-Friedmanesque rate of money supply increment that we have been having, 6.6 percent? That is about at the level that you said is highly inflationary.

Now, if you are right, if 7 percent is highly inflationary, and 6.6 percent is what we have been having, why are we not creating money at a highly inflationary rate?

I realize this is a somewhat different approach from that of Chairman Patman but what do you think?

Mr. MCCRACKEN. I assume that "alarming" and "un-Friedmanesque" are synonyms. [Laughter.]

Representative REUSS. Not necessarily.

Mr. MCCRACKEN. In the first place, we have to remember that the 7.3 percent rate of increase in the money supply in the first half of 1968 came in an economy that was already fully employed and being pressed hard against its productive capacity. As a matter of fact we were already in a rather inflationary—highly inflationary—situation at that time.

The second point to make is that if one looks at the pattern of the rates of increase in the money supply using another release of the St. Louis Federal Reserve Bank, you will find that through May and June the trend was flat. There were, of course, week-to-week swings but the trend was quite flat. For about 8 weeks we had really no increase at all. But the most important point to bear in mind is that we are now starting out on a path substantially below the basic full employment growth path for the economy. Unemployment is about 1 point above where it ought to be. Capacity of the economy is some 4 percentage points or so above where we now are. What we need within a reasonable period ahead is to have the kind of monetary accommodation which will permit us to not only accommodate the normal growth in the economy but to make up for the arrearages that we now have.

Representative REUSS. Thank you.

One quick question of Mr. Shultz. Mr. Shultz, in your statement you gave a pat on the back to the fruitful efforts of the administration in its committee on lumber prices and its committee on copper prices. Unfortunately, we cannot say as much for the efforts of its committee on oil prices, can we? Is it not a fact that you who came forth with what I thought was an excellent recommendation about oil import quotas as chairman of that committee were ceremoniously or unceremoniously removed, I do not know which, and those put in power who watered down that recommendation, to the great disadvantage of consumer prices? Is that not about what happened?

Mr. SHULTZ. The committee that was established by the President was following a recommendation in the report. That is, we recommended that there be a management committee for the program established in the Office of Emergency Preparedness, and we recommended the membership of that committee. The Secretary of Labor was not recommended as a member of that committee, and so I was not on it. I was not removed. That was the recommendation of the task force including my own.

Representative REUSS. But if you had been on the committee, the result would have been different, would it not?

Mr. SHULTZ. So far as I know, the substantive issue of what to do with the program has not been decided. That is still awaiting decision by the President. I notice that the House Ways and Means Committee seems to be bent on preventing him from adopting the kind of recommendation that the task force made.

Representative REUSS. I read in the papers——

Mr. SHULTZ. I hope that does not work.

Representative REUSS (continuing). That the President is bent on helping the House Ways and Means Committee to bring that situation about. You do not know anything about that?

Mr. SHULTZ. Well, as far as I know, that report has no foundation whatever.

Representative REUSS. My time is up.

Chairman PATMAN. Yes, sir.

Representative Brown?

Representative BROWN. Mr. Chairman, first, let me observe that the political ramifications of the status of our economy make us all a little edgy in an election year. I am sure we would agree with that, whichever side of the issue we are on. The party in power wants to have good news, the party out of power can benefit from bad news. I know that all of us want to get on the record arguments that benefit our side of the political issue.

So, I would like for the witnesses and the panel to recognize that I did not mean to terminate the dialogue that was taking place between the Senator from Wisconsin and the witnesses and I must apologize if anybody thought it rude.

However, I do think that the question should be answered not with questions, but with statements. So, Mr. Schultz and Mr. McCracken, if you would like to respond to the comments of the Senator on my time, I would be happy to have you do so. I would like to have you do so without questions to the committee because I have some questions I want to ask.

Mr. SHULTZ. No.

Representative BROWN. All right, sir.

Mr. SHULTZ. It was a rhetorical question.

Representative BROWN. Mr. Shultz, with reference to your new responsibilities as Director of the Office of Management and Budget, and the responsibility of the President to set the budget and then try to live within it, should the President refuse to spend funds appropriated even though he has the authority and even though the Congress appropriates funds in excess of the budget?

It seems to me that the process of having the Congress overappropriate the budget is an abandonment of the congressional prerogative in the area of fiscal responsibility to the executive branch.

Now, if that prerogative is abandoned, should the President exercise his prerogative and not spend the funds, or should the President spend the funds that the Congress appropriates even though it creates fiscal instability and economic instability in the country?

Mr. SHULTZ. I think the problem that we were addressing is the problem of bringing the parts into harmony with the whole. Let us say we agree on what the budget should add up to. The question is how are we going to get it there when we have a process that is inherently a piecemeal process. And in order to make the parts and the total consistent, you have to have some way to bring about a reallocation when you see what the parts really are adding up to. Whether this is done as part of the congressional process, as something that the President does, or—as it seems to me is basically the way we do it and a good way to do it—by an interaction between the executive and legislative branches, is the issue. The last of these three is the kind of an interaction that I took it Senator Percy was inviting us to work at.

Representative BROWN. That interaction begins 6 months before the fiscal year starts with the presentation of a budget to the President and then the Congress goes ahead and works its will as was the case this year when the House expressed its opinions prior to the beginning of the fiscal year. The Senate has not expressed any opinions at all until after the fiscal year to which the budget applied began.

Now, how long does that process of interaction continue? In other words, can the Congress go ahead and overappropriate up to the end of the fiscal year and have the President spend the full amount appropriated, or should we appropriate the full budget as the fiscal year begins and then compare that appropriation budget with the budget that the President set? What is the President's responsibility at that point? You will be exercising administrative responsibility in that area. What are you going to do?

Mr. SHULTZ. Well, the President's obligation and desire is to work at the whole budget process in such a way as to bring it out with a responsible end result. As you suggest, the process goes on continuously. I do not really see that it has an end point. I think that is one of the artificialities that are introduced into our thinking by this great big fat book that comes out once a year. It is a continuing thing. We start this process of interaction, for example, on the 1972 budget long before the budget physically arrives. We are in the process of developing the 1972 budget right now, since actions taken today determine spending in 1972. And we go right through the fiscal year with supplemental requests or increases that result from congressional initiative.

We constantly have a problem of going back and forth between the parts and the whole and it is that problem that it seems to me we need to do better in solving.

Now, the ideal would be if Congress were to complete its work on the appropriations prior to the beginning of the fiscal year.

Representative BROWN. By last June 30 in this case.

Mr. SHULTZ. Preferably, well beforehand, so that we would all then be able to plan for the year ahead on the basis of appropriations actions already taken rather than on speculation about what might happen. Moreover, we could look and see how it all stacks up—what the total is—in the light of our best estimates based upon action actually taken by the Congress. If we then have to cut and fit a little bit, we can do that.

As things have developed, the time has gone further and further into the fiscal year before we do see what this total picture looks like and that is the essence of our problem.

Representative BROWN. Under the law the President cannot spend funds which the Congress does not appropriate, is that not correct?

Mr. SHULTZ. As far as I know, that is right.

Chairman PATMAN. Repeat that, Representative Brown, please.

Representative BROWN. I said, under the law the President cannot spend funds which the Congress does not appropriate. Is there any question?

Chairman PATMAN. No. But there are other agencies that spend money that has not been appropriated by the Congress.

Representative BROWN. I appreciate that and I am an opponent of that sort of procedure, too, but let me——

Mr. SHULTZ. This, I think, comes to some extent from such arrangements as permanent indefinite appropriations (applicable to most trust funds as well as to such Federal fund items as interest on the debt), authorizations to expend public debts receipts, and the effect of asset sales on budget outlays. The unified budget has the advantage that it incorporates all of these under a single concept.

Representative BROWN. But what happens when the Congress abandons its prerogative to set a budget which would be balanced and the President discovers that he has had a great deal more money appropriated for expenditure than he feels it is wise economically to expend? What is your responsibility in that role under the new Office of Management and Budget?

Mr. SHULTZ. Well, a first responsibility is to call attention as strongly as possible to what is going on so that something can be done about it before it is too late.

Representative BROWN. I would assume that process is going on in the administration.

Mr. SHULTZ. That is what we are in the process of doing right now. We hope and expect, since, after all is said and done, both executive and legislative are basically composed of responsible people, that it is going to turn out all right. That is what we are looking for.

Representative BROWN. Well, that is the third time around for avoiding a direct answer to the question and I appreciate——

Mr. SHULTZ. Are you looking for a legal type memorandum on——

Representative BROWN. I am looking for an answer.

Mr. SHULTZ (continuing). What exactly the President's power to not spend funds under this, that or the other act might be?

Representative BROWN. I would just like to have an answer on the question. A legal memorandum is not necessary if I can get a response to the question.

Mr. SHULTZ. Well, I am sure that the answer to it varies with the piece of legislation involved. There are differences and there are also legal aspects of this. Perhaps the best thing that I could do is to submit a memorandum for the record on this subject.

Representative BROWN. Thank you.

(The following information was subsequently supplied for the record by Mr. Shultz:)

Representative Brown asked whether, if Congressional appropriations exceed what the President considers a responsible budget total, the President should refuse to spend the additional appropriations. Director Shultz stated at the hearing that the best way to achieve fiscal responsibility is through interaction between the Executive and Legislative Branches. The President, in his July 18 statement, called attention to the threat posed to fiscal responsibility by additional appropriations, and encouraged such interaction on the fiscal year 1971 budget while there is time to make necessary changes.

In the absence of cooperative action by the Congress, the necessary action could be taken only by the Executive Branch. Clearly, such action would be appropriate if outlays threaten to exceed either, for economic stabilization purposes, the revenues that the tax system would produce at reasonably full employment or, given the requirements of law, revenues and amounts raised through permissible borrowing under the statutory limit on the public debt. However, Presidential action to reduce spending usually depends on facts and circumstances and statutory and Constitutional considerations that vary from case to case. For example, the President is required by the Constitution to "take Care that the Laws be faithfully executed," and he thus must consider the effect of the many statutes that authorize Federal programs, appropriate funds for them, or otherwise control or affect carrying them out—including those statutes that impose limitations or ceilings on Government-wide spending. Moreover, the President's Constitutional authority over foreign affairs or as Commander-in-Chief of the Armed Forces may be important considerations in determining possible restrictions on spending. The situation is complicated by the fact that spending for certain programs has been made mandatory by statute and may not be controlled administratively. In others, the Executive Branch may have sufficient discretion to justify a refusal to spend the appropriations. Because of these factors, the President's July 18 statement called for the establishment of a firm ceiling on total outlays—one that would apply to the Congress as well as to the Executive.

Representative BROWN. Mr. Chairman, my time is up.

Chairman PATMAN. Thank you, sir. I want to bring up a few points here and ask you to answer questions for the record on others.

Now, on the $57 billion I mentioned that has been paid for once and we are still paying interest on it, that interest amounts to over $3 billion a year and that is spent by the Open Market Committee without any authorization from Congress. Of course, the law, that is the Constitution, says that all public funds should be appropriated by Congress before they can be lawfully spent, but this is an exception.

I am going to pass that over with the statement that I think our committee should consider having a special hearing just on that $57 billion plus for the reason that there is no use of us having our national debt inflated that much when it has been paid for once and it would certainly save us a terrific amount of money each year. It is a fact of the business that our operation in that respect is even worse, I suspect, than the Penn Central mismanagement. Anyway, we will get into that.

Now, the housing, I think, is the most important thing we have before us. People are unable to buy homes. Right now a person who contracts to buy a $20,000 home at the present rates and with the traditional 30-year term, the cost would be not only $20,000 for the home but $38,000 interest on that home which would make $58,000 he would have to obligate himself to pay before he could get a $20,000 home.

Now, that is really in my thinking, just against conscience.

I know they claim that they have got to have the market rate, the rate that is fixed by the market. Well, of course, a homeowner is in no position to compete with $27 million in the bank or other banks of almost comparable size and that is the reason you cannot get housing money now because by shooting the interest rates up high, people can get more interest on their money than they could get on housing loans and, therefore, even though we raised interest rates, and we have repeatedly, expecting to get more housing money, we have not gotten any more housing money because then this market rate that you talk about, that is where the corporations meet and they are not restricted on the amount of interest they get or the amount of interest that they pay. They are not restricted.

That is not a very fair competitor with the little man who is trying to buy a home. And then you have the people who are speculating in this marketplace. They run interest rates up. We have the gambling casinoes. They are in this marketplace and they are running interest rates up. And we have the high interest loan sharks. They are in that market. They are running interest rates up.

So, the homeowner has just been unable to compete and, therefore, he is not getting homes built and we talk about environmental quality and how it is necessary for each family, 55 million families in our country, to have plenty of food, adequate food, the right kind of food, clothing, and shelter. Of course, each family certainly is entitled to a decent home, decent shelter for his family, and it just cannot be provided like it is.

I think that should be given special consideration. I think there should be a priority list and housing should be right up No. 1 on that priority list. Like it is now, the big banks allocate the credit of this Nation. They allocate it to anybody they want to. We tried to get a bill through the House that would let the people who have a beneficial interest and who have paid into the pension funds use their own money to buy their own homes at a reasonable rate of interest. That has been denied us. We cannot get that done. There is no way to get a source of funds, it appears, without the opposition of the banking lobby and they have lots of influence. So, we do not have any source of funds for housing and we will not get housing until we have a source of funds.

Now, I proposed before the House Committee, and part of it went on the floor of the House and was defeated on a record vote, to have a development bank like the old RFC. That is where we had $500 billion dollars capital. They could expand 17½ to 1. They operated 22 years and they saved many companies like Penn Central and others and little businessmen, too. Yet, it just absolutely protected the people all during those 22 years and made hundreds of millions of dollars profit for the Treasury and did not lose any money.

Now, I propose that we have a billion dollar corporation similar to the RFC, let it expand 20 to 1. That would take care of all of our credit squeezes for the foreseeable future. There is no doubt about that. But we cannot get consideration of that. Like it is now, we have got to go through the New York banks for big sources of money. There is no other place to go. And when you go before one of these big banks for a big loan in the public interest you find around that table—I know, I have been there—around that Board of Directors, you find the Bethlehem, you find the big steel, U.S. Steel, you find all of them and if you want to build a steel mill you have not got a chance and if you want to do other things, nearly all those directors have interlocking directorates. They have an interest in most any big application that goes there and you just have not got a chance at all getting a loan for a public interest enterprise or project of any kind.

So, we have got to change that and we have got to have something like a development bank that can make loans that cannot be made locally by local banks, give the banks the first chance at it, and if they do not make it, then the development bank will have an opportunity to do it under fair conditions, and then next we could use the pension funds. That way the people who contribute to those funds would get more interest and it would be perfectly safe. They would be guaranteed by the Government and that is a great improvement over what goes on in some sections of the country now. To have that guarantee is worth a lot.

Or there is another way that we could have a source of funds. The Federal Reserve, they issue public credit of the country, at least, make it possible for the banks to use it, and the banks allocate it. We could require of the Federal Reserve to make a certain amount of loans through banks for housing.

In the little country of Mexico, just beyond the Rio Grande River, banks down there, they make 30 percent of their loans by law to low income groups for housing. Now, if little Mexico can do it why can we not do it? And every central bank in the world except our own has social responsibilities that must be considered in the use of the Nation's credit except our own. We do not have any requirement at all. They are footloose and fancy free and here we are, people are suffering for homes, they cannot get homes, they have to pay $38,000 interest on a $20,000 home, or $58,000 in all, and we are just letting it go.

I do not think that is right. I think we should do something about it. We can do something about it. And we must do something about it. Are you giving any consideration to housing now, Mr. Shultz?

Mr. SHULTZ. Yes. I think it is encouraging, first, that we are seeing some decline in rates of interest which do have a bearing, as you brought out, on what happens in housing.

Chairman PATMAN. Well, do you not think there is pretty little decline? There is some on the short-term rates. I have not seen much on the long-terms.

Mr. SHULTZ. It is a beginning, at least we hope so, and we have seen what we hope is the beginning of a recovery in housing.

Chairman PATMAN. Why do you not do something effective? Roll interest rates back.

Mr. SHULTZ. Well, as inflation subsides, interest rates will come down. As Chairman McCracken pointed out——

Chairman PATMAN. We wait a long time for that. We have waited 19 years. Interest rates have been going up all that time.

You are for rolling them back, are you not, Dr. McCracken? [Laughter.]

Mr. MCCRACKEN. I am for reestablishing conditions where interest rates will be lower.

Chairman PATMAN. Well, you never did answer my question. [Laughter.]

In the legislature of Texas one time we had a representative who had a favorite answer whenever he was put on the spot. He would say, "well, in answer to that it all depends upon the fundamental functions of the foundation of the base." [Laughter.]

So, let me ask you this question. You did not answer categorically a while ago. Would you say interest rates now are satisfactory to you or are they too high?

Mr. MCCRACKEN. I think interest rates are too high, but that is why I want to get conditions which will permit lower rates. I would emphasize that we are now beginning to see early evidence of a movement in that direction.

Chairman PATMAN. You are for lower rates than we now have. Do you not think that we should have a different rate for housing since the poor homeowner cannot compete with all these big fellows, these $27 billion banks? Do you not think that the Government should take upon itself to fix a rate beyond which they shall not go for homeowners who want to buy homes for themselves and families? Arbitrary rates, we will call it an arbitrary rate.

Mr. MCCRACKEN. Which would be a rate substantially below the market rate, of course.

Chairman PATMAN. Yes, sir. Substantially below. Say 5 percent. It could be done. Banks have money now at 6 percent. That is not much difference.

Mr. MCCRACKEN. That means that the financing of housing will have to be done entirely through Federal agencies, through the budget.

49-774—70—pt. 3——4

Chairman PATMAN. My time has expired. I will give you the questions that I want to ask you. The clerk will give them to you and if you will answer them when you look over your transcript it will be appreciated.

Representative Widnall?

Representative WIDNALL. Dr. McCracken, Dr. Shultz, I would like to ask you both the same question.

This morning's Wall Street Journal reports the Federal Reserve has forecast that the unemployment rate will rise to 6 percent by early 1971. Does this estimate seem reasonable to you?

I would like both of you to answer that.

Mr. MCCRACKEN. No. That estimate is too high and it certainly ought not to be the basis for policy planning.

Representative WIDNALL. Dr. Shultz?

Mr. SHULTZ. I second the motion. I think it is extremely difficult to forecast unemployment rates for reasons that we discussed a little bit earlier. Unemployment is in a sense the residual of the movement of two very large numbers and it is difficult enough to forecast the movement of a large number. The rate is positioned between them and making precise forecasts for a period as long away as that I think is a very hazardous undertaking.

Representative WIDNALL. Do you have any estimate at all as to what you expect the unemployment rate to be by the 1st of September?

Mr. SHULTZ. I imagine it will be somewhat as it is now. September is not very far away. The best evidence that we have of what is going on in between the monthly readings that we get comes from the weekly reports on insured unemployment. This indicator has shown pretty good stability over a period of time, with a slight increase in the last week or so, I believe.

Representative WIDNALL. By that answer do you mean 4.7 percent or something in the 5 percent area?

Mr. SHULTZ. I would say we are now somewhere in the neighborhood of 5 percent or a little under. I don't put a lot of emphasis of movements of small amounts in the rate from one month to the next.

Representative WIDNALL. And you would expect that to be so around September 1st?

Mr. SHULTZ. Probably. Although, as I say, this business of trying to forecast the unemployment rate is very hazardous because precisely what is going to happen in the labor force can fool you and that can have a big impact on the unemployment rate.

Representative WIDNALL. The same paper this morning reported that the 1970 budget ran a deficit of $3 billion to $4 billion compared to recent Administration estimates of $1.8 billion. Is it possible that the 1970 budget actually ran a deficit of this magnitude?

Mr. SHULTZ. What we know, what we feel fairly confident of now on the basis of the figures we have, is that expenditures have been contained within the figure that was forecast in the May estimates, which is about the same as the original budget estimate. In the May estimate we expressed the view based on the figures to then that revenues would fall short of the estimate, which was the reason for the deficit that was projected in May.

Now, we are gathering the figures on revenues. Just what they will show I don't know. I would reassert the point in my statement, that these revenues will fall short of the revenues that would have been generated in a full employment economy, and so any deficit that may appear under these circumstances, with expenditures having been held within the budget line, is not the kind of deficit that should give us great concern in so far as inflationary potential is concerned.

Representative WIDNALL. Would this be due to a drop in general revenues, or in some particular sector of the economy?

Mr. SHULTZ. The principal difference, I believe, for the revision in May was the lower than expected corporate profits. The lower than expected revenues were principally from that score.

Representative WIDNALL. I have noticed in recent reports that have been published within the last week that the revenues have held up very well for most of the corporations reporting. There have been several outstanding instances where there has been a marked decrease in revenue. But do these reports fall in line, at all, with what you have expected, or do they seem to be better than you had anticipated?

Mr. SHULTZ. Well, I agree with you. I think some of the reports we have seen, spot reports, this corporation and that corporation, have suggested a somewhat better picture than people had originally thought, but we will be in possession of more comprehensive information in a matter of a week or so, and at that time we will be able to make a descriptive statement of what has actually come into the coffers.

Representative WIDNALL. Mr. McCracken, you mentioned the National Commission on Productivity and the inflation alert the President announced in his June 17 message. Will the commission have any material impact on productivity and labor costs over the short run?

Mr. MCCRACKEN. I doubt that these two questions are related because if there is an effect on productivity, it would be apt to show up conversely in labor cost per unit of output.

It would not be reasonable to expect a short-run change but, the cumulative effect of focusing squarely on this matter of trying to improve the productivity performance of the economy might well be susbtantial over a period of time.

Representative WIDNALL. Well, do you really believe that inflation alerts issued after the fact can really have any impact on wage and price decisions?

Mr. MCCRACKEN. I hope so. It certainly will focus attention, more attention, on what is happening to prices and wages in the economy and in this way may have some marginal effect in some cases.

Representative WIDNALL. Well, wouldn't they be more effective in marshaling public opinion if the alerts were issued when price increases and wage settlements were being negotiated, rather than after the fact?

Mr. MCCRACKEN. That raises some extremely complex problems. There is the implication of being in the business of passing judgment on anticipatory price changes and wage changes. There is a possibility there for producing substantial perverse developments.

For example, if this is the procedure no one could handle anything like, anything more than a small percentage of price changes. It further creates an incentive, in those cases where there may be elbow room, to try to establish as high a price position as possible.

I would be very reluctant to go down that path. That comes pretty close to being general wage and price controls.

Representative WIDNALL. What specific activity do you think the commission should become involved in?

Mr. MCCRACKEN. You are talking about the Commission on Productivity?

Representative WIDNALL. That is right.

Mr. MCCRACKEN. It would be worthwhile to consider what the record of productivity changes has been in the economy in the recent past, what kinds of things may be helpful to give the economy generally a better performance.

I would not want to comment specifically. The commission has not yet met. But I am sure there will be no shortage of items on the agenda.

Representative WIDNALL. Dr. Shultz, recently the President has indicated his intention to live within the budget ceiling enacted by Congress for fiscal 1971. However, this ceiling is not binding on the Congress.

How would you suggest the Congress designate an outlay ceiling that would restrain excessive appropriations, yet allow necessary flexibility? Do you have any comment on that?

Mr. SHULTZ. One method would be to be clear about the ability of the President to allocate funds within whatever total there is to meet a ceiling that is mutually agreed upon. There are a variety of other methods, I am sure, that could be worked out, depending upon the congressional procedures that you might want to adopt.

Certainly looking to the future, as we discussed here a while ago, earlier action on appropriations would be of great benefit in this regard, particularly if we could see what the total added up to before the fiscal year actually started and then see whether you wanted to take another pass at it within the Congress.

Representative WIDNALL. My time is up.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. First, Mr. Shultz, to answer your rhetorical question, you asked about the concentration in the construction trade or in the construction industry, and in trucking.

Of course, there is no question that you have a lot of competition in the construction industry itself; but on the labor side, the wage rates are set in the local communities as I understand it, on a monopolistic basis and it is here that wage guidelines, it seems to me, could be effective.

As far as the trucking industry is concerned, as we all know, it is the biggest union in the country, and as we all know, they set their rates also in a local area on a monopolistic basis, concentrated basis, and the enormous increase that they got in wages undoubtedly is going to be reflected in inflation and higher prices.

The President didn't say a word about it. And, of course, what I was really talking about was these concentrations in autos, in steel, in oil, in copper, in chemicals, in drugs, in aerospace, in shipping.

These are the industries where you had, it is true, relative price stability during the period when we had a demand inflation.

However, in the coming months, according to some of the fine economists we have had, we can expect these particular industries to be especially inflationary. That was my point.

Mr. SHULTZ. May I make one comment? You are particularly picking out the construction industry.

Senator PROXMIRE. Yes.

Mr. SHULTZ. And suggesting that is the area where the guidelines should be applied. I think it is a fair statement that if there is one industry that efforts to persuade in this manner has been singularly ineffective, it is construction, just absolutely untouched. Of course, the reason is as you suggest, that it is a very decentralized kind of industry, not only fragmented on the management side, but within the structure of the unions. It isn't a big national bargaining situation at all. It is a local area by local area bargaining situation.

Senator PROXMIRE. Local area, it is true but, of course, in the local area the particular union has control of the labor by and large in that particular area. That was my point. I think you are right.

It is very hard, it is a real challenge. I think in these other areas, however, you have a real opportunity if wage guideposts can ever be effective, and some studies indicate they can be under some circumstances, now when you have no excess demand and where you have wage-push inflation should be the time.

Mr. SHULTZ. We have an interesting example alongside of us that I am sure we will all be watching with keen interest and that is the Canadian efforts where they have high unemployment. They have set a 6 percent guideline and the settlements that have come in since—those I have seen—have been exceeding the guideline by a very substantial margin.

Of course, the labor people refused to take part in the Canadian effort.

Senator PROXMIRE. Now, I would like to go back to the point that was raised by Mr. Widnall on unemployment and this Wall Street Journal article does indicate—it says:

> The Federal Reserve Board reportedly has forecast that the jobless rate will approximate 6 percent of the labor force by early 1971.

They also say that almost all analysts agree unemployment will continue to climb throughout the rest of the year, and I noticed Mr. McCracken also predicted that unemployment would climb somewhat. He said rather modestly, but he indicated unemployment would rise.

Under these circumstances how do you, Mr. Shultz, support your optimism that unemployment will not increase very much in view of the fact that we have a productivity increase anticipated which should absorb much of the increased production? We have labor operating at very short hours, 37.2 hours, which is historically extremely short and, of course, rather than hire new people, the people that work will be put to work full time.

We have indications that on a full employment surplus basis even if we have a deficit of $5 billion or $6 billion or $7 billion in the coming year on the consolidated budget basis, the fiscal effect will be restraining on a full employment basis.

In other words, it will be hard to get back to the full employment from the standpoint of the fiscal policy. And we have every indication, as was indicated this morning, and the Federal Reserve Board has told us repeatedly that they expect monetary policy to be moderate and they expect to increase the money supply at a rate of between 4 and 5 percent, perhaps.

Under these circumstances, where is your optimism that we are going to be able to hold unemployment down, with the evidence that more and more people are going to be discharged from the military and with the evidence that we expect that the military contracts are going to be cut back?

Mr. SHULTZ. Well, first let me say I don't intend to make a forecast about unemployment, and I thought I rather explicitly suggested that I am quite modest in my own assessment of my ability to forecast that number.

My observation of the record of many other people is that they have a lot to be modest about, too. I think it is a difficult thing to forecast well in advance.

Beyond that, it seems to me that the points that you brought out underscore the importance of the third point in the summary of Chairman McCracken's testimony, and I will just read it for emphasis:

> Third, attention should now focus on the requirement for assuring that the upturn will carry through steadily to full employment but not so rapidly as to cause inflation to speed up once more.

But the importance now of recognizing that this is a time to be concentrating on the expansion and to think boldly enough within the framework of this statement to carry us back to full employment——

Senator PROXMIRE. All right. Now, to do that, would you agree that if the forecasts of most economists and analysts developed that unemployment rises above 5 percent, would you feel that a deficit in the consolidated budget might be acceptable, in fact, might be useful?

Mr. SHULTZ. I think in my testimony, in the President's statement, he suggested that a deficit that arises from a shortfall in revenue below the full employment revenue, as long as we are holding expenditures in reasonable check, is not the kind of deficit that produces major inflationary pressures as contrasted with the sort of deficit that arises when you are basically shooting your expenditures over the full employment revenue.

Senator PROXMIRE. I hope you have a talk with your deputy, Mr. Weinberger, because I understand that he is in a position of power and authority in the Budget Bureau now. He is under your supervision. But he said, and I quote:

> At a meeting with newsmen yesterday Weinberger was asked if he agreed with those economists who have argued that a deficit next year would be useful in combating the rise in unemployment and preventing a serious recession.
>
> "I am familiar with that theory," he replied, "but I do not agree with it. I don't think a deficit benefits anyone. It may work for a year or two, but in three or four or five years you really pay the piper."

Many of us were alarmed by that because this seems to be an argument that under no circumstances would this man who has great authority under you in the Budget Bureau, would he tolerate fiscal policy which would be stimulative.

Mr. SHULTZ. Well, I think the really refreshing thing about working with Mr. Weinberger is the zeal that he has to try to do something about this tremendous momentum on the expenditure side. And that is what he is concentrating on and I really believe he can do something about it.

Senator PROXMIRE. Well, I don't disagree with that zeal, but I think we ought to be aware of the economic implications. We can dig ourselves a very deep grave. You, as a very competent economist, I am sure fully appreciate that.

Mr. SHULTZ. Well, I think the President's statement is quite clear on this point.

Senator PROXMIRE. What specific plans does the administration have to find jobs for the million men whom Secretary Laird said are going to be discharged from the military and the hundreds of thousands we expect to be laid off in defense plants. Do you have any plans at all?

Mr. SHULTZ. Certainly.

Senator PROXMIRE. What are they?

Mr. SHULTZ. From the first day of the administration there has been a group working on the transition away from a war economy. Herb Stein, a member of the Council of Economic Advisers, has been the Chairman of that group. I would classify the ways of dealing with this problem in three headings.

First—and of greatest importance—is the maintenance of a healthy economy. Transitions are easy to make, relatively, when you have a demand for labor and we have a healthy, growing economy. That is what we are striving for.

Senator PROXMIRE. On the first point, you don't seem to resist the notion that many economic analysts expect us to have increasing unemployment over the next several months. Now, is that a healthy economy to handle the people who are being discharged from the military, provide jobs for them?

Mr. SHULTZ. We are in the midst, as I think our statements have tried to bring out, of a twofold transition.

One of the transitions is away from a wartime type economy to a more peacetime economy and that does involve not only releases from the military but releases of Government employees and releases of private employees who are working under contract to the military. I expect this number over, say, a 2½-year period, if we go back to the beginning of 1969, to amount to something on the order of 2 million. So that is a big thing to work on. The second is a transition from an overheated, inflationary economy through a mild slowing to one in which there is stable, noninflationary growth.

And we have both these things going on, at the same time.

Now, I think this again highlights the importance of thinking boldly about the kind of expansion that we want as Chairman McCracken brought out. There are two other things——

Senator PROXMIRE. Yes, go ahead.

Mr. SHULTZ. Two other things to concentrate on are, one, the unemployment insurance and Manpower Training Act types of adjustment mechanisms that are important to build into the system.

And then second, and Secretary Hodgson I am sure will talk about this more tomorrow, are explicit devices working between the Labor Department, say, and the Defense Department on programing just where are these releases of personnel going to take place and when and then designing explicit employment programs for the incidents as you see them unfolding.

Senator PROXMIRE. Well, we certainly want to get those details because I haven't seen anything like that before from Mr. Stein or anyone else.

The other question I want to ask is, we have the shocking, shameful fact that 8.7 percent of the blacks are unemployed and in some cases it is much higher, for teenagers, et cetera. You are very much aware of that.

Mr. SHULTZ. Certainly.

Senator PROXMIRE. What plans or programs is the administration pushing to overcome that serious shortcoming?

Mr. SHULTZ. Directly on the employment side are the efforts for affirmative action for equal employment opportunities, which we have been working on within the administration with great vigor. I would say that on the employment side this is a principal matter.

The unemployment among blacks, of course, again highlights the importance of a healthy, strong economy. They are affected like all others are when unemployment increases. There has been some encouragement although I don't think this is——

Senator PROXMIRE. As a mater of fact, they are a lot worse than others are, aren't they?

Mr. SHULTZ. Well, no.

Senator PROXMIRE. Our increase in unemployment?

Mr. SHULTZ. No. I think some recent evidence has been to the contrary, that for a while the employment picture was moving a little better for blacks than for the balance of the population. I don't think that is holding right now, but it isn't worse than it has been historically.

Senator PROXMIRE (presiding). My time is up.

Senator Percy?

Senator PERCY. Dr. McCracken, is my recollection correct that the Federal deficit that accrued in the first 8 years of the 1960's was in the approximate area of about $60 billion?

Mr. MCCRACKEN. Yes. I think that is about correct.

Senator PERCY. How much of our present difficulty, high interest costs and inflation is a direct result of that deficit? How much of the present problems that you face day by day are direct results of our inability and unwillingness to pay for our governmental costs as we went along in the 1960's?

Mr. MCCRACKEN. A very substantial part of our problem now has its roots back at that time, but I would center it specifically in the period beginning about early 1966.

Generally speaking, the management of the expansion in business activities for a period in the early 1960's was quite good. As I indicated in my testimony, it is true that this was the mildest of the postwar recessions. Even so, 4 years later we still had 5 percent unemployment.

Nonetheless, the first half of the 1960's worked out fairly well.

The basic problem came along in 1966 when a decision was made to accelerate substantially both defense and nondefense expenditures and to not face up to the revenue requirement. The result was that by fiscal year 1968 we had a $25 billion deficit in an economy not only fully employed but one with severe demand pressures. That is why I would underscore the language in the President's statement Saturday.

Senator PERCY. Basically the decision, and I recall the phrasing was that we can have both guns and butter.

We are now paying that price for that basic policy decision. I am, therefore, not alarmed at all by Mr. Weinberger's statement. I think what he said is absolutely correct. We will pay the price eventually and eventually is right now. We are paying a very bitter price, and you can't talk about unemployment as it affects this administration without going into why we have the conditions that we have now, which are a result of policies several years ago.

Is it true that the great difficulty we are facing in the housing field is also a direct result of the pressure on debt financing, turnover of that debt, and driving interest costs up which then directly affects housing almost dollar for dollar in the deficit?

Mr. MCCRACKEN. Yes. The deficits directly took money out of the savings stream and indirectly the inflation that was set off got wrapped into interest rates.

Senator PERCY. Mr. Shultz, I have suggested several times that we go to a calendar year for the budget, not that it makes an awful lot of sense other than the psychology of it. I don't know how the administration operates when month after month we have continuing resolutions and no agency or department knows what it has got really for the new year and they are 5, 6, or 7 months into the new year without their budget yet approved.

Psychologically I seem to feel that if we said Congress won't go home for Christmas unless it has an approved budget we would get a budget. Wouldn't it be worth making an extraordinary effort to change from a fiscal year to a calendar year if only for that reason, because I think it costs tens of millions of dollars to operate as ineffectively and inefficiently as we do now.

Mr. SHULTZ. I agree completely that the situation where we don't have our appropriations until well into the fiscal year means that we don't spend our money as effectively as we could.

So this is a big management point, you might say, as well as a budget point. If moving the timing of the fiscal year would really help matters, that would be great. Whether it would really help matters, however, I don't know, but I think it is an idea well worth exploring.

Senator PERCY. On the question of a revised figure for the 1971 budget, if we got a revised figure in May, which is 3 months after the February initial figure is it reasonable to expect that we could expect a new revision in August? Can we expect a revised figure sometime within the next 30 days?

Mr. SHULTZ. We should know more about the outcome of the appropriations process by then. We will know what the 1970 results are and this will give us some guidance in estimating revenues for 1971 and reestimating back. Assuming that we have a substantial increment of new information to go on, then it would be worthwhile making a new estimate.

If we still have all the major uncertainties that we have now, then we really aren't any better off then we are now.

Senator PERCY. I presume that you are making estimates all the time, as you go along.

Mr. SHULTZ. Sure.

Senator PERCY. Could you share those with us within the next 30 days, then, as to what at least your own guess is?

Mr. SHULTZ. Well, we could certainly share them where what we are estimating is our idea of, for example, what interest on the debt is going to cost, and whether or not that piece of the budget has changed, or unemployment compensation payments, and so on.

When it comes to guessing about whether the Congress will appropriate this much or that much, or some other amount, then our guess is certainly no better than yours, or as good.

Senator PERCY. Well, I am sympathetic with the problems. It would just help us a great deal if we could have your best estimate in looking for added revenue in the fiscal 1972 budget.

Our agreement with NATO countries for balance-of-payments offsets and loans ends June 30, 1971. Secretary Laird has recently said, according to the Washington Post, that if they do not burden-share in Europe, we will probably have to reduce our troop level. Is this a firm administration stand? Do you feel that it is now fair and equitable that NATO countries burden-share with us, taking into account the great pressure on our domestic budget?

Mr. SHULTZ. I think I should defer an answer on that to Secretary Laird.

Senator PERCY. All right. Could you describe what role, in your judgment, "jawboning" might play today? I know you don't like the phrase and I don't think it is particularly effective, but what is the role of the President today, with the inflation problem that we have, to put the moral force of the Presidency, and there is no office that can compare with it for moral force, behind management to not ask for unreasonable price rises and labor to not demand unreasonable wage increases?

We have so many big contracts up now. Will the President assume a relatively active role in this area of moral persuasion, taking into account the key factor, and I believe he is absolutely right, that he wants to stay away from price and wage controls?

Mr. SHULTZ. Well, I think we have outlined steps that have been taken and are being put into play—the Purchasing and Regulations Review Board, the Inflation Alert, the Productivity Commission, and what these various units are to do. I think a principal obligation that the President feels on this, however, is to be sure that the fundamentals of our problem don't get out of sight and out of hand. One of the great dangers, I think, is that people get the idea that somehow through some form of jawboning or exhortation we can solve our inflation problem and therefore we don't have to worry about expenditures or revenues any more. I can't help but feel that just that trap may have had something to do with what happened in 1967 and 1968.

Senator PERCY. When I listen to some of the trade associations talk about their import problems, I get the feeling of the United States being a helpless giant. I see, according to your figures, we are going to have a trade surplus of $3.8 billion in 1970 which is a very healthy trade position. Yet I hear all of the problems of quotas and tariffs and I am one of the few Senators not on a quota bill in the Senate. There are 80, I think, that are on quota bills.

Do you think it would be disastrous for us, with this strength that we show, for us to now start imposing absolute quotas on a series of products when we know we will be retaliated against by other countries, and they are more ingenious than we are in restricting trade?

I feel we have got to put a lot of pressure on foreign countries to get them to ease their restrictions but won't it really hurt our efforts if we start imposing restrictions as if we are a developing nation?

Mr. SHULTZ. Yes, I am in complete agreement with that point of view.

Senator PERCY. Does that apply to textiles and shoes?

Mr. SHULTZ. Well, as far as textiles are concerned, the administration has been trying to negotiate a voluntary agreement but that effort has not as yet been successful. There was reluctant support for a form of textile quotas, a form that in a manner that we hope might lead to a voluntary agreement. Beyond that, and so far as quotas are concerned, there was no Administration support for any of those moves.

Senator PERCY. Well, I commend the administration on trying to negotiate a voluntary agreement with Japan. I certainly have tried to warn Japan as a friend of freer trade that unless it does become realistic about the voluntary restraints, that they are going to get a compulsory one, much as I dislike it.

My time is up. Could I have 30 seconds to just comment on Chairman Patman's comments on housing?

Because of our deep interest in housing, and I am sorry Mr. Patman had to leave, but I do feel that this country has provided different interest rates for housing. The administration's proposals for subsidized interest costs, the banking and currency committees of both the Senate and House have prepared revolutionary interest reductions down to 1 percent for low-income families, and now middle-income families frozen at 7 percent.

I would think it would be a great deal better to do it that way where you can see what the cost is, rather than forcing the banks and having us tell them what to invest their money in unless we are willing to guarantee millions of depositors that no matter what happens in the economy, we will furnish the cash in case they can't get the liquidity required when 35 percent of their money is tied up in housing.

So I think the suggestion——

Representative BROWN. Would you yield on that point?

Senator PERCY. I would be happy to yield but I think the Chairman's suggestion would be disastrous so far as the free market is concerned. I think we found in the Congress a much better solution and he is on the very committee that helped find that solution.

Senator PROXMIRE. Congressman Brown has the floor.

Representative BROWN. I just wondered, Mr. McCracken, if it would be possible to calculate a real interest cost in the housing field in the United States today, an average current interest rate for housing, considering all the subsidized housing and other efforts.

Mr. MCCRACKEN. Yes.

Representative BROWN. I don't ask you to respond to that at this moment, but if it is possible to come up with that figure, it would be interesting, I think.

Mr. Shultz, let me, if I may, just pursue the point that I was discussing with you earlier. It seems to me that where Congressional appropriations in excess of income give the Executive two ranges of choice for his spending prerogative, you might call those two choices the inflationary option or the changing priorities option. The inflationary option would see the Executive free to spend all the appropriations made by Congress and run a deficit.

The changing priorities option would see the President required by his own restrictions to live within his own income and spend under the appropriations, but do so as he sees fit, full spending in one area, that is, full appropriations spending in one area, less than the full appropriation expenditure in another.

Now, without asking you to commit to a future course of action, would you concur in that range of choices that might exist for the President of the United States?

Mr. SHULTZ. Yes.

Representative BROWN. Well, either way is an abandonment of the responsibility of the Congress, isn't it? One is the abandonment of the responsibility of the Congress to try to control inflation and the other is abandonment of our responsibility to try to set the priorities pattern of this country, is it not? Maybe that is a rhetorical question.

What problems are presented for you, Mr. Shultz, or do you think will be presented with reference to your operation of the office of management and budget by the failure of Congress to act on appropriations in timely fashion prior to the commencement of the fiscal year?

Mr. SHULTZ. There are two types of problems that we get into. We talked about both of them here. One is the difficulty of seeing, as you start the year, what the budget process is adding up to and therefore, the difficulty of being able to deal with the economic aggregates in a good policy way. The other one goes more to the management of the use of these funds. When you have no good time horizon for the expenditure of the funds, you are going along from time period to time period on a continuing resolution, you can't manage the funds as effectively as when you know that for the year you have these funds available to you.

Representative BROWN. In fact, this leads to that hurry-up expenditure at the end of the year, hurry-up shipping at the end of the month that you were discussing, does it not?

Mr. SHULTZ. Yes, it does.

Representative BROWN. And further creates a considerable problem at the local community level, which we tried to take care of by unusual procedures in the education appropriation this year, where local communities did not know when they must begin their expenditures and what kinds of assistance they are going to get from the Federal level.

Mr. SHULTZ. That is correct. I think the move to break out the education budget and try to get it done, at least that much done early, is a constructive thing to have done.

Representative BROWN. I would dare say that every other segment of the economy is going to want to be removed from the general appropriations procedure so they can find out what is going on in their area.

Mr. SHULTZ. Certainly the major problem to be solved is getting this process concluded earlier.

Representative BROWN. A most impressive part of your statement is where you indicate, and I think establish by statistical evidence, that the priorities in this country have changed. You note the defense expenditures have dropped from 45 percent of the total budget in 1968 to 36.6 percent in 1971 and that social expenditures have gone up from 32 percent to 41 percent in that same time frame. I am interested, however, in the fact that in order to get even the 32 percent of the Federal budget in social expenditures in 1968, the 1968 budget ran at a considerable deficit, did it not?

Mr. SHULTZ. Yes, it did.

Representative BROWN. Well, now——

Mr. SHULTZ. This is a tabulation of the proportions in relationship to the total expenditures.

Representative BROWN. To the total Federal expenditures.

Mr. SHULTZ. Right.

Representative BROWN. And not to a balanced budget; isn't that correct?

Mr. SHULTZ. That is correct.

Representative BROWN. In other words, these are percentages of total Federal expenditures and not percentage of gross national product or anything like that.

Mr. SHULTZ. Well, we do have a statement of percentage of gross national product as well, just to develop that point. That is, I think, something you can do properly when you are talking about defense expenditures since the Government is the defense agency, but when it comes to human resource programs these are spread throughout the economy and it is little more difficult to justify an estimate in proportion to GNP.

Representative BROWN. And the 41 percent for social expenditures deals with a balanced budget?

Mr. SHULTZ. This is a tabulation of the President's 1971 budget expenditures.

Representative BROWN. As it was presented in a closely balanced budget, is that correct?

Mr. SHULTZ. Well, that is correct. It is the 1971 budget as we now see it—as the May estimate suggested is slightly in deficit.

Representative BROWN. So in effect, if that budget becomes heavily in deficit it is possible that the 41 percent for social expenditures could be even higher.

Mr. SHULTZ. I am not sure I am following your——

Representative BROWN. Total social expenditures could run even heavier both in terms of percent of total expenditures and total spending for social programs.

Mr. SHULTZ. Well, if that is where the additional appropriations come from, that is right.

Representative BROWN. Where does the priority of a balanced budget fit into the shifting priorities from defense expenditures to social expenditures in this administration? Would you comment on that?

Mr. SHULTZ. The priority is very strong and is related to the problem that we have inherited and that we are trying to deal with, namely, doing something about inflation and getting the economy back into a healthy and expanding condition. We have at the same time—the President has stated that this doesn't mean that under any and all circumstances and times that we should be shooting for a balanced budget.

Representative BROWN. If the President has those two prerogatives—the inflationary prerogative (accepting congressional over-appropriating) or the reordering of priorities (cutting congressional appropriations to stay within the budget) the President has some latitude in which to operate.

Mr. MCCRACKEN. I think there has been another consideration which is worth introducing here and that is that when you move into the kind of situation such as we had 2 or 3 years ago with an enormous deficit in the budget, then it also has consequences for the allocation of the economy's total resources. Clearly the 1968 deficit, for example, began to set in motion developments which were destined to have very adverse consequences for the percentage of our total economic resources that we would allocate to housing and state and local spending.

Representative BROWN. Well, further than that, as Senator Percy has pointed out, it also has grievous social disadvantages because the problem of that excessive deficit, which resulted from the increase in social expenditures beyond income, has created our current unemployment, isn't that correct?

Mr. MCCRACKEN. Yes. I just wanted to emphasize that this kind of thing can have allocative implications which go beyond the Federal Budget itself and have very important spillover effects in the economy.

Representative BROWN. The effects go beyond the time in which those budget deficits existed; going into debt to reduce poverty has created a lot of poverty for a great number of people who are not working today; isn't that about correct?

Mr. MCCRACKEN. That is about correct.

Representative BROWN. Let me ask you: What effect will the Tax Reform Act of 1969 have on new and old spending programs? Can the Federal Government avoid a liquidity crisis as Federal revenue will be reduced by the act? We are worrying about the possibility of other people being subject to a liquidity crisis in the future;

what about the possibility of a liquidity crisis in the Federal Government?

Mr. SHULTZ. The basic point we come back to is to ask what revenue will the tax system that we have in place produce under full employment conditions? And the basic guideline that the President has laid down, is that we should under no circumstances spend a greater amount than that.

Now, that isn't to say that we should be spending that amount necessarily but that we should never exceed that amount.

Representative BROWN. Let me go back to Mr. McCracken with a concluding question.

If we assume, and I do not, that all the benefits and problems which we face today are a direct result of this administration's efforts, and examine the status of the economy after the first 18 months of this administration, we still see the improvement of the amount of funds available to the housing industry.

Mr. McCRACKEN. Right.

Representative BROWN. Do you claim credit for that social advantage as a result of administration policies?

Mr. McCRACKEN. Certainly. [Laughter.]

Senator PROXMIRE. Could I ask—first let me make a statement: In response to distinguished Senator from Illinois who said, No. 1, that he thought Caspar Weinberger was absolutely right in saying that we should not have deficits, I think it is a question of what we are talking about. I think Mr. Weinberger could well be right if he is talking about 1968; if he is talking about 1967 or 1966 when we had unemployment below 4 percent, and substantial deficits during that period, including 1 year of a $25 billion deficit, a complete mistake almost all economists would agree, but would you agree, for example, in 1960 when we had 5½ percent unemployment and ran a surplus, that that was a wise economic policy, Mr. McCracken?

Mr. McCRACKEN. No, Mr. Chairman, I would not. And I think I would be able to document that I was making that kind of statement at that time.

The full employment surplus at that point would have been so large that it would have been part of the fiscal drag on the recovery.

Senator PROXMIRE. That is exactly my point, that you have to have some degree of selectivity here and recognize there are times when, of course, we ought to run a surplus. It does restrain inflation.

There are other times when a surplus can be very bad for the economy and increase unemployment.

Mr. McCRACKEN. May I just say that that is quite explicit in the President's statement on Saturday.

Senator PROXMIRE. Right.

Mr. SHULTZ. Mr. Chairman, if I could just insert a comment, I think that what is worrying Mr. Weinberger comes from looking back over our shoulders at 1967 and 1968 and then looking not only at 1971 but at 1972, the 1972 budget that we are working on, and seeing the momentum that is developing here.

Senator PROXMIRE. Well, I agree that when the Federal Reserve Board predicts 6 percent unemployment and when many analysts predict it is going to go beyond 5 percent and every independent witness we have had has estimated increasing unemployment, to have a man in Mr. Weinberger's position saying he is against deficits pretty much, period, including the upcoming years 1971 and 1972, that could be very damaging for our economic policy. It could mean hundreds of thousands of additional Americans out of work.

Mr. SHULTZ. It could be terribly damaging also if in 1972 what is developed is a budget that shows expenditures far in excess of the revenues that were produced at full employment.

Senator PROXMIRE. I agree with that.

Mr. SHULTZ. I can tell you it is so easy to have these expenditures go up; it is incredible the momentum that seems to be here.

Senator PROXMIRE. The only point I would like to make, the distinguished Senator from Illinois also raised the point of interest and housing and I think he is right, the 1968 act in which both he and I had a part in drafting, is helpful in providing some subsidized interest rates, getting at housing that way.

But the fact is that in the coming year, the pitiful housing starts, we have 1.3 million when we should have 2.6 million, only a relatively few will be helped by direct Government subsidy policy.

I don't think he or anybody proposes that we could get anything like 2.6 million housing starts by the Government route without, of course, an enormous increase in spending.

Now, let me ask you also about this reassuring answer you gave us on providing jobs for the large number of people who are being discharged from the military.

Mr. Stein indicated to us he is not even going to make a public report on reconversion policy. We can't get anything out of him and he, as you say, is the chairman of that committee as to what plans, specific plans the administration really has, generalities about how they are going to try to do this and that in general, but there is nothing specific about how they are going to put people to work and what concerns me is when you put that together with the fact that you also gave us a generalized response on providing jobs for black people who are out of work at such a very high rate and the administration doesn't seem to be really pushing hard for the family assistance program which is a very constructive proposal by President Nixon——

Mr. SHULTZ. It is hard for me to see how you could possibly say that the administration is not pushing hard for the family assistance plan. It has been talked about and talked up and worked on. Tremendous amounts of time have been spent on it. I know. I have been involved. I am spending a lot of that time myself, and there is a very strong push for that program.

Senator PROXMIRE. Well, have you been working on members of the Senate?

Mr. SHULTZ. Yes.

Senator PROXMIRE. Nobody has called at my door or rung my bell.

Mr. SHULTZ. Well, we have been working. We are working with the Senate Finance Committee at the moment. That is where the hearings are.

Senator PROXMIRE. At any rate, you intend to press hard for that and you——

Mr. SHULTZ. Not only intend to, we have been and are.

Senator PROXMIRE (continuing). Anticipate that that program will be of what dimensions in terms of the minimum income for a family of four?

Mr. SHULTZ. The structure of the family assistance plan has a floor of $1,600. We are talking about a family of four.

Senator PROXMIRE. Plus food stamps.

Mr. SHULTZ. Then food stamps are added to that and it brings the total, I believe, to $2,460. That may be off by $20, I am not sure about that.

Then, beyond that there is a disregard of earnings of $720. That is, a person can earn that much money without having any reduction in the family assistance payments, and then after that there is a reduction at a marginal rate of 50 percent on the family assistance payments.

Senator PROXMIRE. Have you computed what this will cost if unemployment is as high as the Federal Reserve Board estimates, 6 percent?

Mr. SHULTZ. Well, we have made estimates of the cost of the program in its hoped-for first year of operation which would start with the next fiscal year, and I don't want——

Senator PROXMIRE. Yes. An estimate I have seen was when unemployment was around 4 percent or less and at that point I recall, and this was without food stamps, the cost would be around $4 billion. With food stamps and with unemployment 50 percent higher, it would be, I would think, a great deal more than that, would it not?

Mr. SHULTZ. Well, you have to remember that when unemployment rises as a result of people being laid off, let's say that that is going on—I am not predicting that, but just saying suppose that were true—those people are drawing unemployment insurance, so that we have to remember that that is taking up some of the income maintenance job.

Senator PROXMIRE. Only some. Also a lot of people can't find jobs, who are looking for jobs, particularly the poorer people and the people who are coming into the labor force, and those who are working in some uncovered jobs, too, would be undoubtedly affected, and they would be the ones.

Mr. SHULTZ. That is certainly the case. I just wanted to point out, however, that not all of the income maintenance load is carried by the family assistance plan. Some is carried by other income maintenance programs.

Senator PROXMIRE. But you fully expect that some will go into—you are budgeting that. Can you tell us what you are budgeting that program at now, your present estimate for the budget for 1971?

Mr. SHULTZ. Well, we have that number. In 1970, fiscal 1971, of course, the program would not be operative. It would be operative beginning with the next fiscal year.

Senator PROXMIRE. I didn't realize that.

Mr. SHULTZ. This would be preparatory money.

Senator PROXMIRE. So we wouldn't get any of the family assistance program in fiscal 1971. For the next year we can't count on that as a help for those out of work or——

Mr. SHULTZ. Well, we can count on it if the Congress will proceed and do what the President has asked.

Senator PROXMIRE. No, no. You just told me this wouldn't go into effect until July 1, 1971; is that correct?

Mr. SHULTZ. Correct.

Senator PROXMIRE. Then for the next year you can't count on it.

Mr. SHULTZ. We are in that year right now, that is right. The money that is in the budget for it is essentially planning money and, of course, we are also gaining experience that will be helpful in this through the operation of the WIN program which we are working on very hard.

Senator PROXMIRE. Mr. McCracken, we have been after you on this committee for a long, long time, and I don't want to let you get away without asking you once again, will you please in your annual report coming up in January give us an analysis of the impact of defense spending on the economy, the impact, No. 1, on inflation; the impact, No. 2, on jobs; the impact especially now that we expect a cutback, the effects of that on the economy.

We got two pages out of the previous Council of Economic Advisers in 1969 and we got nothing at all out of your Council this time. Many of us feel it is a very important element in the economy. It is one over which the Federal Government does have control. I do hope you will give us a substantial analysis, and I mean a full chapter on this.

Mr. MCCRACKEN. I shall certainly try to do better than we did last time, or even better than the last Council. Seriously, we will certainly do our best.

Senator PROXMIRE. I appreciate that very much because it would be most useful to us.

Any further questions, gentlemen?

Senator Percy?

Senator PERCY. You asked that so hopefully.

Senator PROXMIRE. No, no.

Senator PERCY. I have just a few questions and I would like to make this comment: I spent the weekend with a bunch of investment bankers and Wall Street people who spent the weekend in their favorite sport, maligning the administration's fiscal and monetary policy.

I tried to convince them they have been living on marijuana for quite a few years and the things that are being done are tough and hard decisions that this administration has faced, but I think basically and essentially it has been right and will benefit from it for a long time to come. We are paying for the excesses of the past.

I pointed out what was trying to be done in cutting defense spending and getting away from the concept that we have to have the capability to wage two and a half wars simultaneously, which has been ingrained in us for years. We are trying to cut back a million men out of the Armed Forces, to cut the Space Agency, the administration is working toward a voluntary Army. That is going to cost us, but it will get the essence of voluntary selection for a life's work. This administration has done more than any previous administration ever in food programs for hungry Americans. It is trying to get a sensible farm program right now. It is closing bases, military bases, all over the country and part of them in my State.

I know the outcry. We all want economy except when it comes to our district or our home State, but I support generally what they have done there. I think we shouldn't let this day go by without expressing first, our gratitude to you for the time you put into preparing your testimony, and I know that each one of us will try to make our time as useful as possible to work on the problems that we face.

I would like to ask questions on a couple of specific cases. Dr. McCracken, you mentioned that the high cost of construction is the result of arbitrary limitations placed on the hiring of minorities by construction unions. This administration again has done far more than ever before to try to bust that program.

The Philadelphia plan of Mr. Shultz has been effective. I supported it. I am sure our chairman did.

What progress is being made now in that industry to break those restrictions, Dr. Shultz, and open up employment to all Americans and then remove this monopoly that unions have had for establishing wage increases regardless of productivity increases?

Mr. Shultz. First of all, in Philadelphia, under the Philadelphia plan, there have been people hired on Government contracts that, so far as we can determine, would probably not have been hired were it not for that plan. There are some contractors who have not lived up to a good faith effort as we see it, and they have been called on that. We are working on that aspect of the plan.

From the start of the effort with the construction industry—and I might say we started from scratch: there was no program here at all when we started—we have tried to emphasize the importance of area-wide voluntary agreements as a preferable route to go. That is a preferable route, first, because it includes all construction, not just federally-supported construction, and second, because if it is a voluntary expression, it implies a commitment on the part of those who have agreed to it to carry forward.

Now, there have been some cities where we have voluntary agreements. Boston is one. In Chicago there is one. In Pittsburgh there is one, and so on. Beyond that we have found that we can work with some of the construction unions. Contracts have been signed by now with the plumbers' union and with the iron workers' union for special journeyman trainee programs. This is something that didn't exist before—and is a definite advance.

So, in a number of ways we feel we are getting a response from the industry and from the unions and trying, on the one hand, to be firm about the Federal responsibility under the executive order and, on the other hand, to say we don't want to use enforcement powers as the way to do this if we can help it. We want to work along in the spirit of voluntarism with you, and people are responding to that. I think that we are in movement.

It is not an easy area to work in. It is a very difficult area, but, at any rate, we have some motion going on, and some progress is being made.

Senator Percy. The minority has additional questions but in the interest of time, Mr. Chairman, I would like to submit those for the record so that they can be answered.

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

PAUL W. MCCRACKEN'S REPLIES TO THE QUESTIONS POSED BY MINORITY MEMBERS

Question 1. Former CEA Chairman Arthur Okun estimated in June that the full employment budget surplus would total nearly $19 billion for the final 6 months of the current fiscal year and $14 billion for the year as a whole. Do you subscribe to this unusually large estimate of full employment surplus? Could you provide us with alternative estimates for both halves of fiscal 1971? Is it your belief that the Federal budget during the current fiscal year will be significantly destabilizing as it shifts from ease to substantial restraint?

Answer. The table below compares estimates of the full employment budget surplus for the two halves of FY 1971 as made by Dr. Okun and as made by the CEA on the basis of the May 1970 budget review. The CEA surplus figures are about $5 billion lower than Okun's in each half (annual rates) mainly because of a difference in the estimated expenditures. However, both the Okun estimate and the CEA estimate show a change of about $7 billion in the rate of surplus between the first and second halves of FY 1971.

It would be preferable from the standpoint of economic stability if changes of this magnitude in the full-employment surplus could be avoided. However, this is difficult to achieve when a number of large changes, such as tax or social security revisions, occur on a schedule which is dictated by other considerations. It may be especially difficult to reconcile smoothness in the short-term movement of the full-employment surplus with longer-run objectives. For example, a critical problem of budget policy today is to hold down FY 1972 expenditures relative to full employment revenues, and this complicates the problem of smoothing out the two halves of FY 1971.

In any case, short-run variations, even half-year variations, in the size of the full-employment surplus should not be taken too literally as variations in the economic impact of the budget. As we look at the forces at work in the economy, and at other policy instruments, we do not believe that the projected change in the full-employment surplus would, if realized, prevent movement of the economy along the path to full employment.

FULL EMPLOYMENT RECEIPTS AND EXPENDITURES

[Billions of dollars, annual rates, as estimated by Arthur Okun and by CEA]

	Fiscal Year 1971		
	1st half	2d half	Year
Okun receipts	213.1	223.9	[1] 217.5
CEA receipts	212.7	223.4	218.1
Okun expenditures	201.7	205.2	203.5
CEA expenditures [2]	206.4	210.2	208.3
Okun surplus	11.4	18.7	14.0
CEA surplus	6.3	13.2	9.8

[1] There is a special treatment of the social security rate increase in Okun's fiscal year average.
[2] Unified budget of 205.6 as presented in the May Budget Review.

Question 2. Your analysis of the U.S. balance of payments situation paints an optimistic picture of our current accounts and a pessimistic one of your capital accounts. What do these developments imply for our policy choices in the months ahead? Do they imply the relative unimportance of trying to push ahead with liberalizing the exchange rate adjustment process (which would affect primarily the current account)? Do they imply that we should strive to maintain a high interest rate structure, in order to attract and maintain investment capital here? Do they imply that it is almost impossible to control capital accounts and maintain various domestic economic objectives (e.g., low interest rates) at the same time?

Answer. As monetary conditions in the United States ease relative to those abroad, we would expect a reversal of the unusually large inflows of capital which occurred during 1969, and this is in fact occurring. This temporary result of the disinflationary policies being pursued by the United States had been anticipated both here and abroad, and does not represent a threat to the stability of the dollar and the international monetary system. What is important in this regard is that our current account continue to strengthen so that the ability of the United States to finance its international payments on a sound long-term basis is not in question. Ending domestic inflation is of course crucial to our attaining a strong balance of payments position.

There is considerable question in our minds whether deliberately maintaining a high interest rate structure would help in obtaining this balance of payments objective, even apart from the adverse domestic repercussions which such a policy would have. This is because of the high interest costs which such a policy would entail. With our international short-term liabilities of over $40 billion, a one percentage increase in U.S. short-term interest rates. increases our annual interest payments to foreigners by $0.4 billion. Even after taking into account that the interest receipts on our short-term claims would generally also rise as a result of higher domestic interest rates, a net cost of roughly $0.3 billion per year would result. And with a "permanent" high-interest rate policy, these payments would be a continuing item in the balance of payments each year, whereas most of the balance of payments improvement due to high interest rates would be only temporary, resulting from the reallocation of capital in response to a change in interest incentives. The capital inflows which would be attracted on a continuing basis as a result of high interest rates would be much smaller than this initial stock adjustment. Thus, we do not think that attempting to keep domestic interests rates at high levels is an appropriate or useful balance of payments policy.

Our optimism over improvements in our current account over the near term future does not imply that it is unimportant to push ahead with liberalizing the process of exchange rate adjustment. While we would expect that improvements in the process of exchange rate adjustment should help to mitigate the "devaluation bias" of the international monetary system which has hindered the U.S. in maintaining a strong balance of payments position, the major benefits to be expected from such improvements are not those which might be of direct help in improving the U.S. balance of payments. They would be rather in an overall strengthening of the stability and efficiency of the international monetary system. For instance, if exchange rates could be kept closer to their equilibrium values by prompter exchange-rate adjustments, the major source of the severe speculative strains which have plagued the international monetary system in recent years could be substantially reduced.

Given sufficient flexibility of exchange rates we do not see any necessary contradiction between freedom of capital movements and the pursuit of domestic objectives, which of course are the main concern of the Council of Economic Advisers.

Question 3. On July 16, Dr. Solow of MIT said he was not optimistic that our economic system can combined an unemployment rate no higher than 3.8 percent with inflation as indicated by the GNP deflator and the Consumer Price Index rising no more than 2 percent annually without long-term structural changes. Do you subscribe to this view? Would you describe for us what changes would improve the apparent "trade-off" we have between inflation and unemployment?

Answer. The record since World War II does indeed suggest that it will not be easy to attain an unemployment rate of 3.8 percent with an inflation rate of 2 percent as indicated by the GNP deflator or the Consumer Price Index. The average annual rate of change of the GNP deflator from 1955 to 1969 was about 2.5 percent, while the average unemployment rate was about 4.9 percent. This is a price-unemployment combination that is unsatisfactory in comparison with the goal of 2 percent inflation with 3.8 percent unemployment.

Even in a period of smooth growth with price stability and substantial productivity gains such as we experienced between 1960 and 1965, the unemployment rate on an annual basis has always been over five percent. This historical performance can probably be improved through structural changes, especially with the substantial inflationary expectations that have developed over the past three years.

There are a number of structural changes that can improve the price-unemployment trade-off and many of these are mentioned in the *Economic Report, 1970*. For example, improved manpower policies can reduce the duration of unemployment and the level of the unemployment rate by reducing the time used in searching for a job. Manpower policies may also be used to train workers who have very few skills and who are unemployed for structural reasons.

A second general area where structural changes can be made is the improvement of competition. This relates to an active antitrust policy and the reduction of import duties and quotas. Some agricultural programs required by law—such as the sugar and meat programs—probably have some adverse effect on the price level.

Finally, in a number of industries there are special forces that cause exceptional price rises. In the area of medical care, demand has been high and a bottleneck in the supply of medical services has developed. Further efforts to increase the supply of doctors and technicians in this industry would ease the price rise. In the construction industry wages and prices have been rising at a rapid rate in spite of a relatively low overall demand. This behavior appears to be related to the difficulty of entry into the construction labor unions and to a tendency for inefficient production methods to be preserved or even encouraged. We also have problems in some of the mineral industries where supply sometimes falls behind demand.

There are many other examples of industries that exhibit poor wage, price, and productivity behavior. The recently formed National Commission on Productivity should help in identifying these industries where there is substantial room for improvement and in bringing about agreed solutions.

Representative BROWN. I have a specific question I should like to ask and I will submit it in writing, if I may.

(The following answer was subsequently supplied for the record by Mr. McCracken and Mr. Shultz:)

PAUL W. MCCRACKEN'S REPLY TO THE QUESTION POSED BY REPRESENTATIVE BROWN

Question. Agencies such as the Federal Home Loan Bank system and FNMA are government-sponsored but not controlled by the government. Last year these agencies borrowed $9.1 billion in the money and capital markets, which in turn was loaned out, mostly to support residential and farm mortgages. To what extent does heavy borrowing by these government-sponsored agencies foil a Federal budget policy of reducing federal demands on the credit markets? To what extent did the 1969 security issues of these sponsored agencies for the purpose of supporting mortgages deplete private sources which normally supply the mortgage markets? Wouldn't it be preferable to bring these agencies back under the discipline of the federal budget, to insure their activities do not frustrate progress toward fiscal policy and financial market objectives?

Answer. Borrowing by the government-sponsored agencies supporting mortgages does not "foil a Federal budget policy of reducing federal demands on the credit markets." First, these agencies cannot borrow without the consent of the Secretary of the Treasury. But more important, one of the primary reasons for wishing to reduce federal demands on credit markets is precisely to free funds to meet the needs of housing, a high priority item that has borne too much of the brunt of the recent inflation and efforts to contain it. The borrowing and lending of government sponsored agencies has, we believed, helped to relieve the pressure on housing. To some extent their borrowing probably did draw funds from the capital markets that would otherwise have gone into housing through normal channels. But in view of the difference in character between the kinds of securities they issue and the underlying mortgage instrument, it is reasonable to expect that the agencies drew funds from other parts of the capital market as well. In our opinion residential construction would have performed less satisfactorily in the absence of the efforts of these agencies.

This does not, of course, mean that these agencies should not be subject to more careful control than is possible under the present budgetary arrangement. In the President's budget message for Fiscal 1971 the outstanding loans of these agencies are featured prominently. Moreover, there is a continuing study within the Administration of the problem of increasing the visibility and controllability of the actions of these agencies, so that they do not thwart our budgetary objectives.

GEORGE P. SHULTZ' REPLY TO THE QUESTION POSED BY REPRESENTATIVE BROWN

Question. Agencies such as the Federal Home Loan Bank system and FNMA are government-sponsored but not controlled by the government. Last year these agencies borrowed $9.1 billion in the money and capital markets, which in turn was loaned out, mostly to support residential and farm mortgages. To what extent does heavy borrowing by these government-sponsored agencies foil a Federal budget policy of reducing federal demands on the credit markets? To what extent did the 1969 security issues of these sponsored agencies for the purpose of supporting mortgages deplete private sources which normally supply the mortgage markets? Wouldn't it be preferable to bring these agencies back under the discipline of the Federal budget, to insure their activities do not frustrate progress toward fiscal policy and financial market objectives?

Answer. The question of whether to bring Federally-assisted private credit under the discipline of the Federal budget is under study by an interagency committee. Such institutions as the Federal Home Loan Bank and the Federal National Mortgage Association are now privately owned and operated and, for this reason, are excluded from the budget under the budget concepts currently in use. The interagency committee is considering whether these concepts should be modified in the manner suggested by Representative Brown. Bringing these institutions under the discipline of the Federal budget is but one method of assuring greater consistency between our fiscal policy and financial market objectives. Whether or not these institutions are in the budget, we could place greater emphasis on Federally-assisted credit programs in the President's Budget Message, as well as improve controls over the total volume of Federally-assisted credit.

These institutions have certainly played a vital role in industry during a period of difficulty for the mortgage market. There is no reason to assume that their security issues depleted the flow of private funds into mortgages. To the contrary, the mortgage funds made available by FNMA and the Home Loan Bank Board supplemented private mortgage funds during a period when such funds were limited in availability.

Senator PROXMIRE. I would like to ask one more question of Mr. Shultz if I could.

There is some question in my mind as to how the new budget agency which you head will review the Pentagon's budget, in view of the dichotomy that seems to have been established between the Domestic Policy Council and the National Security Council.

Would a review of the military budget be increased or decreased in the new budget agency? Will it be changed in any way?

Mr. SHULTZ. Well, we expect to review the Defense Department budget as all other budget departments will be reviewed. The process of setting the broad priorities, basic policy decisions in the Budget, will go forward on the one hand in the framework of the National Security Council procedures, and on the other, in the Domestic Council procedures, and that is a priority setting kind of exercise. We are in the process of it now. Beyond that we will have our regular examining procedures, department by department including Defense.

Senator PROXMIRE. Will you allocate to the Defense Department substantial increase in manpower? In the past only 10 or 15 percent of the Budget Bureau's manpower—I am not talking about you, I am talking about the situation over the years—have been allocated to the Defense budget although it constituted a much higher proportion of controllable spending, and do you have any plans to allocate more manpower so you can bring defense spending under better control?

Mr. SHULTZ. In so far as the allocation of manpower within the Office of Management and Budget—and, as you know, the Office does not have a large number of people—we are in the process of thinking our way through that problem. We do expect to have the manpower to make an adequate review in all areas.

Senator PROXMIRE. Can you tell us what proportion of your manpower is now working on the Defense budget as compared with the non-Defense sector?

Mr. SHULTZ. I don't know the answer to that but I suppose we could get it.

Senator PROXMIRE. Can you give us an estimate?

Mr. SHULTZ. I don't——

Senator PROXMIRE. Would it be fair to say one-fourth or one-seventh?

Mr. SHULTZ. I would rather not make a stab at it. In some ways, you know, it is like all these other calculations, it is difficult to make and you have to impute and what proportions—should I include my time, or not?

Senator PROXMIRE. Well, I am talking about the people that you have exclusively assigned—you have, I understand, some people that you assign to particular departments to ride herd.

Mr. SHULTZ. That is correct.

Senator PROXMIRE. And I want to know of those you have assigned how many have you assigned to the Department of Defense and how many to the other departments. If you provide that for the record, I would very much appreciate it.

Mr. SHULTZ. All right.

(The following information was subsequently supplied for the record by Mr. Shultz:)

TOTAL NUMBER OF BUDGET EXAMINERS IN THE OFFICE OF MANAGEMENT AND BUDGET AND THE NUMBER AND PERCENT ENGAGED IN EXAMINING NATIONAL SECURITY PROGRAMS

	Fiscal year 1970 actual	Fiscal year 1971 actual
Total number	182.0	196.0
Engaged in examining national security programs:		
Number	52.0	59.0
Percent	28.6	30.1

Senator PROXMIRE. Gentlemen, thank you very much. We appreciate it.

Tomorrow we will reconvene in this room to hear the Secretary of the Treasury and the Secretary of Labor at 10 a.m.

(Whereupon, at 1:20 p.m., the hearing was recessed, to reconvene tomorrow, at 10 a.m., Tuesday, July 21, 1970.)

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

TUESDAY, JULY 21, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:07 a.m., in room S-407, the Capitol Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire and Javits; and Representatives Widnall and Brown.

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.

Yesterday we heard from two leading economic advisers to the President on the state of the economy. We had hoped to hear some cheerful news but it was not, in my estimation, forthcoming. Dr. McCracken told us that the "game plan" still requires some further increases in unemployment, that expansion of output—if it materializes—will fall short of additions to productive capacity. Even Dr. Shultz, who seemed to be saying at times that unemployment would not increase, could see no near-term hope for reducing unemployment from its present high level—1½ million higher than last year.

Both gentlemen saw some signs of easing inflation, or at least it was no longer a situation of accelerating inflation! I hope they are right and, perhaps, the new consumer price index for June which will be reported later this morning will show some definite evidence of the slowdown. I must confess, however, that the evidence presented so far is not heartening.

We are looking forward to hearing from Secretary of the Treasury David Kennedy and Secretary of Labor James Hodgson.

Secretary Kennedy, we are particularly concerned at the weight of the testimony telling us of the dangerous state of liquidity in the economy. With your vast experience in the banking industry, as well as your role as Secretary of the Treasury, I know you will tell us what must be done to meet this emergency, and what can be done to deal with the terrible imbalances in our so-called market rationing of credit.

Secretary Hodgson, there are many of us here in Congress who believe that the administration has not used all of the anti-inflation weapons available. In particular, I am concerned that the President is not using the vast powers of his office to help us fight the exorbitant wage and price increases. I am hopeful we can have a fruitful dialogue on this and other topics of interest to labor and the American people. And, Mr. Hodgson, I think you are also aware on July 1 I wrote you and asked you to detail the plans that you had to put the unemployed to work in the areas of the country where they were out of work and in the event that unemployment should increase substantially.

We hope that your opening statements can be kept to 15 or 20 minutes, gentlemen. Your full statements will be placed in the record.

Senator Javits?

Senator JAVITS. Mr. Chairman, first, I join the Chair in the expectation of very authoritative testimony from the two distinguished members of the Cabinet.

Second, I would like to say by way of supplement to what the chairman has said that there is legislation being contemplated with regard to the so-called liquidity crisis. I shall ask for comment from the Secretary not specifically with respect to the bill I am proposing to introduce but on the general subject of whether the time has come for Federal Government intercession in the effort to deal with the liquidity crisis on a broader scale than was contemplated by the special rescue party for the railroads, especially the Penn Central. Also, I would like to address the Secretary of Labor on the proposition of accelerating the Manpower Training Act of 1970. The act would answer many of the Chairman's questions about a trigger for more massive efforts in respect of unemployment as well as public service employment. It will also aid the basic manpower training effort, which involves hundreds of thousands of working slots.

I might say that Congress bears a very heavy responsibility in this field. I have considered manpower training legislation to be one of the key elements of the antirecession effort which is being mounted. But passage of such a measure is entirely up to the Congress. I am sure the President will sign any reasonable bill, and I think the administration is entitled to the credit for having offered its own manpower training bill in recognition of that fact.

So, Mr. Chairman, I join the Chair in welcoming the two distinguished witnesses and in the expectation that we may make some measurable contribution to the resolution of our country's economic problem.

Senator PROXMIRE. Secretary Kennedy?

STATEMENT OF HON. DAVID M. KENNEDY, SECRETARY OF THE TREASURY, ACCOMPANIED BY PAUL VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS; AND MURRAY L. WEIDENBAUM, ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY

Secretary KENNEDY. Mr. Chairman, members of the committee, it is a pleasure for me to be here with you this morning. These hearings provide a timely opportunity to appraise the recent performance of the economy and to examine the prospects for the future. Since you have already been over this ground in some detail, my prepared statement is relatively brief and concentrate on matters of basic economic policy.

THE DOMESTIC ECONOMY

The economy is currently in the latter stages of a successful transition from prolonged overheating to renewed expansion in a less inflationary environment. An earlier and crucial stage was the removal of excess demand. This was accomplished, through coordinated application of appropriate monetary and fiscal policies. But so much inflationary momentum was allowed to build up after 1965 that even now cost-price pressures remain strong, even though excess demand pressures have abated. However, there are now multiplying signs that the cost-price situation is in the process of showing significant improvement. Our patience is being rewarded. The orthodox policies of this administration are working. Inflationary pressures are receding, and they should continue to recede while the economy expands.

It is not always fully appreciated that two difficult adjustments have been proceeding simultaneously. The economy is recovering from a most severe inflation. At the same time, we are successfully making the transition from a wartime to a peacetime economy. As President Nixon recently pointed out:

For the first time in 20 years, the Federal Government is spending, in this fiscal year, more on human resources programs than on national defense.

By the end of this fiscal year, defense expenditures are expected to be $7 billion below the fiscal 1969 level.

Over 400,000 military and civilian employees have been released in the past year from our Armed Forces, and defense cutbacks have led to a reduction in the labor force of defense plants by 300,000.

The transition to a more civilian-oriented economy is surely welcome to all Americans. But it does cause some temporary hardships and complicates the tasks of economic policy. The remarkable thing, to my mind, is the relative smoothness with which the economic adjustment has proceeded, given all the difficulties involved.

Impatience by some with the course of economic events is inevitable when unemployment rises and relief from advancing prices is slow in coming. But the price picture itself is now in the early stages of showing significant improvement. As we would expect, the first signs are coming in the area of sensitive raw material and wholesale prices. The spot market price index of 22 basic commodities has declined about 4 percent since early March. On a seasonally adjusted basis, the increase between the first and second quarters in the more comprehensive wholesale price index was down to a 1.7 percent average annual rate, compared to 4.6 percent between the fourth and first quarters. The consumer price index rose four-tenths of 1 percent in May, compared to six-tenths of 1 percent in April.

It took time for our policies of restraint to slow the pace of total spending—a considerable period of time because expectations of continuing inflation were so strong. It is taking even more time for the effects of restraint to reach the cost-price area—but this is now beginning to happen. Experience tells us that still more time will have to pass before the rate of increase in consumer prices recedes to more tolerable levels. These adjustments are occurring in the expected sequence—if not always exactly on the desired schedule. The outlook for early reduction in the rate of inflation is now much brighter.

It is well to recognize that some of the improvement observed up to this point in the price picture stems not only from softer demand, but that some is also the result, in part, of special factors, such as the reduced rise in farm and food products. Wholesale prices of many industrial commodities have continued to rise at a fairly steady rate. This indicates that the "cost-push" problem is not yet altogether solved. There are some encouraging signs. Labor costs per unit of output in manufacturing have shown definite signs of flattening out in recent months. Clear signs of better productivity performance are coming into view. But there is still some way to go before a satisfactory balance will be established between productivity, costs, and prices.

There is strong indication that the first quarter of this year may have been the low point in productivity performance. More rapid productivity gains are likely during the remainder of the year. Given some degree of restraint in wage demands, this should lead to a substantial lessening of cost-push pressures. The usual process can be assisted by the "inflation alert" and Productivity Commission recently established by President Nixon.

While the inflationary process unwinds, it is particularly important that fiscal and monetary policy continue to play a stabilizing role. Some gradual lessening of restraint on total demand was surely appropriate in the first half of this year. With demand no longer excessive and unemployment in the area of five percent, continuation of restraint throughout this year at last year's intensity would have had too severe an impact. The phased expiration of the income tax surcharge and the resumption of growth in the monetary aggregates has helped to insure against any cumulating downturn movement in the economy.

Continuation of the present directions of fiscal and monetary policy throughout the remainder of the year would seem to be the indicated course of action. By its nature the monetary side of the policy equation is more quickly and flexibly adjusted to the short-term needs of the situation, although frequently with lagging effect. For the time being, the responsibility of the Executive and legislative branches is to keep fiscal policy in a relatively neutral position. Above all, fiscal policy should not veer off on a sharply expansionary course with the consequent strains this would place on the credit markets.

Some economists outside of government are now contending that a line of analysis—using the so-called full employment budget concept—would show that the degree of economic restraint implicit in the Federal budget may become even greater than they would care to see. I do not share their confidence in the exactness of such calculations. I believe that the administration must continue to maintain a posture of fiscal restraint.

The actual budget results for fiscal 1970 will be available shortly. I do not have the data today, but it appears that expenditures will be brought in very near to target, if not a bit lower. Revenues will be down somewhat from the estimates made in May. The movement from the small surplus estimated in February to the small deficit now anticipated is due to a revenue shortfall rather than a rise in expenditures.

It will be extremely important to keep a close rein on Federal expenditures in the present fiscal year and beyond. There has been a tendency—particularly evident after the mid-1960's—to spend first and try to find the taxes later. This is one lag relationship that we can—and must—do something about. Otherwise we face the recurring prospect of large Federal deficits at high levels of economic activity. Financing large Federal deficits under such conditions means severe strains on the credit markets, high interest rates, and restricted availability of credit to private borrowers.

Given the probability that economic activity will be rising throughout this fiscal year, it will be extremely important, from a financial markets standpoint, to avoid a sizable budget deficit. This will require close restraint on Federal expenditures and favorable action on proposals already submitted to the Congress to raise needed revenues.

In the domestic financial area, it seems to me that we have laid the base for substantial improvement since the beginning of the year. It is true that some difficulties, latent earlier, have since come into sharper focus. As a result, there has been some concern about the threat of a so-called liquidity crisis. While the markets have continued to function effectively, orderly planning to cope with even such a remote possibility is, of course, the only sensible course of action. To a large extent, this falls within the purview of the Federal Reserve System. But the Treasury has an obvious concern for the smooth functioning of the financial system.

Most of the conventional statistical indicators show sizable declines in private sector liquidity. While some of these follow trends of long standing and reflect basic changes in financial management practice, there is little question that liquidity has been strained, both in the financial and the nonfinancial sectors of the economy. Pressures on profits and cash flow obviously aggravate the situation. In isolated cases, corporations can encounter serious temporary financial problems despite favorable long-term prospects. But recent actions by the monetary authorities and the demonstrated resilience of financial markets should have done much to allay any fears that strains should unduly inhibit financing of sound companies.

A better balance has been emerging in the credit markets during the course of the year. Treasury bill rates are down about 1½ percentage points from their earlier peaks. Key long-term interest rates have also been coming down. New AA corporates and municipals are about three-fourth of 1 percentage point below the peaks of mid-June. Mortgage rates are slower to respond but may well have also passed their peaks.

The decline in short-term interest rates has helped restore a more satisfactory pattern of savings flows to thrift institutions. In conjunction with special Federal efforts, this has supported a welcome rise in mortgage lending commitments which is being reflected in higher levels of housing starts.

Interest rates remain at high levels by historical standards in view of the gradual unwinding of inflationary pressures, but it seems to me that the highest peaks now lie behind us. Nevertheless, the demands for capital to meet the expanding needs of our economy will remain high. Hence, it will be incumbent upon the Federal Government to so conduct its own financial affairs as not to absorb unduly resources needed in the priavte sector.

THE INTERNATIONAL ECONOMY

In the balance-of-payments field, the cooling off of our domestic economy is being reflected in improvement in our current account position. Our trade balance for 1970 may show a rise of close to $2 billion over last year. Nevertheless, it is evident that we still face a strong challenge in this area.

Our recent progress is largely due to the strong growth of our exports, partly in response to the demands of temporarily overheated economies abroad. If inflation abates in these countries as expansion resumes in the United States, our exports may not grow at the rapid recent pace. Meanwhile, our imports have continued to rise somewhat despite the limited GNP growth in the last 6 months. Plainly the need to reinforce the recent improvement in the trade balance clearly emphasizes the need to keep domestic inflation under control and to achieve rapid gains in productivity. We must not only match, we must surpass other countries' performances with regard to price stability to regain our competitive edge.

It is important that we direct more of our energies to selling abroad. It is for this reason that we are urging the Congress to approve a bill which would provide more equitable and competitive tax treatment for export income. We are also trying to assure that financing facilities for our exports are not inferior to those of other countries. We realize these are not the only steps needed for the strong export performance vital for a healthy U.S. balance of payments, but constructive actions along these lines can play an important role in favorably disposing business management towards exporting.

In our efforts to achieve such a surplus, we must not follow the self-defeating course of widespread barriers to imports. Such a course invites foreign retaliation, fosters inefficiency at home, and retards the growth of real income.

Our interest in restoring our trade surplus does not reflect a mercantilistic attitude on our part. Rather, it reflects the fact that the United States will continue to be a large, natural source of capital outflow to the rest of the world. Accordingly, it must cover a substantial portion of that outflow by a surplus on goods and services transactions if we are to restore a satisfactory balance of payments position and discharge our responsibilities for maintaining a strong dollar.

Despite improvement in our trade and current account, the United States had a large official settlements deficit of about $3 billion in the first quarter of 1970, and a still sizable although apparently significantly smaller deficit in the second quarter as well. In broad terms, these deficits reflect the fact that our trade position and current account, despite the real improvement this year, remain at unsatisfactory levels, while capital flows have moved more adversely than in recent years.

Thus far, these deficits have not contributed to an excessive growth of world liquidity. This is partly because both the United Kingdom and France have employed substantial foreign exchange receipts to repay outstanding emergency credits. Indeed, it is worth noting that the available data for May indicate that the reserves of continental European industrial countries as a group still stood well below the level recorded at the end of 1967.

In the IMF, exploration of possible modifications of exchange rate practices is now centering on three practical possibilities: authority for a country to maintain slightly wider margins for fluctuation of market exchange rates around the official parity than the present limit of 1 percent; arrangements by which the IMF, in specific instances, might more readily or speedily authorize small parity adjustments—say by 2 or 3 percent a year; and legalization of a transitional period during which a currency might float, while seeking the proper level for a new parity.

Limited, evolutionary changes of this kind would, I believe, be consistent with the basic purpose and functioning of the exchange rate system established at Bretton Woods. But they could be important, partly by reducing the possibility of speculative disturbances arising particularly out of those changes in official exchange parities that may be necessary from time to time, and that might otherwise be unduly delayed or very large. At this time, I cannot report a consensus among the fund membership on any of these proposals, although the discussions have been extremely useful already in clarifying and limiting the remaining issues in a highly complex area.

From our standpoint, we must recognize that these proposals in the exchange rate area cannot, in any sense, provide an escape from our own serious balance of payments problem. Indeed, none of the three procedures under discussion would be applied by the United States. This country bears a heavy responsibility for the effective functioning of the international monetary system, and that function can, in the end, be discharged effectively only by maintaining the stability of the dollar as the major reserve and transaction currency.

Improvement both in the structure and overall net balance of our international accounts, in turn, depends fundamentally upon the success of the domestic policies upon which we are concentrating our attention today.

THE NEEDS OF ECONOMIC POLICY

I would like to emphasize the underlying strength of the American economy during this difficult period of transition through which we have been going. Total employment in the United States has risen considerably in the past year and a half, by about 1½ million people. Disposable personal income—the spending power available to the average consumer—rose to an alltime high in the April–June quarter, whether measured in real or current dollar terms.

Our patience and determination to carry out our policies of adjustment to a healthier economy are now paying off. I expect to see considerable progress in the remainder of this year and in 1971, both in lower rates of inflation and higher levels of production and employment. Even so, there is much that remains to be done in terms of economic policy actions.

I would like to indicate some of the specific actions that are required in order to regain economic stability and high level employment while reducing inflationary pressures.

Most important of all, in my opinion, the Federal budget must be kept in a stabilizing position. In turn, this suggests the need for prompt congressional action on the adminstration's revenue proposals.

The Congress should speedily approve the President's request for accelerated payment of gift and estate taxes. If enacted promptly, this could yield an additional $1.5 billion of revenues in this fiscal year.

The Congress should speedily approve the President's request for an environmental control tax on the lead additives in motor fuels. If enacted before autumn, this could yield over $1 billion in additional revenues in this fiscal year.

The Congress should speedily approve the President's recommended postal reform legislation, which provides for postal rate increases.

A strong budgetary position will also require a continuation of close control over Federal expenditures. The administration will work with the Congress to achieve this objective.

Another set of actions can help to ease the current transition and promote the early achievement of stable growth. Chief among these are the new initiatives in the productivity and cost-price area described last month by the President. In addition, there are important items of legislation which need to be enacted promptly:

Legislation to expand and strengthen the unemployment insurance system.

The proposed Manpower Training Act, which would automatically increase manpower training funds at times of unemployment.

Legislation to protect investors from loss due to financial difficulties of brokerage firms.

The Emergency Home Finance Act of 1970 to help attract more money into the housing market.

Pending legislation to help small businessmen get necessary credit.

Railroad loan guarantee legislation to provide emergency assistance to railroads in financial difficulties.

This is a difficult period of economic transition. It emphasizes the need to get back on a stable pattern of high employment growth and to stay there. In time, the balance of payments should benefit from the same corrective forces that are at work in the domestic economy. In the simplest terms, our most pressing need is for more productivity growth and better price performance. Both should be forthcoming over the remainder of this year and into 1971, providing moderate and sensible economic policies are maintained.

That completes my statement, Mr. Chairman.

Senator PROXMIRE. Thank you, Mr. Secretary.

I understand, Mr. Hodgson, that the "g" is silent. I just learned that, so I will address you as Secretary Hodgson, is that correct?

Secretary HODGSON. That is entirely correct and I would hope you would not think that is the only thing silent about Hodgson.

Senato PROXMIRE. Well, I certainly hope it is because I know you have a lot to say. Go right ahead, sir.

STATEMENT OF HON. JAMES D. HODGSON, SECRETARY OF LABOR, ACCOMPANIED BY GEOFFREY H. MOORE, COMMISSIONER OF LABOR STATISTICS, DEPARTMENT OF LABOR

Secretary HODGSON. Mr. Chairman, members of the committee, I, too, welcome the opportunity to present my testimony before this committee as it undertakes a review of the state of the economy at mid-1970.

In reviewing the economic situation, we must keep in mind two of the major objectives of this administration, namely,

(1) To control the strong inflation that has gripped the economy and

(2) To shift our priorities from wartime to peacetime programs.

I believe these objectives are generally agreed upon, both within the Congress and the country. I believe also that they can be achieved without widespread unempoyment, which is another generally accepted goal. Now, to these ends, and to reflect our concern for the welfare of workers and consumers, we must continue to adapt Government programs and policies.

This morning my prepared statement is in two parts. The first part deals with aspects of the current economic situation that are the particular concern of the Department of Labor, with some reference to the outlook for the near term future. With your permission, I have presented for the record a number of related charts. The second part is a discussion of departmental policy and of programs that we have undertaken in response to the current situation.

The first section, review of the current economic situation, is similar to what others have said and since my prepared statement is rather lengthy I will move on to section 2, employment and unemployment. I would like to identify some significant factors in the employment situation.

Although growth in employment had nearly come to a halt by the close of 1969, the Nation's labor force grew at an exceptionally brisk pace for several months thereafter. Between December 1969 and April 1970 the civilian labor force expanded by 1.3 million. This was an unusually rapid rate of expansion. It was a very significant factor contributing to the rapid rise in unemployment earlier this year.

Since April, both employment and the civilian labor force have declined by about 700,000 on a seasonally adjusted basis. One result was that by June the unemployment rate, at 4.7 percent, had moved to the vicinity of the April level, which was 4.8 percent, after registering a level of 5.0 percent in May.

Labor force growth appears to have reached a new phase. The earlier rapid growth has slackened off. It is apparent that significant numbers of women and teenagers have now either withdrawn from the labor force or have failed to enter in what were expected numbers. The only group which still shows signs of increase is adult men, whose participation in the labor force is least likely to be optional. An important factor in this increase was the reduction of some 300,000 in the armed services in the past 6 months.

49-774—70—pt. 3——6

The economic slowdown has resulted in job cutbacks and shifts in many sectors of the economy. The earlier reductions, toward the end of 1969, were mostly in durable manufacturing industries. A large proportion were related to lower defense and aerospace expenditures, lower auto sales, and the low ebb of the housing market. Overall employment has been sustained during this period by continued growth in transportation, utilities, nondurable manufacturing, trade, State and local government and other service industries. But by June, however, the strength in some of these sectors had tapered off.

Now, it is worth noting also among what groups and in what locations the impact of unemployment has been greatest. Although, initially, the defense cutbacks sharply affected some relatively highly skilled professional and technical workers, the jobless rate of this group has remained relatively low. Since March, the rise in unemployment has been concentrated more among blue-collar workers, especially those at the bottom of the occupational ladder. The rate for white-collar workers rose from 2.0 to 2.8 percent and for blue-collar workers from 3.8 to 6.0 percent between the second quarters of 1969 and 1970.

The slowdown of employment growth has had repercussions for Negro workers. In the early phases of the slowdown, the Negro unemployment percentage rate rose relatively more moderately than the white rate. In part, this reflected the fact that the service industries, in which Negroes account for a higher proportion of the work force than in durable goods manufacturing, were less affected in the earlier stages of the economic slowdown. Since the first quarter of 1969 the Negro rate as compared to the white rate has varied from slightly less to slightly more than a 2 to 1 ratio.

Furthermore, the geographical impact of unemployment has not been even. The regions that account for a relatively high concentration of durable goods employment and of defense-aerospace jobs have been most heavily affected. This applies particularly to the Pacific coast, not only because of defense-aerospace cutbacks, but also because of weakness in the lumber industry, too. The Midwest has had a significant rise in unemployment, especially in the east-north-central area because of its concentration on automobile and durable-goods manufacturing. New England and the East South Central States have also felt the pinch of defense cutbacks.

Nevertheless, the situation is not characterized by a massive layoff of workers. The actual unadjusted figure for total civilian employment in June 1970 was 79, 382,000. This level has been exceeded only in 2 months, back in July and August 1969. The seasonally adjusted total of civilian employment in June 1970 was 78,225,000, and this is half a million more than it was in June of last year. However, the growth in jobs has not matched the growth in the civilian labor force, a growth of 1.6 million in that same interval.

In any review of changing economic patterns, one must take account of the continuing flexibility and adaptability of the U.S. work force. You know, we count as unemployed anyone who is not working and is actively seeking a job, so it is of interest to note that less than half of those who were unemployed in June had actually lost their job. By that we mean laid off or fired.

Over a quarter of those reported as unemployed were people who had reentered the labor force after a period of neither working nor seeking work, while the rest had either quit before finding another job or simply had not previously been employed. A large proportion of those reported as unemployed in any month were not unemployed the month before and will not be unemployed next month. The average duration of unemployment, that is, the average length of time the unemployed have remained out of work, is relatively low—9.5 weeks in June—although it has risen slightly during 1970 and we feel can be expected to rise further. Those who were jobless for 15 weeks or more constituted less than 1 percent of the civilian labor force. They numbered 658,000 in June, about a quarter of a million more than a year ago.

Now, you may not be fully aware of the extent to which the administration's shifts in defense planning have already affected employment opportunities. In addition to the 300,000 drop in the armed services already mentioned, nearly all of whom have entered the civilian labor force, there have been continuing reductions in civilian employment attributable to the lower level of defense procurement. Secretary Kennedy spoke to you about this. In the four most critical defense industries (ordnance, aircraft, shipbuilding, and communications equipment) employment has dropped 260,000 from June of last year to June of this year. For the economy as a whole the drop in job opportunities associated with defense purchases during this same year has been approximately 400,000. This decline is expected to continue at roughlly the same rate during the forthcoming year as we continue to shift priorities.

So, in summary, we now have an unemployment rate hovering near 5 percent and an average period of unemployment of 9½ weeks. The twin objectives of cooling the fires of inflation and shifting to a peacetime economy have produced this circumstance. Since both of these objectives are considered meritorious by the vast majority of Americans, their pursuit is worth some discomfort. Nevertheless, since a rise in unemployment levels cannot be viewed with complacency by any of us we must carefully examine the effects of this rise and give special attention to mitigating actions, and these will be reviewed later when we discuss manpower activities.

Now, on to a discussion of earnings and collective bargaining settlements.

During the past 12 months, all measures of employee compensation have been rising at relatively rapid rates. During the four quarters ending in March 1970—the latest quarterly period for which data are available—average hourly compensation for all persons in the private sector rose 7.2 percent. This includes both union represented and nonunion groups. Average hourly earnings for production and nonsupervisory employees in June 1970—you will notice I have substituted June for May there. I have got more up-to-date figures—for June of 1970 were 5.6 percent higher than in June of 1969. Despite this increase, average weekly earnings, adjusted for the inflation-induced increase in consumer prices, declined by 1.3 percent over the 12 months.

Today only about one out of four civilian employees have their wages and benefits determined through collective bargaining. Major bargaining situations, those which account for about 60 percent of those covered by collective bargaining, are regularly reported to us. These wage settlements show an 8.6 percent average annual change during the four quarters ending in June 1970. This is to be compared with the average annual increase of 6.6 percent as of June 1969.

Now, several points should be noted in this connection. The first is that the major collective bargaining agreements referred to above cover only 10½ million out of about 75 million employees. Second, only half of those covered will bargain in 1970. The others will receive deferred increases which are usually less than the decisions currently made. Third, most of the settlements are multiyear bargains. This means that they often reflect attempts to catch up with events that have occurred since the last settlement 2 or 3 or more years ago. Fourth, since the settlements are generally on a multiyear basis, increases in wages are now being built into the wage structure for the succeeding 2 or 3 years. These increases will, of course, have favorable effects on the incomes of those who are employed, but less favorable effects on costs and prices, and perhaps on the demand for labor. Where labor cost increases are excessive, they can contribute to unemployment, just as excessive increases in prices create unsold inventories.

Senator PROXMIRE. Could I ask you, Mr. Secretary, you have a 23-page prepared statement. You have read the first eight pages, I believe. At this rate it will take—you have 40 or 45 minutes to complete this if you are going to read the whole thing. It may be that you do not intend to.

Secretary HODGSON. I am afraid I had intended to.

Senator PROXMIRE. We would appreciate if you could summarize it or skip through it so we can get through.

Secretary HODGSON. That is a good idea. For instance, the section on unit labor costs and productivity, I believe, was rather covered by previous members that have come before your committee, so if I may, I will not review that one. And to some extent the same thing is true of prices, but I would like to mention something about prices.

This testimony was prepared before this month's calculation of the consumer price index was available. That figure is being announced this morning and it reflects a 0.4 percent monthly or about a 5-percent annual increase, a little less than 5 percent annual increase. Now, this is consistent with recently improved performance on consumer prices. So, if I may, we will not pursue the section on prices.

I believe the prospects section of my prepared statement rather parallels the prospects that have been outlined to you by other members that have appeared before you. So, let us go to a discussion of manpower and economic policy.

The Labor Department is a strong advocate of the proposition that manpower programs can serve the needs of the Nation's work force and complement monetary and fiscal policy. An active manpower policy does two things.

First, over longer periods of time, it can help create a skilled and adaptable work force, and by improving labor market mechanisms can shorten the period required to match unemployed men and vacant jobs. In so doing, manpower policy restrains inflationary pressures resulting from skill and labor shortage, and at the same time it reduces structural and seasonal unemployment.

In testimony presented by Secretary Shultz before this committee last February, he outlined certain improvements in the labor market. He discussed the manpower role in these and I will not go into them.

Also of importance to improved labor force utilization is the reduction of work time lost due to high and increasing rates of industrial accidents that occur in this country. The administration's proposed Occupational Health and Safety Act designed to achieve such a reduction is still waiting action in the Congress.

Second, manpower programs must be capable of adjusting to meet the changing needs of the Nation's economy and its workers. Accordingly, we believe that manpower programs are of considerable relevance to the present situation.

Now, I would like to talk a bit about the administration's legislative proposals in this area. First of all, some things can be done without legislation, but some cannot. The administration in its early months of office requested a range of legislation—various measures—which would permit rapid response to deal with employment fluctuation. Unfortunately, we do not have these measures available to us since none of that legislation has been enacted thus far. Now, let me review a few of those measures.

1. The Unemployment Insurance Act—now awaiting acceptance of the conference report—would do several important things. It would vastly increase the number of people protected by unemployment insurance and importantly, it would provide for an automatic extension of benefits when unemployment rises.

An additional 4.7 million persons would be covered by the legislation, the largest single expansion of coverage since the program was created. Many of the newly covered are in lower wage and often unstable jobs. These are the people who need the protection the most when unemployment strikes.

The "trigger" feature of the bill is specifically designed to provide rapid response to rising unemployment. When the insured unemployment rate equals or exceeds 4.5 percent for 3 consecutive months, the duration of unemployment insurance benefits would be automatically extended by up to 13 weeks. In addition to this national trigger, there is a specified level of unemployment at which the duration of benefits in an individual State would be extended, regardless of what the national situation might be. These extensions of duration are mandatory beginning on January 1, 1972. However, an individual State could extend duration on a voluntary basis as soon as the bill is passed.

2. A "trigger" concept also exists in the administration's proposed Manpower Training Act. Under our proposal, funds available for manpower programs would be automatically increased if the national unemployment rate reaches 4.5 percent for 3 consecutive months.

Taken together, these triggers markedly increase the effectiveness of manpower programs as economic stabilizers. They do this by strengthening their counter-cyclical characteristics. Because training programs cushion the impact of unemployment while reducing inflationary pressures, the counter-cyclical effect could be especially useful as an aid to monetary and fiscal policy in the current situation.

We feel that just as important as having adequate funds is the ability to spend the money in the right way at the right time for the right need. The Manpower Training Act provides for both decategorizing and decentralizing the administration of the manpower program. Regardless of the needs of the time and the nature of local circumstances, we now are forced to divide our manpower funds among certain specified programs, whose form has largely been preordained by Federal statute or regulation. We know, however, that each community has its own distinct needs, and that both the economic and the local situations change with time.

Defense cutbacks, for instance, are now causing unemployment in cities heavily dependent on defense work. The general reduction in demand affects labor markets unevenly. In June, five major areas moved into the classification of having a substantial labor surplus. However, there are still 29 major areas where the labor market is still relatively tight. Different approaches are needed for each.

A manpower program or system should be flexible enough to permit local officials to adjust their programs to local needs. It should be flexible enough to permit rapid shifts in priorities. We believe our proposed Manpower Training Act would provide this flexibility.

3. The Proposed Family Assistance Act is another tool we need in our kit. It would be a significant addition to our efforts to cushion the effect of economic adversity on the individual. It will help those people still not protected by unemployment insurance, help the working but low-paid poor, and assist many not now enrolled in our manpower programs because of an insufficiency of training opportunities.

We have proposed to Congress these measures for dealing with economic problems of our citizens affected by economic adversity. We need congressional approval to get on with the job.

Now, I do not call attention to these needed pieces of legislation in any spirit of passing the buck to anybody for limiting our ability to cope with current problems. There are still several actions we in the Labor Department can take, are taking and have taken. I will review these shortly. However, the proposed measures are vital both in substance and form. Their usefulness would truly be enormous in dealing with our changing needs. We commend them most urgently to the consideration of Congress.

Let us discuss adjusting to change.

Within the constraints and funds provided by the legislation under which we now operate, the Department has adjusted its manpower and labor market programs to meet changed economic circumstances.

Manpower program adjustments are these:

1. In view of slackened hiring, particularly in manufacturing, a sizable portion of 1970 and 1971 funds for the JOBS program have been reprogramed into areas of greater need.

2. We have also used available funds to expand employment opportunities for the disadvantaged in the public sector. We have done this in two ways.

The program of reimbursing State and local governments for the training costs of filling regular job vacancies with disadvantaged workers has been enlarged.

A new supplementary training and employment program (STEP) was created to provide a limited number of short term, but meaningful, work experience opportunities with public and private nonprofit agencies.

3. In an effort to assure best use of funds, the field staff has been alerted to watch projects carefully to spot those in trouble and shift emphasis to shortage areas. Programs should be tailored to the needs of changing times—this is our goal.

4. We have also supported the appropriation of $50 million for creating additional employment opportunities this summer for youth.

Let us examine our labor market adjustments as contrasted with our programmatic adjustments.

In addition to these programmatic adjustments, we are also taking steps to improve the efficiency of the labor market.

1. Our employment service has established and is utilizing an "early warning layoff procedure." Under this procedure when a local employment office is alerted to an impending layoff of significant proportions, a series of actions is set in motion: Meetings are held with employers to determine the timing and size of the layoff and affected employees are preregistered, frequently at the plant. Then all resources of the employment service, with special national office assistance, are marshaled to provide both training and job development services.

2. We are making arrangements for job vacancies in work done under contract with the Defense Department to be listed with the employment service. This is a new arrangement.

3. We want to increase the effectiveness of the employment service in dealing with an economic downturn.

First, we have created the employability team concept and use this concept in employment service operations. It will provide a capability for developing individual employability plans related to changing labor market conditions.

Second, we have introduced computerized job banks. Only one existed when we came into office. We expect to have 66 in operation by September 30th. These banks speed the mechanics of reemployment of unemployed workers.

4. We have undertaken a number of pilot programs—one or more—to relocate workers from labor surplus areas to places where jobs exist. We believe we have learned quite a bit from these projects and that they have put us in a position to operate a larger effort. There is provision for relocation assistance in both the proposed Manpower Training Act and the proposed Family Assistance Act. We think such assistance would be beneficial in facilitating labor market adjustments.

These measures, we believe, are helping us to maintain an effective program in the face of a slower growing economy. However, the manpower program could respond far more adequately to such situations if the critical legislation now in Congress is enacted into law.

Finally, I have a section with regard to responding to the unexpected. Now, we in the Labor Department are going to be watching unemployment closely. We will continue to be most sensitive to the needs of the Nation's work force—particularly its unemployed people. We will promptly recommend additional measures to the Congress if we believe they are needed.

For example, we might well consider a legislative proposal which would extend the duration of unemployment insurance payments immediately, as was done on prior occasions. Also, we would consider requesting additional appropriations for the manpower program.

I have a few examples of what we might do with additional funds, in the event that was felt necessary from our standpoint.

The duration of institutional training might be expanded so as to postpone entry into the labor force and provide more basic education and higher skill levels for the disadvantaged. We would expand training for occupations where demand remains firm even in more adverse times, such as in service and governmental occupations.

Also, we could temporarily enlarge our program of public service opportunities, as an expansion of actions we have already taken. However, we would still expect that such temporary work experience programs would remain the smaller part of our total effort.

However, I want to emphasize that a greatly deteriorating employment problem is not anticipated. It is not indicated by the vital signs of the economy. I only want to state to you that in the event of a seriously worsening circumstance, now, or at any time, this administration will act through its manpower program to reduce the hardships of American workers.

Now, I would hope that the range and effectiveness of our possible areas of action might shortly be enhanced by the enactment of the several legislative measures I cited earlier. In the Labor Department our overriding concern is with the people problem and we will be able to serve our people better when the provisions of the Unemployment Insurance Act, Manpower Training Act, and Family Assistance Act are available to us.

Thank you, Mr. Chairman.

(The prepared statement of Secretary Hodgson follows:)

PREPARED STATEMENT OF HON. JAMES D. HODGSON

Mr. Chairman and Members of the Committee, I welcome the opportunity to present my testimony before the Joint Economic Committee as it undertakes a review of the state of the economy at mid-1970.

In reviewing the economic situation, we must keep in mind two of the major objectives of this Administration, namely,

(1) to control the strong inflation that has gripped the economy and

(2) to shift our priorities from wartime to peacetime programs.

I believe these objectives are generally agreed upon, both within the Congress and the country. I believe also that they can be achieved without widespread unemployment, which is another generally accepted goal. To these ends, and to reflect our concern for the welfare of workers and consumers, we must continue to adapt government programs and policies.

My statement is in two parts. The first part deals with aspects of the current economic situation that are the particular concern of the Department of Labor, with some reference to the outlook for the near term future. With your permission, I present for the record a number of related charts. The second part is a discussion of Departmental policy and of programs that we have undertaken in response to the current situation.

I. The Current Economic Situation

This review by the Joint Economic Committee takes place at a critical juncture in the Administration's efforts to bring inflation under control.

The first stage is largely behind us. We have achieved a moderation of the pressures of excess demand which generated serious and unacceptable price increases in recent years. Poor productivity performance during this period contributed to rising costs that, until recently, slowed the response of prices to the cooling of demand.

Now, however, we are at the second stage—a transition from an inflationary economy to an economy with less rapidly advancing prices, and with a prospect of real economic growth. At the same time, we are continuing to shift from a wartime to a peacetime economy.

It would be unrealistic to expect the achievement of these results without some transitional disruptions in the economy. As Secretary of Labor, I am particularly concerned about the effect of these transitions on the working men and women of our Nation.

II. Employment and Unemployment

I would like to identify some significant factors in the employment situation.

Although the growth in employment had nearly come to a halt by the close of 1969, the Nation's labor force grew at an exceptionally brisk pace for several months thereafter. Between December 1969 and April 1970 the civilian labor force expanded by 1.3 million. This was an unusually rapid rate of expansion. It was a very significant factor contributing to the rapid rise in unemployment earlier this year.

Since April, both employment and the civilian labor force have declined by about 700,000 on a seasonally adjusted basis. One result was that by June the unemployment rate, at 4.7 percent, had moved to the vicinity of its April level, which was 4.8 percent.

Labor force growth appears to have reached a new phase. The earlier rapid growth has slackened off. It is apparent that significant numbers of women and teenagers have now either withdrawn from the labor force or have failed to enter in the expected numbers. The only group which still shows signs of increase is adult men, whose participation in the labor force is least likely to be optional. An important factor in this increase was the reduction of some 300,000 in the Armed Forces in the past six months.

The economic slowdown has resulted in job cutbacks and shifts in many sectors of the economy. The earliest reductions, toward the end of 1969, were mostly in durable manufacturing industries. A large proportion were related to lower defense and aerospace expenditures, lower auto sales, and the low ebb of the housing market. Overall employment has been sustained during this period by continued growth in transportation, utilities, nondurable manufacturing, trade, state and local government and other service industries. By June, however, the strength in some of these sectors had tapered off.

It is worth noting also among what groups and in what locations the impact of unemployment has been greatest. Although, initially, the defense cutbacks sharply affected some relatively highly skilled professional and technical workers, the jobless rate of this group has remained relatively low. Since around March, the rise in unemployment has been concentrated more among blue-collar workers, especially those at the bottom of the occupational ladder. The rate for white-collar workers rose from 2.0 to 2.8 percent and for blue-collar workers from 3.8 to 6.0 percent between the second quarters of 1969 and 1970.

The slowdown of employment growth has had repercussions for Negro workers. In the early phase of the slowdown, the Negro unemployment percentage rate rose relatively more moderately than the white rate. In part, this reflected the fact that the service industries, in which Negroes account for a higher proportion of the work force than in durable goods manufacturing, were less affected in the earlier stages of the economic slowdown. Since the first quarter of 1969 the Negro rate as compared to the white rate has varied from slightly less to slightly more than a 2 to 1 ratio.

Furthermore, the geographical impact of unemployment has not been even. The regions that account for a relatively high concentration of durable goods employment and of defense-aerospace jobs have been most heavily affected. This applies particularly to the Pacific Coast, not only because of defense-aerospace cutbacks, but also because of weakness in the lumber industry. The Midwest, too, has had a significant rise in unemployment, especially in the East North Central area because of its concentration on automobile and durable-goods manufacturing. New England and the East South Central states have also felt the pinch of defense cutbacks.

Nevertheless, the situation is not characterized by a massive layoff of workers. The actual unadjusted figure for total civilian employment in June 1970 was 79,382,000. This level has been exceeded only in 2 months, July and August 1969. The seasonally adjusted total of civilian employment in June 1970 was 78,225,000, half a million more than in June 1969. However, the growth in jobs has not matched the growth in the civilian labor force, which was 1.6 million in that same interval.

In any review of changing economic patterns, one must take account of the continuing flexibility and adaptability of the U.S. labor force. We count as unemployed anyone who is not working and is actively seeking a job, so it is of interest to note that less than half of those who were unemployed in June had actually lost their job. Over a quarter of those reported as unemployed were people who had re-entered the labor force after a period of neither working nor seeking work, while the rest had either quit before finding another job or had not previously been employed. A large proportion of those reported as unemployed in any month were not unemployed the month before and will not be unemployed next month. The average duration of unemployment, that is, the average length of time the unemployed have remained out of work, is relatively low—9.5 weeks in June—although it has risen slightly during 1970 and can be expected to rise further. Those who were jobless for 15 weeks or more constituted less than one percent of the civilian labor force. They numbered 658,000 in June, about a quarter of a million more than a year ago.

You may not be fully aware of the extent to which the Administration's shifts in defense planning have already affected employment opportunities. In addition to the 300,000 drop in the Armed Forces already mentioned, nearly all of whom have entered the civilian labor force, there have been continuing reductions in civilian employment attributable to the lower level of defense procurement. In the four most critical defense industries (ordnance, aircraft, shipbuilding, and communications equipment) employment has dropped 260,000 from June 1969 to June 1970. For the economy as a whole the drop in job opportunities associated with defense purchases during this same year has been approximately 400,000. This decline is expected to continue at roughly the same rate during the forthcoming year as we continue to shift priorities.

So in summary we now have an unemployment rate hovering near 5 percent and an average period of unemployment of 9½ weeks. The twin objectives of cooling the fires of inflation and shifting to a peacetime economy have produced this circumstance. Since both of these objectives are considered meritorious by the vast majority of Americans, their pursuit is worth some discomfort. Nevertheless, since a rise in unemployment levels cannot be viewed with complacency by any of us we must carefully examine the effects of this rise and give special attention to mitigating actions.

III. Earnings and Collective Bargaining Settlements

During the past 12 months, all measures of employee compensation have been rising at relatively rapid rates. During the four quarters ending in March 1970—the latest quarterly period for which data are available—average hourly compensation for all persons in the private economy rose 7.2 percent. Average hourly earnings for production and nonsupervisory employees in May 1970 were 6.7 percent higher than in May 1969. Despite this increase, average weekly earnings, adjusted for the inflation induced increase in consumer prices, declined by 1.1 percent over the 12 months.

Today about one out of four civilian employees have their wages and benefits determined through collective bargaining. Major bargaining situations, which account for about 60 percent of those covered by collective bargaining, are regularly reported. These wage settlements show an 8.6 percent average annual change during the 4 quarters ending in June 1970. This is to be compared with the average annual increase of 6.6 percent as of June 1969.

Several points should be noted in this connection. The first is that the major collective bargaining settlements referred to above cover only 10½ million out of approximately 75 million employees. Second, only half of those covered will bargain in 1970. The others will receive deferred increases which are usually less than the decisions currently made. Third, most of the settlements are multi-year bargains. This means that they often reflect attempts to catch up with events that have occurred since the last settlement two or three years ago. Fourth, since the settlements are generally on a multi-year basis, increases in wages are now being built into the wage structure for the succeeding two or three years. These increases will have favorable effects on the incomes of those who are employed, but less favorable effects on costs and prices, and perhaps on the demand for labor. Where labor cost increases are excessive, they can contribute to unemployment, just as excessive increases in prices create unsold inventories.

As for the immediate future, recent collective bargaining settlements have generally reflected larger increases during the first year of the contract than during its subsequent years. Compared to the average of 8.6 percent over the life of the contract, the first year average was 12.0 percent for the decisions made during the 4 quarters ending in June 1970, and approximately 7 percent for the remaining years. Collective bargaining settlements in construction have been consistently much higher than the average.

IV. Unit Labor Costs and Productivity

One of the underlying contributory factors to inflation has been the pressure of rising unit labor costs. In the first quarter of this year alone, unit labor costs in the private economy rose by an annual rate of 10.6 percent. Moreover, the increase in unit labor costs has become larger during each of the past five years, which makes it the largest and most sustained movement of this nature in the past two decades.

Part of the increase in labor costs stems from the sharp rise in hourly compensation, part is attributable to the slowing down and more recently the decline in labor productivity.

The recent slowdown in productivity growth is not without precedent. There have been other periods since the end of World War II when productivity declined even more sharply. These have often occurred at the onset of an economic downturn. The sequence of events seems to be this: first, a fall-off in demand and shortly thereafter a cut in production, which in turn results in less-than-optimum utilization of plant and equipment and adversely affects productivity growth.

Another factor which might have contributed to the decline in productivity is that producers often do not at once adjust their work force to reflect fully the lower level of demand. When business declines, a producer seldom reduces employment as much as current production schedules might suggest, since many workers have duties which are not directly related to the volume of production. In addition to normal reluctance to quick layoffs, many employers have contractual commitments such as severance pay and supplementary employment benefits which may tend to discourage prompt and widespread reductions in staff.

Employers may also be deterred from immediate employment cutbacks by the state of the labor market and the previous unavailability of skilled manpower. In recent years, there have been large investments in manpower training which have resulted in improvements in the quality of labor and, until recently, in larger productivity gains. Following a period of tight labor markets, employers often prefer to retain skilled workers rather than lose them through layoffs, and then face the prospect of being unable to rehire them. For these reasons, despite some slowing in the overall rate of output growth during 1969, hiring for most of that year was as great, or even greater in some sectors, than in periods of more vigorous growth.

Present information indicates an improvement in productivity may be getting underway. It appears that in the second quarter of 1970, as a result of a small rise in output and a decline in manhours, the growth of productivity was at an annual rate of between 3 and 4 percent, which is closer to the normal rate than it has been in the past year and a half.

The fact that productivity is currently growing bodes well for the fight against inflation. Higher productivity will reduce pressures on costs and help to moderate the rise of prices.

V. PRICES

As everyone knows, prices have increased substantially during the past year. The rate of increase, however, has been fairly steady rather than accelerating, as it had been in previous years. During the past few months, there has been some hint that the rate of advance may be beginning to decline and that we are reaching the first stages of the deceleration process. The Consumer Price Index, which does not measure all price changes but only those of concern to consumers, is carefully watched. Its typical month-to-month rate of increase on a seasonally adjusted basis has been 0.5 percent or less since February, as compared with 0.6 percent late last year and early this year. The recently announced GNP price deflator for the second quarter 1970 rose at an annual rate of 4.2 percent, a lower rate than in any of the previous five quarters.

The Wholesale Price Index, which often precedes movements of the commodity section of the Consumer Price Index, has experienced a deceleration much more noticeable than in the Consumer Price Index. We consider this to be a hopeful sign. Since February, the month-to-month rate of change has been 0.3 percent or less, seasonally adjusted, compared with earlier increases of as much as 0.7 percent. Most of this deceleration can be traced to the fall in prices of foodstuffs.

Another critical price indicator is the weekly industrial raw materials spot market price index, which measures changes in the prices of 13 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. This index first increased at a slower pace in 1969 and now has actually declined about 6 percent since February of this year. Changes in prices at this level in the economic structure are important indicators of changes in costs. Thus, they often lead to changes in prices at later stages in the process of production.

Thus, the evidence of a break in the upsurge of prices is to be found mainly in the sensitive commodity index and the general whole sale price index. Given the softness of demand in manufacturing, I believe that we shall not have to wait for more than a few months before the economy begins to see more significant declines in the rate of increase of consumer prices.

PROSPECTS

The United States economy is undergoing a transition from a state of excessive demand and inflationary price increases to a state of stable and sustainable real growth with increased confidence in the future purchasing power of the dollar. At the same time, we are moving steadily from wartime to a peacetime emphasis in government programs. It is not possible to make these changes in the economy so smoothly that no one notices it. The transition has been accompanied by an increased level of unemployment.

I am quite familiar with prescriptions for the cure of inflation that propose rashly high levels of unemployment. And, I am quite familiar with some proposed remedies for unemployment whose implementation would promptly put us back into a thorough-going inflation, in which expectations of still more inflation would be reinforced by bitter experience. I do not consider either of these to be valid approaches to the current situation. What is important is the mix and the strength of policies, and the actual achievement, in due time, of a desired result.

The Administration has in fact succeeded in moderating excessive monetary demand by persistent general restraint exercised through monetary and fiscal policies. There are now some preliminary signs of a moderation of the rise of prices, and all historical experience suggests that the easing of demand pressures will have this result.

Undoubtedly, the process of transition has been and will be difficult for many, including many workers. Unemployment is not the first thing to be mended by an economic upswing. It is important, then, that I outline in this review the steps taken and intended by the Department of Labor toward alleviating some of the effects of unemployment and in preparing the labor force to meet the challenges of future economic growth.

MANPOWER AND ECONOMIC POLICY

The Labor Department is a strong advocate of the proposition that manpower programs can serve the needs of the Nation's workforce and complement monetary and fiscal policy. An active manpower policy does two things.

First, over longer periods of time, it can help create a skilled and adaptable work force, and by improving labor market mechanisms can shorten the period required to match unemployed men and vacant jobs. In so doing, manpower policy restrains inflationary pressures resulting from skill and labor shortage, at the same time it reduces structural and seasonal unemployment.

In testimony presented by Secretary Shultz to this Committee last February, certain possible improvements in the labor market were highlighted. He discussed the manpower role in achieving reasonable employment levels and reasonable price stability, in reducing frictional unemployment, in increasing labor market effectiveness, in smoothing the transition from school to work, and in reducing seasonability and intermittency so as to increase output and reduce unemployment.

Also of considerable importance to improved labor force utilization is the reduction of work time lost due to the high—and increasing—rate of industrial accidents that occur in this country. The Administration's proposed Occupational Health and Safety Act designed to achieve such a reduction is still waiting action in the Congress.

Second, manpower programs must be capable of adjusting to meet the changing needs of the Nation's economy and its workers. Accordingly, we believe that manpower programs are of considerable relevance in the present situation.

ADMINISTRATIVE LEGISLATIVE PROPOSALS

Some things can be done without legislation, some cannot. The Administration in its early months of office requested a range of legislation—various measures—which would permit rapid response to deal with employment fluctuation. Unfortunately, we do not have these measures available to us since none of that legislation has been enacted thus far. Let me review a few of these measures.

1. *The Unemployment Insurance Act*—now awaiting acceptance of the Conference Report—would do several important things. It would vastly increase the number of people protected by Unemployment Insurance and it would provide for an automatic extension of benefits when unemployment rises.

An additional 4.7 million persons would be covered by the legislation, the largest single expansion of coverage since the program was created. Many of the newly covered are in lower wage and often unstable jobs. These are the people who need the protection the most when unemployment strikes.

The "trigger" feature of the bill is specifically designed to provide rapid response to rising unemployment. When the insured unemployment rate equals or exceeds 4.5 percent for 3 consecutive months, the duration of Unemployment Insurance benefits would be automatically extended by up to 13 weeks. In addition to this National trigger, there is a specified level of unemployment at which the duration of benefits in an individual State would be extended, regardless of what the National situation might be. These extensions of duration are mandatory beginning on January 1, 1972. However, an individual State could extend duration on a voluntary basis as soon as the bill is passed.

2. A "trigger" concept also exists in the Administration's proposed *Manpower Training Act*. Under our proposal, funds available for manpower programs would be automatically increased if the national unemployment rate reaches 4.5 percent for 3 consecutive months.

Taken together, these triggers markedly increase the effectiveness of manpower programs as economic stabilizers by strengthening their counter-cyclical characteristics. Because training programs cushion the impact of unemployment while reducing inflationary pressures, the counter-cyclical effect could be an especially useful aid to monetary and fiscal policy in the current situation.

Just as important as having adequate funds is the ability to spend the money in the right way at the right time for the right need. The Manpower Training Act provides for both decategorizing and decentralizing the administration of the manpower program. Regardless of the needs of the time and the nature of local circumstances, we now are forced to divide our manpower funds among specified programs, whose form has largely been pre-ordained by Federal statute or regulation. We know, however, that each community has its own distinct needs and problems, and that both the economic and the local situation changes with time.

Defense cutbacks, for instance, are now causing unemployment in cities heavily dependent on defense work. The general reduction in demand affects labor markets unevenly. In June 5 major areas moved into the classification of having a substantial labor surplus. However, there are still 29 major areas where the labor market is still relatively tight. Different approaches are needed for each.

A manpower system should be flexible enough to permit local officials to adjust their programs to local needs. A manpower system should be flexible enough to permit rapid shifts in priorities. We believe our proposed Manpower Training Act would provide this flexibility and responsiveness.

3. *The Proposed Family Assistance Act* is another tool we need in our kit. It would be a significant addition to our efforts to cushion the effect of economic adversity on the individual. It will help those people still not protected by unemployment insurance, help the working but low-paid poor, and assist many not now enrolled in our manpower programs because of an insufficiency of training opportunities.

We have proposed to Congress these measures for dealing with economic problems of our citizens affected by economic adversity. We need Congressional approval to get on with the job.

I do not call attention to these needed pieces of legislation in any spirit of passing the buck to anybody for limiting our ability to cope with current problems. There are still several actions we in the Labor Department can take, are taking and have taken. I will review these shortly. However, the proposed measures are vital both in substance and form. Their usefulness would be enormous in dealing with our changing needs. We commend them most urgently to the consideration of Congress.

ADJUSTING TO CHANGE

Within the constraints and funds provided by the legislation under which we now operate, the Department has adjusted its manpower and labor market programs to meet changed economic circumstances.

Manpower Program Adjustments

1. In view of slackened hiring, particularly in manufacturing, a sizeable portion of 1970 and 1971 *funds for the JOBS program have been reprogrammed* into areas of greater need. A considerable portion of these funds has been used to expand institutional training programs, using available capacity in skill centers.

2. We have also used available funds to *expand employment opportunities for the disadvantaged in the public sector* in two ways.

The program of reimbursing State and local governments for the training costs of filling regular job vacancies with disadvantaged workers has been enlarged.

A new Supplementary Training and Employment Program (STEP) was created to provide a limited number of short term, but meaningful, work experience opportunities with public and private non-profit agencies for manpower trainees or recent graduates of such programs who are displaced from employment or unable to find a job.

3. In an effort to assure best use of funds, the field staff has been alerted to watch projects carefully to spot those in trouble and shift emphasis to shortage areas. Programs tailored to the needs of changing times is our goal. In selecting occupations for new training programs, we plan to emphasize areas and industries where demand still exists, and we will do more training for skills above the entry job level so as to better assure placement in a job.

4. We have supported the appropriation of $50 million for creating additional employment opportunities this summer for youth.

Labor Market Adjustments

In addition to these programmatic adjustments, we are also taking steps to improve the efficiency of the labor market.

1. Our Employment Service has established and is utilizing an "early warning layoff procedure." Under this procedure when a local employment office is alerted to an impending layoff of significant proportions, a series of actions

is set in motion: meetings are held with employers to determine the timing and size of the layoff and affected employees are pre-registered, frequently at the plant. Then all resources of the Employment Service, with special national office assistance, are marshalled to provide training and job development services. These include exchange of information on job and applicant availability between local and out-of-area employment offices. The object is to facilitate and speed job placement. We believe this special procedure has proven of significant benefit to affected workers.

2. We are making arrangement for job vacancies in work done under contract with the Defense Department to be listed with the Employment Service.

3. We want to increase the effectiveness of the Employment Service in dealing with an economic downturn.

First, the employability team concept is now being introduced broadly in Employment Service operations. It will provide a capability for developing individual employability plans related to changing labor market conditions. Also, present experiments in "self service," using posted job vacancies from the Employment Service, for the better equipped and qualified clients will free up time for others who need considerable help.

Second, we have introduced computerized Job Banks. Only one existed when we came into office. We expect to have 66 in operation by September 30th. The Banks speed the mechanics of re-employment of unemployed workers.

4. We have undertaken a number of pilot programs to relocate workers from labor surplus areas to places where jobs exist. We believe we have learned quite a bit from these projects and that they have, put us in a position to operate a larger effort. There is provision for relocation assistance both in the proposed Manpower Training Act and the proposed Family Assistance Act. We think such assistance would be beneficial in facilitating labor market adjustments.

These measures, we believe, are helping us to maintain an effective program in the face of a slower growing economy. However, the manpower program could respond far more adequately to such situations if the critical legislation now in Congress is enacted into law.

Responding to the Unexpected

We will be watching unemployment closely. We will continue to be most sensitive to the needs of the Nation's workforce—particularly its unemployed people. We will promptly recommend additional measures to the Congress if they are needed.

For example, we might well consider a legislative proposal which would extend the duration of Unemployment Insurance payments immediately, as was done on prior occasions. Also, we would consider requesting additional appropriations for the manpower program.

I will give a few examples of what we might do with additional funds.

The duration of institutional training might be expanded so as to postpone entry into the labor force and provide more basic education and higher skill levels for the disadvantaged. We would expand training for occupations where demand remains firm even in more adverse times, such as in service and governmental occupations.

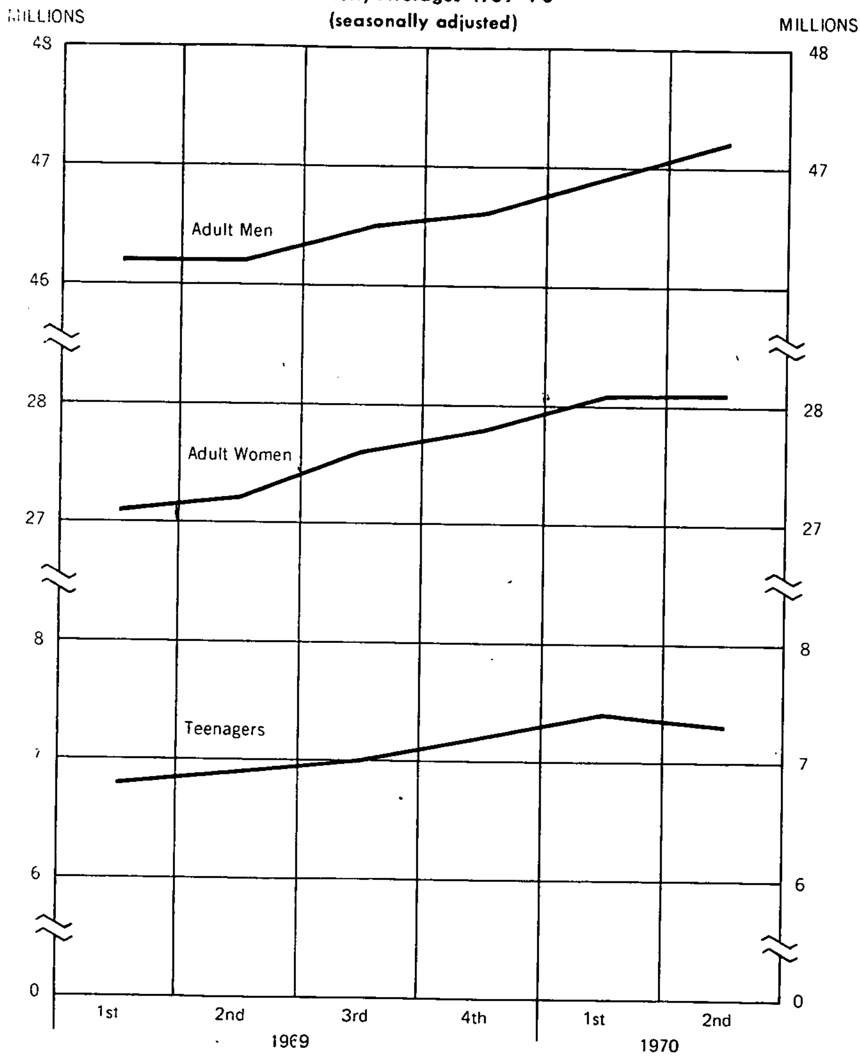
Also, we could temporarily enlarge our program of public service opportunities, as an expansion of actions we have already taken. However, we would still expect that such temporary work experience programs would remain the smaller part of our total effort.

However, I want to emphasize that a greatly deteriorating employment problem is not anticipated. It is not indicated by the vital signs of the economy. I only want to state to you that in the event of a seriously worsening circumstance, now, or at any time, this Administration will act through its manpower program to reduce the hardships of American workers.

I would hope the range and effectiveness of our possible areas for action might be shortly enhanced by enactment of the several legislative measures I cited earlier.

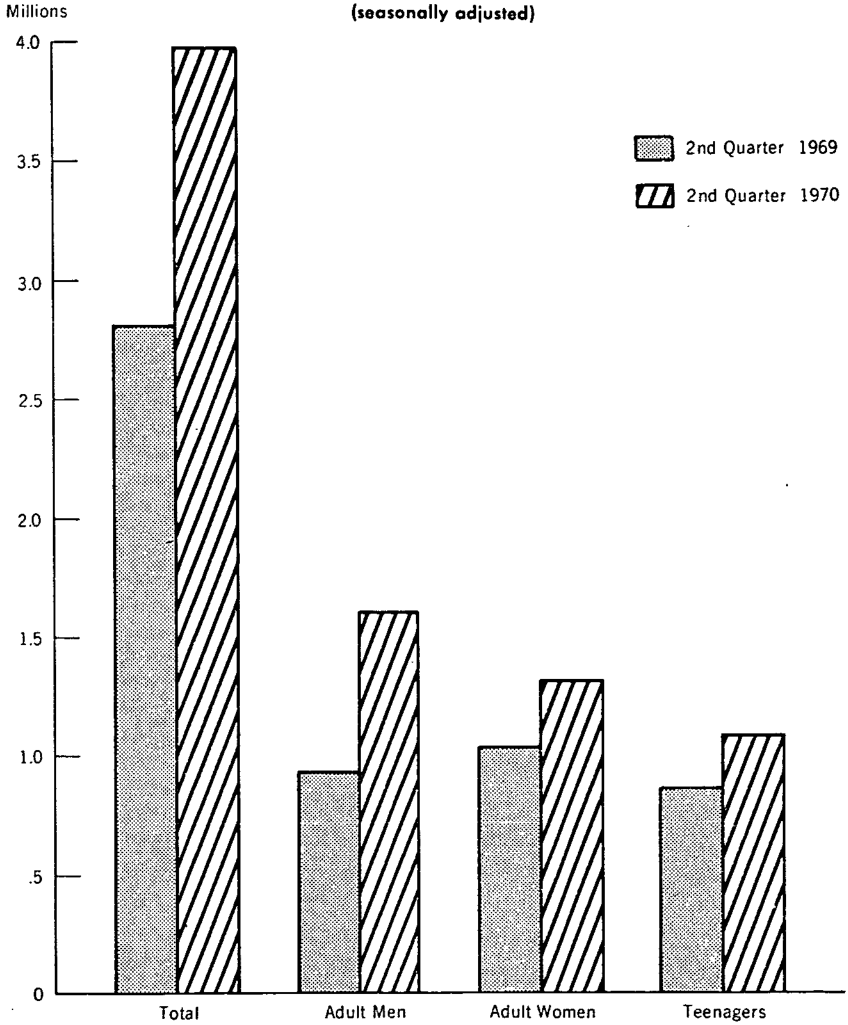
In the Labor Department our overriding concern is with "people" problems. We shall be able to serve our people better when the provisions of the Unemployment Insurance Act, the Manpower Training Act and the Family Assistance Act are available to us.

Chart 1
Civilian Labor Force
Quarterly Averages 1969–70
(seasonally adjusted)



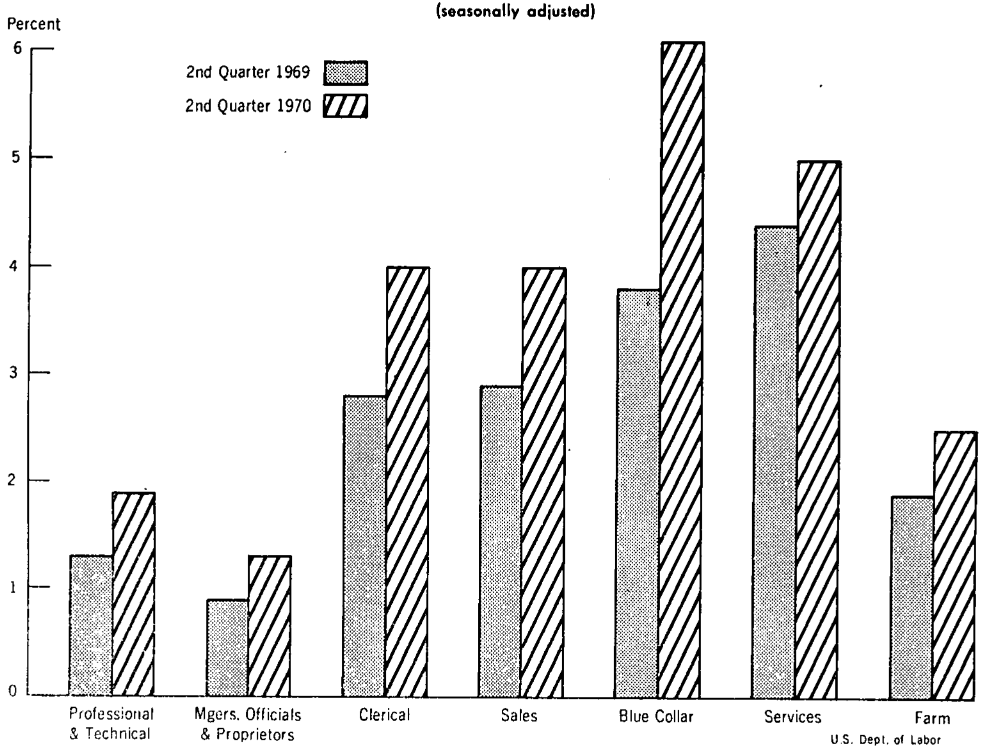
U.S. Dept. of Labor
Bureau of Labor Statistics

Chart 2
Unemployment
Quarterly Averages
(seasonally adjusted)



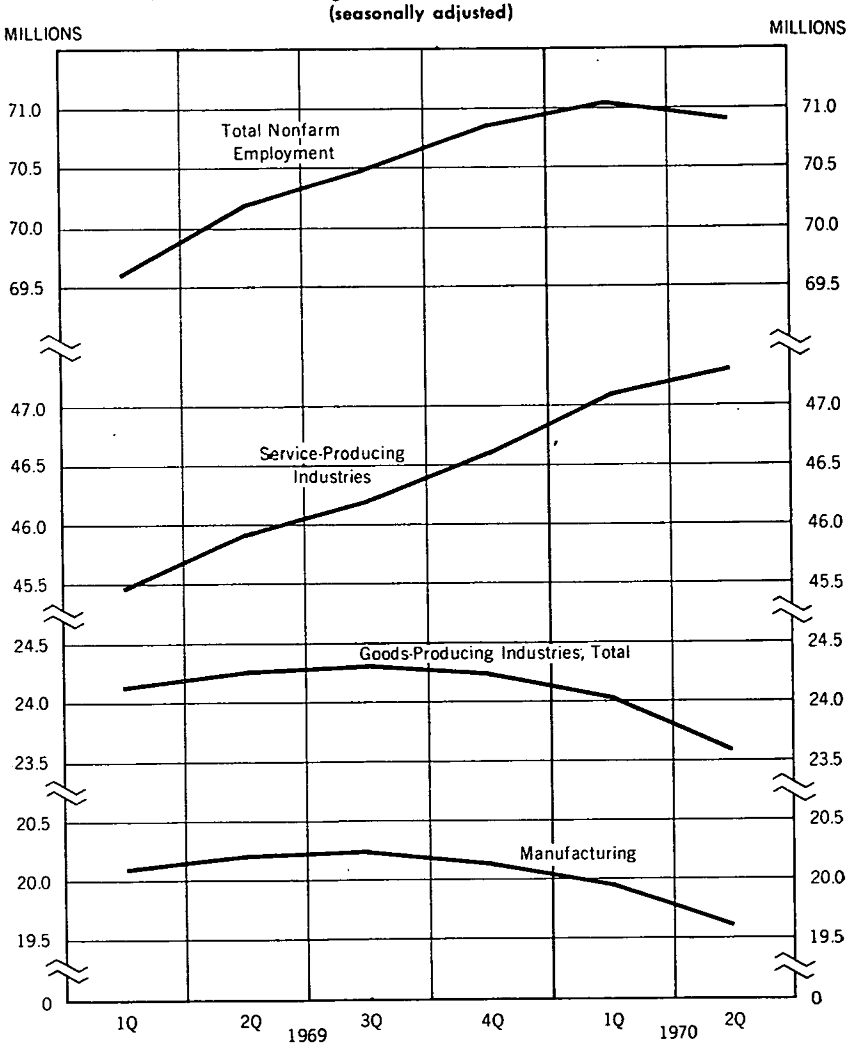
U.S. Dept. of Labor
Bureau of Labor Statistics

Chart 3
Unemployment Rates by Occupation
(seasonally adjusted)



U.S. Dept. of Labor
Bureau of Labor Statistics

Chart 4
Employment in Nonfarm Goods-Producing and Service-Producing Industries Quarterly Averages, 1969-70 (seasonally adjusted)

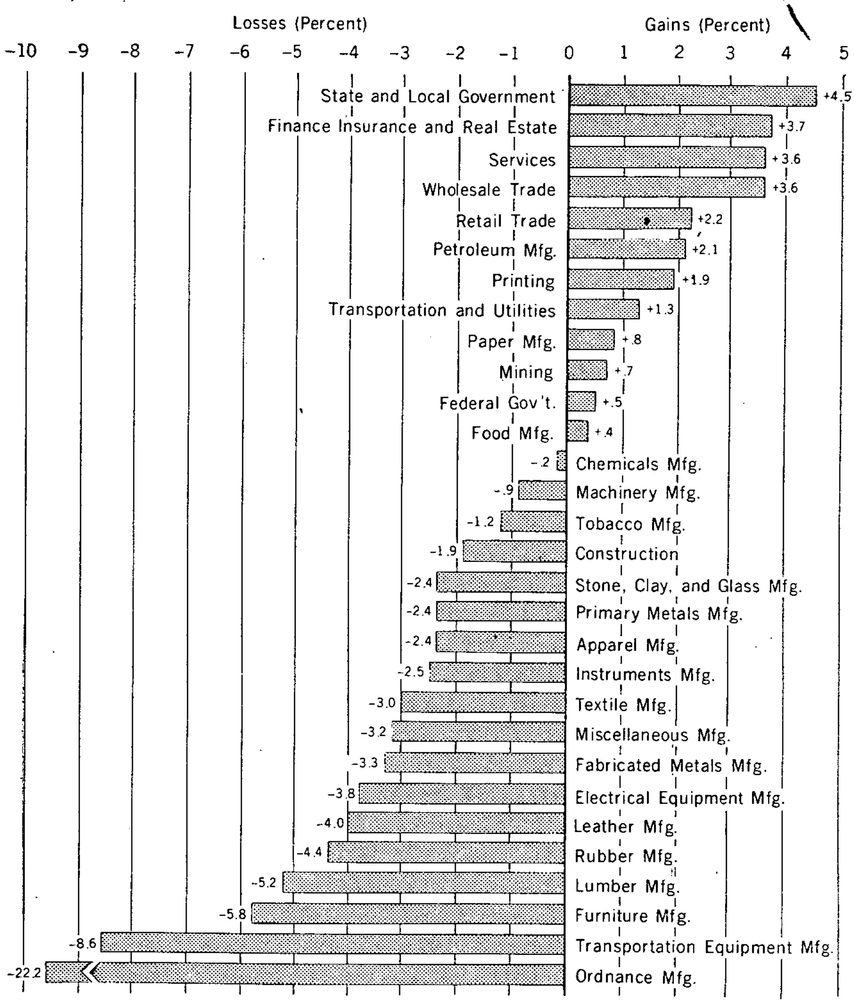


U.S. Dept. of Labor
Bureau of Labor Statistics

Chart 5

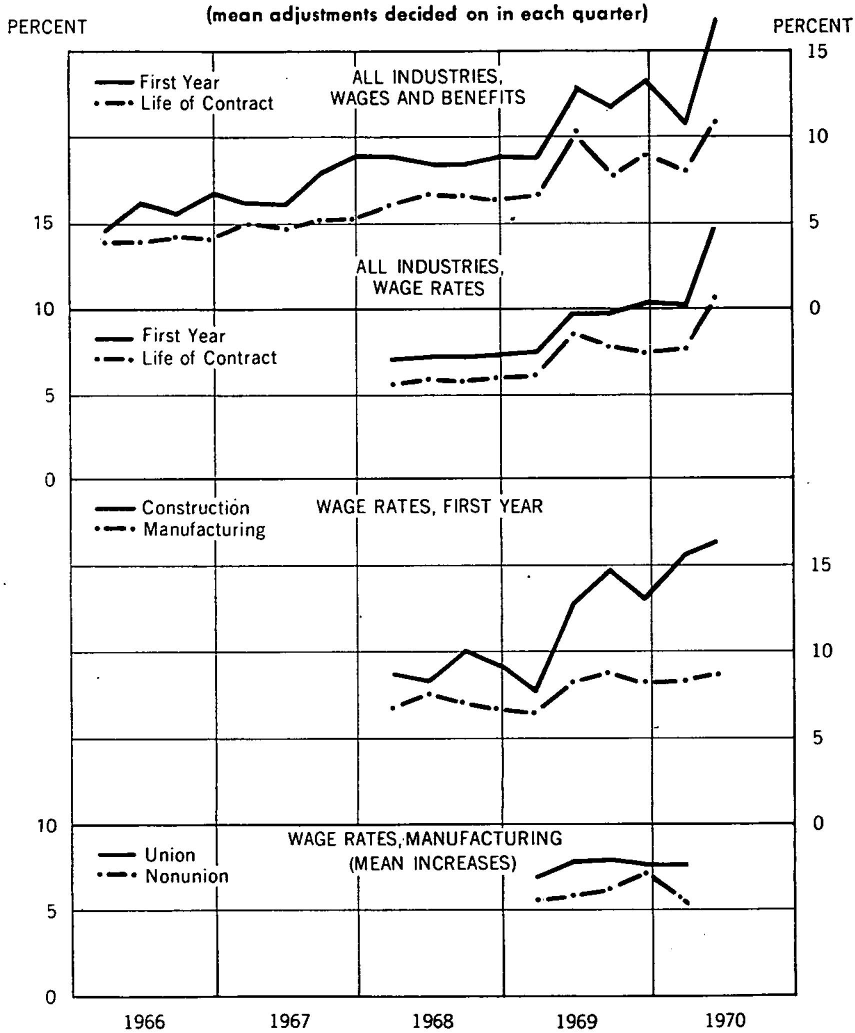
Changes in Employment by Industry

Second Quarter 1969 to Second Quarter 1970



U.S. Dept. of Labor
Bureau of Labor Statistics

Chart 6
Negotiated Wage Changes
(mean adjustments decided on in each quarter)

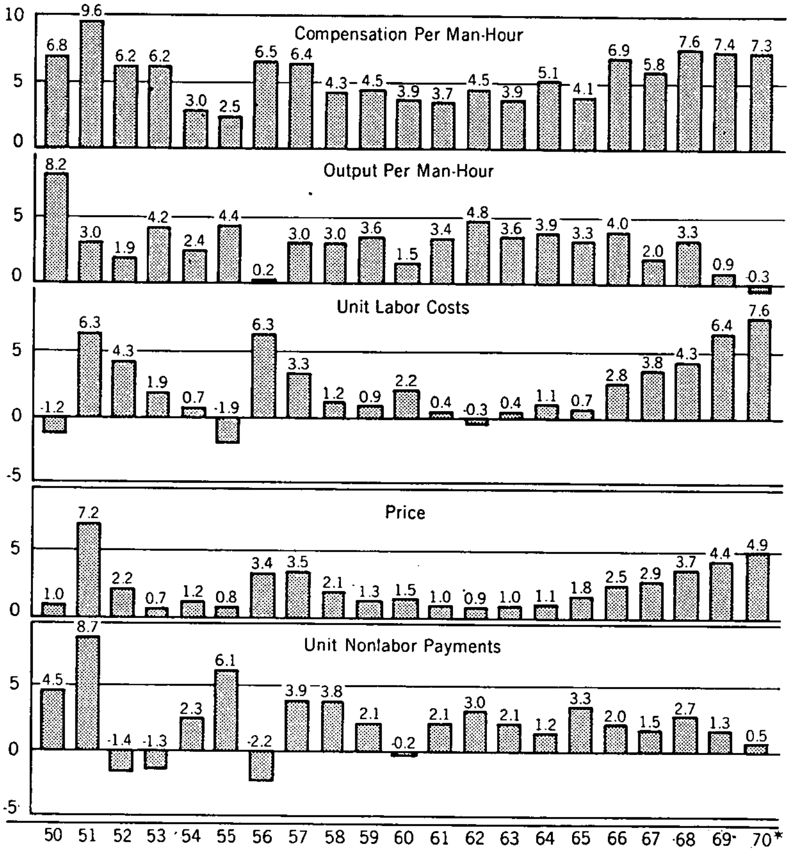


Note: Second quarter 1970 data are preliminary.

U.S. Dept. of Labor
Bureau of Labor Statistics

Chart 7

Annual Rates of Change in Wages, Productivity, Costs and Prices--Total Private Economy



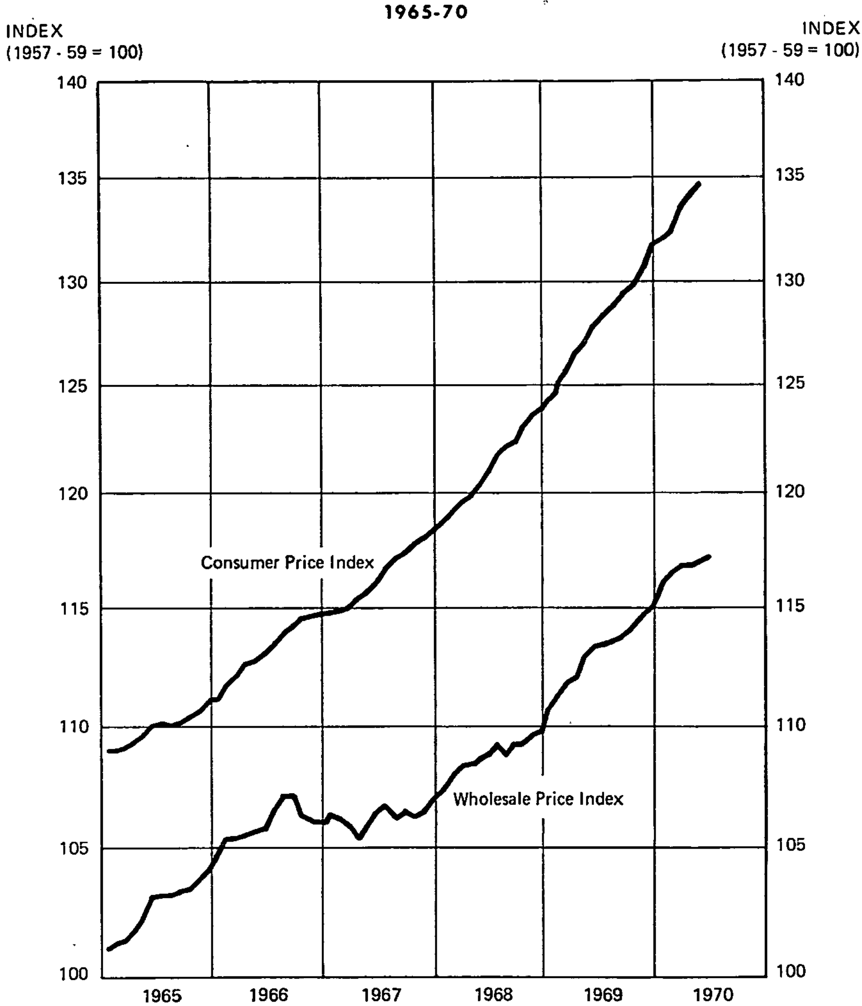
*First quarter 1970 over first quarter 1969.

Compensation includes wages and salaries and supplemental payments for employees and an estimate of the salaries and supplements for the self-employed.

Nonlabor payments include profits, depreciation, interest, rental income and indirect taxes.

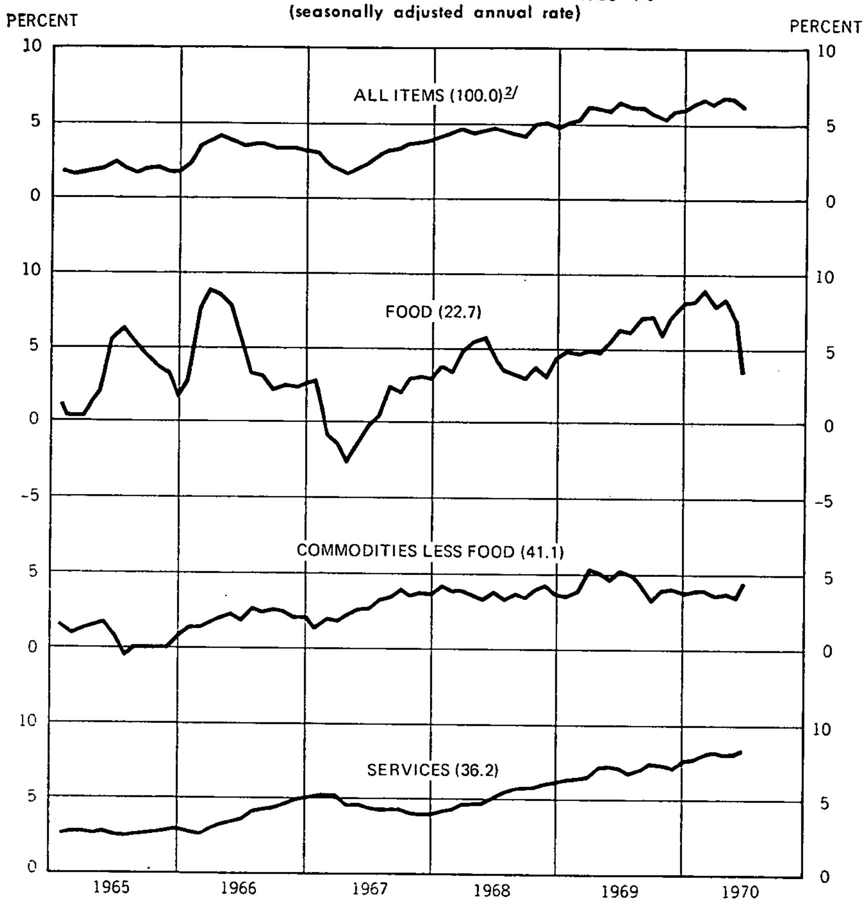
U.S. Department of Labor
Bureau of Labor Statistics

Chart 8
Consumer and Wholesale Price Indexes
1965-70



U. S. Dept. of Labor
Bureau of Labor Statistics

Chart 9
Rate of Change[1] in Consumer Price Indexes 1965 - 70
(seasonally adjusted annual rate)



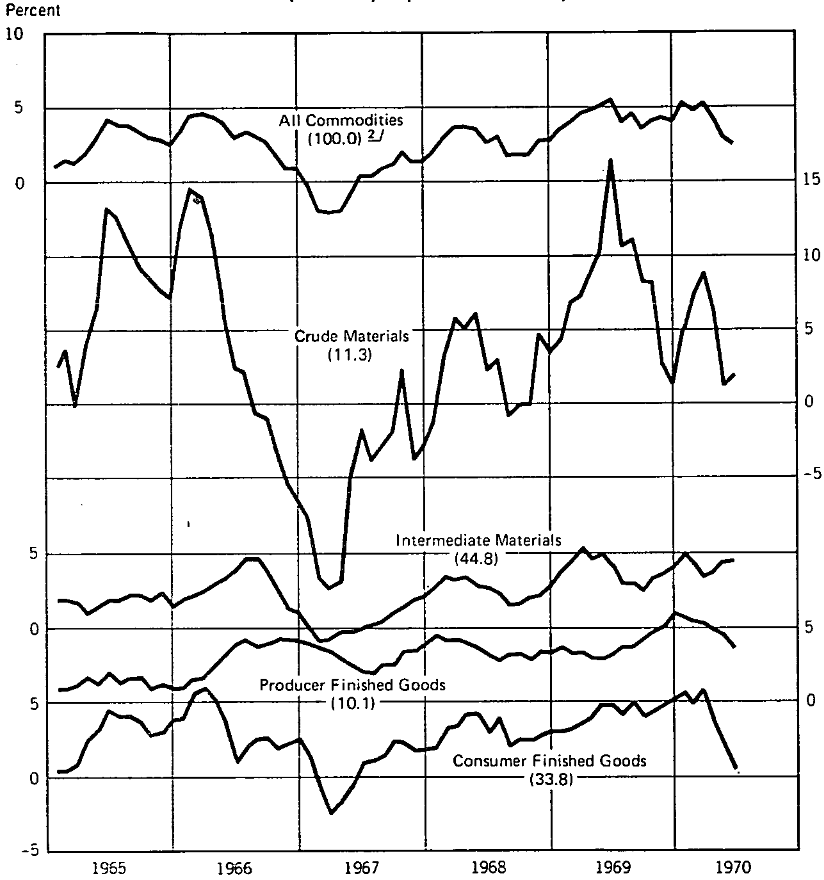
1/ In each month shown, the rate of change is measured over preceding 6 months, at an annual rate.

2/ Figures in parentheses are the December 1969 relative importance for the CPI.

U.S. Dept. of Labor
Bureau of Labor Statistics

Chart 10

Rate of Change 1/ in Wholesale Price Indexes 1965-70
(seasonally adjusted annual rate)



1/ In each month shown, the change is measured from 6 months earlier at an annual rate.

2/ Figures in parentheses are the December 1969 relative importances (1963 wts.) for the WPI

U.S. Dept. of Labor
Bureau of Labor Statistics

Senator PROXMIRE. I thank both of you gentlemen for most interesting and useful statements.

Secretary Kennedy, it seems that the economic problems of our country have rarely been worse. That is, we are still suffering from serious inflation, from high unemployment, from stagnation and lack of growth. This morning, it seems to me, you give to us a program which is not really encouraging. For example, you talk about maintaining fiscal restraint and yet the heart of that fiscal restraint would seem to me to be holding down spending.

The President went after Congress on Saturday, as you know, attacking us hard for increasing spending and yet the President yesterday, as I understand it, said that he did not see that we could reduce defense spending any further. He said we had gone about as far as we could go in that area.

This puzzles me when you recognize that in fiscal 1970, a year for which the Nixon administration is completely responsible, we actually increased defense spending by $150 million, although Congress cut the budget very sharply. They cut the Johnson budget and the Nixon budget, but unobligated balances enabled the President to go ahead and continue spending.

What is your answer to the fact that the President seems to have left out of account in talking about restraint, spending restraint, this very large sector, in fact, the biggest sector of the spending spectrum?

Secretary KENNEDY. Mr. Chairman, substantial reductions in defense expenditures have been made. There is no question or doubt about that.

Senator PROXMIRE. They have not been made this year. I have the figures now for fiscal 1970. They show that they have gone up about $150 million. That is, as of the end of June 30th.

Secretary KENNEDY. One of the factors that we are having to deal with at the present time is that substantial reductions in defense contracts and defense employment have added to the unemployment factor. It has also been a factor slowing business in many areas of the country, particularly the west coast area, and in those areas that are predominantly in the defense business.

Now, there are further cuts ahead in fiscal 1971—substantial cuts in defense. So that area of the budget, it seems to me, is being effectively reduced.

Senator PROXMIRE. Well, I hope so, but we have before us on the floor of the Senate coming up in a few days, as you know, the defense procurement bill. It is a big bill. It is a $20 billion bill and the Armed Services Committee has already cut the administration's request by $1.3 billion. We hope to cut it more but we do not anticipate getting a great deal of support from the administration for those cuts.

Let me move into another sector. We talk about holding down inflation and yet many economists argue that the real problem is the wage-cost increases. As you know, wage settlements have been very high, higher than they have been in a long time. Productivity has not increased very much. You talk hopefully about the prospects of improving productivity and, of course, this will help greatly if we can do that, and yet when you talk about the restraint on the wage front you just say we would like to have restraint but there is no indication that the administration has any program for getting that restraint. The President has refused to use any kind of jawboning technique. He has generally talked about how he would like to hold wages down to noninflationary settlements but it is not very helpful if he does not use that powerful office of his to indicate what a reasonably noninflationary settlement might be.

Secretary KENNEDY. The demand factor in the economy has been now, I think, brought into balance or corrected, so excess demand has been taken out of the economy. We are in the period now of adjustment and transition at the lower level. It seems to me that from the corporate standpoint, with corporate profits reduced, and with inability to pass on price increases to take care of their full costs, they will be, I think, tougher bargainers. At the same time, the labor negotiators and the labor unions now should be able to take into account the fact that inflation is not an endorsed way of life, that we are making a determined effort to reduce inflationary pressures so that any settlements they might have should take that into account. I think the productivity council will be able to focus attention publicly on these issues. They will be able to consider the long run as well as the short run aspects of inflation. The inflation alert will add to that, at least from a public standpoint, by indicating what the issues are in this.

Senator PROXMIRE. I think these are all most encouraging hopes but they are all generalized. There is an ability on the part of labor unions, as we have seen, to ask for wage demands and to get them. The Teamsters have just shown us that even though excess demand has gone out of the economy. There certainly has been a historic ability on the part of concentrated industry to increase prices when they are operating far below capacity and to get it. The administration just does not have a strategy, it seems to me, to cope with this.

Secretary KENNEDY. Well, the figures now are starting to show at least in the wholesale price index, less of an increase, and this will be reflected in the consumer level also. We also would expect, and have seen in all adjustment periods of the past, a substantial increase in productivity as you move up into additional production after an adjustment process. That has been true in every economic adjustment that I have studied.

Senator PROXMIRE. I think that is true. That is true that we are likely to get an increase in productivity but whether it will be enough to overcome the enormous wage settlement is another question.

Secretary KENNEDY. I think——

Senator PROXMIRE. I would just like to move on quickly, if I can, to the next main sector, which is growth. And yesterday we seemed to get from Mr. McCracken and Mr. Shultz, we get the same thing from you gentlemen, the time has come for the economy to begin to grow and move. We should not restrain it as much as we have in the past. Yet, I do not see any real kind of a growth program.

Where is your program for growth? Where would you say are the principal initiatives by the administration to make this economy begin to move again?

Secretary KENNEDY. Well, there are in the private sector very, very large demands. Housing is a great area. With additional funds in the savings institutions, more availability of funds, and with interest rates moving in the right direction, that should be an area of growth.

Senator PROXMIRE. Let me just stop at that point and say housing is one thing we have considered very, very thoroughly and as long as interest rates are as high as they are, there just is not much prospect for getting a great deal moving in housing. I would agree the needs are enormous, but as you know, the mortgage rates are just down fractionally. They are still at a level of 9.1 percent, which seems to us to be very, very high. Even if they should go down to 8½ percent they would be punishing and it would be very difficult to get housing moving in any substantial way.

I would agree this is a most hopeful sector. You get the private funds involved very well and we certainly have great needs but there is no indication that the administration program is to get that really moving in the coming year.

Secretary KENNEDY. Well, when you say really moving, that is a term that depends on interpretation.

Senator PROXMIRE. Well, we have——

Secretary KENNEDY. Housing starts were up 11 percent in June and they are moving in the right direction now. I agree with you that I do not see them moving up to a level that I would like to see in the present. But it is an area of strength, at least in demand.

Senator PROXMIRE. I would call it a weakness. I would hope it would develop into an area of strength. It is a slight improvement from a depression level to a deep recession level.

Secretary KENNEDY. And there is heavy demand there. As conditions change it will move up.

The other point is the municipalities. All of the cities have great demands and needs. As the money markets improve, and that is showing right now, the municipalities are moving in this field to get money for needs that they have.

Now, on the Federal side of this thing, there are very substantial supportive measures. The surtax is ended. Add that to the spending stream, that is a significant factor. There are other areas there. An increase in personal exemption, that was put in the tax reform bill is in effect now.

Senator PROXMIRE. There is not any question that there are——

Secretary KENNEDY. There are additional ways. You have to keep in mind that a large share of our restrictive measures in the past have been not only from the fiscal side, the tax side, but from the monetary side through Federal Reserve policy. That has eased and more funds are becoming available to the private and the Government sectors of the market.

Senator PROXMIRE. In a sense I am afraid both of us are trying to have it both ways. We talk about stimulating growth and at the same time holding down inflation. It is a very, very tough kind of thing to have to do. But certainly one area that everybody recognizes as a problem is unemployment. Unemployment is high. The figures that you and Mr. Hodgson give us do not come to mean very much because you talk about a growth in employment. Every single month since March employment has diminished seasonally adjusted, every month. It was lower in April than it was in March, lower in May, lower in June, and in a growing country with a growing labor force or potentially growing labor force this is most discouraging.

When you stress productivity that means you are not going to get big increases in employment as demand increases because the people working will produce more. They will work a little longer hours.

Where is your program for putting people back to work under circumstances in which the Federal Reserve Board has estimated according to reports yesterday that unemployment could go as high as 6 percent in 1971?

Secretary KENNEDY. I think that would be Mr.——

Senator PROXMIRE. Secretary Hodgson?

Secretary KENNEDY. I do not like to give a lateral pass here but I think that——

Senator PROXMIRE. Well, I meant to direct it to either one of you gentlemen.

Secretary Hodgson?

Secretary HODGSON. Well, first of all, I do not believe that I would share the Federal Reserve Board's pessimism as to where the unemployment rate would go. But, second, with regard to where the economy will pick up and start to provide supportive jobs, it seems to me quite clear that if we get this Housing Assistance Act with the assistance that that will provide in financing housing——

Senator PROXMIRE. That bill is on the President's desk. We passed it, the conference report is through the Congress.

Secretary HODGSON. That will speed the thing that you and the Secretary were talking about, the housing pickup.

Senator PROXMIRE. A little. But still far below what it ought to be.

Secretary HODGSON. Substantially. As you pointed out in your letter to me, a few dollars here and there reap vast rewards in the private sector and I think that is what is going to happen in that case.

Second, I think we can look upon the service industries and the retail sectors as sources of strength. Personal savings are up. Personal income stays high. The amount available for consumer spending is very considerable and my feeling is that this is going to be one of the big pickup areas as we enter the third and the beginning of the fourth quarter.

Senator PROXMIRE. My time is up. I want to come back to that. You gentlemen just do not seem to have a program. You seem to think there is strength in the economy and you are relying on that rather than any specific program you have to put people to work.

Senator Javits?

Senator JAVITS. Mr. Chairman, if I may have the attention of both secretaries, I would like you both to answer this.

I see a common thread through both statements. I do not know whether I am right or wrong, but I would like you to confirm it. It looks to me as if the administration is beginning to go after the Congress to do its duty, as a means of making major improvement. I find with great interest the Secretary of the Treasury has a number of measures. He says this suggests the need for prompt congressional action on the administration's revenue proposals, accelerated payment of gift and estate taxes, tax on lead additives in motor fuel, and the approval of postal reform including rate increases.

I notice with great interest that the Secretary of Labor's presentation lists four top priority bills. The first is unemployment insurance, which awaits but the vote in the Senate on the conference report and has not been brought up by the majority leadership. I hope it will be brought up immediately. There is no reason why it should not. Let us fight out our objection, which concerns the unionization of agricultural employment and have it voted up or down. But that should be on the books.

The next one is the Manpower Training Act. There I have a heavy responsibility, as has Senator Nelson of Wisconsin. We are working very hard and we should be able to turn out a bill within the next 2 or 3 weeks, assuming that we get a meeting of the Labor and Public Welfare Committee, which I am sure Senator Yarborough will give us.

The proposed Family Assistance Act, which you refer to, has been tied up in quite a hassle in the Finance Committee.

Again, it is the Congress' responsibility to turn it out, fast or slow as it chooses.

The same is true of the Occupational Health and Safety Act, a highly controversial measure in which business is taking a very strong line against a very comprehensive bill, but again it is something where Congress can cut the Gordian knots.

Now, I do not believe that there is any reason except in the Unemployment Compensation Act, for particularly faulting the Congress, but I do think that a program is a national program. Therefore, the administration has a right to turn to the Congress and say, "you say we have no program; what about you? We have given you our program. If you will legislate it as we have asked, promptly, then you will have an arguable case when you allege that we have no program."

I would like to ask a few questions in the limited time available, if I may. Secretary Kennedy, you sat at the same place you are sitting now about a year or so ago and had quite a set-to with some of us about what was an acceptable rate of unemployment, and I notice in your statement you now speak about "with demand no longer excessive and unemployment in the area of 5 percent, continuation of restraint throughout this year at last year's intensity would have had too severe an impact," and so on.

Now, are we to gather from your statement and that of the Secretary of Labor's, who has just responded to our chairman with respect to the same question, that the administration expects to stabilize the risk of the country in respect of unemployment at or around this 5 percent level and that the country need have no particular fears beyond that?

Secretary Kennedy. What I was saying, Senator, was that as we have moved through this adjustment into a period where inflation expectations are now diminished, and I consider not as severe, the time has come and we have responded by having monetary policy more responsive or less restraining. As we increase our outlook and productivity, and as the economy moves up, then there will be an absorption of this labor force. But we have no way of assuring any particular figure of unemployment. That will be the result of—the combined result of—all of the factors in the economy and what I am saying now is that we have reached the point of adjustment downward. We are moving now to increase production and employment and that is the thing that will be necessary and it will not in my judgment, now cause resumption of inflationary expectations unless we go overboard with spending and too easy a money policy.

Senator JAVITS. Mr. Secretary, may I respectfully suggest that something more is called for, however, and that is the resolution of the administration on this question. The administration has resolved to hold unemployment and the risk of unemployment in the country to around the 5 percent level, no more. It may not make it but at least, it must have that resolve. I say this because one of the big criticisms directed against this administration is the fact that it believes too much in automaticity of adjustment, and it is not ready to throw the weight of the Government into the battle in order to avoid difficulties and injuries to the people which result from automaticity. Automaticity may work out all right if you can live long enough and you want to shed enough blood and spend enough money. But sometimes we cannot do that. The intercession of government at all stages deals with avoiding automaticity. So, I think it is fair to ask you, is our government—here you are, the two responsible authorities—is our government going to do everything it can to keep unemployment at a stop-loss basis of around 5 percent?

Secretary KENNEDY. I think that is self-evident. We are making every effort to move the economy up and to prevent that—and to keep it at this level for as short a period as possible, a temporary period, but again, we realize that next week there could be a figure that we would not want to tolerate.

Senator JAVITS. But is the policy of our government directed at considering this figure beyond which, if it possibly can avoid it, it does not wish to go?

Secretary KENNEDY. We do not wish even this figure, but we try to keep it down below that.

Senator JAVITS. I see. The Secretary of Labor?

Secretary HODGSON. Yes. I would like to reinforce the impression that we are particularly sensitive to this particular subject, the subject of unemployment. We are sensitive to it generally, though, and not just to a single figure that exists. The question of employment and unemployment levels in this country is usually thought of in the single term of a percentage figure. A percentage figure is something related to something else. Well, that something else is the number of people in the labor force and that is essentially an unpredictable kind of thing. One of the reasons, as I cited in my testimony, that the percentage rose as rapidly as it did in the early part of this year is that we had an unusually high rise of people entering the labor force. For reasons we do not know, within 4 months we had practically an anticipated full year's rise of people entering the labor force.

Now, in June we seem to have reversed that trend, and there are fewer people entering than there were in the earlier period. So, we must consider that employment is not necessarily a single statistic, but it is a condition.

We examine a lot of other things about unemployment in the Labor Department. One of the things, as I mentioned, is the length of time a person is unemployed.

Now, that length of time at present is 9.5 weeks. This has risen only slightly during the last few months and it is quite in contrast to the length of time or duration of time that people have been unemployed in previous slowdowns—16 and 17 weeks, for instance, in the 1958 and 1961 slowdown. So, we do not have a kind of aggravated condition that we had at those particular times.

It seems to us that we are sensitive to this. By the terms of the legislation that we have put forward, there are triggers in it, to reflect our interest and our willingness to take action on the basis of certain levels of unemployment. This shows a seriousness of purpose. We have asked for this legislation not in the sense, as I emphasized in my testimony, of saying "Congress, get on with your business," so much as we have asked for it in the sense of saying "We need, we would like to have, we would profit by having, we could do a better job if we had, this legislation." That is the basis on which we are interested in this and I personally, as the Secretary of Labor, and having a particular concern for the wage earners of this country, would like to have that kind of flexibility at my disposal.

Senator JAVITS. Thank you, Mr. Chairman. I would like to ask the Secretary some questions about liquidity, but I will wait until the next round.

Senator PROXMIRE. Congressman Brown?

Representative BROWN. Secretary Kennedy, in February you observed that the average maturity of the public debt had fallen by 1½ years since mid-1965 and stood at only 3 years and 8 months. Such a drastic decline in maturity means that the Treasury must enter the money and capital markets more often than otherwise. Repeated entries can frustrate the effects of fiscal policy designed to see us have a balanced budget and reduce the need for entering those money markets.

Can you tell us what has happened to the maturity of public debt since February?

Secretary KENNEDY. Since that time, with the movement of time, I am sure that it has moved down slightly, but it will be about where it was at that time. I think it was 3 years—was it 3 years and 7 months or 3 years and 9 months?

Mr. VOLCKER. 3 years, 7 months in February.

Representative BROWN. 3 years, 8 months.

Secretary KENNEDY. It is 3 years, 8 months now. The decline since 1965 is a reflection of the passage of time and of our inability to issue long-term securities over this long period of time. It goes back to the 4¼ percent interest rate ceiling that precluded the Treasury from issuing anything beyond 7 years for a long period of time.

Representative BROWN. Do you have any suggestions which might help increase the average maturity of the Federal debt?

Secretary KENNEDY. I think that it would be appropriate to remove the 4¼ percent interest rate ceiling. At this stage I would not intend, in the debt management process, to start to move the debt out because I think from an economic standpoint we would want to keep those markets open for housing and for other areas. Over a period of time we have got to remove that ceiling in order that we can do a reasonable job of structuring the debt.

It has not only caused us to enter markets too often and caused problems within the market by constantly refunding, but it has added substantially to the interest cost of the debt because those securities that were coming into maturity all had to be refunded at the current high level of interest rates.

Representative BROWN. When you say gradually, what specifically do you have in mind? Are you suggesting that we raise the long-term debt rate slightly now and the ceiling later?

Secretary KENNEDY. No. I would remove it entirely and leave the decision with the Secretary of the Treasury as to timing when the issues would come about. I think last year we proposed that the ceiling be eliminated and it was not acted upon. The savings bond rate was pulled out of that proposed legislation. We have not renewed our request because the market was such that we would not have used it, but at some time we will be back to the Congress on this.

Representative BROWN. Do you think this would serve to achieve the purpose that Chairman Patman is so interested in, and that is maintaining at least some ceiling on the interest rate or perhaps even reducing the interest rate?

Secretary KENNEDY. I think artificial ceilings of that kind just distort markets and cause problems. We found that to be the case every time we have had artificial ceilings and this one is the best example I know.

Representative BROWN. I agree with you about the artificial ceiling concept but I am asking specifically if this action which you propose would have the effect of decreasing the pressure on financing short-term debt?

Secretary KENNEDY. Well, it would to the extent that we put out long-term bonds under it. At the time that we would actually issue long-term bonds it would take a certain volume of securities out of the short-term area and put them into the longer-term area.

Representative BROWN. So, it would relieve the pressure for short-term debt?

Secretary KENNEDY. Yes.

Representative BROWN. A number of the agencies in the Federal Government or related to the Federal Government, such as the Federal Land Bank System and FNMA, are not specifically controlled by the Treasury when it comes to entering into the money markets to borrow to meet their needs. Last year these combined agencies borrowed $9.1 billion in the money and capital markets. To what extent does heavy borrowing by these agencies foil the Federal budget policy of reducing Federal demand on the credit markets?

Secretary KENNEDY. I think that the issuance of the large volume of agency securities has had an important effect on the market and on interest rates. While we have no control over the lending operations of these agencies, we do have complete discussions with them and have something to do with the timing and the issuance of the securities when they borrow. But their needs are so great that they are in the market for a very large amount every month. That is running now at about a billion dollars a month, is it not?

Mr. VOLCKER. A little more than that.

Representative BROWN. In effect, competing with the Treasury.

Secretary KENNEDY. A little more than a billion dollars a month at the present time.

Representative BROWN. Would it not be preferable, for these agencies to be connected to the Federal budgetary process by bringing them under the purview of the Treasury? Wouldn't this insure that their activities would be more in concert with your fiscal policies, wouldn't this help in maintaining reasonable interest rates or at least, reasonable increases in the interest rates?

Secretary KENNEDY. This will be a matter under study with the President's Commission on Financial Institutions. Also we are having an inter-Government discussion and study of this very subject at this time. Not with respect necessarily to bringing them into the budget but to have a more analytical approach to it and a racking up of these figures and we may well come to the Congress with some recommendations in this field.

Representative BROWN. Let me suggest that the tendency is towards reducing control by the Treasury and the Government——

Secretary KENNEDY. Right.

Representative BROWN (continuing). Of this kind of financing and the other tendency is toward increasing amounts of pressure on the money market from this kind of agency. In the last few months there has been a tendency to expand the kinds of agencies, or the kinds of purposes, which can be served by these independent agencies in this borrowing process. I think that unless some action is taken this may get out of control.

Secretary KENNEDY. You are precisely right. These activities have grown substantially in recent years. It does present a real problem and with the budget stringency, the cutting back of Government expenditures, every one wants to get outside of the budget purview, and at times I would almost like to get out myself, but——

Representative BROWN. I think the fact is we are not fooling anybody.

Secretary KENNEDY. That is right.

Representative BROWN. We are certainly not fooling the money markets because the money markets respond to the number of people coming to them for capital financing and this kind of borrowing.

Secretary KENNEDY. That is right.

Representative BROWN. I think Members of Congress recognize what is going on here and apparently the administration does, so I do not know what the purpose of it is.

Secretary KENNEDY. Well, you have raised a real issue and one that we are concerned about and we are studying.

Representative BROWN. I have been raising it for some months and will continue to do so——

Secretary KENNEDY. Good for you.

Representative BROWN (continuing). Until I get some kind of response from the administration on it.

Yesterday, we had in our exchange with Secretary Shultz, a discussion about the changing pattern of government spending. We have had a drop in defense spending from 45 percent in 1968 to 36.6 percent in 1971. Meanwhile our expenditures for social programs have increased from 32 percent in 1968 to 41 percent in the 1971 budget.

Can you tell me what has happened to the real dollar spending in this area?

Secretary KENNEDY. We will be glad to submit a table for the record, but this one that I have from the budget document shows 1969. It does not show 1968; $81 billion in 1969. The 1970 figure, of course, down here is $79,432 million. That is an estimated figure. And then for 1971, $73,583 million which is $5 billion lower from 1970 to 1971, $5.8 billion lower.

Representative BROWN. So, the anticipation is not only a percentage drop but an actual drop in real dollar spending as well.

Secretary KENNEDY. That is right.

Representative BROWN. In the defense spending area?

Secretary KENNEDY. That is precisely right. We will be glad to give you those figures for the 1968–69 period and I am sure you would like the human resource figure total, too.

Representative BROWN. I have more questions in that area, but my time is up.

(The following information was subsequently supplied for the record by the Department of the Treasury:)

BUDGET OUTLAYS ON NATIONAL DEFENSE, HUMAN RESOURCE, AND OTHER PROGRAMS, FISCAL YEARS 1968–71

[In billions]

	Fiscal years			
	1968	1969	1970 [1]	1971 [1]
National defense	$80.5	$81.2	$79.4	$73.6
Human resource programs [2]	57.4	63.6	73.3	81.9
Other	40.9	39.8	45.1	45.2
Total budget outlays	178.8	184.6	197.9	200.8

[1] As estimated in the budget for fiscal year 1971.
[2] Includes the following functional categories: education and manpower, health, income security, and veterans' benefits and services.

Senator PROXMIRE. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Secretary Kennedy, you mentioned that Congress has not yet acted on three administration proposals to increase revenues. The tax on lead and gasoline, the speedup of estate and gift tax collections, and an increase in postal rates, which together add up to about $4.5 billion in fiscal 1971.

What course will the administration take if Congress makes clear it will not enact any or all of these measures?

Secretary KENNEDY. I have been in touch with Chairmen Mills and Byrnes of the House Ways and Means Committee and I understand that they will have hearings fairly soon, in August sometime, and that they will move forward with legislation in this field.

Now, that does not assure that it will go through the process of the Senate and become law. If it is not done, of course, the budget deficit is larger and there it has to be compensated by, if necessary, monetary policy.

What I would like to see is a very tight rein on Government expenditures because they have a way of creeping up.

Representative WIDNALL. In other words, you think that further cuts in expenditures might be forthcoming as a result.

Secretary KENNEDY. I would be in hopes that we could find cuts but that is a very difficult, painful act. To the extent that we cannot have a strong fiscal position, then monetary policy cannot be as responsive to the situation as we would like. That is what we need in this climate, to add to the reserves and liquidity of the economy.

Representative WIDNALL. Would you agree that Congress has a right to reject Administration budget proposals, that while they have that right, it also has a responsibility to help form an overall fiscal policy appropriate to the state of the economy?

Secretary KENNEDY. I think that there is something lacking in our whole legislative process. I have talked a good deal to a good many of you and I am sure a lot of you share this. You have actions upon individual bills and each one looks desirable, and so on, and without regard to the total or the revenue to supply the funds for the total price. The budget tends to get out of balance on the expenditure side very quickly. And the tax side is a very difficult side because that takes a long time usually to get an action bill through, and so it is not as responsive.

We have looked at expenditure ceilings and tried to get some tie-in. I think in the long run that the Congress must—and particularly in these times be responsive to the situation—take a look at what the total is going to add up to, and not just case by case by case and then find out at the end that we have expenditures far in excess of what we want.

Representative WIDNALL. I would certainly agree with you on that, Mr. Secretary.

I would like to ask this question further. Should not congressional rejection of revenue increases and spending restraint be implicit advocacy of an overly expansive budget?

Secretary KENNEDY. I think it should.

Representative WIDNALL. You mentioned a tendency all too frequent in the last several years, "to spend first and try to find the tax revenues later." Recently we have seen this problem aggravated by cuts in Federal revenues while spending has increased simultaneously. How do you suggest we reverse this unfortunate tendency?

Secretary KENNEDY. Well, that gets back to the previous question, Congressman Widnall, in trying to find a way to relate not only the expenditures but the receipts to a total package. We review our total program when the debt limit hearings are on. We review our total program when the budget is presented. We talk about it when we talk about expenditure ceilings. But we do not find a way case by case to do it.

Now, I think that we have got to find some measure and perhaps the expenditure ceiling would be the best way—I do not know.

Representative WIDNALL. You suggest a spending ceiling for the Congress with provisions for necessary flexibility?

Secretary KENNEDY. That is what the President suggested in his message, that it be a ceiling applied to the Congress as well as the executive.

Representative WIDNALL. I think you have indicated that over the foreseeable future fiscal policy should maintain some degree of restraint or at least maintain a "relatively neutral position." What sort of range in the unified budget deficit in fiscal 1971 would indicate that fiscal policy is restrictive or neutral?

Secretary KENNEDY. It seems to me there that in the present economic climate the deficit that we came up with in May is reasonable. If you increase it substantially further we get into the problem that Congressman Brown was talking about of the market impact, too much Federal borrowing, agency borrowing, and so on. While you cannot pick a figure and say this is beyond which you cannot go, I think the thing we ought to do is reduce the expenditures to the minimum that we can get by with and then approach it on the revenue side.

Representative WIDNALL. My next question was going to be, would deficits of $8 to $10 billion be too stimulative for a return to price stability?

Secretary KENNEDY. Well, you have to bear in mind that in the present economy our revenues are down substantially because of the level of economic activity and you get back to the question then of a full employment concept. I think what we would like to see is the budget in balance in periods of strong economic activity and low unemployment. In periods where unemployment is high, and periods when economic activity is on the low side, then some measure of deficit is reasonable partly because it is lack of revenues that is causing it. As the economy picks up, the revenues pick up and balance out.

What we do not want to get into, because of the experience we have just gone through with the inflationary pressure, is large budget deficits—I will not define large—at a time when the economy is going full speed and employment is almost over full and unemployment is at a minimum level. That puts too much pressure on inflation and prices and problems in the economy, money markets, and so on.

Representative WIDNALL. How sizable a deficit would there have to be to have you alarmed about it?

Secretary KENNEDY. That, again, is a very difficult one to answer. I would not want to pick a number. It would depend on economic circumstances. As I indicated, if the economy is moving at full speed and our tax revenues are coming along at their maximum revenue producing capacity, then very little or any deficit is a bad thing.

If you get into a position where we are in an adjustment, where we are trying to get the economy going up, a deficit is perfectly agreeable to me.

The thing that I am afraid of is that we might get expenditures too large. I do not know what that amount would be, but we would have to watch those case by case.

Representative WIDNALL. Just one question for Secretary Hodgson. You mentioned the fact that some 300,000 have been released from the Armed Forces in the last 6 months. Has this had a substantial impact on the recent growth of the labor force?

Secretary HODGSON. Yes, it certainly has. It is one of the things that cannot help but affect the course of the labor force. You see, that is 300,000 more released than went in. The net is 300,000.

Representative WIDNALL. Well, are the kind of people mustered out of the service likely to end up amongst those unemployed for 15 weeks or more?

Secretary HODGSON. I do not have any figures on that. My own judgment is that one of the most employable persons in the Nation today is the released veteran, and he is a person which as an ex-employer myself I was very interested in bringing aboard as an employee. He was usually a man that was ready to go to work.

Representative WIDNALL. Well motivated.

Thank you. My time is up.

Senator PROXMIRE. Yes.

Mr. Hodgson, I want to get back to the question I was asking when my time expired. You responded to my letter asking you what programs the administration has to do something about unemployment increasing to about 5½ percent, which many people expect it to and do something about those sectors of the country where unemployment is especially heavy, you take it up in three principal areas. One is improving unemployment compensation and we—hopefully, this Senate is about to act on that. I agree with Senator Javits we are overdue. It is our fault, not yours.

The second point is manpower training, and the third is the family assistance program.

Now, with regard to unemployment compensation, while this is good and helpful, I think it is a very limited kind of a program to cope with short-term unemployment and rising unemployment. Manpower training is a very frustrating—the best kind of manpower training you get is when you have low unemployment because employers will hire people and train them. When you train people and you have unemployment and they are trained for jobs that do not exist, that is, or jobs that are diminishing, that can be counterproductive. The family assistance program we were told yesterday, will not even go into effect for a year, cannot do any good until July of 1971 to help this unemployment picture. So, what do you really have in terms of a program to put people to work?

Secretary HODGSON. I would not write off training as you have written it off and I will tell you why. Much unemployment is not cyclical unemployment. It is what is known as structural or transitional unemployment. Unemployment occurs while a person is looking for a job or while he is preparing himself for another job. Even in times of unemployment at the level we have now and greater unemployment there are still hundreds of thousands of job vacancies in this country, and one of the purposes of a good manpower program is to shift its training emphasis into areas where these vacancies exist and thereby create the opportunities there and speed people into those sectors of the economy. That is one of the big purposes.

Senator PROXMIRE. I think that is excellent, but I think we have to have some demand there. You have to have some need.

Secretary HODGSON. That is right and there are some areas where there are demands and continuous——

Senator PROXMIRE. Let us spell that out in terms of what your program can do for Seattle or Kenosha, Wis., and other areas where you have eight or 10 percent unemployment, or I understand 11 or 12 percent. What would any of these things really do in a situation like that? Most of those men are on unemployment compensation. They have in Wisconsin already a maximum period of unemployment compensation.

Secretary HODGSON. One of the principal things in our programs—not manpower but our labor market services—is to have these early warning provisions. We provide special employment services in areas where either unemployment is anticipated in sizable numbers or exists in sizable numbers.

Now, we could profit there by having some relocation assistance. We do not have that now. We have provision for it in both the Manpower Training Act and in the Family Assistance Act. We found with the experiments that we have conducted that for approximately $800 per person we can relocate people and 80 percent of them relocate successfully. We think this would be a useful thing. So, relocation is something.

Now, you have suggested in your letter to me that we also ought to look at the question of where we place Government business. Of course, this is one of the purposes of the new Regulations and Purchasing Board that is established by the President's Economic Report. So, that is something that is being undertaken. Also, the Defense Department's Order No. 4 circular was just revised in June to allow for placement of additional kinds of work into areas where there is an excess of employment and excess of facilities.

Now, these kinds of things are not readily evident on the surface, though they are there and going on.

Senator PROXMIRE. I certainly hope they are going on because in all these sectors, areas, I have talked to Senators from Washington, Oregon, parts of Wisconsin, parts of Minnesota, other parts of the country. It seems to me, we are a long way away from getting much assistance from the Federal Government.

Secretary HODGSON. Another thing——

Senator PROXMIRE. Let me be specific in indicating what I have in mind. What is wrong with having a program on the shelf of useful work, anti-pollution area, for example, the health area, the public education area, some kind of a program that would put people to work in the areas where we need work, we need manpower, and do it on a substantial basis so that we could provide work which would be in a sense anti-inflationary so, in other words, you would be pushing people into the areas where we need personnel. Why is not the Labor Department——

Secretary HODGSON. That thing has the smell of sweet reasonableness, I must admit, because it looks attractive and there are these areas that we know this Nation needs to give some attention to. I am told that there are some problems with this sort of thing. Among them are these. For one thing, on-the-shelf programs turn out to be very perishable. A program that was prepared for an economic condition or for a locality that it was appropriate for at one time turns out six months, eight months or a year later to be frequently quite inappropriate for that time.

Second——

Senator PROXMIRE. We know there are some of these things that you are going to need for a long time. We are going to need people in the health field for many, many years before we get enough. We know we are going to need more activity and probably a lot more manpower in the antipollution field probably for the next 50 years or more.

Secretary HODGSON. Well, I was going to say, secondly, one of the hazards one finds in experimenting with this kind of thing is that a locality or municipality that undertakes to employ people in this way, frequently finds that they can then substitute for the people that they already have. So, instead of solving a job creation problem, the new people substitute for existing people and frequently at lower rates than the existing people are making. It is a kind of thing that——

Senator PROXMIRE. This is exactly why it seems to me you ought to get into the areas where we know the need, the basic social need is so great in terms of availability of resources.

Secretary HODGSON. I understand.

Senator PROXMIRE. Now, let me ask Mr. Kennedy, frankly, I am depressed at the fact that you seem to be telling us that we should continue to exercise a considerable amount of fiscal restraint and you reject the notion—you seem to reject the notion of a full employment surplus, an idea which both Mr. Shultz and Mr. McCracken seemed to embrace yesterday. Are we not exercising a kind of cruel restraint on the economy in the sense that we are running a substantial full employment surplus at a time when unemployment is high and increasing?

Secretary KENNEDY. No. I am not.

Senator PROXMIRE. I think the best way to get at this, Mr. Kennedy, something that will be very useful to us and something that no official has given us so far, is what is your estimate of what the full employment surplus is right now?

Secretary KENNEDY. I have no specific number on the full employment surplus. What I was saying there——

Senator PROXMIRE. I do not want to interrupt you again. I do not want to be rude, but I do think this is something which the Secretary of the Treasury, especially you—you are a very able man; you have two of the most able men in Government sitting at your right here—it seems to me, if any officials in our Government ought to have them along with the Council of Economic Advisers, it is you. It is appalling that you do not know what the full employment surplus is now.

Secretary KENNEDY. Do you want to speak to that?

Senator PROXMIRE. Mr. Volcker?

Mr. VOLCKER. There are really too many numbers, Senator Proxmire. I think the trouble is, not that we do not have a number, but we have too many. It is a very difficult estimate to make and every estimator comes up with a different number.

Senator PROXMIRE. Tell us what your assumptions are and you would come——

Mr. VOLCKER. Precisely——

Senator PROXMIRE. Say full employment is unemployment at 3.8 percent.

Mr. VOLCKER. The critical assumption is what percentage of gross national product or national income corporate profits are at some hypothetical full employment level. Since estimates of that differ over an area of 1 percent of GNP this makes a tremendous difference.

Senator PROXMIRE. Give us a range. Anything would be helpful so we would know what we are talking about. We want to know whether the economy is in restraint now or if it is stimulative.

Mr. VOLCKER. Well, I think certainly you can say with the budget outcome that we had last year, and given the performance of the economy during the past year, we had some full employment surplus last year.

Senator PROXMIRE. Well, now, how about—you Republicans are great on history. How about the future?

Mr. VOLCKER. That depends a good deal upon what Congress does in terms of spending programs.

Senator PROXMIRE. Well, how about on the basis of what we are doing—what the Administration asks us to do? Would we be in restraint, and if so, how much?

Mr. VOLCKER. If we had a budget of the kind that was estimated in May, we would have a full employment surplus.

Senator PROXMIRE. How much?

Mr. VOLCKER. Well, in a—this comes back to the difficulties in the estimate. It would range from, I think, a small one to estimates I have seen of $10 billion or more, at least during part of the year.

Senator PROXMIRE. Do you quarrel with the argument that the full employment surplus now during this first half of the fiscal year would be about $7 billion and the second half would go as high as $13 billion?

Mr. VOLCKER. Those figures seem high to me.

Senator PROXMIRE. Our staff tells me that this is what approximately their estimates are.

Mr. VOLCKER. Well, some——

Senator PROXMIRE. Anyway, you would agree it would be full employment surplus. You would agree present fiscal policy is restraining on the economy, isn't that right, even though we have a——

Mr. VOLCKER. Given the latest budgetary number. Whether or not you come out with one anywhere near that kind of magnitude or come out with a small full employment surplus depends on what actions are taken on the budget.

Senator PROXMIRE. Let me ask you, Mr. Kennedy, a few minutes ago you read some figures from the budget document for national defense. The figures for fiscal 1970 and fiscal 1971 were forecasts?

Secretary KENNEDY. That is right.

Senator PROXMIRE. Estimates of what you expect to be spent in the future. Now, fiscal 1970 is over and we compare actual outlays with your forecasts. Purchases for defense goods and services went up, as I stated earlier, from $78.6 billion to $78.75 billion, $150 million. The June economic indicators also show a $100 million increase for the first 10 months of fiscal year 1970. It seems to me that your forecast was wrong for fiscal year 1970, and that is why I am so skeptical about claims that the defense budget has been reduced and national priorities have already changed.

What were actual outlays for defense in fiscal year 1970?

Secretary KENNEDY. We will have to get those. I haven't got them. We will have them at the end of the week, next week.

Senator PROXMIRE. You will have them at the end of next week.

Secretary KENNEDY. We will send them to you for the record, yes.

(The following information was subsequently supplied for the record by the Department of the Treasury:)

Department of Defense (military functions) expenditures for the fiscal year 1970 were $77.1 billion.

Senator PROXMIRE. How confident are you that defense will go down to $73.5 billion in fiscal 1971?

Secretary KENNEDY. I have the assurance of Secretary Laird that that is his goal and program and that he will accomplish it. And so far he has lived up to this kind of commitment. He has indicated that that is his objective.

Senator PROXMIRE. He is a very fine and very honorable man, and very able man. I know him extremely well.

Secretary KENNEDY. He sure is.

Senator PROXMIRE. As you know, he is from Wisconsin. [Laughter.]

As I said, the estimates were wrong last year and I——

Secretary KENNEDY. When you are estimating in that field, in fairness, it is pretty hard to come within a few hundred million dollars.

Senator PROXMIRE. Finally, let me ask you, even if it goes down to around $74 billion or $75 billion, is that your idea of a peacetime defense budget?

Secretary KENNEDY. Well, I think that depends on an assessment of the world problems and that is in the realm of the National Security Council. We are having, of course, discussions in the SALT talks. We are having a number of discussions on various other areas of the world. Hopefully over a period of time we can get down below that, but there is an irreducible minimum and I don't know just where that is.

Senator PROXMIRE. Well, I was very hopeful when you talked about transition to a peacetime economy, I thought we would be able to get those figures down quite a bit more.

Mr. Brown?

Representative BROWN. Mr. Secretary, I have been listening now for 2 days to Budget Director Shultz and Mr. McCracken, to you and Mr. Hodgson, and I am rather struck with the ignorance of this administration with reference to the budget. I get the impression that you gentlemen do not know what a Democratic Congress will do to a proposed budget in an election year.

Secretary KENNEDY. I think that is a correct statement. We are trying, of course, to call attention of the Congress to the responsibility of keeping this in some measure of balance and to be very careful in expenditures because I think it is necessary in this economic climate.

Representative BROWN. That does have some bearing, then, on your answers to what may happen in the future?

Secretary KENNEDY. That is one reason we can't give you the figures, because we haven't the appropriations bills. We don't know what will come. We have to just quote our previous estimates and that is a planning document.

Representative BROWN. Yesterday Budget Director Shultz suggested that the spending process was the result of an interaction between Congress and the administration. I think you can assess rather accurately what Congress will do to your budget if you look at the actual spending figures you have given in light of this interaction process.

I have the impression that the administration is really presenting the Congress with a serious plan to reorder our priorities. Congress, of course, talks a great deal about priorities. It is difficult to take such talk seriously, however, when you reflect upon the fact that there has been virtually no action on any of the appropriations bills.

Secretary KENNEDY. I think that is right. We have been studying priorities for 18 months or so and trying to reorder them into the areas where it would be most helpful and taking away as best we can from the defense area.

But again, that depends on the Congress.

Representative BROWN. There is a significant difference, I think, between the 1968 budget and our current one. In 1968 the allocations for defense were substantially greater than the present defense appropriation. Our spending for special programs was exclusive in 1968 because of the administration's reliance on a guns and butter philosophy. The result, of course, was a badly unbalanced budget in 1968.

This year the administration reduced its defense spending, gave greater emphasis to nondefense and social programs and managed to do both within the confines of a rather responsible and balanced budget. I think these are two distinctly different budgetary situations.

Not long ago this Congress established a ceiling on spending which it felt the President should be obliged to heed. Shortly after that ceiling was set Congress appropriated additional new sums without considering the disastrous effects those sums would have on the overall budget. Apparently we now have a kind of double standard which leaves Congress relatively free to violate its own economic dictates.

Secretary KENNEDY. Well, that is generally true. A tight ceiling—it is a tight ceiling with respect to the executive side but on the legislative side it is not.

Representative BROWN. Well, isn't that an abandonment——

Secretary KENNEDY. Rubber ceiling.

Representative BROWN (continuing). Of the vaunted congressional prerogatives? In other words, we appropriate what we think sounds good with reference to the problem and leave it to the administration to balance the budget.

Secretary KENNEDY. Well, it should be a joint responsibility, and the Congress has a responsibility here.

Representative BROWN. We are debating on the House side the reorganization plan of the Congress. Perhaps we ought to have some legislative suggestions in this area. Because when you consider these new appropriations in light of the revenue reduction implicit in the tax reform bill it is difficult not to feel that Congress is abandoning its responsibilities to the President. We seem to think we can simultaneously cut taxes, increase our appropriations, and balance the budget.

Secretary KENNEDY. It doesn't work that way. In the end it will add up to a budget deficit unless we are controlling the parts.

Representative BROWN. Well, if you go ahead and spend according to the appropriation.

The other choice is for the President to live within the revenues he is provided by Congress. Especially since one of the oldest games in this business is for the Congress to authorize huge sums and then appropriate with a good deal more discrimination.

Do you feel that the Congress is falling into that trap with reference to the executive, that we just appropriate in a political sense and leave it up to the administration to determine what it shall spend in a fiscally responsible sense?

Secretary KENNEDY. Well, I think in the appropriation process the committees do take a look at the overall. I talked to Mr. Mahon and Mr. Bow, and others, on this very problem. But to have the appropriations far in excess and have the executive be responsible for cutting or reducing, that it seems to me is placing a responsibility on the executive that is too heavy. The executive should be able, with the Congress, to come out with a budget that would be acceptable within narrow ranges and to be able to have it in effect, whether a budget surplus or budget deficit, according to plan rather than to have piecemeal action by action add up to a much larger figure and then expect the executive to find ways and means of just withholding payments or withholding action on legislative matters.

Representative BROWN. That yields the economic responsibility to the President but, of course, it also yields the onus of the political responsibility to the President, and when you have the Congress in the hands of one party and the President the leader of the other party, that political arrangement has some important implications.

Secretary KENNEDY. It has some very serious implications.

Representative BROWN. Secretary Hodgson, we discussed the veterans returning from the war in Vietnam. In the past veterans' programs have not only been designed to assist the veteran but also to be a part of national policy. Years ago it was free homesteads and the national policy served thereby was the settlement of the West.

More recently we have gone into educational benefits in order to serve the increasing technological nature of our society.

Is there any change anticipated in veterans' programs following the war in Vietnam that would modify this assistance and also serve as an instrument of national policy?

Secretary HODGSON. On the rider question, regarding the total services to veterans, I would suggest that question be addressed to the head of the Veterans Administration. With regard to those services that the Manpower Administration of the Labor Department provides to veterans, it does this on the basis of attempting to make him employable through training and to acquaint him with the opportunities for employment, to speed the time from his discharge to meaningful employment.

These services it offers to everyone, but it has a special unit through the U.S. Employment Services that gives special additional services to veterans. So there is nothing new from that standpoint. Anything new that would go beyond that kind of service probably would come within the purview of the Veterans Administration.

Representative BROWN. We are a mobile society, but I think that perhaps veterans just out of the service are more mobile than anybody else in our society.

Secretary HODGSON. They certainly are. That is our finding.

Representative BROWN. I am wondering if there is any aspect of the job location service that you have been able to refine so that veterans might more quickly find the location where jobs are available.

Is there any way they are being specifically assisted in that regard?

Secretary HODGSON. One of the great things we are doing that will assist the mobile employee, veterans or others, is the establishment of these job banks where computerized job information is available now in 55 cities throughout the country. We plan to increase that markedly. We are starting several statewide systems. The use of these systems to supply rapid information, absolutely up-to-date information, to employers and prospective employees, including veterans, is going to ease the problem of the mobile worker.

We are doing other things in that connection. Veterans are at the time of their discharge asked to what area of the country they wish to have their service records forwarded, so that their placement is not just limited to their previous home or to the area of discharge, but to any desired area in which they wish to be placed. We found this to be quite helpful and quite a satisfying service to the affected veterans.

Representative Brown. Mr. Secretary, my time is up but I would like to suggest to you that more attention be given to relating this job information to the training that the veteran might elect to take in a career field and also that some thought might be given to expanding the veterans' careers beyond national borders and into international service which may also serve the national interest by employing veterans in fields that would relate to international activity.

Secretary HODGSON. Well, even though your time is up, I will exercise a bit more on your behalf because there is one subject that I am particularly interested in, and that is the placement of veterans in the skills-hungry construction industry. We are mounting a massive effort to try to get veterans who have some construction skills or who are desirous of entering this industry, to either undertake training or go directly into the industry on an on-the-job training basis, and we think that this is going to be one of the greatest sources of potential construction workers in the next 10 years.

Senator PROXMIRE. Senator Javits?

Senator JAVITS. Thank you very much, Mr. Chairman.

Secretary KENNEDY. I won't detain you but a few minutes, but I did want to ask you about the liquidity crisis.

I notice that you say that there is little question that liquidity has been strained both in the financial and the nonfinancial sectors of the economy. Then you go on to make the following conclusion:

In isolated cases corporations can encounter serious temporary financial problems despite favorable long-term prospects.

Now, the liquidity crisis is tied up in my mind with a crisis of confidence. In short, if because of a temporary liquidity squeeze a thinly capitalized corporation goes down the drain, I thoroughly agree it should go into receivership. That is the essence of the enterprise system.

But there are many companies where that is not the case and where the problem is simply the inability to get money at a time when banking institutions are comparing whom they are going to serve with the limited resources. This is so even though these corporations have water in their capitalization such as to justify receivership.

It may be that putting more money into the system through the Federal Reserve, which I gather is inherently indicated by your statement, will ultimately produce the proper results. It takes a little while for that to find its way through the various arteries into the financial bloodstream.

And so I would ask you whether you would feel that as an interim measure, as a temporary measure, it would be in the interests of the country to do something by way of legislation to give the United States either lending or guarantee authority in order to deal in individual cases with this very serious problem which, notwithstanding that it is interim, could easily bring the house down if enough companies were wrecked as a result.

Secretary KENNEDY. I would like to make a few comments on that, if I may. A few months ago there were indications that quite a number of companies and institutions were having difficulty in finding funds. Part of it had been the result of a restrictive monetary policy over an extended period of time.

Part of it, of course, had been a changing pattern that had been growing over the years in corporate management. They had been relying in many ways on less liquidity and more ability to borrow short-term funds. Some of them had perhaps overextended in short-term obligations. Their funds had been placed into long-term developments or commitments.

But be that as it may, in recent months or recent weeks, through the Federal Reserve's activities, the banking system has had more funds available to it. The drain on Eurodollars has been lessened. Their funds have increased through a change in the regulation at the Federal Reserve which permitted them to increase the rate on short-term certificates of deposits in the larger denominations.

It seems to me that, even with the impact of the Penn Central failure, the market and the banking system has responded admirably to the pressures and those were severe. The commercial paper market has been adjusting very well. The banking system has been making credit available to the corporations as maturities of paper came along, and so far it has moved in a very orderly way.

That does not say, Senator, that there may not be individual cases where something should be done. Within the Government we have, of course, very little leeway, as we found when we started working on the Penn Central. The Defense Production Act offered one area.

In the small business area, maybe the Small Business Administration can take care of certain things. The Federal Reserve has some powers.

It seems to me this is one area we should look at, and I think we shouldn't do it very casually but very carefully because it is not the place of government to step in and, as you indicated yourself, to take care of those whose earnings and whose financial operations are such that it is a rescue operation, unless it is regulated or some kind of industry that requires that.

So, I think it is one that we should look at very carefully. We have been in discussion with Chairman Burns of the Federal Reserve and we have been looking at this matter, and we will further. I will not say at the moment that it is as serious as it was 2 or three months ago. I think gradually the funds that have been—and are being—created through open market operations, or through the discount window that has been opened for the purpose of adjusting the commercial paper market are doing the job at this time. But it requires some further consideration.

In the brokerage area we are moving, as you well know, and we do have proposals in the limited field of railroads for legislation which would permit some action.

Now, further than that we should take a very careful look.

Senator JAVITS. Does the Secretary believe that it would be an important contribution to confidence in the system if it was felt that important operations—production and movement of goods and services, and so forth—would not be stopped by any temporary absence of liquidity? To me the grave aspect of the Penn Central crisis was not that the Penn Central was going through the wringer in 77(b). It was the fact that there was a danger of material stoppage of railroad transportation. It is the same with many other companies.

As I said before, the United States is not a guardian for security holders who bought their stocks with their eyes wide open, with SEC rules of disclosure, and so forth. But I think we do have the duty as a Nation to see that a temporary liquidity crisis does not prevent the Nation from producing and moving the goods and services that are its life's blood.

Would the Secretary agree with that?

Secretary KENNEDY. I would agree with that. I would be very careful, Senator, in not indicating that we have a liquidity crisis where you could touch off more problems than we would solve in this process. I think one danger in this, if you start a major effort in this field, is that the psychology of it could very well in a period of adjustment such as we are going through, touch off a lack of confidence rather than an actual giving of confidence. I think it can be done so that confidence is given and that is what you are directing your efforts to and that is what I would like to work toward.

Senator JAVITS. Would the Secretary say that the mere fact that we are now discussing this seriously, and that it is within the projection of governmental policy, could itself have a beneficial effect upon loosening up the banks?

Secretary KENNEDY. I should think it would. I should think this would have an effect of letting the banks and the financial community know that the Government is concerned. We don't want any kind of a liquidity crisis. That causes problems. Our efforts here are to get through with a minimum period of time of adjustment and to as quickly as we can get back to a growth pattern where employment will increase and unemployment will decrease.

Senator JAVITS. Well, I can assure the Secretary that anything I contemplate in legislation will be sure to have that character of restoring and fortifying the confidence which we wish to establish.

Secretary KENNEDY. Thank you very much.

Senator JAVITS. Thank you, Mr. Chairman.

Senator PROXMIRE. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Secretary Hodgson, what are the current figures on the unemployed? How many in total last reported?

Secretary HODGSON. I believe, roughly 3.9 million.

Representative WIDNALL. And of that 3.9 million, how many are in the category of hardcore unemployed?

Secretary HODGSON. We don't keep unemployment on that basis. We do have some breakdowns of the sex composition, race composition, and that kind of thing.

Representative WIDNALL. Don't you have any kind of a compilation that would show how long people have been on the unemployed rolls?

Secretary HODGSON. Yes. We have how long they have been on but not whether they are disadvantaged or hardcore or not. If you mean by hardcore the length of time in unemployment, then we can give you some information. I thought you meant what is commonly discussed in manpower as hardcore unemployed, which are those that come from disadvantaged circumstances. Just a moment and I will give you some figures.

Representative WIDNALL. Disadvantaged and handicapped.

Secretary HODGSON. Right. The average number of weeks unemployed, as I said in my prepared statement, at the present time is 9.5 weeks.

Then there are at the present time a group of people that have been unemployed 15 weeks or more that we keep track of; 658,000 have been unemployed 15 weeks or more.

Representative WIDNALL. Do you have any figures on how many have been unemployed for 6 months?

Secretary HODGSON. 232,000.

Representative WIDNALL. Nine months?

Secretary HODGSON. No. 26 weeks or 6 months is the longest figure we keep.

Representative WIDNALL. Now, has that figure been mounting in the last 6 months?

Secretary HODGSON. It has gone up, yes, sir.

Representative WIDNALL. Do you have any comparison with 6 months ago?

Secretary HODGSON. In 1969, an average of 19.8 percent of those drawing unemployment compensation stayed on unemployment compensation until it was exhausted. That average is now running at 21.7 percent. That is slightly above last year's figure.

Representative WIDNALL. The unemployed force is constantly shifting, so that many times you might have, say, 3 million unemployed at one period and 3 months later have 3 million unemployed, but the complexion of it would have changed completely, isn't that so?

Secretary HODGSON. That is very true, and it is particularly true in a time of transitional unemployment like the present.

Representative WIDNALL. Many times the figures are more horrendous than the actualities.

Secretary HODGSON. Well, they have to be interpreted on something more, as I said earlier, than just a straight percentage basis. One has to examine some of the things that you have just examined.

Particularly we feel the average length of time of unemployment is significant. As I mentioned earlier, 9.5 weeks is a slight increase, but only a little more than a week increase on the unemployment rolls, as compared with those unemployed 6 months or so ago.

In some of the earlier downturns, this period of time on unemployment was at the 16- or 17-week level.

Representative WIDNALL. I wasn't here for your entire testimony. Did you give an estimate of what you believe the unemployed figures will be or the percentage of the labor force unemployed?

Secretary HODGSON. No, I didn't.

Representative WIDNALL. For October 1?

Secretary HODGSON. I didn't. In Senator Proxmire's letter to me he pointed out that I was in one place reported as having made an estimate that unemployment might go as high as 5.6. This is the result of the following kind of interchange with the press.

At the time, I said I had not really the slightest idea how high unemployment would go, that I felt it would go somewhat higher, but whether that would be 5.2, 5.4, 5.6, I didn't think I or anybody else could tell. This became translated into the fact that I had predicted that unemployment might go as high as 5.6.

I must tell you, Congressman, I don't know how high unemployment is going to now. I don't know this for a number of reasons: One is that the predicting of things of this kind is apt to be highly fallible.

The second is that unemployment is expressed in percentage terms and as I indicated earlier, it is a percentage of an unpredictable figure, which is the figure of the number of people who will be in the labor force looking for work. We don't know what that figure is going to be. So I can only estimate that there may be some slight rise in unemployment but I do not think it can be predicted with accuracy by myself or almost any other person.

Representative WIDNALL. In the current figures it is true, isn't it, that there is a higher percentage of skilled unemployed workers on the unemployment rolls than there was 3 to 6 months ago?

Secretary HODGSON. Well, one of the things that we noticed in the layoffs occurring in the early part of this year, particularly because of the defense cutbacks, was that large numbers of highly skilled and technical people were laid off during that period.

However, the percentage of unemployed among that group, professional and technical group, is only 2.4 percent at the present time, which really isn't very high.

Representative WIDNALL. Secretary Kennedy, you analyzed the U.S. balance of payments situation and in that you painted a relatively optimistic picture of our current accounts and a pessimistic one of our capital accounts. What do these developments imply for our policy choices in the months ahead?

Secretary KENNEDY. Well, I think it means that we cannot make relaxation of the controls that we have in this field. I think it means that as we see the movement in interest rates that we may have some shift of funds that we will have to be concerned with.

The area where we are putting the greatest effort, of course, is on our trade balance. As I indicated in my statement, that is both short-run and long-run. In that short-run period we are showing improvement, very large improvement. In part it is as I indicated, the result of inflation abroad where they are importing from us, we are exporting to Europe, and that could change.

One of the features that we are noticing in this adjustment period, where we in times past have usually had a substantial reduction in imports, in this period imports have been holding up very high.

We are moving in these areas to make sure that we do have our financing of exports competitive with Europe or the industrial nations through our Eximbank. We are also trying to get through the Congress our DISC proposal, which has been tentatively approved by the House Ways and Means Committee and which will give us, I think, help in the export field from home base operations and help employment here, too.

On the capital side, our money markets, and so on, are now more favorable and what the corporations will do with respect to their financing will depend on individual situations. You must bear in mind that we now have large multilateral corporations that can borrow in any market and they in the past, because if tight funds here, have been borrowing in European markets for their needs on the international operations. They can well change their programs and policies and borrow in our markets for export capital.

For this reason, we are not able to liberalize, although we would like to take off all restraints, but we cannot at this period of time.

Now, I am sure that Mr. Volcker who is following this very closely may want to make a comment in this field because he lives and breathes it every day here.

Mr. VOLCKER. I don't think I have anything to add, Mr. Secretary, except to note that the relative optimism that Mr. Widnall noted about the current accounts does refer to a short-run situation. I think this is the major problem for the longer run and the basic answer has to be doing a better job on inflation and competitiveness in this country.

Representative WIDNALL. Well, isn't it implied that we should strive to maintain a high interest rate structure in order to attract and maintain investment capital here?

Secretary KENNEDY. No. I think that there is a relative balance of interest rates and that no longer can world rates be in disequilibria. We found that when our adjustment was taking place and our monetary policy was restrictive and interest rates were going up here, it in effect pushed up Eurodollar rates and caused rates abroad to go up.

So that there is now in the international monetary system some balance of rates that has to take place because if our rates are low and other rates are high, money will find that level.

Representative WIDNALL. I just have one further question. Isn't today your birthday? [Laughter.]

Secretary KENNEDY. It surely is. This is a good place to celebrate a birthday, isn't it?

Representative WIDNALL. I would like to wish you a happy birthday. The best of health and success.

Secretary KENNEDY. Thank you.

Representative WIDNALL. And continued fine service to the American people.

Secretary KENNEDY. Thank you.

Senator PROXMIRE. I think it is a very good place to celebrate a birthday, and I think you have celebrated it very well. You have done a fine job.

I would like to ask a question which I can't resist asking. I am outnumbered this morning. There were three Republican committee members here. I am the only Democrat. There are five or six or seven very fine and able members of the Republican Administration here fighting hard for the Republicans.

The question was asked in a vein of—I wouldn't say sarcasm, of irony, at least, that they don't know what the Democratic Congress will do with the administration's request for the budget restraints in an election year. I would like to go back and point out that in the last 26 years the Congress has cut the budget 26 times. Every single Eisenhower budget that came before a Democratic Congress was cut, that the Nixon budget last year was cut, the Nixon budget this year is going to be cut again in spite of the fact that the President is belaboring Congress for spending.

I would like to ask for your help, Mr. Secretary. I know you can't help us perhaps in cutting the military budget or space budget or cutting out the SST, although you tried nobly in that area, these people in your department have, but I would like to ask you and Mr. Hodgson to cut in another area where you can help.

Last year we cut the Treasury budget, and last year we cut the Labor budget. We would like to do it again, and with your help I think we can.

Now, if you will come forward with your very understandable feeling that we should exercise restraint and cut down Federal spending in the area where you are responsible and ask Congress to cut below your original estimate, if both you gentlemen will do that, I think the Congress would be in good position to accomodate you.

Secretary KENNEDY. I think the odds are pretty good. For one against three you are doing very well.

Senator PROXMIRE. Well, I am serious about this. I do think if we are going to exercise restraints, we are going to cut the Interior——

Secretary KENNEDY. That is right.

Senator PROXMIRE (continuing). State, Justice, and Commerce Departments. We will cut them. There is every indication we will cut. If we are going to cut the budgets, we have to get the heads of the departments to come up and help us reduce them.

Secretary KENNEDY. We will give you help in cutting the budget, I assure you of that.

Senator PROXMIRE. Somebody else's budget.

Secretary KENNEDY. Surely.

Senator PROXMIRE. I would like to say to you, Mr. Hodgson, that silent "g" is silent once again.

Secretary HODGSON. Not really. I was just sitting here wondering how we are going to do this with mirrors. You know, 95 percent of our budget is for these manpower programs you want us to increase, and yet we are supposed to come up here and cut the budget, and it is going to be a little bit of a problem, but we will work at it.

Senator PROXMIRE. That is exactly the point. Every department has something that is important for all of us, and it is very, very hard to make these cuts.

I would like to ask about a figure you gave in response to, I think, Congressman Widnall or Senator Javits on unemployment. You said unemployment was 3.8 or 3.9 million.

Secretary HODGSON. 3.9 million.

Senator PROXMIRE. Well, what I have from your department here is that unemployment in June of 1970 was 4.669 million. Now, those are not seasonally adjusted. Seasonally adjusted you are right, 3.9.

When you talk about the people that are out of work, whether it is seasonal doesn't help them very much. The fact is that there are 4.669 million.

Secretary HODGSON. You are 100 percent right. One never knows how people want to have that question answered.

Senator PROXMIRE. Yes, I understand that.

Secretary Kennedy, I would like to return just a moment to the question of defense spending briefly, because it is so important. In yesterday's press conference the President said the defense budget "has been cut" by $1.1 billion less in 1970 than it was the previous year. But you have just told us that the figures for 1970 won't be available until next week.

Now, was the President referring to the forecast for fiscal year 1970 when he said the defense budget has been cut by $1.1 billion or were you inaccurate when you said the figures won't be available for another week?

Secretary KENNEDY. The final figures are not available. I don't know—could that be the budget estimate?

Senator PROXMIRE. This was based on forecast and estimate and not on the basis of what is actually developed and determined.

Secretary KENNEDY. We will have to check that.

(The following information was subsequently supplied for the record by the Department of the Treasury:)

The $77.1 billion expenditure total by the Department of Defense (military functions) for the fiscal year 1970 represents a reduction of $777 million from the total for the fiscal year 1969.

Senator PROXMIRE. All right. Just one other question: I would like to ask you, Secretary Kennedy, in view of the administration's often-expressed fears that Congress is going to spend too much and as a result we are going to be in an inflationary situation again, how would you feel about a proposal to give the President the authority to raise taxes under these circumstances, and I suspect the only way you could get that through the Congress would be to let Congress lower them.

Secretary KENNEDY. Well, I know this has been a matter of consideration to have some——

Senator PROXMIRE. Give him discretion within a certain area, a year, 5 percent, 10 percent, surtax, something like that.

Secretary KENNEDY. I think a strong case could be made for such a proposal.

Senator PROXMIRE. I am serious about giving Congress the right to reduce them because this is a congressional right we wouldn't like to surrender.

Secretary KENNEDY. Well, I don't know what the administration's position would be on it. We would have to talk about it. But my feeling is that taxes are not now a flexible instrument for adjustment in the economy. It takes too long, is too difficult, and many times tax legislation can turn out to go in different directions because of pressure groups and various considerations, and if there were some way of having a percentage adjustment within some reason, it could have been very helpful in times past and it might in the future. At the present time it would not perhaps be used because we are in this period of adjustment, but at some period in the future it would be.

Senator PROXMIRE. Mr. Brown?

Representative BROWN. Secretary Kennedy, I am fascinated by the Chairman's comment on the fact that Congress has been so economy minded over a period of years and I wonder if we could get from you or from some other source comparisons of the administration's budget proposals as they have been presented and the action which Congress has taken which affects spending, appropriations, or the bills that add to appropriations spending over recent years?

Secretary KENNEDY. Yes, we would be glad to put a table in the record. It goes back to that old scorekeeping thing of Congress versus the recommendations of the administration, and one of the difficulties in a case like that is that in the course of action conditions change, and you may very well have a bill come out and then who takes credit for this, that, or the other.

Now, Mr. Weidenbaum is itching to say something here. He contends that this is not the case.

Senator PROXMIRE. I always thought you were a Democrat, Mr. Weidenbaum.

Mr. WEIDENBAUM. I am pleased to have the opportunity to correct that. I am a loyal, long-term Republican, Mr. Chairman.

Senator PROXMIRE. Sorry to hear it.

Mr. WEIDENBAUM. Proud to be a member of this Republican administration.

Representative BROWN. It depends on what figures you are going to come up with, Mr. Weidenbaum. [Laughter.]

Mr. WEIDENBAUM. I call the committee's attention to the Congressional Record for July 16th, a statement by the Honorable George Mahon, Chairman of the House Appropriations Committee, in which he inserts tables showing congressional action on the President's budget and he has a table here showing for the fiscal year 1971, congressional actions on budget authority as of the date of that report.

According to Congressman Mahon, the House increased the appropriations requested in the President's budget by $7,486,977 billion.

The Senate was a bit more parsimonious. I will come to your defense, sir. The Senate only raised the President's budget by $4,335,950 billion. I would be pleased to make this available for the record.

(The following information was subsequently supplied for the record by the Department of the Treasury:)

SUPPORTING TABLE NO. 1.—EFFECT OF CONGRESSIONAL ACTIONS DURING THE CURRENT SESSION ON INDIVIDUAL BILLS AFFECTING BUDGET AUTHORITY AND OUTLAYS (EXPENDITURES) (AS OF JULY 9, 1970)

[In thousands of dollars]

Items acted upon	Congressional actions on budget authority (changes from the budget)			Congressional actions on budget outlays (changes from the budget)		
	House (1)	Senate (2)	Enacted (3)	House (4)	Senate (5)	Enacted (6)
Fiscal year 1971:						
Appropriation bills (changes from the 1971 budget):						
Labor, Health, Education, and Welfare, and related agencies, 1970 (H.R. 15931, Public Law 91-204)				[1] +248,000	[1] +248,000	+248,000
Education (H.R. 16916) [2]	+319,590	+966,047	([3])	+215,000	+567,000	([3])
Legislative branch (H.R. 16915)	−9,394	[4] −7,540		−8,750	[4] −7,000	
Treasury, Post Office, and Executive Offices (H.R. 16900)	−73,053			−65,000		
2d supplemental, 1970 (H.R. 17399 P.L. 91-305)				−19,700	−200,300	−273,000
Independent Offices and Department of Housing and Urban Development (H.R. 17548)	+173,389	+1,186,796	([3])	−114,650	+89,000	([3])
State, Justice, Commerce, the Judiciary and related agencies (H.R. 17575)	−136,949			−50,000		
Interior and related agencies (H.R. 17619)	−731	−4,637	([3])	−3,350	−2,300	([3])
Transportation and related agencies (H.R. 17755)	−36,235			−34,700		
Foreign assistance and related agencies (H.R. 17867)	−665,578			−150,000		
District of Columbia (H.R. 17868)	−150	−150	[5] −150	−150	−150	[5] −150
Agriculture and related agencies (H.R. 17923)	−81,587	+727,581	([3])	+105,800	[6] +635,000	([3])
Military construction (H.R. 17970)	−137,763			−11,000		
Public Works and Atomic Energy (H.R. 18127)	−26,625					
Subtotal, appropriation bills	−665,086	+2,868,097	−150	+111,500	+1,329,250	−25,150
Legislative bills with "backdoor" spending authorizations (changes from the 1971 budget): [7]						
Emergency home financing (S. 3685)	+1,500,000		([3])	([3])		([3])
Alaska Omnibus Act extension (S. 778)		+851			([3])	
Navajo Road (S. 404)		(+5,000)				
Land and water conservation (Public Law 91-308)	+30,000	[1] +30,000	+30,000			
Unemployment trust fund (H.R. 14705)	[1] +194,000	+194,000	[4] +194,000			
Outdoor advertising controls (S. 1442)		(+15,000)				
Federal-aid highways (H.R. 14741)	(+26,000)					
Urban mass transportation (H.R. 18185)	[4] +2,118,000					
NSLI trust fund for veterans home loans (H.R. 9476)				([7] +1,000,000)		
TVA bonds (H.R. 18104)	[4] +3,050,000					
Subtotal, "backdoor"	+6,892,000	+224,851	+224,000			
Legislative bills with mandatory spending authorizations (changes from the 1971 budget):						
Additional district judges (Public Law 91-272)	−2,370	[1] −727	−727	−2,370	[1] −727	−727
Court leave for Federal employees (H.R. 12979)	([8])			([8])		
Uniform relocation assistance (S. 1)		([8])			([8])	
Employee health benefits (H.R. 16968)	+140,000			+140,000		
Wage board pay revision (H.R. 17809)	[4] +230,000			[4] +230,000		
Defense: overseas mailing privileges (H.R. 8434)	(+8,900)			(+8,900)		
Military lawyers retention (H.R. 4296)	(+7,000)			(+7,000)		

Family separation allowance—residence (H.R. 110)	(+17,000)			(+17,000)		
Family separation allowance—POW (H.R. 9486)	(8)			(8)		
Air evacuation subsistence (H.R. 9654)	(+50)			(+50)		
Dependents' health care (H.R. 8413)	+255			+255		
Reserve retirement—Berlin-Vietnam (H.R. 3813)	(8)			(8)		
Reserve retirement—aviation midshipmen (H.R. 11265)	(8)			(8)		
Public Health Service retirement (Public Law 91-253)	+259	[1] +259	+259	+259	[1] +259	+259
Social security (H.R. 17550)				+1,500,000		
Family assistance (H.R. 16311)	-450,000			-350,000		
Federal lands for parks (reduces offsetting receipts) (S. 1708, H.R. 15913)	(4) (8)	(8)		(4) (8)	(8)	
Postal reform (H.R. 17070, S. 3842)	[9] +891,700	[9] +891,700	(3)	[9] +891,700	[9] +891,700	(3)
Foreign Service retirement (Public Law 91-201)	(8)	(8)	(8)	(8)	(8)	(8)
Veterans' hospital care for 70-year-olds (H.R. 693)	(+7,000)	(+7,000)	(3)	(+7,000)	(+7,000)	(3)
Veterans non-service-connected benefits (H.R. 372)	(+8,538)			(+8,538)		
Veterans education assistance (Public Law 91-219) [10]	[1] +185,500	[1] +185,500	+185,500	[1] +169,000	[1] +169,000	+169,000
Veterans additional $5,000 insurance (Public Law 91-291)	+45,000	[1] +45,000	+45,000	+45,000	[1] +45,000	+45,000
Veterans compensation increase (S. 3348)	+226,481	+114,370	(3)	+226,481	+114,370	(3)
Redefine "child"—(dependency compensation) (Public Law 91-262)		+6,900	+3,552		+6,900	+3,552
Veterans auto allowance increase (H.R. 370)	+938			+938		
Railroad retirement (H.R. 15733)	-7,700	(8)	(3)	-7,700	(8)	(3)
Subtotal, mandatory	+1,260,063	+1,243,002	+233,584	+2,843,563	+1,226,502	+217,084
Subtotal, legislative bills	+8,152,063	+1,467,853	+457,584	+2,843,563	+1,226,502	+217,084
Total, fiscal year 1971 [11]	+7,486,977	+4,335,950	+457,434	+2,955,063	+2,555,752	+191,934
Fiscal year 1970:						
Appropriation bills (changes from the revised 1970 budget):						
Foreign assistance (Public Law 91-194)	[1] -150	[1] -150	-150	[1] -100	[1] -100	-100
Labor, Health, Education, and Welfare and related agencies (H.R. 15931, Public Law 91-204)	[1] +567,000	[1] +567,000	+567,000	[1] +335,000	[1] +335,000	+335,000
2d supplemental, 1970 (H.R. 17399, Public Law 91-305)	-153,957	[1] +122,203	-558,637	-121,300	-84,800	-99,000
Subtotal, appropriation bills	+412,893	-689,053	+8,213	+213,600	+250,100	+235,900
Legislative bills with spending authorizations (changes from the revised 1970 budget):						
Food for needy children (Public Law 91-207)				[1] +30,000	[1] +30,000	+30,000
Veterans education assistance (Public Law 91-219)	[1] +107,400	[1] +107,400	+107,400	[1] +94,000	[1] +94,000	+94,000
Airports and airways development (Public Law 91-258)			+840,000			(8)
Subtotal, legislative bills	+107,400	+107,400	+947,400	+124,000	+124,000	+124,000
Total, fiscal year 1970 [12]	+520,293	+796,453	+955,613	+337,600	+374,100	+359,900

1 Reflects conference or final action for comparability.
2 $425,000,000 budget authority ($212,000,000 outlays) for impacted area school aid. carried in budget as "proposed legislation," is regarded as budget appropriation request for scorekeeping purposes although no formal amendment has been transmitted.
3 Subject to or in conference.
4 Committee action.
5 Pending signature.
6 Does not reflect outlay effect of $20.000 payment limitation.
7 "Backdoor" refers to budget authority and outlays provided in basic legislation not requiring further appropriation action.
8 Not available.
9 Reflects retroactive pay and ½-year delay in rate increase.
10 Congressional increase of $185,500,000 subsequently included in budget amendment (H. Doc. 91-312).
11 Excludes actions taken in previous session, shown in parentheses above.
12 Does not reflect provision of $300,000,000 for food stamp program to be charged against 1971 Agriculture appropriation bill. Reflects points of order on the floor against foreign military credit sales and emergency school assistance.

Representative Brown. I have known Chairman Mahon for about 30 years, somewhat longer than I have known Senator Proxmire, so I must say that my tendency is to ride with Chairman Mahon, although I am not on his committee. Maybe I ought to be more interested in riding with Senator Proxmire on this issue.

As a relatively new member of Congress I have to observe that the Chairman of the committee is never outnumbered. [Laughter.]

So I should be very careful. But I would like to get from the Treasury—maybe I ought to take a nonpartisan source—the Joint Committee on Reduction of Federal Expenditures. Maybe we can get some information from them, too, and see if we can resolve this argument.

Secretary Hodgson, may I get into another area to follow along Mr. Widnall's questions: The statistics on employment—we have a subcommittee in this committee that is supposed to go into that and it may be inappropriate for me to get into the question in too much detail—I would like to ask you what do you do with wives who lose their jobs and then decide that they are not going to seek employment after their unemployment compensation runs out, or conversely, with a wife who decides to seek employment who actually is in the labor market, actually seeking a job, but dosn't register with the United States Employment Service?

What do you do with a veteran out of service who lays off for a few months and decides he is going to go to school, take advantage of his GI bill of rights? What do you do in fact with students who are in school and quit to join the labor market or quit school to join the service and actually are in the labor market picture?

How do you resolve those problems in the statistics that you have?

Secretary Hodgson. Any country that is trying to measure what its unemployed contingent is has the problem of making decisions in this kind of thing. In the United States a person must be able to work and looking for work to be listed as in the work force, and if they are able to work and looking for work and are not employed, then they are counted as unemployed.

So you can see there can be categories of people that are not included in that figure who yet are actually unemployed, and the contention is frequently made there may be some in that figure who indicate they are able and looking for work but who really aren't, and they possibly aren't unemployed in the traditional sense.

So these things to some extent balance each other out.

We think over the years the way we have measured the unemployed in this country is about as accurate and as well done as any Nation in the world is doing.

Representative Brown. What is the degree of accuracy? What is the give or take range?

Secretary Hodgson. I will ask Mr. Moore. I brought with me Commissioner Moore of the Bureau of Labor Statistics, who is our economist in residence in the Labor Department, and he will give you the answer.

Mr. Moore. Well, I would first like to add to the Secretary's answer regarding people who have been discouraged by the job market and are not seeking work because they think they can't find work. We do collect statistics on people who want a job and have been unable to find it and have dropped out of the labor force for that reason, and the figures I have seen recently show something over 500,000 in that group, according to the most recent count, but it has not increased appreciably over the last year or so.

It has remained in the neighborhood of 500,000 to 600,000 in almost every survey that we have taken.

There is that large number of people that have become discouraged in their efforts to find a job.

Now, on the matter of accuracy, we do publish figures on the sampling error or sampling variability of the unemployment statistics. I don't have them at hand. I would certainly be glad to supply them for the record. But they do reflect the fact that the unemployment figure we get, and the employment figure as well, is based on a sample. It covers about 50,000 households in the country every month, which is a pretty large number, so we think we do get reliable estimates from such a large sample. But it doesn't cover the millions of people that are actually employed or unemployed. It is a sampling procedure and, hence, it is subject to error for that reason.

(The following information was subsequently supplied for the record by the Department of Labor:)

TECHNICAL NOTE ON SAMPLING VARIABILITY OF UNEMPLOYMENT RATE

The range of sampling error of the overall unemployment rate is related to the statistical reliability that is required. The more stringent the requirement is, the wider is the range of sampling error. The sampling distribution is such that one "standard error" gives 68 chances out of 100 that the overall unemployment rate will be within the error range of plus or minus 0.1 percentage point. Within the Bureau of Labor Statistics, it is customary to use 90 percent confidence limits; in this case, there are 9 chances out of 10 that the rate will be within the range of plus or minus 0.16 percentage point. That is to say, a change must exceed 0.16 percentage point to be deemed significantly statistically. However, the statistical reliability of the overall rate in any one month must also be judged in the light of other economic developments.

Representative BROWN. That is to confirm what you have in available statistics, isn't that correct?

Mr. MOORE. No. That is the basic source of the unemployed percentage rate which is from the sample survey that the Census Bureau conducts.

Representative BROWN. But the range of error in that—what is the range of error? In other words, when we say there are 3.8 or 4.2 percent, or 4.9 as opposed to 5.1 percent unemployed, how right is that? How many decimal points do we really work that out to?

Mr. MOORE. Well, I would say it is within a very few decimal points. One of the reasons for error, besides the sampling, is that we do make adjustments for seasonal variations. The number of unemployed regularly is larger in the summer months than it is the rest of the year, and, to get a better estimate of the long-run situation, we eliminate those seasonal variations as best we can. We can't do it perfectly at the time, so we revise the seasonal adjustments the following year, and that may make for a few tenths of a percentage point difference in the published rate. But it is limited to a few decimal points.

Representative BROWN. One of the things that happens in Federal employment is when a GS-11, say, loses his job in an RIF procedure of Federal employment cutbacks, the law provides that if there is a job available for him, he can hold his salary at a different kind of job, a lower level job, for a period of time.

So he may have a GS-11—whatever GS-11 is now, $13,000 or $14,000 a year—filling the slot of a GS-3 or GS-4 at $5,000 or $6,000 a year, compensated at his previous rate but actually doing less sophisticated work, and I would assume that this happens in the private area, too.

Now, is that in anyway covered in the statistics that are available?

Secretary HODGSON. In the private area that process is usually known as red circling. In red circling you are in a job but you aren't performing the full range of skills required by that job but you are still being paid at a previous rate, so that is the term that is used for that.

The question is, does that kind of pattern show up in the unemployment statistics. No, it does not. I would like to say, Congressman, I am interested in the fact that you have this subcommittee. We in the department are very concerned about the unemployed, who the unemployed person is, where he is, what patterns of unemployment exists, what can be done about it, and we would be very happy to work with you extensively in trying to exchange information and piece together whatever additional data would be helpful to you.

Representative BROWN. Thank you very much. My time is up.

Senator PROXMIRE. Mr. Widnall?

Representative WIDNALL. Nothing further.

Senator PROXMIRE. I just have a couple of more questions. The hour is late and I know that Secretary Kennedy is enjoying spending his birthday with us, having a birthday party with the Joint Economic Committee, but I guess we can overdo it. So I will make——

Secretary KENNEDY. I can't eat cake because it is too fattening.

Senator PROXMIRE. Well, speaking about being too fattening, Mr. Weidenbaum, I want to get back to your——

Mr. WEIDENBAUM. My wife says the same thing. [Laughter.]

Senator PROXMIRE. The figures you gave us are what Mr. Mahon put in the budget for budget authority for fiscal 1971 on the one hand, and you didn't mention the actual enactments, what the actual enactments are. In budget authority there are three big items. One is the Emergency Home Financing Act which the House passed at $1.5 billion. We just finished conference. I was on the conference.

The Senate had a different approach which the administration enthusiastically supported. The Senate prevailed and I think you will find that President Nixon will enthusiastically sign that bill and he favors what is provided in that.

Mr. WEIDENBAUM. Yes.

Senator PROXMIRE. Now, the second big item is urban mass transportation, $2 billion. Now, this is—it is true this is also—it passed the House above what the President requested but it is for a long period. It is over a ten-year period.

Then you come to TVA bonds, $3,050 hundred thousand and that also is something which I think both of us would agree is not of the same nature of expenditure as the general appropriations are.

When you come to appropriations, actual appropriations enacted, it is true that the Congress is now $191 million over the President. That is $191 million and we haven't begun to consider the defense budget which we have cut in the past, and I am sure we are going to cut again, and the Armed Services Committee in the Senate has cut very sharply, more than a billion dollars below the President, already.

So I think when all these are added up we can still make the case in 1971 we are below the President. And you haven't touched the fact that 25 years of Presidential requests, the Congress has in every single year been below the President.

Mr. WEIDENBAUM. I suggest, Mr. Chairman—you now have my copy. I am at a disadvantage.

Senator PROXMIRE. That is the reason I asked for it [Laughter.]

Mr. WEIDENBAUM. Would you look at the table for the fiscal year 1970 that Mr. Mahon inserted? It is directly below—it is the bottom part of that table. I think if my memory holds me correct, that the Congress did increase the President's request a bit in 1970.

Senator PROXMIRE. Well, the totals that we have used again and again, and Mr. Mahon seemed to support that, every Republican in the Senate agreed, that we had cut the President's request overall by $5.5 billion in 1970.

Mr. WEIDENBAUM. I must recall at the time that the Administration first made the cuts in the program, Secretary Laird first announced the massive reductions in the defense budgets and then only because of delays in the appropriations process, later on were the reductions in the defense appropriations forthcoming.

In a sense you could say, I believe, that they ratified the reductions in defense spending made previously by this administration.

Senator PROXMIRE. Well, we could argue on and on. My feeling was that Secretary Laird recognized the inevitable [laughter] and I would like to give credit primarily to Mr. Mahon. Mr. Mahon made it clear that he was going to act and use his very great influence in the House to cut the defense budget. He did cut it, very, very sharply. We cut it a little bit further in the Senate, but he deserves the principal credit.

The fact is, however, on the basis of the bookkeeping which the administration seems to accept, we did cut sharply below the President's request last year, and it is interesting that you have a table here which indicates somehow that we are above it.

It is the first one I have seen, but I would like to go into and consider that more thoroughly.

I am advised that no other administration official has had the ingenuity and perspicacity. I suppose it is because it is Secretary Kennedy's birthday that you gave him this present.

Well, if there are no further—Mr. Brown suggested the chairman is never outnumbered. The one thing the chairman can do is end a meeting.

So, having had the last word, I will say that we will reconvene tomorrow morning at 10 o'clock to hear three very distinguished economists.

(Whereupon, at 12:50 p.m., the hearing recessed, to reconvene tomorrow, at 10 a.m., Wednesday, July 22, 1970.)

APPENDIX

(The following additional questions posed by Chairman Patman and answers thereto were subsequently supplied for the record by the Department of the Treasury:)

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. The question of adequate liquidity for basically sound firms is one to which both the Congress and the Administration should give attention, but it would be inappropriate to conclude either that the economy faces big troubles from this source or that current or proposed facilities are inadequate to deal with the problem.

In the latter respect, the powers now held by the Federal Reserve System, the Small Business Administration, the Defense Department under the Defense Production Act, and other authorities should be carefully evaluated before new departures are proposed. The Administration's proposal to guarantee loans to railroads is a worthy example.

Thus far, the private financial system—particularly the commercial banks—has been able to finance sound credits in a satisfactory manner. Their ability to do so has been greatly aided by Federal Reserve actions with respect to discount policy and in relaxing Regulation Q.

Before additional steps are taken, a number of important questions will have to be thought through. For example—

How far does Government responsibility extend when part of the difficulties of a firm appear to stem from the Government's regulation of that industry? To what extent should "de-regulation" be considered?

Is any effort to "bail out" such firms properly viewed as an effort to protect its owners, managers and creditors? Or can other public interest factors be identified and, if so, how?

If the Government assumes "bail-out" responsibilities, it will insist upon protecting itself through some type of reporting and/or regulation. To what extent can these activities be carried out without undermining the very strength of our free enterprise economy?

What are the budgetary implications of establishing such a facility?

How could such a facility be established in a manner that would not impair the proper adjustment process as the economy shifts from one stage of activity to another?

These are only a few of the difficult questions that arise.

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. There is no doubt but that the overly rapid expansion of the economy after 1965 pushed interest rates to levels that are too high. Rates will come down as more and more people are convinced of the Administration's determination to stop inflation. The increasingly evident signs that the anti-inflation program is working have in recent weeks contributed to strength in bond markets. (See table.)

The Congress can join the Administration in its fight against inflation by joining with the President in his efforts to maintain fiscal responsibility.

MAJOR INTEREST RATE SWINGS IN 1969 AND 1970

	1969 yield range				1970 yield range				Latest 1970 July 31
	High		Low		High		Low		
	Date	Yield	Date	Yield	Date	Yield	Date	Yield	
Treasury bills:									
3 months	Dec. 29	8.08	Apr. 30	5.87	Jan. 16	7.93	Mar. 24	6.08	6.38
6 months	do	8.09	do	5.96	Jan. 5	7.99	Mar. 23	6.18	6.48
12 months	Nov. 24	7.86	Jan. 16	5.86	Jan. 30	7.62	Mar. 25	6.22	6.53
Treasury coupons:									
1 year	Dec. 29	8.40	Jan. 20	6.16	Jan. 2	8.28	do	6.73	7.00
3 years	do	8.51	do	6.02	Jan. 7	8.42	do	6.87	7.51
7 years	do	7.77	Jan. 16	6.09	May 26	8.12	do	6.98	7.56
Federal agency:									
1 years	Dec. 30	8.76	Jan. 20	6.33	Jan. 2	8.75	do	7.50	7.58
3 years	Dec. 31	8.55	Jan. 28	6.53	do	8.54	do	7.75	7.95
New Aa corporation bonds: (Treasury series) [1]	Dec. 5	9.29	Jan. 24	7.27	June 19	9.90	Feb. 27	8.72	[2] 8.98
New municipal bonds: (Bond buyer series)	Dec. 18	6.90	Jan. 23	4.82	May 28	7.12	Mar. 12	5.95	6.40
New home conventional (FHA series)	December	8.36	January	7.53	March	8.57	January	8.54	[3] 8.54

[1] Series based on issues with no-call protection, for 5-year call protected issues deduct (at present time) approximately 25 basis points.
[2] Preliminary.
[3] June.

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 provisions 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 administration has been vigorously pursuing a wide range of policies to improve the availability of funds for home mortgages. Federal agencies and Government-sponsored institutions provided $8.7 billion to the residential market last year. During the first quarter of this year, their activities financed slightly more than 60 percent of the entire growth in residential mortgages.

We have initiated a voluntary program under which pension funds, commercial banks, and other investors are being encouraged to increase their mortgage financing operations. Those institutions have pledges to channel about $2 billion of additional funds into home mortgages. We believe such voluntary cooperation by a wide range of investor groups is preferable to a legislative requirement that certain of these groups invest a fixed percentage of their assets in a particular type of housing security. Experience has shown that such rigid requirements lead to serious distortions in the allocation of resources.

Moreover, on May 19 we offered $400 million of mortgage backed securities, which are guaranteed by the Government National Mortgage Association and are especially suitable for investment by pension funds. We are hopeful that this approach to encourage pension funds and other investors to broaden their participation in the mortgage market will help to effect more stable and healthy conditions in home finance.

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 Department of Justice has provided an answer to this question.

Question 5. Unemployment is 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. Current levels of unemployment are reflecting the effects of two difficult adjustments. The economy is recovering from a most severe inflation. At the same time, we are successfully making the transition from a wartime to a peacetime economy. Over 400,000 military and civilian employees have been released in the past year from our armed forces, and defense cutbacks have led to a reduction in the labor force of defense plants by 300,000. The transition to a more civilian-oriented economy is surely welcome to all Americans. But it does cause some temporary hardships and complicates the tasks of economic policy.

In addition to the general tools of economic policy and adjustments that have been made by the Department of Labor in its manpower and labor market programs, two special legislative steps need to be taken promptly to ease the transitional burden of unemployment:

Legislation to expand and strengthen the unemployment insurance system.

The proposed Manpower Training Act which would automatically increase manpower training funds at times of unemployment.

Question 6. What should be done about the trend toward forming one bank holding companies? Do you believe 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. We see no reason to stop the formation of one-bank holding companies, but believe strongly that such companies—and especially their acquisitions—should be brought under Federal control. To this end, the Administration in March 1969 submitted a comprehensive proposal designed to draw a firm but reasonable line between banking and commerce.

Last year the House passed one-bank holding company legislation that was far too restrictive, and which would harm financial consumers because of its anti-competitive thrust. Recently the Senate Banking and Currency Committee voted to report a bill which, although not consistent in its particulars with the original Administration bill, would effectively bring one-bank holding companies under Federal regulation. We hope very much that the ultimate outcome of Senate action and the following conference will be a bill closer to the one originally proposed by the Administration.

The question of the source of banks' monetary functions and whether they should "go into competition with their own depositors" is beside the point. The question is what sort of structure and regulation would best serve the public interest, especially the needs of financial consumers.

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 explained in my July 21 statement before the Joint Economic Committee that, while the inflationary process unwinds, it is particularly important that fiscal and monetary policy continue to play a stabilizing role. Continuation of the present directions of fiscal and monetary policy throughout the remainder of the year would seem to be the indicated course of action. For the time being, the responsibility of the executive and legislative branches is to keep fiscal policy in a relatively neutral position. Above all, fiscal policy should not veer off on a sharply expansionary course with the consequent strains this would place on the credit markets.

Signs of better productivity performance are coming into view. Given some degree of restraint in wage demands, this should lead to a substantial lessening of cost-push pressures. The usual process can be assisted by the "inflation alert" and Productivity Commission recently established by President Nixon.

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

WEDNESDAY, JULY 22, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:03 a.m., in room S-407, the Capitol Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Moorhead, and Conable; and Senators Proxmire and Javits.

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

Chairman PATMAN. The committee will please come to order.

In the last 2 days we have heard from the chief economic and fiscal advisers of the Executive. Today we once again ask a panel of eminent private economists to assess the appropriate economic policy mix for the present and near-term future. I should amend that statement to note that one of the panelists today is also senior consultant to the Treasury Department.

I must say that I, for one, have become more convinced as these hearings have proceeded that we have not yet found a solution to the major economic problems facing us today. As I recall, not one witness could assure us that we have the serious unemployment problem under control; we have unnecessarily lost billions of dollars of real output; inflation has not been brought under control; and we are still choking off vitally needed housing and public facilities with usurious interest rates.

We have with us today Dr. Gardner Ackley, former Chairman of the Council of Economic Advisers and U.S. Ambassador to Italy in the Johnson administration; he is currently professor of economics at the University of Michigan; Dr. Paul Samuelson, professor of economics at MIT and one of the most renowned economists in the world; Dr. Henry Wallich, professor at Yale, also a former member of the Council of Economic Advisers and, as I have already mentioned, presently senior consultant to the Treasury Department.

Professor Ackley, I ask you, and the other witnesses, to confine your opening statement to, say 20 minutes, if you can do so without doing violence to your text. The full text of your prepared statement will be placed in the record.

Dr. Ackley, you may proceed, sir, in your own way.

49-774—70—pt. 3——10

STATEMENT OF GARDNER ACKLEY, PROFESSOR OF ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. ACKLEY. Mr. Chairman, it is a pleasure to be back before this distinguished Committee. I shall indeed confine my remarks to a few minutes. My prepared statement would take much longer than that and I shall appreciate having it put in the record.

Chairman PATMAN. Yes, sir. It will all go in. If you desire to enlarge upon your prepared statement when you review your transcript, you may do so by inserting anything additional that you desire to insert.

Mr. ACKLEY. Thank you.

My prepared statement addresses itself to two policy questions: First, the appropriate posture for monetary and fiscal policy; and second, the contribution of voluntary methods of wage-price stabilization to the fight against inflation.

Given the agreed economic outlook—and I think that in its broad outlines it is pretty well agreed at this point—my conclusion about the appropriate posture for monetary and fiscal policy is that we should have more easing of the combined impact of monetary and fiscal policy than we have yet seen.

With respect to fiscal policy I should like to call the committee's attention to some words contained in the statement which President Nixon made last Saturday. He said as follows, and I quote:

> In raising the issue of budget deficits, I am not suggesting that the Federal Government should necessarily adhere to a strict pattern of a balanced budget every year. At times the economic situation permits—even calls for—a budget deficit. There is one basic guideline to the budget, however, which we should never violate: Except in emergency conditions, expenditures must never be allowed to outrun the revenues that the tax system would produce at reasonably full employment.

Now, with minor qualifications, that is a prescription for fiscal policy that I think makes very good sense. Applying that prescription of the President's, I would like to make three points.

One, the budget for fiscal 1971 is now estimated to produce a surplus of $13 billion under full-employment conditions. I suggest that that is not an appropriate budgetary posture for an economy in which there exists currently a gap of about $40 billion between our productive capacity and our current rate of production, a gap which is likely to rise to perhaps $50 billion during fiscal year 1971. That is not, in Secretary Kennedy's terms yesterday, a "neutral budget." And I would suggest that the administration now ought to stop berating the Congress if it fails to pass all of the suggested tax increases that it has proposed, and/or if the Congress should increase some appropriations above the President's recommendations. And I suggest, Mr. Chairman, that congressional leaders might appropriately stop taking pride in the fact that they are cutting budgets more than the administration.

If the gap between our potential output and our actual ouput in fiscal 1971 should be $50 billion, the short-fall of actual revenues below full-employment revenues would be at least $15 billion. If the actual deficit is no greater than that, then the full-employment budget would be in balance, which is the best suggested by the President.

Second, I would hope that the Treasury would stop talking about proposing new tax legislation in 1971: Income tax or excise tax or value-added tax. Given the outlook for the economy, there appears to me at this point little need or justification for a major upward change in our tax rates. It could be justified, it seems to me, only if the economy recovers substantially faster than any economist I know expects; or if our expenditures on social programs should increase more rapidly than I now expect.

Third, on several occasions the President has berated his predecessors for having run a deficit which he says was cumulatively $57 billion during the 1960's, and that this $57 billion cumulative deficit is responsible for all of our present problems. I would hope in view of what he said on Saturday that he would stop referring to this $57 billion deficit. Perhaps he has not been informed that, applying his test, there was a cumulative surplus for the decade of the 1960's of $31.4 billion in the full-employment budget.

To be sure, this is on a calendar-year basis. The President was using fiscal year figures. There is not that much difference. This is based on the national income accounts budget, while the President was using the total budget. But the national income accounts budget is the appropriate one for analyzing the impact of the budget on the economy.

The President's rule about no deficit in the full-employment budget was indeed violated three times in the 1960's, in 1966, in 1967, in 1968, with cumulative full-employment deficits in those 3 years totaling about $23 billon. These deficits were inflationary. They should have been avoided. But for the rest of the decade—seven years—there was a cumulative surplus of $56 billion in the full-employment budget.

On monetary policy, judging by the press, Paul McCracken said to this committee essentially what I would want to say. Given the present economic situation, I believe that the Federal Reserve should be acting in such a way as to keep interest rates trending downward, to assure generous finance for housing, and to supply the needed rebuilding of liquidity. And if this requires an increase in monetary aggregates at a rate in excess of some theoretically predetermined established level—and I think that it does—then I say let it.

Second, I want to say a few words about the contribution of voluntary methods to price stabilization. I am being very selective here, Mr. Chairman. I believe that voluntary methods—"guideposts," "income policies," whatever you wish to call them—can contribute usefully to the fight against inflation. I believe that the rejection of these methods by the adminstration up to this point has cost us appreciably in the price level. I fear that, even now, their hearts are not in it. If so—if they only go through the motions with an incomes policy—I think it will do very little good.

I do have in my prepared statement, Mr. Chairman, a few, what I hope are constructive, suggestions about the use of voluntary methods. If I may, I would like to call them to your attention.

As I have said on many occasions, the principal weakness of the Kennedy-Johnson "guideposts" was the failure to inspire any feeling of responsibility for their success on the part of labor or business. Neither group felt such a sense of responsibility, because neither had participated in the formulation, adoption, operation, or interpretation of the guideposts. Instead, the guideposts were devised by the Council of Economic Advisers and promulgated by the President. They were expected to be "enforced" by the pressure of "public opinion"—an expectation that was almost always disappointed, since the public could rarely see any direct stake in the price of sulphur or the wages of boilermakers, while the press—on the whole—treated the resulting confrontations between Government officials and labor or business leaders as an interesting spectator sport, whose outcome was of no great consequence to anyone except those directly concerned.

It seems to me that a voluntary wage-price restraint program can be made to work mainly to the extent that the leaders of labor and business can be made to feel some commitment to its success. This requires that they be fully involved in recognizing the need for the program, formulating its targets, and planning its overall strategy. I believe that some kind of a stabilization compromise can be negotiated which the leaders of labor and business will, in private, support, and, in public, at least accept. Surely, both labor and business must realize that they are on a treadmill that is getting no one anywhere. Instead, each firm and union feels it has to run ever faster just to be sure that it stands still. I believe that a great many of the leaders on both sides now know that this is a losing game, and that the country's interests, as well as their own, justify their committing themselves to some degree of wage and price restraint—offered in return for a simultaneous commitment of restraint by others—in a pattern of mutual deescalation.

It may not work, but I believe it is well worth a try. However, to sell the idea to business and labor will require leadership by Government officials who believe that the achievement is possible, worthwhile, and not ideologically suspect. I do not know whether that degree of commitment yet exists in the administration.

If it does, then the proposed machinery—a National Committee on Productivity, a President's Conference on Productivity, and professional analytical support from the Council of Economic Advisers—could be effective. If there's is not adequate commitment by the administration, no machinery will work.

I do not contend that a voluntary system can accomplish a great deal. It certainly cannot control an inflation arising from genuinely excessive aggregate demand. Its real purpose, in my view, is to fight a cost-push inflation. Its task is to prevent—or to help slow down—the wage-price spiral: To break the pattern under which rising prices require large wage increases, which in turn push up prices. I believe it can accomplish this task, at least in part.

Let me conclude by summarizing my belief:

That commitment and enthusiasm on the Government side are far more important than the particular machinery used;

That the main objective must be to enlist the support (in private) and the tolerance (in public) for the system on the part of the leaders of labor and business;

That achieving such "consent" is far more important than the theoretical nicety of the standards that are evolved; and

That a voluntary stabilization program can reduce the present unacceptable rate of inflation sooner than would otherwise occur; and, in the longer run, it can permit us to operate our economy at a somewhat lower level of unemployment, or a lower rate of inflation, or both, that would be possible without it

Thank you.

Chairman PATMAN. Thank you, sir.

(The prepared statement of Mr. Ackley follows:)

PREPARED STATEMENT OF GARDNER ACKLEY

I purpose today no detailed analysis of recent economic developments, the current economic situation, or the outlook for economic activity. Nor will I review systematically the whole range of available policy alternatives. Rather, I propose to direct my comments to two questions:

1. What should be the over-all posture of fiscal and monetary policy now and in the months ahead?

2. What can be the contribution of "voluntary methods" of wage and price stabilization to the slowing down of the rise of prices?

I believe that, at this particular time, there is sufficient agreement on the general character of the economic outlook that the answer to neither of these questions requires any detailed analysis of our situation and prospects. I will say only that I have been a relative optimist, expecting that we would avoid a recession of the character of 1949–50, 1953–54, 1957–58, and 1960–61. Preliminary estimates for the second quarter of 1970 were not available at the time this statement was being prepared, but I believe they will confirm my expectation that the low point for real gross national product would be reached in the first quarter. However, I have in the last several months trimmed back appreciably my estimates of the probable extent of the pick-up in real GNP during the final three quarters of 1970. Perhaps I had underestimated the extent and the effects of the intangible lack of confidence, which some feel exists in the business community, that our present political leadership is in full control of the economic situation and knows what it is doing. In any case, I surely did not anticipate the Cambodian adventure, and the shock that it has caused to the confidence both of investors and of consumers. My best judgment still is that we will see a slow revival of economic activity during the remainder of 1970. Yet I cannot rule out the possibility of a severe cutback of investment plans that would bring a renewed decline in the second half and a genuine recession.

POSTURE OF FISCAL AND MONETARY POLICY

However, the weaker economic performance and outlook, and the weakening of my own confidence in recovery, only confirm, rather than alter, the views I have held since last winter on economic policy—namely, that more easing than we have yet had is appropriate in the combined impact of monetary and fiscal policy.

In recent months there has been much beating of breasts in the financial community, the Congress, and the Administration regarding the need to persevere in a highly restrictive fiscal policy stance. In particular, great importance is attached to perserving something close to balance in the Federal budget, regardless of the state of economy. Many seem already to have concluded that economic disaster can be avoided only through a substantial increase in excise or income taxes next year.

I agree with the breast-beaters in attaching great importance to fiscal policy —as they apparently do. That is, I join them in denying that only money counts. I have not abandoned my view—which this Committee will perhaps recall—that *both* fiscal policy and monetary policy are important. I disagree only in what the posture of fiscal policy should now be.

I would support a tax increase only if the economy recovers considerably faster than any economist I know now expects, or if the Federal Government were to spend a good deal more than I now see any reason to believe that it will spend. That is, I could support a tax increase which would lead the Administration and the Congress to increase substantially the planned allocation of resources to domestic social programs: for the rescue of our cities, for education, mass transit, pollution control, manpower training, and anti-poverty programs. But I see very little chance of that happening. And I fear that a tax increase might reduce some of the pressure to restrain spending for defense, space, SST, and agriculture, and could seal the doom of the President's proposals, in his Budget of last January, for desirable cuts in a number of obsolete or low-priority domestic programs.

In short, as of now, I would support a tax increase *to finance added spending on desirable social programs.* I would not support it—as of now—to reduce a deficit that is primarily a symptom of a weak economy, or to permit larger spending on defense.

Regarding monetary policy, I believe that it is important to keep interest rates trending downward, to assure a generous flow of finance to housing, and to supply a needed rebuilding liquidity. If this means, temporarily, accelerating the rate of increase of monetary aggregates above some theoretically predetermined level, then let it!

The last three times I appeared before this Committee, in February and June of 1967 and in February of 1968, I was an urgent propagandist for fiscal and monetary austerity, pleading for enactment of the surtax, which—I am sorry to say—the majority of this Committee failed to recommend either in its 1967 or its 1968 Reports on the President's Economic Report. The whole basis for my position then was that a tax increase was essential to avoid inflation. We are surely still experiencing inflation—at a higher rate than I was probably willing even to predict in 1967 or 1968. Why then am I no longer a supporter of fiscal austerity? To me the reason is clear and simple. Inflation today and in the months ahead does not rest on any excessive demand for the national output, and there is no reasonable prospect that an excess of aggregate demand over our potential output will be generated in the forseeable period ahead. Cutting back the expansion of aggregate demand, through fiscal and monetary austerity, is essential for avoiding or curing an excess-demand inflation. It has little revelance for the "cost-push" inflation which we face now and will continue to face in the months ahead.

The present inflation *originated* in an excess demand, that developed when fiscal policy was far too expansionary during much of the period from 1966 through mid-1968. But that excess has been eliminated. The unemployment rate is no longer at 3.3% but stands close to 5.0%, and no one expects it to fall for some time to come. Instead, almost all economists—I included—expect it to rise. The rate utilization of industrial capacity is low—and falling. In the first quarter of 1970, real output was about $22 billion below our potential. This gap grew in the second quarter and will undoubtedly expand further in the second half.

Given the current and prospective levels of unemployment and capacity utilization, the advance of prices will surely slow down. Not all at once; not as rapidly as we wish. We should not have expected a quick slowing down of price increases, nor that it would come before an appreciable rise in unemployment. The overly optimistic predictions of the Administration, which could not be and were not met, have probably contributed to the wide-spread demands on the part of many persons for full wage and price controls, and on the part of others for a continuance or even tightening of the fiscal and monetary squeeze on economic activity.

The fiscal and monetary policy requirement for stopping inflation was to create and maintain some slack in the economy. That has been done. And this slack will not quickly be reabsorbed as a result of any easing of policy restraints that is presently contemplated. Past policies have already guaranteed a slack economy for some time to come. The Administration may exaggerate the lags in the effects of policy when, after a year and a half, it continues to blame the present economic situation on the acts of its predecessors. But there *is* a lag, and the policies we are discussing in July of 1970 will have more effect on next summer's economy than on this summer's.

Will Inflation Slow Down?

But will the inflation slow down even *with* some continuing slack in the economy? I believe that it will. (I also think that we should help the process along with some supplementary policies. But that is a separate matter. Here I speak only of the effects of the slack alone.) Table 1, below, relates rates of unemployment, averaged by quarters, to rates of change in prices, during 64 quarters from 1954 through 1969. Price change is represented by the implicit GNP deflator for the private nonfarm economy—which I regard as the most suitable index of price change for this purpose—and is measured over the four quarters ending in the given quarter. One of the dividing points for the unemployment rate which I chose for this distribution was a 4.7 per cent—last month's rate of unemployment. The table shows that at rates of unemployment between 4.7 and 5.7 per cent, the average rate of price increase, 1954 through 1969, was only 1.40 per cent a year. It was a bit less—1.26 per cent—for rates of unemployment in excess of 5.7 per cent.

Not only has the average rate of price increase been quite moderate (I regard less than 1½ per cent as moderate) whenever the unemployment rate has exceeded 4.7 per cent, but there were only *two* such quarters when the rate of price rise exceeded 2.0 per cent. Those two quarters occurred during the recession of 1957–58, as Table 2 indicates.

Table 2 demonstrates how, following an inflationary boom, prices begin to decline as pressures on resources ease. However, it also shows that rates of price increase remain high—relative to those which normally prevail at similar rates of unemployment—until a considerable period of time has passed. In 1957–58, there were three successive quarters of high unemployment before the rate of price increase got below 2.0 per cent.

It will be noted that, during the period of the recent inflationary boom, both unemployment rates and price increases averaged less than in 1956–57. However, the length of the inflationary period has been considerably longer this time than in 1956–57, and during this period, the rate of price change was edging upward. Thus, we can probably expect an even longer lag in the moderation of price increases. So far, the disinflationary process has barely begun. Indeed, no decline in the rate of inflation was yet apparent in the first quarter of 1970, when the rate of price increase actually exceeded the average for the preceding three years. And when the decline does begin, I expect it to be even slower than in 1957–58. But the decline will come.

TABLE 1.—RATES OF UNEMPLOYMENT AND OF PRICE CHANGE, QUARTERLY, 1954–69

Average unemployment rate	Number of quarters	Average increase of private nonfarm deflator from one year earlier (percent)
4.00 percent or less	17	3.32
4.01 to 4.70 percent	12	2.45
4.71 to 5.70 percent	22	1.40
More than 5.70 percent	13	1.26
All	64	2.17

TABLE 2.—UNEMPLOYMENT RATES AND PRICE INCREASES, 1956–58, AND 1967–70

Period	Average unemployment rate (percent)	Average increase of private nonfarm deflator from one year earlier (percent)
3d quarter 1956 through 2d quarter 1957 [1]	4.07	3.97
3d quarter 1957	4.23	3.46
4th quarter 1957	4.93	2.91
1st quarter 1958	6.30	2.15
2d quarter 1958	7.37	1.63
3d quarter 1958	7.33	1.42
1st quarter 1967 through 4th quarter 1969 [2]	3.64	3.74
1st quarter 1970	4.17	4.61
2d quarter 1970	4.83	NA

[1] The quarterly rate of unemployment ranged between 3.93 and 4.13 percent, and the rate of price change between 3.70 and 4.14 percent.
[2] The quarterly rate of unemployment ranged between 3.37 and 3.90 percent, and the rate of price change between 2.99 and 4.54 percent.

There is a further question which the historical evidence does not directly help us to answer. Suppose that instead of continuing into full recession—as happened in 1957–58—the unemployment rate should stick for several quarters at around 5 to 5½ per cent before moving back down to the neighborhood of 4 per cent. Will the deceleration of inflation then be even slower than if the unemployment rate had risen further? I believe that it might be a little slower but not much; and that the social and economic losses to the nation from unemployment rates of 6 and 7 per cent far outweigh any slight gain that might come in a faster deceleration of price increases. The only evidence I can point to, and it is only suggestive rather than conclusive, is that, for all quarters since 1953 in which the unemployment rate exceeded 5.7 per cent, the average rise in prices was only slightly less than for those quarters in which the rate stood between 4.7 and 5.7 per cent.

Thus, to defeat inflation, we can gain little by persevering in highly restrictive fiscal and monetary policies that threaten progressively to raise the rate of unemployment. By now loosening the restraints, we can hold down the social and economic costs of high unemployment some months from now, and reduce the chance that the economy will slide further into recession.

"Voluntary" Wage and Price Stabilization

But if fiscal and monetary policy can now do very little to hasten our return to an acceptable degree of price stability, are there other tools we can use to help stabilize prices? This brings me to my second topic—the contribution of so-called "voluntary methods": "jawboning", "guideposts", or "incomes policies". (For lack of time, I omit discussion of other tools—which, in the absence of a better term, I call "structural" policies.)

Let me move into this question by way of some comments on the recent debate over price and wage controls.

First, I agree with those who contend that the President should always have stand-by authority to impose legal wage and price controls. If desired, use of such authority could be effective at any given time for only a few months, giving Congress time to debate its extension. The trouble is that there is never a good time for Congress to vote stand-by authority. In times of price stability, no one is interested. If prices are rising enough so that there is even the slightest prospect that the authority might be used, Congressional consideration of the measure will induce many to raise prices and wages—just in case. The resulting faster increase of prices makes it more plausible that the authority may be used when finally voted, inducing others to attempt to beat the gun. By the time Congress has acted, the speculative momentum may very well have reached the point that the authority has to be used. This is at least an important part of the sad history of 1950–51.

Specific legislative authority for stand-by controls is a good idea, although I do not think now is a good time to vote it. But does not the President already have wage-price control authority, or could he not assume it in an emergency and then ask for a legislative spelling out of it? Surely he must have the authority at any time when American military forces are engaged in action.

Second, I am appalled by Kenneth Galbraith's advocacy of full wage and price controls, which would be permanent in the case of large firms and important collective bargaining situations. Permanent price controls would convert most of American industry into the status of a public utility. But even our historical regulation of power, communication, and transportation rates does not extend to government setting the wages of these industries' workers. With the inflation of the last few years, the average rate of price increase for the decade of the sixties was just 2 per cent a year. I see no reason why we cannot expect to do nearly that well on the average in the future. The possibility of reducing this average through permanent wage-price controls to, say, 1 per cent a year surely cannot justify so revolutionary a change in our economic system. Established on a permanent basis, industrial price controls could well lead (as they have in utility regulation) to compulsory controls over extension of service, to controls over investment, and so on. Even more horrible to contemplate—in my view—are permanent wage controls, which mean that strikes are not against private employers but against the government. Are we ready to put labor leaders in jail?

I can only believe that Professor Galbraith had his tongue in his cheek.

Third, there is the Roosa proposal: for a quick, temporary, wage and price freeze, limited to six months and allowing no adjustments. This is quite a different matter. However, it may not be possible to shrug off even for six months the inequities created by a freeze at a time when wages and prices are in movement. It was not possible at the time of Korea. If any effort is made to deal with such inequities, a substantial staff is required. On balance, I think the Roosa plan unwise, and, surely, too late.

It seems to me, however, that Roosa's proposal focusses our attention on the real problem. He wants a freeze while the leaders of labor, business, and government negotiate a system of voluntary standards for wage and price behavior. It is surely possible that this would be easier to accomplish if the participants were negotiating their way out from under controls. In any case, I see a negotiation of the kind that Roosa describes as the real key to any effective system of voluntary stabilization.

As I have said on many occasions, the principal weakness of the Kennedy-Johnson "guideposts" was the failure to inspire any feeling of responsibility for their success on the part of labor or business. Neither group felt such a sense of responsibility, because neither had participated in the formulation, adoption, operation, or interpretation of the guideposts. Instead, the guidepost were devised by the Council of Economic Advisers and promulgated by the President. They were expected to be "enforced" by the pressure of "public opinion"—an expectation that was almost always disappointed, since the public could rarely see any direct stake in the price of sulfur or the wages of boilermakers, while the press—on the whole—treated the resulting confrontations between Government officials and labor or business leaders as an interesting spectator sport, whose outcome was of no great consequence to anyone except those directly concerned.

It seems to me that a voluntary wage-price restraint program can be made to work mainly to the extent that the leaders of labor and business can be made to feel some commitment to its success. This requires that they be fully involved in recognizing the need for the program, formulating its targets, and planning its over-all strategy. I believe that some kind of a stabilization compromise *can* be negotiated which the leaders of labor and business will, in private, support, and, in public, at least accept. Surely, both labor and business must realize that they are on a treadmill that is getting no one anywhere. Instead, each firm and union feels it has to run ever faster just to be sure that it stands still. I believe that a great many of the leaders on both sides now know that this is a losing game, and that the country's interests, as well as their own, justify their committing themselves to some degree of wage and price restraint, offered in return for a simultaneous commitment of restraint by others—in a pattern of mutual de-escalation.

It may not work, but I believe it is well worth a try. However, to sell the idea to business and labor will require leadership by Government officials who believe that the achievement is possible, worthwhile, and not ideologically suspect. I do not know whether that degree of commitment yet exists in the Administration.

If it does, then the proposed machinery—a National Committee on Productivity, a President's Conference on Productivity, and professional analytical support from the Council of Economic Advisers—could be effective. If there is not adequate commitment by the Administration, no machinery will work.

I do not contend that a voluntary system can accomplish a great deal. It certainly cannot control an inflation arising from genuinely excessive aggregate demand. Its real purpose, in my view, is to fight a cost-push inflation. Its task is to prevent—or to help slow down—the wage-price spiral: to break the pattern under which rising prices require large wage increases, which in turn push up prices. I believe it can accomplish this task, at least in part.

Let me conclude by summarizing my belief that:

Commitment and enthusiasm on the Government side are far more important than the particular machinery used;

That the main objective must be to enlist the support (in private) and the tolerance (in public) for the system on the part of the leaders of labor and business;

That achieving such "consent" is far more important than the theoretical nicety of the standards that are evolved; and

That a voluntary stabilization program can reduce the present unacceptable rate of inflation sooner than would otherwise occur; and, in the longer run, it can permit us to operate our economy at a somewhat lower level of unemployment, or a lower rate of inflation, or both, than would be possible without it.

Chairman PATMAN. Dr. Samuelson, you may proceed, sir, in your own way.

STATEMENT OF PAUL SAMUELSON, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. SAMUELSON. Mr. Chairman, members of the Joint Economic Committee, it is a pleasure to return to this seminar. I have a very brief statement and then I would like simply to elaborate on it.

Where do we now stand? The country obviously has been going through a severe retardation. I think we might permit ourselves to call it a midi-recession. It is not a mini-recession, which is no recession at all, and certainly it is not a good old-fashioned recession. But by most definitions of the National Bureau of Economic Research and others, this probably does qualify as a recession.

I think if you turn this recession upside down and examine the marking on it you will see "Made in Washington." It was not the result of the ordinary dynamics of laissez-faire. I do not say that in the way of criticism. For its purpose has been to reduce the rate of inflation caused by the post-1965 escalation of the Vietnam war.

I think it is appropriate to point out that this situation was inherited by the present administration from the previous administration. I think the name "Okunism" might also be applied to the general philosophy involved here, because the last Chairman of the Council of Economic Advisers also prescribed contrived retardation for an inflationary situation which would have threatened to snowball.

I concur in the implied criticism which my predecessor, Ambassador Ackley, was too polite to make—since he has become an Ambassador he has lost that Middle Western frankness for which he was so well known—that Congress was in some measure to blame for the fiscal policy it pursued in the years 1965-68: as which Professor Ackley said, in 1965-68 we had a full employment deficit when there should not have been a full employment fiscal deficit.

I would not have you think, however, that this retardation has been proceeding according to the Nixon game plan or, I should say, according to mark I game plan, mark II game plan or mark 77(a) game plan. Game planning has been a very flexible, fine-tuned instrument.

The February 1 Economic Report of the President which is not yet 6 months old, grossly misforecast the actual weakness in the economy for the months since then. That is a very large error to make in economic forecasting for so near a time period. But the President's economic advisers were not alone in this: the economic fraternity generally will have to write this down as a bad year for the forecasters. The errors have been large and the square errors enormous.

I think that Paul McCracken has testified before you that hindsight gives him different figures from what they expected at that time. In particular, unemployment has been higher than planned. The growth in real output has been lower than expected. The gap of excess capacity is higher than planned, and in consequence, for anyone who might be interested, profits are a good deal lower than was expected both in the estimates of the Treasury and in the official report of the President.

We are told under people's capitalism we now have 30 million people who are suffering common stock losses, who have seen their assets decreased, perhaps in many cases decimated, in the last year or two. A back-of-the-envelope calculation suggests that when you go beyond listed stocks half a trillion dollars in net worth—what people so nicely call paper net worth, as if there is another kind—has disappeared in the last years. Suffering along with the very rich are the very poor. Minority unemployment which surprised us by not going up in the early retardation periods according to previous patterns, finally got its cue and has been up, and is up the most— in accordance with historical patterns which are that the black unemployment rates, to take one example, are about double the volatility those of white.

In my own State of Massachusetts, in the town of New Bedford, they do not say, "It looks as if it may be a long, hot summer ahead," because there it has already been a hot, hot summer, with inner city racial rioting traceable in significant part to the economic environment and retardation that I have spoken about.

I recommend that a Congressional Medical of Honor should be given by Congress to Congress. (I do not come before you every year with such recommendations.) For, if Congress had not overcome the administration's resistance to a number of measures—increased social security benefits, Government pay increases, and so forth—then by the very analysis of the Department of Commerce itself, we would not have had in the quarter just passed that razor's thin rise in real GNP which has made all of us so very happy.

The stock market went up for eight days in a row and was a full 64 points in anticipation of this delicious event and in relish of it afterwards.

I also suggest, and I hope that the chairman will take due notice of this, that the Victorian Cross—I do not know if our Government has the power to allocate it—but that it should be awarded to each member of the Federal Reserve Board for heroic violation in recent months of the doctrine that this committee in the past has occasionally recommended, that the rate of growth of the money supply should be kept within the range of 2 to 6 percent per annum. When Chairman Burns appears tomorrow, I hope that Senator Proxmire will not crucify him because the money supply has grown at more than a 6 percent rate in recent months. On the contrary, I think he deserves our applause and approval because, make no mistake about it, the bankruptcy of Penn Central threatened a liquidity crisis in a situation which had plenty of tinder already there in terms of deterioration of the quality of credit. In the face of possible panic in the commercial paper market facing the country, I believe the Fed was masterful in its departing from what is a good enough rule for most periods. Two to six percent is a good rule if you do not adhere to it through thick and thin. It is not like New Years resolutions which you should adhere to at all times. You should have the money supply growing between 2 and 6 percent except when you should not have it growing between those rates. And this was such a period.

I also applaud the modification of regulation Q, which made CD's more viable in a time when commercial paper ceased to be attractive to the market and when you could have had some very serious problems incident to disintermediation.

Well, that is the past. That is where we stand. What about policy for the future?

First, let me say that I agree that it is likely that the decline in overall output is now behind us. But I warn you that you as policymakers should not proceed upon the assumption that the recession is over, that the turn has come. On request and with very small prompting I will supply you with reminders of expert testimony before your committee that was fallible on timing, often with dire consequences. As a small sample of this, I will try to confine myself for the most part to testimony before you in which I have appeared as one of the quality culprits.

In June of 1957 when we were on the eve of a typical postwar recession, one that was more than a midi-recession, I and three or four other so-called experts appeared before you and not one of those experts was aware that we were in for a recession.

In February of 1967 when a real recession we now know was in the process of being averted, you had a whole clutch of monetarists appear before you—I was not in that group—who were sure that we were going to have a recession. Their error for that year was a very large one. (I may say that the last 12 months has not been a good year for monetarists in terms of the mean squared error of forecasts that I have collected from them.)

Well, I could go on. In May of 1958 the best talents in economics of the country marched up to the Hill and delivered their message which was that the recession was still on, but history records that the recession had already been over for a month.

Moreover, the razor thin increase in second-quarters' real output, which has made everybody so happy, is really just a gleam in the eye of the Department of Commerce. Dr. George Jaszi, who is a dedicated civil servant and who is the greatest expert in this matter, if he had blinked his eye, might have decided that instead of our having a three-tenths of 1 percent increase in real output, we instead would have had a zero increase in real output or a two-tenths of 1 percent decrease in real output. He necessarily, for example, had to give the figures on the basis of no knowledge of the inventory situation for June and on the basis of the May inventory figures which only a little time before then had turned sour.

There is plenty of other evidence, if you wish to look for it, and I do not mean for the purpose of picking on anybody but for the purpose of having a reasoned view as to where we stand and where we are going, that the issue is still in doubt.

Let me mention a few items. The Federal Reserve Index of Production, which is a measure of real output, albeit not the same measure of real output as the Department of Commerce's, has gone down in all three of the months. The leading indicators which, if they are to do anything worthy of their name, are to lead and not lag, have not yet testified to a business cycle turn.

I will point out that on July 4th, in Business Week, there appeared a collection of seven eminent economic forecasters. I know they are competent because a lot of them are my students and friends. Monetarists are included in the group—the Wharton School, Data Resources, which is a euphemism for Otto Eckstein, Philadelphia Research, G.E., RCA's monetarist forecast, IBM.

When this appeared the quarter was already over but George Jaszi had not yet made his Delphic judgment. Five out of seven of those gentlemen expected a considerably bigger increase in real output than occurred. If we take the estimates of these groups, and by the way, my personal estimate falls within their range, for the current quarter, there should be a more substantial increase in real output. Still the average overestimate of these seven forecasters in the last three quarters has been a bigger error than the amount of increase which they forecast. That is, their own past error in estimating real output growth.

So, although we may well find that history will record that the recession is over and that we are on the upswing, we cannot for policy purposes, operate upon the assumption that this is a sure thing or even that this is a 2 to 1 bet.

Well, now, what is implied for a policy? We have learned, if we have learned anything from the last couple of years, that rejection of the knowledge which had been acquired up to Inauguration Day of 1969 has not been borne out by the facts. There is in the short run a definite tradeoff between unemployment and price inflation. (Restate that if you wish to make it grammatically more elegant.)

There is a difficult social choice and there becomes a problem of democratic pressure upon the Government to determine how that balance shall be made.

Now, I suggest that as we are 5 months before an election, this is your best opportunity and maybe your last opportunity for pressure against unemployment. If it were not for the nagging of Congress, if it were not for the agitating of columnists, you would find, in my judgment, the administration in great temptation to be tolerating more and more unemployment in the interests of fighting the inflation. The following argument will be made, indeed it has already been made before your Committee in these hearings: Do not give up everything that we have accomplished now. We are in sight of the home goal of controlling inflation. So, do not spend an extra pfennig, do not listen to Professor Ackley when he quotes the President about precepts in terms of the full employment budget but tries to apply that to the present situation. Do not listen to those who worry about unemployment, list everything that we have sacrificed, every black in New Bedford who has lost his job will have lost his job for nothing. (It is the same argument, I may say parenthetically, that is used to perpetuate the Indochinese War. Do not make a mockery of that soldier who was killed in that war, because if you now pull out of Vietnam, then he will have died in vain—as if that were the choice which we have.)

Well, I do not want to discuss rhetoric. I want to discuss the behavior equations of inflation.

We have had a great number of studies of this tradeoff. These are studies made within the Government, outside the Government, by economists who subscribe to the Republican Party, who subscribe to the Democratic Party, who subscribe to the Birch Society and the new left. And they all show the same thing. They show that during unemployment and for a delayed period afterward you get some improvement on the price front. The effects are quantitative and cumulative and are not qualitative. It is not that if you do something here, then suddenly you have given up the ghost, you have given up the good fight, and you will see the results in the price indices.

There is no evidence for what we econometricians call such nonlinear effects. They are rhetoric and I urge you to disregard them.

Let me summarize, then, the general import of my policy suggestions to you. I think at this time we should have a proper sense of priorities. At this time inflation and intensifying the fight against it is not the number one problem. It is not on the front burner. So, at this time President Nixon, Congress and the Federal Reserve should give the highest priority to fighting the economic retardation that is increasing unemployment and harming living standards, and which will continue to do so by all expert testimony, including that of the Government itself, even if the recession has past its lowest point, because nobody, not even the ebullient Dr. Pierre Rinfret, has come before Congress and predicted healthy, full employment growth. So, this is a time to pay attention to the shoe that is pinching, which is the suffering due to the retardation.

I wish to emphasize that to do this will not negate what has already been accomplished in reducing inflation, and I do think that something has been accomplished. Nor will it prevent any future actions designed to increase the Nation's ability to enjoy high employment and vigorous growth at a more reasonable rate of price stability.

Thank you.

Chairman PATMAN. Thank you, sir.

Next, we have Dr. Henry C. Wallich, professor of economics at Yale University. Dr. Wallich, we are glad to hear from you in your own way, sir.

STATEMENT OF HENRY C. WALLICH, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. WALLICH. It is a privilege, Mr. Chairman, to address this group. I shall summarize my rather lengthy prepared statement and I shall make them purely as a professor at Yale.

There are two ways of viewing the economy at this time. One is to look at the figures and find that growth has been very poor, interest rates have been enormously high, unemployment is high, and the balance of payments is not good. If one abstracts from the background, why we are here and how we got here, this is certainly not an attractive picture. But this would be like viewing, let us say, 1962 or 1964 in terms of the then existing level of unemployment without asking why it existed.

If we look at it in terms of the historical context, we see that the United States has been negotiating a very difficult passage from high inflation to what hopefully will be a low rate of price increase and full employment. This, to my knowledge, has never been done in this economy, even though, unfortunately, there has been plenty of opportunity to try it, and I do not believe other countries have done it. It is too early to claim victory and say that we have found a kind of Northwest Passage from inflation to stability, but it looks as if we were in midpassage and as if the stretch ahead looked promising.

This is in conflict, as you are aware, with the many skeptics that we heard half a year ago and even more recently, whose views were either that the brakes would not work at all, that there would be a continued boom, or on the other side that we were going into a serious recession.

In fact, in terms of nominal GNP, we are extraordinarily close to forecasts. The forecasts' rough mean might now be $980 billion GNP, as against a forecast by the average economist and also the Council of maybe $985 billion at the beginning of the year.

Growth admittedly has been less than expected and, therefore, unemployment higher, and prices have been higher than expected. We have had compensating errors.

I would like to say a word about the fiscal-monetary mix that we have had. Clearly the weight of the burden of battle has shifted to monetary policy. This is logical in the conditions in which we have been. At less than full employment fiscal policy is powerful, monetary policy less powerful. When we get to full employment or into an inflationary period, most of the power is shifted to monetary policy and fiscal policy becomes the junior partner. This has been the history of the last few years.

In looking at the combined restraint that we have obtained from fiscal-monetary policy, I have great difficulty clarifying some of the numbers. First, there is the full employment surplus about which we ought to arrive at some conclusion. It is very difficult to figure it out, not only because we are uncertain about the budget but because we are uncertain about what kind of price assumption to make. Depending on those assumptions the full employment surplus could be computed at little more than zero to something like $15 billion. The only thing that is clear as we move into 1971, is that the full employment surplus will probably be rising and will exert increasing restraint.

The second factor that gives me pause about the budget is the off-budget financing that we are doing. In fiscal 1971, we have over $20 billion of federally assisted credit programs that do not get into the budget but get into the capital market and into the economy. What the Government does is to subsidize private borrowers with guarantees or outright subsidies for interest and principal or to enable agencies that are sponsored by the Federal Government but are ostensibly private, to borrow and then lend to private borrowers an incremental amount of more than $20 billion.

Not all of this money is incremental in the sense that the borrower would not be able to get a loan without this assistance and would not be able, let us say, to buy a home, buy a farm, buy equipment, but a good part of it is. As a rough guide, I would say, let us take something like one-half of this off-budget financing. In this year this would be $10 billion plus. Let us honestly say that the budget is really that much larger on the expenditure side, even though it does not show. This off-budget financing has been a recent development and I think one that needs very much to be watched. The fiscal position in those terms is not nearly so restraining as we like to think it is.

The same kind of ambiguity attaches to the stance of the monetary policy. We have shifted to a money supply target from what used to be an interest rate target. I think it was a necessary step, but it is not a forward step. In less-developed countries money supply targets are the rule because interest rates do not mean a great deal. The United States has not yet reached that condition but we are dangerously approaching it.

The reason interest rates do not mean a great deal today is that the real interest rate after taking the inflation out of the nominal rate is a subjective variable. Suppose somebody pays 9 percent but he thinks that inflation will be 5 percent for the length of the loan. He is really only paying a real 4 percent.

By the same token, inflation makes increases in the money supply uncertain. If you look at the real increase in the money supply that we are having now that money is going up at 4 or 5 percent annual rate of growth, the real increase is zero at an inflation as fast as the increase in the money supply. In real terms we are not increasing the money supply at all which looks like a very tight policy.

At the same time, as interest rates go down and as inflation hopefully goes down, the demand for money to hold in balances will increase. In other words, liquidity preference steps up. That is another reason for saying there ought to be an adequate supply of money to meet this increased liquidity preference.

It leaves me with a feeling that a fixed amount of money growth per year is a very weak reed right now even though it may be better than an interest rate target. We really do not have a very good guide as to what a safe and good increase in the money supply should be.

I would like to say a word about how to get interest rates down. Very clearly our principal need is to stop the inflation. Inflation has raised not real rates but nominal rates. It looks now as though inflation very quickly affected interest rates whereas in the past it took a long time. It almost looks as the central bank had lost control at least of the long term rate. Earlier this year, when the long term rate had come down somewhat, shortly thereafter it appeared that the Federal Reserve was opening up and increasing the money supply at what temporarily looked like a 10 percent rate. You would then have expected the long term rate to come down the same as the short term rate did. It did not. It went right back up again. People feared and expected the inflation to be resumed. That is a signal nowadays in this environment for interest rates to go up.

Hence, confidence that inflation will be stopped is the first condition of getting interest rates down.

The second condition is to increase saving, the good old-fashioned prescription. We have just passed a tax bill which had many virtues. It shifted us toward greater equity in the tax system. But it greatly reduced saving because it shifted something like $6 billion more taxes to corporations and upper brackets and it untaxed lower brackets to the tune of $9 billion. It changed the income distribution in a socially desirable way, but in a way that tends to reduce savings. It also makes for a larger Government deficit which in turn reduces savings and makes a greater claim on the capital markets.

Structurally, I would say we need a tax increase in order to offset these losses of savings. Cyclically, I would be very doubtful about proposing that now. This is probably not the time. But looking toward the more distant future, I think we have a capital shortage. I think we need more saving and if we do not want very high interest rates, we had better supply those savings somehow through the Federal budget.

I am not saying we should raise taxes now to alter that fundamental stance of the budget.

I do not have much confidence in selective credit controls for accomplishing these objectives. I would like to have an open mind about them because I can see situations in which they might be appropriate. But when I see what happens when you create a sort of captive source of funds for some industry, such as the savings and loans associations for housing, I think that is an unhealthy situation, unhealthly for the source, unhealthy even for the beneficiary, the industry. We have now a proposal to force pension funds to channel some percentage of their savings into housing. This might have an immediately beneficial effect. I do not see how, once that is voted, we would get it out of the law even long after the emergency has passed, long after some other allocation of resources, maybe in favor of environmental programs, had become desirable. One would have to count on the fact that such a requirement would become a quasi-permanent one.

I would like to stay clear of that kind of thing as long as we can and as long as it is possible to think of more market-oriented devices. For instance, the sale of bonds backed by mortgages such as GNMA helps housing. That seems to be a market-oriented device. Flexibility in Regulation Q and its equivalents would be desirable to help money flow into housing-oriented intermediaries. Variable interest rate mortgages and devices of that kind would help those intermediaries. I would much prefer that to selective controls.

On wage and price controls, I share the views of my—of all economists, I guess. I would strongly oppose them. I think the testimony of Assistant Attorney General McLaren showing that concentrated industries had less price increases in the recent inflation rather supports the case against wage and price controls.

On wage and price guideposts, I think a much better case can be made. I think their importance probably has been overrated. There has been so little difference in view between economists of the previous Administration and the economists such as I know of the present Administration that guideposts have become the focal point of dispute. It has been made to sound as though guideposts were the difference between an adequate and inadequate anti-inflation policy. I think it is probably de minimis but perhaps we should have something like that.

What I do think worth examining is the possibility of doing something via the tax system to encourage firms to follow implicit or explicit guideposts. I see these tremendous wage increases in a small number of industries. They are plainly the result of an imbalance of bargaining power between the employer and the union. The employer just caves in. If there were some way through the tax system of giving the employer a little more backbone, I think that would be very helpful in those industries and I think one ought to examine those possibilities.

I have another very small proposal in the tax area. Suppose at the present time somebody loses a job and finds another job. He will be withheld upon for income tax immediately. He will be overwithheld, because his income for the year will be lower than if he had had the job all year, yet he is withheld on an annual rate.

If this withholding could be postponed or perhaps forgiven altogether, the following things would happen. First, this injustice of a temporary overwithholding with a subsequent refund would be removed.

Second, by getting a larger immediate amount of money, the incentive to seek a job would be increased, which in turn would permit higher unemployment compensation without damage to incentive. I think this is a small but perhaps useful improvement in our system.

Now, to conclude, the great question is, where do we go from here? I am seriously concerned that we might repeat 1967. In other words, I am the man to whom Paul Samuelson addressed himself who is concerned that we might blow what we have achieved. I sense a pressure to step on the gas now and take the foot altogether off the brake. I would prefer to see this resisted.

I am aware that there may be factors increasing the demand for money that would require the Federal Reserve for a while to have a higher rate of increase in the money supply than normally. I have no difficulty with that. I would think, however, that insofar as we have a choice, we ought to step on the budgetary brake and on the Federal Reserve gas, hold down expenditures and create room in the economy for more credit expansion and lower interest rates rather than do the opposite.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, sir.

(The prepared statement of Mr. Wallich follows:)

PREPARED STATEMENT OF HENRY C. WALLICH

It is an honor to participate in this distinguished Committee's review of the economy at midyear. The enterprise, I believe, is a timely one. The evolution of the economy is coming into clearer focus. It is important to understand developments correctly.

ACHIEVEMENTS THUS FAR

As we review the economy, two alternative views are possible. One is to look at the "numbers," unrelated to their history and background, and evaluate them on their own terms. We shall then observe that economic growth has been very slow, unemployment relatively high, inflation serious, and interest rates beyond all recent experience. These observations would be correct as far as they go; but, unrelated to history and background, they would have very limited meaning. The alternative view is to note that the economy is making a very difficult transition from a high rate of inflation to what promises to be a more tolerable rate of price increase, without passing through a serious recession. The American economy, to my knowledge, has never accomplished this passage before although the attempt unfortunately has had to be made on more than one occasion. Nor, to my knowledge, have other major countries accomplished this feat. I would be too early to claim that we have discovered a "northwest passage" from inflation to stability, just as it was too early to claim that we had discovered the means of fine-tuning the economy at high growth, full employment, and stable prices. Nevertheless, a better passage than any traversed before seems to lie partly behind and partly ahead of us. This I believe is the most fruitful way to view the present state and movement of the economy. This view will help us see what could have been done better and what unfinished business is still ahead.

In its early stages, the success of this passage from inflation to relative stability was widely doubted. Some skeptics argued that inflation would continue unchecked. Monetary and fiscal policy, it was argued, were powerless against built-in forces. On the other side there were predictions of serious recession. Both extreme views have been disavowed by events so far. I believe they will continue to be disavowed. It is indeed remarkable to observe how closely the economy has moved along the lines of the standard GNP forecast made by economists in and out of Government. There have been deviations, of course.

The most troublesome one has been the relatively high rate of unemployment, although fortunately so far this has been far below earlier peaks. High interest rates and inflation have taken longer to come down than was expected. But overall the picture is that of a very mild slowdown of which even now it is not clear whether, by traditional criteria, it can be called a recession or not.

Monetary Policy Has Gained Strength Relative to Fiscal Policy

The experience plainly indicates that we have had progress in understanding and guiding the economy. It also indicates, however, that much further progress is needed. As regards the management of aggregate demand, we have seen a transition from primary reliance on fiscal to primary reliance on monetary policy. At the time of the tax cut of 1964, economic analysis and economic policy focused on fiscal policy, with a very junior role assigned to monetary policy. Today, monetary policy clearly is the senior partner. This shift in the relative importance of the two policies should not surprise economists. It is not a "new new economics." It is still the same old economics under different circumstances. What happened in the last few years was the elimination of slack, real and monetary. While there is such slack, fiscal policy has elbow room. The Government can increase its expenditures, or reduce its taxes, without greatly interfering with the plans of others in the economy. But once the economy has reached full employment, or even overfull employment and inflation, and once interest rates have risen high, both real and monetary slack will have been eliminated. Then fiscal policy no longer has its old leeway. When the Government changes its demand for credit and for physical resources, the plans of private borrowers must change. Somebody is squeezed out of the market or is given access previously denied. Under those conditions, fiscal policy has little effect. The Government comes to be just one more borrower claiming a share in an unchanging flow of loanable funds. Only monetary policy can change that flow of loanable funds. But even monetary policy can increase the flow at the expense of encouraging further inflation. At full employment, neither fiscal nor monetary policy can generate additional resources.

In combination, however, monetary and fiscal policy can alter the flow of savings, and they can alter the incidence of anti-inflationary restraint. In accordance with the Chairman's request, I shall endeavor to comment on this and related aspects of the mix of fiscal, monetary, and other policies.

As you will have noted, I have already dwelt on one aspect of the fiscal monetary mix that is not frequently emphasized. It is the relative weight that the two policies carry in managing aggregate demand. This weight has shifted from fiscal to monetary policy. I have also pointed out that this is nothing new. Every textbook carries and explanation of the conditions in which fiscal policy is strong and monetary policy weak, and vice versa. In the last few years we have moved from one condition to the other.

The Stance of the Budget Is Obscured by Off-Budget Operations

A different aspect of the fiscal monetary mix is the degree of restraint imposed by the two. To begin with fiscal policy, it is not easy today to describe accurately the stance of the Federal budget. In terms of the unified budget, we have had a modest deficit last year. The outlook for 1971 depends on tax and expenditure proposals that have not yet been fully acted upon. At times of sub-potential economic activity, however, the surplus or deficit of the unified budget, or even of the national income accounts budget, is not a reliable guide. For such conditions, the concept of the full employment surplus has been developed. The usefullness of this concept, unfortunately, is undetermined seriously by inflation.. To estimate what tax revenues and also expenditures would be if the economy were operating at full employment, what rate of price increase should be assumed? That which might result if a crash program were instituted to push the economy back to full employment? Undoubtedly that would be a higher rate than now prevails. Or should we employ the rate of inflation that might prevail when the economy returns to its potential after some further quarters of slack? That rate ought to be substantially below today's. Still other assumptions are possible. All yield a different tax base, especially for corporate profits, different expenditure levels, and therefore widely different full employment surpluses. The full employment surplus of 10–

15 billion that I have seen estimated, therefore, has only very limited validity. The true number, if there is one, may well be substantially lower.

All these budget concepts—the unified, the national income accounts, and the full employment budget—fail to take adequate account of Federally assisted credit programs. These are programs sponsored by the Federal Government, sometime through ostensibly private organizations such as Fanny Mae, through guarantees, or through outright subsidies of various credit operations that are then financed in the private capital market. For many of these operations, the economic effect is very much the same as if the Treasury had borrowed the money and had loaned it out. Doing the same through a Government-sponsored but not Government-owned agency, or letting a Government agency provide a guarantee but not the money, or letting a Government agency subsidize interest of or principal and so with a small expenditure of funds in any one year mobilize large sums of money, gets these operations out of the budget. It does not get them out of the economy or out of the capital markets. Not all Government assisted credit, it is true, leads to additional spending. In some cases, the beneficiary could have raised the money on his own. Government assistance merely improves the terms on which he raises it. But at a rough estimate, something like one-half to two-thirds of the funds mobilized under Federally assisted credit programs implies incremental spending. In 1970, the amount of this form of non-budgetary spending was about $15 billion. In 1971, it is scheduled to be about $20 billion.

Monetary Policy Has Borne the Main Burden

The net of all this is that while the Federal Government has run a moderately tight budget, it has nevertheless put considerable pressure upon capital markets. The burden that has fallen upon monetary policy, within the fiscal-monetary policy mix, has been all the heavier. Evidence thereof has been seen in the severe restraint of the rate of money growth. During the second half of 1969, that rate became virtually zero. Interest rates in nominal terms have been exceptionally high.

Inflation, unfortunately, obscures the true stance of monetary policy as it does that of fiscal policy. Nominal interest rates become a poor guide to policy. Under present conditions, they contain an inflation premium of unknown magnitude, depending on the maturity of each loan or bond and upon borrowers' and lenders' expectations concerning the rate of inflation over the life of that loan or bond. In "real" terms, particularly taking into account that income tax is levied on the inflation premium as well as on the "real" interest, the after tax real interest rate in many instances may be zero.

Shift to a Money Supply Target

Under those conditions, it becomes advisable for the central bank to adopt a money supply target rather than an interest rate target. This the Federal Reserve did in January 1970. A money supply target is new in the United States, but not elsewhere. In developing countries, where interest rates mean little, and particularly in inflationary countries, monetary policy guides based on money supply or volume of bank credit have been the rule. The sad fact is that the United States, far from taking a great technical step forward, has had to adopt the methods of developing and of inflationary countries because conditions, for a while, had become not dissimilar to those prevailing in these other countries.

The rate of money supply growth, however, is itself not a reliable indicator of appropriate policy. Most economists would agree that, as interest rates rise and inflation accelerates, people want to hold less money. If the money supply is nevertheless increased at a stable rate while interest rates and the rate of inflation go up, this increase in the money supply may actually be excessive. It might be appropriate to increase money at less than the normal rate. On the other hand, when interest rates drop and inflation abates, as seems now to be the case, the amount of money people wish to hold tends to increase. Under these conditions, creation of money at the usual rate may not be sufficient. Money may be absorbed into balances that firms and households want to hold in order to restore their liquidity. A higher rate of money growth than ordinarily may therefore be appropriate. Unfortunately, there is no knowledge as to how far the rate of money growth ought to deviate from the normal growth rate of the economy under these conditions.

The appropriate rate of money growth is further obscured by the fact that the analysis necessarily proceeds in terms of nominal money supply. During inflation, the real money supply shrinks relative to the nominal. A zero rate of money growth, such as prevailed during the latter part of 1969, means that the real money supply was actually falling. Even the money supply target, therefore, although more reliable in conditions of inflation than an interest rate target, does not provide a secure guide.

Another problem that inflation has posed for monetary policy has been the tendency of interest rates to react very quickly to changing prospects of inflation. Economic reasoning makes clear that interest rates should move with the rate of inflation. Borrowers can afford to pay more when the real value of their debt diminishes. lenders must charge an inflation premium. Historically, these adjustments of interest rates seem to have occurred only with very long lags. Recent studies indicate. however, that the lags have shortened dramatically. By the early part of 1970, it appeared as if the central bank had lost the power to influence at least long-term rates even temporarily. That is, an increase in the rate of money growth such as occurred during certain months of 1970, was immediately interpreted by the market as a signal of more inflation ahead, and interest rates, instead of going down in response to greater monetary ease, moved up in response to intensified inflation fears. Fortunately, events have made clear that these interpretations of monetary policy were erroneous. Interest rates, both long and short, have come down accordingly.

How To Reduce Interest Rates

This leads us to the action that might be taken to bring down interest rates. As I have pointed out, a 9 percent interest rate with 6 percent inflation is not a high real rate. But when the inflation comes to an end, it would be an exorbitant rate. Under stable conditions, such rates are unlikely to persist.

In my view, two fundamental means of reducing *nominal* rates now are open to us. One is, precisely, to end the inflation. The other is to increase the volume of saving, i.e., the percentage of income that firms and households devote to saving. The first will bring down the nominal interest rate only. The second will reduce also the real interest rate. Raising the savings ratio will produce a genuine increase in the supply of investable funds, and that is what we most need.

It is widely believed that for the foreseeable future, the country faces a capital shortage. Vast needs for capital lie ahead — to finance housing, finance environmental improvements, finance expansion of the capital stock required to provide jobs for a rapidly growing labor force. The Federal Government itself, through the credit programs it assists and sponsors, and quite aside from its own deficit, contributes probably not much less than 15 percent of this demand for capital. The need for saving, therefore, is urgent.

Prospects for achieving this increase in saving have not been aided by recent tax legislation. In shifting the tax burden increasingly toward the upper brackets and corporations, in an effort to enhance the equity of the system, tax reform has tended to weaken the flow of savings. If these consequences cannot be corrected, another method of providing additional savings would be through the Federal budget. A budget surplus, leading to debt retirement, would make room in the capital markets for more rapid expansion of private debt. I am aware that such a surplus would not be easy to attain nor, once attained, to preserve.

To use credit controls as a means of reducing interest rates I do not find promising. These controls could be of two kinds. First, some borrowers, presumably corporations wanting to expand plant and equipment, might be restricted in their financing. Second, some lenders, such as pension funds, might be required to divert part of their inflow or assets to particular uses, such as housing. Both techniques interfere with the principle of free markets which is basic to our economy. Particularly in the financial sphere, violations of this principle usually have led to consequences both unforeseen and undesirable.

If corporations were limited in their access to the bond market, or to bank credit, they probably would find other sources, be it through the stock market, or through commercial paper, or the Euro-dollar market. In any one of these alternative markets, they would raise interest rates, which would react back upon the mortgage market. If their ability to raise any funds whatever were restricted, they might cut dividends, which would reduce an important source of personal income going in good part into savings. In addition, limiting the ability to raise funds might create serious liquidity problems.

Alternatively, to require pension funds to invest to some extent in mortgages would not only interfere with the market's test for allocation of resources, but also create the usual problems of enforcement. I would prefer market oriented measures, such as improved technical facilities for pension funds and all other investors to participate in housing finance. Ginny Mae (Government National Mortgage Association), which issues bonds backed by mortgages, represents an important step in that direction. In addition, measures that would help savings and loan associations to compete more effectively for funds, such as variable interest mortgages, seem promising.

In summary, I question the usefulness of selective credit controls in our present situation, although I would like to keep an open mind about them in some circumstances.

On the related topic of price and wage controls, my view is much the same. I can conceive of circumstances in which they would be needed. I do not believe that those circumstances prevail today. A fact that I have found particularly impressive is the evidence presented by Assistant Attorney General McLaren at an earlier session of these hearings. He found that price increases during the recent inflationary period have been inversely related to the degree of concentration in particular industries, that is, to the degree of market power prevailing in those industries. This suggests that corporate market power has not been one of the important factors in promoting the inflation. The case for direct controls over these prices is accordingly weakened.

A better case can be made, in my view, for wage and price guidelines. I welcome the decision of the Administration to establish an inflation alert and to examine the implication of particular wage and price increases. Specific guideposts on wages and prices, however, should arise not from a purely governmental decision but from a consensus of business and labor. I do not see how else, under prevailing conditions, such guideposts could acquire the necessary degree of moral authority. Moral authority is the only kind that in my view such guideposts should have.

The debate over the respective merits of guideposts and so-called jawboning has been very extensive. It happens that with respect to fiscal and monetary policies, as well as with respect to the economic outlook, there has been a high degree of consensus among the economists of the present and the previous administration. Guideposts have become the principal difference. This has caused the subject to acquire a degree of importance that, in my view, is greatly exaggerated. The debate sometimes has sounded as if the presence or absence of guideposts meant the difference between an effective and an ineffective anti-inflationary policy. This impression is dangerous. It could induce the wholely erroneous belief, that, once some version of guideposts or price surveillance such as the President's inflation alert had been instituted, the need for a rstraining fiscal and monetary policy had altogether disappeared. Even a successful guidepost policy — and there is no clear evidence that guideposts in the past were particularly effective — can at best shave a few fractions of a percentage point off the rate of inflation.

It is tempting to think that guideposts could be given teeth via the tax system. Theoretically it is not inconceivable that some kind of income tax penalty or concession could be attached to the degree of compliance with guideposts on the part of individual firms. The difficulty is in the practical administration of such a proposal. It is not easy to define the precise amount of a wage increase and hence the degree of compliance with particular guideposts. Yet, for tax purposes, absolutely precise definitions are needed. Despite its obvious difficulties. I think the matter would be worth examining because I can see no other good way of coming to grips with a relatively small number of wage increases that are totally beyond past normal experience, and totally inconsistent with price stability. I am referring to increases in some recent contracts. in the range of 10-20 percent. and in some cases. I believe. in excess of 20 percent. This I believe, is a totally new phenomenon. It reflects a degree of imbalance of bargaining power that raises questions concerning the viability, in those industries, of normal collective bargain. If collective bargaining is to be preserved there, as I think it should be, a way needs to be found to strengthen the bargaining power of the employer. To give the employer a stronger incentive to resist extreme demands, be it through the tax system or otherwise, seems to be a way of doing so.

Fighting inflation by orthodox means unfortunately implies some sacrifice of employment. I need not stress the enormous importance of dealing with this unemployment on two fronts: first, to provide adequate compensation, through wider coverage, higher benefits, and longer duration of unemployment compensation; and second, through structural measures to improve the labor market, including manpower training and better job information. In addition, I would like to put forward a suggestion that would help those who have found a job after suffering unemployment, and may also provide an increased incentive to seek a job. Persons having suffered a spell of unemployment might be freed from income tax withholding in their new employment for a period related to the duration of their unemployment. This would give them a better chance to restore their financial position. It would, in fact, be no more than fair at least to reduce, if not altogether suspend, the withholding because, in terms of their full year tax liability, persons having suffered substantial unemployment would probably be exposed to overwithholding at going rates. Relief along these lines would also increase the incentive to find a job by widening, at least temporarily, the gap between unemployment benefits and the regular pay rate. Conceivably, the amounts not withheld could be forgiven altogether, but that would be a net tax loss that raises issues of a different order.

Conglomerates and One Bank Holding Companies

In response to the questions posed by the Chairman, I would like to comment briefly on conglomerates and one bank holding companies. I have at various times written in opposition to the formation of conglomerates, and maintain that view today. It is based, not on the questionable financial and accounting practices of certain conglomerates that have since come to light, but on the simple fact of concentration of power. I regard that as a threat to democracy, even in the absence of a clear restraint of competition.

If bank holding companies were to lead to conglomerates of this kind, I would certainly be opposed to them. I very much doubt, however, that this would happen. Banks, to be sure, have money and can buy other companies — but so have all large companies. Bankers have no special aptitude for the management of large industrial and commercial enterprises outside the financial field — as witness the familiar pejorative term "banker control."

My concern with one bank holding companies is that banks should have the power to evolve within the financial field and closely related activities. Else they will go the way of the railroads. I cannot foresee what the course of innovation in the banking field will be, and therefore do not believe in spelling out a list of permitted activities.

The creation of mammoth institutions seems to me unwise. There is a tradeoff, consequently, between any additional expansion that banks should be permitted to engage in geographically, through branching and merger, and additional expansion into new lines of activities. If no limits were set in either direction, we would indeed be in danger of fomenting mammoth institutions that would constitute excessive centers of power. In general, my preference would be to allow banks to diversify into newly emerging fields, directly through the holding company route, rather than into already existing activities, although I would not apply this rule rigidly.

Chairman Patman. You gentlemen have presented very interesting statements and I think they bear on our current problems as much as any statements we have had.

The problems mentioned, I think, are overshadowed by the lack of money or a source of credit for housing and things like that which are so essential to the people.

As brought out here by another witness, if you purchase a $20,000 home now at current interest rates and 30-year term, the buyer of that home must obligate himself to pay not only the $20,000 but also $38,000 interest, or a total of $58,000 for a home. Of course, very few people can pay that kind of money, and the number of housing starts, of course, is not up to expectations.

We have passed in Congress an ambitious program for housing, with a goal of 26 million residential units over a period of 10 years, and, of course, we are not living up to that goal. We are not anywhere close. And one of these days we are going to reach a serious situation in housing if it is not already reached in some particular areas.

Now, as much money as we have available for all purposes, including speculation and gambling and high cost loan sharks, it occurs to me that we should siphon off some of that money for decent homes in this country, and yet we do not have an adequate source of money for housing.

In other countries central banks are required to assume social responsibilities. In Mexico, just south of the Rio Grande, 30 percent of all the loans that the commercial bankers make, using Government credit, of course, must be made to finance housing for low income groups. It is working quite well.

In other countries of the world, I think you will find that all central banks have some social responsibility or responsibilities. But in this country we do not seem to have anything like that.

Would you comment on whether or not that would be good or bad, Dr. Ackley, to require our monetary authorities to assume social responsibilities particularly in the housing field?

Mr. Ackley. Well, I would think that on balance it probably would be mistaken, Mr. Chairman. I believe that we ought to appropriately reallocate credit toward housing construction. We ought to do a better job of protecting it from the periods of tight money used for restraining inflation. But it seems to me that the reallocation ought to be one that is accomplished by the legislature, which ought to define and implement society's goals rather than simply telling the Federal Reserve to do it.

There are, of course, many ways—

Chairman Patman. Well, I am asking you, should the Congress do that?

Mr. Ackley. Well, there are many ways, of course, in which the Congress is doing that now. Perhaps it could do it more. The bill which, I gather, has just passed both houses provides some subsidy for interest rates. Interest rates could be further subsidized to help certain classes of housing if it were so desired. And, of course, the Home Loan Bank Board, FNMA, GNMA, et cetera, have a number of programs. If necessary, they can be expanded—

Chairman Patman. Let me revise that question to ask whether we should make more demands of the monetary authorities along the lines of priorities including housing? In other words, should we have a different approach? Instead of just letting the banking people go and allocate credit as they desire, have some guidelines for them and some requirements—a must list to give some attention to the most desirable needs of the people, including housing?

Mr. Ackley. I certainly believe that it is appropriate for public policy to concern itself with the allocation of credit. We sometimes think that if we just leave it to the banking system—to credit markets—it somehow gets perfectly allocated. Well, that is a lot of nonsense. The institutional structure of our financial system is such that it inevitably warps the allocation of credit in certain ways, sometimes accidental, sometimes otherwise. But it seems to me that the approach to a better allocation should be through legislation. Public housing, interest rate subsidies, rent subsidies get directly at the objective.

Chairman PATMAN. My time is very limited. Let me briefly ask the other witnesses here today, Dr. Samuelson, how do you feel about the suggestion I put to Dr. Ackley?

Mr. SAMUELSON. I believe that if the American people seriously wish to give higher priority to housing—and I do not think the fact that Congress, on one happy day, not knowing really what they were doing, passed a resolution that we ought to have 26 million new units of housing over a decade, constitutes a serious approach to the problem—if the people through its congressional representations, and, I would add to Dr. Ackley's statement, through its administration, which should be responsive to the wish of the people, wish to have more resources go into housing than will flow under laissez-faire, this can be done and it should be done and it should be done by precisely the backdoor financing that Prof. Wallich referred to earlier, which is responsible for housing having held up as well as it has held up in this tight money period. Housing would have been very much down if the Government had not been increasing, through the housing agencies, the flow of funds.

I see no reason to give that task to the central bank itself. The central bank will make it possible for the markets to have the right total funds but it is the duty of the Executive and the Congress to see where those funds go.

The only reason for having the central bank do it would be if you really do not believe in the program and do not believe that the people are really convinced but that they momentarily are in its favor, in which case by subterfuge the central bank could continue to do something which your good resolution thought ought to be done on a momentary basis.

Chairman PATMAN. Do you believe that all the interest rates should be fixed in the marketplace?

Mr. SAMUELSON. I think that the Government, through its housing agencies, should intervene in the marketplace but then the interest rates subject to intervention, should find their competitive levels.

Chairman PATMAN. Yes. What do you think about that, Dr. Wallich? Do you think that interest rates should be determined by the marketplace?

Mr. WALLICH. They should, as far as the lender is concerned, Mr. Chairman. Now—

Chairman PATMAN. As far as the lender is concerned, but—

Mr. WALLICH. As far as the borrower is concerned, if appropriate, he can be subsidized. But if you constrain the lender, you create a disequilibrium system. You make him lend where he does not want to. If you give the subsidy to the borrower, he can compete. You can make the subsidy as large as you like, and the lender will—

Chairman PATMAN. Well, that, of course, has its objections, too. Right here in Washington, Philadelphia, Chicago, and many places in the Nation today, we thought we had enacted a pretty good law, section 235 and 236. You know, that contemplates subsidies, particularly on interest rates, section 235, and even right here in Washington, as good as our intentions were, people have bought homes that, of course, are rundown and not worth much money, say, for $6,000 and then find some poor person who can qualify for the section 235, 8 percent of the 9 percent interest as a subsidy, and sell it to him, say, for $19,000. That is going on all over the country right now. It has gotten to be quite a racket. Everything we attempt along that line seems to turn into a racket, and we have got to do something about that very thing right now, about the subsidizing of the interest.

But what gets me is that we cannot find any source of funds for housing. You take corporations, they are not restricted on the amount of interest that they can receive for their funds or for the money that they borrow. As long as we have that system and have the speculators and the gamblers and all the others bidding for money, I do not think the outlook for housing money is very good.

So, I think we have got to find a source of funds, a real source of funds, without reference to subsidies.

I want to make one statement about the bill that we passed out of our committee yesterday and I will yield to another member. We passed a bill out of the Banking and Currency Committee yesterday in the House that provides for wage and price controls, salaries and rents, if the Executive desires to impose these controls. It could be on a selected basis. It would not have to cover all the ten or 15 million prices and wages as it did one time before in our country. That, of course, required patriotic fervor to enforce, and we do not have that right now. This legislation would give the President the power to have some control, so that if he is dealing, to take a hypothetical case, but one which could happen, with a case of steel manufacturers who decide they wanted a 5 percent increase right quick and who put it into effect, the President could call up the leader and say, "now, you should not do this. It is not in the public interest. We are trying to keep down prices and wages and I want to respectfully ask you to eliminate that 5 percent increase."

Of course, if the President does not have some power to back that up, moral suasion or so-called jawboning does not amount to anything because the President does not have any power to reach back and say, I have another weapon.

Congress has also given the President the authority to impose credit controls, even to roll back interest rates. A law that the President signed just before Christmas last year gave him that power. The President, and I am sure he is using sincere judgment, has not seen fit to impose any of those controls. Now, we are giving him more power, in other words, more weapons in his arsenal to fight inflation and high interest rates. That is our purpose. It is not to make him impose them but to enable him to pick out any one of them or all of them that he wants, to impose them at the proper time if in his judgment he wants to impose such controls.

So, I think it is very necessary to have that in order to properly control the economic situation that is causing us so many problems now.

I just wanted to bring that up and when time allows me again, I expect to pursue it further. But, now, I yield to Mr. Conable.

Representative CONABLE. Thank you, Mr. Chairman.

I would like to thank this distinguished panel for its contributions at this rather perplexing point in our transitional economy.

I have some questions, I guess, for Prof. Samuelson. There has been a lot of notice in the press lately about the new modesty among economists. I think that maybe I may have detected that somewhat in your statement. I am a little confused about it. At one point it seemed to me you were saying there had been some very bad forecasts for the second quarter, but that it was the fault of the economy and not the economists. Is that—

Mr. SAMUELSON. I do not think I pronounced upon—

Representative CONABLE. I thought I got that implication, sir, from what you said.

Mr. SAMUELSON (continuing). That matter. Well, let us just put it this way. They are God's creatures playing the piano as best they can but they finally had a very difficult piece to play.

Representative CONABLE. I quite agree this is a difficult time. We are grasping at a lot of straws and we do not know which way the wind is blowing them yet.

You say you are not a monetarist, sir, and yet I notice in your statement that you do not talk about the surtax or the possibility of imposing higher taxes and that you do not mention the probable impact of a return to substantial deficits, something which is a very real threat at this point in terms of the Congress's unwillingness to act on the President's recommendations on revenue and in terms of the built-in escalators we have in so many of our Government programs. You also say that we must not proceed on the assumption that the recession, the mini-recession, you call it, is over. Do you think we can afford to proceed in fiscal matters on the assumption that inflation is over?

Mr. SAMUELSON. No. I think that the best diagnosis of the current situation is that the peak of inflationary pressure as measured by the rate of increase of the comprehensive price indexes in all probability occurred in the first quarter of the year, and that we are making progress on the inflation front. I wish to say that I think it will be small progress and that the administration's economists have made some of their grossest errors, errors which I will not myself confess to, in optimism on where we would be 6 months ahead in their pronouncements on the rate of price inflation. But I think that we are making progress, we have made progress, we will not lose that progress if you follow the general advice which I gave, which is at this time to be preoccupied with the recession problem.

Now, I wish to correct any impression that you may have derived that if I were prescribing fiscal policy at that time I would be recommending higher taxes because, of course, that is not consistent with the tenor of the highest priority which I am urging upon you. If I thought that you were receptive, I mean, the Congress generally and the administration, to greater use of fiscal ease at this time in the fight, in the concern against slow growth, I would indeed recommend that. I think monetarism—I am sorry, the monetary weapon which, by the way, is not the exclusive property of economists called monetarists, it also belongs to eclectics—I think that is what is used because Congress has not shown receptive signs of being willing to use fiscal policy for macroeconomic stabilization purpose and I want to go on record as deploring this tendency among your colleagues.

Representative CONABLE. Do I take it, then, that you are not concerned about the return to possible substantial fiscal deficit?

Mr. SAMUELSON. I do not think that is the proper first concern now because we do not have, upon any of the forecasts which anybody in this room has mentioned, a deterioration of the full employment deficit. If you wish to look for a guide to policy, I do not regard it as a perfect guide, but as a more appropriate guide than the deficit which has been developing because the economy's own weakness has generated low profits and low tax receipts. That kind of deficit is not to be avoided.

I also want to comment because I suppose it was not said in jest, the Assistant Director of the new Budget Bureau or Bureau of Management was quoted as saying before your committee, and I hope that this is a misquotation, that you should never have a deficit for economic reasons, and the answer to that is, of course, that is the only reason that you should ever have a deficit and you should have a good economic reason for having that deficit. I hope we have not lost 30 years of understanding. I think we have lost 2 or 3 with each passing year. I hope it is not 30 or 40 because then the consequences, and I now speak as a common stockholder, the consequences would be ominous for my wife's portfolio.

Representative CONABLE. Professor Wallich, would you like to comment on the possibility of return to substantial governmental deficits here and its relationship to possible new revenue sources as well as the attitude of Congress toward the general issue of fiscal restraint?

Mr. WALLICH. I think the general danger of our going into large deficit exists. Very plainly if the tax proposals that are up are not acted upon, if various expenditure proposals are exceeded, we could have the kind of deficit that congressional committees and others have computed, going on toward $10 billion. To this deficit I would always add as a memorandum item, the fact that there is some effect in $10 billion of extrabudgetary expenditures that are thereby incremental that are not just nominal. The nominal are $20 billion and at least half of those may be effective in raising aggregate demand.

What concerns me mostly about that kind of a deficit even in a recession or near-recession, is that it compels us to maintain a much tighter monetary stance. I would like to get interest rates down. I think this 8½ percent rate is a serious impediment to the functioning of the economy. This we will not accomplish if the Government borrows very heavily in the capital markets, preempts the very inadequate flows of capital that we now have from savings, and in effect takes them away from housing, from business, and from the consumer.

Representative CONABLE. Professor Wallich, if I may interrupt at that point, there is a pretty direct trade-off, is there not, between these very substantial deficits and the housing market? In other words, if the Government is borrowing a very substantial sum of money, it is most likely to come out of the housing market generally, is it not?

Mr. WALLICH. That is unfortunately the case, because it is in the housing market where demand is most elastic and is most easily squeezed out as interest rates rise. Every billion dollars that we can save on the budget gets transmuted into potential credit in the market and the marginal beneficiary again is likely to be housing. It enables the Federal Reserve to open up that much more. The choice really is not between quicker recovery or slower recovery, although that too might be involved. The principal choice, I think, is whether we want more expansion on the monetary side or on the fiscal side. I would vote for the monetary side.

Representative CONABLE. Dr. Ackley, you say in your statement there has been much talk recently about the need to perserve in a highly restrictive fiscal policy stance. I wonder what in your view is the size of deficit you would prefer to see during the current fiscal year?

Mr. ACKLEY. Mr. Conable, without a very detailed projection of both the economy and probable course of expenditures and tax legislation, and so on, I would hesitate to use a single figure. I tried to make very clear in my summary that I was in favor of a deficit in fiscal 1971; that the economic situation, as every one that I know sees it, is one which makes a deficit appropriate, and a sizable deficit. I would not be frightened by a $10 billion deficit.

Representative CONABLE. $10 billion. Thank you.

Mr. Chairman, my time is up.

Chairman PATMAN. Yes, sir. Senator Proxmire?

Senator PROXMIRE. Following up that question that has been pursued so well by Mr. Conable, yesterday we had the Secretary of the Treasury, Undersecretary of the Treasury, and Assistant Secretary of the Treasury before us and I thought that among these, the Nation's principal fiscal officers, we could get some notion of the degree of fiscal restraint based on the full employment surplus that we are likely to run in the coming year. None of them could come up with anything like a figure. They said this depends upon assumptions. We asked for their assumptions and they just could not tell us.

Now, we have three of the most eminent economists in the country before us and would you care, Mr. Ackley, to give us your estimate of the likely full employment surplus that we would be running, and if you want to break it down between the first half of this fiscal year and the second half it would be very helpful.

In other words, some of the top people in the Government did not seem to know how much restraint, fiscal restraint, we are actually exercising. If you could tell us that we would like to know.

Mr. ACKLEY. Well, the best estimates that I know of, of the full employment surplus, are those which were published about 2 or 3 weeks ago in the Brookings Institution volume entitled "Brookings Papers on Economic Activity, No. 1," table 4 on page 108. It estimates the full employment surplus on the basis of the January budget as $11.4 billion for the second half of 1970 and $18.7 billion for the first half of 1971. Together they make up the fiscal year 1971.

Now—

Senator PROXMIRE. That would be about a $15 billion overall surplus.

Mr. ACKLEY. Yes. In the text it is noted that the May budget revisions will reduce that by roughly a billion and a half dollars.

Senator PROXMIRE. Now, are you saying, then—

Mr. ACKLEY. So that $13 to $14 billion would be the size of the full-employment surplus for fiscal year 1971.

Senator PROXMIRE. I also understood you to indicate that you thought we ought to start the economy moving and we ought to start growing and cutting down on unemployment. Did I understand you to say that to do this we should try to achieve a full-employment budget balance, which would translate itself then perhaps into a surplus of some $10, $12, or $13 billion?

Mr. ACKLEY. A deficit—

Senator PROXMIRE. A deficit, I mean, of $10, $12, or $13 billion if unemployment remained at this level.

Mr. ACKLEY. I would not prescribe policy solely on the basis of the size of the full-employment surplus or deficit. It is not that accurate a tool. I think that fiscal policy for the year ahead needs to be made on the basis of the best possible forecast of developments in every sector, and so on. This is simply not the way to do it. But the outcome of the specific steps that I should think appropriate would be, as I suggested, a substantial actual deficit—which would still be consistent with a small full-employment surplus.

I point out that during the first 7 years of the 1960's we had each year a substantial full-employment surplus, yet we were employing a stimulative fiscal policy to get the economy expanding, and it did. We cut taxes not once, but several times.

Senator PROXMIRE. It was not a very substantial expansion policy if you were running a full employment surplus, was it?

Mr. ACKLEY. Yes, it was. It was much more expansionary than if we had not had the effect of those tax increases.

Senator PROXMIRE. I think your position is clear. You think we ought to run a substantial deficit under present circumstances, perhaps in the area of $8 or $10 billion more or less. Now, how about the effect of that which I think Mr. Wallich very well delineated on the capital markets? How about the effect of that on housing? That means the Federal Government has to borrow another $8 or $10 billion or more, much more, because of the consolidated budget estimates. And the administrative budget would be more than that. They might have to borrow $15 or $20 billion. Does this drive up interest rates and make money available for State and local governments and housing more scarce?

Mr. ACKLEY. It does not have to, Senator. That depends on the monetary policy. Under the economic circumstances that I envision, and I gather that my colleagues see it much the same way, I believe that we ought to be stimulating the economy both by monetary and fiscal policy. Mr. Samuelson gives up on fiscal policy and says, well, let us do what we can by monetary policy, because neither Congress nor the administration is likely to set out to have a big deficit. I would like to see both policies somewhat more expansionary. It is not automatic that deficits have to come out of housing or that deficits have to raise interest rates. That depends on what kind of monetary policy is being followed, and what kind of policy is appropriate under the economic circumstances.

Senator PROXMIRE. Well, you gave us a very impressive, I thought, analysis that easing monetary policy substantially, easing fiscal policy, will not result in increasing inflation. However, while the historical analysis was comforting, I did not hear any analysis in terms of specific impact. Are you counting on or expecting a slowdown, for example, in business investment in plant and equipment? What other developments in the economy do you feel are likely to occur that would reinforce this notion that inflation will not resume if you ease up on the restraint now?

Mr. ACKLEY. I think the outlook for business plant and equipment spending for the next year is at best one of holding its own in terms of dollar expenditures, with a reduction in real terms. It could possibly do a little better than that, but I think we should not count on any real expansion in business plant and equipment spending. We should be getting a substantial recovery in housing. Consumer expenditures should continue to rise and perhaps rise substantially. State and local purchases will be rising rapidly. But the total picture, so far as I can see from the forecasts that I have seen, and the ones that I am able to put together myself, suggest only the tiniest rise in real gross national product over the next year. Yet, quarter after quarter, our capacity to produce is increasing steadily, as our labor force grows and its productivity improves. Those are resources that we ought to be using. We can use some of them for Federal expenditures. We can also use some of them for housing. At full employment, budget deficits may come out of housing. But when we have idle resources they do not have to.

Senator PROXMIRE. Let me call your attention to a development which I think, although I was one of the authors of the bill, I overlooked and I think all the witnesses we have had have overlooked. I think it could have a dramatic effect on employment and stimulating the economy. We passed the Emergency Home Financing Act. You referred to that. It has passed both houses, is on the President's desk, he endorses it enthusiastically. He will sign it. This bill on the basis of the most careful analysis that we can get, will provide in the first year additional housing starts amounting to 512,000. It will result in, we estimate, 429,000 construction jobs on the site. It will result in addition to 797,000 jobs in allied areas which will supply housing. In other words, it will increase employment by 1,226,000. That is the estimate. And this would reduce unemployment by about one-third.

Now, while, of course, this does not allow for replacement, does not allow for slippage and that kind of thing, I think this could be a very profound impact that has been overlooked because what we are getting into is not simply the low and moderate income housing. This provides a subsidy for people buying $20,000, $25,000, and $30,000 homes, bringing the interest rates down to 7 percent. It is a very small amount of Federal spending. It will not be translated into budget deficits but would trigger a lot of private sector spending, we think.

Now, would that tend to change your view on the economic outlook?

Mr. Ackley. My view of the economic outlook already includes a very substantial increase in housing. The last time I tried formally to put together a forecast I had the rate of housing starts getting up to close to two million by the middle of next year. That is pretty high. I do not know what the impact of this—

Senator Proxmire. I think that would be very consistent. I think that would be about right.

Mr. Ackley. I was counting on the Government contributing substantially.

Senator Proxmire. That would be about 600,000 on top of the 1.4 million housing start rate we are operating now. I think that is pretty close. Then you took that into account. In spite of that you feel we should even further ease up, then, on monetary and fiscal policy, in addition to this, I should say?

Mr. Ackley. Well, residential construction is between $25 and $30 billion in a GNP of a trillion dollars. It can expand a lot, without picking up all of our slack we are likely to have.

Senator Proxmire. Dr. Samuelson, when you were before us last, I think the last time, you gave this committee a C-minus rating. This morning you referred to something that we did that you thought was right.

Mr. Samuelson. Yes.

Senator Proxmire. Would you revise that, maybe give us a C or C-plus?

Mr. Samuelson. No. I think since you are fishing, considering the difficulty of the situation and your improvement, I am going to give you a B-plus rating.

Senator Proxmire. B-plus.

Mr. Samuelson. And I like the trend and I think a little more assiduous application is going to result in even better results.

Senator Proxmire. Unfortunately, my time is up. I want to come back.

Chairman Patman. Mr. Moorhead?

Representative Moorhead. Thank you, Mr. Chairman.

Dr. Ackley, the Chairman mentioned the fact that the House Banking and Currency Committee reported out a standby wage and price control bill yesterday. I think you are making a very good suggestion. The Committee wanted to have some cut-off date, an arbitrary date which it set as February 28, 1971. If you put controls into effect, they will expire then. Your suggestion, as I read it, is that at an appropriate time the President should be given permanent authority to establish wage and price controls for a limited period. Is that correct?

Mr. Ackley. I did make that suggestion. I tried to make it clear—and for those who have not read my prepared statement, I want everyone to be fully aware—that I would be opposed to the use of wage and price controls under present circumstances. But I do believe the President ought always to have standby authority to use wage and price controls.

Representative Moorhead. As I understand your testimony, you say this inflation just started because of aggregate demand, but is now cost-push. So would not this be the appropriate time to invoke wage and price controls, when we are in the cost-push stage of an inflationary spiral?

Mr. ACKLEY. Yes, very much so in the sense that price controls under a cost-push situation do not necessarily involve the traditional black markets, the requirement for rationing, and so on. Yet, it seems to me that the complexity, the administrative nightmare, the distortions that are bound to come with price controls make them a last resort kind of device, that we surely should not consider using until we have done everything we can short of controls. It seems to me that, until we have made a valiant attempt to construct an effective incomes policy we ought not to be thinking about controls.

Robert Roosa's suggestion of a quick 6-month freeze—limited to 6 months—has some attraction. I think the time is not appropriate; in general I am against it. But certainly there could be a situation in which a quick freeze could deflate inflationary expectations, could slow down the spiral, and give the economy a chance to start over with a little higher degree of stability.

Nevertheless, I do not think now is the time. I would be opposed to wage-price controls now.

Representative MOORHEAD. But as I read it, all of you gentlemen are considering federal devices in varying degrees. Professor Samuelson says this is the time to give our primary attention to economic retardation. Professor Wallich suggests, I gather, keeping the foot on the fiscal brake but stepping on the monetary accelerator. And Dr. Ackley, I gather, proposes easing up on both the fiscal and monetary situations. Would this be a correct analysis? I ask you all to comment on it.

I sense that all of you think we can do this without the fear of recurring inflation. Still, should we not hedge our bets by creating stand-by controls at this time, so that if we make a mistake and ease up too fast, we can still act quickly to stop it. Dr. Wallich?

Mr. WALLICH. I would say in that case we had better be more careful with the policies and ease up less on money. We are concerned about limited government, hence, about all power given to the government. I am concerned even in the case of standby powers that are not supposed to be used. Allow the Government to arrest the movement of wages and prices, why not allow the Government to arrest me? We have a limited Government, and it should not have any powers that it does not actually need, however wise the Government may be.

Representative MOORHEAD. Dr. Samuelson?

Mr. SAMUELSON. I think that direct wage and price control are extremely powerful weapons in the short run, but they spring leaks and become inequitable fairly rapidly, so I would save them for really extreme emergencies.

Now, I have no strong opinion one way or the other about stand-by powers when that strong emergency comes. However, implicit in your question are two different aspects. While we are in a period of weakness of demand-pull which we are now and have been in, that in principle is the time when you could most easily introduce a wage freeze.

In 1951 and 1952, just after the Korean outburst, you had a measure of the direct wage and price controls and if you just look at the record in a superficial way they worked extremely well. Now, they were able to do so because the situation was already in process of being relaxed, so in answer to your first question to Dr. Ackley, if you asked me when are they going to work better and more easily, in a period like 1968 when the inflation is still building up or in a period like 1970 when Senate control as far as demand-pull is concerned, I have to answer they work more easily in the 1970 period.

In giving you that answer, however, I am undermining the answer to your question, which is, suppose we are off to another bout of inflation which will be demand-pull inflation; do we not then want to have the price controls for that purpose?

Now, maybe you want to have them for that purpose but I must in all consistency say they will be very hard to apply.

One last thought. If, now that we, by agreement for the moment, say we are not in demand-pull but have cost-push, if you say, is not this the time to put in wage-price controls, giving equal emphasis to wage and price, there is a little element of a swindle in that. The horses have been allowed to run out of the stable and now you are going to beat up on the grooms who are left there. So, if you look at this from the standpoint of the rank and file of labor, they think of themselves, quite honestly think of themselves as having been cheated, that the increases in the cost of living which have not come through to them in their usual improvement factor have already taken place. The settlements which are taking place now are delayed settlements to try to restore justice, and you are saying just at this time we will put in a freeze. So, without commenting on the equity, I simply say you are borrowing a mess of trouble as far as expecting cooperation either from the union rank-and-file member or from his official in having a policy which is deliberately designed to come in after the demand-pull is over and while the cost-push is still on.

Representative MOORHEAD. Dr. Ackley, do you have any comments?

Mr. ACKLEY. I think only this. The only possible purpose I could see for wage and price controls in the period ahead would be in the nightmare situation in which we continued to have slack in the economy and yet wage settlements continued to be at eight, nine, or ten per cent. Suppose the spiral were to continue for another six months with no sign of slowing down. Conceivably, in that kind of circumstance, I would be willing to see a freeze used. I do not anticipate that. And I certainly would not suggest that we use controls now.

Representative MOORHEAD. Dr. Ackley, may I return to a section of your prepared statement? In connection with a possible tax increase you suggested that if we did do this, it would reduce the pressures to restrain spending in defense, space, the SST, agriculture, and some of the obsolete programs that the President mentioned. But the President indicated in a press conference this week that there was little room, if any, for further cuts in the defense budget for fiscal 1972. You have had your experience with defense budgets. I am sure our other witnesses have too. Would you agree with the White House's position, implied in the new stories this morning, that reductions in defense spending for Southeast Asia are going to be fully achieved in 1971 and that nothing will be left to be cut in defense budgets in subsequent years?

Mr. ACKLEY. I could give you an off-the-cuff reaction to that, Mr. Moorhead, but I do not think it would be worth much. It seems to me that one has really to study the details of the defense budget to have an informed opinion. I am glad that you and Senator Proxmire and others are really looking into the nuts and bolts of the defense budget and seeing what can be done. Without the benefit of that careful study, I would hate to make an off-the-cuff judgment.

But my hunch is that there is still room for some cuts in that budget.

Representative MOORHEAD. Thank you, Dr. Ackley. My time has expired.

Chairman PATMAN. Dr. Ackley, I did not quite understand your answer to Mr. Moorhead's question a while ago about temporary price controls such as proposed by the House Committee on Banking and Currency yesterday. Do you look with favor upon that now or not?

Mr. ACKLEY. I do not object strongly to it. I do not expect it to be used within the period of its authority. If we are to have price control legislation, I would prefer permanent stand-by legislation. However, it seems to me that the passage of such legislation at this time is neither desirable nor necessary.

Chairman PATMAN. But you believe some type of control should be within the power of the President?

Mr. ACKLEY. Yes, for emergency purposes.

Chairman PATMAN. I agree with that.

Mr. ACKLEY. I agree strongly with Professor Samuelson that they ought not to be used casually. But as a last resort.

Chairman PATMAN. That is right. I agree with you. I went through this the other time when we had 10 million prices and wages controlled at one time, and I certainly would not look with favor upon enforcing them right now at all, but it is only for the purpose of giving the President what you might call something to back up his moral suasion or his jawboning.

Every constituent, every citizen has four people to look to in Washington, D.C. One, his own representative in Congress, from his congressional district, the two U.S. Senators from his State and the President, who is also elected by all the people. Now, those four are the ones that each constituent looks to, and the President of the United States is in a position where he can do things that are tremendous, especially in his area, and why should he not be—if he goes before these steel manufacturers like I mentioned a while ago, and he says, I just want you to roll your steel prices back and not put that five per cent into effect, it is against the public interest, and you want to be a good citizen, I think you ought to do it because other people are cooperating with the Government. I think the President is well within his rights in doing that, do you not, Mr. Ackley?

Mr. ACKLEY. I do, Mr. Chairman, yes.

Chairman PATMAN. Do you agree, Dr. Samuelson? In other words, I am talking about jawboning and moral suasion now. Do you not think the President has not only the right but the duty under circumstances when the public interest is not being protected?

Mr. SAMUELSON. I go farther and I think that there is more efficacy to Presidential leadership and jawboning and moral suasion than has been suggested even by some of the remarks said here and I think a great opportunity was thrown away in 1969, part of which can still be recovered. I have reference to a Presidential adviser, that is, an adviser to the candidate and to the President, who said that he urged in the first days of this administration that the President use his leadership and he was told that was alien to the philosophy of this Government. He said on public radio, so I quote it, that he went back and sent out a telegram to 3,000 clients to raise prices because that is the way the new system is to be run. And he can do it, in monitoring the Wall Street Journal and other sources. I myself, not knowing of this, was picking up a great number of increases in prices because there was no reason not to do so, and I think that was bad from the longrun business standpoint since we were moving into a period of retardation.

But, I want now to be responsive to your question, I have fears of giving to any one man, the President included, the authority to decide in his judgment what are the proper prices and by force of law to be able to set that price. It seems to me that none of the last couple of Presidents or the present President would misuse that power but I would not feel that way about Peron in Argentina, and he was a man of great voting power among the electorate, and I would not want Congress to abrogate that policy and give it to an executive officer. It goes contrary to what, it seems to me, is likely to be good economics and good equity and good efficiency in running the economy.

Chairman PATMAN. Where a steel price increase appears to be contrary to the public interest and it is wholly contrary to the desire of the Government to keep down inflation and stabilize the economy and help the consumers, do you not think that Congress has a duty to at least provide the President with some support for his jawboning and moral suasion? If there was a contrary group in the minority, we will say, a half dozen out of the many steel manufacturers who just adamantly say we are not going to cooperate at all, if we have armed the President with another weapon in his arsenal, he can just say, "Well, now, of course, you gentlemen are just wrong about this, most of the manufacturers are willing to comply. Our whole program cannot be wrecked by a small minority. I have the power to impose temporary price controls and if you do not go along, I will have to consider whether or not I impose those controls." Do you not think he would have more power to back up his demands in the public interest and the public good, Mr. Samuelson?

Mr. SAMUELSON. Yes, he certainly would and in many cases that power would be used to public advantage, but I do not see how you can give him that power without introducing the possibility of its misuse.

Chairman PATMAN. Well, I am not even discussing that because I feel that a President acting in the public interest would not do it and I do not think we have ever had a President that would just absolutely go contrary to the will of Congress and the people and do something that is not in the public interest. I just do not.

Mr. SAMUELSON. But we never had a President who had for one of his important preoccupations to determine what are just prices as between industries.

Chairman PATMAN. That can be handled by law if he does not do it right. You see, Congress can have the veto over the President as the President sometimes has a veto over Congress.

Mr. Wallich, what do you think about temporary controls?

Mr. WALLICH. I do not favor them, Mr. Chairman. I think standby powers are likely to give rise to an uptrend in prices, precautionary price and wage increases, and if used, I agree with my colleagues, they would distort. For instance, in the case of steel, I find it hard to visualize a situation in which it would be in the public interest to raise the price of steel. The price of steel in that case could practically never be raised. Extending this a little to other products, it would mean that certain parts of our industries would deteriorate. They could not raise the money to invest, would become less competitive. Imports would rise. It would be the kind of a situation that we know from price controls. I think there are better ways of handling this.

Chairman PATMAN. Well, was there not an attempt made under Mr. Kennedy to raise the price of steel and did he not through jawboning or moral suasion methods induce them not to do it?

Mr. WALLICH. I think suasion is perfectly legitimate, Mr. Chairman. Jawboning and threats of investigation of tax returns and antitrust action and withdrawal of Government contracts, this gets into a ——

Chairman PATMAN. Well, I did not bring that in. You are bringing it in.

Mr. WALLICH. I am sorry. I think of this as jawboning, perhaps erroneously. In other words, using the muscle of the Government.

Chairman PATMAN. I know, but always in the public interest, solely in the public interest. You see, if he attempted to use it otherwise, Congress would have a veto power over him.

Mr. WALLICH. Well, I think that kind of activity is not in the public interest, in which case it is ruled out, and we could agree that suasion applied fairly and equally on everybody, not just a few big industries, would be quite appropriate.

Chairman PATMAN. Yes, sir. Fine. Well, my time has about expired. I do want to ask you gentlemen one other question but I will wait until it is in order for me to do so.

Mr. Conable?

Representative CONABLE. Thank you, Mr. Chairman.

I think we had better be a little frank about this business of standby controls. I thank Professor Wallich for his contribution in his last answer. I am well aware of the extent to which psychology is one of the weapons of the economists, particularly Government economists, and I think perhaps at this point that it is no less a weapon in the economists arsenal than it is in the arsenal of the politician. Standby wage and price controls are a pretty cheap way to get absolution for Congress from any responsibility on the fiscal side, and also with respect to further monetary responsibility. Once we gave standby controls to the President it is easy for us to stand back and say, there, we have done our job, now anything that happens from now on is the President's fault. I think it is almost inevitable that we are going to have a good deal of political discussion thereafter about why the President does not use these things. For this reason I subscribe to Professor Wallich's statement that the existence of standby controls could very well have a psychological impact on the very wage and price level that we are trying to restrain as business and unions hear this debate and worry about the imposition of even a temporary freeze. Almost inevitable they are going to try to get ahead of the gun. And, so, I just wonder if any of you gentlemen would feel that controls, wage and price controls, at any time would have been appropriate during the past 4 years. Would they have had a positive effect or not during the past 4 years? Would they have operated to restrain or even substantially to delay the inflationary upward thrust of our economy during that period of time? Does anybody want to——

Mr. SAMUELSON. I did not in that period advocate controls and as I review the record to see what kind of report card to give myself on that, I do not, in retrospect regret, not having advocated them. I think that there were periods of time, almost any time, when they were introduced, when there would have been a flurry of increases in prices and wages to try to beat them. Then, I think they would have been extremely effective for the next 6 months or so, but then what? Then what? And I only go by experience.

I look at the experience of Holland, I look at the experience of Sweden, I look at the experience of Canada, which now has the experience, and I gathered 12 to 15 case studies in which direct controls were used and I do not find any one of those studies which shows the glowing results that a very tall colleague of mine from Middlesex County, Mass., is able to discern in direct wage-price controls.

Representative CONABLE. Dr. Ackley, let me ask you a more pointed question here. You seem willing to give the administration subpena power to require advance notice of certain price increases, and perhaps even the right to delay such increases for a time. It seems to me right at this point that rapidly rising wage costs, however justified, are as much or more of a problem than price increases and I wonder how you deal with inflationary wage behavior? Would not an administration need some sort of power with regard to large collective bargaining activities? Or would you concentrate on the price side alone of the subpena power and leave the wage side to follow its own pattern? If we go to this kind of standby authority subpena powers, do you see any problem?

Mr. ACKLEY. I surely would not leave the wage side alone. Indeed, it seems to me that any attempt to have a wage-price policy that leaves wages alone is nonsense. The fact is that, with respect to wage changes, one knows well in advance when the problem is going to arise. One is on notice that on a certain date in September the United Automobile Workers contract will expire. We have plenty of time to exert whatever influence we have as a Government, if we desire to do so. The only purpose of the authority to require advance notice or to delay increases is to allow a Government which wishes to exert such influence to do so. Otherwise price increases can be announced today effective today. And it is much more difficult to persuade someone to roll back a price increase than to try to persuade him that it was unwise to make it in the first place.

While I have the microphone, may I make it very clear that I do not believe standby authority should be used to help enforce guideposts. Indeed, the discussion today almost makes me recant on the idea that there ought to be standby price and wage authority. I simply do not think it appropriate for an incomes policy to be enforced through the threat of controls.

Representative CONABLE. Professor Wallich, do you have anything you want to add in the light of this further discussion? I thought you made a very fine contribution earlier.

Mr. WALLICH. I would like to be a little more explicit about what I meant earlier when I said strengthening the bargaining power of the employer in collective bargaining situations where the balance of power seems to be very uneven. Pressures build up on an employer when his order backlog is lengthening, or he has a big customer who tells him to get the job done by such and such a date or this is the last order he gets. As these pressures to keep producing fast build up the employer becomes very weak vis-a-vis his union. Is there some way in which bargaining power can be evened out? It occurs to me to suggest the possibility of using some kind of tax device that would either reward those who resist unreasonable increases or penalize those who give them. This would not be compulsion. Wages would not be controlled. Firms that genuinely feel that they have to give a 20 percent wage increase can do so and pay the penalty. But it would strengthen their backbone in the negotiations. The difficulty is in the administration and implementation. One would have to define very precisely what it means to give any wage increase or an above guidepost increase. Where taxes are concerned, everything has to be accounted for to the last penny, and I do not quite see the way of doing that. But, I should not think it is impossible if one puts some accounting expertise behind it.

Representative CONABLE. Thank you, sir.

That is all, Mr. Chairman.

Chairman PATMAN. Yes, sir. With the permission of Senator Proxmire, who is entitled to this time, I am going to ask you gentlemen a question which I hope you will answer for the record when you review your transcript. That question involves $57½ billion in bonds that are in the Federal Reserve Bank of New York that were acquired this way.

When the Federal Reserve Act was first passed and signed by President Wilson about 2 days before Christmas, 1913, and its operation commenced in 1914, it required a lot of money to operate the Federal Reserve System even with the limited personnel that they had at that time. They realized that eventually they would have to go before Congress and ask for appropriation for funds or else get the funds from the banks which they ruled out because the Federal Reserve was rather weak at that time, and just a little static from the banks would probably have caused it to be repealed or discontinued. So, they wanted to get the funds some other way, and they commenced a perfectly legal system of using their power to create money—of course, the Federal Reserve and the commercial banks are the only two who have the power to create money under our system—and buy Government bonds, interest-bearing bonds. That money obviously comes from the Bureau of Engraving and Printing, and they said that money which is another obligation of the Government for these bonds.

Well, they acquired the bonds and when they were finally paid for and both Mr. Eccles and Mr. Martin have testified many, many times that these bonds have been paid for, no question about that—they should be canceled. Of course, they have not always said they should be canceled but you have heard of churches burning bonds when they acquire the necessary money to pay off their bonded indebtedness. The church has a celebration. They burn the bonds.

Well, if we were to have that kind of celebration now we would cancel $57½ billion worth of the bonds because they have been paid for once.

If they take those bonds and sell them back into the market and then buy them back again, they have paid for them twice, the taxpayers have. This has been demonstrated in congressional committees and there is no doubt about it in the world.

Have you gentlemen given any consideration to that question at all, about these bonds being a part of our national debt and having been paid for once? Have you, Dr. Ackley? Have you given consideration to the position——

Mr. Ackley. I believe you have asked me that question, at least on one occasion.

Chairman Patman. All right. Well, you can put the answer back in when you review your transcript. What do you say about it, Dr. Samuelson?

Mr. Samuelson. In order that I understand the examination question, in giving the answer, may I ask you to broaden that and include the bonds which are held in the other 12 Federal Reserve banks which also were acquired?

Chairman Patman. They do not hold any bonds, incidentally.

Mr. Samuelson. Well, let us say all the bonds held within the system sold the bonds.

Chairman Patman. No. They do not hold any bonds. You see, only the Open Market Committee holds the bonds and they hold them in the bank of New York. Mr. Mellon got that changed when he was Secretary of the Treasury. He got them to all agree that the New York bank would do all the bond buying and selling and that has been going on ever since, but I am looking at this, that it is true that they have been paid for once and I have Mr. Eccles' word for that many times. I have Mr. Martin's word for it. I have the President of the Federal Reserve banks at the time, every one of them, to that effect and I have other people and there is no denial of it. In view of those bonds being paid for, this would solve our problem for at least a few years to come if those bonds were canceled. Our national debt could be reduced that much. It would be very helpful. So, if you will comment on that when you review your transcript, it will be appreciated very much and I will not pursue it further, but you understand now, I am sure. Thank you.

Senator Proxmire, since I have a matter that compels me to go to the floor, I would appreciate it if you would take charge of the committee and preside.

(The following answers were subsequently supplied for the record by Mr. Ackley and Mr. Wallich:)

GARDNER ACKLEY'S REPLY TO THE QUESTION POSED BY CHAIRMAN PATMAN REGARDING THE CANCELLATION OF THE $57 BILLION OF U.S. GOVERNMENT BONDS HELD BY THE FEDERAL RESERVE

I fail to find this question as vital as it appears to be regarded by Chairman Patman. The interest paid by the Treasury to the Federal Reserve System is paid from one Government agency to another. Excess earnings of the Federal Reserve System are returned to the Treasury. If the interest were not paid, some other source of funds would have to be substituted to cover the operating costs of the System.

The question undoubtedly has significance from an administrative standpoint —in terms of Congressional control over the operating expenditures of the Federal Reserve System. I have no informed judgment on the administrative issues involved. I see, however, no great significance from an over-all economic standpoint.

HENRY C. WALLICH'S REPLY TO THE QUESTION POSED BY CHAIRMAN PATMAN REGARDING THE CANCELLATION OF THE $57 BILLION OF U.S. GOVERNMENT BONDS HELD BY THE FEDERAL RESERVE

In examining the case for canceling the $57 billion of Government bonds held by the Federal Reserve, I regret I can discern no real advantages but believe to see some serious difficulties.

(1) Cancellation of bonds held as a backing for the Nation's currency might reduce confidence in the currency. In fact, the stability of the dollar depends upon our monetary and fiscal policies and not on the backing of the dollar by Government securities. Yet so drastic a departure from normal procedure as cancellation of the assets against which the Federal Reserve issues money is bound to create disturbance.

(2) If bonds held by the Federal Reserve were canceled, the question would imediately arise why bonds held by the Treasury in its various trust funds should not also be canceled. Any net outpayments by those funds could in that case be handled from the budget. This action, too, would disquiet other bondholders as well as the trust fund beneficiaries.

(3) The possibility that the Federal Reserve may have occasion to sell part of its portfolio cannot be precluded. This might occur, for instance, if the Federal Reserve some day were authorized or required to purchase other assets.

(4) Cancellation would give us no added fiscal leeway. We could not spend more money, or borrow more money, just because a bookkeeping entry was being made. If one of the consequences of cancellation were to be a widespread public belief that for a while we would be relieved of fiscal constraints, that possibly would be one of the most potent arguments for not undertaking the cancellation.

(5) The cancellation would deprive the Federal Reserve of much of its income. This would be detrimental to the independence of the Federal Reserve within the Government. The Federal Reserve probably could offset the income loss by rediscounting or purchasing in the open market claims on the private sector instead of on the Federal Government. But such maneuvers designed to produce income would be objectionable if they did not also serve a sound monetary policy purpose.

Senator PROXMIRE (presiding). The testimony we have had before this committee from Chairman McCracken and the new Director of Budget Management, Mr. Shultz, from Treasury Secretary Kennedy in a slightly different way and from you, Mr. Ackley, has all been that we ought to move ahead, that it is time to resume growth in the economy. Dr. Samuelson, I take it that you would agree with that.

Mr. SAMUELSON. Yes.

Senator PROXMIRE. Mr. Wallich, you seemed to hedge somewhat on fiscal policy, although you eased up on monetary policy, but do you feel in general that this is the time for us to try to move the economy ahead, grow rather than maintain the present level of economic activity?

Mr. Wallich. We certainly should not long maintain the present level of activity because that means no growth and continually rising unemployment. If the question is, should we now so accelerate the economy that from here on out, the third quarter of 1970, we are going to get back to potential as quickly as possible, in other words, grow at a rate somewhat faster than potential to catch up with potential, I would say we should make haste slowly. We ought to have one or two quarters of gradual growth that may be less than potential so that some more slack ——

Senator Proxmire. Is not that pretty inevitable, though? No matter what policy we adopt we are not going to assume 4 percent annual rate of growth in this quarter and probably the next quarter, is that not right?

Mr. Wallich. I would agree that would be my forecast.

Mr. Samuelson. I think that would be an understatement. If we want to take the discredited economists' forecast, say the seven in Business Week or any other seven you want, there is nobody in Government or out of Government who thinks we are remotely going to have growth in the next four quarters at a 4 percent rate.

Mr. Wallich. But that is on the assumption that we do not follow a policy that would tend to produce that. Now, two quarters is a very short time for any policy to turn the economy around. Allowing for lags, we will have to look a little further ahead.

What I am saying is, we should not now step drastically on the gas in order to get back to potential as fast as was possible.

Senator Proxmire. To get as specific an answer as I can, can you give us any notion of how large a deficit you think would be sensible? Would you say that we could have a $3 or $4 or $5 billion deficit in fiscal 1971, for example, without increasing inflationary pressures?

Mr. Wallich. Well, provided the appropriate monetary policy were followed so that money would be a little tighter as the budget was easier.

Senator Proxmire. No. Your basic premise, as I understand it, is that we should ease up on monetary policy. Now, with that, what kind of a fiscal picture should we aim at?

Mr. Wallich. I have not made myself clear. I think we ought to aim at a certain level of economic activity. To achieve this we use both fiscal and monetary policy. Now, if you say let us have for argument's sake, a $5 billion deficit then I would reply this means a monetary policy—I have not figured it out—but such and such. A $5 billion deficit, particularly if it comes from short-fall of revenues and from not increases of spending, I think would not be unbearable. I would prefer a smaller one because I assume then monetary policy will be easier. If I did not do that, I would have to say that the economy in the face of a very tight monetary policy probably needs some fiscal stimulation.

Senator Proxmire. All right. Dr. Samuelson, I want to say that either we are getting on your team or you are getting on ours. I think we are seeing monetary policy pretty much the same way.

You say in your statement that, "The doctrine of this Committee," Joint Economic Committee, "the rate of growth of the money supply should be kept within the range of 2 to 6 percent per annum." You say that may be a good enough rule but we should not hesitate to vary from it. We said in our report in June of 1968, and I quote:

In normal times for the present the desirable range of variance appears to be within the limits of 2 to 6 per cent. The committee requests that the monetary authority report promptly to it the reasons that the Federal Reserve System would give for any divergence.

And then we say:

If after several years' experience with the rule refinements in the guidelines seem warranted they could and should, of course, be made.

We are not saying it is rigid. If they want to go up to a 10 percent in any quarter, we want to know why. If they want to reduce it to below 2 percent that may be reasonable, too. So, I do not think we really disagreed with you very sharply.

Mr. SAMUELSON. I am satisfied with that.

Senator PROXMIRE. Now, suppose we proceeded on the basis that many of the Senators seem, and I suppose Members of the House, would seem to support. Supposing we cut military spending rather sharply and some other spending, too, space, and so forth, and increased the President's requests in some of the other areas, particularly in the area of education, and so on. But the net effect, the aggregate effect would be a reduction in spending. Do you feel that this would be restraining and from an economic policy standpoint would not be the desired policy? In other words, you feel that we should either reduce taxes or increase spending in aggregate above what the President requested, is that correct?

Mr. SAMUELSON. Yes. I feel, not only in terms of my diagnosis of the current situation, but looking at the next 5 years as the President's economic report did, there was not sufficient attention paid in that report to the amount of our national resources which ought properly to go into the civilian public sector because of the very pressing needs of modern life. And, therefore, since the business cycle does not call for a squeezing of the civilian public sector, I include ecology, education, manpower training, all those things, since the long run does not call for that, I would definitely be opposed to a reduction, say, in the next 18 months.

Senator PROXMIRE. You see, Congress and the President are arguing about who is going to cut spending the most and I have argued that Congress has the better of the argument because we have cut every President's request including President Nixon's, for the last 25 years, Congress has, with an aggregate ——

Mr. SAMUELSON. Why argue about the fellow who is the biggest son of a gun?

Senator PROXMIRE. Perhaps that is what we are doing, perhaps from your standpoint, but I just wanted to get your views on this because I do not think that those of us who favor, and I am one of them, who favor keeping aggregate spending down and from your standpoint that is a faulty position to take, should not be identified with those who take a position you take, that the desirable economic policy is to expand spending in aggregate, although you apparently perhaps would support Mr. Ackley's position, we should cut military spending below what the President asked. What do you mean by future actions needed to enjoy high employment without inflation?

You suggested that but you did not indicate your position on guideposts, credit controls, aid to housing specifically.

Mr. SAMUELSON. Well, what I had in mind—I think you were looking at me, were you not?

Senator PROXMIRE. Yes, sir.

Mr. SAMUELSON. In my last sentence, I had in mind that we have not done all the exploration that I think should be done on manpower retraining and on the structural unemployment problems in our society. I think that if we spent more resources in retraining and manpower programs we could get a better Phillips' curve, a better tradeoff between employment and price stability. And that was the general range of matters that I referred to there. I am thinking of the kind of thing the Urban Institute is now doing.

Senator PROXMIRE. That is a long-term structural effect, then. How about in the short term? What is your position on guideposts? Do you think they are realistic right now under present circumstances? Do you think we can get the kinds of cooperation out of labor and management that would make a guidepost policy work?

Mr. SAMUELSON. I think that if the President and Congress show that they really mean business, you can get some gains.

Senator PROXMIRE. How do we do that? How do we show we mean business?

Mr. SAMUELSON. From guidelines.

Senator PROXMIRE. I take it, both you and Mr. Ackley say we should not hold the sword of price controls and wage controls over their head in order to enforce——

Mr. SAMUELSON. Yes, but I do think——

Senator PROXMIRE (continuing). Guideposts.

Mr. SAMUELSON (continuing). That it will take more than a Productivity Council and an alert from the Council of Economic Advisers. I think it will involve bringing before the bar of public opinion, in the most pointed and painful fashion possible, many key decisions such as the steel price increase, and I would not be frozen into a previous philosophical position that that was a bad thing in principle to do.

Senator PROXMIRE. How about invoking the kind of credit controls we have on the books. As you know, we passed them in December of last year. The President has a full arsenal of compulsory credit controls he can put into effect any time. He can peg interest rates in any sector he wishes. Do you think he ought to use any of this now?

Mr. SAMUELSON. No.

Senator PROXMIRE. None. I would like to ask Mr. Ackley, do you support the concept of requiring the President to include guideposts as a regular part of his annual Economic Report? Congressman Reuss and I had a bill to propose this. I know you are familiar with it.

Mr. ACKLEY. I think the President always ought to discuss guideposts in his annual Economic Report. I do not know whether, if an administration feels that this kind of activity is ideologically wrong and useless, there is much point in making him go through the motions, but perhaps there is. I certainly do not object to it. And any encouragement you can give to this or another administration to use to the maximum such influence as the Government can command to slow down the increase in administered prices and wages I think is all to the good.

I may say that I agree thoroughly with Professor Samuelson that one of the most important things that can be done in the longer run is in the area of manpower policy where we can improve labor markets and improve the terms of the tradeoff between unemployment and wage increases by reducing the simultaneous incidence on the one hand of vacancies and on the other of large-scale unemployment.

Senator PROXMIRE. If you have a President who was indifferent to guideposts or hostile and a Congress that believes in them, is it possible that Congress could evolve guideposts by holding hearings, et cetera, or do you think that is just too clumsy and the Congress too diverse to be able to act that way?

Mr. ACKLEY. I think it probably would be difficult. But you are certainly more of an authority on what the Congress can do than I am, Senator, and I—if the President does not want to do it—suppose perhaps Congress might try it.

Senator PROXMIRE. You seem to put a great deal of confidence in the notion that even under present circumstances you could persuade labor leaders and business leaders they were not in on the takeoff on guideposts to go along with them. I have talked to many labor leaders and I talked to some business leaders last night. I just cannot find any support at all among these people for guideposts. The labor leaders want them on industry and the management wants them on labor. But as for the notion that this would serve the public interest and in the long run serve their interest, it seems to me it is very, very hard to get it.

Mr. ACKLEY. I agree it is very difficult. I do not think it can possibly be done except by an administration that is willing to use its authority, its influence, its prestige, to accomplish it. But I think the very fact you mention—that business is worried about wage increases and labor is worried about price increases, and each feels that the other ought to be restrained—does provide the setting in which, conceivably, with proper leadership, some kind of a deal could be struck. A stabilization compromise would not slow price increases to zero immediately, but at least it would have some influence in reducing the pace of the spiral.

Senator PROXMIRE. Dr. Samuelson, you say there was a letup in inflation in the second quarter. Where do you see this?

Mr. SAMUELSON. In the seasonally corrected numbers. I have reference to the wholesale prices, to consumers' prices, to the GNP deflator, including the GNP deflator purified of the recent Government wage increase.

Senator PROXMIRE. My staff tells me here that if you purify it for the Government pay increase, purify the first quarter for that, that there is no improvement, just about a washout, and the Commerce Department release acknowledging the second quarter GNP figure contains the following statement which I shall quote:

> Most of the remaining difference between the first and second quarter increase in the GNP deflators after allowing for the pay raise was due to changes in weights rather than a deceleration in the rate of price inflation.

Mr. SAMUELSON. I do not wish to insist this is a strong confident signal being given us. On the basis of the evidence that I know of before, including now this new evidence, I think history will probably record the changes around the first quarter but I want to add that we have had many false indications of the same type. Nobody, for example, at the end of 1969 expected a flareup of the inflation in prices which occurred in the first quarter. So, I do not think you can count upon the inflation as definitely being over. It just looks as if the smooth data suggest that and I would not wish to be speaking with great emphasis and authority that that is not now an accomplished fact.

Senator PROXMIRE. Senator Javits?

Senator JAVITS. Thank you, Mr. Chairman.

I hope you gentlemen will forgive me for not being here sooner but I had several conflicts, including an executive meeting of the Senate Foreign Relations Committee.

I would like to ask just two questions of the panel. I have been briefed on what has gone on and I know that Senator Proxmire as always, will have asked very searching and important questions.

One question relates to stimulating productivity. Could we have the view of the members of the panel on, (1) the relative importance of stimulating productivity in real terms, (2) the best way to go about it, and (3) what measures could be taken in Government, including a revision of the depreciation schedules, on which we now have a treasury report which I will be putting in the Congressional Record, a revival of the equipment tax credit or any variant thereof, and also on the issue of the morale of the American workers in respect to productivity.

Can we start with you, Professor Ackley?

Mr. ACKLEY. Clearly, in the long run, the stimulation of productivity is one of the most important things we can do, not only because of its impact on prices but because of its impact on our longrun growth and ability to produce the goods and services that we need. I really believe that there is probably very little we can do in the very short run to stimulate improvements in productivity. I wish there were; and if someone finds some ways, I am all in favor of them. It seems to me, however, that the approach to improving the rate of productivity increase has to run, first, in terms of funds devoted to research and development, and, second, to efforts to encourage some of the lagging industries to make use of the best technology that is currently available. Certainly, we do have some industries—housing, medical care, other services—where even with our current basic knowledge and a little development work we could do a lot to improve productivity.

Whether, at this point, revision of depreciation guidelines or renewal of the investment tax credit would be useful, I guess I would want to think more about it. Obviously these measures have possible impacts not only on productivity but also on income distribution, because they affect the sharing of the tax burden between business and the rest of the economy. Perhaps some device in which you liberalized depreciation but compensated for it by a higher corporate tax rate might be useful, or similarly with some kind of an investment tax credit.

I still like the idea of the original proposal which would try to make the investment tax credit apply only at the margin instead of to the whole of investment.

Right now, more investment is not very easily stimulated, nor even necessarily a good thing, with the utilization rate as low as it is. It is going to be hard to get more investment right away. But for the longer run, it certainly is an avenue to be considered in an effort to speed the growth of productivity.

Senator JAVITS. Professor Samuelson?

Mr. SAMUELSON. I agree that the longrun trends in connection with productivity are the most important trends and the best thing the Government can do in this respect is probably in the field of sponsoring of research, helping finance research and education.

Now, I would call your attention to a rather anomalous feature of the way we have run our economic system for the last 15 or 20 years. A great part of interesting scientific research has been subsidized directly or indirectly by the defense budget. I, for example, was a coauthor of a fundamental work, well reviewed, in the field of advanced economics which was completely financed by an agency which received all of its money from the Defense Department. For very good reasons the Defense Department is on the defense now and is in contraction, and I think that is proper because there was no reason why such a book should have been financed by the Defense Department or why the fundamental working probability was on a defense contract. Nevertheless, that is part of the Nation's business for fundamental works on probability to occur and to be written.

I am referring, for example, to the classic by the late Professor Feller. And I do not know just which branch of the Government is bucking eagerly to take on that function and I would just call your attention, since you ask about productivity, to the fact that there is a vacuum developing which the National Science Foundation has not yet the funds to fill.

Now, with respect to the short run, there is every hope that we will get an improvement in productivity without regard to government if the acts of government do cause the economy to end being in retardation and recession and start on the upward climb. You have to some degree a self-fulfilling prophesy. In our history the one time when productivity does worst is in period of retardation because of labor hoarding, and so forth, and the one time it most surely does best is in the reaction from a V-bottom recession.

Now, I hope that that will materialize. We have it coming to us. But I would caution that it is a hope. It is a hope based upon reasoned past experience but there is a great deal of noise in those patterns and we may not get it.

Now, on your most direct question which is, should we stimulate plant and equipment expenditure by business as a contribution to productivity by some new acts at this time such as faster depreciation, I would call attention to the fact that the investment tax credit has very valuable features which could be used, could have been used, were used for this purpose. Unfortunately, that was repealed and not suspended, which I think was a mistake because when we had too much plant and equipment investment last year and a little bit before, you did not get a reduction in it of the same predictable magnitude as you would have had under a suspension.

Whether the time has come, now that the plant and equipment expenditure is levelling off in money terms, to give it a shot in the arm by, say, faster depreciation, I think is a moot question at this time.

A number of your colleagues have asked us in effect, how more room can be made for housing. Obviously, more room cannot be made for everything in a finite credit market, and if plant and equipment expenditure took on a new lease of life because of some clever gimmick or law change which a member of the Senate or of the administration could put into effect, that would have to be considered a competing demand for the resources which go into housing, and I include not only real resources but also the money resources of the capital market.

Most economists have not been able to explain the strength of private plant and equipment investment in recent years. Every regression or equation which has ground out numbers has had to be increased to face reality. That being the case, I do not think I can honestly say that one can diagnose the present situation as one in which plant and equipment looks like one of the most important elements that ought to be stimulated in the period just ahead, and so reserving judgment on the answer I might give two quarters or three quarters or four quarters from now, I cannot find in our present experience a strong reason for a new stimulus on plant and equipment as such.

Senator JAVITS. But you do speak for a new stimulus on housing.

Mr. SAMUELSON. I concur in the desire expressed in this room on both sides of the table that housing, which has been very low in terms of almost any calculation of needs of the community, should desirably be expanded. I did not get a chance, in the give and take of questions earlier in connection with Senator Proxmire's questioning, to put in one caveat. You know, we can solve the inflation problem. It can be solved, and there is a vice president of a large New York bank who believes in this method, by having enough unemployment and if it takes 19 percent, well, that is the way the cookie crumbles, and so forth. There is a way of solving the housing problem which is the same. If you run a very slack economy so that plant and equipment and inventory spending and all the other things are on their backs, then the Federal Reserve, following prudence, including your elastic formula, will find itself creating the extra fluid credit which will, in that circumstance, go into housing and regulation Q, and all the other things will begin to work in your favor. But I would speak against, and I do not think anybody who seriously thinks about it would speak in favor of, that kind of solution for the housing problem—to have the whole economy, let us say, increase its gap between full employment and what it is performing by doubling it from the present level.

If you do that I think you will get a spontaneous so-called "increase" in housing. That is not the kind of an increase in housing which I, as a witness, could advocate before you.

Senator JAVITS. Thank you.

Professor Wallich?

Mr. WALLICH. I think it is useful to focus on productivity because it shows that there are competing demands in our economy. We have talked mostly about the need for more housing. Given a limited supply of total saving, that really means taking it away from business investment.

Now, if we do that, we will reduce the resources that are available for increasing productivity.

This would not show up very immediately. For one thing, we have got about a 3 percent productivity increase coming that we did not get last year. Somewhere along the line, not in 1970 or 1971, necessarily, that ought to be caught up with. Productivity has been a very stable figure in our economy and whatever was lost in a weak period tends to be made up later.

But if we do not put enough finance behind it, we will cut down a little the rate of increased productivity. Capital is by no means everything in economic growth. Technology, education, and other factors are very important. But still money is needed. To ask what to do about productivity now reminds us that we have very limited capital resources with which we want to accomplish a number of important objectives, not only housing and productivity gains but State and local expenditures, environmental expenditures, and foreign aid. All of these are making demands on our capital pool. In looking at the methods of doing this, I would focus more on ways that increase total savings than on ways that, let us say, shuffle existing saving around.

I suspect, without being able to demonstrate it immediately, that the investment tax credit it is more a way of shuffling savings around. The Government loses a given amount of revenue. The corporation gets the money and spends it. If there is a leverage effect so that the corporation, let us say, borrows more money as well, then again, it draws on the limited pool of capital. Only if the corporation were induced by the ITC to pay less dividends, then the ITC may increase the supply of savings.

Other devices would be to go easier on the corporation tax, or to shift to the value added tax. These are means of increasing corporate saving, thereby probably increasing total saving. That would help, of course, not only corporate investment in productivity. It would help the other areas of the capital market, too, such as housing and State and local.

Senator JAVITS. Thank you very much, gentlemen. I had one other question, but my time is up.

Senator PROXMIRE. Go right ahead, Jack. I have got a couple of more questions.

Senator JAVITS. My question is on the liquidity crisis. What is your observation, gentlemen of the panel, on that crisis and what would you do about it? I myself testified this morning in favor of a bill to enable the United States to guarantee up to $750 million in credits mainly to ease the liquidity problem of the railroads. I have contemplated a more massive effort generally along the same lines of a guarantee RFC operation based on the theory that there is a liquidity squeeze which could seriously impair the ability of American business to operate. The businesses could then function without any regard to receiverships or other actions which would squeeze the water out of their capitalization, et cetera, the normal risks of the enterprise system, but simply to enable enterprises essential to the national interest to operate, like railroads.

Could we have your observations on that?

Let us start at the other end at this time, Dr. Wallich?

Mr. WALLICH. I think there are two objectives to be observed here. One is to keep the enterprise operating if it is a necessary one like a railroad. This is not true of every manufacturing plant whose output can be substituted by some other plant.

Now, a railroad in receivership may be quite able to operate. I have been riding on what used to be the New Haven for many years. It was able to get by because it did not pay interest and so it had some more money to pay wages. From that point of view, there is no compelling need to keep even a railroad out of receivership.

The second objective is to prevent serious upsets in capital and financial markets. In the case of the Penn Central the problem was the commercial paper market. It turned out that so far there have been no visible severe repercussions, but one could not know. This second objective therefore would be to prevent failures if they clearly are threatening to upset capital markets, cause other enterprises to to become embarrassed, or perhaps just raise the cost of money sharply because lenders put a risk premium on their money thereafter.

Given these two objectives, I would still say that the Government should protect itself as much as it can, so that the loss falls on the stockholders and perhaps ultimately in the workout of the situation also on the bond holders. Also, we should not make this a device for increasing total drains on the capital market.

I come back to the same theme. We hear of a guarantee of $750 million. This may be a necessary and desirable measure. I am not speaking to it. But if it leads to an increased preferential financing with Government guarantee of $750 million, there will just be $750 million less money available for something else. In setting up some kind of guarantee RFC, we would have to be sure that we do not finance unnecessary expansion but only backstop the meeting of existing obligations.

Senator JAVITS. Thank you.

Professor Samuelson?

Mr. SAMUELSON. Very briefly, I approve of such efforts. I think the Reconstruction Finance Corporation, which was introduced prior to the New Deal Administration of President Roosevelt by President Hoover, had an extremely useful function to perform, and after a very long boom such as we have had, there has been a deterioration of the quality of credit in many lines which tends to be revealed to us by types of money crunch. We have illiquidity just in the formal sense of tight money. And I think it is a function of the Government, a useful function, to help out in situations involving a very large railroad, a very large defense contractor, particularly since these effects spread.

In the case of the Penn Central bankruptcy, the whole commercial paper market was thrown into disarray. I have no reason to think that a company like Chrysler was in any real trouble but in a situation like that a woman's virtue only has to be whispered about for her to have lost her good name and there was a problem.

I commented earlier in my testimony that the Federal Reserve had done some very good things in relieving the macroeconomic effects of that. Let me add, though, that when you have these things you must also have in Congress an absolute watchdog committee because it is very hard to draw the line between conflicts of interest, or chicanery, or incompetence, and the Government pulling chestnuts out of the fire under influence, and so forth. So, you are buying yourself a lot of headaches, but that is what you are paying for.

Senator JAVITS. Thank you very much.

Professor Ackley?

Mr. ACKLEY. I agree with my colleagues.

Senator JAVITS. Thank you very much, Mr. Chairman. Very helpful. Thank you.

Senator PROXMIRE. I am somewhat concerned about this revival of Reconstruction Finance Corporation because it seems to me that we are finally getting some results out of the liquidity squeeze. After all, if liquidity—I should say out of the restricted monetary policy and that translates itself into a liquidity squeeze on corporations.

Now, there wasn't much concern really expressed by the corporations about restrictive monetary policy until they began to be hit.

We know what it did to housing in 1966 and what it has done to housing in 1969. Now that it is beginning to hit the corporations so that the weakest, mismanaged, incompetent ones are having trouble and going into receivership, which might be an improvement, we are concerned about bailing them out.

I think that Senator Javits is as fine a Senator as we have and he may well be right on this and your responses may be correct, but we are not just buying headaches. It seems to me we are buying a situation which might result in incompetence and in keeping resources in operation which—management resources, at least, that we shouldn't.

Senator JAVITS. Would the Senator yield?

Senator PROXMIRE. Yes.

Senator JAVITS. I would hope very much that Senator Proxmire, whom I also regard as a fine Senator, would use his mind to meet that issue. I think it can be met. I think we are ingenious enough to meet it without jeopardizing situations in which the national interests will suffer.

For example, Penn Central, to be precise, should have gone into receivership. It does have a $20 million-a-week payroll. It seems beyond belief that the wheels would stop rolling, but they could, just because they can't meet the $20 million-a-week payroll. My purpose is to devise a piece of public machinery which would avoid that.

Senator PROXMIRE. Well, yes, I would certainly go that far. I think you are right about that.

Let me follow that up because this is most appropriate in view of what is coming before the Senate in a few days, the Defense Procurement Authorization Act, which includes a bailout for Lockheed of $200 million. And this morning's Paper reports a deal has been struck between the administration and a number of banks and Lockheed to bail out that company's financial problems, providing Congress appropriates that extra $200 million this year, probably another $200 million next year, and underwrites $100 million in loans..

What do you gentlemen think Congress could do? We will have an opportunity to vote yes or no because I am going to put in an amendment to knock out that $200 million.

Mr. SAMUELSON. I have no informed judgment on the merits of that particular issue. If I may comment on your first intervention, I think it consists of two parts which should be kept separate.

First, a Reconstruction Finance Corporation, either of the magnitude that existed in the great depression or as is envisaged here or what might grow out of that which is envisaged here, would not possibly protect the economy from an illiquidity squeeze such as was engineered by the Federal Reserve. Its purpose would not be that, and you have only to go through the arithmetic of the problem to realize that it wouldn't remotely keep the economy from being subject to Federal Reserve policy.

Senator PROXMIRE. Well, except I have this in mind. One of the reasons why—one of the many reasons why the monetary policy didn't bite where we thought it would—many people thought it would—in reducing credit to business, was because after a long period of prosperity and after very few failures and no big failures, business felt they could operate on relatively small amounts.

Now, if you are going to be bailed out, if they can expect that if the cataclysm comes there won't be any real disaster to the people who have loaned to them, et cetera, it seems to me that they will maybe tighten their cash position even further because, of course, they can make more money if they operate on a tighter cash position. It is that kind of psychological.

Mr. SAMUELSON. Yes, I agree. I don't mean to register any disagreement with that, but I want to agree with the second part of your statement and that is that there is a great problem, in pursuing the public interest, in judging where you will get involved in conflicts of interest and in giving people exemption from acts of their own folly.

Now, I think the test should be whether the result has macroeconomic implications. If, for example, a mismanaged savings and loan association in Long Beach, Calif., is going to go to the wall, I think we should all say God bless it. But if it is going to carry many or most of the S & L's in California to the wall, the good with the bad, that is a macroeconomic effect which cannot be allowed to happen, and it is very hard to draw the line between those.

Senator PROXMIRE. Well, we have the same kind of problem with brokerage firms now, and Senator Muskie has proposed a bill. As I understand it, it wouldn't bail out incompetent management but it would preserve the cash that has been put with these brokerage firms that might otherwise evaporate and innocent stockholders would be ruined.

The same kind of principle that we have applied in the FDIC. That kind of thing to protect debtors—rather, lenders. It seems to me it is good. If we are trying to protect stockholders, it seems to me we should not do it.

Let me ask, I was very intrigued, because this has puzzled me, too, Dr. Wallich. Your argument that in view of inflation, and increase in the money supply of, say, 5 or 6 percent is really highly restrictive. I am not sure that I have thought enough about this to fully understand it.

But is it—are you implying that if we have an inflation of 5 percent and a desired growth of 4 percent, that then the logical increase in the money supply would be 9 percent; 5 plus 4 percent?

Mr. WALLICH. If this were a stable situation where everybody anticipated this 5-percent inflation, one would have to say this was so.

Senator PROXMIRE. So that under present circumstances, as long as you have a 5 or 6 or 4 or 5 or 6 percent inflation, during those years while we have it, an increase in the money supply of about that amount is quite restrictive.

Mr. WALLICH. I would not go quite that far because I don't think really people anticipate with full certainty that degree of inflation, although they seem to have a fair inkling.

Senator PROXMIRE. You have had it for a couple of years now.

Mr. WALLICH. And you got 9-percent interest rates, which seem to say that people are indeed figuring on some high rate of inflation. In that case people will have made up their minds to carry minimal cash balances, and they will have adjusted to that.

Now, if we are going to continue at that rate of inflation which, of course, I do not advise, then we would have to allow for the depreciation of money and for the rate of growth of the economy.

Senator PROXMIRE. Well, one thing about monetary policy, as I understand it, is that it can be varied rather quickly and in view of the fact that we are in that kind of state, if we are talking about an expansive monetary policy, a reasonably expansive, moderately expansive monetary policy, then I take it your conclusion is we ought to be thinking in terms of rise in the cost of living that everybody experiences plus the kind of growth we would like to have.

Mr. WALLICH. That puts it very strongly. I would say that we have got to bear in mind that if we have a 5-percent rate of inflation, and a 5-percent rate of money growth, we are not really increasing the real money supply at all, but yet we want the economy to increase in real terms at 4 percent. There is clearly some disparity.

Proceeding that way, if it doesn't throw us into a recession, will eventually bring the inflation down. Then we will have 4 percent real growth and 4 percent nominal growth and that 4- or 5-percent rise in the money supply will be just right. But there will be a period of deflationary pressure from the discrepancy between the real increase and the nominal increase in the money supply.

Senator PROXMIRE. Do you agree with that, Dr. Samuelson?

Mr. SAMUELSON. Well, I would like to put it my way. I know of no credible estimates which believe that in the next 5 years, by whatever policies we pursue, we shall have averaged out for the 5 years to a rate of price increase lower than 3 percent. Remember, we have to average fives and fours. So let's say for the 5 years 1970 to 1975 there is a best figure to hope for, an average of 3 percent per annum.

Now, I am willing for us to have contributed something in the first part of this decade in the way of slow growth toward making those inflation goals feasible as against the earlier excesses. But nevertheless for the half decade as a whole, when I think of the people who will be age 18 to 23 in those years and will never have another youth again, I don't want them to pay the full price of inflation.

So let's suppose that the rate of growth for that half decade in real terms is to be something like 3 percent, which is below our potential. Add to this the fact that when you moderate inflation the velocity of circulation of money is lowered.

Add to this the face that higher real incomes reduce that velocity according to the greatest expert on the history of money in this country, I am referring to Mrs. Anna Schwartz [laughter], has calculated that as we grow wealthier, with higher income, there is an increased desire for cash. That is a reduction in the rate of velocity.

Senator PROXMIRE. Mrs. Anna Schwartz isn't the economic name of Mrs. Friedman, is it?

Mr. SAMUELSON. No. No. By the way, I think this is a very degrading interrogation. [Laughter.] I meant those two National Bureau authors. I have forgotten the name of one for the moment. It will come back. It was Professor Milton Friedman of the University of Chicago.

But my point is that there has been a slowdown in the velocity, secularly. I would personally offset that against some technological changes speeding up velocity.

Senator PROXMIRE. Anyway, what all this adds up to, what you and Dr. Wallich are telling us, it seems to me, is right now we are existing on the assumption that the money supply is increasing the 5 or 6 percent, that we are exercising monetary restraint, and everybody seems to agree we are exercising fiscal restraint on the full employment basis, so the governmental thrust is a restraining one now. And it is likely to continue that way under likely developments.

Mr. SAMUELSON. In part, but to conclude in my way, this suggests to me that the magic formula of 4½ percent per annum which is, by the way, in the range of 2 to 6 percent, is really biased downward from the standpoint of what I would believe if I were a monetarist.

In "Alice in Wonderland" somebody could believe several impossible things before breakfast. Well, on a good breakfast I can imagine myself a monetarist and if I were a monetarist I would not think that that number is really high enough for best monetary dosage to produce lasting prosperity.

Senator PROXMIRE. Do you want to comment on that, Dr. Ackley?

Mr. ACKLEY. No. I think that covers it very well. Some inflation has to be built into it.

Senator PROXMIRE. I have one final question. None of the panelists this morning has had much to say about the economic consequences of the defense budget or the war in Indochina. Can we expect to solve our serious economic problems through the proper mix of fiscal and monetary policy without curbing the defense budget or ending the war? Hasn't defense spending been the largest contributor to inflation?

Dr. Ackley, you were silent in the last one. Would you like to speak to that?

Mr. ACKLEY. Unfortunately I do not accept the view that defense spending per se is more inflationary than any other kind of spending. What is inflationary is any increase in spending when you are already at full employment that isn't offset in an appropriate degree by increased taxes. I don't think there is anything inherently inflationary about defense——

Senator PROXMIRE. Excuse me. Let me interrupt. Do you mean to say if you produce something that doesn't meet any economic need at all, economic need, aircraft carrier, missile, ammunition, that it makes no difference if on the one hand you are producing that as compared to manpower training or housing or something which is in short supply, a skill that is in short supply? Do they both have the same impact?

Mr. ACKLEY. No. I would say that in taking a slightly longer run, expenditures which increase our productive capacity are of a different character than those which are pure consumption—that the substitution of, let us say, higher welfare expenditures, greater tax reduction, greater income redistribution, for defense expenditures would not seem to me to change their inflationary character. In the short run it is the overall pressure on our resources, and our ability to reduce it, that is important for inflation.

I think that this is frequently used by people who are trying to find another argument for getting out of Vietnam. But I think there are enough good arguments without having to drag in one which seems to me essentially unsound.

Senator PROXMIRE. Dr. Samuelson, do you want to comment?

Mr. SAMUELSON. I don't wish to dissent with the formal point which Dr. Ackley is making, but I think that I would like to observe that the acceleration of the war in the post-1965 period impinging on an already full employment economy, and, if I may say so, rather stealthily accelerating it without asking the public to pay in the form of taxes what was being voted in the way of expenditure, that history I think will record as the proximate cause of the demand-pull inflation and the dynamics of what has happened.

Mr. ACKLEY. I would accept that.

Mr. SAMUELSON. Right. I wanted to add that I think an unpopular war or a war that divides the people very seriously has a very serious economic effect. It has effect upon the willingness to tax to pay for it.

To return to productivity, I don't think you can have your society torn apart and riven particularly among the youth, the people whom I deal with, and not have that show in productivity in the future. I think it will show in adverse productivity and I think some of what we have been picking up has been more than the usual slowdown activity.

Now, that is a pessimistic fear of mine. I can't be sure of it. But it seems to me that it fits in with reason and with experience.

When France was a very divided nation she was a very unproductive nation. So there will be macroeconomic consequences in this. By and large I am able to say in writing, in lecturing, and to people like you that I can't think of any of our current economic problems for which faster withdrawal from the war, if desired for other reasons, would not in fact help. The balance-of-payments problem would be greater. The only problem which would not be helped is a problem we ought to face and that is the return from the Army of a large group of people who in part would have difficulty, if there had been no war, in finding employment for structural reasons. Then structural problems which ought to come to our attention will be brought to our attention.

We shouldn't sweep them under the rug of Indochina.

Senator PROXMIRE. Dr. Wallich?

Mr. WALLICH. I agree with my colleague's analysis of the effect of spending, military spending, consumption, and also the incremental effect of stepping up the war. But I seem to recall that 10 years ago there was great concern that we weren't spending enough for defense and at that time I think the defense budget was a higher percentage of GNP than it is now. Under those conditions I am not sure that the defense budget is going to be realistically very fertile source of savings.

Senator PROXMIRE. We haven't done this historically. We certainly lower proportion of the GNP that that is an argument that it cannot be reduced? You are not saying that?

Mr. WALLICH. I think broadly nations gear their defense to their economic capabilities, which rise with the GNP. Now, this doesn't mean that——

Senator PROXMIRE. If they do that it certainly is completely irrational.

Mr. WALLICH. It is a very deplorable state of the world and anything that can be done to change that would surely be the top priority for all of us.

Senator PROXMIRE. We haven't done this historically. We certainly haven't had an average 7 percent let alone a 9-percent GNP for our defense. We didn't in the 1920's, didn't in the 1930's, anything like it.

Mr. WALLICH. That is right, and partly because those were better times. Partly we lived to rue it. I view this as insurance which in a family's budget bears some relation to the family's income. The way to go about this is to reduce tension all around the world. That is far more important, of course, then any economic concern we could have.

Senator PROXMIRE. Well, thank you, gentlemen, very, very much. You have done an excellent job. This has been one of the best panels we have ever had.

Tomorrow morning we will have the Chairman of the Federal Reserve Board at 10 o'clock and the following day Leon Keyserling.

(Whereupon, at 12:55 p.m., the hearing recessed, to reconvene tomorrow, at 10 a.m., Thursday, July 23, 1970.)

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

THURSDAY, JULY 23, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:03 a.m., in room S-407, the Capitol Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, Moorhead, Widnall, and Conable; and Senators Proxmire, Symington, and Javits.

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.

We have with us today one of the Nation's finest economists, a statesman and a dedicated public servant, Dr. Arthur Burns, Chairman of the Federal Reserve Board. This is the first time we have had an economist in that important position and it is encouraging.

He has reversed the truly disastrous policy of his predecessor, which sent interest rates soaring to the highest level on record for this country. There is still a question in my mind whether he is moving as fast as he should. We shall be going into this matter later in the morning. I might say, Mr. Chairman, that there has been a general consensus among our previous witnesses that your reversal of the extremely tight money policy of 1969 was definitely in the right direction. I think it is fair to say that the only major question was the one I raised: Were your Board's steps sufficient to reduce the terrible liquidity squeeze, get the economy moving again, and bring down those high interest rates which have choked the housing industry and State and local governments?

It is my opinion that if Dr. Burns were allowed to rewrite the charter for a United States of America central bank, he would set it up somewhat differently than it now exists; I believe he would make it more responsible to the American people and to the Government, both the Congress and the President. The truth is that our Federal Reserve System has grown up as a kind of legal conglomerate over the last half century and too often it has been molded to serve the special interest of the bankers rather than the whole country. Upon taking office, Dr. Burns faced the problem of administering this very imperfect institution and it is my strong impression that he would change it for the better if he had the power. However, I do want to make the point, Dr. Burns, that the Federal Reserve, as it is now constituted, according to my view—I know that my view is not shared by all the people of the country and certainly not even by many Members of Congress—in my view, it was never intended to be independent of the executive branch. It was never intended to be independent from the Government or independent within the Government. I have searched the banking statutes on many occasions as well as the Constitution and I find no provision that gives it any such independence, either expressed or implied. From the beginning, the Federal Reserve was intended to serve the whole people, although I would be the first to admit that the law should be revised to spell this out much more clearly.

Mr. Chairman, you may proceed in your own fashion, but please have your opening statement short enough to give members an opportunity to question you on monetary policy and related matters. Your full statement will be placed in the record, and when you look over your transcript you may insert any matter that is related to your testimony and even extraneous matter.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BURNS. Thank you very much, Mr. Chairman. I assure you that I shall take reasonable advantage of the liberty that you have extended to me this morning and in the days that will follow. However, I shall not insert any extraneous material into the record.

It is a pleasure to meet with this committee again to present the views of the Board of Governors on current economic and financial conditions. As we are all well aware, the performance of the economy thus far in 1970 has left much to be desired. I believe, however, that the available evidence indicates that our economy is basically sound and resilient, and that we are making progress in resolving the inflationary problems that have plagued us over the past 5 years.

A year ago at this time, we were still searching for ways to deal with the upsurge in demand that had given rise to a dangerous degree of inflationary pressure. The income tax surcharge was extended for another year; Federal expenditure programs were curbed, and monetary policy moved to a highly restrictive posture over the summer months. The consequence of these policies has been a significant slowing in the pace of total spending, an elimination of excess demand, and a period of relatively sluggish economic activity. The process of wringing out the inflationary excesses of the past has not been painless, but the alternative of letting inflation run rampant would have been utterly disastrous.

The economic adjustment underway since the latter part of 1969 reflects in large part a decline in the resources devoted to residential construction and the national defense. The latter decline is less widely recognized than the former. During the past year the Armed Forces have been cut back by about 350,000 men, and civilian employment in the Department of Defense has dropped another 75,000. Moreover, production of defense equipment during the past year has fallen almost a fifth, and is now nearly 25 percent below the peak reached in the late summer of 1968. Employment in defense-related manufacturing industries began to edge down a little more than a year ago, and the rate of decline accelerated in the first half of this year. In June, employment in these industries was 14 percent below that of a year ago.

As a result of this reduction in defense jobs, communities heavily dependent on defense production have faced difficult adjustments. It is evident, however, that the long-run benefits of defense cutbacks greatly outweigh these transitional developments. We have needed to free resources for other high priority uses, and we should welcome the contribution that reduced defense spending has made—and will continue to make—to abatement of inflationary pressures.

In view of the declines in defense industries, homebuilding, and some other branches of production, a sizable effort on the part of the business community to bring inventories into better balance with sales and orders was to be expected. In fact, the annual rate of inventory accumulation has fallen by about $9 billion since the third quarter of last year. This is the largest decline of any category in our national income accounts.

Total private final demand—that is, demand for goods and services other than for inventory accumulation—has held up rather well, despite the substantial cutback in outlays for residential construction. Continued expansion in business expenditures for plant and equipment was an important sustaining force in the second half of last year, though such outlays have leveled off recently. Consumption expenditures, however, have remained quite strong. In each of the past three quarters, consumer purchases have risen at annual rates of a little more than 7 percent. This is higher than the rate of increase in prices, so that consumer takings have continued to advance in real terms. Federal supplements to disposable income—starting with the January reduction in the surcharge—have contributed to the strength of consumer spending. The expiration on July 1 of the remaining portion of the surcharge should further bolster consumer buying in the months ahead.

With consumer outlays growing and business fixed investment expenditures reasonably well maintained, the overall economic adjustment since last summer has been much milder than in any of the recessions since World War II. For example, the 3½-percent decline in industrial production since last July contrasts with a fall of almost 6 percent in the 1960–61 recession—the mildest of the postwar period. The decline in total man-hours worked in nonfarm industries has also remained small by comparison with the 1960–61 experience.

In recent months, however, the effects of the economic slowdown have become increasingly apparent in the labor market. Total nonfarm employment, which continued to increase through March of this year, declined significantly during the second quarter, and the length of the workweek in manufacturing was curtailed further. The unemployment rate rose to 5 percent in May; the decline to 4.7 percent last month, though welcome, apparently resulted in part from special factors. While layoffs in maufacturing have been an important source of the increased unemployment, many of the new entrants to the labor force have also had difficulty in finding jobs.

The number of women entering the work force was especially large in the first quarter, and substantial additions to the civilian labor force have recently resulted from cutbacks in the Armed Forces.

Clearly, we cannot afford to be complacent at this juncture. Further declines in employment and industrial production must soon be halted, if we are to avoid a significant deterioration of business and consumer attitudes. But as I interpret the incoming evidence from the real sector of the economy, there is little basis for anticipating a cumulative economic decline. Indeed, there are some signs that the decline may bottom out in the near future.

We learned last week, for example, that total real output of goods and services stabilized in the second quarter, after declining at a 3 percent annual rate in the first quarter of the year. Total new orders for durable goods—an important advance indicator of economic developments—have remained approximately level during the past several months, following significant declines earlier. Claims for unemployment insurance since May suggest that the rate of layoffs has subsided, and that unemployment among workers covered by the insurance program may have stabilized.

It seems probable that the drag on the economy of a diminishing rate of inventory investment is now largely behind us. While the ratio of inventories to sales has risen and is relatively high at durable goods factories, this ratio has begun to decline at the retail level. The drop partly reflects developments in the auto industry, where dealer inventories have recently fallen while sales of domestic cars have strengthened considerably.

There are also indications that residential construction may already be turning up. The financial resources of savings institutions have of late improved significantly, and a larger volume of funds will soon be flowing through to the housing sector—where backlogs of demand are enormous. In recent months, the trend of both mortgage commitments and residential building permits has been upward. In June, the level of housing starts also increased. Thus, the recovery in home construction that we have been anticipating may actually be underway, and it will be aided powerfully by the new housing legislation just passed by the Congress.

State and local spending, particularly on construction, is also likely to return soon to more normal rates of growth, partly because of the release of previously impounded funds, and partly also because of improvement in the money and capital markets.

In some sectors of the economy, however, expenditures will remain sluggish in the immediate future. Outlays for defense will fall further. It appears, also, that the boom in business expeditures for fixed investment has come to an end. Reports for recent quarters indicate that expenditures for new plant and equipment have been falling below businessmen's earlier anticipations, and that planned outlays have been revised downward. If historical experience is any guide, further reductions in these spending plans are likely.

This moderation in capital spending was to be expected, and it, too, should be welcomed. Continued large increases in capital outlays eventually would have raised excess capacity to a level threatening a serious investment decline later on. Furthermore, an ending of the capital goods boom of the past 5 years will tend to reduce upward pressures on prices, on costs, and on interest rates. This is added insurance that excess demand will not reemerge as economic activity turns up again, and that we will make further progress in getting inflation under control.

Thus far, our success in moderating inflationary pressures has been disappointingly small. Last month, for example, consumer prices continued to rise at about a 5-percent annual rate. The unwinding from the inflationary excesses of the past is proving a longer and more difficult process than we anticipated. However, while our economy is still some distance from the stability of costs and prices that we seek, progress is being made in this area—more progress, perhaps, than is generally realized.

We are now witnessing some clear signs of reduced upward pressure on prices. In the past 4 months—that is, from March through June—wholesale prices have risen at an annual rate of less than 2 percent, compared with an increase of more than 6 percent in the previous 4 months. Much of the improvement has been due to a decline in the prices of agricultural products as supplies of some basic commodities have become more ample. Also, however, the rate of price increase has moderated for a number of important industrial commodities. Prices of sensitive materials, such as copper, steel scrap, rubber, and tin have fallen both here and abroad. In addition, reports are multiplying that many business firms have begun to shade list prices—offering discounts that are not fully reflected in the price indexes.

This improved performance of wholesale prices reflects intensified competition in product markets and a marked change in the trend of productivity and unit labor costs in manufacturing. Last year, output per man-hour showed almost no growth—partly because of labor hoarding, but also because business practices had become generally lax in an inflationary environment. This year, as sales weakened and profit margins deteriorated, closer attention to costs and efficiency has come to pervade the business community. Many manufacturers have begun to release some of their excess work force, overtime has been cut back, and other cost-cutting measures have been widely adopted. The result has been a distinct improvement in the trend of productivity, and a sharply reduced rise of unit labor costs in manufacturing—even though unduly large increases in wage rates have continued.

These are signs that the elimination of excess demand last year brought about by restrictive monetary and fiscal policies is beginning to bear fruit. With the attitudes toward cost control that now prevail in the business community, we may expect this improved rate of productivity in manufacturing to be extended, to spread to other sectors of the economy, and indeed to accelerate as growth in output resumes. The prospect for gains in productivity is especially favorable now, since a large part of the outlays for capital goods during recent years has been for modernization and improvement of plant capacity. The benefits of improved technology should be increasingly realized in the months ahead.

I believe, therefore, that we can look forward to further abatement of upward pressures on unit labor costs and on industrial commodity prices in the latter half of this year. And as the effects of these developments work their way through to consumer prices, the prospects for lower and more reasonable wage settlements will be enhanced.

The return to general price stability will, of course, be hastened if greater moderation is practiced with regard to wages and prices. I welcome, therefore, the measures taken by the administration to enlist the aid of business and labor in voluntary efforts to improve productivity and to curtail excessive price and wage increases. There is reason to hope that a system to identify and call attention to inflationary wage and price developments will mobilize public opinion against behavior that is prolonging the inflation. But we must remember that success in our efforts to regain full employment without inflation will depend principally on the conduct of monetary and fiscal policies.

Let me turn now to the implications that domestic economic developments have for our international balance of payments. Trade experience this year has been encouraging, but the overall balance on international transactions is still far from satisfactory. As the year began, our trade balance was improving, with the pace of economic activity slowing down in our country but rising briskly abroad. In the first half of 1970, the trade surplus rose to an annual rate of $2½ billion or more—compared with less than $1 billion in 1968 and 1969. We expect further improvement in the year ahead.

The increase in the trade balance has occurred despite a high rate of imports, considering the sluggishness of domestic economic activity. The high rate of imports undoubtedly reflects the persistent inflation in the United States during the past 5 years, which has given foreign competitors an added advantage. Inroads into our markets by foreign competitors cause dislocations, as all competition does. But the Nation also benefits from the added incentive to our business firms to innovate, cut costs, and increase productivity. Moreover, if we attempt to hold down imports through administrative limitations, we will suffer injury to our exports as foreign countries retard their liberalization policies or retaliate wth restrictive measures of their own, as they well may.

While the trade balance has recently strengthened and some increase has also occurred in receipts of investment income, capital movements have been adverse and our overall balance of payments is still registering very large deficits. Looking ahead, we can reasonably expect some improvement in international capital flows. As the economy recovers, our markets are likely to become more attractive to foreign investors. Also, outflows of U.S. private funds, which appear to have been exceptionally large in the first half, should diminish. Together with the stronger balance on goods and services that we anticipate, we should, therefore, see some reduction in our overall deficit.

However, to obtain lasting improvement in the balance of payments, we must continue to pursue domestic policies that restrain advances in costs and prices. By doing so, we will serve our national interests and also contribute to the maintenance of a viable international monetary system. At the same time, our policies must provide reasonable assurance of early recovery in output and employment. The health of the world economy, as well as our own, depends heavily on orderly economic growth in the United States.

The appropriate course for monetary policy in 1970, as I stated at the hearings of this committee last February, is to tread cautiously the narrow and slippery path that lies between too much restraint and too much ease. Early this year when many of the advance economic indicators were pointing downward, there was a need to permit resumption of moderate growth in the supply of money and bank credit. At the same time, however, we knew from unhappy past experience that too abrupt or too large a change in the course of policy could jeopardize our chances of success in the battle against inflation.

Looking back from our present vantage point, it seems to me that we have achieved the middle course with regard to monetary aggregates that we sought. During the second quarter of this year, the money supply grew at an annual rate of about 4½ percent, compared with a rate of about 3¾ percent in the first quarter and virtually no growth over the preceding 6 months. Commercial bank credit (including loans sold to affiliates) showed little increase in the first quarter, since many holders of time deposits were still withdrawing funds from the banking system in the early weeks of the year. In the second quarter, growth of bank credit advanced to an annual rate of about 5½ percent.

The increased growth rate of bank credit in the second quarter resulted, in part, from a return flow of time deposits into the commercial banking system. The turnaround in time deposits was aided by the January increase in the ceiling rates that depositary institutions could offer. This action brought ceiling rates into closer alignment with prevailing market rates of interest. Also, market rates began to decline soon after the turn of the year—especially rates on short-term securities, which have remained well below their 1969 highs. Yields on time and savings deposits thus become more attractive, and deposit inflows improved at the nonbank thrift institutions as well as at the commercial banks. Growth of savings accounts at mutual savings banks and savings and loan associations, taken together, was at about a 7-percent annual rate in the second quarter of this year—compared with growth in the 1½- to 2-percent range during the latter half of 1969.

The principal instrument of monetary control employed this year to insure a renewal of moderate growth in the monetary aggregates has been open market policy. To this end, the Federal Open Market Committee has placed increased stress on the longer run objective of achieving an appropriate growth rate of money and bank credit. There was for a time, I believe, widespread misunderstanding as to the significance of that change in operating procedures. A few clarifying comments may, therefore, be helpful in laying this matter to rest.

An impression seems to have prevailed in some quarters that the Federal Reserve had decided to pursue fixed target rates of growth in the monetary aggregates on a more or less continuous basis. This was a misreading of our intent. We believe that the Nation would be ill served by a mechanical application of monetary rules. We know that large, erratic, and unpredictable short-run changes often occur in demands for money and bank credit. One of the important functions of a central bank is to prevent such short-run shifts from interfering with the smooth functioning of money and capital markets. We have no intention of abandoning our responsibilities in this area.

The evidence from the first half of this year indicates that performance of this function need not compromise a longer run objective of maintaining an orderly rate of monetary expansion. Thus, large month-to-month changes have occurred recently in the growth rate of the money stock—in response to unusual factors influencing the public's demand—but over the past 6 months the annual growth rate averaged out to a little over 4 percent.

Let me assure you, moreover, that the Federal Reserve does not view its responsibility as merely that of assuring reasonably steady growth of the monetary aggregates over the longer run. Our obligation as a central bank is more basic. It is to promote monetary conditions conducive to full employment, rapid improvement in productivity, reasonable price stability, and equilibrium in the balance of payments. We do not propose to let adherence to any fixed growth rate of the money supply stand in the way of achieving these objectives.

We are well aware, also, that the oldest and most traditional function of a central bank is to serve as a lender of last resort. As this committee knows, our money and capital markets experienced unusual strains during the past few months. The tensions resulted from a variety of forces—heavy corporate demands for long-term credit, expectations of large Treasury borrowing in the latter half of this year, disappointment over the slow progress in getting inflation under control, concern that some prominent firms might be financially overextended, and so on. In my judgment, the strains in financial markets stemmed in large part from irrational fears of lenders and borrowers, rather than from careful calculations of the fundamental factors underlying the demand for and supply of credit. Whatever their source, however, we know that anxieties of this kind could lead to a scramble for liquidity whose effects might endanger the prospects for recovery in output and employment.

To date, efforts by business and financial firms to strengthen their liquidity position have remained orderly and selective, and they should diminish as it becomes increasingly apparent that we are making real progress in the battle against inflation. But I want to assure you that, in the highly unlikely event that a liquidity scramble developed, the Federal Reserve would use all the authority at its command to insure that unusual demands for liquidity were satisfied.

Demands for liquidity, even exceptional demands, can ordinarily be met by using conventional monetary tools. Credit demands on the banking system at large can be accommodated by open market operations, while the needs of individual member banks can be met through the discount window. Both instruments have been used constructively for this purpose in recent weeks. We have found, also, that minor adaptations of conventional monetary tools can provide solutions to special financial problems. Thus, once it became apparent that some firms were having difficulty in refinancing their maturing obligations in the commercial paper market and might, therefore, need to increase their bank borrowings, the Board moved promptly and on June 23d suspended Regulation Q ceilings on large denomination certificates of deposit with maturities of less than 90 days. This action has enabled banks to obtain funds that investors might be hesitant to place in other markets, and to rechannel these funds to borrowers previously dependent on issuance of commercial paper. Also, it was made clear that the discount window would be available to assist banks in meeting the needs of businesses unable to roll over maturing commercial paper, and member bank borrowings for this purpose subsequently have risen. Increases in bank credit resulting solely from a rechanneling of funds represent a redistribution, and not an addition to the supply, of loanable funds.

These conventional tools are buttressed with standby procedures to permit the Federal Reserve to make funds available to creditworthy borrowers facing unusual liquidity needs through "conduit loans"—that is, loans to a member bank to provide funds needed for lending to a qualified borrower. Administrative arrangements for making such loans to nonmember banks and to nonbank thrift institutions were developed in 1966 and updated in 1969. Furthermore, the Federal Reserve could—under unusual and exigent circumstances—utilize the limited power granted by the Federal Reserve Act to make direct loans to business firms on the security of Government obligations or other eligible paper, provided the borrower is creditworthy but unable to secure credit from other sources.

The powers of the central bank as the ultimate source of liquidity can, and obviously should, be reserved for extraordinary circumstances. Our financial institutions have demonstrated that they are sufficiently strong and flexible to handle with their own resources the needs of creditworthy borrowers—even when these needs are exceptionally large. In recent weeks, the Nation's commercial banks have shown that they are able on short notice to put together very large lines of credit to meet the needs of creditworthy borrowers experiencing temporary financial difficulties. The banks that played so vital a role in these credit arrangements have served the Nation well.

The fact that we have weathered so successfully the financial stresses of recent weeks has renewed confidence in the resiliency of our financial system. The consequence has been a noticeably more tranquil atmosphere in financial markets. But prudence requires, I believe, that we consider what additional precautionary measures might be advisable.

There are now bills before the Congress to provide insurance for customers' accounts in brokerage houses and for shares held in Federal credit unions. These deserve prompt attention.

The Congress might also give consideration to the feasibility of establishing a Federal program to guarantee loans to necessitous borrowers. This possibility should, of course, be explored very cautiously. It would be a disastrous mistake to use Federal moneys to keep unsound firms from failing, or to substitute public for private tests of creditworthiness, or to convey the impression that the Federal Government will bail out loosely managed or speculative enterprises. But there may be a role for Federal guarantees in helping basically sound firms that experience temporary financial distress to find access to funds, where the alternative might be a degree of financial dislocation inimical to the national interest.

Let me conclude, now, by reiterating what I indicated at the outset. Our economy and our financial system have experienced unusual strains and stresses this year. The tests we have weathered indicate that our economic and financial structure is built on a solid foundation. Confidence has been preserved, long-term interest rates have declined in recent weeks, equity prices have made some recovery, and a much calmer atmosphere has come to prevail in financial markets. Meanwhile, we have avoided excessive monetary stimulation and paved the way for resumption of sustainable economic growth.

In the real sectors of the economy, the weaknesses that developed earlier this year have been contained, and I believe we can look forward to an early and orderly recovery in output and employment. The recovery, I both hope and expect, will be characterized by a well-balanced structure of output. Residential construction and State and local outlays should pick up, consumer expenditures should strengthen further, while business outlays on fixed investment taper off. And, with productivity trends already improving, we have good reason to expect further diminution of upward pressures on costs and prices.

This assessment of the strength and resilience of our economy will be tested in the months immediately ahead. Meanwhile, we at the Federal Reserve Board recognize that the future of man's lot on earth can be only dimly foreseen. That is why we always stand ready to revise our judgments and policies in the light of unfolding experience.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, Dr. Burns, for your very interesting and helpful statement.

At this time the Chair will recognize Senator Symington of Missouri for questioning under the 10-minute rule.

Senator SYMINGTON. Thank you, Mr. Chairman.

Chairman Burns, I have a few questions here and I will make them as short as possible and inasmuch as I am under the 10-minute rule, I would appreciate your answers being as short as possible.

Mr. BURNS. That is not always easy for a former university professor.

Senator SYMINGTON. Well, sometimes the questions for a Senator are long also.

Mr. Chairman, the economy has declined considerably more in the first half of this year than most people had anticipated and we are now operating some $40 billion below our potential. As you say in your statement, there are some signs that the decline may bottom out in the near future but we are not certain it will. Our main problem now would appear to get the economy headed up towards its potential again. How long do you think it will take to restore the economy to its potential output level?

Mr. BURNS. I cannot give you a definite date, Senator. I wish I could. Historical experience indicates that once the economy begins recovering, the unemployment rate will drop by 1½ or 2 percentage points in a year or in a little less than a year.

Now, no two cases are alike. I feel that we should restore full employment some time in 1971. Whether we will do it by March or by July or by September I am really unable to say and any guess on my part would not serve the committee well.

Senator SYMINGTON. Thank you, Mr. Chairman. Do you believe that we can get back to potential without touching off a new round of accelerated inflation?

Mr. BURNS. I think we can if we proceed cautiously. There are great presures, now, as you know, to expand the Federal budget. There are great pressures now to expand the money supply faster. I think that if we proceed on the moderate course that we have set, we are likely to regain full employment without touching off a new wave of inflation.

Senator SYMINGTON. What rate of monetary expansion, Mr. Chairman, is appropriate during a period when we are trying to catch up to potential? Many of our witnesses have indicated that the rate of monetary growth will have to exceed the rate of potential output growth, that is, that the degree of the money supply must exceed a 4 percent rate. Would you comment as to whether you think it is correct or not?

Mr. BURNS. The rate of monetary growth of late has exceeded a 4 percent rate. That is my first point.

Second, I think the rate of monetary growth under the circumstances has been about right.

Third, the Federal Reserve Board has the economic situation and the financial situation constantly under review, and I assure you that the thinking of this committee and the thinking of others will be very fully evaluated.

Senator SYMINGTON. Now, you and members of the administration would appear to look at increases in productivity as proof that inflation is abating, but I question the comfort that previous executive spokesmen have brought up if it is due to decreased employment rather than increased output. It is fine, as you say in your statement, to have an abatement of unit labor cost, but what if this is due to reduced employment?

Mr. BURNS. I think you are quite right in saying that the improvement in productivity in and of itself does not constitute proof that the battle against inflation is being won. Also, economic recovery remains to be achieved.

However, as I have studied the business cycle, and I have done that over a period of almost a half century, I have come to expect improvements in productivity as a forerunner of economic recovery. Certainly, improved productivity lays the basis for raising our living standards. It lays the basis also for lower costs of production and lower prices, other things equal.

Senator SYMINGTON. Thank you, Mr. Chairman.

Now, if I may shift a minute to the international scene, last year through Eurodollar transactions U.S. banks borrowed some $7 billion from their foreign branches. If you do not have the figure of such borrowings this year to date, would you supply them for the record?

Mr. BURNS. This year, I believe, there has been a net reduction of about $3 billion.

Senator SYMINGTON. What is the effect of these borrowings on the inflation in this country?

Mr. BURNS. Well, I do not really think that the borrowings that we had last year had any significant effect on the inflation. The borrowings last year involved a certain rechanneling of funds. They were also a protective device. The banks were badly squeezed under regulation Q and they sought other sources of funds. But I think the net effect of Eurodollar borrowing on the total credit available in this country was quite small.

Senator SYMINGTON. Thank you, Mr. Chairman.

Now, two more questions. A well known economist who is a friend of yours and mine, has worried about the competition of the Government in the Eurodollar market with private industry. In any case, if U.S. banks were not able to borrow overseas, thereby providing the source of liquidity or cutting it out, would this force the Federal Reserve to increase the money supply at a faster rate to prevent interest rates from soaring to new levels?

Mr. BURNS. I doubt it.

Senator SYMINGTON. Thank you.

In your statement you say something which to me as a former businessman and one who has been on a good many bank boards in my time, is extremely interesting. You say:

> The Federal Reserve could—under unusual and exigent circumstances—utilize the limited power granted by the Federal Reserve Act to make direct loans to business firms on the security of Government obligations or other eligible paper, provided the borrower is creditworthy but unable to secure credit from other sources.

There has been a good deal of publicity about two major corporations in this country, one, the Penn Central, which is now in bankruptcy, and the other, Lockheed, which now has heavy claims against the Government.

Is the Committee to understand that the Federal Government, through the Federal Reserve, is going to enter directly into loans to these companies if they decide that they should not go into receivership or bankruptcy?

Let me add just one point. They would not come to you, of course, presumably, unless they were turned down by normal banking processes.

Mr. BURNS. That is correct. The power that we have under the Federal Reserve Act is very limited. My purpose in including that sentence in my statement was merely to call attention to the existence of such a power.

Now, you may recall a few years ago the Congress rescinded section 13(b) of the Federal Reserve Act, which gave the Federal Reserve Board larger powers. That has been eliminated. But we still have some power, power we have not used, and I simply wanted to remind the committee that this power is on the statute books and can be used in the event of an emergency. But the tests are very difficult. You need eligible paper and that is a test that not all borrowers are able to meet, and the borrower must be creditworthy and he also must demonstrate that he cannot secure credit from other sources.

Senator SYMINGTON. Thank you, Mr. Chairman. At one time in my career, I ran the Reconstruction Finance Corporation; and based on your statement, it seems to me that you are embracing considerable aspects of what President Hoover had in mind when he started that company. I believe I have exceeded my time. I thank you for your courtesy and I thank the Chair and the rest of the committee.

Chairman PATMAN. Just one question before yielding to Senator Javits. You did not mention the surplus or deficit position in the budget for 1970 or what is contemplated for 1971. Would you very briefly mention that?

Mr. BURNS. I expect that the deficit for fiscal 1970 will be about $3 billion. As for 1971, all that I can supply, Mr. Chairman, is a very big question mark and a bit of anxiety.

Chairman PATMAN. Senator Javits?

Senator JAVITS. Thank you, Mr. Chairman.

Mr. Burns, I join the members of the committee in welcoming you and consider your testimony most significant.

With regard to the chairman's remarks about the fiscal situation, it is a fact that you are optimistic—I think very optimistic—and I do not say that critically; I think it is great and I hope also that it comes through, and that we will attain full employment in 1971. Your optimism is hinged upon some suppositions or some postulates respecting the fiscal policy of the Government and that is, what budget deficit it will incur and what taxes it will raise?

Mr. BURNS. Well, I have been a believer—I have said so more than once, Senator—in a congressional ceiling on expenditures. I have come to the conclusion reluctantly—but it is a definite conclusion—that about the only way that we can bring the growth of Federal spending under control is through a rigid congressional ceiling on expenditures. I was very pleased when the President made this point the other day.

Now, Federal spending has been growing at a rate that I find most disturbing. According to my calculations, last year Federal and State and local government spending in the aggregate constituted something like 35 percent of the dollar value of our national output.

Now, I do not mean to say to you as an economist that 35 percent is the ceiling, that we cannot go to 36 percent. We might be able to go to 40 percent, but I think we are in a dangerous area if we want to retain a vigorous free enterprise economy.

Senator JAVITS. Therefore, you urge upon the Congress the adoption of an expenditure ceiling which will accommodate the one deficit which arose from declines in corporate income, or declines in personal income predictions of $3 billion. What about 1971? What would you say would be the roof deficit to accommodate your expectation from the economy?

Mr. BURNS. I would accommodate for calendar year 1970 whatever deficit arose from declines in corporate income, as declines in personal income if any should occur—personal income as you know, has been rising—or declines in revenue from excise taxes. I would not seek higher taxes beyond the few small additions to revenue that have been recommended by the administration. Although I would support those, I would not look to additional taxes being levied in order to meet a deficit that arises from a declining economy.

I cannot rule out the possibility that the decline of the economy may go further. I think that rising taxes would be wrong at a time when the economic activity is slow. But I also would not under present circumstances increase expenditures beyond the very large budget that has been submitted to the Congress by the administration. If that happened, I would be concerned about what would occur in financial markets. As is, the Treasury will be coming into the financial markets the second half of this year with very large borrowing. That cannot have a good effect on interest rates which concern this committee and its chairman. If you increase the budget deficit further, interest rates might be stepped up further. Fears of inflation could easily be renewed. Anticipatory borrowing could easily be stimulated and new turbulence in financial markets could result.

Therefore, I would put a lid on expenditures at this time but I would also not try to make up through additional taxes any decline in revenue that may occur.

Senator JAVITS. Mr. Chairman, one last question on this fiscal matter.

We are to assume, therefore, that you would keep the ceiling roof at the budget figure but that does not prevent us, does it, from shifting priorities within that roof figure.

Mr. BURNS. Not at all.

Senator JAVITS. The point I would like to ask you about liquidity is this, on Monday I am proposing to introduce a bill which carries out precisely what you say about guaranteed loans, and I have also heard Senator Symington's very excellent point about the powers of the Federal Reserve. Which do you prefer, a guarantee system which would be a new kind of RFC based upon guarantees and which takes into account of the new development of the banking system of the United States since the time of the RFC, or, do you prefer enlargement of the authority of the Federal Reserve Board and banks to make direct loans and perhaps direct guarantees?

In short, shall this authority be vested in the Treasury or shall it be an additional authority given to the Federal Reserve Board?

Mr. BURNS. Let me say first of all, that I very much hope that this authority will not be given to the Federal Reserve Board. On the other hand, if the Congress saw no better way of dealing with the problem, I want to assure the Congress that the Federal Reserve Board would take on whatever additional burdens the Members of the Congress in their wisdom sought to put upon us.

Now, second, I am not at all sure as to the device, but I do have some doubts about giving this power to the Treasury. I have struggled with this problem and I am still struggling with it. The best that I can do today is to give you my very preliminary thoughts.

I think I would set up a loan guarantee board—virtually without staff, however—consisting of a director appointed by the President with the consent of the Senate, the Secretary of the Treasury, and the Chairman of the Federal Reserve Board. It would be a 3-man board.

I would give this Board the authority to make guarantees under conditions that are spelled out with some specificity in the statute, but I would not stop there. I would make the issuance of any such guarantee subject to consultation with the chairman of our two banking committees and with the ranking minority members of the two banking committees.

I think that such consultation would be advisable, if we travel this route, in the interests not only of protecting the public against possible abuse, but also of removing or reducing the possibility of suspicion that abuse is taking place.

Senator JAVITS. Well, I thank you very much, Mr. Chairman.

I had just one question also on foreign policy. My mind, like that of Senator Symington, seems to go in both of these areas. Would you define the bill reported out of the House Ways and Means Committee as a bill which runs afoul of the warning you give us in your statement: "Moreover, if we attempt to hold down imports to administrative limitations we will suffer injury to our exports," et cetera.

Please feel free to say you do not want to comment. I do not want to force you into any position, but this is a burning question. There is a tremendous amount of sentiment for this protectionist approach and if it is unwise in the total economic interests of our country, some people other than people like myself and a few others here, and there are mighty few, have to say so.

Mr. BURNS. I must say in all honesty that I am concerned about this bill. I think we are in danger of traveling a protectionist road. Great concern has been aroused abroad. Retaliatory measures are already being discussed abroad.

I would make one qualification to this statement and one qualification only, and I hope that the members of this committee will not misunderstand what I say. I think as far as textiles are concerned, we are in the position—never mind how we got there—where many members of the Congress have gone on record in favor of a voluntary quota and where the President has committed his prestige in behalf of such measure. I think Presidential prestige cannot be, must not be, expended lightly. In view of that Presidential commitment, in view of the sentiment in the Congress, I would favor continuance of efforts to work out voluntary quotas, restricting the growth—not reducing the volume, but restricting the growth—of textile imports.

Senator JAVITS. That is manmade textiles.

Mr. BURNS. Manmade textiles.

Senator JAVITS. But not on any other commodity.

Mr. BURNS. That is as far as I am prepared to go this morning. I would want to study the matter of other commodities, but I would approach other commodities with a certain bias, you might call it preconception, you might call it philosophy. I would approach other quotas, or other increased tariffs, with great anxiety because it may set off a repetition of the kind of trade wars and restrictive practices that we had during the 1930's.

The end result could be a shrinking world economy, and that is not the worst of it. When you resort to restrictive trade practices, you give rise to political suspicions, and we have had too much of that in this world already. You may release forces that make for international friction and conflict. Let us try to avoid traveling this route if we possibly can.

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

Mr. Chairman, may I ask my colleague, Senator Symington, if he would like to get a written statement of the Chairman as to the legal authority of the Federal Reserve to make loans? Would that be a good idea?

Senator SYMINGTON. Subject to the Chair's approval, I would think it would be a very good idea.

Chairman PATMAN. I think it is written into the law. Under certain circumstances they can make direct loans.

Mr. BURNS. I have the precise authority with me and I will be glad to supply that for the record.

Chairman PATMAN. If you will supply it for the record, please.

Mr. BURNS. It consists of paragraphs 3 and 13 of section 13 of the Federal Reserve Act.

Senator JAVITS. Thank you very much.

(The following information was subsequently supplied for the record by Mr. Burns:)

PARAGRAPH 3, SECTION 13, FEDERAL RESERVE ACT

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of Section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange of the kinds and maturities made eligible for discount for member banks under other provisions of this Act when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: *Provided*, that before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

PARAGRAPH 13, SECTION 13, FEDERAL RESERVE ACT

Subject to such limitations, restrictions and regulations as the Board of Governors of the Federal Reserve System may prescribe, any Federal reserve bank may make advances to any individual, partnership or corporation on the promissory notes of such individual, partnership or corporation secured by direct obligations of the United States or by any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States. Such advances shall be made for periods not exceeding 90 days and shall bear interest at rates fixed from time to time by the Federal reserve bank, subject to the review and determination of the Board of Governors of the Federal Reserve System.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. Dr. Burns, you have given us a highly optimistic picture of our economic condition including an answer to a question—I understood you to say that we will be back to full employment in your view, sometime in 1971, without naming the month. You expect we are moving in that direction, is that true?

Mr. BURNS. I did not make a categorical prediction. I am not a prophet. I am just an economic analyst. I referred to past experience and I stressed my hope and expectation.

Senator PROXMIRE. Well, I certainly hope and pray your hopes and expectations come true but you are really going to have to be Mr. Magic or somebody in the administration is going to have to be to pull this off. It seems to me we have the most unsatisfactory kind of economic position right now. We have high unemployment, very high inflation. We have the highest interest rates in history. We are not growing at all.

From the standpoint of the employment act which this committee is charged to oversee and to work to bring to fruition, we are achieving none of our objectives and one of the rare times in history when we have not been doing so.

Furthermore, it seems to me, Dr. Burns, that nothing the administration or the Federal Reserve Board is doing seems to be moving us in the direction of any of these fronts. I say that, number 1, because it appears on the basis of your speech in February when you said there is no more excess demand in the economy or it seems to be diminished and virtually absent, that the administration's game plan to further slow down the economy and restrain the economy through fiscal and monetary policy will not do the job.

See your head come up and I know what you are going to tell me is that you are not restraining the economy. Well, let me ask you a question about that and see if we can determine whether you are or not.

Previous witnesses have told us that Federal fiscal policy will restrain the economy based on a substantial full employment surplus. Brookings Institution made a study on the basis of the projected budget in January and found that the full employment surplus in 1971 would average about $15 billion. Even if we have a $5 or $6 billion deficit in the consolidated budget we will have a full employment surplus of $10 billion.

Now, what is wrong with that analysis? Does not this indicate that we are going to have fiscal restraint?

Mr. BURNS. Well, let me turn to your question, Senator Proxmire. I do not see the economy as you do. What I see is a very prosperous Nation, a Nation that is the envy of the entire world. The slowdown that we have had in the economy is very small. And had we not had that, had we not made the efforts that we did make in the Congress and in the executive establishment and in the Federal Reserve Board, we would have a rampant inflation now and we would probably be headed for a major bust in our economy.

Now, when you say, Senator, that nothing is being done to advance our economic goals, that nothing is moving, I find it difficult to agree.

Senator PROXMIRE. What is?

Mr. BURNS. I am in the process of answering that question, Senator. I think that we have moved on a massive scale on the fiscal front already in reducing the income tax surcharge, first in January, now in July, also in increasing social security benefits. These have been very large additions to disposable income. And, of course, the reduction of the income tax surcharge is also proving of some aid to our business corporations.

Next, thanks in large measure to your efforts, Senator, the Congress has just passed a very powerful, and I think highly constructive, housing bill. This housing bill, once it is fully implemented, and I hope it will be promptly and fully funded, and will give a great stimulus to residential construction.

I have not been attending these hearings but I was informed by one of my colleagues that you made an estimate recently that this housing bill may stimulate an additional half million housing units.

That may be on the high side. My own estimate would be more conservative. But, I would not differ greatly from you. I would expect perhaps 400,000 housing units to be added as a result of that piece of legislation.

Next, I think you have before the Congress some legislation that can move matters along. I hope that the unemployment compensation bill will pass the Congress promptly. It is a liberalizing piece of legislation. We need it and I think delay would be undesirable, even unfortunate.

Senator PROXMIRE. Let me just interrupt, Dr. Burns, to say that my principal point was that the overall, overall impact of fiscal policy will be restraining on the basis of the arguments by the eminent economists we have had before us. They say we are going to run a substantial full employment surplus, which means restraint, if it means anything. You are as eminent an economist as we have in the country. Would you agree that that is true or not?

Mr. BURNS. I can say this. First, estimates of the full-employment surplus made by the Brookings Institution and by other economists in recent months have varied a good deal.

Second, these estimates do point to a rather large full-employment surplus later on.

Third, if a new calculation were made as of today, those estimates would be substantially lowered.

Senator PROXMIRE. I would agree; $10 billion is $5 billion lower than the $15 billion estimate that they made in January. It still is a substantial restraint and I do not know any economist who would estimate that we would not have a full employment surplus of substantial proportions regardless of what the Congress or President is going to do in the coming months. So, there would be restraint, would you not agree, on the fiscal front?

Mr. BURNS. If you use that measure of fiscal restraint I would agree that, according to present calculations, that is indicated.

Senator PROXMIRE. Well, now, what other measure is there? Why is not that measure valid?

Mr. BURNS. Well, I think there are other measures and I do not think that this is the one key to economic policy.

Senator PROXMIRE. No. I am just talking about fiscal policy, as a measure of fiscal policy. I will come to monetary policy. We had Dr. Wallich, who said that with 5 percent inflation, 4½ and 5 percent growth in the money supply was in effect no real growth. Now, this is rather an interesting new concept to me and I would like to have your reaction to that.

Mr. BURNS. Well, I will give it to you and I will give it to you quickly. This is very dangerous reasoning. Let us go back to the great inflation in Germany in 1922 and 1923. You remember what happened at that time. It took a bushel of paper money to buy a loaf of bread in that period. But some business people and economists were then complaining that the money supply—you needed logarithms to express what was happening to the money supply—but these people were complaining that the rate of growth of the money supply was so much lower than the growth in the dollar volume of production and, therefore, that the rate of growth of the money supply had to be increased.

Senator PROXMIRE. I am not saying that we should take the rise in the cost of living and add that to growth and come to a 9-percent increase in the money supply as being desirable. All I am asking is that under present circumstances as long as we have 5 percent inflation, would not a 5-percent increase in the money supply be in effect, no real growth, or would it?

Mr. BURNS. Senator, as far as the money supply is concerned, let us not be simplistic. We get into the habit of talking about the money supply as if all of us knew precisely what we are talking about. Now, I must say to you that that is not so.

If you take a very narrow definition of the money supply, confining your concept of the money supply to demand deposits and currency in circulation, you get one rate of growth.

If you take another concept of the money supply, no less valid, one which includes time deposits of commercial banks, you get another figure showing a higher rate of growth for recent months.

If you take still another concept of the money supply, one which includes the deposits of mutual savings banks and the share accounts of savings and loan associations, and that is also a valid concept of a money supply, you get still another rate of monetary growth.

Moreover, Senator, there are tricks in measurement—most of them, I am sure, are inadvertent—that we must be sensitive to. We at the Federal Reserve Board devote our full time to managing money and credit. I can show you rates of growth of the money supply—well, take the second quarter of this year. If you measure the rate of growth during the second quarter, using the narrow concept of the money supply, and if the rate of growth is measured from the month of March to the month of June, you will get a rate of growth of 4.4 percent. But if you were to measure the rate of growth from the average of the first quarter to the average of the second quarter, you would get a rate of growth of 6 percent.

Now, I do not want to manipulate figures. I am warning this committee, watch these figures and watch these economists, and also let us watch one another. [Laughter.]

Senator PROXMIRE. My time is up. I would like to ask, though, if you could give me an answer, is the present presumably 4½ percent increase in the money supply in your view expansive, restrictive, or neutral?

Mr. BURNS. In my judgment when you take all facets of the money supply, and I have tried to indicate imperfectly an quite incompletely what I think they are, the present expansion of the money supply is laying the foundation for a renewal of growth in the economy. I consider it to be expansive, yes, moderately expansive as it should be. It is no more than that, and it should not be more than that at this point.

But, Senator, I made some remarks that may have sounded excessively critical. While I have criticized my fellow economists I have also learned from them. I have questioned your remarks, but I have learned from you in the past and I expect to do so in the future. Nothing that I have said here implies even remotely that the Federal Reserve is in a static position. I think we have demonstrated that we are not in a static position, that we are quite alert, that we are flexible, that we can move promptly and have actually moved promptly. As far as the future is concerned, we will watch developments, take into account criticisms, reassess our own position, and do our level best to get this country moving again—but also not release new inflationary forces.

Senator PROXMIRE. My time is up, Mr. Chairman.

Chairman PATMAN. Yes, sir.

Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Dr. Burns, the other day our House Banking and Currency Committee voted out a bill giving the President standby price and wage control authority. In your opinion, would the implementation of such controls be appropriate now or in the foreseeable future?

Mr. BURNS. Well, Senator Symington is leaving. He wanted brief answers. My answer to this one, not counting this professorial introduction, is one word—no.

Representative WIDNALL. What effect do you think debate in the Congress over this authority has on wages and prices?

Mr. BURNS. Well, I think it may unsettle the business community needlessly. I see no point in this legislation at the present time. But I should go on and say I am getting on in years. Whether or not I have accumulated a touch of wisdom, I certainly have many prejudices.

I am opposed to price and wage controls. I have studied them over the years. I have not seen good consequences. There are very exceptional circumstances when my mind would turn in that direction. These circumstances do not exist and I do not foresee them.

Representative WIDNALL. Well, apropos of what you have just said, do you see any merit in the argument that such standby authority can be used by the President as an implicit threat to get labor and business to toe the line on wage and price increases?

Mr. BURNS. Well, you know, when a group of Congressmen debate an issue like this, and decide that it might be a good thing, my instinct tells me that there must be some merit in that argument. However, in all candor, I must add that I see insufficient merit. I think it would be a very unsettling factor in the business world. If we had this kind of legislation on the statute books, people would be wondering. Rumors would be flying and all kinds of unsettling forces on markets would be released. I would, therefore, have to oppose it.

Representative WIDNALL. You have mentioned the unusual number of servicemen being released from the Armed Forces and entering the civilian labor force. You also mentioned that, and I quote: "Communities heavily dependent on defense production have faced difficult adjustments."

Do you have any specific suggestions as to how we might ease the transition of men and areas to a peacetime economy?

Mr. BURNS. Well, I certainly would like to see many of our men who served in the Armed Forces go back to school, enter a university if possible, or get vocational training in a high-paying skill. This is something that interests me greatly. We are spending a great deal of money on training programs. I feel a little uneasy about the results that we are getting. If this committee should run out of work to do, I would recommend strongly taking a very close look, not with a view to criticism but with a view to sound apraisal, at the training programs, to see how well they are being conducted, and possibly to change legislation or change the administration of these programs.

I think we can do a better job with training programs than we are doing. And I would particularly favor doing that for men who leave the Armed Forces.

Representative WIDNALL. Well, does that statement indicate in any way that the degree of employability of former servicemen indicates that little more need be done than sophisticated job matching and increased labor mobility programs?

Mr. Burns. Yes, but I am impatient with regard to job matching. There are hundreds of thousands of jobs available that are not being filled. I gather from the businessmen I talk to, Government officials I talk to, looking at our own Federal Reserve Board, that there is a very large number of unfilled vacancies. I have advocated repeatedly a computer job bank. This is getting underway. Perhaps as much progress is being made as can be made, but I am impatient for more rapid progress because I think this is a reform that we very badly need.

Representative WIDNALL. I am interested in hearing what you say about a computer bank on that.

Mr. BURNS. Well, with the technical facilities that now exist, it should be possible for a workman to enter an employment office and be informed within a matter of minutes of jobs of a kind that he seems to be qualified for that are available within a radius of 10 miles, within a radius of 25 miles, 50 miles, a hundred miles, et cetera. And likewise for employers.

In this way we can remove in large part the frictions of the labor market. We are already moving on that front. But as I say, I am impatient for faster progress. This, I think, would help the unemployment problem and also would not release inflationary pressures.

Representative WIDNALL. Dr. Burns, how can Congress be helpful in obtaining faster progress?

Mr. BURNS. Well, as I suggested a moment ago, this committee might want to make a study of our training programs. I hope that you will consider this possibility and also the computer job bank.

Representative WIDNALL. In your testimony you allude to large erratic and unpredictable short-run changes that often occur in demands for money and bank credit and how this complicates monetary management. Has not one of the major sources of this erratic behavior been the deficit financing needs of the Federal Government?

Mr. BURNS. The Treasury borrowing is an unsettling factor, a complicating factor certainly, in conducting monetary policy.

And also I should add that the average life of Treasury obligations has been shortening, shortening progressively in recent years. That makes more frequent calls to the money and capital market by the Treasury necessary, and this too is a complicating task for monetary management.

Representative WIDNALL. My next question is do large and frequent demands on the money and credit markets made necessary by substantial budget deficits and the short-term structure of the public debt dangerously constrain the Federal Reserve in its effort to shape a monetary policy appropriate to the needs of the economy?

Mr. BURNS. As of the present time, I would say that it hampers us a little. It does not dangerously constrain us at the present time. But such a time could come and I hope it never does.

Representative REUSS. Thank you, Mr. Chairman.

Chairman PATMAN. Yes, sir.

Mr. Reuss?

Representative REUSS. Thank you. Mr. Chairman.

Dr. Burns, having heard your colloquy about wage-price freezes with Mr. Widnall just now, I shall follow my instincts and not ask you any more about it.

I would like to talk about monetary policy. The majority of the Joint Economic Committee for the last 3 or 4 years has been issuing a general guideline to the Fed, I am quoting from the 1967 report, and it has been substantially unchanged:

> The policy of moderate and relatively stable increases in the money supply, avoiding the disrupting effects of wide swings in the rate of increase or decrease generally within a range of 3 to 5 percent per year.

I notice in your statement you set forth with your usual tact the following:

> We believe that the Nation would be ill-served by a mechanical application of monetary rules.

I have been somewhat concerned over the years that possibly our admonition may be a little mechanical and, therefore, in the 1968 report I tried to set forth some qualifications on the 3- to 5-percent money supply, narrowly defined admonition, and I would like to read those qualifications to you to see what you think of them. I have not had that opportunity.

In our 1968 annual report I started out by saying that, "The Federal Reserve system through open market operations, reserve requirements and discount policy shall endeavor to accommodate a growing full employment, gross national product, by expanding the money supply, narrowly defined to include commercial bank demand deposits and currently outside banks by 3 to 5 percent yearly with the following qualifications," and then I set forth the qualifications, some seven of them. I would like to put them to you. And this was a tentative formulation, I might say, so that we can perhaps get our minds a little closer.

Qualification No. 1:

> The target figure should be adjusted up or down from the above band from time to time to reflect the extent to which time deposits in commercial banks and in savings and loan associations, mutual savings banks, and credit unions, substitute for the narrowly defined money supply.

Anything bother you about that?

Mr. BURNS. No. I am not bothered by that. I think that is sensible.

Representative REUSS. Qualification No. 2:

> The target figure should be on the higher side of the band in periods of less than full use of resources, on the lower side in periods of full use of resources.

Anything bother you about that?

Mr. BURNS. Yes. It is an incomplete statement. You doubtless were thinking of a recession and——

Representative REUSS. Or an inflation.

Mr. BURNS. Well, when you have a slowdown in the economy and are also having an inflation, then I think that while the qualification that you just read should be carefully kept in mind, it, too, might need to be qualified in the light of developments and prospects.

Representative REUSS. Would you perhaps at your convenience suggest the qualification or the qualifications which suit you?

Mr. BURNS. I will try to do that.

(The following information was subsequently supplied for the record by Mr. Burns:)

The qualification as stated is too specific to be universally applicable. Information about the recent behavior of prices and economic activity, and the course of fiscal policy, are critical considerations in determining the optimal course of policy. The lags between monetary actions and their effects on output and prices also are important. If the recent past has been dominated by excess demand and substantial inflation, an attempt to reach full use of resources in the short-run through accelerated monetary growth could sacrifice the prospects for noninflationary growth over the longer run. Under such circumstances, if the economy were operating somewhat below its potential, but moving upwards, a rate of money stock growth "on the higher side of the band" might risk overstimulating the economy. On the other hand, when the economy is relatively free from inflationary pressures, and fiscal policy is restrictive, a relatively expansionary monetary policy may be needed to maintain full resource use.

Representative REUSS. Although I might say that I was obliquely patting the Fed on the back with that qualification for what it has in fact done, we have had an inflation and we have had a slowdown in recent months and the Fed as you have testified, has increased the money supply on the high side.

Mr. BURNS. Well, may I ask a question, Congressman? I am a little confused. You speak of a 3- to 5-percent band. Now, my recollection is never good but I had a band of——

Representative REUSS. Two to six.

Mr. BURNS (continuing). Two to six percent as issuing from your committee. Am I wrong on that?

Representative REUSS. No. I think we are both right. I quoted the 1967 report which said 3 to 5 and over the years we have expanded that to 2 to 6. And so in your answers, take that into account. Let me now read you qualification No. 3:

The target figure should be exceeded when resources are underemployed and simultaneously businesses are making exceptionally heavy demands on credit not for the current business expenditures but for additional liquidity in anticipation of future needs or to replenish unexpected liquidity losses.

Does not that qualification tend to justify what in fact you have done in recent months?

Mr. BURNS. I do not know that I would say the target figure should be exceeded. I think what I would say is this should be kept very much in mind and a move toward a somewhat higher rate of monetary expansion might well be appropriate at such time.

(The following information was subsequently supplied for the record by Mr. Burns:)

Business liquidity demands should be allowed for in judging the appropriateness of any growth rate of the money stock. It does not, of course, follow from this that the appropriate rate of monetary expansion should be above 6 percent. Moreover, it must be recognized that additions to money holdings to satisfy present liquidity preference could prove to be a source of funds to finance inflationary demands later on, should the preference for liquidity decline. This possibility would have to be taken into consideration.

Representative REUSS. I will submit these to you in writing. Perhaps you can tidy them up along these lines.

Qualification No. 4, this one you may not like, but listen:

The target figure should be exceeded to the extent necessary to reflect the increase in dollar Gross National Product, estimated to be attributable to cost-push inflation.

Mr. BURNS. Well, you anticipated my thinking very accurately, as you generally do, Congressman Reuss.

Representative REUSS. You notice I emphasized cost-push. God forbid that we should apply that to the demand-pull inflation.

Mr. BURNS. This is very troublesome. It is very hard and I think really unwise for a monetary authority to try to fight a cost-push inflation. On the other hand, to accommodate a cost-push inflation fully might also be unwise. I think that I would be inclined to leave this to the discretion of the monetary authority and merely request the monetary authority to weigh this factor in its thinking.

(The following information was subsequently supplied for the record by Mr. Burns:)

An effort to offset, through monetary restraint, all of the upward push that rising costs exert on prices may unduly restrict aggregate demand, and increase greatly the risk of substantial underemployment of resources. On the other hand, expanding the growth rate of the money stock by the amount of inflation attributable to the pressure of costs on prices would provide the potential for an unending round of price and wage increases. Given a moderate rate of growth in the money stock, and a sound fiscal policy, a cost-push inflation will tend to be self-limiting.

Representative REUSS. So, we will modify that one.

Qualification No. 5:

The target figure need be sought only over periods such as a 3-month period sufficient to allow the Federal Reserve System to accommodate large Treasury borrowings with the averaging out to occur over the remainder of the period.

How does that sound?

Mr. BURNS. Not bad, but I——

Representative REUSS. Fair?

Mr. BURNS. I would want to take counsel with my colleagues on that one. My own inclination would be to lengthen the period beyond 3 months.

(The following information was subsequently supplied for the record by Mr. Burns:)

The period over which any rate of growth of money should be sought may need to be longer than three months. Neither the amount nor the time span over which the money stock may need to deviate from its long-run path is invariant. The current and immediately prospective state of the economy and of financial markets, the size of Treasury borrowings, the management of the Treasury balance, the source of short-run variations in private money demands —all have to be considered.

Representative REUSS. Qualification No. 6:

Balance of payments considerations should affect monetary policy only through varying the maturity of the Federal Reserve System's portfolio so as to achieve to the extent possible appropriate interest differentials as between long-term and short-term securities.

Mr. BURNS. I want to postpone an answer to that one.

(The following information was subsequently supplied for the record by Mr. Burns:)

The conduct of fiscal and monetary policies cannot overlook the influence of price inflation on the country's international transactions in goods and services, or the vital role of the dollar as an international reserve currency. It would be inappropriate to try to establish a separation of domestic and international stabilization policies applicable at all times and under all circumstances.

From the point of view of international capital flows, differentials between short- and long-term yields in any one country are less directly relevant than are differentials between levels of both short- and long-term yields in one country and those in another. For a country experiencing persistent balance-of-payments difficulties, adverse differentials in long-term yields may assume considerable importance, though their effects may be offset by devices such as the Interest Equalization Tax. With respect to short-term interest rates, large changes in yield differentials may also be undesirable, because they may induce large flows of short-term investment funds. On the other hand, adverse yield relationships and adverse flows of funds may at times be unavoidable, and if they appear likely to be self-limiting they need not be a cause of special concern.

Representative REUSS. Qualification No. 7 and last, to which I think your reactions will be mixed:

The consequences of monetary policy for the homebuilding industry should be taken into account by including Federal National Mortgage Association and Federal Home Loan Bank Board securities in the Federal Reserve System's portfolio in meaningful amounts and by lengthening its portfolio whenever homebuilding finance is unduly retarded by overall monetary stringency.

My guess, without trying to testify for you, is that you do not want those securities in the Fed's portfolio but that a little portfolio lengthening at a time of housing stringency may help. In fact, the Fed since 1968 has done some of that. But I will let you testify, not me.

Mr. BURNS. As I informed this committee, we have a very serious and comprehensive study of housing underway from the financial side. If I do nothing else during my term as Chairman, I hope that I may help this committee and our economy to deal with housing finance better than we have during periods of monetary restriction.

Now, I would want to postpone an answer to your question until that study is in. But let me say Congressman Reuss, this is not a study in the interests of postponing action or decision. The study will be completed this year and I hope to be able to advise this committee on the subject. Let me say further to this committee, that I sometimes have doubts, conservative though I am in financial matters, whether we may not have been excessively purist in not wanting to take agency issues into our portfolio. Perhaps I have said too much already.

Representative REUSS. Not at all. My time is up, but let me conclude by saying that this list of the rules plus what seem to me the seven exceptions was included in our annual report for 1968 at pages 44 and 46. I referred to it as the above-proposed guidelines are designed to elicit what the Federal Reserve regards as proper monetary criteria. Would you, therefore, review your testimony at this point, indicate where you think those guidelines could be improved, as you have in a tentative way, and if you think that additional qualifications are necessary, by all means suggest them because I think it would be desirable if this committee and the Fed got on a closer relationship. As I said:

Perhaps our advice has been too tersely stated with insufficient regard for other factors than the money supply narrowly defined.

That seems to be in your mind, too, and rather than be in the position of giving the Fed advice which it really is not going to take, I would much prefer to see if the advice the Fed wants to receive is not advice that we may be prepared to give.

Mr. BURNS. I want to thank you, Congressman, for the thinking you have done in the past on this subject and for stimulating our own thinking. I will deal with this question. I only want to add that this subject is difficult and what I will submit for the record will be preliminary. Just as you stand ready to amend your qualifications in the light of fact and reason, so I would want to submit no more than a preliminary statement for the record at this time. This is something that deserves the most careful deliberation and the week or two ahead may not give me sufficient opportunity to do what I think ought to be done in dealing with the questions that you put before me.

Chairman PATMAN. Dr. Burns, I will reserve for the members of this committee the right to submit written questions with the understanding that you will answer the questions when you look over your transcript. It would be appreciated very much if you will.

Now, we have a meeting of the House at 11 o'clock this morning, and I may have to leave at any time, but I do want to ask you some questions about interest rates.

You have been insisting on the market rate prevailing on all interest rates on housing. Am I correct in that? The market rate, the rates fixed in the market.

Mr. BURNS. I have great faith in the market and little faith in legislating interest rates, yes.

Chairman PATMAN. Do you not think, though, that we are so desperate in our needs for housing right now, for residential construction, that we could well afford to consider a rate just for housing? It could be made possible by the methods that you mentioned in your statement, and I was really encouraged by what you said. It looks like you are going in the direction of another RFC, which would please me very much. I know we would probably call it something else which would be all right, but the RFC when it started out, it was for the banks, railroads, and insurance companies only. No one else even could make an application. That was in 1932 when it passed under Mr. Hoover. He proposed it and it was a very fine thing that he proposed. But it did not go far enough and it was not long until the RFC was changed to apply to anyone who had a worthy project which was in the public interest. Of course, the rules were that the RFC would not make certain loans, it would not make loans involving communication, printing, or intoxicating liquors for example.

But others, small businessmen and people like that, could get consideration. First, they would have to go to their local bankers and offer the opportunity to the local bank and try to get the local bank to grant the loan at reasonable rates. If the banks would not do it, they could take statements from the banks and go to the nearest RFC office and get consideration for a loan.

That happened in 1932. It helped a lot of people, and it really kept our country from being in a lot worse shape than it was. It helped the big railroads, it helped the big banks, it helped the big insurance companies, which was all right. Nobody objects to that. They are in the public interest, too. But there are other people that are just as deserving and until we did this, we had sheriffs' sales going on all over the country. We had many bankruptcies.

Now, I think it could serve the same purpose now.

The RFC was in operation 22 years and, of course, when it was repealed, we only had one source of big credit to go to. That was the big banks. When you go to a big bank, and this is where you usually go for big loans, you will see around these directors' tables interlocking directorates with almost every big industry in the United States. If your application steps on the toes of some of those directors, you do not have a very good chance. So, the only source of credit since the repeal of RFC, big source of credit, is through the big banks and now when they not only charge the highest rate of interest but they add some points to it, as they did for the Penn Central, then they require compensating balances and in some cases they even demand a part of the action.

Some person or company may have worked for months or years getting up a project involving millions of dollars. When the proposal is looked over the banks will say, well, we will charge the prime rate, then we have to add a couple of points for different reasons, then we have to have compensating balances, and we notice here where you will get a substantial sum out of this for the next 20 years which is all right, you are entitled to it, but since we are furnishing the money, we want a part of that action.

At first they would say just so much a year for the 20 years, but then they began to change that, and now, some of them are demanding everything for the first 10 years or, changing it around, let them have everything for the first 10 years, the bank taking everything after that. In other words, a piece of the action. And, of course, interest rates are not considered. A corporation is not restricted by interest and I think that is the reason we cannot get housing lenders, because lenders can make so much more money making loans to others. It is hardly fair the way I see it, to require people who so desperately need a decent home, to have to go into competition with the big corporations, the big banks, and speculators, the gambling casinoes, the high rate loan sharks.

In the last few years people have not been able to get money for housing. For that reason, I think that we would be justified in setting a separate rate for housing.

We could do this in one of three ways. We can either do it through the Federal Reserve, require that they must provide a certain percentage for housing, as they do in Mexico. In Mexico, they require commercial banks using the Government's credit to make at least 30 percent of their loans for low-income housing, and it has helped tremendously. Since we have not been able to get a source of funds for housing, and we must have a source of funds, we could use the Federal Reserve that way. Not, of course, in a way that would create ruinous inflation or anything like that, but discretely and prudently.

Another way is to use pension funds. This, of course, would help the beneficiaries of the pension funds. It would be absolute safety for the pension funds. They would have no more of this making loans to people who are not creditworthy. The Government would guarantee it and give them the going rate of interest, and they could not lose on it, not at all.

Personally, I cannot see any reason why that should not be used, but, of course, there was objection to it and it was voted down in our committee and by not a heavy vote but by a substantial vote, and we could not get anything like that done.

So, do you not think under those circumstances we would be justified in setting up some special interest rate, say 5 percent, especially in view of the fact that under today's market, Dr. Burns, interest rates fixed in the marketplace, a person who wants to buy a $20,000 home has interest rates and terms, say 30 years, that homeowner would have to pay not only $20,000 for the home, obligate himself to pay that, but he must obligate himself to pay $38,000 interest on that home over the next 30 years, making the home cost him $58,000.

Now, that is pretty hard for people to take. Under the present monetary policies and interest rates, it is necessary to do that in order to get a home. So, therefore, home construction is deferred and families needing homes are crippled in their efforts to get a decent home for themselves and their families.

Do you not think that that requires special consideration Dr. Burns, for the purpose of getting poor people, middle income people, and others an opportunity to buy and own a home?

Mr. BURNS. Mr. Chairman, let me say first of all, that while the housing industry is a depressed industry, something that you deplore and I deplore, it is still important that we not exaggerate the degree of depression in that industry. I, as an economist, would never have predicted that we would have housing starts at an annual rate of 1,350,000, as we do at the present time, with interest rates at present levels.

Next, I think we have to take into account mobile homes and the production of mobile homes is——

Chairman PATMAN. Dr. Burns, may I respectfully suggest that mobile homes should not be considered decent housing. Up to a point they could be, but I do not think they ought to be considered, but if you say consider them, of course, you say so.

Mr. BURNS. Well, you know, we talked about this in an earlier meeting of this committee and at that time I agreed with you. Then Congressman Widnall, I believe it was, called my attention to the changing quality of mobile homes and I looked into that a bit. While I must in all honesty confess that I would not want to live in a mobile home myself, rather decent housing can now be attained through mobile homes for people of modest means. Great improvements in that area have occurred.

In any event, about 400,000 mobile homes are being produced at the present time annually and I think we ought to add that to the volume of housing.

Now, next, the Congress has just passed a piece——

Chairman PATMAN. The interest rate is terrific on that. It is about 15 to 20 percent.

Mr. BURNS. It is. Interest is uncomfortable. Other costs are uncomfortable. Taxes are uncomfortable. Nearly everything I think of is much too high. In fact, Congressman Patman, you know, I do not know why you stop in your arithmetic with $58,000. I can give you a higher figure than that.

Chairman PATMAN. Well, put it in the record.

Mr. BURNS. A home costs $20,000. Interest over a certain period of years will be $38,000. Taxes over those years will be—God knows how much. Repairs will be—God knows how much. You can run up a total probably to $100,000.

However, before we get too depressed about that, let us consider the fact that the head of the household being healthy, being a wage-earner, or a salaried worker, he will be earning income. If we add up the income that he will earn over the next 20 or 30 years and compare it with that cumulative cost figure, well, perhaps he is not so poorly off after all.

Now, I do not want to debate this issue and I certainly——

Chairman PATMAN. No. It will be satisfactory to me, Dr. Burns, if you will answer it in the record. The House is in session and it is necessary that I be over there soon.

Mr. BURNS. I shall do that and I shall deal with your specific suggestions concerning pension funds and also the Federal Reserve.

Chairman PATMAN. If you will, please, I will appreciate it very much.

(The following information was subsequently supplied for the record by Mr. Burns:)

We at the Federal Reserve fully recognize the importance of making progress towards the goals for new and rehabilitated housing set forth by the Congress. We deplore the disproportionate burden that housing has had to bear because of the impact of tight money, necessary as that policy has been for the health of the economy generally. And we are encouraged by the relatively better maintenance of housing starts during 1969-70 than during the previous period of tight money in 1966. This improved performance is due in no small part to the vigorous Government programs to support housing activity that have been approved and supported by the Congress through such agencies as FHA, GNMA, FNMA and the Home Loan Bank System.

Further substantial support for housing has just been provided through passage of the Emergency Home Finance Act of 1970. Titles I and V, respectively, call for (a) a one-time appropriation of $250 million to the Federal Home Loan Banks to subsidize selected advances by the savings and loan associations and (b) an annual appropriation to HUD of $105 million per fiscal year (to an amount of $315 million by the third and final year) to be used by the Federal National Mortgage Association and the proposed Federal Home Loan Mortgage Corporation for the subsidization of new residential home loans at below market interest rates for eligible middle-income families. In addition, Title IV authorizes $750 million more for disbursements by the Government National Mortgage Association under its special assistance programs. Also, Titles II and III would permit secondary market operations in conventional mortgages for the first time by FNMA and the new FHLMC.

The thrust of this new legislation is promising. In particular, the possibility of standardization and other improvements in conventional mortgages which might result from attempts to implement secondary market trading in such loans could be of fundamental significance over the long run.

As for a program of enforced investment in mortgages, by pension funds, commercial banks, or any other types of investors, I believe that this would be most unwise. Lenders have to be free to channel their funds into the most profitable and productive uses, if we are to maximize the efficiencies of our free enterprise system. If institutions are forced to invest in particular assets, the interest rates on such assets might well be lowered. But this would dissuade other investors from participating in these protected markets, and it would infringe on the profitability—and hence the growth—of the captive group of lenders. It would be far preferable to stimulate the interest of pension funds and other institutional investors in mortgages by permitting interest rates on such instruments—whether subsidized or not—to be competitive, and by providing instruments—such as the GNMA mortgage-backed bonds—that are more suited to the needs of these investors.

Chairman PATMAN. I will ask Senator Proxmire to chair the committee.

Senator PROXMIRE (presiding). I would like to resume, Dr. Burns, the line of questioning I was pursuing before. It seems to me that restraint was called for in 1967, 1968, and 1969, when unemployment was very low and resources were tight and inflation was clearly the principal threat. We have now 1,200,000 more people out of work than we had 1 year ago. Many eminent economists, including, I understand, some Governors of the Federal Reserve Board, predict a 6-percent unemployment rate.

You do not agree with that, obviously, you made it clear this morning.

Mr. BURNS. I am not aware of the Governors of the Federal Reserve Board making such a prediction.

Senator PROXMIRE. I refer to that very respectable and accurate publication, the Wall Street Journal without identifying the authority who said that some Federal Reserve Board authorities had predicted 6 percent unemployment.

Mr. BURNS. I have so many good friends on the Wall Street Journal that I must not say anything that might sound like criticism. However, to say the least—no, I have got to correct myself——

[Laughter.]

Senator PROXMIRE. Well, we have a long record——

Mr. BURNS. That is——

Senator PROXMIRE (continuing). In the hearings here of eminent economists not members of Federal Reserve Board then who have predicted unemployment at 6 percent or more.

Mr. BURNS. That is all right, but I want to complete the sentence. That report about the Federal Reserve Board is inaccurate. The source of it may possibly be a study made by some members of the staff of the Federal Reserve Bank of St. Louis. The board of directors of that bank does not stand back of that study and certainly the Federal Reserve Board assumes no responsibility whatever. We have freedom in the System, you know. We let our research people write and think. That 6 percent figure should not be attached in any way to the Federal Reserve Board.

Senator PROXMIRE. All right. We will forget the Federal Reserve Board.

Mr. BURNS. Not completely, no. [Laughter.]

Senator PROXMIRE. Let me simply assert that there have been a number of eminent economists whom I am sure have your respect, who have estimated that unemployment would go as high as 6 percent. The Secretary of Defense has said that there will be a million more men coming out of the Armed Services, of course, seeking work in civilian employment over the next couple of years. We have, as you say, a slowdown in capital goods which has been the great accelerator in the economy for the past 5 years. Under these circumstances, it seems to me that the restraining fiscal policy which you described when I was questioning you before and the policy of increasing the money supply by 4½ percent is not a policy designed to provide much growth in employment, especially in view of your description of the expected increase in productivity, and the fact that people are working short hours now, two factors which will certainly mean that there can be more production without increasing employment.

So, I would like to then turn to the inflation part of our objectives, to overcome inflation. You said, as I recall, in February that excess demand was no longer the problem it had been before in terms of inflation. The problem is primarily cost-push. You said in answer to Congressman Reuss that with monetary policy, Federal Reserve policy, it is very hard to cope with cost-push inflation. So, I do not see any either fiscal or monetary policy which is going to cope with holding down prices in a very effective way because I think the same thing would be true of overall fiscal policy. That cannot help very much on cost-push inflation.

In your statement you put considerable hope apparently, although it is somewhat disguished, in the President's productivity proposal, and his inflation alert. You say: "There is reason to hope that a system to identify and call attention to inflationary wage and price development will mobilize public opinion against behavior that is prolonging the inflation."

Does this mean that you anticipate what the President has proposed, that he will identify the union that is making the excessive demands, identify the company or the specific industry, steel, auto, oil, that is making an excessive inflationary increase at a time when it would be possible to restrain that increase or roll it back?

Mr. BURNS. I have no definite knowledge at all of what the Council of Economic Advisers or this new commission plan to do. My guess would be, and I must emphasize that I am guessing, that the Council of Economic Advisers would not identify individual unions or companies with any frequency, that the emphasis will rather be on industry developments in wages and in prices.

Senator PROXMIRE. Now, over the next year or so how could that really help?

Mr. BURNS. I think that if the country knew and if the country was reminded that collective bargaining settlements in the construction industry, have been raising wages on the average in the neighborhood of 15 percent a year and that many individual settlements have been in a much higher range, I think that this would have a significant influence on the demands made by construction unions and on the wages that contractors would be willing to pay. I think public opinion would be mobilized.

Senator PROXMIRE. Mobilized after the fact, though. For example, take the increase in wages for the teamsters, for the truckers. An enormous increase. Presumably if this inflation alert, and so forth, had been in effect we would have gotten an analysis of that after the wage increase had gone into effect on the basis of the testimony we have had so far. Is it your view that we would get it in advance so that the President could exert some pressure and bring public opinion to bear to discourage such a big wage settlement?

Mr. BURNS. I cannot answer that. I do not know. But I would say that a criticism or simply pointing to what has happened will make for more reasonable behavior in the future.

Senator PROXMIRE. I agree wholeheartedly. This is why some of us have been urging wage guideposts and urging that the President jawbone. But he seems to have responded with an institutional construction which some have described as being historical and after the fact, and generalized, and not sufficiently hard hitting or specific enough to do any kind of a real job.

Mr. BURNS. Senator, we have made some progress. I do not complain when we make progress.

Senator PROXMIRE. All right. Progress is small and slow.

Now, let me get into the Lockheed matter. Why should the Federal Government, and we are going to apparently vote on this in the Congress, bail out Lockheed with a $200 million grant, gift, above the contract, nothing we owe, and another $200 million and perhaps more next year and then $100 million guarantee in order to assure a bank loan of a $100 million to the Lockheed Corp.?

Mr. BURNS. I have not studied the Lockheed problem at all and I do not think I can help you on that.

Senator PROXMIRE. Do you think that this has any relationship with the liquidity crisis? Would it be something that would forestall any kind of a money panic or any kind of a problem of that sort, in your view?

Mr. BURNS. I would look upon this as a problem in the realm of the national defense. If it is to the interests of our national defense to assist Lockheed, then I think this financial assistance would deserve serious consideration by the Congress. But I do not think I would want to go beyond that.

Senator PROXMIRE. Then, are you saying that in your view, from your knowledge of the situation, that there are no national economic reasons why the Government should bail out Lockheed this way?

Mr. BURNS. I prefer not to express an opinion on a matter that I have not studied, Senator.

Senator PROXMIRE. Thank you. You say in your statement that the Federal Reserve Board might under some circumstances be a lender of last resort and I welcome this enthusiastically. It seems to me that you would be far better qualified than a new RFC for many reasons. One, you would be relatively insulated from the kind of lobbying pressure that a RFC or similar corporation would be.

Two, you are in the best position by far to determine whether or not a particular situation threatens the liquidity, the monetary soundness in the economy. I think that it is most promising that you feel that if Congress decided that this was the way to handle these situations like the Penn Central and some of these other dangerous situations that might develop, I think that this would be an excellent way to do it, especially with the restraint that you have indicated here.

This would not be a bail-out of an incompetent corporation. It would not be simply to keep a firm in business. It would only be if there were a serious threat to the monetary soundness and to the liquidity situation. I think that is most encouraging.

I would like to ask also about your conclusions that production of defense equipment has fallen almost a fifth during the past year. Our figures seem to pretty clearly contradict that.

For the first four months of 1970, compared to the corresponding period last year, inventories were $29.2 billion. That is defense inventories in 1969. And $29.4 billion in 1970. Manufacturers shipments, first 5 months of 1970 compared to the corresponding period, were up substantially, $20.2 billion in 1969, $21.4 billion in 1970. Furthermore, the defense purchases of goods and services increased in fiscal year 1970 by $150 million over 1969. So, while the administration has been telling us that we are reducing our defense commitments and our defense spending, the figures do not seem to corroborate that.

Mr. BURNS. I believe that the figures that you have cited relate to the dollar value.

Senator PROXMIRE. That is correct.

Mr. BURNS. At the stage of shipment.

Senator PROXMIRE. That is correct.

Mr. BURNS. Whereas the figures that I cited relate to the physical volume of activity at the stage of actual production.

The figures that I cited are based on the Federal Reserve Index of Production of Defense Equipment and possibly that index is faulty. I have not studied it in any detail, but that is the source of the data that I cited. Beyond that let me say this. If——

Senator PROXMIRE. That does not mean there is a 20-percent increase in defense prices, then, does it, because our figures; if you are going to reconcile these, it would suggest that.

Mr. BURNS. You see, you have a long production period in defense equipment, and much depends on whether you look at production at the stage of shipment or at the stage when the work is actually done. That can lead to a very large discrepancy between "production" and "shipments" in the case of defense equipment or any kind of equipment which involves a long period of production.

Let me make this further observation. There is a governmental publication with which you are doubtless familiar. It is called "Defense Indicators."

Senator PROXMIRE. By the way, we got our figures out of that Defense Indicators. As a matter of fact, this committee is responsible for that. We asked for this statistical series from the Defense Department a year or two ago.

Mr. BURNS. I know you did. That is a supplement to what used to be called "Business Cycle Development." I think it is called "Business Conditions Digest," now.

Well, there are other figures in that publication which, as I reviewed it, suggested to me that the cutback in defense activity is not a great deal less than we had in the year following the end of the Korean War. Now, a good many charts——

Senator PROXMIRE. I wish you would point those out to us and document that for the record, because as I say, our figures seem to contradict that.

Mr. BURNS. I shall do that, yes.

(The following information was subsequently supplied for the record by Mr. Burns:)

A wide range of data confirm the substantial reduction that has occurred over the past year in defense activity. A comparison of data for the first five months of 1970 with the same months in 1969 indicates substantial declines in the value of military prime contracts, output of defense equipment, employment in defense industries, and the size of the Armed Forces, as shown in Table 1.

The rise over the same period in shipments and inventories in defense industries is attributable partly to increased deliveries and inventories of commercial aircraft. The series for defense products (a better measure of defense-related activity) shows declines in defense orders and inventories, while the value of shipments is virtually unchanged. The "value of defense output" (an approximation of the value of work done, calculated by adding inventory change to shipments) is also down. These value series, of course, reflect price changes as well as changes in real activity. With prices rising over the past year, the declines in real magnitudes are larger than those shown by the dollar figures.

Even when deflated for price changes, however, shipments are not always a reliable measure of current production, since they reflect past as well as current activity. A better portrayal of changes in current activity is contained in statistics relating to employment and production. The data contained in Tables 2, 3, and 4 indicate that substantial declines have occurred over the past year in the size of the Armed Forces, in civilian employment in the Department of Defense, in employment in defense-related manufacturing industries, and in the output of defense equipment.

There are several series in *Defense Indicators* which support the view that, in some respects, the recent cutback in defense activity has not been a great deal less than in the period immediately following the Korean War. The data in Table 5 show changes in several defense indicators for the five quarters from December 1968 (a Vietnam conflict peak for most of the series shown) through March of this year, and for the period of comparable length following the June 1953 peak of the Korean conflict. With the exception of the data on output of defense equipment, all of the figures shown in Table 5 are based on series published in *Defense Indicators.*

The recent decline in the backlog of unfilled orders at defense industries has been somewhat less in dollar value than after Korea, but somewhat more in terms of the number of months' shipment it represents. The declines in both military and civilian manpower employed by the Department of Defense are nearly as large as after Korea, and the reductions in defense equipment output are comparable.

TABLE 1.—*Indicators of defense activity*

[Percent change, January-May 1970 from January-May 1969]

Military prime contracts, value	−13
Output of defense equipment	−12
Employment, defense industries	−10
Size of Armed Forces	−5
Value of shipments:	
Defense industries	+6
Defense products	+1
Value of inventories, end of period:	
Defense industries	+6
Defense products	−4
Value of new orders:	
Defense industries	−3
Defense products	−16
Value of unfilled orders, end of period:	
Defense industries	−14
Defense products	−14
Value of output:	
Defense industries	+1
Defense products	−6

TABLE 2.—EMPLOYMENT IN DEFENSE-RELATED MANUFACTURING INDUSTRIES

[Seasonally adjusted, in thousands]

	Manufacturing	
	Total	Defense related [1]
1969:		
May	20,195	2,290
June	20,248	2,274
July	20,247	2,287
August	20,246	2,263
September	20,252	2,242
October	20,233	2,237
November	20,082	2,199
December	20,083	2,176
1970:		
January	20,018	2,151
February	19,937	2,127
March	19,944	2,110
April	19,795	2,066
May	19,580	1,998
June	19,460	1,964

[1] Ordnance, aircraft and parts, ship and boat building, communications equipment and electronic components are classified as defense-related manufacturing industries. These industries all have considerable production of nondefense goods, but their production and employment levels appear to be particularly responsive to defense spending.

TABLE 3.—ARMED FORCES AND EMPLOYMENT IN DEFENSE DEPARTMENT

[In thousands, not seasonally adjusted]

	Military	Civilian
1969:		
January	3,477	1,131
February	3,475	1,130
March	3,504	1,129
April	3,516	1,128
May	3,522	1,125
June	3,524	1,162
July	3,521	1,168
August	3,530	1,143
September	3,543	1,112
October	3,528	1,103
November	3,493	1,091
December	3,440	1,084
1970:		
January	3,386	1,076
February	3,341	1,069
March	3,318	1,057
April	3,271	1,053
May	3,228	1,048
June	3,179	(1)
Change:		
May to May	−294	−77
June to June	−345	(1)

[1] Not available.

Note.—These data are from the Bureau of Labor Statistics and differ somewhat in coverage and timing from comparable data published in Defense Indicators.

TABLE 4.—INDEX OF OUTPUT OF DEFENSE EQUIPMENT

[Seasonally adjusted, 1957-59=100]

	1968	1969	1970
January	174.6	156.5	152.2
February	177.4	163.9	149.8
March	176.5	170.6	146.4
April	174.2	169.1	141.0
May	176.1	170.8	138.1
June	179.3	167.9	137.0
July	179.7	169.9	-----
August	180.4	167.6	-----
September	177.8	165.5	-----
October	169.5	161.3	-----
November	169.1	155.3	-----
December	168.3	156.0	-----

Note.—This index is based on employment and manhours data (adjusted for estimated productivity changes) for producers of military aircraft, Government arsenals and shipyards, ordnance plants, and plants working under contract with the Atomic Energy Commission.

TABLE 5.—PERCENT CHANGES IN DEFENSE INDICATORS

	September 1954 from June 1953	March 1970 from December 1968
Defense industries:		
Value of unfilled orders	−21	−11
Ratio, unfilled orders to shipments	−11	−20
Defense Department manpower:		
Military	−8	−7
Civilian	−11	[1] −9
Output of defense equipment	−14	−13

[1] From July 1969 peak.

Senator PROXMIRE. And, of course, we are also told that even though we all hope and expect and pray that the Vietnam War will be ended in the next year or so, we are told that this may be the lowest figure the administration will recommend for a defense budget because there are other responsibilities and demands.

Mr. BURNS. Well, as I recall, the defense budget for fiscal 1971 is about $7 billion below that for fiscal 1969.

Senator PROXMIRE. That is right, and Congress cut the Nixon budget by $5½ billion, the defense budget we are getting.

Mr. BURNS. I think everybody deserves some credit.

Senator PROXMIRE. Let me ask you, Dr. Burns, do you agree with the President's criticism of Congress for spending too much? Do you really believe that this is a Congress of big spenders?

Mr. BURNS. I have great admiration for the Congress. I have great admiration for the President. What I agree with is that the policy, which you and I have advocated over the years, of great restraint on the growth of Federal expenditures should be adopted by both the administration and the Congress.

Senator PROXMIRE. That was not my question. My question is, do you believe this Congress is spending too much? Do you believe it is spending more than the President has requested? I might point out that historically the Congress has cut every single Presidential budget for 25 years, including the Nixon budget.

Mr. BURNS. I think that there is a danger that this Congress, before it goes home, may spend too much and there I am going to stop or I will be in trouble.

Senator PROXMIRE. Well, I am glad you do not agree with the President. [Laughter.]

Mr. BURNS. I never disagree with the President publicly.

Senator PROXMIRE. I did not say you disagree. You just do not agree.

Mr. BURNS. I never disagree with the President—publicly. [Laughter.]

Senator PROXMIRE. Well, I am glad—you say I never disagree with the President publicly.

Mr. BURNS. That is what I said and I do not object to your emphasis.

Senator PROXMIRE. Congressman Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Dr. Burns, I would like to come back for just 1 minute to the question of mobile homes, because it has been referred to by Mr. Patman.

At the time that we had our colloquy some months ago, I think the emphasis was on the fact that this was the only place where we are getting low-income housing, low-cost housing, from $10,000 to $12,000, and I made the remark at that time I had seen a lot of mobile housing which was trucked to the spot, in two pieces, put together, and you have a far better home than you have got many places in the United States, and an excellent value as well.

I also at that time said I had seen many that I would rather live in than homes in Georgetown that are over-priced at $60,000, $70,000, with no ceilings, impossible to get through doors, no outside spaces, and actually a false value simply because of the nature of the preservation out there. No public housing authority would accept as adequate housing, decent housing, some of the houses in Georgetown because of the space requirements out there.

Now, this is my quarrel, and a lot of the mobile housing is much better inside, you get air conditioning and everything else with it.

Mr. BURNS. Your remarks last time were very helpful to me. I learned something about mobile homes as a result of your observations.

I would make one further comment and that is that what is happening in the mobile housing industry may lead to great technological improvements in building homes—that is, resorting more and more to factory construction, and relying less and less on work on the site.

The late Walter Reuther placed great emphasis on that. In fact, he carried out a successful experiment along with some of the automobile people out in Detroit by using factory methods. I believe the enterprise that Walter Reuther set up with the automobile people was able to produce a three-bedroom home costing something like $13,000—an incredible achievement, I thought.

I hope I have described this effort correctly. In any event, the mobile housing industry may give inspiration to homebuilders over the country and this should be kept in mind. I think that unless we really resort to mass production techniques in the housing industry, it will be very difficult to fulfill the goals that the Congress seeks and that Mr. Patman so ably emphasized before he left.

Representative WIDNALL. Dr. Burns, getting back to your testimony, you describe our encouraging balance of trade, but note that capital movements have been adverse and our overall balance-of-payments is still registering very large deficits.

What do these developments imply for our policy choices in the months ahead?

Mr. BURNS. I am glad you asked that question and if I am wrong, I hope that you or Senator Proxmire will correct me. I have the impression that witnesses before this committee have given very little attention to the balance-of-payments.

Of course, we at the Federal Reserve Board must. This is our responsibility, to protect the dollar, its value at home and its external value. In making policy judgment, we must give some consideration to the balance-of-payments. A policy that might be suitable from the viewpoint of domestic needs might have to be modified in view of international considerations. And I can tell you that if we resorted to a highly expansionist monetary and fiscal policy now, that the consequences for the dollar would be disastrous internationally.

Representative WIDNALL. Do you believe that liberalizing the exchange rate adjustment process by means of the crawling peg, wider band, et cetera, could help stem our capital outflow?

Mr. BURNS. I think that this is a highly sensitive subject still in stages of exploration and the administration has not taken any position on that. The Federal Reserve Board has not taken any position on that; I think this subject should be very carefully studied before any of us does take a definite position.

Representative WIDNALL. Well, should we worry about these outflows as long as other countries are willing to accept dollars?

Mr. BURNS. We must worry that they may change their mind.

Representative WIDNALL. Do you believe that as interest rates subside we shall see even further outflows?

Mr. BURNS. Well, I think that there is a very good possibility that this difficulty will not arise.

Representative WIDNALL. It will adjust itself.

Mr. BURNS. I think there is a good chance things will work out in that fashion.

Representative WIDNALL. Secretary Kennedy remarked before us this week that the interest rate structure vis-a-vis the United States and Europe was in structural balance and that the United States does not need to maintain domestic interest rates as high as the European rates in order to maintain payments equilibrium. Why is this so?

Mr. BURNS. Well, I think Secretary Kennedy could answer that better than I can. This is his generalization, not mine.

Representative WIDNALL. Well, thinking back on what he had said it was not clear in my mind exactly why he said it. I should have asked the question at that time, I am sure.

That is all at this time.Thank you.

Senator PROXMIRE. I just might say before we conclude, as I understand it, there were seven witnesses who appeared before the committee who did discuss to some extent the balance-of-payments problem.

Mr. BURNS. Oh, I see.

Senator PROXMIRE. We had Mr. McCracken, Mr. Kennedy, Dr. Wallich, Dr. Saulnier, Mr. McLaren, and Congressman Boggs, and

Senator Javits as witnesses. Congressman Boggs and Senator Javits appeared as witnesses before the committee last Friday. And I might add the distinguished chairman of the Federal Reserve Board, Dr. Burns, today.

Mr. BURNS. Yes. May I add that what I meant to convey was—my language must have been imprecise—not that this subject has not been discussed but that in giving advice on monetary policy, little account was taken of the balance-of-payments. This is my impression. I have gone through some of the testimony. There would be a section, sometimes a long section, on the balance-of-payments, but when the man testifying came to discuss monetary policy, he related monetary policy exclusively or almost exclusively to the domestic situation.

Senator PROXMIRE. Well, leaving out of account also, of course, the witnesses like Cyrus Eaton, who emphasized the Vietnam War and pointed out that this is one of the most aggravating segments of the balance-of-payments. To the extent that we can reduce our military activities overseas, that this will help greatly.

Dr. Burns, once again you hit nothing but home runs. You did a fine job. Even though we may disagree sometimes, thank you very much.

The committee will be in recess until 10 o'clock tomorrow morning, when Leon Keyserling will be our next witness.

Mr. BURNS. Thank you very much.

(Whereupon, at 12:20 p.m., the hearing was recessed, to reconvene, at 10 a.m., Friday, July 24, 1970.)

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

FRIDAY, JULY 24, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:35 a.m., in room S-407, the Capitol Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, Widnall, 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.

Representative REUSS (presiding). Good morning. The Joint Economic Committee will be in order.

I will preside briefly, pending the arrival of Chairman Patman. It was to have been a great pleasure for Mr. Patman to welcome Dr. Keyserling, but it is equally one for me. He has been a friend of this committee over many years and has helped us very much with his testimony on many occasions. He is a former chairman of the Council of Economic Advisers, an economic consultant and an attorney.

Dr. Keyserling, you have had a great deal of knowledge about the Penn Central situation which has troubled all of us in recent weeks and perhaps in the course of your remarks and in the questioning you can give us the benefit of your information and views on this subject.

Would you step forward, Dr. Keyserling.

For the minority, Representative Conable has a statement. You may proceed.

Representative CONABLE. Thank you, Mr. Chairman. I have been asked to represent the minority in presenting this opening statement at this session of the Joint Economic Committee. All members of the minority join in this statement.

Mr. Chairman, recently there has been a movement among some in Congress to recapture certain "legislative prerogative," particularly in the field of foreign policy. There has been much public debate on this issue. But there is one area of interest to this committee where those in control of the Congress have abandoned the prerogative of the legislative branch in recent years and appear to be repeating this performance again this year. That is the prerogative of defining spending limits for each of the functions of the

49-774—70—pt. 3——16

Federal Government. This has taken the form of excessive appropriations, while leaving it to the executive branch to determine spending limits among the various functions of Government in order to meet its budgetary policy. Worse yet, efforts are sometimes made to force the executive to spend excessive amounts, making it impossible to achieve its budget objectives.

Each year, the executive constructs a budget with an eye to the overall prospects for and economic effects of revenue, expenditure and lending totals, and Congress breaks down this spending into 13 appropriations bills. Then the Congress proceeds to act upon each measure in isolation, without adequate regard for the effects each given appropriation will have on the budget as a whole. All too frequently, Congress has been preoccupied with the growth of individual trees, while ignoring the implications of a rapidly expanding forest. And the executive branch has been forced into the unfortunate position of a woodsman who must thin this forest by pruning someone's favorite trees.

Administrations have approached the task of changing the nature of the budget "forest" in different ways. The Johnson administration attempted to reorder priorities by recommending that both defense and nondefense programs expand simultaneously, the famous philosophy of "both guns and butter" which wreaked a havoc on the Nation's economy that has continued into the present. The inflation engendered by the unusually large deficits of the Johnson years went a long way to eroding the very benefits to the economically disadvantaged which were being sought by Federal spending on social programs. The deficit financing of these programs has turned into a boomerang.

The Nixon administration has taken a different, and in the long run, more effective approach to reordering priorities. The current administration has shifted resources among competing demands within the framework of a budget aimed toward balance at high employment. To our mind, this approach to reorienting the benefits of Government spending will produce much more lasting and beneficial effects. But it is essential that the Congress match this determination to produce a budget in harmony with the needs of the economy, while redirecting Federal objectives.

Congress occupies the controlling position in the budget process, yet does not use its powers in a coherent, relevant fashion. Rationalizing the congressional budget process does mean reducing a few appropriations while allowing others to balloon out of control. Nor does budget rationality imply that revenues can be cut substantially without due consideration for the need for appropriations. Rationality in the way the Congress handles the budget each year involves seeing the total budget in its relation to the total needs of the economy, refusing to vote higher appropriations or lower revenues than requested without enacting offsetting budget changes, and specifically, controlling Federal spending.

Those in control of the Congress shirk their responsibilities when they demand that the whole budget be somehow different from the sum of its parts. We call upon Congressional leaders to fulfill their responsibilities in this area, and to become the major force in shaping a rational budget policy, both in terms of revenue and outlay totals and component program priorities.

That concludes my statement, Mr. Chairman. Thank you.

Representative REUSS. A very good statement that all the ranks of Tuscany could scarce forebear to cheer.

Representative CONABLE. I am pleased to welcome you to the ranks of Tuscany.

Chairman PATMAN (presiding). Dr. Keyserling, we are delighted to have you as a witness, sir. We have had you many times before this committee. You always make a good witness. You are not only knowledgeable, intelligent and have the information, but you present it in a dramatic way that we can understand.

We appreciate your appearance here today. You may proceed in your own way but if you will summarize your testimony, we will place it all in the record. When you look over your transcript you may insert anything you desire that you think will be necessary to support your contentions.

STATEMENT OF LEON H. KEYSERLING, FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS, CONSULTING ECONOMIST AND ATTORNEY, AND PRESIDENT, CONFERENCE ON ECONOMIC PROGRESS

Mr. KEYSERLING. Mr. Chairman and members of the committee, I would like to benefit by the kind suggestion of the chairman that I insert my prepared statement in the record and proceed orally, which I can do briefly.

I will do that by summarizing a few pictures that I have here which my friend, Mr. Small, will put on the easel, and I think they will be easily visible, but if not, you have the black and white copies attached to the prepared statement and properly numbered.

Chairman PATMAN. And we will place them in the record.

Mr. KEYSERLING. I was very pleased to know that my good friend, Congressman Reuss, is a reader of "Horatius At the Bridge," which I could recite here and it might perhaps be more interesting than my testimony, but I will forgo that pleasure.

I have also heard the request that I somehow entangle my discussion of the economic situation with the debacle of the Pennsylvania-New York Central Railroad. I can do that best perhaps when you have questions to address to me, but let me say at the beginning that I studied this particular situation, I think on behalf of the public, appearing before the ICC for 8 years in opposition to the merger, appearing before the Supreme Court in opposition to the merger. One interesting thing is that, when I started out, I had supporting my viewpoint the Department of Justice with a 288-page brief, the Port of New York Authority, the Commonwealth of Pennsylvania, and the Railway Labor Executives Association and numerous others, but for some strange reason between the time when I got through with the Commission and the time when I went to the Supreme Court, they had all departed.

I will not attempt to ascribe the reasons for the departure. It was certainly not that the conditions of the roads had gotten worse. They were much better when it was before the Supreme Court than when it was before the ICC.

Perhaps the simplest answer is that the defense of the public interest is a hard job.

Now, there is a direct connection between the Penn Central debacle and the condition of the economy in this sense: The current debacle is due very substantially to bad management, which has now been recognized even by the management itself, a management that did not understand the railroad problem and believed its function was to make money in any way it could instead of providing railroad service, which in the inexorable law of time hurt them as well as the public. I hope that the new trustees, with such appropriate interest and guidance as congressional committees can give, will redirect themselves to the problem that railroads exist to provide railroad service and not primarily to build luxurious hotels at Boca Raton.

However, the basic reason for the Penn Central debacle has not been this bad management, serious though it was. The basic reason has been the condition of the economy, and what has happened to Penn Central affords such a tremendous and vivid example of this with respect to our greatest railroad and one of our greatest corporations that I hope it will not be lost sight of.

As a matter of fact, I pointed out to the ICC in 1961, when the crisis button was being pushed by the two roads, namely, that they would be in bankruptcy right away if they did not merge, I pointed out that most of the decline in their income had been due to the very, very low rate of U.S. economic growth during 1953–60, which naturally impacted more severely upon a carrier of this kind than upon most other industries.

Then by 1966 or 1967, when I was before the Supreme Court, the financial position of the two roads, despite the bad management, had improved enormously. But in 1966, as I shall show, the deterioration of the rate of U.S. economic growth began to set in severely again, and this impacted again with double vengeance upon the merged railroad and brought them to the pass where they are now.

It follows from this that whatever the new management may do, and whatever the trustees may do, and whatever the Congress may do, and however much public money may be pumped into the Penn Central, and I will delay any discussion of that unless someone later wishes to ask me questions on it, no matter what is done on these subjects, there can be no real revival of the Penn Central Railroad without a restoration of the American economy to a full rate of economic growth and full employment and production because the railroad is in a situation where it depends upon this to live and to thrive.

Now, coming over to the real body of my testimony which deals with the current economic situation, we have here a great case example of delayed response. The fact is that economists—including the very distinguished economists who have appeared before this committee, from inside and outside of the Government, and the general public—and national economic policy, do not commence to wake up until the crisis bell rings. They are like a doctor who starts treating the patient when he is almost in extremis, and does not begin to consider before then what has been happening to the men and whether the medicine is wrong.

Nobody really got greatly concerned, almost nobody, about the economic situation until the absolute recession started in the middle of 1969, and even then the arid debate continued about whether the recession was big or small or whether there really was one or how long it would last or whether we are still in one now. But this is not the big issue. The big issue is that, from 1966 forward, the U.S. economy started a clear, consistent, and sharp departure from the condition of economic health which is based upon a rate of real economic growth high enough to absorb productivity and to absorb the labor force.

Now, my first chart illustrates this, I hope, clearly. If we will look at chart 1, in my prepared statement, we see that from 1960 to 1966, as shown in the top bar at the right, the average annual real growth rate of the economy was about 5 percent. The average from 1966 to the second quarter of 1970 at an annual rate was only 2½ percent and it is very interesting to note that this 2½ percent is practically the same as the very low growth rate during 1953–60, which ultimately galvanized national economic policy and the public attention.

I want to say here, for what is is worth, that one observation which might arise clearly from what I say is that I am not attributing the trouble mainly or exclusively to any particular Administration. My general political position may be well known, but I have always believed that, before this Committee and elsewhere since I have been out of the government, it is my function to look at things as they are and not to take political quick tricks. This trouble started in 1966. This is not to imply that it has not gotten worse recently, and it is not to imply a relative comparison of the relative demerits in the wrongful economic policies which have persisted all along.

Now, we see from the chart that the real economic growth rate declined further and further as time went on, and that from 1968 to the second quarter of 1970 the average annual real economic growth rate was only 1.3 percent, and then we got into an absolute economic recession from second quarter 1969 forward, and it would seem that during the second quarter of 1970 the economy was no longer receding but was moving forward at the heroic Tuscany rate of 0.6 percent.

Now, there is no use quibbling about whether 0.6 percent is the beginning of a big rise or about whether the figure is exact, or even about what the outlook is. We do know definitely that for 4 years the great American economy, in the face of incomparable burdens and responsibilities, has been in a serious state of stagnation and recession. And we do know that this has occurred at a time when, because of the real or alleged inability to afford what we need to do, whether domestically or internationally, and I am not going to get into the international quarrel here, although I have some views about it, at the very time when these pressures upon us have been so great, we find ourselves progressively unable to afford what we most need to do.

Coming now to chart 2 in my prepared statement, which is rather complex, and which I am going to treat rather briefly, the middle sector of that chart shows the trends in unemployment of manpower. It is vitally important to realize that the official measurement of unemployment—when we say unemployment was 3.5 percent, when we say that unemployment has risen to 5 percent—is a very limited measurement. There is, in addition to that, the full-time equivalent of part-time unemployment. If 100,000 men are unemployed for a month, that enters into the official unemployment count. If 200,000 men are working 18 hours instead of 36, that is the same thing as 100,000 full-time unemployment, but it does not enter into the official count at all.

There is also a third type of unemployment which is equally serious, and which is not noticed at all and that is, as I shall show later, when the economy gets slack, when the economic growth rate falls, when plants are operating far below full capacity, they do not fire a comparable number of workers, and they should not. But when you have a plant operating at 80 percent of capacity, but retaining 90 percent of its workers, the so-called productivity growth rate drops greatly, and, as I shall show, while the productivity growth rate was growing at 3.8 percent a year during 1960–66 when the economy was growing 5 percent a year, the productivity growth rate has dropped practically to zero in the last year or two. So, we appoint commissions to see how we can increase productivity, and we do not recognize that productivity will increase when capacity comes into fuller use, and when the economy begins growing again.

Now, when the productivity growth rate drops from almost 4 percent to 1 percent, that is a form of unemployment, or under-utilization, and it explains why overt unemployment did not commence to rise from 1966 forward, but in the end murder will out. So that more recently, from December 1969 to now, full-time unemployment, as officially counted, has risen from 3½ to 5 percent in May, and apparently 4½ percent in June.

When you add to that full-time unemployment the full-time equivalent of the part-time unemployment, and the people who are not in the labor force and are not counted as unemployed because they have gotten discouraged, the true level of unemployment now is over 6 percent. Even this does not count the under-utilization in the plant or employed workers with a productivity growth rate of 1 percent rather than 4. When you add that in, the true level of unused manpower in the United States, which is the really vital thing, is now in the nature of 8 to 10 percent.

Another way of measuring the seriousness of the situation is by the production gap which has now become famous, although nobody started doing anything 4 years ago when it began to appear. As the last cross-section of this chart 2, in my prepared statement, shows, according to my estimates, the production gap, which is depicted in uniform dollars, the difference between actual production and the maximum production which is the objective of the Employment Act of 1966, the production gap rose from 7.4 percent in 1966, as is shown by the bottom cross-section of the chart, to 10.9 percent in 1969, and to 14.9 percent in the second quarter of 1970.

Other economists might have different estimates as to the size of the gap, because they would make a different estimate of how much the economy ought to grow, but if you take a 4-percent growth rate as ideal rather than the 5 that I take, you would get somewhat lower figures but they would still be staggering as to the size of the production gap.

What have we lost through this? This brings me over to chart 3, in my prepared statement which shows that, from the beginning of 1966 through the second quarter of 1970, we have lost according to my estimates about $400 billion of total national production, $400 billion lost by the worker, lost by the consumer, lost by the businessman, lost in Federal, State and local revenues. These revenues and here I use an extremely rough figure—to about a quarter of the GNP, so that, at existing tax rates, regardless of whether the Government should have been spending more or less, there has been a loss of about $100 billion in public revenues due to the $400 billion lost in total national production.

As I estimate it, the annual rate of this gap between actual production and full production was in the neighborhood of $150 billion, annual rate, during second quarter 1970. Some other estimate might be somewhat less. This is arguable. It does not really make much difference for the main point in hand.

When we come to unemployment, and this is less arguable because there is not so great a judgmental factor involved, we can count it, from 1966 to the second quarter of 1970, total unemployment opportunity measured on a man-year basis was about 5 million less than maximum employment. In second quarter 1970, it is about 1.7 million below maximum employment. And this does not count in the underutilization.

Now, the economists tell us that, wily-nilly, whichever forecast we accept, and whatever ambit of policies they recommend, unemployment is certain or almost certain to rise for the balance of 1970. I never like to discuss with members of the Congress who live in the communities what the effect of unemployment is, so I will pass that over the economic effects, the social effects, the civil effects.

These developments certainly seem to me to call for drastic reconsideration and reconstruction of economic policy. When this has been happening for 4 years something must be wrong. And it certainly seems to me that during most of this 4 years, the preoccupation—I will not say preoccupation, I will say almost exclusive obsession of economic thought and policy—with the problem of restraining inflation has thrown out the baby with the bath.

I am not going into all the reasons why the price level is merely a means of making the economy work, and why the loss of $400 billion in production and 5 million man-years of opportunity is a more serious loss than any hypothetical difference in the price level which might have resulted if we had adhered to a policy of maximum production and employment. I do not need to go into that, not only because it is obvious but because it is beside the point. For as I shall show conclusively, contrary to the prevailing dogma, but now supported by 17 years of empirical experience, a declining and stagnating and recessionary economy generates more inflation than an economy operating near full employment and near full resource use.

This violates the old story of selling the 10 apples that we learned in the copybooks, and it violates most of what we hear, but this is the way it has been happening, and here again recently everybody is rubbing their eyes and saying: "how is it, how is it that, while our real wealth production has been shrinking in its growth rate and while unemployment has been rising, prices have been going up faster and faster?"

The only explanation given is that there is a time lag and that if we wait long enough, the policies, the tight money policies, the tight fiscal policies, the rising interest rate policies, designed to "slow down" the American economy which is the source of all our real wealth, will "some day" stop the price inflation.

I think 17 years, or 4 years is long enough to dispose of the "time lag" argument, and I will come back to that.

What has been the main problem? And here again, I would like to say that I have been disturbed that most economists whom I honor, and Government economists whom I also honor and sympathize with from experience, have never really addressed themselves to the problem of saying what is really the trouble. What they usually say is that the economy does not operate at full production and employment because demand is not high enough. This is obvious. It is like saying a glass of water is full when it is full, but it does not get to an analysis of the structure of demand. It does not get to the question of whether or not the economy is in balance.

Our real trouble all along has been that, in each of the boom periods as shown by chart 4, in my prepared statement, the rate of investment in plant and equipment which stimulates our productive capacities has grown enormously faster than the ultimate demand for the products which has two components, private consumer spending and public outlays. From the first three quarters of 1955 to the first three quarters of 1957, as my chart shows, this investment grew at an annual rate of 10.4 percent. Ultimate demands grew only 2.7 percent. You cannot keep that up forever, and I say this not because I am against business investment but because I want it to thrive a healthy environment. So, after that imbalance goes on for a while, it becomes impossible to sustain the level of business investment, and it is cut back very sharply, as is shown by the second box in the lower part of the chart.

From third quarter 1957 to third quarter 1958, business investment went down 20.5 percent. So, we had a recession. Then the recuperative forces started again.

I am not going to bore you nor take your time with all the examples contained on my chart, but when there is opportunity to study them, you will see that this has happened again and again and again. And the most dangerous thing about the current situation is that, although we have been in a recession now for almost a year, business investment in plant and equipment is still running at a relatively excessive rate. From first quarter 1969 to first quarter 1970, it was increasing 3.7 percent while ultimate demand, taking into account both consumer spending and Government spending, was increasing only 0.8 percent. Thus, despite all the lessons, we were still continuing to build investment more than four times as fast as the ultimate demand for products.

It follows that every one of the economic policies in which we have recently indulged have conspired in this unfortunate result. The policy of tight money and rising interest rates has absolutely done so. It does not stop this kind of investment, because these people do not finance with borrowings. They finance by raising prices and by retained earnings. But it has stopped housing. It has reduced real consumer purchasing power. It has meant that the average homeowner pays out one year of his total income in rising interest rates alone over the life or the mortgage, when he purchases a home on time, which he always does, and so forth and so on.

The basic problem of economic restoration is to produce a shift in the balance between this investment and consumption, and let me say that when I was saying that before this committee and elsewhere for so many years there may have been some lifting of eyebrows, but now I read the leading business journals, and they do not say any more that the inflation has been a wage inflation or a consumer buying inflation. They say the inflation has been in the industrial sector, the excessive and overexuberant and against their own interests in the long run rise in this plant and equipment investment at the expense of the rest of the economy.

Tight budgetary policy does the same thing; it does not curb such investment. Insofar as Government programs supplement consumer incomes, and meet the great priorities of our Nation's need, you have that same deficiency operating when such programs are too restrictive.

Charts 5 and 6, in my prepared statement, which I am going to skip over, go into meticulous detail on the relative rates of growth in these different parts of the economy. Chart 5 does it from 1961 to the first quarter of 1970, and chart 6 does it from 1960 to the first quarter of 1970 for some of the key industries. I am going to skip over these for the sake of brevity, but when they are studied, they corroborate in detail what I have said generally and show generally in the preceding charts.

Chart 7, in my prepared statement, merely takes one illustration, and it is not a partisan illustration, of how economic policy has conspired in this result, and I take as an example the tax cuts between 1962 and 1965, not to say I told you so, although I opposed these cuts from the beginning. Those tax cuts were altogether too big, and altogether misallocated. They allocated far too much increase in income to those who needed it least and to investment as shown by my chart 7, and far too little to the consumer.

The tax reform bill of 1969, so-called, did a great deal of the same thing, as I showed in my testimony on that bill. And second, because of this excessive reduction in taxes at a time when we had great national needs and purposes, the Government was left in the position where it had to run big deficits, which many of us do not like, even to support, as every member of the Congress knows; a totally inadequate level of certain vital types of domestic programs in the public interest.

So, it is not a matter of arguing at this point whether or not one should run a deficit. It is a matter of pointing out that the whole composition of policy has been misdirected in terms of our need for growth, and has been misdirected in terms of our social or human priorities which, after all, are really the basic purpose of any free and decent people. That is why policy exists, to improve standards of living and improve services on an equitable basis.

I now come to the final portion of this, I hope, not too long summary. I said earlier that, if we assumed hypothetically and contrary to fact that this enormous shrinkage in our real wealth and our real economic growth and this rise in unemployment had accomplished some measurable price stabilization, it would not have been worth the cost. But I do not need to argue that point. I do not need to argue it because the fact of the matter is, and again without being prideful I began pointing this out in 1953, we have now had 17 years of experience instead of a few years of experience. The prevalent dogma is that as you come closer to full employment and full capacity use, the inflation is greater because there is more pressure on the economy, and as you deliberately use money policy and fiscal policy to create idle plants and idle manpower, there is less inflation.

Well, let us look at the record, as Al Smith used to say, and the record is here on chart 8, in my prepared statement, and I am going to emphasize it a little bit because it is very vital to the whole policy question today.

Here we see that during 1952–55 the average annual real economic growth rate was 3.5 percent, and the growth rate in consumer prices averaged 0.3 percent a year. I am not going into the wholesale and industrial prices here orally, but they tell about the same story.

Then during 1955–58, including the recession of 1957, the average annual real economic growth rate shrank to 0.8 percent, but the consumer price index annual average rose to 2.6 percent, and the industrial and wholesale price annual increase about the same, at 2.5 percent. Then from 1958 to 1966, the aevrage annual real economic growth rate was lifted to 4.9 percent. The unemployment rate full-time was reduced from 6.1 to 3.5, as I recall it. According to the prevalent economics, this should have increased price inflation. But actually, the average annual increase in consumer prices was only 1.5 percent, in industrial prices, only 0.7 percent. And in wholesale prices only 0.6 percent.

Then, as I have shown, the economy began moving downward again as we adopted policies to stop an inflation which had not yet appeared and lo and behold, from 1966 to second quarter 1970, the real average annual economic growth rate was reduced to 2.5 percent, the concealed unemployment begins to appear, and the average annual increase in consumer prices jumped up to 4.6 percent. Then lo and behold further, from the second quarter of 1969 to the second quarter of 1970, when we were in an absolute economic recession, the average annual increase in the consumer price was 6.1 percent, in wholesale prices, 3.7 percent, and in industrial prices, 3.8 percent, the highest in 25 or 30 years or what have you.

Now, really, under these circumstances, to say all of this is due to a time lag has passed from the irrational to the ridiculous.

Let me just mention a few reasons why this has happened, although I do not care so much about the theoretical reasons as about the actual observation. The reasons why it has happened are clear. I think one of the only economists who has made this clear to this committee is

Gardiner Means, who for 40 years has been a great theoretical economist but also has had the virtue of looking at things as they were and certainly never has had any axes to grind.

The reasons are simple. In the first place, when the rate of economic growth starts to shrink, and when unused capacity increases in the administered price areas, which is a fancy term but merely means where prices are fixed by overt decisions rather than by supply and demand, the business managers, and I do not criticize them, try to compensate for the unrewarding volume by increasing prices per unit in the thought, right or wrong, that they can hold profits and obtain funds for their relatively excessive investment booms although they have low volume.

Let us take the outstanding example, the automobile industry. The automobile industry a year ago correctly forecast a 6-percent decline in sales. They were about right. At the same time they raised their prices a lot. Was their capacity under pressure? No. They had been engaging in tremendous investment programs for years, and they were running into more and more idle capacity. Were their profits so low that they had to raise prices? Hardly in that industry, although they had maybe begun to be lower than fabulous all-time peaks. They raised their prices to maintain revenues despite a declining economy, and even if they had been successful in doing so, it is not a healthy situation.

As a second cause of inflation in a stagnant economy, skipping over my chart 9, I turn to chart 10, in my prepared statement, on productivity growth rate.

In the long run, the productivity growth rate, which is the increase in output per manhour in private industry in the U.S. economy, has accelerated, which shows the fabulous asset that we have in the American economy if we give it the incentive of full use. It accelerated, as my chart shows. It was 0.5 percent from 1910 to 1920, it rose from 3.8 percent as I said, from 1960 to 1966, and then it began to decline because the economy was declining. So that, from 1960 to 1969 the average was only 3.2 percent, and from first quarter 1969 to first quarter 1970, the productivity growth rate was only 0.1 percent.

We are now appointing commissions to examine how to make productivity higher. It is very easy to know how to make productivity higher. When unused plant is reduced, when employment is increased, when demand for goods and services increases, the productivity growth rate will rise again to the 3.8 percent averaged during 1960–68 and rise still more because the technology is advancing. You cannot do it with imprecations, and you cannot do it with studies.

The inflationary impact of the low productivity growth rate is very clear because if the productivity growth rate is only 0.1 percent rather than 3.8, per unit labor costs increase greatly, so you get an increasing gap between the trends in per unit labor costs and the trends in hourly wages. This is called, of course, push inflation.

Some people would say, let us reduce the wage rate gains to the level of the current productivity gains. In other words, let us budget the whole economy further downward. If you did that, you would have still less consumer demand. You would have still more idle capacity. You would have still more unemployment, and the productivity growth rate would sink to minus.

On the other hand, if you stimulate the demand for products, the productivity growth rate will go up, and the wage rate increases related to productivity gains will be back where they were during the 1960–66 period, where the wage rates did not exceed but rather lagged somewhat behind the productivity gains. So, this is the second reason why tight money and tight budgets and the other measures designed to stop inflation by slowing down the economy increase inflation. It is a second explanation of what actually happens.

The third explanation is that the excessive "fine-tuning," the Government changing its policy every few months to stop inflation or to start the economy going, for example, changing the investment tax credit, I think it was three or four times in 2 years. This was not knowing what they were doing, and these drastic and perpetual changes in public policies and business expectances are highly inflationary.

This brings me to my chart 11 in my prepared statement. Just look at that bottom sector, showing ups and downs of monetary policy from year to year. Is this fine-tuning? No economy can thrive and prosper under drastic changes in policies up and down and crosswise at that speed. And these rapid changes in the monetary policy (in addition to the fact that the money supply growth in the long run has been held much too low to float the economy in reasonable health)—these sharp changes produced changes in business expectancies and, strangely, changes in business expectancies which are very sharp, both on the upturn and on the downturn, produce price increases. When the economy starts moving downward, as my data show, they begin to increase their prices to try to maintain their profit position nonetheless. When the economy suddenly starts moving up too sharply, they say, let us get ahead of the game, because all the other prices are going to rise more, and they are told by the Government that the economic restoration is going to mean more inflation.

The fourth reason for inflation in a stagnant economy is that the tight money policy, by raising interest costs, is inflationary per se, because money is a cost. The utilities all over the country are necessarily increasing the price of fuel to the homeowner because they finance 60 percent out of debt, and a 6 percent rate of return which made sense when they were borrowing at 6 percent cannot be maintained when they are borrowing at 9 to 10 percent.

In housing, the same thing. The interest rates jumped from 4 to 8 percent, and then they wonder why the rise in the cost of housing is one of the biggest factors in the rising cost of living.

Thus, the tight money and tight budget policies are inflationary, first, because they promote the low economic growth rate and the idle manpower and plants which are inflationary as I have shown; and second, because these policies leads to serious shortages in some services, including housing, including medical facilities and personnel, which is again, I believe, among the most rapid increase in the cost of living. So, we have not made a trade-off between employment and inflation. We have not made a trade-off between the real wealth of the economy and inflation. We have simply made a bad bargain on all scores, and got the worst on all scores, and it has continued far too long to be an accident. So, we need a reversal and a reconsideration of these erroneous policies.

In the first place, I think the President should send to the Congress, and the Congress should process, a deliberate commitment to restore the real wealth of the American economy by setting goals for bringing us back to full employment and full production within 1 year. I do not believe the Federal Reserve Board should wait longer to increase the money supply much faster. What are they waiting for? What are they waiting for? Their policy has been tested for a long time. Then, when we had these kind of goals, and when we were not still fighting the wrong enemy, we could start to move forward with other policies.

The money policy should be drastically changed. I do not agree with Milton Friedman on many things, but I do agree with him that the Federal Reserve Board should be required by legislation—I do not know if he says required by legislation—should be required to advance the money supply at a fairly stable rate, roughly compatible with a healthy rate of American economic growth, say 5 percent a year, instead of moving up and down like a roller coaster and making the economy move like a rollercoaster and averaging far too low in the long run.

Second, Federal Reserve should place more emphasis on a selective monetary and credit policy. For just to shrink the entire money supply means a very simple thing. It does not stop those who are running too fast, but it kills those who are running too slow. Here we have been enacting housing legislation, based on the idea that this is one of our greatest problems, and we have produced through the policy of tight money and rising interest rates designed to stop inflation the most catastrophic decline in any industry suffered since the great depression. It does not make any sense.

These are the basic needed changes. I believe also that the Congress should, by legislation, lower the traditional statutory interest rate ceilings with respect to some basic areas where the Congress has already recognized the problem to be of sufficient significance to have acted in these areas.

I remember way back, more than a decade ago, when the proposal was made to raise the interest rates on savings bonds the argument being that these people should not be left out of the procession upward?

I said, in the first place, you are doing an average family no favor. If it has $5,000 in savings and you raise its interest rate on those savings by 1 percent—well, they do not have $5,000 in bonds, but perhaps $1,000. So, they get $10 more a year in interest. But they pay, as I have said, a year of their whole earnings over a period of 25 years in retiring the mortgage on their house because of the higher interest. You can go on forever adjusting interest rates upward to bring them into "balance," and they are never in balance, they are just moving upwards. If we are going to adjust them to bring them into balance, why not adjust them downward and bring them into balance? I think this is a field for legislative action.

Well, I have about covered the main elements in my testimony, and what I am saying in essence is that we are in a very difficult situation where, in the face of an established and long verified and consistent series of economic developments, we are still in the process of an economic policy which, in its fundamental assumptions, not just in its detailed applications, been proved to be erroneous and not working.

On the matter of the Federal deficit, I do not like a Federal deficit. I happened, by accident, to serve an American President who carried us through a war much bigger than the Vietnam War with a very much smaller average Federal deficit in most years than any President since him has achieved, and in fact a Federal surplus on the average, not to speak of Roosevelt's situation which includes the Great Depression and World War II. And yet, through some curious vagary, we who served President Truman are now looked upon as the "radicals" or the "spenders" or what have you, committed to Federal deficits. We did the best on balancing the budget for the reasons that I have given, because we were not afraid to propose and get tax increases when a big war started, instead of reducing taxes even during that war, and we were not afraid of spending in the national interest.

I think we should, in the immediate situation, and I recognize some will disagree, start worrying about the national economy, and then the Federal budget will take care of itself. We have a tax rate structure now which will better balance the Federal Budget, when and if the economy is operating near full employment. This indicates that taxes should not be increased. I am appalled at the talk of increasing taxes to stop inflation now, or to put a 6 percent tax increase across the board, which, in addition to other defects, would be mostly on the wrong people. But I do not think, either, that we should reduce taxes to stimulate the economy, simply because we need other things more. Taxes are the price we pay for civilization. You cannot reduce them gradually to zero.

I think we should start spending more in the vital areas of the greatest national needs. This will do two things. It will create a deliberate deficit for the purpose of stimulating the economy, instead of the unplanned and reckless deficit that we are going to get anyway through neglecting the economy. I would rather have a $10 billion deficit through a recovery program than a $10 or $8 billion deficit resulting automatically from the continuation of the economic stagnation and recession.

I thank you for your attention.

Chairman Patman. Yes, sir. Thank you, Dr. Keyserling. It is very interesting and we will read your statement with interest because you always have good information and you explain it so well.

(The prepared statement of Mr. Keyserling follows:)

PREPARED STATEMENT OF LEON H. KEYSERLING

Mr. Chairman and Members of the Committeee:

I appreciate this opportunity to be heard by this distinguished and influential Committee, at a time when the cumulative and empirical evidence during many years, and especially during the most recent years running through the second quarter of 1970, make it conclusively clear that our national economic policies require fundamental and drastic review and reconstruction.

These policies have *not* effectuated a trade-off between the objective of maintaining maximum employment and production and the objective of reasonable price stability. To the contrary, they have combined an enormous forfeiture of production and employment opportunity with an intolerable amount of price inflation. They have rendered us progressively less able to afford to meet the imperative priorities of our domestic needs, and thus have contributed to social and civil division, misunderstanding, resentment, and disorder. They have shifted the discussion of our national security problems in a dangerous world, from a sober examination of what course of action offers the best prospects for enduring peace, to a dangerous assumption that our international security policies shall be governed by what it is mistakenly alleged "we cannot afford."

One of the most disturbing aspects of the current situation is the extent to which economists inside and outside of Government, and even a majority of the distinguished economists before this Committee in the current year, have failed to adjust themselves to the reality of the need for drastic reconstruction of basic economic theory and practice. They do engage in relatively minor nuances of emphasis, they do express some relatively minor differences of opinion, and in some instances they do not permit the tinge of political coloration to affect their positions. But in the main, they accept the broad outlines of the prevalent position, refuse to take a fresh look at the facts as they are, and consequently have little to offer that is new and pertinent, when much that is new and pertinent is needed.

To be sure, there are a few who have had the perception and courage to stand out against the prevalent view. Outstanding in this connection, among those who have appeared before this Committee in the current hearing, is Dr. Gardiner C. Means, who for four decades has combined the merits of a great theoretical economist with the willingness to study the facts as they unfold, and to modify his theory accordingly. I therefore urge that the testimony of Dr. Means be given most careful attention by this Committee. I know that it will be.

The main points that I shall make here today are as follows:

I. The Neglect of Economic Growth and Its Consequences

The abysmally low rate of real national economic growth during 1953-1960, averaging 2.4 percent annually, which galvanized the nation into some remedial action, has reasserted itself with a vengeance since 1966. From 1966 to the second quarter of 1970, the average annual rate of real economic growth was only 2.5 percent. From 1968 to the second quarter of 1970, it was only 1.3 percent. From second quarter 1969 to second quarter 1970, it was minus 0.2 percent, and from first to second quarter 1970, the growth was only 0.6 percent. It was an appalling commentary, in view of these developments during a period of almost four years, that most economists and the nation appear not to have been gravely and widely concerned about the economic growth problem until an absolute recession commenced around the middle of 1969. Government policy, meanwhile, has hardly responded yet.[1]

During this very substantial period of time since 1966, the gap between actual total natitonal production and the maximum production declared by the Employment Act of 1946 to be a primary objective of national economic policies and programs has grown consistently. The gap, as I estimate it in constant dollars, was 7.4 percent in 1966, 9.0 percent in 1967, 10.9 percent in 1969, and at an annual rate of 14.9 percent in the second quarter of 1970.

For a variety of reasons, especially the underutilization of employed manpower which has reflected itself in tremendously adverse trends in productivity rather than in overt unemployment—I shall discuss the productivity issue in detail later—the adverse trends since 1966 in actual output relative to maximum output were slow to reveal themselves in the official unemployment figures. Nonetheless, the time came when murder would out. Full-time unemployment, as officially recorded, rose from 3.5 percent of the civilian labor force in 1969 to 5.0 percent in May 1970. The true level of unemployment, taking into account both the full-time equivalent of part-time unemployment and the concealed unemployment arising from nonparticipation in the civilian labor force due to scarcity of job opportunity, rose from 4.7 percent in 1969 to 6.1 percent in May 1970.[2] Even the 6.1 percent figure does not reveal the underutilization of employed manpower in plants, which reflects itself in the decline in the productivity growth rate to almost zero during the period from the first quarter of 1969 to the first quarter of 1970. Taking this additional factor into account, although I have not been able to develop a precise index to measure it, the true

[1] See my chart 1 at end of statement.
[2] See my chart 2 at end of statement.

level of total manpower underutilization, including both the unemployed and the underemployed, may now be close to 10 percent, and is certainly above 8 percent.

The gross neglect of this problem of economic growth for so many years, and the secondary or tertiary importance attached to it even in current economic exposition, and more importantly in national economic policies, call for some estimates of the cost of this neglect. During 1953–1968 inclusive, measured in uniform 1967 dollars, I estimate that we forfeited more than 917 billion dollars of potential national production. From the beginning of 1966 through the second quarter of 1970, we forfeited about 399 billion dollars. In second quarter 1970 alone, the annual rate of total national production, measured in 1967 dollars, was almost 150 billion dollars below the maximum. Even if these estimates were to be reduced appreciably by using lower potential growth rates than those which I believe to be sound, the losses have been staggering.

Concurrently, during 1953–1968 inclusive, we forfeited more than 38 million man-years of employment opportunity, based upon the true level of unemployment concept. From the beginning of 1966 through the second quarter of 1970, we forfeited 4.9 million man-years of employment opportunity. And in May 1970 alone, the true level of employment was at least 1.7 million below the optimum.[3]

Under these circumstances, it has become monstrous to be so preoccupied with the problem of containing inflation that we have permitted this wastage of output and manpower to persist for so many years, and recently to augment again. For no amount of sophistry, and no amount of stylish changes in preoccupation and emphasis from year to year, can alter the basic truth that the production and use of wealth is the most fundamental of all economic problems, and that there are no other considerations which can justifiy neglect of this.

Moreover, appropirate stress upon the problems of equitable distribution and priorities of need does not reduce the vital importance of the growth problem, although it has again become fashionable in some quarters to claim erroneously that the proponents of growth neglect these other *desiderata*. Actually, as I shall show, appropriate attention to distribution and priorities augments and sustains economic growth, while the recent and current neglect of distribution and priorities militates against growth.

Even if the immense forfeitures of production and employment opportunity which I have detailed, and the attendant neglect of the problem of equitable distribution and priorities of need, had resulted in a somewhat lower average annual rate of price inflation, the gain on the price side would have been egregiously short of the cost of the sacrifices. But as I shall show later in my testimony, the policies of commission and omission which have led to the forfeitures in production and employment have vastly augmented the price inflation in the long run, and also made it the worst kind of price inflation. There has been no trade off; there has been a very bad bargain on all scores.

II. The Neglect of Analyses and Policies Conducive to Optimum Economic Growth at Maximum Employment and Production

In the United States economy, sustained optimum economic growth at maximum employment and production depends upon an allocation of resources and incomes conducive to these goals, and failure to attain these objectives results when the allocatiton of resources and incomes is seriously perverse. Yet, recent and current discussion of national economic policies, including that before this Committee in the current hearings, and actual development and application of economic policies, have come close to neglecting this whole problem of optimum or even workable allocation of resources and incomes. Consistently, the actual application of national economic policies has served in the main to accentuate the misallocation of resources and incomes.

In this connection, the corrective process must start with an empirical observation of why and how each period of so-called boom has been followed with insistently regularity by a period of slow-down and then recession. The central and consistent adverse phenomenon has been that each boom period has generated a relatively excessive and therefore nonsustainable rate of advance in investment in the plant and equipment which increase our production capabilities, accompanied by a relatively deficient growth rate in ultimate demand in the form of total private consumption expenditures plus total public outlays at

[3] See my chart 3 at end of statement.

all levels for goods and services. In consequence of this disequilibrium, the time has recurrently come when very drastic cutbacks in the investment process have occurred. And these cutbacks, combined with the more enduring deficiencies in ultimate demand, have brought on the periods of stagnation and recession.

For example, during the "boom" period from the first three quarters of 1955 through the first three quarters of 1957, investment in plant and equipment, measured in uniform dollars, rose at an average annual rate of 10.4 percent, while ultimate demand rose at an average annual rate of only 2.7 percent. In the ensuing recessionary period from the third quarter of 1957 to the third quarter of 1958, investment in plant and equipment declined at an average annual rate of 20.5 percent, while ultimate demand was maintained at an average annual rate of only 2.2 percent. The respective trends during the "boom" period from the first half of 1959 to the first half of 1960, the recessionary period fom the first half of 1960 to the first half of 1961, the "boom" period from the first half of 1961 to the first half of 1966, and the slow-down and recessionary period from the first half of 1966 to the first quarter of 1970, repeated the same process and verify the same analysis.

However, it is deeply significant that, from the first quarter of 1969 to the first quarter of 1970, despite the economic recession, investment in plant and equipment rose at an average annual rate of 3.7 percent, while ultimate demand rose at an average annual rate of only 0.8 percent. This is the prime weakness in the current economic situation, but national economic policy has not yet focused upon it.[4]

I have some other factual materials, which further reinforce the same conclusions. Measured in constant dollars, from 1961 to the first quarter of 1970, total national production rose only 45.7 percent, private consumer spending only 46.3 percent, and government outlays for goods and services at all levels only 46.0 percent, while private investment in plant and equipment rose 75.8 percent. During the period 1968-first quarter 1970, total national production rose only 2.4 percent and private consumer spending only 4.2 percent, and government outlays for goods and services at all levels declined 1.1 percent, while private investment in plant and equipment rose 7.6 percent. I do not see how we can come quickly or completely toward maximum employment and production until national economic policies concentrate upon overcoming these disparities. And the current emphasis in such policies continues persistently in the wrong direction.

Meaningful income-allocation analysis must be derived from the foregoing analysis of the allocation of resource use, for no appraisal of income allocation is pertinent, except in the perspective of its impact upon resource allocation and use. This, too, is woefully neglected in most current economic analysis, as well as in recent and current national economic policies.

From 1961 to the first quarter of 1970, measured in uniform dollars, corporate profits grew 29.2 percent, or very much less than total national production, wages and salaries, or private consumer spending. Superficially, this imports that the advance in profits was very moderate, or even deficient. But the fact remains that the main function of profits is to support investment, and that private investment during this period, as indicated above, grew at a greatly excessive and nonstabilizing rate relative to the other factors mentioned. By this functional test, there was no general shortage but rather a relative excess of profits, in terms of the requirements for sustained economic equilibrium at reasonably full resource use. Besides, profits are the most volatile factor of the income stream, and are customarily most affected in percentage terms by recessionary developments. Thus, while corporate profits (as already stated) grew only 29.2 percent from 1961 to the first quarter of 1970, they grew 48 percent from 1961 to 1969. In short, the excesses exacted the penalty.

Moreover, even the most recent level of profits has been sufficient to support, as already indicated, a growth of investment in plant and equipment of 7.6 percent during the period 1968 to the first quarter 1970, and 3.7 percent from first quarter 1969 to first quarter 1970, or highly excessive in ratio to developments in other important sectors. To put this in another way, the restoration of an upward trend in profits depends upon shifting resources use drastically toward ultimate demand, so that profits may grow in a healthy fashion in an economy growing at a healthy and balanced rate. The most seriously inflation that we have been suffering during the years under review has been in the investment

[4] See my chart 4 at end of statement.

process, and in the price-profit trends supporting such investment, and certainly not in wage growth or consumer-income growth generally. And national economic policies which have inflated the fat and starved the lean, including policies throughout the 1960's and on into 1970, should promptly be reversed accordingly.[5]

Further light is shed upon relative income trends, and their impact upon fundamental resource use, by looking at the trends in some key sectors of the economy in a reasonably long-term perspective. From 1960 to the first quarter of 1970, in total manufacturing, profits after taxes, measured in current dollars, rose 81.1 percent, and investment in plant and equipment rose 124.0 percent, while wage rates rose only 45.7 percent. Meanwhile, prices rose 15 percent. This indicates that the price increases were sufficient to support the inordinate and disequilibrating rate of growth in profits after taxes and in investment in plant and equipment, while the growth in wage rates was grossly insufficient to support the adequate expansion of personal consumer spending.

Looking for the same period of time at such key sectors as petroleum and coal products, chemicals and allied products, electrical machinery, and motor vehicles and equipment, the same disparate trends have been profundly manifest. Iron and steel is a unique case, in that its entire performance has been plagued by large excess capacity during most years, in view of the gross inadequacy of total economic growth.[6]

Among other things, this analysis disposes of the prevalent dogma of wage-push inflation, and I am glad to note very recently a more general recognition of this fact, even though it has not yet been translated into national economic policy.

In the light of my whole analysis thus far, it is clear that the entire complex of our national economic policies, fairly persistently since 1953, and more acutely during the more recent years, has been perverse in terms of the entire problem of economic growth, employment, equitable distribution, and priorities.

In fiscal policy, the outstanding example has been the excessive and misdirected tax-cutting programs. The extensive and varied tax cuts between 1962 and 1965, and especially in 1964, allocated relatively far too much to the investment function, and relatively far too little to the consumption function.[7] The immense propaganda to the effect that the tax cuts of 1964 produced an economic performance record of unparalleled duration and size has by now been shown to be with merit. As these cuts occurred in 1964, they can take no credit for the upturn during 1961–1964, which in fact was a grossly deficient economic recovery. To be sure, these tax cuts in 1964 produced until 1966 an unbalanced and nonsustainable boom, not much different in character from the earlier booms followed by periods of stagnation and recession. But by 1966, a recession was certainly just around the corner, and the "New Economics" was saved only by the unexpected and immense increase in public spending due to the Viet Nam war. And even with that increased war spending, the economic growth rate, as I have shown, commenced to deteriorate seriously from 1966 forward, averaged a terribly inadequate performance from 1966 to date, and culminated with the recession commencing in 1969. The tax cuts of 1969, despite being heralded as reforms, proceeded in many respects in the wrong direction from the viewpoint of resource allocation, and were especially devastating in their impact upon the very high priority of housing, and also non-housing urban investment.

In addition, the extent and direction of the tax cuts completely ignored our great domestic priorities which require vast increases in Federal spending. This evil has been compounded by the excessively tight budgetary policy on the spending side, which has given higher priority to the condition of the Federal Budget than to the condition of the national economy, and also, as in the past, has brought us to the prospect of a huge Federal deficit for the very obvious reason that the blood of Federal revenues cannot be squeezed from the turnip of a stagnant, underemployed, and recessionary economy.

The prevalent monetary policy, which I shall discuss in detail later on in my testimony, has had the same perverse and destructive effects. It has placed no restraints upon the relatively excessive investment booms, which are financed primarily out of retained earnings and often excessive price increases. It has had powerfully adverse effects upon those activities which have been most in

[5] See my chart 5 at end of statement.
[6] See my chart 6 at end of statement.
[7] See my chart 7 at end of statement.

need of stimulation, from the viewpoint both of economic performance and priority needs. Housing has been the most shocking example of this. The policy of tight money and rising interest rates has hit the Federal Budget by imposing additional interest costs now running at about nine billion dollars a year, and has had even more serious adverse impacts upon the capacity of State and local government to perform their essential functions.

I see no signs, as yet, of alterations in fiscal and monetary policies, compatible with the lessons of the past or the needs of today and tomorrow.

III. The Prevalent Fiscal and Monetary Policies, Designed To Curb Inflation by Stunting Economic Growth and Employment Opportunity Have in Fact Been Profoundly Inflationary

Although I have been making this point repeatedly since 1953, before this Committee and elsewhere, the actual record during the past few years has corroborated my position even beyond my own expectancy. The proof of this is to be found, not in theoretical discussion, but rather in the realism of the acutal behavior of the economy—a behavior which appears to have remained strangely unobserved by those who should watch it most closely.

During 1952–1955, an average annual economic growth rate in real terms of 3.5 percent was accompanied by virtual price stability. During 1955–1958, the average annual real economic growth rate sank to 0.8 percent, but the average annual rate of price inflation rose to 2.6 percent for consumer prices, and practically the same for wholesale and industrial prices. During the shorter period 1956–1958, including the recession therein, the average annual growth rate in real terms was only 0.2 percent, but the average annual increase in consumer prices rose to 3.1 percent. In vivid contrast, during 1958–1966, the average annual rate of real economic growth was 4.9 percent, but there was virtual price stability, with the average annual rate of increase in consumer prices being only 1.5 percent, in wholesale prices only 0.7 percent, and in industrial prices only 0.6 percent. But from 1966 to the second quarter of 1970, while the average annual rate of real economic growth declined calamitously to only 2.5 percent, the average annual increase in consumer prices was 4.6 percent, in wholesale prices 2.6 percent, and in industrial prices 2.8 percent. And from second quarter 1969 to second quarter 1970, while the economic growth rate in real terms was minus 0.2 percent, the increase in consumer prices was 6.1 percent, in wholesale prices 3.7 percent, and industrial prices 3.8 percent.

The persistent attempt to explain these opposite trends in fundamental economic performance and in price movements on the ground of time lags has now moved from being merely irrational to being ridiculous and tragic. The periods I have selected for my analysis are, in the main, far too long to be explained by time lags. If the upward movement of prices during the recessionary period from the second quarter of 1969 to the second quarter of 1970 had been at a reduced pace, there might be some miniscule ground for argument that restraints placed upon economic growth and employment opportunity were doing the price-restraint job. But when the declining growth rate of the economy and the sharp rise in unemployment have been accompanied by an actual acceleration of the price inflation, especially during but not limited to the most recent year, the prevalent theory loses all force and meaning.

Then, it is argued that price inflation is caused by a movement toward full use of resources, and that a movement away from full use of resources tends to subdue the price inflation. This is also completely refuted by the empirical evidence. The level of full-time unemployment was reduced from 6.7 percent in 1961 to 3.7 percent in 1966, but (as I have already indicated) we maintained virtual price stability for the period as a whole. Contrariwise, full-time unemployment rose from 3.5 percent in 1969 to 5.0 percent in May 1970, but the price inflation rose and was vastly higher than during any previous period in two or three decades.[8]

It is interesting to note also that my findings appear to be corroborated by the experience of other countries, although international comparisions are affected by so many variables that it is hard to make much use of them. During the most recent years for which I have data, the price inflation in the United Kingdom, which has been plagued by economic stagnation and many other economic problems, and also in the U.S., appears to have been more severe than in France, and much more severe than in Germany and Italy, countries which in the main

[8] See my chart 8, and also see again my chart 2 at end of statement.

have registered very rewarding economic expansion. Even in Japan, where the real economic growth rate has been almost inconceivable, it appears that during the most recent years a better record of price stabilization has been made than in the United States, especially when account is taken of wholesale as well as consumer prices.[9]

The fundamental reasons why stunting the economy, reducing economic growth to intolerably low levels, and lifting unemployment to intolerably high levels, have actually increased price inflation greatly, are both clear and abundant.

First, is an economy characterized largely by administered prices, that is prices fixed consciously by overt managerial decisions, attempts are recurrently made to compensate for an unrewarding expansion of business volume through an effort to increase profits *per unit* by lifting prices. Whether or not this effort is successful in the long run is immaterial because, my examination of key sectors of the economy over many years demonstrates conclusively that the effort is made, whether it is successful or not.

To take one outstanding example, the automobile industry more than a year ago foresaw correctly a very large decline in sales. It promptly increased its prices greatly. This increase in prices could certainly not be explained on the ground of excessive demand or an "overheated" industry, for the investment programs of the industry had been enormous, and idle capacity was increasing. Nor could the increase in prices be explained on the cost-push theory, for the profits of the industry remained fabulous, although reduced below all-time peaks. The steel industry recently raised its prices greatly, in the face of very large excess capacity.

As applied to the economy as a whole, the claim that price increases have been due to an "overheated" economy, that is, an economy where total spending is pressing hard against available capacities, is indeed nonsensical in the face of development since 1966. And yet this claim has persisted, and is even now reflected in national economic policies.

Second, with respect to so-called cost-push inflation, a stunted and retarded economy tremendously reduces the rate of productivity gains, and thus increases *per unit* labor costs. For example, during 1960–1966, when the real rate of U.S. economic growth averaged annually 5.1 percent, and when unemployment was steadily reduced, the average annual rate of productivity gain in the U.S. private economy was 3.8 percent. But this average annual rate of productivity growth fell to 2.0 percent during 1966–1969, and fell further to the almost imperceptible figure of 0.1 percent during first quarter 1969-first quarter 1970.[10] Increased *per unit* labor costs push up prices, independently of whether such price increases are justified.

Whether or not the current and recent rates of money-wage increases justify any part of the price increases which have recently occurred—and I doubt this justification in the main—the obvious remedy is not to clamp harsh restraints upon money-wage expansion, for this would further cumulate the deficiencies in consumer spending and prolong recession or stagnation. The remedy is rather to bring the rate of productivity growth back to the levels averaged during 1960–1966, and even higher in that the long-range trend in the U.S. economy has been toward the acceleration of productivity gainst during periods of reasonably full resource use and high employment. Thus, whether we talk about demand--pull inflation or cost-push inflation, the remedy is not through the appointment of additional study groups to examine how productivity may be improved. Productivity *will* improve enormously, if and when the processes of economic growth are restored, when idle plant capacity is reduced, when unemployment is reduced, and when the concealed unemployment in the form of underutilization of employed manpower is correspondingly reduced. The empirical evidence on this whole subject is so plain that I rub my eyes in wonderment at the failure of most economists and policy-makers to take account of it.

IV. The Prevalent Policy of Tight Money and Rising Interest Rates Is Grossly Inflationary

It would appear that I need not develop this phase of my discussion in detail. For insofar as I have already shown that the contrived stunting of economic growth is highly inflationary, it must follow incontestably that a monetary policy deliberately designed to stunt the economy will bring increased inflation in its wake. Nonetheless, some examination of the evidence is in order.

[9] See my chart 9 at end of statement.
[10] See my chart 10 at end of statement.

During 1955–1957, the extremely severe contraction of the money supply was a major factor in the economic stagnation (and in the 1957–1958 recession). But the inflation of consumer prices rose to 3.5 percent during 1956-1957. During 1960–1965, the average annual growth in the money supply was quite high, and the average annual economic growth rate was very high. Meanwhile, as I have alredy pointed out, there was virtual price stability.

During 1965–1966, the growth rate in the money supply was grossly contracted; and this helped to reduce the real economic growth rate, to only 2.5 percent during 1966–1967. But the price inflation was tremendously higher, on the average, than during 1961–1966. During 1966–1968, the money supply was greatly expanded, and did succeed in helping to lift the real economic growth rate to 5.0 percent from 1967 to 1968. But from 1968 to second quarter 1970, the average annual growth rate in the money supply was reduced to 3.2 percent, while the average annual real economic growth rate was only 1.3 percent, and price inflation mounted in an alarming fashion.[11]

There are additional reasons why tight money and rising interest rates increase inflation, aside from the fact that their adverse impact upon economic growth and employment is inflationary. The cost of money is like any other cost, and when that cost rises, it is passed along by those who can do so. The price of fuel used by all American households and industries is now being increased substantially throughout the land, and necessarily so. This is because the utilities finance themselves more largely than any other industry, except housing, with borrowed money, and their embedded debt costs are rising so rapidly that they must get a higher rate of return to avoid aggravation of the shortages which are already appearing in the utility field. The tight money and rising interest rates, aside from their disastrous effect upon home construction, have produced shortages so severe that the cost of housing is rising more rapidly than most elements in the cost of living, both for those who rent and those who buy.

Still another reason why the prevalent monetary policy has been highly inflationary in the long run is that this policy has been the outstanding example of what is called "fine tuning," which means sharp and continuous changes in the direction of policy to deal allegedly with expected or desired changes in economic conditions. A glance at the trends in the rate of expansion of the monetary supply, even from 1955 to date, indicates an almost unbelievably erratic series of upward and downward movement.[12] This kind of fine tuning, or constant changes in public policies, which in themselves forecast or attempt sharp changes in the business world, produce changes in business expectancies, and sometimes these expectancy changes generate the unfavorable developments sought to be avoided.

In any event, it is clear that the change in business expectancies, produced by the excessive fine tuning of monetary and other national economic policies, tend both on upward and downward movements of the economy to produce price increases in many sectors. The price increases during downward movements come, as I have said, from the desire to compensate for inadequate volume with higher returns *per unit*. The price increases in the first stages of an upward movement come from the general atmosphere produced by the expectancy of a quick and sharp march of the economy toward another "boom," especially when it is anticipated, on the basis of recent experience, that the "boom" will not be durable and that "hay should be made while the sun shines."

It therefore follows that the entire policy of fine tuning, a poor and pretentious substitute for a stable long-range economic policy, keeps the economy in a constant state of excitement and anxiety, and this is not conducive to price stability. It may be conceded that the drastic efforts which are now required to get the economy moving upward again might, *for a short time*, intensify some types of price inflation, although this is dubious on the basis of the 1961–1966 experience. But even if this were to be conceded in part, the gains would be far more than worth the cost.

Be this as it may, I am thoroughly convinced, on the basis of empirical observation, that *in the long run* a sustained policy for optimum economic growth and full employment yields far less price inflation than an economy behaving like a roller coaster at Coney Island, and has manifold other advantages.

Beyond all this, the prevalent monetary policy is utterly unconscionable in its impact upon income distribution. No array of statistics is required to demonstrate that those who lend are usually in much stronger financial circumstances than those who borrow. It suffices to say that, according to my estimates, the

[11] See my chart 11 at end of statement.
[12] See again my chart 11 at end of statement.

prevalent monetary policy since 1952 has distributed in the neighborhood of 150 billion dollars of national income in an upward direction. It penalizes severely the small businessman and farmer. It applies veritable extortion to the average consumer. The family with an income of $8,000 or so after taxes, which buys a new home for $16,000 or so will, because of the rising interest rates since 1952, pay out during the life of a conventional mortgage about the equivalent of a full year of its income after taxes. And for reasons already stated, in view of the chronic tendency of the U.S. economy to generate excessive investment relative to consumption, the income maldistribution generated by the prevalent monetary policies is not only inimical to economic justice but also injurious to economic growth and employment opportunity. This is because high-income families have a lower propensity to consume relative to their incomes than low- and middle-income families.

V. The Excessively Tight Federal Budget Is Highly Inflationary in the Long Run

There is no commonplace of prevalent economic theory and practice more firmly established than the proposition that a tight Federal Budget is anti-inflationary. Of course, a Federal surplus tends to be anti-inflationary when the economy is running under conditions where excessive total demand presses against our production capabilities. But when a tight Federal Budget, in the form of an attempt—whether successful or not—to keep the Budget in balance or in surplus results in aggravating excessive economic slack and unemployment, the budgetary policy is in itself inflationary. I need not develop this point further, because I have already developed fully why policies designed to stunt the economy and increase unemployment, in the name of fighting inflation, are in themselves inflationary.

Thus, the attempts to balance the Federal Budget and even to run a surplus, initiated with increased vigor a year and a half ago and still underway, have contributed mightily to the inflation under prevailing economic conditions. This conclusion is doubly true when the attempt to balance the Budget and run a surplus has not placed its reliance upon properly designed and progressive tax increases, but instead has made itself manifest entirely on the side of reduced or excessively restrained public spending. To illustrate this, let us take a look at medical care and housing, two of the fastest rising major components in the cost-of-living index.

With respect to medical care, without passing any judgment upon the behavior pattern of the profession, the excessive and rising cost of medical care is due predominantly to the shortage of medical facilities and personnel, and the serious maldistribution of such facilities and services throughout the nation. These deficiences have occurred primarily because of the failure to commence to make even a beginning toward the adequate expansion of public investment in such facilities and services. So, in this instance, the short-sighted policy of fighting inflation by avoiding necessary public outlays has aggravated this inflation.

With respect to housing, the case is equally clear. There is nothing more ironical than the repeated enactment of comprehensive legislation for housing and urban renewal projects, which by definition require vast increases in public outlays, and the persistent failure to implement the declared purposes with outlays even faintly related to them.

Many other examples couuld be directed to the same point, including the entire transportation problems which is now approaching crisis porportions.

It is strange that we accept in general the axiom that increased private investment, toward the enlargement of the supply of goods and services, will be anti-inflationary at least in the long run, but that the same is not true of increased public investment in equally needed facilites and services, although the deficiencies in these areas are in many instances far greater than those anywhere in the private sector.

When we add to these observations the unassailable proposition that an excessively tight budgetary policy contributed mightily to large and growing deficiences in nationwide production and employment, which are in themselves highly inflationary, we percieve the exact confluence between sensible economic policy in a narrow sense and sensible social policy in a broader view.

VI. "Inflation" May Be Desirable or Undesirable Depending Upon Its Nature and its Consequences

Thus far, I have discussed the proposition that efforts to restrain inflation through sacrifice of production, employment, and priorities have in fact increased inflation. I am profoundly convinced that the empirical evidence since 1953 in support of this thesis has by now become almost unanswerable.

But there are many who are not prepared to accept this viewpoint. Thus, the next question is whether any trade-off of potential production and employment gains, in order to restrain inflation, is a desirable national policy. Generally speaking, within the American context, I rather doubt the desirability of any such trade-off.

Theoretically, neither a rising nor a falling price level hurts anybody, except insofar as it works against real production and purchasing power and their equitable distribution. None of the economists, to my knowledge, who has raised cries about the dangers of inflation has even tried to advance anything conclusive on why a rising price level of any stated pace is really less desirable than a stable price level. None has even put forth anything which negates the respectable position that moderate increases in the price level, in the context of the U.S. economy, tend to be associated with both improved economic performance and more equitable distribution.

Further, no economists have brought any evidence to bear in support of the widely-held view, cultivated by much of what they have said, that it is "inflation" which tends to produce recession or depression. It is very illuminating to note that we had a remarkable stable price level, except for falling farm prices, between 1922 and 1929. The Great Crash came because of misallocations in resource use and incomes, which can occur under a rising, stable, or a falling price level. It is not the trend in prices *per se*, but the effects upon resource and income allocations, that matter most.

Indeed, it appears clear that "inflation" may be desirable or undesirable, within moderate bounds, depending upon *how* it occurs. If, during the past few years, we had incurred the same amount of inflation that we have actually incurred, but through programs which maintained reasonably full production and employment, improved the distribution of income, took care first of those who need help most, and made great inroads upon our deficiencies in housing, urban renewal, education, health services, and social security protection, then that amount of inflation would have been not only acceptable, but a very good trade-off indeed.

The trouble is that the inflation during recent years has been of a diametrically different sort. The change in prices and income which have occurred have been so composed as to deprive the nation and the people of hundreds of billions of dollars worth of goods and services and millions of years of employment opportunity, distributed income upward in a shameful manner, and grossly starved the most urgent priorities of our domestic public needs. This type of inflation, especially when augmented by national economic policies designed to *reduce* inflation, is both stupid and unconscionable.

This is another way of saying that no nation's economic policy can be successful which aims directly and primarily upon restraining inflation. A sound and viable national economic policy must commence with adequate long-range goals for employment, and the distribution of goods and services in reasonable accord with priorities of need and with the social conscience. It must analyze maturely what allocation of resources and incomes will promote these ultimate goals, and what national policies will promote these types of allocations. And the high probability is that, if such a course is pursued successfully, the problem of "inflation" will be of negligible proportions, or in any event will be manageable.

Even during World War II, when inflationary pressures were immense in a true and classic sense, we did not start by becoming preoccupied with controlling inflation. We started with a viable, long-range tableau of our production and distribution needs, with an income policy in facilitation of these needs and also armed toward "equality of sacrifice," and with fiscal and monetary policies attuned to these objectives. Because we did this first, we were able to superimpose upon this basic effort an anti-inflationary policy and program suited to the times and to make it work reasonably well, even though we made the mistake of not taxing heavily enough during the war to restrain inflation during the transition from war to peace.

We certainly did not claim that inflation was a greater danger to use than the dictators, nor did we try to contain inflation by deliberately contrived disuse of plan and manpower. We used the term "equality of sacrifice," but what was really meant was "equity of participation." Although the situation now is fundamentally different, the same basic principles remain valid—but we have forgotten them.

VII. Proposed Reconstruction in Program and Policy

I do not need to linger long upon this final phase of my discussion, because all that I have to say is implicit, and even explicit, in what I have already said.

We are now in imperative need, not of minor variations in national economic policies ad programs, but rather of drastic change. Indeed, the policies concentrating upon the restraint of inflation have been based upon a thesis so upside down as to causes and consequences that an almost complete reversal of these policies is needed. It is needed to get inflation under control and, even more importantly, to respond to those throbbing problems of the nation and the people which require maximum production and employment and enormously enlarged allocations to our great domestic priority needs.

The precise steps in such an effort may be set forth quite briefly:

(1) The Employment Act of 1946 needs to be restored to its original and still pertinent purposes. Under that Act, the Council of Economic Advisers should develop, and the President should send to the Congress, a set of interrelated goals for the restoration of maximum employment and production within a year from now at most. This must necessarily be accompanied by a much more penetrating economic analysis than we have had from official sources during the past decade (not implying that we had it earlier) as to that relationship between growth in investment and growth in ultimate demands in the form of consumer expenditures and public outlays which will promote economic equilibrium at full resource use. This has always been, and still is, the core problem of economies, but no one would think so when listening to more than nine-tenths of the current economic discussion among those who should be best informed;

(2) The goals for production and employment must also take account of urgent priority needs, not only with respect to the rapid further reduction of poverty, but also with respect to the enormous unmet public needs in education, health services, housing, urban renewal, transportation, resource development, social insurance, and the redress of the glaring imbalances between urban and rural living standards, services, and opportunities. I have developed detailed projections in these areas, which were set forth in my comments for this Committee on the 1970 Economic Report of the President, and will not repeat these in my testimony here today;

(3) On the basis of the foregoing exercises, and not without them, fiscal and monetary and other national economic policies can achieve consistency, effectiveness, and on increasing purpose, instead of being devised as they have been, and still are, on an *ad hoc*, improvised, inconsistent, and partially misdirected basis. In this connection, "fine-tuning" has failed. We need a reasonably stable and consistent long-range policy, and with this, today will take care of itself. Instead of erecting economic Maginot lines against evils when or after they appear, we should accent affirmative achievement goals;

(4) The fruitless quest for a balanced Federal Budget at the expense of the national economy and the unemployed must be adandoned. Higher tax rates are undesirable and self-defeating until the economy moves much more fully and speedily toward complete restoration. This does not preclude some progressive redistribution of the tax burden. Tax reduction should not now be utilized to stimulate the economy; instead, Federal spending should be greatly increased to serve this purpose and to meet urgent domestic priority needs. The current tax structure now provides a "full employment surplus" in the Federal Budget. This means that the Federal Budget, even under existing tax rates, will be in surplus when we approximate reasonably full use of plant and manpower. The only way to achieve this surplus, in fact, is to move without delay toward that reasonably full use;

(5) The consideration of all outlays related to our national security must be freed from the terribly dangerous notion, now so widespread, that our high national security outlays are the core explanation of recent and current inflation; that these outlays must be drastically reduced in the process of economic restoration; and that we cannot adequately service our great domestic priorities until this course is followed.

The level of spending for national security creates a demand for goods and services, which is exerted against our total production capabilities. As the *total* demand for goods and services now being exerted against our production capabilities is very far short of the requirements for a reasonably healthy and growing economy and since in reality the recent and current inflation is due as I have shown to deficient rather than excessive demand, it becomes preposterous to assert that the national security sectors of active demand explains the recent or current inflation. It would be far more realistic to admit, in view of our manifest unwillingness to lift total demand to levels consistent with maximum employment and production, that but for the high level of national security outlays we would have even more idle man and plant manpower than we now have, with at least as much inflation for reasons I have already stated.

Similarly, what we can really afford is determined by our production capabilities, and not by the legerdemain of Federal bookkeeping. Thus, when we are so short of using our production capabilities fully, it is equally preposterous to assert that the reasons we are neglecting our great domestic priorities is because of the high level of national security outlays. We neglected these priorities almost equally before the great escalation in Viet Nam; and our choice of the tax reduction route in 1964, instead of attending to these great domestic priorities through increased Federal spending, occurred before there was much going on in Viet Nam.

This is not to argue that defense outlays are productive in an economic sense; they are largely wasteful in that sense. Nor is it to argue that national security outlays should be maintained for the purpose of stimulating the economy or preventing idle resources from increasing still more. There are other ways of accomplishing these objectives. But it *is* to argue that, the world being what it is today rather than what we would like it to be, we are in great peril when the American people, through the bad advice of so large a part of their leadership, are led to believe that the course of our natitonal security policies should be determined by utterly fallacious economic reasoning, and not by the international situation as best we can appraise it in an uncertain world;

The national security burden is always unpleasant and, as I have said, wasteful in a purely economic sense. But at no time since the end of World War II have we been in the situation where the burden of our national security outlays really made us unable to afford what we should have been doing in other areas, or posed inflationary pressures which could not be contained by sound policies;

(6) The policy of tight money and rising interest rates is regressive, unfair, inflationary, and conducive to economic stagnation and recession. This pernicious policy should be abandoned. This will require, in addition to the strong assertion of Presidential leadership, a wide range of Congressional action. I favor Congressional establishment of the principle that the growth rate in the money supply shall be kept consistent with the requirements for optimum economic growth and full resource use, and be kept entirely consistent with the programs toward these ends which should be set forth in the President's Economic Report. Legislation should be enacted to reduce interest rates in some important sectors on a selective basis. Legislation should also be enacted to require the Federal Reserve System to employ selective controls, because the blunderbuss approach thus far applied has resulted in stimulating that which should be restrained, and restraining that which shoud be stimulated.

(7) Price and wage controls through Federal law should not be considered at this time. My friend Professor Galbraith, in his nostalgia for price and wage controls, harks back to a World War II situation in no ways analogous to the one we face now. He also forgets that even World War II experience showed that such controls can at best be supplements to sound and effective fiscal and monetary policies, and other policies also. Until these policies are recast along sound and effective lines, we cannot know what the function or policy-content or price and wage controls should be; and we would probably find that we would not need such controls if such other policies were developed and applied. Certainly at the very least, the Government should commence to execute more satisfactorily the traditional policies which it must execute perpetually, before it embarks, during a period short of anything approximating total war, upon policies so strange to our system, habits, and wishes as the direct controls.

In the second place, price and wage controls can be useful only if they are in implementation of sound economic analysis and goals. So long as the policymakers remain caught in the grip of the unsound and upside-down policies, which I have described throughout my testimony, and so obsessed with containing inflation that they neglect all else and increase inflation to boot, the content which they would give to price and wage controls would presumably worsen the situation. That happened with the late Price-Wage Guidelines.

I do favor the development of new guidelines, as an integral part of the other points in my suggested program, promulgated by Government after true consultative relationships with the leadership of labor and industry. Admittedly, price-wage aberrations can defeat other national policies, even when such other policies are well considered. We must therefore find a *modus operandi* which steers between the long-range defects of definitive price-wage controls and the undesirability of basic price-wage decisions in so narrow a perspective that they are inimical to the public interest.

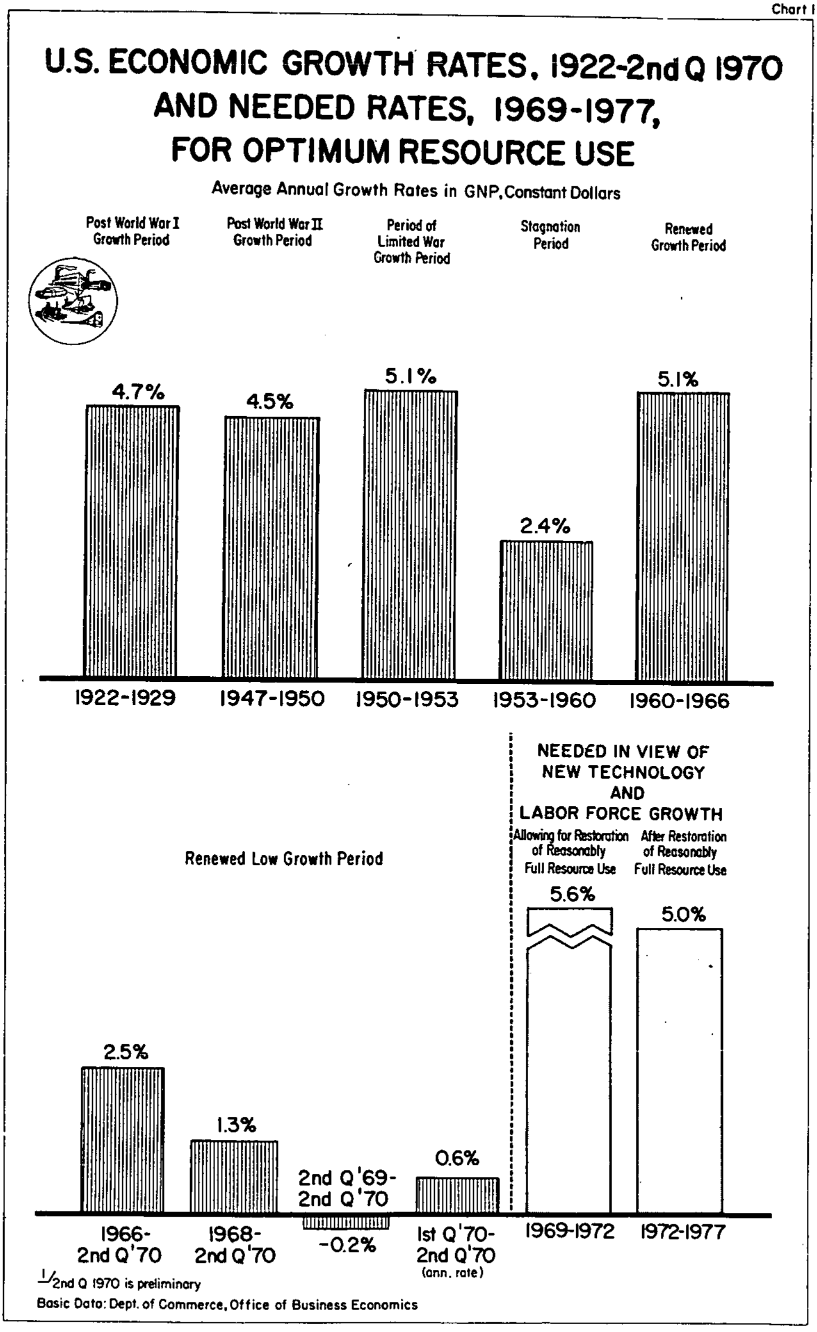
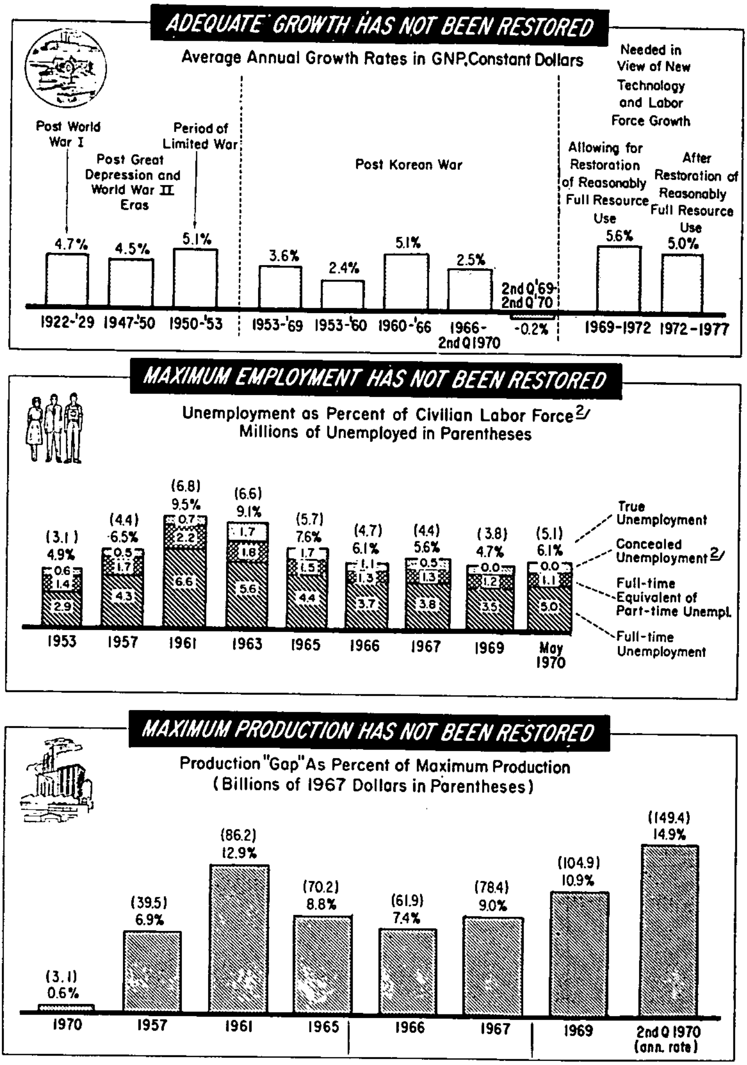


Chart I
U.S. ECONOMIC GROWTH RATES, 1922-2nd Q 1970
AND NEEDED RATES, 1969-1977,
FOR OPTIMUM RESOURCE USE
Average Annual Growth Rates in GNP, Constant Dollars
Post World War I Growth Period
Post World War II Growth Period
Period of Limited War Growth Period
Stagnation Period
Renewed Growth Period
4.7%
4.5%
5.1%
2.4%
5.1%
1922-1929
1947-1950
1950-1953
1953-1960
1960-1966
NEEDED IN VIEW OF NEW TECHNOLOGY AND LABOR FORCE GROWTH
Allowing for Restoration of Reasonably Full Resource Use
After Restoration of Reasonably Full Resource Use
Renewed Low Growth Period
5.6%
5.0%
2.5%
1.3%
0.6%
2nd Q'69- 2nd Q'70
-0.2%
1966- 2nd Q'70
1968- 2nd Q'70
1st Q'70- 2nd Q'70 (ann. rate)
1969-1972
1972-1977
1/ 2nd Q 1970 is preliminary
Basic Data: Dept. of Commerce, Office of Business Economics

Chart 2

BASIC U.S. ECONOMIC TRENDS,1953- 2nd Q 1970



1/ All 1970 data preliminary.

2/ In deriving these percentages, the Civilian Labor Force is estimated as the officially reported Civilian Labor Force plus concealed unemployment. Full-time unemployment of 2.9% and true unemployment of 4.1 % would be consistent with maximum employment. All data relate to persons 16 years of age and older.

Basic Data: Dept. of Commerce; Dept. of Labor

Chart 3

COSTS OF DEFICIENT ECONOMIC GROWTH
U.S. ECONOMY, 1953-1968 AND 1969-1977

(dollar items in billions of 1967 dollars)

1953-1968

Total National Production (GNP) 1966-2nd Q 1970: $398.6 2nd Q 1970: 149.4 (ann. rate) 1953-1969: $917.8 1969: 81.8	Man-years of Employment 1/ 1966-2nd Q 1970: $4.9 May 1970: 1.7 (ann. rate) 1953-1968: 38.6 Million 1968: 2.1 Million	Personal Consumption Expenditures 1953-1968: $692.8 1968: 73.1	Gov't Outlay for Goods and Services 1953-1968: $32.9 1968: -11.7
Private Business Investment (Incl. Net Foreign) 1953-1968: $192.1 1968: 20.4	Average Family Income 1953-1968: $11,459 1968: 1,208	Wages and Salaries 1953-1968: $637.2 1968: 67.3	Unincorporated Business and Professional Income 1953-1968: $79.4 1968: 8.4

1969-1977

Total National Production (GNP) 1969-1977: $1,173.7 1977: 215.4	Man-years of Employment 1/ 1969-1977: 31.4 Million 1977: 5.0 Million	Personal Consumption Expenditures 1969-1977: $764.0 1977: 144.4	Gov't Outlay for Goods and Services 1969-1977: $151.1 1977: 27.2
Private Business Investment (Incl. Net Foreign) 1969-1977: $263.6 1977: 43.8	Average Family Income 1969-1977: $11,958 1977: 2,349	Wages and Salaries 1969-1977: $702.7 1977: 132.8	Unincorporated Business and Professional Income 1969-1977: $87.6 1977: 16.6

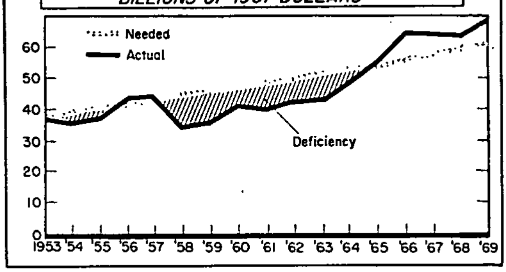
1/ Based upon true level of unemployment concept, including full-time unemployment, full-time equivalent of part-time unemployment, and concealed unemployment (nonparticipation in civilian labor force) due to scarcity of job opportunity.

Basic Data: Dept. of Commerce; Dept. of Labor

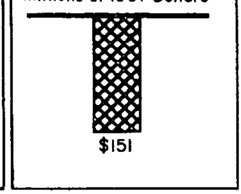
Chart 4

INVESTMENT IN PLANT AND EQUIPMENT WAS NOT EXCESSIVE, 1953-1st Q 1970 AS A WHOLE

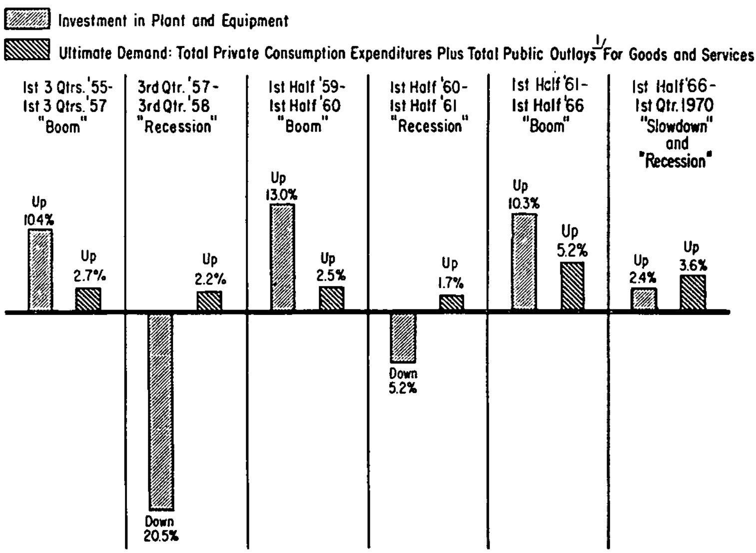
ACTUAL AND NEEDED INVESTMENT 1953-1969
BILLIONS OF 1967 DOLLARS



AVERAGE ANNUAL DEFICIENCY
1954-1969
Millions of 1967 Dollars



BUT INVESTMENT IN MEANS OF PRODUCTION AT TIMES OUTRAN DEMAND; HENCE INVESTMENT CUTS AND RECESSIONS

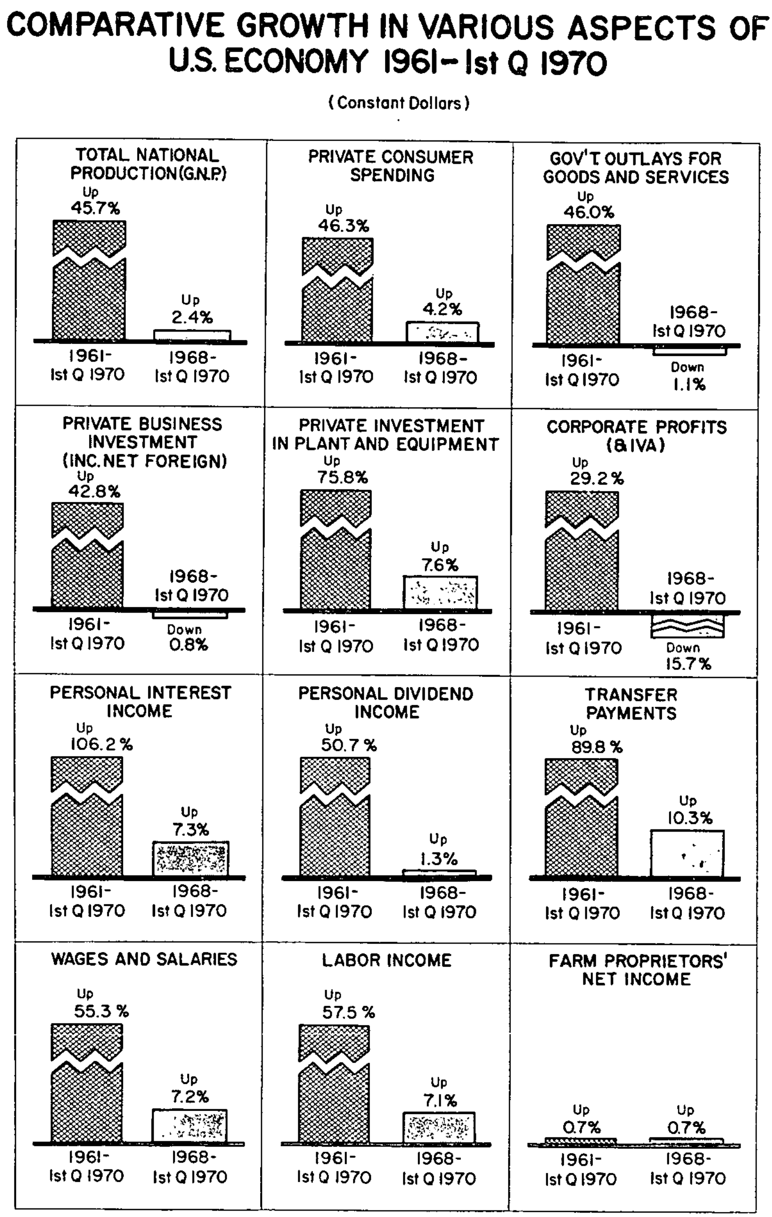


AVERAGE ANNUAL RATES OF CHANGE
- In Uniform Dollars

1/ Federal, State and local.

2/ However, from first quarter 1969 to first quarter 1970, the rates were up 3.7% for investment and up 0.8% for ultimate demand.

Chart 5

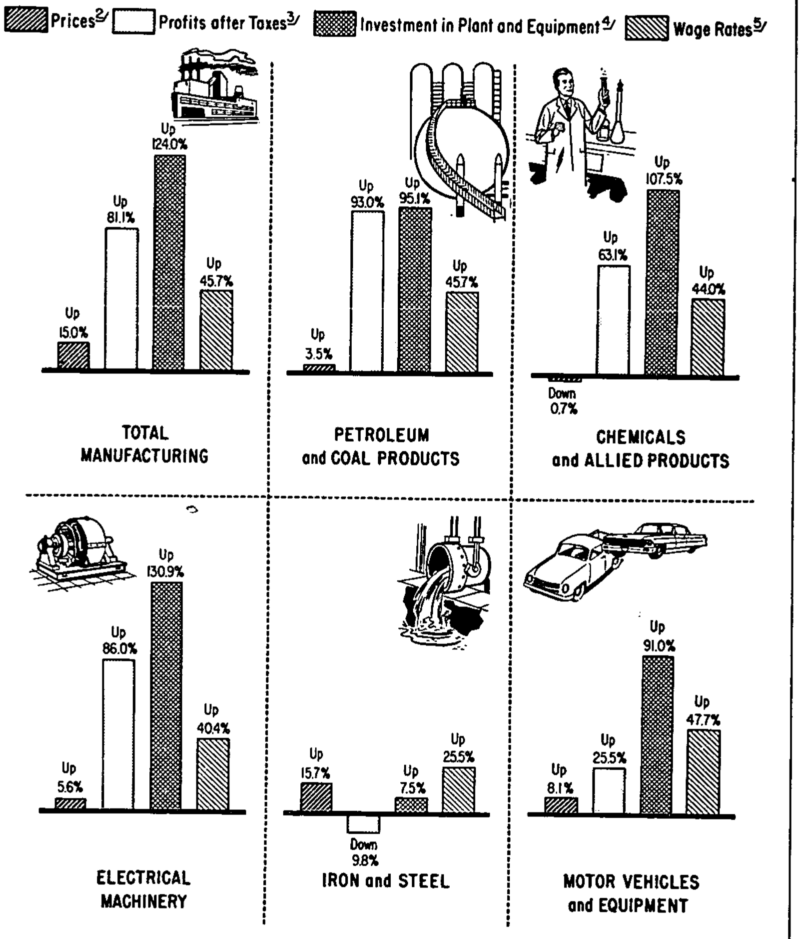


Source: Dept. of Commerce, Office of Business Economics and CEP

Chart 6

PRICE, PROFIT, INVESTMENT, AND WAGE TRENDS, 1960 TO 1st Q 1970[1]

(Total Percentage Change, 1960–1st Q 1970)



1/ All 1970 data preliminary.

2/ Data: U.S. Dept. of Labor, wholesale commodity price indexes.

3/ Data: Federal Trade Commission–Securities and Exchange Commission.

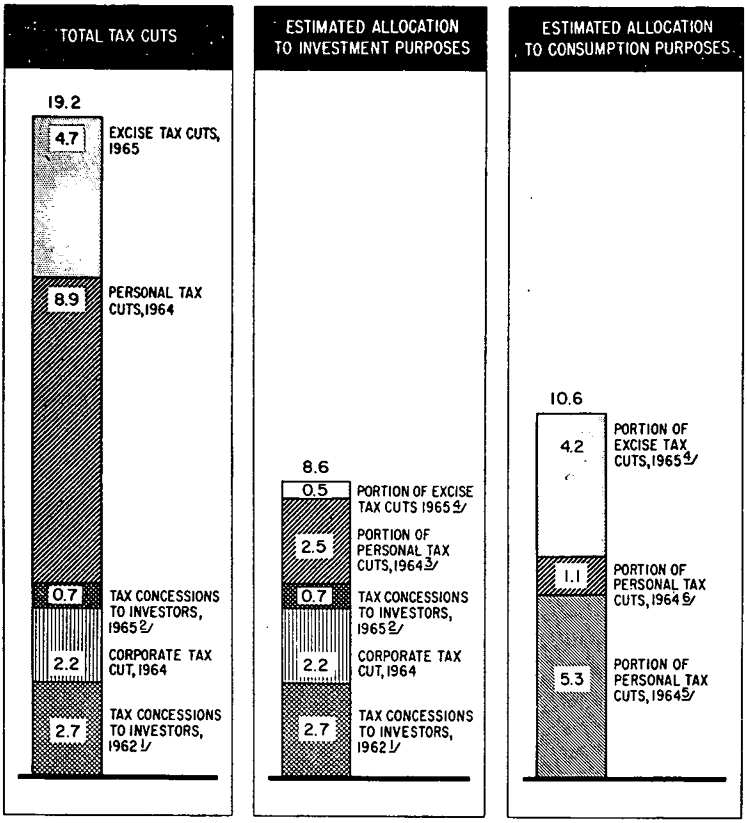
4/ Data: U.S. Dept. of Commerce and Securities and Exchange Commission.

5/ Data: U.S. Dept. of Labor, Bureau of Labor Statistics; Average hourly earnings of production workers.

Chart 7

ALLOCATION OF TAX CUTS, 1962-1965: INVESTMENT AND CONSUMPTION PURPOSES

(Billions of Dollars)



1/ Through Congressional & Executive Action

2/ Through Executive Action

3/ Estimated portion of personal tax cut, for those with incomes of $10,000 and over, which they would save for investment purposes.

4/ Based on estimates of excise tax cuts passed on to consumers through price cuts.

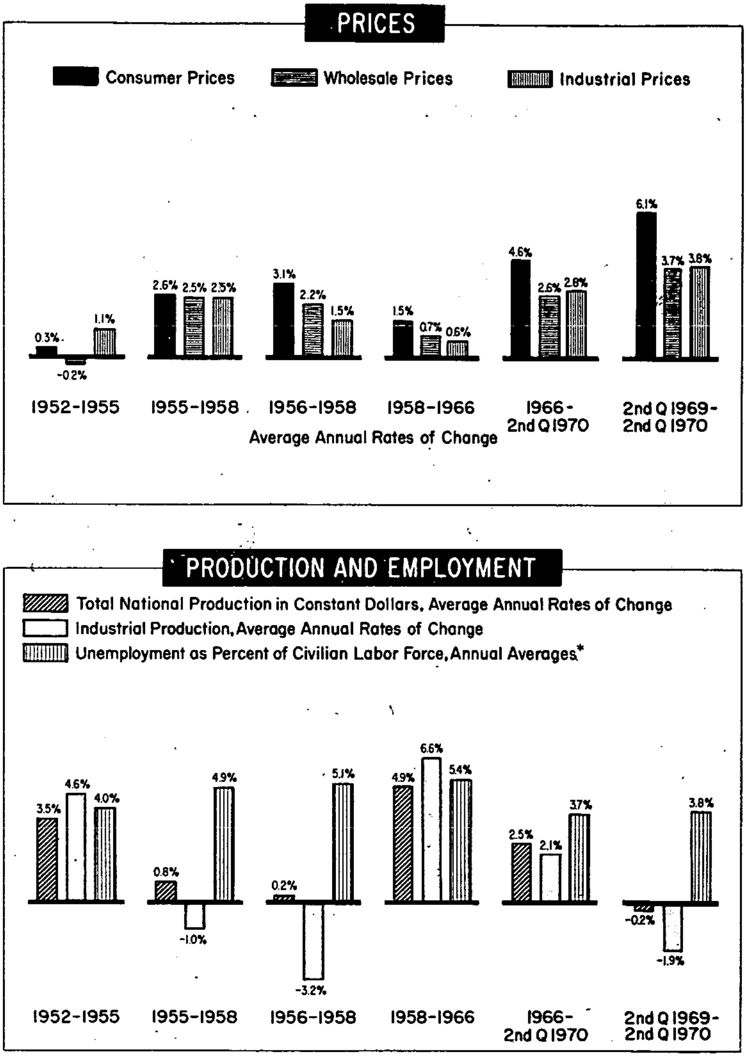
5/ Personal tax cuts for those with incomes under $10,000.

6/ Estimated portion of personal tax cuts for those with incomes of $10,000 and over, which they would spend for consumption.

Note: Estimates of excise tax reduction allocation by C.E.P. (amount might be passed on to consumers by price reductions.) However, a large portion of this did not go to low income consumers.

Chart 8

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT, & PRICES, 1952 - 2nd Q 1970[1]



[1] Preliminary 1970 data.

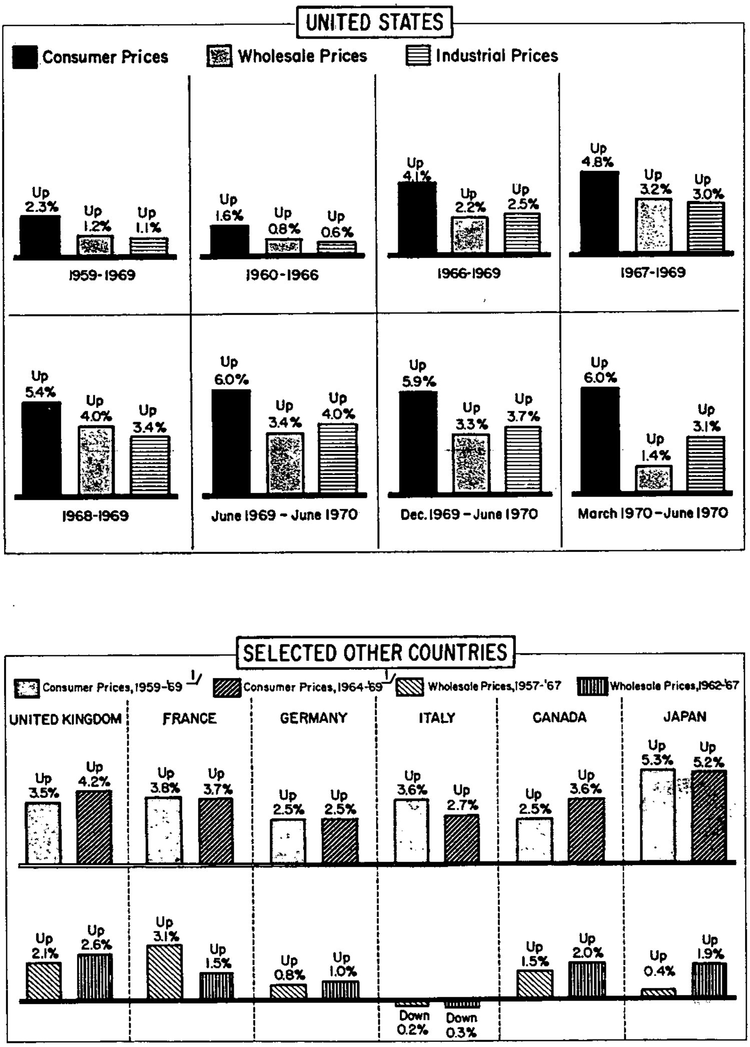
* These annual averages (as differentiated from the annual rates of change) are based on full-time officially reported unemployment measured against the officially reported Civilian Labor Force.

Source: Dept. of Labor, Dept. of Commerce, & Federal Reserve System

Chart 9

SELECTED PRICE TRENDS, 1959-JUNE 1970
U.S. AND SELECTED OTHER COUNTRIES

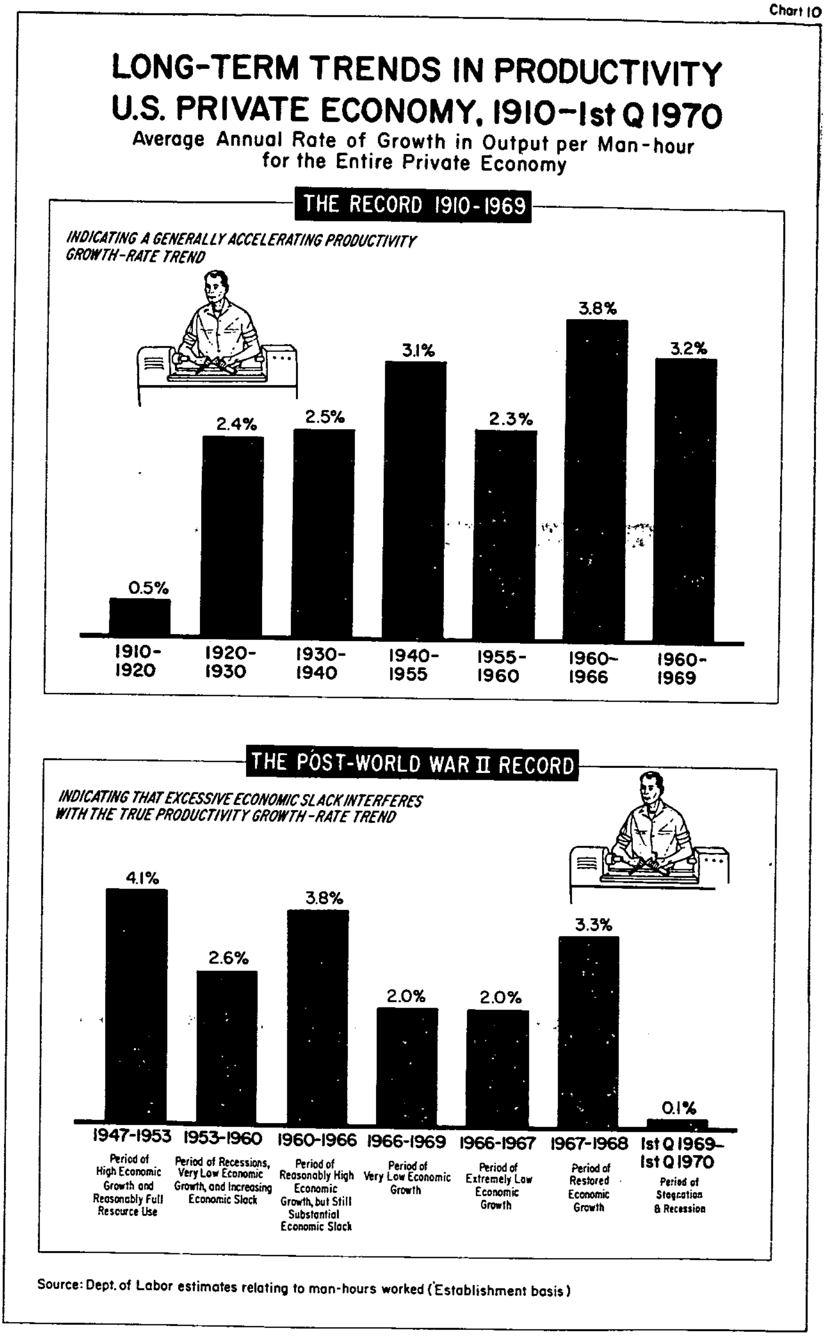
(Average Annual Rates of Change)



1/ Based on 11 months data for 1969; Italy, 9 months data.

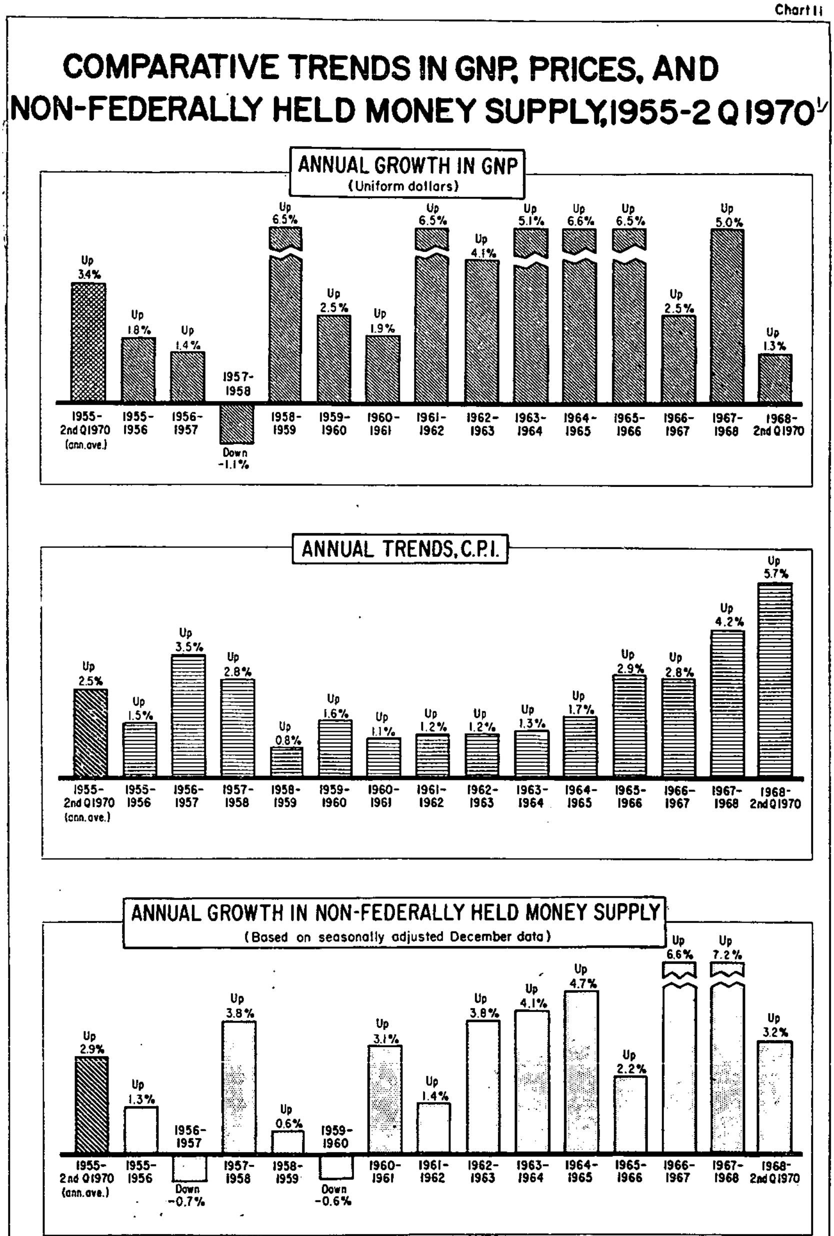
Source: Bureau of Labor Statistics, Department of Labor; and Organization for Economic Cooperation and Development

Chart 10



LONG-TERM TRENDS IN PRODUCTIVITY
U.S. PRIVATE ECONOMY, 1910–1st Q 1970
Average Annual Rate of Growth in Output per Man-hour for the Entire Private Economy
THE RECORD 1910-1969
INDICATING A GENERALLY ACCELERATING PRODUCTIVITY GROWTH-RATE TREND
0.5%
2.4%
2.5%
3.1%
2.3%
3.8%
3.2%
1910-1920
1920-1930
1930-1940
1940-1955
1955-1960
1960-1966
1960-1969
THE POST-WORLD WAR II RECORD
INDICATING THAT EXCESSIVE ECONOMIC SLACK INTERFERES WITH THE TRUE PRODUCTIVITY GROWTH-RATE TREND
4.1%
2.6%
3.8%
2.0%
2.0%
3.3%
0.1%
1947-1953
Period of High Economic Growth and Reasonably Full Resource Use
1953-1960
Period of Recessions, Very Low Economic Growth, and Increasing Economic Slack
1960-1966
Period of Reasonably High Economic Growth, but Still Substantial Economic Slack
1966-1969
Period of Very Low Economic Growth
1966-1967
Period of Extremely Low Economic Growth
1967-1968
Period of Restored Economic Growth
1st Q 1969–1st Q 1970
Period of Stagnation & Recession
Source: Dept. of Labor estimates relating to man-hours worked (Establishment basis)

Chart 11



1/ 2nd Q 1970 data preliminary.

Data: Economic Report of the President

Chairman PATMAN. Without objection, I would like to offer for the record some excerpts from material submitted to me by Mr. Donald R. Bonniwell, Sr., a senior vice president of Walston & Co., of Chicago. Mr. Bonniwell is very concerned about the present state of the economy and economic policy and was willing to testify personally. However, because time did not permit, I asked him to send me his views with the thought that I would place them in the record, those parts that seemed to me pertinent to what we have been dealing with here. I do this in the interest of providing a variety of viewpoints on these important matters as has always been our practice.

(The material referred to above follows:)

PREPARED VIEWS OF DONALD R. BONNIWELL, SR., A SENIOR VICE PRESIDENT, WALSTON & CO., CHICAGO

I have long held valid the charge to the American people to "write your Congressman"—and took the next logical step forward, which was to 'write everybody's Congressman."

On the subject matter of the economics of our nation, I addressed four letters to each of the 535 members of the House and Senate of the 1ST and 2ND Sessions of the 91ST Congress of the United States of America, with copies to the President and the 12 members of his Cabinet, making a total of 2,192 individually addressed communications. All of this was in an endeavor to induce the Congress of the United States to influence the thinking of the Administration in such a manner as to make them acknowledge that their program for the control of inflation was self-defeating and self-destructing, thus forcing the Administration to abandon practices which were dealing sledgehammer blows to an economy that was already threatened by the burdens of war and an unbelievable tax-structure at the Federal, State and Local level.

I have endeavored to construct a precise of my tetralogy of "Open Letters to Congress," and find that the only practical method of accomplishing this is to excerpt from those letters, with the hope that the material, selected, will inspire you to request replacement of all of the letters previously sent to you.

I am going to initiate these excerpts from my letter of June 19, 1969, entitled —"The Credit Crunch and Poverty Row"—with nonadjacent paragraphs separated by a series of dots:

"Small business enterprises are being forced to the wall and soon will be in a race competing with personal bankruptcies. Medium to relatively large corporations are seeking a haven in consolidations, hoping to merge good earnings with good cash flow and/or available credit, or losing their identity under the umbrella of fast-growing conglomerates.

". . . The cost of Federal and Local Government is at an all-time high, and going higher. Credit at the national, state and local levels has become so restricted and so exorbitant in cost that even essential projects, necessary to the protection of health and welfare of our citizenry, have become impossible of accomplishment.

". . . Under the foregoing circumstances, the rising cost of relief is totally understandable. All of the foregoing symptoms are strange for a nation presumably dedicated to the tenets of free enterprise.

". . . For more than 18 years, this nation has been suffering from what must be categorized as the 'Martin Syndrome.' The Federal Reserve Board has insisted that the control of Reserve Requirements, the Discount Rate to Member Banks, operations of the Open Market Committee in Treasury Obligations, control of the issuance of Currency and cooperation of the U.S. Congress in the imposition of (or relief from) Federal Taxation, could and would control the economy. It has been the presumption that this combine could be used to defeat inflation or ease the impact of a recession.

"During the last 18 years, this panacea has been applied on numerous occasions. In a few instances, it has given the appearance of success, but the facts are that even in those few instances the economy was already moving in the desired direction. As a matter of fact, if the Federal Reserve's format really worked, then the Federal Reserve System has always been 'too late with too little,'—or 'too soon with too much.'

"Let us examine why the 'Martin Theory' does not, has not and cannot control economic contraction or expansion. The demand for goods and services by the American Public is controlled not by the cost of money but by the consumer's needs as interpreted by himself, his presumed ability to pay over the long-term, and the availabliity of credit, regardless of cost. It is self-evident that the Federal Reserve Board has no real control over any of these factors.

". . . In recent months, the Federal Reserve Board has used its full force and majesty—the Bank Discount Rate, Reserve Requirements, Open Market Operations, plus congressional cooperation in the form of a 10% Surtax Rate and the discontinuance of the 7% Investment Tax Credit.

"The results of the foregoing are: Bank loan rates that are moral usury, and loan rates and conditions from other financial institutions that would make Shylock's demand for 'a pound of flesh' seem to be a mere bagatelle. The impact on people has already been noted in preceding paragraphs.

"Do we have to bankrupt Mr. and Mrs. American Family and the little businessman to curb inflation? Do we have to destroy the American economy and multiply, significantly, the number of unemployed, and do we have to substantially increase the nation's relief costs to decrease inflationary pressures? Can inflationary pressures be reduced without going directly to Federal Wage and Price Controls, thus destroying our economy and American business initiatives, There is one answer to each of the foregoing questions and that is emphatically NO. We need no new alphabetical Agency or Agencies. It is only necessary to implement present structures with added authority and directives from the Congress of the United States."

My next excerpts are from "Operation Overkill"—a sequel to "The Credit Crunch and Poverty Row," dated August 28, 1969. The predictions were being written before coffee had been served at the Summer White House in San Clemente, California:

"The title of this sequel was conceived within 30 days after my recent communication to Congress, entitled—'The Credit Crunch and Poverty Row.' Events of the last 30 days and the predictable events which are already casting their shadow on this nation's immediate economic outlook suggest that an even more apt title for this sequel might have been selected.

"The destruction fo France's military might and the dignity of its government were prepared in the forests, the foothills and the rice paddies of North and South Viet Nam and at communists' conference tables in other parts of the world. The fall of Dienbienphu, on May 8, 1954, marked the fall of France in Southeast Asia.

"The blueprint for America's economic Dienbienphu (the foregoing phrase might have been a more apt title for this sequel) was initiated in those identical geographic areas and at communists' conference tables, allied and unallied, accompanied by strong military backup.

"Even as I prepare this paper, President Nixon and his economic advisors are meeting at San Clemente, California, in an atmosphere of panic over the predictable failure to quell or even soften inflationary pressures. As a result of this conference, 'Operation Overkill' may go into effect as early as Tuesday morning, September 2, 1969.

". . . Without any action of the senate and House Committees on banking and finance with respect to the credit crunch, and even without the proposed violent readjustments in Federal Income Tax Laws, as proposed in the House Ways and Means Committee and the Senate Finance Committee, the progression from credit crunch to 'Operation Overkill' was a totally predictable event. Arrival at the point of 'Overkill' was merely accelerated by the inaction on the one hand and over-reaction on the other by the Congress of the United States, as indicated in the preceding comment.

". . . Unfortunately, tax reform has become as popular, politically, as bare buttocks have become to the movie-going public. The real need of the nation at this moment is for the nationalization of all credit resources and their absolute management to the same degree as we presumably manage the issuance and circulation of currency.

". . . The future of this nation rests in your hands. Your failure to act will not only bring about disorientation of this nation's economic and financial resources, but also social disorders teetering on the thin line dividing civil disobedience from outright revolution."

Chairman PATMAN. Dr. Keyserling, you stated that a deflationary condition started in 1966. What time during the year? Was it the middle of the year? Was it in the spring of 1966?

Mr. KEYSERLING. I think it is a little hard, Mr. Chairman, to pinpoint it to that degree. I have that in chart 11 of my prepared statement, top cross section.

Chairman PATMAN. It is not too important about the time. But it started in 1966.

Mr. KEYSERLING. I would say so. My chart 11 of my prepared statement shows in the top cross section that from 1966 to 1967 the real economic growth rate was only 2.5 percent. So, it really commenced really to move down as of about that time.

Chairman PATMAN. You will recall that on December 5, 1965, the Federal Reserve Board was expected in Johnson City, Tex., to see President Johnson about whether or not interest rates should be increased. Instead, when they arrived at Johnson City, Mr. Martin, the Chairman of the Federal Reserve Board, gave out the statement that they were down there not to ask the President whether they should increase interest rates but to tell the President that they had just voted a couple of days before here in Washington to increase the interest rates. In other words, that was looked upon as a confrontation between the Chairman of the Federal Reserve Board and the President of the United States. The President had no immediate weapon to deal with them, and so he was not only confronted but he was overruled by the Federal Reserve Board. Interest rates increased.

Did the interest rate increase in the early part of 1966 contribute to the deflationary condition?

Mr. KEYSERLING. Of course, it did. If you will look at this chart 11, Mr. Chairman, it traces the trends in the money supply, which affect interest rates.

Chairman PATMAN. Yes, sir.

Mr. KEYSERLING. Looking at the bottom sector of chart 11, the growth in the Federal money supply was contracted to 2.2 percent a year from 1955 to 1965, which is the counterpart of rising interest rates because the interest rates go up as the expansion of the money supply decreases.

Chairman PATMAN. Is it to be expected that when interest rates increase this will increase the price of all goods and services, everything? As you inrease interest rates, you have higher prices and higher prices lead to inflation?

Mr. KEYSERLING. Higher prices, it might be said, lead to inflation, or rising prices might be regarded even as the simplest definition of inflation. You get into theoretical arguments as to whether it is the symbol or the reaction or the cause, but if I am trying to state simply what is inflation, inflation is rising prices.

Chairman PATMAN. That is right. Now, then, in 1969 there was a deflationary condition you indicated.

Mr. KEYSERLING. Oh, no question about it.

Chairman PATMAN. And that commenced about when? Early part of the year? Middle of the year? Latter part of the year?

Mr. KEYSERLING. Well, the deflationary condition, in the sense of the declining growth performance of the economy, as I say, commenced long before that, say 1966–67. But if you regard the deflationary condition as the onset of absolute recession, you are correct, it started in 1969, somewhere around the middle of the year.

Chairman PATMAN. That leads me to this question. On June 9, 1969, an official of a New York bank, which is traditional when the prime rates are to be raised, announced that the prime rate hereafter would be not 7½ percent, but 8½ percent. This was a case of a banker carrying out a tradition that changes in the prime rate either are made by a Wall Street banker, a big banker. In two instances in the last 50 years the Continental Illinois Bank in Chicago and the First National Bank in Boston were allowed to increase their rates first. Outside of that they have always been increased or decreased by a Wall Street bank. The increase in June 1969 was twice as large as ever before in history for the prime rate, if my information is correct. Before that they had increased by a quarter of a percent. Twice they had increased it one-half of 1 percent, but this is the only time in history, so far as I know, that the rate was increased by 1 percent. That is why I got to studying about the cost of that interest rate increase. I want to see if you agree with me about this cost.

That 1 percent increase was a potential increase in all interest costs of at least $15 billion a year, based upon the fact that our total public and private debt at that time was one trillion five hundred billion dollars plus. Is that a rough estimate of what you would consider would be a fair estimation of the potential cost?

Mr. KEYSERLING. Let me answer the two questions you asked, and then answer your more general question, which is the most important of all.

First of all, if we look again at my chart 11, we will see in the bottom sector that from 1968 to the second quarter of 1970, which encompasses the period you mentioned, the money supply was contracted in its growth to 3.2 percent a year. This did two things. It slowed down the economy still further and brought on an absolute recession, and it accelerated the price increases throughout the land for the reasons I have already stated. Whether or not every item of goods on every shelf was affected by an increase in interest rates I could not check, but it is true that the cost of money enters into more product than anything else, and that the cost of most products is pyramided and increased when money costs go up. There is no question about it.

Next, on your question of the $15 billion, it is substantially correct. The policy of rising interest rates alone, and I have studied this for years, has since 1952 transferred about $150 billion from those who borrow money to those who lend money. Now, you do not have to make a study to know that broadly speaking the transfer of income from those who borrow money to those who lend money is not to the benefit of the American economy or the American people. The annual rate of that transfer is now somewhere in the nature of $15 to $20 billion a year. If you look at the Federal Budget alone, and compute what interest rate the Federal Government is paying and how much is in the budget for interest charges, those interest charges are about $9 billion higher on an annual basis, or maybe more than that, than they would be if the interest rates had not been raised.

Even more important, if interest rates had not been raised, the economy would have been performing better and the Government would not have been running so big a deficit.

Now, it is curious that people say a Federal deficit is the biggest cause of inflation. Yet, the Federal deficit today is $9 billion bigger or the Federal surplus is $9 billion smaller than it would have been if the Federal Government were not carrying $9 billion more of interest payments, annual basis. The rising interest payments have been the biggest factor in the increase in the Federal deficit. So, if you follow the argument which Arthur Burns subscribes to, that a Federal deficit is inflationary, then how can you reconcile the argument that rising interest rates are anti-inflationary when they have been the biggest factor in the rising Federal deficit?

Now, coming to your last question, which is really the most important of all. Chairman Burns sat here yesterday. I am not going to analyze his economics or his views, but I am going to say this: He said to this committee in effect, and I do not think anybody can challenge this, and I am just expressing it in a general way, you, members of the committee, are facing the most powerful economic force in the United States because no matter what policy the President wants and no matter what policy the Congress wants, or no matter what policy this committee believes in, I, Arthur Burns, am going to follow the monetary policy that I think best.

Now, Arthur Burns as a private individual is entitled to favor the monetary policy he thinks best. But the Federal Reserve System is a creature of the Congress, operating as a central bank, dealing with the money factor, indeed creating money, changing the money supply, performing what Burns would claim is the most powerful economic influence in the United States. Therefore, the Federal Reserve should not be independent of the President and Congress of the United States, any more than the Treasury in the making of tax policy, or an agency making price and wage policy in time of total war.

Why should we say, because we do not want monetary policy to be political that, therefore, this fantastic power of regulating money should not be answerable to anybody in practical effect? We say the Federal Reserve System is under the Congress, but how? It is not in practice answerable to anybody, and this is not democracy. It is not answerable to the Supreme Court. The Supreme Court does not review its actions. It reviews everybody else. The Fed is not answerable to anybody. This is wrong. Legislation should do something to redress this, partly by the kind of actions I indicate.

Chairman PATMAN. Mr. Keyserling, my time has expired, but when I get back again I want to ask you about the Penn Central and another question or two.

With respect to your point about the independence, I prefaced my remarks in the introduction of Dr. Burns yesterday with the statement that I do not agree that the Federal Reserve is independent of the executive and certainly it is not independent of Congress. The Constitution is very plain that the laws are made by the Congress and enforced by the President, a separate branch of Government.

Each citizen has four people in Washington to look to and to ask that they do certain things that will help the country. One is, of course, number 1, the local representative in the House. Number 2, the two U.S. Senators. And number 4, the President of the United States, who is elected by the people. And I do not think it was ever intended that the President of the United States, who is elected by all the people, can just pick out someone who has never been elected by the people at all, has never been tested in public service, and just pick him out and say, "I am making you chairman of the Federal Reserve Board and your decision will be final over the President of the United States. I am selecting you, I have just been selected by the people but I am going to give you all the powers that you need to carry out the Federal Reserve System as you want to carry it out." I do not believe that was ever intended.

Mr. KEYSERLING. Mr. Chairman, may I say I agree with you completely, and point out why what you say is not inconsistent with what I have said.

I am distinguishing between things as they ought to be, which you properly describe, and things as they actually are today. Historically, the Federal Reserve System was created under Woodrow Wilson. Neither Woodrow Wilson, a Democrat, nor Warren G. Harding, a Republican, nor Calvin Coolidge, a Republican, nor Franklin Roosevelt, a Democrat, nor Herbert Hoover, a Republican, coming before Roosevelt, of course, conceived that the money power of the United States as exercised by the Federal Reserve should be independent of the United States. The issue never arose in their time. You can hardly find any discussion of the independence of the Federal Reserve System in those times.

Chairman PATMAN. Never mentioned.

Mr. KEYSERLING. The existing law was satisfactory. The "independence" issue arose for the first time, and I lived through it, in the very early 1950's, when a great clamor went up by the banks and financial institutions that the Federal Reserve policy of low interest rates had been the great engine of inflation during World War II. This was ridiculous. The great engine of inflation during World War II was World War II. We had more inflation in World War I, and we had still more inflation in the Civil War when there was no Federal Reserve System. But they raised that clamor, and they became successful, and they got their way through the Treasury-Federal Reserve Board accord, and I was before your committee in 1951 debating this matter, debating it among others with some very distinguished members of your committee.

As a practical matter today, as distinguished from what a President can do and what a Congress can do in my view should do, as a practical matter, nobody can really say that Arthur Burns was sitting here yesterday as a man who recognized that the views of the President or the views of the Congress should alter one iota the decisions of the Federal Reserve System as to what they are doing about the money supply. That is what I am talking about.

Chairman PATMAN. My time has expired. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Keyserling, you criticize sharp and continuous changes in monetary policy and say they tend to destabilize the economy. This committee has actually voiced the same view. Would you characterize monetary policy in 1970 as being destabilizing?

Mr. KEYSERLING. I would characterize monetary policy in 1970 as being destabilizing in the sense—in two senses. First, as representing a continuation of the very sharp and erratic changes in monetary policy from year to year, and second, as being destabilizing in the sense of not being properly adjusted to the need of the economy for recovery and growth. In other words, being deflationary in an economic sense. And that is destabilizing in a way.

Representative WIDNALL. Do you believe that the abrupt change in the money supply between the second half of 1969 and the first half of 1970 was necessary?

Mr. KEYSERLING. Well, I would have to explain just a little bit what I said before. I do not mean that you should never make an abrupt change. If you make such large mistakes that you are fundamentally in the wrong position, you have to make an abrupt change, and I would say that my whole testimony is to the point that we need to make a lot of abrupt changes now to get the economy going again.

When I say that you should not have to make these very sharp ups and downs, what I am really saying is that, if there were more thinking in the Government, more planning, and I am not afraid of that word, more of a long-range view, and you set a long-range stable policy, you might have to change it some from time to time, but not so often and so severely. If you set a long-range policy for a steady rate of growth, instead of trying to react, through this fine-tuning from year to year, to what is occurring, what you think is occurring, you would in the long run get a much better economic performance.

So, I criticize the abrupt changes from year to year over the years. I do not mean that, as of a given point in time, if you are moving in the wrong direction, or if the situation needs correcting, you do not need to make an abrupt change before you get on the course. So, I would not criticize that one abrupt change. It correctly enlarged the expansion of the money supply, but not nearly enough. But I am against the idea that the Federal Reserve System should continuously be fiddling with the money supply up and down, and it is very interesting to note as I said before, that Milton Friedman, who has given more attention to this subject than anybody else and who certainly is accepted widely by conservative interests, takes the same position. He would not say you never need a change in the money policy, and he is saying now that the Federal Reserve Board is increasing the money supply too slowly. He disagrees with Arthur Burns, but he still says they have got to get on the course of not going on forever as they have gone on since 1952 in fiddling up and down every year, but rather having a long-range stabilizing policy.

Representative WIDNALL. What consequences do you believe that change will have on the economy?

Mr. KEYSERLING. I believe that a rapid—much more rapid increase in the money supply, which would also exercise downward pressures on interest rates, would have a wholly satisfactory effect on the American economy. It would help to speed up the rate of economic growth, it would help to reduce unemployment, and, for the reasons I have given, it would greatly help to reduce the price inflation. It would have no unfavorable effects.

Representative WIDNALL. I am interested in your comments on price and wage controls because our committee has just voted out action that would provide for standby wage and price controls with the President having the ability to put them into effect.

You said in your prepared statement, "Price and wage controls through Federal law should not be considered at this time." What effect do you believe debate over these controls in the Congress will have on the economy?

Mr. KEYSERLING. Well, I never like to dodge a question, but that is one of the hardest questions in the world to answer, because if you say that the debate may have an unstabilizing effect, then you get into a box because you say that the Congress should not have open and considered discussion of issues because it might be unstabilizing. In a sense, in that sense, the entire congressional process is unstabilizing. By that I mean, you put up any bit of legislation, and while you are debating it, people are uncertain what is going to happen, so that is unstabilizing. But that is the very process of Government. So, I am not worried about the debate.

Now, I would say that the executive branch in its consistent obsession with talking about inflationary dangers, to the exclusion of the whole problem of employment and production and national income and real wealth and all the other things I have mentioned, has not only been responsive to some of the inflation but has caused a good deal of it. I think that you frighten people by making one problem seem like an obsessive ogre which is going to eat you, which completely misinterprets its real relationship to the whole problem of the economy.

On the problem of what the committee has voted out, I am not testifying on that subject. Naturally, I stand by what I said. My view is that this is not the time for direct price and wage controls. The reason why, it seems to me, follows these common sense lines: I believe that a Government should learn how to do reasonably well the traditional things that it always has to do, and use correctly these powerful implements, before it embarks upon thorny and unusual and temporary measures. If the Government were executing reasonably well its fiscal and monetary policies and its housing policies and its farm policies and its international economic policies, if it were bringing them together in a rational program for growth, and if it were found that we were still sorely vexed with the problem of inflation, then I would not on theoretical grounds or on ideological grounds oppose price and wage controls. But when the Government is not doing these things well, and when I believe that the inflation is being caused mostly by their not doing them well, I do not want a Government engaged in the task of trying to straighten out its own house to be further encumbered with the torments and conflicts all over the country insisting on bringing a new and obstreperous visitor into the house. This is my basic and practical argument.

Second, I do not like to give an additional policy weapon to a Government, and as I have said before, I am not political about this, which is wrong in the policy weapons it is already using. In other words, if price and wage control would be used under a rational economic analysis and geared to the problem of quick economic restoration, I might be willing to say I was not too concerned about it. But as against the idea that price and wage controls solve a problem simply because there is something definite, they could be misused just like any other policy. My fear is that, just as money policy and tax policy and the other policies, as I have indicated, are now being used to cause inflation by stunting the economy instead of to fight inflation by increasing employment and production, price and wage controls can be used for the same purpose, and would merely give another weapon to those whose analysis needs to be changed and whose fundamental point of emphasis needs to be changed.

That is my reasoning on this subject. I respect the reasoning of others, but that is my reasoning on the subject.

Now, my friend Galbraith, writing in the New York Times, says that he knows more about the subject than anybody else because he administered price and wage controls during World War II. Well, here is the difference.

In the first place, it is obvious that during World War II we were burning up more than half of the national products in fighting a war which, is wasteful in an economic sense, so we had only half of the product left for civilian use and yet civilians were earning all the income that came from fighting the war, so that you had a tremendous redundancy of purchasing power, exerted against a civilian supply which was only half of the total supply.

Second, during World War II we were growing at a real annual rate of 9 percent. We did have an overheated economy in a real sense. Productive facilities were under pressure. We were feeding the whole world. Unemployment was down to less than 1 percent.

Well, that is a proper situation for traditional and classical price and wage controls. Today, the situation is the opposite in every respect. The defense outlays, we all wish they were lower. We all have different views about international security policy. Yet, these outlays are only absorbing 9 percent of the economy. Instead of overused plants, we have underused plants. Instead of unemployment below 1 percent, we have it above 5 percent, or above 6 percent depending on how you measure it. It is an entirely different kind of inflation, due to an entirely different set of causes.

Representative WIDNALL. Mr. Keyserling, just one further question. You said that by 1966 a recession was certainly just around the corner and the new economics was saved only by the unexpected and immense increase in public spending due to the Vietnam war. What led you to believe a recession was near in 1966?

Mr. KEYSERLING. I am not the only one who believed it. If you retrace the history by reading what was written during that time, you will see that most people were concerned about it. The economy was definitely faltering in its course and definitely in deep trouble in 1966, until the Vietnam war came along, there is no question about it, because of earlier errors in economic policy to which I have already referred, and with which I was in disagreement.

Second, even with the increased expenditure in the Vietnam war, as I pointed out, the economy began to contract in its rate of economic growth from 1966 forward very sharply and seriously, which simply means, and this brings me to one aspect of international policy, there is one thing I am more frightened about in this country than the economic situation and that is the international situation and here is why. I think we are living in an uncertain world where nobody can be sure about what our international policy should be, but I am sure of one thing. I am sure that our international security policy should be dictated by the best judgment, fallible though it is, as to the international situation and, not dictated by mistaken horror cries that getting into this or out of that or cutting national security outlays should be attempted because that is the only way to stop inflation, or because you cannot attend to your domestic needs otherwise.

This is not true in a slack economy. Everything else being equal, we would have more unemployment and more idle plants if we had less defense outlays. I am not saying that you should maintain defense outlays for that reason. You should not. But you cannot attribute the inflation to the defense outlays, when you have this irony of increasing inflation in an excessively slack economy even with the defense outlays. So, the people who are agitating and stirring up the country to the point, as I put it dramatically, where the time is going to come when an American President will not be able to send a marine anywhere without taking the plebiscite of the freshman class at Bennington College, this is not democracy. This is chaos. I am worried about it. I am worried about how we can forge a sensible international policy when we have got it tied in so improperly with the problem of inflation and the problem of our domestic priority needs. And the neglect of these priorities started before the Vietnam war. There was not any great big Vietnam war in 1964, when we went the wrong course on fiscal policy, and that problem is not going to be solved by getting the men out. I am not arguing whether they should or should not be gotten out. But when you confuse the problem of what to do internationally, which is really a noneconomic problem in the sense that we have the resources to do internationally what we must, and should not do internationally what we should not, when you confuse and intermingle that with the domestic economic question, you are in a terrible situation in world affairs.

I think 500,000 men in Vietnam was not too many if we should be there, and one was too many if we should not, and the same as to $30 billion of expenditures.

Now, I do not claim to have the right answer to that, but that is how it should be debated, and not debated on the ground that people are in slums in Harlem because there is a Vietnam War, or we are having inflation because there is a Vietnam War. It is not so, and it is dangerous to say it is.

Representative WIDNALL. Thank you, Mr. Keyserling. I would like to say to you that I think the Congress and the American people would heartily agree with you, with your comment about taking a plebiscite at Bennington College in connection with what to do in the future. We have certainly gone way out on a limb recently in trying to appease some of these people.

Chairman PATMAN. Mr. Keyserling, before I ask you about the Penn Central, when I was trying to determine how much 1 percent would amount to on all debts, public and private, it ran up not only to millions and billions but in the trillions. I just wondered if we would run out of names if we keep on hearing the arguments here that we will soon have a—take enough wheelbarrow loads of money to buy a loaf of bread like it was in Germany, what we are going to call this money, and I just wondered—now, this is an elementary question to you—you have no problem with it because you know—but I looked into it a little bit and I decided that after you go from a million to a billion to a trillion, you go to a quadrillion and quintillion, sextillion, septillion, octillion, nonillion, decillion. Is that right?

Mr. KEYSERLING. I believe that is right.

Chairman PATMAN. Now, how much of a decillion is a billion?

Mr. KEYSERLING. There you have got me. I know that a thousand billion is a trillion but when you get beyond that, I have not really mastered the subject because it has not yet become relevant.

Chairman PATMAN. Has not come up yet.

Mr. KEYSERLING. Has not come up yet.

Chairman PATMAN. We have only gotten to the trillion.

Mr. KEYSERLING. That is right.

Chairman PATMAN. OK. Now, on the central bank, I just wanted to comment here. It was never intended under Woodrow Wilson that we would have one central bank. As you know, we had 12 separate banks to service 12 separate regions. Woodrow Wilson never would have anything to do with advising the Federal Reserve System. He said, "they are making loans in their areas. I do not know anything about their areas and it is not for me, the President of the United States, to advise them what they should do in any particular area out of the 12." He was against a central bank.

Later on when Mr. Andrew Mellon became Secretary of the Treasury under Mr. Harding, he made it a central bank. He did it not by law but by persuasion. He persuaded the Presidents of the banks, the 12 banks, and the directors, six out of every nine. Of course, there are nine directors in each of the 12 banks, and six of them were selected by the banks anyway, and it would not be a difficult problem to persuade them that they would just have one bank like the New York Bank to do all the buying and selling of Government bonds and thereby start on a central bank idea.

It was not long until that was perfected without any law at all under Mr. Mellon and then, of course, the time came in 1935 when Congress actually passed a law which in effect, caused it to be a central bank.

You agree to that, do you not, Mr. Keyserling?

Mr. KEYSERLING. Yes, sir.

Chairman PATMAN. So since that time we have had a central bank, but I agree with you that there must be a lot of changes made in this Federal Reserve banking system or we are going to have more problems than we have now.

On this 1 percent interest rate increase, since the first of January 1969, our prime interest rate had gone up from 6 percent, as it was election day 1968, to 8½ percent. That is an increase of 2½ percent. Based upon the estimate we made a while ago, that would be an increase, potential increase, in interest costs in the United States which the 55 million families would have to pay each year from now on.

Mr. KEYSERLING. I agree with you, and I would say it is really an increase of more than 30 percent.

Chairman PATMAN. We are talking about a cost of 37½ billion dollars a year just on that 2½ percent increase.

Mr. KEYSERLING. All I am saying is that when the interest rate goes up from 6 to 8, to make it simple, we say it is a 2-percent increase.

Chairman PATMAN. Yes, sir.

Mr. KEYSERLING. It is really a 33⅓d percent increase in money cost to the average family.

Chairman PATMAN. That is right.

Mr. KEYSERLING. 33⅓d percent higher. If an interest rate goes up from 4 to 8, that is—we say that is 4 but it is really a hundred. The interest cost is doubled.

Chairman PATMAN. And from 6 to 8 percent would be—

Mr. KEYSERLING. 33⅓d percent.

Chairman PATMAN (continuing). 33⅓d percent. Yes, sir.

Well, there are a lot of things that can be done about this, I hope. They must be done.

It occurs to me, Mr. Keyserling, that since the banking system has not made it possible for money to be available for housing and since we are so desperately in need of housing in this country, that there should be a special rate just for housing.

At the market rate which is insisted upon, a homeowner is in no position to compete in the market for $20,000 to buy a home. He cannot compete with a 27½ billion dollar bank. He cannot compete with all these thousands of corporations that can either pay more than 15 percent or get that much.

Mr. KEYSERLING. He certainly cannot compete, Mr. Chairman, when broadly-speaking, the person looking for a house is paying the housing rate and the bank is getting it.

Chairman PATMAN. That is right. And he cannot compete with the gambling casinoes. He cannot compete with the high-interest loan sharks who can pay any amount. He cannot compete with these numbered bank accounts in foreign countries or even in our own country. So, he is just in a helpless position. Do you not think the Government of the United States, in the interests of all the people in the country, would be justified in setting up a separate rate for homeowners?

Mr. KEYSERLING. I not only think they should set one up, I think they should return to policies which did set one up.

Let me illustrate what I mean. We created, when I first came into Government service—I do not mean I created it, the Nation created it—a wide range of housing activities in which the Federal Government was interested. The Home Owners Loan Corporation, the Federal Housing Administration, the U.S. Housing Authority.

Chairman PATMAN. You were the first general counsel of the Housing Administration, to the best of my recollection.

Mr. KEYSERLING. That is right, and I worked on all of this legislation.

Chairman PATMAN. Yes, sir.

Mr. KEYSERLING. And the Federal Home Loan Bank Board. Now, all of those agencies were designed to and did create a special interest rate for housing. The HOLC, when the insurance companies and the banks were virtually bankrupt in consequence of the Great Depression and had out housing loans at huge interest rates which they could not collect on, the Government turned that over and refinanced it at very low interest rates. Then, of course, when the Government had salvaged the situation, they gave the assets back to the people whom they had rescued, who then began to bite the hand that fed them.

Chairman PATMAN. The Government paid a hundred million dollars through HOLC. Mr. Roosevelt went on the radio and said anyone who is in distress by reason of being unable to make the payment on your home, you either call me over the telephone, send me a telegram, write me a letter, or write me a message on a postcard and I will see that you get consideration immediately to refinance your loans, reamortize them, at lower interest rates, lower monthly payments, and you can pay your homes out, and millions of people did that and millions of people saved their homes that way. You remember that so well.

Mr. KEYSERLING. And this is another way of saying what reinforces everything I have said here today. We hear that, if you have higher interest rates, people will have more with which to do business. Not if you kill the goose that lays the golden egg, and actually, what Mr. Roosevelt did, although it reduced the interest rates, did not help homeowners only. Mr. Roosevelt really rescued our American business system, and saved the system of so-called private enterprise that we all want to preserve. He conducted a great rescue operation for them.

There is also the Federal Housing Administration, which insures private investment in housing, and which for many years was and probably still is the biggest single factor in the housing field. Before the FHA, the effective interest rate on housing was 8, 9, 10, and 12 percent. You had two and three and four mortgages, each at a higher interest rate. Under the FHA, the whole system of private house financing was reorganized, and the effective FHA-insured interest rate, which was private lending insured by FHA on housing, was gotten down to 4¼ percent. Even at 4¼ percent you could take care of the upper middle income families, you could not really take care of the lower middle income families and the low income families. So, during World War II, as a postwar measure, I began to work on what became the Wagner-Ellender-Taft Housing Act of 1949.

Chairman PATMAN. You worked for Senator Wagner when it first started.

Mr. KEYSERLING. I had worked fulltime for Senator Wagner years earlier. In the case of this legislation, I was a consultant to Senator Wagner and also a consultant to Senator Taft. I mention Senator Taft particularly because he was called Mr. Republican, and was supposed to be a conservative. It ended by his being called a socialist by the National Association of Real Estate Boards.

Senator Taft joined in this legislation, which was designed to cut the interest rate on housing from 4¼ percent down to 3½ and 3 and 2, with the hacking of Government guarantees or Government lending for that matter, so that you could really get the housing within the reach of the people who really needed it and stop the proliferation of slums.

Well, then, this law was passed. But after the law was passed, the administrations administering it were not too sympathetic to these new purposes, and then you had the tight money policy coming along, so that the effective interest rate today on an FHA insured loan, instead of moving from 4¼ percent to 3½ or 3 (as even Senator Taft wanted, and not only wanted but put his name on; not that I intimate that he was the leader as against Senator Wagner or Senator Ellender or you who were then on the Banking and Currency Committee and many others, including John Sparkman, I just mention Senator Taft to illustrate the point in that he was a conservative Republican) has moved up to 8 percent or more, even without all the undercover premiums and payments. Really what you have is about 9 percent. Is it any wonder—

Chairman PATMAN. That is the effective rate now, 9 percent?

Mr. KEYSERLING. Approximately.

Chairman PATMAN. For that reason the person who buys a $20,000 home has to obligate himself to pay $38,000 in interest, or $58,000 for the home.

Mr. KEYSERLING. Yes. Saying it in another way as I said it before, the family that buys that kind of house will, over the life of the mortgage, devote 1 whole year of its income just to paying the higher interest rates. In other words, they work a year for nothing because of the higher interest rates.

Chairman PATMAN. A year for nothing.

Mr. KEYSERLING. And this is supposed to stop inflation. So, when they do that, and because their housing costs are so much higher they ask for a wage increase to cover it, they are told you are pushing up prices. And when the utilities ask for a rate increase because their cost of borrowing has gone up from 6 to 10 percent, the same thing is said about them, and so forth, all up and down the line. It is perfectly obvious that money is a cost, and if you raise that cost, everything else is going to rise, too.

Chairman PATMAN. Mr. Keyserling, you are the only person I know who can really give an account of what happened from, say, before World War II up until the present time on interest rates and things that are as important as interest rates.

In 1936 people everywhere felt like we were going to get into a war. War clouds were over Europe. We got into the war on December 7, 1941. Mr. Roosevelt decided that we would have to keep interest rates down over the period of the war.

Mr. KEYSERLING. Yes, sir.

Chairman PATMAN. Because we could not pay for that war and come out with anything unless we kept interest rates down. And he called in the Federal Reserve Board. Marriner Eccles was chairman of the Board. Marriner Eccles was a very rich man, very reactionary in his views, but a mighty good man, and he was convinced that President Roosevelt was right. It was against all of his views. He had never done anything like that, but in order to be patriotic as he should in time of war, he argued to carry out the desires of the administration.

Mr. KEYSERLING. And also, if I may say so, because in those days the Federal Reserve people knew whom they were working for.

Chairman PATMAN. Yes, they did know who they were working for. That is a good addition. And he agreed to do that and for 14 years before that war started, and during the war, and after the war, long-term interest rates were maintained at 2½ percent and less.

Mr. KEYSERLING. That is right.

Chairman PATMAN. And anyone who wanted to get his money for Government bonds, 2½ percent, 2¼, 2 percent, he could take it in and get cash for it. No problem at all, and long-term rates were easily maintained because, of course, the Government debt was so large, so huge, and all other interest rates had to follow. So, it was no problem there. And even when Mr. Eisenhower came in on January 20, 1953, and Mr. Humphrey of Cleveland became his Secretary of the Treasury. Mr. Humphrey put out a bond issue of 2⅜ percent and it sold quickly.

Mr. KEYSERLING. That is correct.

Chairman PATMAN. Another one, 2½ percent, sold quickly. Then Mr. Humphrey decided that he wanted to raise rates, and he put out an issue at 3¼ percent, just jumped it up, for a billion dollars, that is all. He did not need it. He had several billion dollars in the Treasury. But it was solely for the purpose of raising interest rates. It almost caused a depression. And it retarded them in their efforts to raise interest rates for a while. But finally, they got started again and interest rates have increased ever since that time.

Mr. KEYSERLING. And an interesting footnote on this is that when this battle about the accord and the rising interest rates started, Mr. Marriner Eccles, who as you say, had realized whom he was working for back during World War II, that those in charge of the money power should be working for the people elected by the people who represent their interests rather than working for the banks, yet by 1952 and 1953 and 1954 when this issue was reraised, Mr. Eccles became the outstanding champion of rising interest rates, and you described him correctly.

Chairman PATMAN. I can call your attention to something else on that. You know, he first wanted the short-term rates raised, and he got them raised. That is the reason Mr. Truman would not reappoint him. I happen to know a little about that. Mr. Truman felt when he did not reappoint him he would get off the Board. You know, it is somewhat customary and traditional for things like that to happen. But he did not. He stayed on.

Mr. KEYSERLING. And then the trouble was that the man whom Mr. Truman did appoint as chairman—

Chairman PATMAN. From Philadelphia.

Mr. KEYSERLING. I do not like to use a hard word, but let us say he disappointed the President, to be charitable about it.

Chairman PATMAN. No question about that.

Mr. KEYSERLING. And then a certain undersecretary of the Treasury was sent over to be chairman, who was chairman until last year.

Chairman PATMAN. That is right.

Mr. KEYSERLING. And he disappointed the President even more.

Chairman PATMAN. Very much so. And these interest rates being kept low enabled our country to be saved. Not only that, Mr. Truman paid $29 billion on the national debt at one time before he went out.

Mr. KEYSERLING. I said before that Mr. Truman, during the almost 8 years of his Presidency, reduced the national debt and maintained a better record of a balanced budget than any succeeding President, even though he fought a bigger war relative to the size of the economy then the Vietnam War.

Chairman PATMAN. That is right, and let me remind you again, Mr. Keyserling, that 1944 was the hardest year the United States, I believe, ever had. No one knew whether or not we were going to win that war. At some times it looked kind of bad against us, but notwithstanding that, a lot of people, in Congress and out, began to work on something to be done when the war was over, if and when we were lucky enough to end the war. We got up the GI Bill of Rights, we got up housing loans, we got up loans to small business. We had 15 million men on the battlefields and people would say after every major war the country has always suffered a devastating depression. They said, we are bound to have a major depression when this war is over. These 15 million men will come back here, they cannot all sell apples. They cannot all get jobs and we will just have distress, unemployment, breadlines, and all kinds of hardships. We tried to make arrangements to prevent that, and we were successful.

I say "we." I was just a small cog in the wheel but I was working on it with them. I was the author of the first housing bill gotten out for veterans, and I worked with other things. By reason of our efforts, when these boys came back, they went to college. They became engineers, they became doctors, architects. Almost every profession was represented under the GI Bill of Rights.

The Government had money enough due to low interest rates to pay their board, their lodging, their tuition, and send them to college for 4 years and more and take care of their wives and families at the same time.

Mr. KEYSERLING. Well, I remember this experience very well, because I remember the prediction that there would be an 8 million unemployment rate after the war, and I had articles disagreeing with their prediction. But the reason there were not 8 million unemployed was not an accident. The reason there were not was the very long-range planning I am talking about here. The Government did not start to prepare for the end of the war on VJ Day, but started long before that, had a wide range of programs, housing programs, loan programs, veterans' training programs, and so forth and so on, educational programs, and we went over that transition fairly smoothly.

If we had had them the economic philosophy and thinking that we have now, what would have happened is very clear. People would have said, well, the one big problem we are going to have when the war is over is inflation, and they would have set everything in motion to stop inflation. They would have jacked up the interest rates to stop inflation, and they would have slashed domestic programs to stop inflation. They would have said the veterans' benefits and the educational programs are all going to cost too much, we cannot afford them, and they would have gotten the bad economic results we are getting in now during our withdrawal from a smaller war. They would have gotten the inflation which they were trying to stop, and they would have gotten a proportionately bigger economic recession, and so forth and so on. But we have not learned as much as we should from the history.

Chairman PATMAN. And furthermore, Mr. Keyserling, if they wanted to buy a home, they could buy it through Government sources at a reasonable rate of interest. If they wanted to go into business, they could borrow money for the purpose of going into business at a reasonable rate of interest. We had so many opportunities for them.

Now, you have done so much for public service. I do not know of any man who has done more for the public service of this Nation than Leon Keyserling. You have always worked in the public interest since I have known you and I have known you ever since Senator Wagner came here to the U.S. Senate and you worked with him. You worked on all these programs, every one of them.

I do not know of a person in the United States who has more knowledge and information of what went on than you do. I think it would be a wonderful thing in extending your remarks here if you would summarize all those things so they will not be forgotten, especially about the period, you know, in World War II and subsequent to that time. Would you be willing to undertake that, Mr. Keyserling?

Mr. KEYSERLING. Well, I can undertake some of the modest parts of it but may I make one comment on the record now?

Chairman PATMAN. Yes, sir.

Mr. KEYSERLING. I want to correct something that was said by the chairman. The chairman said that he was a small cog in the wheel in 1944. The chairman was not a small cog in the wheel even in the 1930's, when I was appearing before the House Banking and Currency Committee on some of the early housing legislation. The chairman may only have been the third or the fourth ranking member of that committee, but he was a great force for doing what was right.

And let me say this on this whole money thing. One of the biggest troubles we have in this country—of course, there is a lot of bad analysis that I have been talking about, and a lot of bad policy—the biggest thing lacking is guts. Even people who know this policy is wrong, they are afraid to stand up. I do not know any public figure, at least in the 37 years that I have been in Washington, who deserves as much or more credit than you do for the way you have stood up tirelessly on this whole money question, and nobody has ever been more right, and by now nobody has been more proved right. Yet, as we read the journals, they sometimes say you are an extremist, they sometimes say this or they say that. This is what always happens to people when they do what you have done, and some people may think you are always talking on this one subject. Well, Pasteur was always talking about getting rid of what he was trying to get rid of, and all the doctors in the academies were saying that his vaccination was going to kill all the sheep. Ultimately, he was proven right, and those are the most valuable kinds of people, and I am a tremendous admirer of the way you have stood up on this money question.

Chairman PATMAN. Thank you very much, sir.

Now, I want to ask you one or two things about the Penn Central. When the Defense Production Act was enacted back in 1950, we provided for a type of loan I think they called it "V" loan at that time. Under that provision Penn Central made application for a $200 million guarantee.

Naturally, this attracted my attention and I went into it rather thoroughly. I found out that we had provided in that law originally that applications of a certain size, I believe, had to be passed on by the Federal Reserve Bank where the application originated, where the company was domiciled, and I began to inquire. They began to put pressure on me to approve the deal, and I said, "well, let me see all the papers. I want to see what is happening around here and what Penn Central has." It has three holding companies and hundreds of corporations worth a lot of money. Then I called on them for that Federal Reserve report. I said, "now, I think you have to have a Federal Reserve report." None of them seemed to know anything about it but I said, " I want that report. I know it must have been made." I did not get that report until the day before yesterday, a month after I had made the same decision that the Federal Reserve Bank of New York had made a month before, saying that the loan was not justified, the Government could not get its money back, it would just be a loss of $200 million. They wrote a rather devastating report on why it should not be granted, and all the time that I was being persuaded to help them get that loan through. Some of these people who were trying to persuade me knew of that Federal Reserve report, but never told me a thing about it. I only received it accidentally because I found out who had it and just demanded it, sent a messenger down for it. I received it the day before yesterday and put it in the record. I imagine you have seen it in the record.

Mr. KEYSERLING. Yes, sir.

Chairman PATMAN. It is a devastating report and that goes to show that there are some things that are pretty bad around here yet that should not go on. I will appreciate it if you will recount in your testimony what you can without too much trouble about your connection with this Penn Central problem. I have said a number of times that you are the one person who knows more about Penn Central, the merger and all these things, than all the rest of us combined, because you lived with it, you went through the courts with it, as a public official you dealt with it, and you have knowledge that no one else has. Would you give us the benefit of that knowledge to the extent of your ability to do so, taking into consideration your own commitments and your own business? Would you try that, sir?

Mr. KEYSERLING. Well, I will try it in a brief way. Of course, my testimony before the ICC in the Penn Central matter ran to hundreds of pages and I do not know how many charts, but I could make some kind of summary of it at some time. Could I make that available to the committee separately from this particular hearing?

Chairman PATMAN. That would be all right.

Mr. KEYSERLING. Because I will have to get the record on my corrections on this particular—

Chairman PATMAN. We could have it printed and I think the committee would be willing to print it.

Mr. KEYSERLING. Well, at some reasonably near time I will attempt that but not as part of this hearing.

Chairman PATMAN. All right.

We found you in Europe when we wanted you to testify here and you were kind enough to come back to testify today. You have only been back a couple of days, have you not?

Mr. KEYSERLING. Since Monday.

Chairman PATMAN. Since Monday, and we appreciate it very, very much, more than we can ever tell you. You have rendered a great public service throughout your career to my knowledge, because I have known you all during that time and I knew how valuable you were.

Thank you very much for your appearance.

Mr. KEYSERLING. Thank you, Mr. Chairman.

Chairman PATMAN. The committee will stand in recess, subject to the call of the Chair.

(Whereupon, at 12:30 p.m., the hearing was recessed, subject to the call of the Chair.)

O