

Even if it is true that we are beyond diminishing returns in tax policy, I think it would create some very serious damage if we were to actually increase taxes. I put this on the record because this is one reason why I move toward expenditure cuts as a solution to what is an overall fiscal policy problem. We are going to have to finance this budget. If we don't do one or the other, increase taxes or cut spending, as you point out, we will have further deficits which then impinge on the money market.

The macroeconomists had their way in this removal of the 7-percent investment credit. If anyone paid any attention to the details of it I am sure he would realize that this credit is just about the worst kind of thing that they could use to turn off and then turn on again.

I must say, too, for the record, that I feel, unlike your testimony, the investment credit is unsound both economically as well as taxwise. I might say another thing, too. On expenditure policy I am convinced that improving our expenditure policy will go both ways. One: It will cut down the deficit. But also weeding out unnecessary spending is going to improve the programs. We flood the carburetor and damage what we are seeking to attain in many of these expenditure programs. I am simply taking this occasion to put these thoughts on the record, because I think this will come into the discussion when the Ways and Means Committee goes into this area of trying to figure out what, if anything, ought to be done about financing the budget.

Now if I could get over to questions. I will preface this by some remarks. The stock market I think is increasingly becoming a good economic indicator. I have always felt the flow of gold was one of the greatest economic indicators, if we follow it. Last year, as I understand it, no new gold, additional gold from all the mined gold, ended up in the hands of governments. To me this is a very disturbing indication of hoarding on the part of individuals and institutions, and suggests to me that there should be considerable concern. Would you comment on that?

Mr. MARTIN. Well, I regret the hoarding of gold that is taking place. And as you say, there was practically nothing left over last year for monetary purposes. This is one of the reasons why I think we ought to press our studies on international liquidity. I think that the International Monetary Fund is an ideal place to work on this. The administration is working quite hard in this area. It seems to me that this is a—

Representative CURTIS. Well, liquidity might help that part of the problem, but I was referring to this as an economic indicator. Why is it that institutions, private institutions and people around the world are in effect "battering down the hatches"? I think we had better look to see what they foresee, and this is what I say creates this disturbance. When I start looking at some of the indicators, I think I begin to share this concern.

It seems to me our international picture is in a very delicate balance, and certainly improving the liquidity or our methods of handling international imbalances would be helpful. But I think most people that I have heard would agree that this isn't going to get at our basic problem of a deficit in international payments and some other world problems. Would you care to comment?

Mr. MARTIN. There is no comment I could make other than that that is the problem.

Representative CURTIS. Now one of the other thinks that will be before Ways and Means almost as soon as we get back after raising money—I might say here that the Democrats do that as well as the Republicans around this time of year. Yesterday they tried to claim that when Lincoln ran the second time he didn't run as a Republican but as a Union candidate.

The interest equalization tax is up again before the Ways and Means Committee, and it has been proposed that the President be given the power to double the tax. To me this is a very unwise approach. Of course, I opposed it in the beginning. By the way, I was very pleased to see an article by Jack Behrman, who was the former Assistant Secretary of Commerce under President Kennedy's administration. He is now teaching at the University of North Carolina. He points out in this article that our foreign investment comes back within 2 years, so the impact of this on our international balance of payments actually is not as great as is often said. Certainly in the long run the restraints are deleterious, because as you mentioned, our greatest asset in our international balance of payments is our plus on trade and investment income. We have been getting a fine return on our investments abroad.

What is the policy, if there has been any expression on the part of the Federal Reserve, on continuing what was supposed to be a temporary restraint on private investment abroad?

Mr. MARTIN. Well, it is our hope that the voluntary foreign credit restraint program, which is our arm of this, you see, will not become permanent, but we decided after considerable discussion this year to continue it for another year and see how things develop.

Representative CURTIS. Did you continue it simply because of the equities involved, or did you do that as a basis of policy because you thought the entire weapon of restraining investment abroad was sound economics for these times?

Mr. MARTIN. We thought that under the current circumstances, the way it has been working, that it would be wise to give this a further try, and we have been following it very carefully. You know we have one of our Board members who works on this full time.

Representative CURTIS. I know. Let me see if I am coming through to you clearly. When we put the interest equalization tax into the law, it was quite a job to try to hit other areas in the same way, and now your program is part of a third area of control. But I think that it relates more to the inequity of hitting only one form of investment. When we first applied the tax, bank loans increased as a way of getting round it. Now the question is on direct investment. I am trying to find out whether the Fed's position is based on the fact that a principle has been adopted, to my regret, by Congress and the President and you are simply implementing that to create a more equitable situation, or do you think that the law itself is sound, and that we ought to be restraining foreign investments because of our problem with the international balance of payments. Do you understand what I am trying to say?

Mr. MARTIN. I think I got what you are saying but it is not easy to separate it. For the long term there isn't any question we favor foreign investment. It is an asset to us over the long term.

For the immediate problem we have decided to go along with these special measures, with the hope that the interest equalization tax, the voluntary foreign credit restraint program—both the Commerce part of it and ours—will not become permanent but will be temporary.

Representative CURTIS. Let me ask it this way. I see my time is up. The President has recommended that the interest equalization tax be extended. Does the Fed go along with that proposal?

Mr. MARTIN. Yes, I think the Fed does.

Representative CURTIS. I am very sorry to hear it.

Chairman PROXMIRE. Mr. Rumsfeld?

Representative RUMSFELD. Just to get this clear in my mind, your position is that your comments in your statement with respect to the President's tax proposal, and your support of that is based on basically your concern about the deficit, and that your overall attitude is that either of the two would be equally effective, whether it be a tax increase or reduction in Federal spending.

Mr. MARTIN. That is correct.

Representative RUMSFELD. Now with that in mind, did you take into consideration the President's proposal concerning changes in the Social Security Act, and if you did take it into consideration, did you make the assumption that his budget makes that they will in fact be passed at roughly the 20 percent level. And finally, does it make any difference to you, since it doesn't bear directly on the question of deficit?

Mr. MARTIN. Well, I wasn't involved in any way in that.

Representative RUMSFELD. I appreciate it, but you are making a judgment on the tax proposal and this is in the same general area. Are you assuming it will pass at the President's requested level?

Mr. MARTIN. Yes, I am.

Representative RUMSFELD. That is part of the assumption.

Mr. MARTIN. Right.

Representative RUMSFELD. Would it matter if it wasn't passed at that level in your position with respect to the tax? Say instead of passing it at the average 20 percent level it were passed at 8 percent with no increase in taxes, social security taxes. Since it doesn't affect the deficit, I would assume it wouldn't matter.

Mr. MARTIN. No, I don't think it would matter in that respect.

Representative RUMSFELD. I don't think it would matter particularly.

Mr. MARTIN. Yes.

Representative RUMSFELD. But with respect to your position on the tax.

Mr. MARTIN. That is right.

Representative RUMSFELD. I have been aware for many years of my absence of knowledge, but as a new member of this committee I have been impressed with the broad areas where we as the society lack knowledge and information, and the ability to effectively relate different trends and activities. Are you satisfied, I would guess you would agree with that statement from your earlier comment—

Mr. MARTIN. Right.

Representative RUMSFELD. Are you satisfied that the country is applying sufficient brainpower in these areas to try to see if we can't develop the ability to relate things more precisely? Do you have the feeling that generally in the country there is a good deal of attention

being paid to making progress, or that we are not spending sufficient effort and brainpower on it?

Mr. MARTIN. I think we are making quite a bit of progress right now. I think in the academic fraternity, and in both government and business, that there is more attention being paid to this than there has been for a long time.

Representative RUMSFELD. I am glad to have that encouraging comment. Thank you, sir.

That is all, Mr. Chairman.

Chairman PROXMIRE. Mr. Brock?

Representative BROCK. Mr. Martin, to go back to the questions of both Senator Proxmire and Representative Curtis, Senator Proxmire suggested that one of our previous witnesses indicated maybe it would be well for Congress to consider reinstituting the depletion allowance.

Chairman PROXMIRE. Investment credit.

Representative BROCK. The investment tax credit at the rate of 1 percent a month, starting say in July, so that we do not have the full 7 percent hanging over our heads until December 31, 1967. Is this an approach which would be interesting to you?

Mr. MARTIN. I am really not competent in this area. It is a tax problem. I think it may have some merit. It appeals to me as an approach.

Chairman PROXMIRE. If the Congressman will yield at that point I would like just to say your response reminds me of the question "How is your wife?" and the answer "Compared to what?" You are certainly competent in that area or in almost any area with regard to economics.

Mr. MARTIN. On the tax you mean?

Chairman PROXMIRE. Yes, indeed. I disagree with you but you are certainly competent.

Mr. MARTIN. I try to keep out of precise details in the tax field in my present job. I do have some knowledge of it, but I really do not think that I ought to get involved in what is essentially the Treasury's business.

Representative BROCK. Let me phrase it from a different point of view. You do have a specific interest in our international balance-of-payments position.

Mr. MARTIN. I do.

Representative BROCK. Has it ever developed in discussions on the investment tax credit that we might consider the possibility of allowing extra inducement in this form to export industries, to ease our balance-of-payments position?

Mr. MARTIN. Oh, yes, and that has been considered actively in the Treasury.

Representative BROCK. Has any recommendation been made to the Congress?

Mr. MARTIN. No. I think they decided not to do it, but this has been considered.

Representative BROCK. On the international problem as you mentioned, this is of great concern. Someone brought up the subject of gold hoarding. If it is a fact that the production of gold today is going into nongovernmental hands, in other words, it is going into

sources which do not use it as a reserve behind currency of any description, doesn't this tend to place even greater pressure on the dollar as the primary medium of international exchange?

Mr. MARTIN. It does indeed.

Representative BROCK. As Mr. Curtis was trying to bring out the fact that perhaps this could be an economic indicator. I think more than that, to me it is an international liquidity indicator. It would tend to give me concern over the dollar as the basis and foundation of international exchange in the coming 12 to 24 months. I think that is unrelated to the question of interest rates in this country, for example, but this is another pressure that can follow the dollar.

Mr. MARTIN. No question about it.

Representative BROCK. What development is encouraging to you on the international field insofar as international liquidity is concerned? Do you honestly think that we are making some progress in achieving a greater liquidity, and isn't this a problem, and doesn't this also relate to President de Gaulle's position of wanting to go to a full gold standard? Wouldn't that create the darnedest chaotic situation we ever saw specifically in light of this gold hoarding?

Mr. MARTIN. I think you have raised the issue very clearly here. I think there is more attention being paid to this than in a long time. In the Group of Ten, in the OECD, I think that they have been gradually realizing clearly what the implications of the return to the old-fashioned gold standard would be, that there are no countries today that would permit an inflow or an outflow of gold to determine their domestic money supply. If you increased the price of gold and got out of the dilemma at the moment by doing that, for a little while it might operate, but then you would need fiduciary money on top of it.

Now the reason I am encouraged about this is that I think the International Monetary Fund is one of the real achievements of Bretton Woods, and I think that the participants, in their activities, are aware of this problem. The work on the liquidity problem has not yet reached the stage where there is general agreement, but there is general recognition of what the problem is. I think that is a precursor to getting—

Representative BROCK. But the essence of it is that you have some optimism about the possibility for greater cooperation.

Mr. MARTIN. I have indeed.

Representative BROCK. Thank you very much.

Chairman PROXMIRE. Thank you, Mr. Brock. And thank you very much, Mr. Martin. You have been an extremely responsive witness. We have heard you many times. You have always been good but I don't think you have ever been as concise and direct as you have today. It is refreshing to have a witness who is both responsive and concise and gives members of the panel a chance to ask all the questions they wish.

Our witness this afternoon is the Under Secretary of Commerce, Mr. Trowbridge.

The committee will recess until 2 o'clock.

(Whereupon, at 1:10 p.m., the committee recessed until 2 p.m. of the same day.)

(The following material was subsequently submitted in response to Representative Brock's questioning; see p. 422, preceding.)

Question. Is monetary policy less appropriate or less effective under conditions of "cost push" or "demand shift" inflationary pressures than under conditions of "demand pull" inflation? Is it possible to differentiate in practice as to when one or the other of these situations is dominant?

SUMMARY

Business fluctuations in the United States since World War II, while differing from one another in many ways, have had features in common with respect to the interactions of demands, output, costs, prices, and profits. The description of these relationships provided below indicates that the problems of inflationary pressures arise during the expansion phase of the business fluctuations characteristic of industrial economies, when demands are expanding. In the early stages of a business expansion, production and employment are likely to increase without generating widespread upward pressures on prices and costs. Continued expansion in demands eventually generates upward pressures on prices and costs as output in some industries reaches high levels in relation to capacity and unemployment is reduced. If the pace of expansion is moderate and competitive conditions are maintained, increases in prices and costs are likely to be confined to a relatively few markets. On the other hand, if demands expand rapidly and expectations are ebullient, increases in prices and costs are likely to become widespread.

With respect to the second of the two questions raised, once the process of inflation is under way, it is usually not possible to determine whether the dominant influence on prices stems from "cost push" or "demand shift." Since prices of goods and services represent costs to someone, increases in costs are one of the ways by which inflationary pressures are transmitted through the economy. At the same time, increases in some costs are promptly reflected in income payments and thus exert an influence on demands. Through this interaction of demands, prices, and costs, the inflationary process is initiated, and once in operation, the demand and cost elements interact in such a manner that they cannot be disentangled as separate and distinct forces.

In the chain-reaction process of demands, prices, and costs, the most direct influence that monetary policy can exert is on demands for goods and services. Through its influence on credit availability and on liquidity, monetary policy endeavors to maintain a climate of demands and expectations during business upswings that is conducive to a high rate of utilization of available resources without widespread upward pressures on prices and costs. Should upward pressures nevertheless develop, monetary policy can help to restrain them. Appropriate monetary policy can limit the funds that may be made available through bank credit to finance the expansion in demands stimulated by the income effects of price and cost increases, by expectations, and by other forces.

When business activity is high, prices generally are advancing, and the community expects continuing advances in prices, a monetary policy that restrains the use of bank credit is an appropriate and necessary tool. Whatever the causes or the means of propagating inflation, expansion of bank credit would influence both spending and expectations and so would provide additional impetus to the price-cost spiral. Under these conditions, individual and group efforts to hedge against inflation or to protect against it by tying contractual arrangements to price indexes would tend to aggravate inflationary forces.

In appraising the effectiveness of monetary policy, a number of factors must be considered. The formation of policy, first of all, depends on current assessments of developing business and financial conditions and, despite improvements in economic intelligence over the years, it is not possible always to judge accurately the strength of the forces developing. Other activities of the Federal Government, furthermore, have an impact on levels of production, employment, and income, and thus they influence needs for greater or lesser degrees of monetary ease or restraint. These policies, consequently, may complicate or simplify the task and they may inhibit or enhance the performance of monetary policy. Government policies that affect the functioning of markets and those that directly affect prices—such as import duties and quotas and antitrust policies—also bear on the effectiveness and results of monetary policy. The

degree of market power exercised by private groups also may affect the sensitivity of markets to current and prospective demands. If monopoly power were widespread, it could have an influence on the effectiveness of both monetary and fiscal policies in pursuing their goals.

NATURE OF COST-PUSH AND DEMAND-SHIFT EXPLANATIONS

Controversy over causes of postwar inflation has focused mainly on developments since 1954. On the causes and nature of the episodes of inflation in the earlier postwar years, there appears to be widespread agreement. World War II left a legacy of accumulated demands for goods of all kinds, and methods employed in financing the war resulted in highly liquid financial positions. When wartime price controls were removed, effective demands at current prices were considerably in excess of supplies in virtually every market.

When the Korean War began in mid-1950, memories of war-induced shortages and price increases provoked protective buying by consumers and businesses, here and abroad. In both periods of inflation, costs as well as prices rose and there were large shifts in the composition of demands, but the influence of strong demands in originating and sustaining price advances was by far the predominant one.

In the 1954-57 inflation, demands were not strong in all markets simultaneously, and the advance in prices was moderate in comparison with the war-related experiences. In view of these circumstances, several interpretations of the period since 1954 have emphasized the independent nature of costs. Another interpretation has stressed rapid changes in the composition of demands. What is common to these interpretations is that they have attributed primary importance to rigidities or to autonomous elements in markets for goods and services and have given little or no weight to the role of aggregate demands. From these theses, further interpretation is drawn that use of general instruments of restraint on aggregate demands in order to check such price increases would be ineffective or would incur unacceptable social costs in terms of unemployment of human and material resources.

The "cost-push" approach to the explanation of price inflation seems fundamentally to assume that costs are more or less independently determined by market power and, therefore, little can be done about them. Prices are set by administrative decisions to cover all costs, including a satisfactory margin of profit, without regard to current or prospective demand conditions. Production is scheduled to conform to sales at these prices.

In such circumstances, it is said, Government policies—monetary and/or fiscal—must operate to provide demand sufficient to assure maximum output and full employment at the wages that are the result of labor-management agreements and at the prices businessmen—and, sometimes, public agencies—deem necessary. Otherwise, output and employment will be held or reduced below attainable levels, but there will be no appreciable restraint on advances in price levels and labor or other costs.

In practice, however, the extent to which the price of a product can be raised is limited by actual or potential competition from other products or from imports; these checks are strengthened by Government policies that operate to restrain demands and prevent ebullient expectations from developing. Competitive constraints on prices strengthen resistance to increases in costs and at times may exert downward pressures as businessmen attempt to maintain or increase profit margins. The influence on costs may take such forms as programs to raise productivity, various efforts to economize on the use of materials, control of administrative and other types of salaried employment, or resistance to increases in wage rates and fringe benefits.

The "demand-shift" explanation of the type of inflation experienced in the 1954-57 business expansion rests on a combination of factors. Inflation, it is said, originates in the general excess demands which temporarily emerge as the economy passes from recession to full employment, and from the excess demands in specific sectors that often remain after the aggregate excess has been eliminated. Inflation is perpetuated and spread throughout the economy, the argument proceeds, by the influence of costs in wage and price determination and by the relative insensitivity of prices and costs to decreases in demands.

In this view, particularly as it relates to the 1954-57 business expansion, demands increase and full employment is reached without generating upward price and cost pressures. Then, a rapid shift in the composition of demands is reflected in excess demands in some sectors and insufficient demands in others.

Because prices are more sensitive to increases than to contractions in demands, a general rise results as prices advance in those sectors where demands are increasing rapidly and decline by smaller amounts or not at all in those sectors where demands are decreasing. General monetary and fiscal policies appropriate to combat an inflation arising out of excess aggregate demand are not suitable, it is contended, to combat an inflation arising out of excess demands in particular sectors of the economy.

The composition of demands relative to the composition of available resources has an important bearing on developments in business expansions. The problems of inflationary pressures, however, are likely to arise well before demands and output reach the limits of capacity, partly because the use of marginal production facilities raises costs. Problems of inflation certainly arise before output reaches capacity in all major sectors because resources are not highly mobile. In 1955 and 1956, for example, output was well below capacity in the basic textile industries but very close to capacity in the basic metals industries. As E. A. Goldenweiser wrote in 1941:

"It should be mentioned * * * that there is no clear-cut line at which an increasing number of bottleneck advances in prices passes over into a general inflation. The development of a number of bottlenecks in many leading commodities may be the introductory phase of a general inflation. It can occur long before the entire country is operating at full capacity, because neither plant capacity nor labor supply is completely mobile. The existence of unused capacity in some industries may not prevent great shortages of capacity in others, and the presence of large numbers of unskilled workers without jobs may not prevent grave shortages in many skilled lines. So long as these instances of shortages are scattered and relatively few the situation is not properly described as inflation and can be handled by nonmonetary remedies. But it may become general long before full capacity is achieved. It should be kept in mind that it is the available supply of goods and not the theoretically possible supply that must meet a growing demand in order to prevent inflation."¹

The demand-shift approach treats the milder, peacetime inflations of the sort experienced in 1954-57 as something different in kind from the type often associated with wars, whereas the difference appears rather to be one of degree. The immobility of resources is more obvious in the former cases, but it is not confined to them. In the more severe inflations, immobility of resources also limits shifts to areas of strongest demands, but its existence and influence are concealed by the general excess of demands.

In an economy with high and rising standards of living and many other features fostering change, demands are not likely to expand in such a way that their composition is always in balance with the location and types of existing plant and other resources. In business expansions, imbalances are likely to exist, and they are not likely to be precisely the same from one expansion to the next. Such imbalances operate to attract the newly available resources (and savings) into the sectors of strongest demand pressures.

PATTERNS OF PRICE AND COST CHANGES IN BUSINESS FLUCTUATIONS

Prices are determined by the interaction of a number of factors functioning continuously in many different types of markets, and there is an unending process of market adaptation to changes in the various factors. While business fluctuations differ from one another in important respects, they all have features in common with regard to the interactions of demands, output, costs, prices, and profits. Reviewing the process of change during postwar business expansions and contractions in this country, certain relationships and patterns of behavior are discernible.

Periods of expansion

Early in expansions of business activity, prices usually are rising in markets for "sensitive" industrial materials—that is, the materials whose prices are most responsive to short-run changes in demand. For rubber, hides, and some other sensitive materials, world production cannot be increased much (if at all) in the short run in response to rising demands. As a result, increases in demands are rather promptly reflected in price advances and may alter the international flows of commodities.

¹ E. A. Goldenweiser, "Inflation," *Federal Reserve Bulletin*, April 1941, p. 292.

Production or supply can be increased in the short run for other sensitive materials, such as scrap metals, wastepaper, copper, lead, zinc, and lumber. Because increases in output are accompanied by rising costs per unit of output or because of other conditions of supply, expansion in demands is reflected in price rises which provoke increases in supply. Price trends for a group of these sensitive materials often suggest the direction and strength of demands before other types of data for the same time period become available.

Many foods and foodstuffs—including livestock, poultry, and some crops—also conform to the type of market behavior described for sensitive industrial materials. For these, however, the response of domestic demands to cyclical and secular income changes is slight (the income elasticity of demand is low). Substantial changes in output may occur, however, mainly because of variations in weather, swings in the hog and cattle cycles, or rising productivity. Consequently, price fluctuations for these commodities usually reflect changes in supplies to a greater extent than they reflect shifts in demands.

Agricultural commodities subject to Federal support programs are largely protected from the price-depressing influence of large increases in production. At the same time, the existence of stocks previously accumulated in the process of supporting prices has limited in recent years the response of prices to a crop failure or other events that reduce production and supply.

For most industrial materials other than those described as sensitive, supply is expansible in the short run until some relatively high rate of capacity utilization is reached. This is true for steel mill products, paper products, many chemicals, cement, brick, and other materials. In the early stages of expansion, variable costs per unit of output are not likely to rise as increases in output are accompanied by gains in productivity and wage rates do not rise much. Fixed costs per unit and average costs per unit decline, and profit margins as well as total profits rise. Expansion in demands for these materials is accompanied for a time by rising output and supply without widespread advances in list prices. Absorption of freight and other concessions from list prices which had developed during the previous recession tend to be reduced during the early stages of expansion. These changes in actual prices are not reflected in the established price indexes, which are based mainly on manufacturers' published price lists.

The behavior of wholesale or manufacturers' prices of most finished industrial products in the early stages of expansion is much like that described for the second group of industrial materials—for similar reasons. Therefore, increases in their prices early in expansions are likely to be restricted in scope.

Continued expansion of demands eventually generates upward pressures of costs on prices of industrial materials in the second or nonsensitive group and on prices of finished products. The upturn in costs is primarily a consequence of higher levels of output in relation to available manpower and material resources.

Contrary to the suggestion sometimes made that pressures of demand against resources available to produce specific products cannot possibly contribute to increases in their prices and costs until operations are at 100 percent of capacity, costs of production often begin to rise before output approaches such high levels. The plant and equipment existing in an industry at any time is of varying age and efficiency. As demands expand, less efficient facilities must be used if output is to be increased to fill the rising volume of orders. Partly because these marginal facilities have to be activated, over-all productivity advance slows and may actually cease or be reversed. This contributes, along with increasing wage rates, premium payments for overtime, and advances in prices of some materials consumed in the industry, to rising costs per unit of output.

Price- and cost-raising pressures of demands in specific industries, furthermore, may become widespread enough to constitute a general problem before output reaches high rates in relation to capacity in all major industries. Usually, some industries are growing while others are not, and some regions are gaining while others are losing business. A number of important bottlenecks may develop even while unused capacity exists elsewhere. These developments also contribute to a higher level of frictional unemployment of labor than might exist otherwise. A judgment that output in the whole economy is at a high rate relative to plant capacity does not require that there be no margins of unused capacity, any more than "full employment" means that there are no persons looking for jobs.

Given variations in the timing and intensity of demand and cost pressures among industries, Governmental policies to further expand aggregate demands

in order to raise demands and output in those industries where capacity is not being intensively utilized would intensify demand pressures on those industries where output is already close enough to capacity to result in rising costs and higher prices. Consequently, while a higher level of aggregate demand might increase total output somewhat, it would also accentuate upward pressures of demand on prices.

An additional and important aspect of these developments and relationships is that an expansion of capital outlays is likely to be stimulated well in advance of full utilization of plant capacity. Business enterprises always have some capital replacement needs, and additional capital expenditures in most cases reduce costs or increase sales potentials. Incentives to undertake new commitments for expansion as well as for replacement are intensified if business managers expect higher levels of demand for their products from both secular growth and cyclical expansion. Since it ordinarily takes many months before new facilities can be acquired and efficiently integrated into the production process, business managers must plan expenditures to increase capacity well before output reaches the limits of their ability to produce.

Among the elements of cost, attention in recent years has been focused on changes in labor costs, partly because wage rates have risen persistently and labor costs are an important part of total variable costs. In major industries, where changes in wage rates tend to be industry-wide, such changes occur at a particular moment in time and they usually are widely publicized. On the other hand, changes in productivity, which operate in the direction of offsetting the effect of wage rate increases on labor costs per unit of output, occur over a period of time. Also, the advances are likely to vary considerably from plant to plant and from one producer to another.

For many industries, average measures of productivity show more cyclical variability than wage rates, rising in the early stages of expansion, leveling off as output approaches capacity, and declining in the early stages of recession. This pattern of change is probably accentuated by the short duration of the business fluctuations of postwar experience. Many new facilities are put in place late in expansion—or in the early months of recession—and there is some time lag between installation and their efficient operation. When there is such a lag, the resulting productivity gains may appear late in recession and early in expansion.

Partly for this reason, unit labor costs tend to decline in the early stages of expansion when productivity gains generally exceed increases in wages. As expansion develops, unit costs turn up because productivity advance slows and the rise in wages continues and possibly accelerates. In recession also, unit labor costs typically rise in certain industries as output per manhour declines.

Meanwhile, capital consumption and other relatively fixed costs—by definition—do not vary with the level of output. On a per unit of output basis, therefore, they show an inverse correlation with output, decreasing when output is rising and increasing when output is falling.

Cyclical variations in costs per unit of output, which result in considerable part from swings in production, are not accompanied by similar variations in prices. Consequently, profit margins fluctuate more widely than labor and other costs per unit of output, generally moving in the opposite direction. In the early stages of expansion, profit margins rise sharply; in later stages, they level off or decline; in recession, they decline decidedly.

The preceding review of price and cost influences indicates that in early stages of economic expansion, production and employment are likely to advance without generating widespread price and cost pressures. While wage rates and prices of certain materials increase, margins of profits over costs widen and are likely to approach their cyclical peaks. After expansion has progressed for a time, however, upward price and cost pressures build up, primarily because output in some industries has reached high levels in relation to capacity and unemployment has been reduced. As described earlier, less efficient plant facilities must be used and productivity advance slows or is reversed. At the same time, reduced unemployment and enlarged profit margins intensify pressures for increases in employee compensation.

With demands strong and output in some industries already at high levels in relation to capacity, the subsequent behavior of prices and costs is strongly influenced by the rate at which over-all activity has been expanding and by expectations. If the pace of expansion has been moderate, competitive conditions are maintained within most industries, between industries serving

common markets, and between domestic goods and goods produced abroad. In these circumstances, increases in prices and costs are likely to be confined to a relatively few markets and are unlikely to be very large.

On the other hand, if demands have been expanding rapidly and assessments of prospects are highly optimistic, increases in wage rates and fringe benefits are likely to be large and price advances extensive. Increases in wages will be propagated throughout industry and may directly cause further expansion in demands for goods and services. Price advances may indirectly contribute to expanding demands by generating expectations of additional advances.

Increases in the price indexes will further contribute to cost increases through escalator provisions of labor, rent, and other contracts. Some State and local taxes and fees may be raised to cover the rising costs of current services and higher costs of school, highway and other construction. These taxes are also reflected in the consumer price index used for escalation purposes. And thus an interacting inflationary process of demands, prices, and costs can get in full operation.

Implicit in this description of price behavior for industrial commodities is the fact that relatively few markets conform to an ideal competitive model. In the competitive model, prices are determined by the interaction of buyers' bids and sellers' asking prices in the market; the individual seller has no significant influence on total supply and therefore has no discretion except with regard to his acceptance or rejection of the going price or how much he will supply at that price. This type of market behavior is approached most closely in markets for livestock, some other agricultural commodities, and the industrial materials earlier described as sensitive.

Markets for industrial commodities, on the contrary, are generally characterized by "imperfect" or "monopolistic" competition. Prices in these markets often are described as "administered." In such industries, a producer must make decisions regarding the pricing of the product—including all the price-related decisions associated with quality, design, and selling techniques. These pricing decisions are based on judgments of what sales would be at different levels of prices, on calculations of what costs per unit would be at various levels of production, and on the behavior of competing producers and products. Thus pricing decisions take into account, in addition to demand, the range of forces affecting production and costs, just as sales, production, and costs are influenced by pricing decisions. Producers must attempt to find a price that is in harmony with all the relevant short- and long-term demand and cost considerations, but without knowing precisely what will most effectively accomplish this aim.

The fact that prices are set by the decisions of producers implies a degree of market power—stemming from the nature of the product and the nature of the production process—but it does not connote full monopoly power. On the contrary, market forces—including competition within the industry and from other domestic or foreign products or alternative sources of satisfaction—are constantly working to alter past price decisions.

Rates for utilities, freight, public transportation, insurance, and postage are also administered prices, as are rates for many other business and consumer services. Both the cost and demand conditions encountered in the service industries vary widely. Some services are produced under conditions affording opportunities for basic technological improvement and productivity advance while for others such opportunities are limited. Some are primarily labor while others have a higher commodity content. Prices of some services are very responsive to local labor market and related economic conditions while others are subject more to nationwide forces. Some are regulated by public commissions and still others are stipulated fees for public services. In particular instances, service prices follow trends in wage rates fairly closely.

The result of most of these influences is that inflationary pressures in the economy are transmitted to services via increases in costs. For the regulated prices, advances may lag considerably behind the initiating causes and may occur in many instances even after business expansion has given way to recession.

Periods of recession

During contractions in demands and activity, changes in prices and costs and in relationship between them are determined mainly by the duration of the contraction and by developments in the preceding expansion. In a prolonged and severe depression, accompanied by distress sales and substantial decreases in prices of existing assets, strong downward pressures develop on

prices of currently produced goods and on wage rates and other elements of production costs. Since a contraction of this severity has not occurred since World War II, attention may be confined to the milder recessions experienced since then.

In recession, prices of sensitive industrial materials generally decline. Contraction in domestic demands and decreases in prices may reduce domestic supply by altering international commodity flows and/or by making marginal operations unprofitable. For the nonsensitive materials, analysis is complicated by the tendency of producers to change prices by varying concessions and discounts from unchanged list prices. While it is known that net or actual prices fluctuate more widely than list prices, little information is available to show the degree of change in actual prices.

List prices tend to be maintained in the early stages of contraction and if the recession proves to be brief, recovery in activity begins before many list-price cuts have been made. When it becomes clear that demands are reviving, the list price for a product on occasion is lowered to conform to actual transactions prices—because the operation of new facilities or some other development causes demand-cost relationships to be fundamentally different from those on which producers had been basing their decisions.

In describing the behavior of nonsensitive materials during business expansion, it was emphasized that producers' price decisions are based largely on calculations of costs at various possible levels of output as well as on judgments about demand. When demands contract and production is reduced, many elements of costs do not decline. Wage rates, for example, are maintained—or may actually increase in some lines owing to the terms of long-run labor agreements. The tendency of wage rates to be maintained was characteristic also of the mild recessions of prewar years.

Even in an administered price market, individual producers, faced with declining demands, have an incentive to reduce prices in order to increase sales, if they think competing producers will not also reduce prices. This goes far to explain the preference of producers for unpublicized price cuts—for price cuts brought about through concessions rather than through reductions in list prices. In certain situations, however, there may be incentives to publicize price reductions by cutting list prices: a cyclical contraction in demand for a particular material may be accompanied by competition from a new and lower cost source of supply or a new substitute material, or it may be accompanied by a change in the methods of production that appreciably reduces costs.

The recession behavior of manufacturers' prices of most finished industrial products is similar to that of the nonsensitive materials. To the extent that prices of materials decline, however, downward pressures on prices of finished goods are intensified. Prices of services tend to resist forces of decline in recession. In many cases, they rise further because of the increases authorized by regulatory agencies on the basis of earlier increases in costs, but the rate of rise in average prices of services slows down.

To summarize, prices of many sensitive materials typically decline in recession. These commodities have little weight in broad price indexes, however, and their influence currently is much less than in the indexes available for prewar years. Declines in prices of some other commodities are likely to be concealed in concessions from stable list prices. Still other prices, however, may resist any downward adjustment to declines in aggregate demand in moderate recessions.

If the previous expansion was accompanied by inflationary developments and appreciable increases in levels of prices, the increases are not likely to be fully erased during mild business recessions, giving rise to what has been called the "ratchet effect." If, however, price increases in the previous expansion were small, they may be subsequently offset as the competitive pressures that develop during recession, domestic and foreign, strengthen incentives to cut costs and to reflect these reductions in the form of lower prices. This emphasizes the importance of containing growth in credit and in demands for goods and services during periods of economic expansion and of preventing a climate of expectations conducive to large and widespread advances in prices and costs.

DEVELOPMENTS SINCE 1954

The interpretations of the functioning of the market system which have led to skepticism about the efficacy of general measures of public policy have been supported almost exclusively by analyses of the 1954-57 business expansion. A

comparison of developments in the period with the process described above will tend to show that the originating causes of inflation in the 1954-57 expansion—as in other periods of expansion characterized by inflation—were strong demands and overly optimistic appraisals of prospects. Once begun, the inflation was sustained by persistence of strong demands, by demand-price-cost-demand interaction, and by generation of widespread expectations of continuing inflation.

The business expansion that began in the spring of 1958 had not, through the spring of 1960, led to large and widespread increases in prices, as producers endeavored to hold down and reduce costs. Comparison of this period with both the process described previously and with the 1954-57 experience shows that the growth in final demands, while substantial, was reasonably well balanced and moderate in relation to available resources.

The 1954-57 expansion

Recovery from recession began in the second quarter of 1954. Expansion of consumer buying and residential construction activity was followed shortly by a shift from liquidation to accumulation of inventory. This was a period of rapid industrial expansion abroad, and foreign demands were contributing strength to domestic markets.

Prices of sensitive industrial materials began to rise in the spring of 1954, as shown in the attached chart, and were back to the prerecession level by the spring of 1955. By that time, prices of some other materials and producers' equipment also had been raised. Changes in wholesale prices of industrial commodities from June 1954 to June 1955, and over succeeding 12-month periods, are shown in the accompanying table.

Wholesale prices—Percent increase

	June 1954 to June 1955	June 1955 to June 1956 ¹	June 1956 to June 1957	June 1954 to June 1957
Industrial commodities.....	1.8	4.9	3.2	10.2
Materials.....	2.4	5.4	2.9	11.0
Sensitive.....	² 5.4	5.4	-2.6	8.1
Other.....	1.3	5.4	4.9	11.9
Finished goods.....	.9	4.2	3.7	9.0
Consumer.....	.3	2.6	2.5	5.5
Durable.....	.5	3.5	3.0	7.2
Nondurable.....	.2	2.1	2.1	4.5
Producers' equipment.....	2.1	7.9	6.1	16.9

¹ Well over half of the increases in this period occurred during the 2d half of 1955. The rate of increase in prices in that period was faster than after the end of 1955 when the rapid shift in the composition of demands is said to have become a major influence.

² The rise in this group began in March 1954, and from that time to June 1955 amounted to 7 percent

Source: Based on Bureau of Labor Statistics data.

Industrial production reached a new high in the spring of 1955 and continued to expand, while the labor market tightened. Sales and output of autos far exceeded previous records, under the influence of price concessions, radical changes in design, and a shift in credit terms to considerably longer maturities and lower downpayments. The volume of residential building was exceptionally large, and production of other consumer durable goods and business plant and equipment all advanced. Even though steel production reached capacity levels and output of other primary metals was at peak rates, metals were in short supply, and capacity was under mounting strain in many other important industries. Business profits after taxes increased considerably. This intensified incentives to expand capital investment and also provided some of the needed funds, with the result that business investment plans rose sharply further.

These were the conditions and expectations in mid-1955, when some important labor contracts were negotiated. Demands for large increases in wage rates and fringe benefits were strong, and resistance to them was weak. In the auto, steel, and certain other major industries, large increases were agreed upon, and these liberal contract terms were negotiated for the most part without work stoppages.

Given the demand conditions and prospects of the time, prices could be and were raised to cover not only the increases in wage rates but also advances in other costs such as those resulting from the sharp increase in hiring of non-production or salaried workers. Costs of materials and supplies were also ad-

vancing. Partly because of the lagged effects of the World War II and Korean War inflations on the book values of the stock of real capital, depreciation charges were higher in relation to sales than in earlier postwar periods of rising economic activity. A widespread rise in prices of industrial commodities erupted in mid-1955 and a price-cost spiral was set in motion.

By the spring of 1956, the rise in business capital expenditures—which had been stimulated partly by the surge of consumer buying in 1954–55—reached boom proportions. Total spending by government was also rising. Economic activity abroad continued to increase and foreign demands for United States products gained further in strength. Meanwhile, some categories of demand were increasing less rapidly than earlier and still others, such as demands for autos and new houses, declined.

Curtailments in output in some of these lines in 1956 released resources and thus permitted expansion elsewhere. Unemployment remained low. For the most part, pressure of demands against capacity in basic industries was maintained. The capital goods industries depend on many of the same materials and types of labor as are required in the auto industry. Similarly, industrial and commercial construction use essentially the same labor and some of the same materials consumed in residential construction.

In the industries producing basic metals, for example, the operating rate was about 93 per cent of capacity in mid-1955, when the advance in prices became widespread among industrial commodities. By the end of 1955, the rate was up to 97 per cent. New capacity was being installed in these industries during 1956, and at least some of it became fully available for production during that year. While rated capacity increased 4 per cent from the end of 1955 to the end of 1956, output rose 3 per cent, so that the year-end operating rate was 96 per cent. Some other industries producing basic materials also maintained very high operating rates.

Expectations of continuing prosperity remained strong in 1956, despite decreases in sales of autos and housing. The decrease in automobile sales came to be regarded as a normal falling-off from the extraordinarily high levels of 1955, and expectations in the industry and elsewhere were for a renewed rise after introduction of new models toward the year-end. The capital goods boom that began in 1955 continued through 1956 and into 1957.

Price and wage developments in 1956, then, were dominated by strong demands, by shifts in the composition of demands for finished durable goods, and by ebullient expectations. Prices of a few sensitive materials declined: prices of lumber declined after February 1956 in response mainly to the decrease in residential construction; and in the spring of that year, copper prices began to decline—from very high levels associated with strikes—as supplies caught up with demand. Prices of most industrial commodities, however, continued to increase.

In lagged response to the inflationary developments begun in 1955, moreover, the consumer price index began to rise in early 1956. This rise resulted in wage increases based on escalation clauses in existing contracts and intensified demands for other large wage increases. In the summer, long-term contracts negotiated in the steel, aluminum, and some other industries, provided for liberal annual increases in wages and fringe benefits and automatic cost-of-living adjustments.

In early 1957, prices of industrial commodities rose further—reflecting partly a working through of earlier increases in prices of materials and other costs and partly the fact that the expectations of inflation continued to be widespread. Concurrently, rising prices were limiting sales, and inventories were increasing. After nearly three years of expansion, the seeds of recession—invariably sown in a boom—were beginning to germinate.

By the autumn of 1957, wholesale prices of industrial commodities had risen about 10 per cent from the early 1954 level, the total wholesale index 7 per cent, and the consumer price index 6 per cent. Given the strength of demands and the optimistic nature of expectations, increases of these magnitudes over a three- to four-year period are perhaps not extraordinarily large. Nevertheless, the rise in prices would have been larger had monetary policies not been restrictive. Developments through the period emphasize the need for vigorous efforts to contain the growth in demands for credit and for goods and services during periods of economic expansion and to prevent the generation of a climate of expectations conducive to widespread advances in prices and costs.

The 1957-58 recession

In the early autumn of 1957, more than three years after the upturn in business, expansion gave way to recession. A capital equipment boom by its very nature cannot be indefinitely prolonged. Exceptionally high rates of capacity expansion, rapid rise in equipment prices, and reduction in business liquidity eventually weaken incentives to make additional outlays. A decline in business capital spending will usually entail a period of inventory liquidation for capital goods industries, with reduced employment in these industries. Secondary effects of these developments are reductions in business inventory holdings, employment, incomes, and demands generally. The recession that began in the autumn of 1957 was of this type—although other elements were present, including cutbacks in defense ordering and contraction in foreign demands for U.S. exports.

Recession was not accompanied by widespread liquidation of credit and distress sales, however, and the basis was soon formed for recovery and renewed expansion, in part because of the increased availability and reduced cost of credit. Policy actions had operated to restrain the use of bank credit for speculative purposes during the expansion, and then operated in recession to encourage expansion in bank credit and increase the liquidity of the economy.

During the recession, prices of sensitive industrial materials declined, as the chart shows, with the average returning to the early 1954 low. While it is likely that various forms of concessions from list prices developed for other industrial commodities, list prices generally were maintained and, in fact, were raised further for some commodities. The failure of list prices to decline may be attributed in part to continuance of expectations of rising prices, to additional increases in costs arising out of commitments made during the preceding boom, and to the brevity of the recession.

Expansion since early 1958

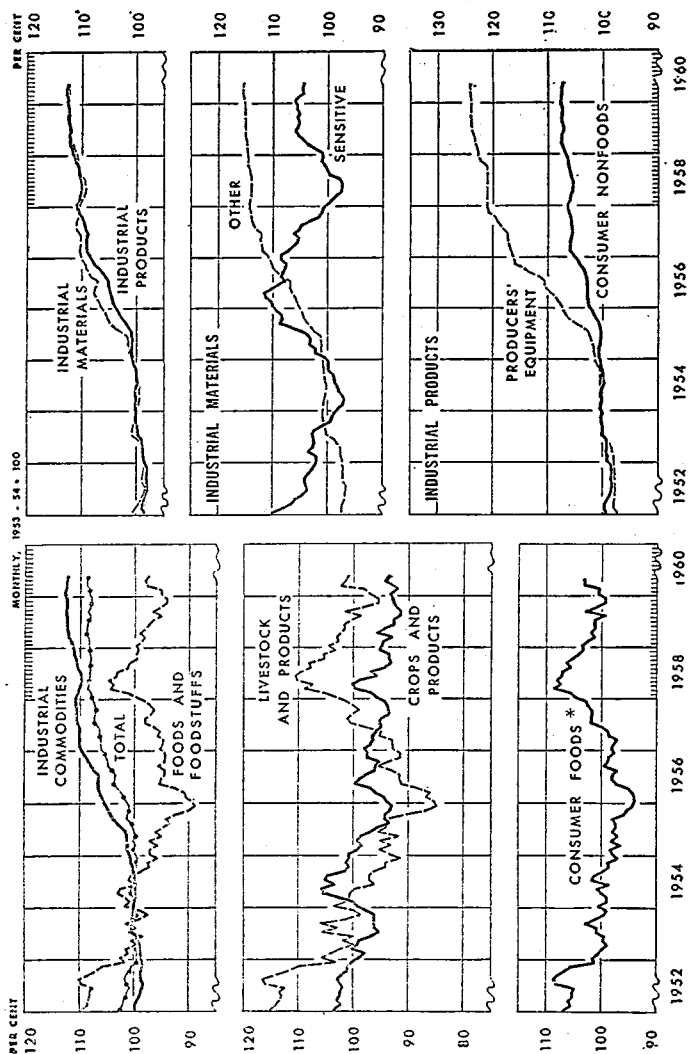
When recovery in business activity began in the spring of 1958, average levels of prices were appreciably higher than in early 1954—when the previous recovery began. Expectations of continuing upward creep in prices remained widespread. The reality of expectations of inflation became obvious not so much in the behavior of commodity markets but in a further advance in common stock prices to new highs and a continued increase in land values. Moreover, interest rates turned up promptly and long-term rates which had declined only moderately in the recession, quickly approached or reattained prerecession highs.

The pattern of demands, production, productivity, prices, and profits through the first year of expansion was similar in many important respects to the comparable period of recovery from the 1954 low. Consumer buying expanded rapidly, housing starts closely paralleled the rise of 1954-55, and liquidation of inventories slowed down and then gave way to accumulation toward the end of 1958. Constant dollar gross national product reached a new high in the fourth quarter of 1958 and industrial production exceeded the 1957 prerecession peak by March 1959. Prices of sensitive industrial materials responded to expanding demands, rising about as much in the first year of economic expansion as in the comparable period of 1954-55.

However, growth in final demands was less rapid than in the comparable period of 1954-56. Consumer buying of autos rose less sharply—for a variety of reasons, including higher prices and no important further easing in credit terms on contrast to the marked liberalizing of terms in 1955. Moreover, merchandise imports rose substantially while exports changed little. In recent years, there has been a considerable improvement in the ability of other industrial nations to satisfy their own requirements and also, partly because of price advances in this country, to compete with American manufacturers of many materials and finished products in domestic markets as well as in markets abroad.

Consequently, while consumption of materials in manufacturing reached a new high in the spring of 1959 and inventories were being accumulated at a rapid rate (stimulated in part by the expectation of interruptions of supply by strikes), the margins of capacity over output for most major materials were somewhat greater than in mid-1955, and greater than during any other period of high-level activity since World War II. The margins were not large, but their importance was magnified by the fact that they existed simultaneously in several industries whose markets overlap. Government policy actions and policy pronouncements, furthermore, lessened the expectation of rising prices. Altogether, there was more uncertainty in the outlook, and prospects were for more intensive competition.

WHOLESALE PRICES SPECIAL GROUPINGS OF B.L.S. INDEXES.



BASED ON MONTHLY INDEXES OF THE BUREAU OF ECONOMIC ANALYSIS

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From the spring of 1959 to the spring of 1960, therefore, developments were quite different from those in the comparable period after the spring of 1955. One of the most obvious differences was the development of strong resistance to cost increases as manufacturers were less confident of their ability to pass them on in the form of higher prices. Specifically, strong resistance to demands for increases in wages and fringe benefits in the steel and other industries, as reflected in prolonged work stoppages, resulted in generally smaller increases. Gains in productivity, meanwhile, were as large as or larger than in the earlier period. Salaried employment, which had declined more in the 1957-58 recession than in previous recessions, increased less rapidly than in the 1954-57 expansion. Advances in prices were limited, and wholesale prices of the various groups of industrial commodities were nearly stable.

AFTERNOON SESSION

Chairman PROXMIRE. The committee will come to order.

I might explain, Mr. Secretary, that we had a very late hearing this morning. It lasted until after 1 o'clock. The result is that the committee members are slow in coming back. We certainly welcome you to this committee and congratulate you as the Acting Secretary of Commerce—do I have the right title?

Mr. TROWBRIDGE. That is right, Mr. Chairman.

Chairman PROXMIRE. In any case, you have the authority of the office and all. You have a fine statement here. You may go right ahead, and we will be happy to hear you.

Mr. TROWBRIDGE. Thank you very much, Mr. Chairman. With your permission I will submit this statement for the record in its entirety, and in order to save time I would like to just go over some of the high points of the statement.

Chairman PROXMIRE. Very good. You might indicate the page you are on, to the extent that you skip, and so forth, so I can follow you.

Mr. TROWBRIDGE. Yes; I certainly will.

STATEMENT OF HON. ALEXANDER B. TROWBRIDGE, ACTING SECRETARY OF COMMERCE; ACCOMPANIED BY WILLIAM H. SHAW, ASSISTANT SECRETARY FOR ECONOMIC AFFAIRS; EDWARD K. SMITH, DEPUTY ASSISTANT SECRETARY FOR ECONOMIC POLICY; LOUIS J. PARADISO, ASSOCIATE DIRECTOR, OFFICE OF BUSINESS ECONOMICS; AND ROBERT L. McNEILL, DEPUTY ASSISTANT SECRETARY FOR TRADE POLICY, DEPARTMENT OF COMMERCE

Mr. Chairman, I am grateful to be given this opportunity to testify on the Economic Report of the President.

The great value of the Economic Reports and the hearings held upon them as they are transmitted to the Congress has been demonstrated over time. The work of the Council of Economic Advisers and the Joint Economic Committee has become more valuable with each passing year since the enactment of the Employment Act of 1946.

Business, labor, government, and the public at large have come more and more to recognize that we are not at the mercy of inexorable economic forces which propel us from boom to bust and back again. We have obtained an increasing control of economic forces, not by way of direct controls which we have avoided and must continue to avoid, but by use of general fiscal and monetary instruments, and more importantly by understanding how our economy works, where it is, and

where it is likely to go, in the light of the policy decisions we wish to make. We have learned to look ahead.

The increasing flexibility of our responses to changing events has been demonstrated. In the face of uncertainty, flexibility is necessary. The quicker we are able to adjust the less we need fear uncertainty. Today we are operating with an economy which has moved forward since 1961 to close the gap between actual and potential output. The gap was closed last year. Now we have to operate in an economic setting which will preserve balance while the economy grows at a more moderate pace. But balance in total demand and supply does not mean balance for every element within these grand aggregates. We have to watch each element and the balances in each sector carefully. But we should be thankful we are concerned with specific imbalances and not with problems of total imbalance, with all that the latter implies for spiraling inflation or deflation.

If we have to live in a world of uncertainty, it is better to have uncertainty at full employment than to have the harsh certainty of boom or bust.

We should welcome a situation in which business cycle prognosticators are kept in a continuous ferment. In the long run we hope to put them out of business anyway.

THE CURRENT STATUS OF THE ECONOMY AND RECENT SHIFTS

In my judgment, the President's Economic Report presents a cogent analysis of recent economic developments and a clear appraisal of the economic prospects and problems which we are likely to face in the year ahead.

Over the past year the economy has forged ahead at an exceptionally high rate. Real output recorded another sizable gain—5.5 percent. A major accomplishment was the reduction of unemployment to a rate of less than 4 percent, the first time since 1953 that such a low rate has been achieved. Civilian employment in 1966 increased by an average of 1.9 million with all major groups in the labor force benefiting in varying degrees. The purchasing power of our people, as measured by real disposable income per capita, advanced by 3.6 percent.

But our overall accomplishments were by no means uniform, either by industry or by groups of persons. The homebuilding industry, for example, suffered a severe setback and many groups in our society are still in an impoverished or otherwise underprivileged status. And we cannot forget the sacrifices being made by thousands of our men in the Armed Forces fighting the war in Vietnam.

Furthermore, the rapid expansion has resulted in some serious imbalances which must be corrected in the coming months in order to achieve a sustainable and healthier economic growth. In some sections of the economy, the combination of a relatively tight supply situation and rising costs brought on serious inflationary tendencies, thus interrupting the relative price stability that we had enjoyed in the preceding 6 years. Fortunately, in the latter part of 1966, some easing of the industry imbalances and price distortions was already evident.

Indeed, the fiscal measures taken in 1966 and the monetary restraints of the Federal Reserve Board became increasingly effective in the later months of the year. The economy cooled down to a more sustainable

rate of growth. As the attached table and chart 1 show, the growth in real GNP in the first quarter of 1966 was at an annual rate of 6 percent, and by the fourth quarter the pace of advance had slowed to a little over 4 percent. But despite the reduced pace, the unemployment rate was maintained at less than 4 percent.

The slowing of the economic tempo came in the private sector as the rate of business fixed investment slowed, consumers' durable demand slackened, and housing activity continued to decline. At the same time inventory accumulation proceeded at a high and nonsustainable rate, particularly in the fourth quarter of last year. This easing of the economic pace has had salutary effects by moderating rates of capacity operations and by lessening price pressures.

According to McGraw-Hill estimates, the rate of manufacturing capacity utilization in December 1965 was 89.5 percent. During 1966 manufacturing capacity was increased by 8 percent. Manufacturing output over the year rose more than 6.5 percent. As a result the rate of capacity utilization in December 1966 was down to 88 percent. This lessened the pressure on industry to increase capacity and is one of the factors accounting for the current and prospective slowdown in the immoderate pace of fixed investment outlays.

Furthermore, the slowing economic tempo contributed in part to some moderation of the pace of price movements. Wholesale prices for 1966 as a whole were 3.2 percent higher than in 1965. As the year progressed these price movements came to a virtual halt and, in the last 3 months of the year, actually declined 1 percent. Consumer prices were 2.9 percent higher in 1966 than in 1965; but food prices receded during the last few months of the year.

As 1966 drew to a close, there were still some problem areas. Housing activity continued at depressed levels. Inventory accumulation was at a disturbingly high rate. Cost pressures on prices were being felt in many sectors. Certain skilled and professional workers were still in short supply relative to demand.

Clearly, further progress can be made in 1967 in correcting existing imbalances. While we must recognize the problems and make further progress in correcting them, we must not let our concern with them obscure recognition of the major accomplishments of 1966. The important point is that both employment and personal income have continued to make steady and impressive gains. In December of last year, civilian employment was 75.2 million (seasonally adjusted) up 1.8 million from December 1965. The employment gain has more than kept pace with the increase in the civilian labor force.

The major sources of demand which pushed the economy upward in 1966 were nonresidential fixed investment which rose more than \$9.5 billion, and Federal Government purchases which rose more than \$10 billion.

As to the other sources of demand, the charts clearly show the mixed picture which prevailed in 1966. Consumer purchases of durable goods rose much less than in 1965, expenditures for residential structures dropped 23 percent from the first to the fourth quarter, and net exports fell sharply. On the other hand consumer purchases of nondurables and services rose 8.3 percent, and State and local government purchases increased by nearly \$7 billion.

This, then, is the general picture of the economy as it developed in 1966, and as it looks today. The expansion is moderating, and it is our task to see that this present less vigorous, but more sustainable pace, is maintained. At the same time we must see that those sectors which did not fare well last year participate more fully in the general progress of the economy, while those sectors of excessive demand which gave us problems last year continue to grow, but at a slower and healthier pace.

PROSPECTS AND PROBLEMS CONFRONTING US IN 1967

A prerequisite for intelligent planning by the Government as well as by business is a reasonably accurate forecast of economic activity. However, as we know, economic forecasting is still an art involving the use of a combination of sophisticated techniques and the experience and judgment of the forecaster.

The Economic Report forecasts for 1967 an overall growth rate of 4 percent in real GNP, a price rise of slightly more than 2.5 percent, and a rate of unemployment averaging about the same as in 1966 — a little below 4 percent. On the basis of the information we now have, these appear to be reasonable expectations.

A year ago, the Economic Report forecast for 1966 an advance in real output of 5 percent, but it turned out to be 5.5 percent. The degree of escalation in Vietnam and its impact on the private economy was not evident in January of last year, and the forecasting of war expenditures is inherently difficult. Partly as a result of the much larger rise in GNP which occurred in 1966, actual Government revenues were far above those estimated; at the same time, Government expenditures greatly exceeded the forecasts made a year ago.

There are some specific aspects of the report which are very important as we look ahead, and I would like to review them in greater detail.

Purchases of goods and services by the Federal Government have risen sharply over the past year, mostly due to the acceleration of spending for the Vietnam operation. Chart 2 shows the recent spurt in defense purchases compared with prior years when such purchases were rising. For calendar year 1966 as a whole, defense purchases amounted to \$60 billion—a rise of \$10 billion from 1965. The budget implies a further rise of about the same size in calendar year 1967. In the fourth quarter of 1966, the annual rate of defense purchases was \$65.5 billion, \$5.5 billion higher than the average for the year 1966.

We know that unfilled orders of companies producing defense products have risen sharply over the past year. These orders are currently equivalent to nearly 11 months of the rate of shipments, compared with a little over 10 months ago. Thus, it may be expected that defense purchases will continue fairly strong in the first half of this year with a slowing in the second half of the year. I believe that this pattern of defense spending is realistic, unless, of course, a significant change should occur in the Vietnam situation.

We should be aware, however, of the implications of any marked deceleration in the pace of defense purchases later this year. While it is true that defense production would continue at an exceptionally

high rate, a tapering off in the rate of advance in defense purchases could mean little or no further increases in job requirements of the defense-oriented industries. Providing an offset, in case such a development should occur, would be the moderately expanding Federal nondefense programs and expenditures, as now contemplated in the President's budget, such as higher social insurance benefits and enlarged grants-in-aid to State and local governments.

In addition, the President has instructed agency heads, under the leadership of the Chairman of the Council of Economic Advisers, to review priorities for programs and fiscal and monetary measures which will assure a flexible response to the opportunities peace will present, and assure continued growth and prosperity in our economy.

Chart 3 shows the recent upsurge in investment outlays. In the past 3 years alone these outlays have totaled \$210 billion. The exceptionally high rate of investment in 1966 was not sustainable and, as I noted earlier, a considerably slower pace of advance in investment is now proceeding.

As chart 4 indicates, the rate of manufacturing capacity utilization had begun to drop in the fourth quarter. But perhaps the major factor affecting investment decisions has been the suspension last year of the investment tax credit and the accelerated depreciation allowances. In view of recent business intentions, the council has estimated an increase of less than 4 percent in capital outlays in 1967. This is a rather small increase and implies a leveling off in such outlays. But if the effect of the tax credit suspension is substantial, the leveling could be relatively brief, since this proved incentive for investment is scheduled to be restored next January 1. If a weakness not presently foreseen should develop here, it would be possible, of course, to consider an earlier removal of the suspension.

One aspect of the 1966 developments which is of particular concern is the admittedly excessive overhang of inventory. As chart 5 clearly shows, inventories have fluctuated widely over the postwar period, but last year inventory additions were exceptionally large. While most industries geared their inventory needs to their current operations, the booming capital goods, industry and the defense products companies increased their inventories on the basis of their sharply rising backlogs of unfilled orders. In the fourth quarter of 1966, the annual rate of business inventory accumulation was \$14.5 billion, one of the largest quarterly increases of the postwar period. Some adjustment is in order, indeed, may have already started. Sharp repercussions on employment and income seem unlikely, however, since the smaller inventory requirements of the slower advancing capital goods and defense industries could be offset by increases in demand in other sectors such as consumer nondurables and services and housing. Nevertheless, the course of inventory investment must be watched closely.

I need not review the well-known troubles of the housing industry. But the picture is already beginning to brighten. With some easing in interest rates and a less restrictive monetary policy in recent months, the flow of funds into savings and loans associations is improving. The FNMA and the Federal home loan banks are providing further stimulus. In addition, the less vigorous demand for funds to finance capital goods should increase funds available to housing. Certainly,

there is no lack of demand for housing, particularly in view of the more rapid growth in new household formations which is expected this year. On balance, it seems more than reasonable to expect accelerating improvement in housing activity, particularly after midyear.

The demand for consumer durables, particularly automobiles, is being influenced by both economic and noneconomic factors. Last year's 9.0 million new car sales, the second best year, followed the record high sales of 9.3 million in 1965. While it is difficult to prove conclusively, it would appear that the auto sales of the past 2 years were somewhat high in relation to expectations based on consumer incomes, car prices, and other factors. An adjustment more in line with the economic factors is now taking place, and auto companies are gearing their production schedules accordingly.

Consumer expenditures for nondurable goods and services comprised over 78 percent of the disposable personal income in 1966. In the past, these expenditures have been closely geared to personal income after tax, as is shown in chart 6. Since there is little reason to believe that this close relationship will change in the coming year, they are expected to advance along with the anticipated gain in personal income.

The council has forecast that overall prices will rise more moderately than the 3-percent increase of last year. It is true that recently the inflationary forces have abated, as is shown in chart 7. But many basic labor contracts are to be negotiated this year. Labor is reluctant to negotiate on the basis of the long-term average productivity gain, especially in view of the sharply rising consumer prices experienced in the past year and a half. If wage settlements significantly exceed the long-term average productivity gain, profit margins of many industries will be squeezed, thus putting pressure on such industries to raise prices. Corporate profits have flattened out in the past 6 months and with some further tapering in the advance in sales—particularly in those industries which account for a large proportion of profits such as autos and capital goods—profits may be squeezed later.

There is also the question of the productivity gain which may be realized this year. The 1966 productivity increase in the private economy was 2.8 percent, slightly below the long-term trend of a little over 3 percent per year. The 1967 gain may be somewhat higher than the 2.8-percent gain of 1966 in view of the large capital outlays of the past 2 years, which will bring in a substantial amount of more efficient productive facilities this year.

Thus, the 1967 price picture is not at all clear. Nevertheless, the expectation of a more moderate rise than in 1966 seems warranted, particularly if, as it now appears, food prices advance more slowly than last year. Prices of consumer services are sure to continue strongly upward. But the extent of the overall price movement will depend to some extent on the degree to which the unions restrain their demands for wage increases and the extent to which businessmen try to hold the line on prices.

In summary the economic picture is mixed, more so this year than it has been for some time. But the economy may be expected to proceed in a more balanced and orderly fashion than it did last year. Inflationary pressures, we expect, will continue to abate. Easier money and lower interest rates, already being felt, should help to revitalize

housing. Consumer demand should be strong as incomes advance, and if social insurance payments are raised by the Congress, Government expenditures will increase, with State and local governments making a large contribution to the rise.

There remain a number of uncertainties notably in the areas of plant and equipment spending, inventory adjustments, and automobile purchases.

The President has wisely proposed that a 6-percent surcharge on personal and corporate incomes be made effective July 1. This will come at the proper time to steer the economy toward a more balanced and sustainable growth.

Given our present expectations, and assuming the policy changes to take place, this adds up to a rising pace of economic activity throughout the year ahead.

I am, on balance, cautiously optimistic in economic outlook. And I am optimistic also in the sense that I believe we have the tools to influence our economy in the direction of stability when instability threatens. This is the import of our mixed outlook and the package of responses to it, which have been admirably set forth in the President's Economic Report.

Let me now turn to some matters of importance to the Nation's economy, which are of particular interest to the Department of Commerce.

FOREIGN TRADE

U.S. foreign trade reached new record highs in 1966.

U.S. exports—excluding military grant aid—rose to \$29.4 billion. This was \$3 billion or 10 percent higher than the 1965 total—a rate of growth well above the 7-percent average achieved during 1961–65.

Imports, however, increased by nearly 20 percent to \$25.6 billion. The 1966 rise was double the average import growth rate in the preceding 5 years.

Thus, although exports showed great strength, the gross export surplus declined from its 1965 level by \$1.5 billion to \$3.8 billion.

A further expansion of U.S. trade is in prospect for 1967, with exports advancing almost as strongly as last year and imports rising at a considerable reduced rate. Unlike 1966 when our foreign purchases expanded at double the pace shown by our foreign sales, the growth rate for imports is expected to fall.

Exports of manufactured products are expected to continue at a brisk pace. Unfilled export orders for U.S. machinery point to a further rapid increase in shipments well into the first half. Continued technological progress will enable the United States to maintain its generally strong competitive position in several important fields. We may double the 1966 rate of increase in transport equipment exports.

There should be good gains in agricultural exports for the second year in a row. Last year's sharp rise, mainly in wheat and feed grains, will not, however, recur in 1967.

Imports are expected to increase much less strongly than last year in line with the more moderate pace of our economy. Imports of consumer goods should move up more slowly. Business purchases of foreign equipment are likely to be similarly affected by the much

more moderate increase in spending on new plant and equipment. And as high inventories are drawn down, purchases of foreign industrial supplies could slacken appreciably. Moreover, a repetition of the unusual 1966 growth in food imports is not anticipated.

COMMERCE PROGRAMS FOR TRADE EXPANSION

An important stimulus to further expansion of U.S. exports in 1967 will be stepped-up Government efforts in the export expansion field. Commerce will continue to improve its market research and other services to the U.S. foreign trade community and endeavor to bring new firms to new and existing world markets.

We will get more firms to use our oversea centers and match more new firms with established exporters in providing oversea distribution channels under our "piggyback" program. More foreign retailers will be encouraged to stage America Weeks programs.

COOPERATION BETWEEN BUSINESS AND GOVERNMENT ON TRADE EXPANSION

Cooperation with the business community is an essential ingredient of our program in the Department. It is reflected in continuing consultations with all parts of the business world—merchants, manufacturers, and bankers—small as well as large, and throughout the country.

The work of the National Export Expansion Council (NEEC) affords a good illustration. Composed of business executives in the field of international trade, the council serves in an advisory role in the promotion and expansion of U.S. exports. It also provides leadership and guidance to the 42 regional export expansion councils. Its work has assumed increasing importance in view of the pressures on our international balance of payments. It has contributed to new ideas and Government policies that help American business to become more competitive internationally.

Its recommendations on export financing led to improvements in the U.S. export credit and insurance facilities such as (a) a 15- to 25-percent reduction in certain Eximbank and FCIA fees and charges and liberalization of maturities of transactions eligible for Eximbank guarantees and FCIA insurance; (b) an expanded program of credit guarantees, including guarantees of long-term commercial bank loans to foreign buyers; (c) greater discretionary authority to provide guarantee coverage of export credits; and (d) a new Eximbank discount facility for export paper, with incentives for commercial banks to provide financing for U.S. exporters.

TRAVEL PROMOTION

Tourism is big business and tourism is growing. But our travel deficit increases. It rose about \$130 million in 1966, to over \$1.8 billion. Our gain in oversea visitors has averaged 18 percent since 1961, but we need to gain about 25 percent yearly to hold even in the oversea account. We need to reduce the travel deficit in order to help our balance of payments.

We hope to increase our efforts to attract tourists this year, especially business travel, as trade and travel go together and we have requested more funds to bolster the operation of the U.S. Travel Service. Countries such as Mexico and Greece invest more than \$5 to attract each foreign visitor. We spend 50 cents.

The President has stated in the Economic Report that "the most satisfactory way to arrest the increasing gap between American travel abroad and foreign travel here is not to limit the former but to stimulate and encourage the latter." The President intends to appoint a special task force drawn from industry and Government to advise on how best we can stimulate foreign travel to the United States. We will welcome this advice and the Department will promptly act on it.

VOLUNTARY PROGRAM

Secretary Fowler has already discussed balance-of-payments developments and the programs designed to deal with the problem of the U.S. deficit. I will not duplicate that discussion, but will comment briefly on the Department's role in carrying out the President's balance-of-payments program.

Secretary Connor made a most significant contribution in formulating policies in this area, and we owe him a great debt of gratitude for enlisting the cooperation of the business community in an effective joint effort. The wide extent of voluntary participation in that effort has been a fine tribute to his leadership.

Business leaders realize that they have an especially vital interest in maintaining the strength of the U.S. dollar and in forestalling resort to radical measures. They are willing to lend their help in a balance-of-payments effort that avoids controls on international trade and continues to foster the healthy development of the world economy. Their investments abroad have continued to increase.

We must rely on the industrial and commercial sector of the economy for the foreign earnings to cover the bulk of our costs of foreign operations, both public and private. While we have always emphasized that the Department of Commerce program applies to this entire sector, we have asked only a selected list of some 750 companies to report regularly on their balance-of-payments transactions.

In the first 2 years of the voluntary program, these companies were able to expand their annual average balance-of-payments contributions by about \$1.3 billion, largely through increased exports and repatriation of foreign earnings. In addition, they have made noteworthy efforts to contribute on capital account or limit the adverse effects of their own foreign investment programs. Their initial contributions in 1965 included repatriation of more than \$400 million in short-term assets held abroad. Subsequently, they made unparalleled arrangements to borrow abroad in order to finance the rapid expansion of capital expenditures by their foreign affiliates and thus limit U.S. capital outflows.

In the 2 years 1965 and 1966, long-term foreign borrowing by the U.S. companies and their foreign affiliates has averaged about \$1 billion more than in the preprogram year 1964. This borrowing, undertaken at high cost, made it possible for the companies to hold their direct investment transactions in developed countries below the levels we had suggested as targets for the 1966 program.

We have asked the companies to look carefully at investment proposals and to eliminate marginal projects, but we have not suggested the cancellation of projects vital to the competitive strength of U.S. business abroad. This year we have tightened our direct investment target somewhat, although in most cases the suggested level of outflows plus reinvested earnings in developed countries remains at or near the level occurring last year. The implication is that the growth in capital expenditures by foreign affiliates in developed countries should be financed abroad. This is not, in my mind, an unreasonable expectation. American businesses are adaptable. However, for individual companies it may require some sacrifices, especially if it should prove more difficult to raise needed funds in the European capital markets.

In view of the outlook for continued high levels of military expenditures abroad and a possible halt or even reversal of some of last year's capital inflows, there is a need for offsetting increases in contributions in other areas to proceed at an even more rapid rate in 1967. We hope that the reporting companies will be able to increase their overall net contributions on major selected transactions by \$2 billion this year compared to an annual average increase of \$1.3 billion in 1965 and 1966. The increase in contributions must come largely from expanding exports and increases in U.S. income from foreign investments. At the same time, these improvements on current account would be safeguarded from offsetting increases in capital outflows through the application of the direct investment target.

We are ever mindful of the fact that the voluntary program is by no means a permanent solution. It has helped to improve the balance of payments and had some favorable side effects, such as the accelerated development of the European capital market. But it was not designed as an element of a basic adjustment process. In current circumstances, however, faced with the special costs of the Vietnam situation, we found it reasonable to ask for an extension of the voluntary program. The American businessman has responded and will continue to respond to the interests of the Nation.

KENNEDY ROUND

The substantial reductions in trade restrictions sought by the United States in the Kennedy round should contribute importantly to expanded international trade. These negotiations which formally opened in 1963 must be concluded in the very near future as the President's authority to negotiate reductions in U.S. duties expires with the Trade Expansion Act on June 30, 1967.

Issues that are both thorny and difficult of settlement remain to be resolved in the Kennedy round.

In the industrial area we need a consensus between ourselves and our negotiating partners as to what can be accomplished in the important sectors of chemicals, steel, pulp and paper, aluminum, and textiles, as well as in the important machinery sector.

The field of agriculture has its uncertainties, too. The EEC is being asked for liberalized access for its imports of agricultural products. One hopeful area for agricultural progress is in the area of grains where discussions aimed at a multilateral agreement are progressing.

In addition, there are problems of achieving general reciprocity, since there is unevenness in the offers of the United States as compared with those of some of our major trading partners.

The answers basically lie with the EEC. The Ministers are to meet again early in February. It is our firm hope that they will agree to clear mandates for their representatives so that conclusions may be negotiated in the weeks to come. Time is short. If we see renewed flexibility and adaptability on all sides our hopes for the future of liberalized trade in the free world will be confirmed. The opportunity must not be lost.

TRADE PREFERENCES FOR DEVELOPING COUNTRIES

Regardless of the outcome of the Kennedy Round, the developing countries are very likely to press even more vigorously than before for international answers to their trade problems. The developing countries are urging the developed countries to adopt a one-way, generalized system of trade preferences by all industrialized countries applicable to importation of processed and manufactured goods from all developing countries.

The United States has expressed serious misgivings about such a system and has questioned whether the advantages would really outweigh the disadvantages. Nevertheless, the United States is willing to explore all alternatives respecting this issue and together with senior trade policy officials of the United Kingdom, France, and the Federal Republic of Germany is engaged in a study of trade problems between developed and developing countries.

The aim of this study, which is being sponsored by the Organization for Economic Cooperation and Development, is to formulate constructive and concerted policies for encouraging increased export earnings by the developing countries. Thus far, the group has concentrated its attention on the preference issue and has been examining ways of dealing with the practical problems which would inevitably arise if new preferences were to be extended to the developing countries. The results of these discussions will have an important bearing on the outcome of the United Nations Conference on Trade and Development to be held next year.

EAST-WEST TRADE

A third trade problem urgently requiring our attention is East-West trade.

Two-way trade between the free world and Eastern Europe, including the U.S.S.R., has increased substantially during recent years to about \$12.5 billion in 1965. Over half—\$7.7 billion—of this trade has

been with Western Europe and the United Kingdom. However, I am encouraged by our 1966 trade which I believe will exceed \$350 million—one of the highest levels attained in almost two decades. Under favorable circumstances, I can foresee substantial increases in our trade with Eastern Europe in goods and technology for peaceful uses.

Major increases in our trade will not be possible, however, until we remove the political and commercial obstacles involved in our continued denial of most-favored-nation tariff treatment of imports from most Eastern European countries. For its part, Eastern Europe must improve substantially its export products and its ability to market them in the United States.

The administration sought authority to extent most-favored-nation treatment as part of broad bilateral commercial agreements to be negotiated with these countries under the proposed East-West Trade Relations Act which Secretary Rusk submitted to the Congress last May. President Johnson has clearly indicated that he will seek similar authority from the present Congress. I fully support the need for such authority and believe the resulting commercial agreements would in many ways facilitate improved commercial relations with these countries and lead to worthwhile increases in peaceful trade.

Mr. Chairman, this completes my statement. Let me thank the committee again for the opportunity to appear before you.

Thank you.

((The tables and charts referred to follow:))

TABLE 1.—A 3-year performance of selected major economic measures

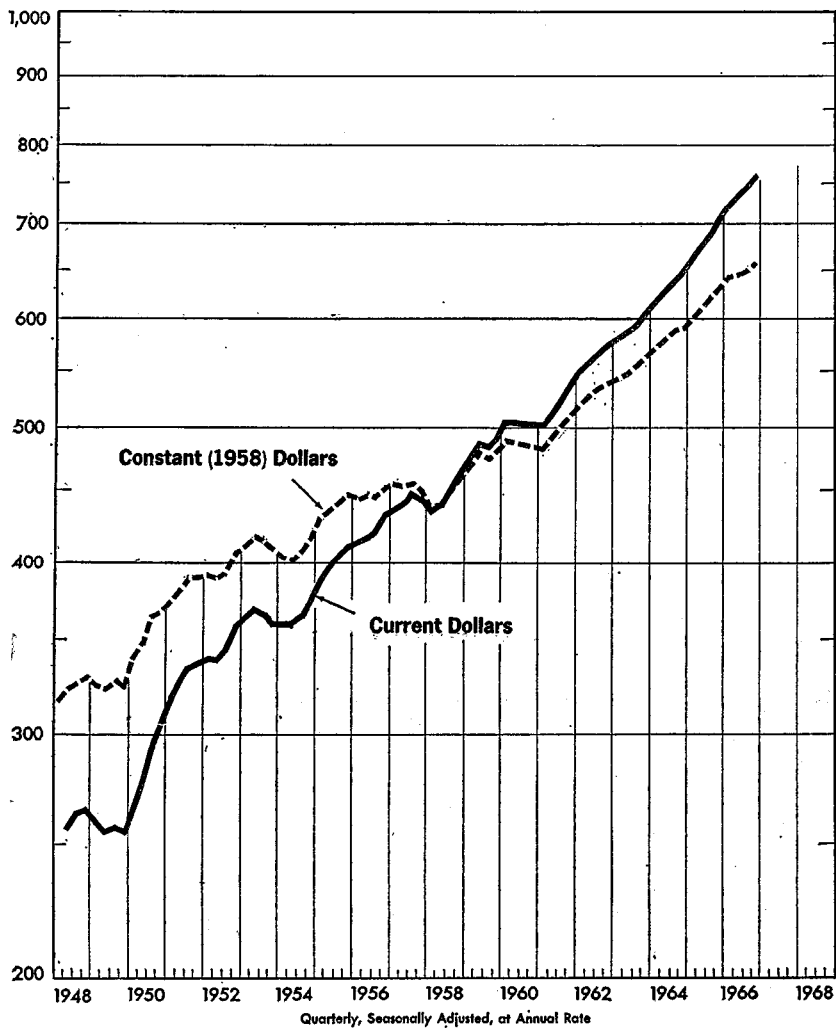
	Quarterly changes ¹ in—					
	Real GNP	Real disposable income	Civilian employment	Wholesale price	Consumer price	Rate of unemployment
	Percent	Percent	Millions	Percent	Percent	Percent
1964:						
1st quarter.....	5.6	8.0	2.2	-0.4	1.2	5.5
2d quarter.....	6.0	10.0	1.7	-2.0	.8	5.3
3d quarter.....	4.8	5.2	1.0	1.6	1.6	5.1
4th quarter.....	1.6	3.2	2.0	.8	1.6	5.0
1965:						
1st quarter.....	8.8	4.8	1.8	2.0	.8	4.8
2d quarter.....	4.8	4.8	2.4	4.0	2.8	4.7
3d quarter.....	6.8	12.4	.8	2.8	1.6	4.5
4th quarter.....	8.4	6.4	4.6	2.8	2.0	4.2
1966:						
1st quarter.....	6.0	4.0	0	5.6	2.8	3.8
2d quarter.....	2.0	-4	2.2	2.0	4.4	3.9
3d quarter.....	4.0	4.0	.7	4.0	3.6	3.9
4th quarter.....	4.4	4.4	4.2	-2.8	3.2	3.8

¹ Quarterly changes at annual rates; based on seasonally adjusted data.

Source: U.S. Department of Commerce and U.S. Department of Labor.

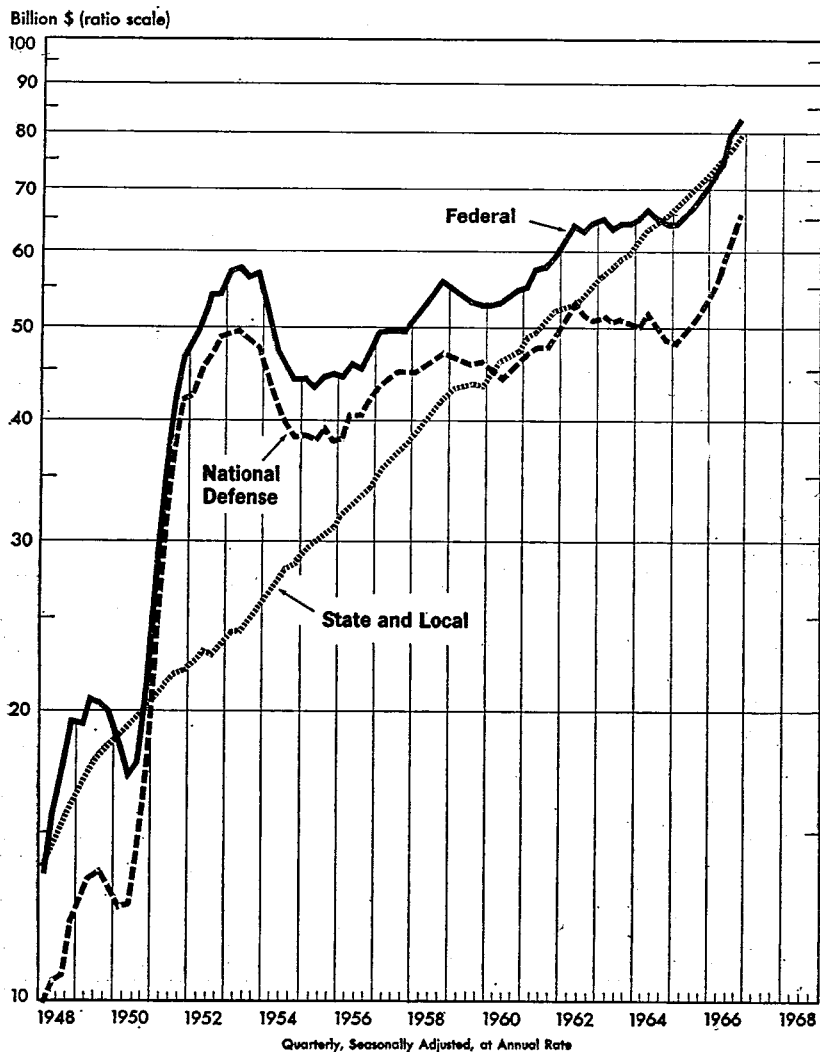
CHART 1.—GROSS NATIONAL PRODUCT

Billion \$ (ratio scale)



U.S. Department of Commerce, Office of Business Economics

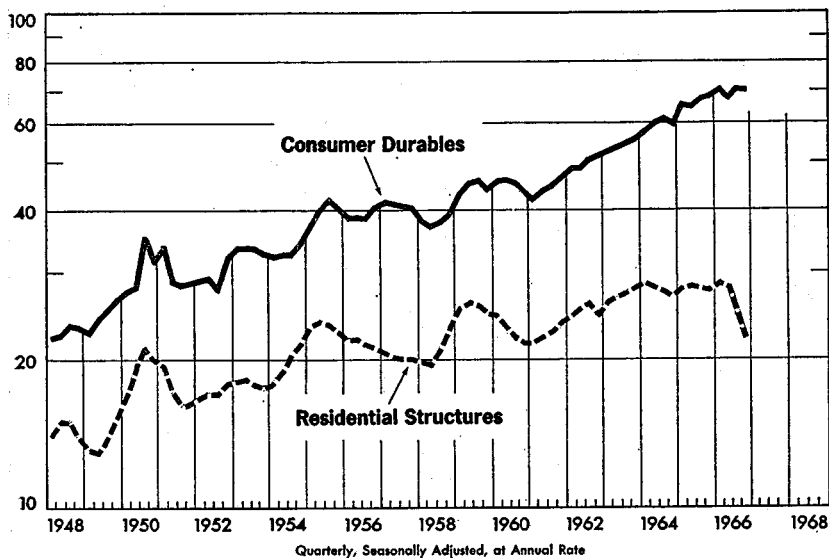
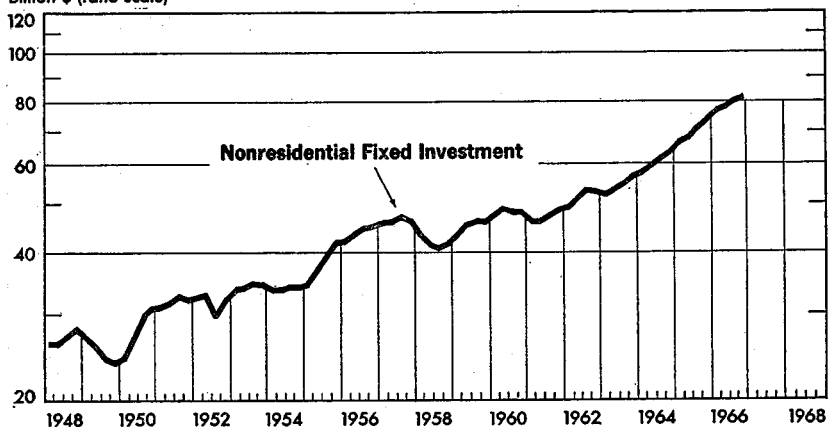
CHART 2.—GOVERNMENT PURCHASES OF GOODS AND SERVICES



U.S. Department of Commerce, Office of Business Economics

CHART 3.—DYNAMIC SOURCES OF PRIVATE DEMAND

Billion \$ (ratio scale)



Quarterly, Seasonally Adjusted, at Annual Rate

CHART 4 MEASURES OF UTILIZATION

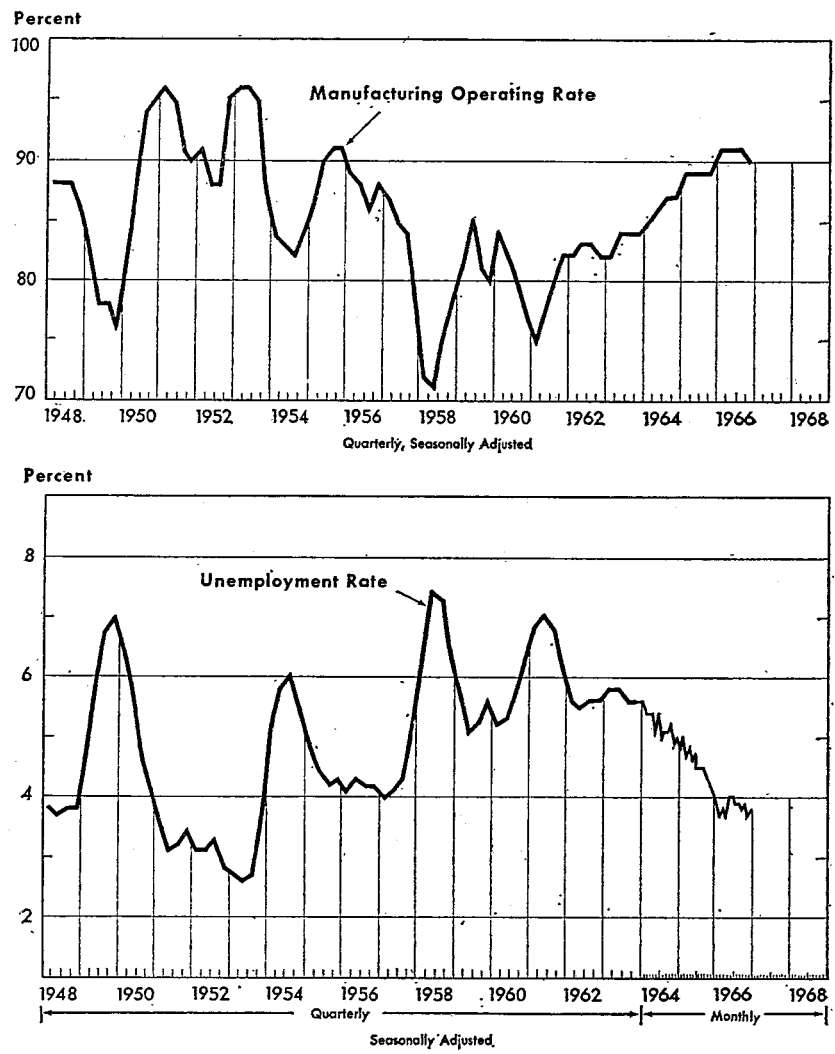
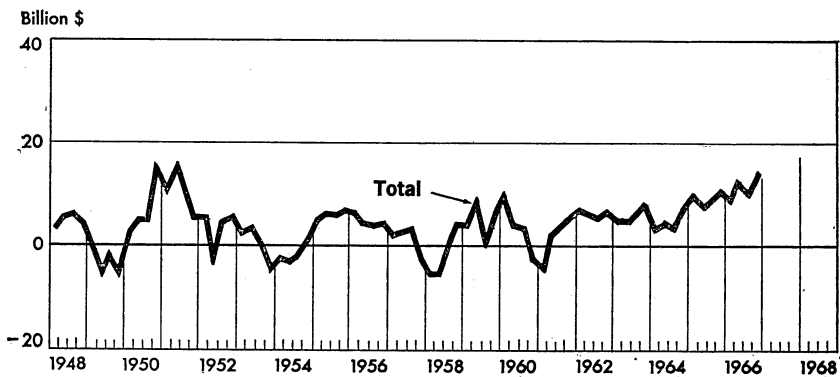
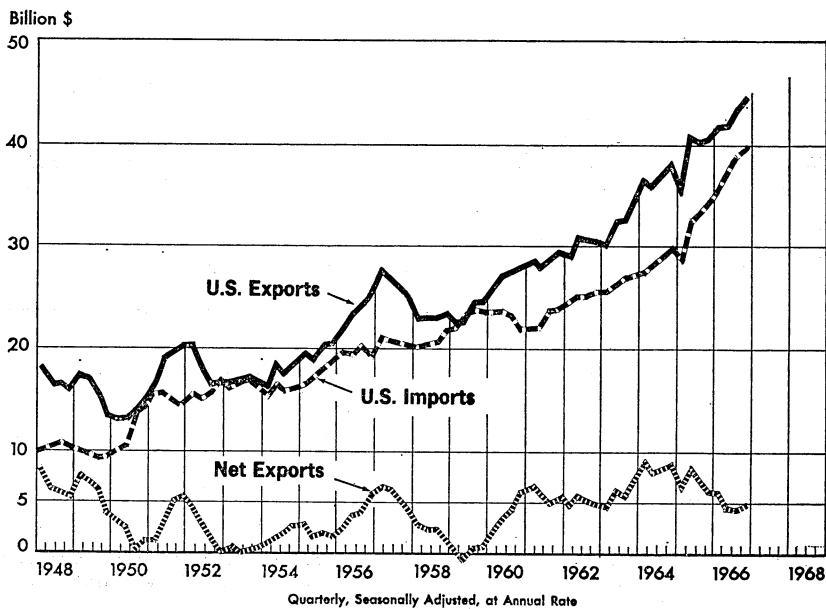


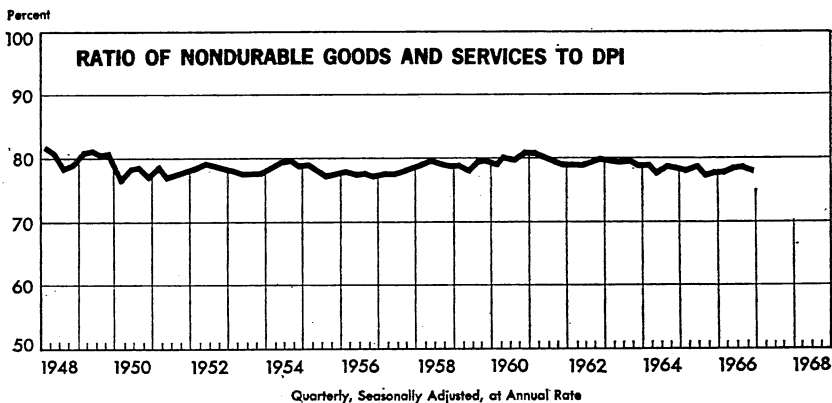
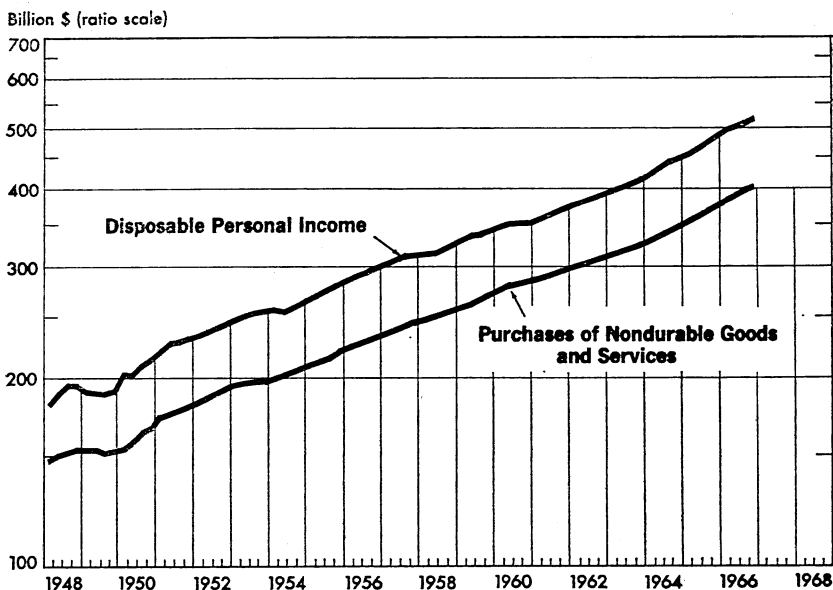
CHART 5.—CHANGE IN BUSINESS INVENTORIES



NET EXPORTS OF GOODS AND SERVICES



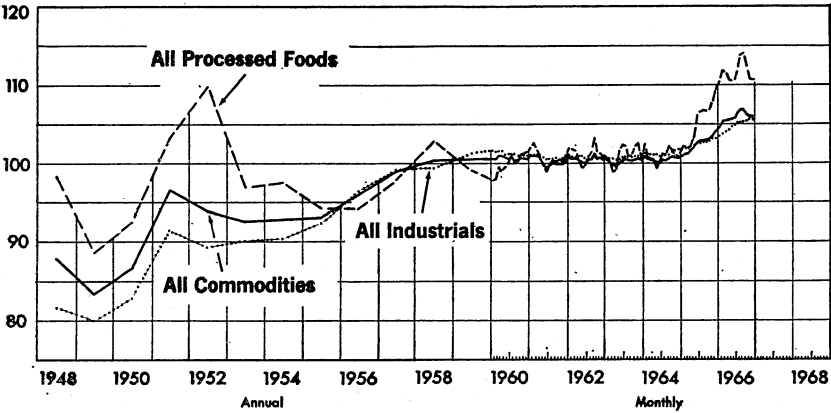
U.S. Department of Commerce, Office of Business Economics

**CHART 6.—CONSUMER SPENDING ON NONDURABLES
AND SERVICES MOVES WITH INCOME**

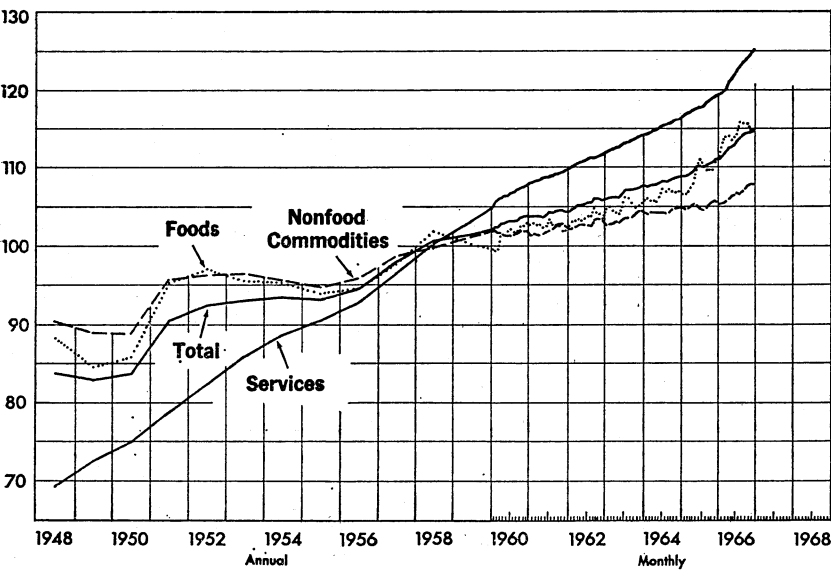
U.S. Department of Commerce, Office of Business Economics

CHART 7.—PRICES IN WHOLESALE AND RETAIL MARKETS

Index, 1957-59=100



Index, 1957-59=100



Chairman PROXMIRE. Thank you very much, Secretary Trowbridge, for a very comprehensive and encouraging statement.

You have referred, in your statement, to the Council's Report, and to their estimate of the overall growth rate of 4 percent in real gross national product.

It has seemed to me that this 4 percent is pessimistic, when you recognize that the Department of Labor "Projections 1970" suggested that a 4.2 or 4.3 percent growth rate would be necessary between 1965 and 1970 to sustain even the present level of employment, and that if we have only 4 percent growth rate that we might suffer increased unemployment.

Now this is particularly true not only of the employment situation but of the plant capacity ratio.

You say that we operated in December of last year at 89.5 percent, and we are now down to 88 percent.

In view of the immense increase in the productivity of our plant facilities, it seems here again we are underutilizing our resources by setting too low a mark. What is your comment?

Mr. TROWBRIDGE. Mr. Chairman, I think the 4 percent projection, which is the growth in real GNP, is a fair one for this coming year. It seems to me that last year, in looking at what was the growth of 5.5 percent, I believe, in real GNP—closer to 8.5 including price rises—we were really operating at a rate of growth which I would prefer not to see on a constant basis, because it was basically pretty overheated.

I think we had in 1966 a substantial increase in the total GNP growth up to a level of \$740 billion which I believe was the final figure. Projections for this year, with some moderation in the economy makes sense to look at the 4-percent figure as a real one.

We, yesterday, came out with the unemployment figures for January. They remain at about the 3.7 level. This may continue; it may inch up. But the projections, as the Council looks at it, in an economy where the first half of the year probably will be one of a certainly lesser growth rate, perhaps being spurred on in the second half of the year by increased consumer demand. I think the projection is at this point a realistic one: that we can maintain 4 percent real growth and keep unemployment in the 4 percent or below area.

Senator PROXMIRE. I realize that this is realistic in the sense that it is easier to achieve than a more rapid growth rate, but since the Labor Department's projections, which were widely hailed as being competent, and this is an expert Department of Government estimates we need a 4.2 or 4.3 percent or better, if we are going to maintain the present level of unemployment, and since we have had lower unemployment, in 1952-53 unemployment hovered between 3.1 and 2.9 percent, with much lesser increase in the price level, 2 percent in 1952 I guess, about 0.7 of 1 percent in 1953, and it actually went down the following year.

I just think that we are being too pessimistic about what our economy can do, in view of that record, and the fact that we have expanded so rapidly, and what should result as you imply in your statement as a greater productivity because of the additions of new plant and equipment.

So I would hope that we would reconsider this, particularly since business, which the Department of Commerce to some extent repre-

sents, has been so progressive and so vigorous in making the kind of progress that it has made.

Mr. TROWBRIDGE. It certainly has. The business investment, the whole productivity of last year was going along at a tremendous rate. I know I dealt in more specific terms with a number of the problems that were created by some of our fast paced movements.

Chairman PROXMIRE. It creates problems, but it also opens up opportunities.

Mr. TROWBRIDGE. It does, of course.

Chairman PROXMIRE. The full utilization of our resources with stable prices is our objective.

Mr. TROWBRIDGE. That is right.

Chairman PROXMIRE. So the kind of investment in plant and equipment and new automated equipment and so forth is certainly in our interest, which calls my attention to the second point I wanted to raise. You talk about the incentive for investment, and say that will be restored January 1.

You don't seem to adjust your estimates in the latter half of the year for the fact that you have this big gap. September, October, November, December, with an anticipation that if they wait until January 1 for their investment in plant and equipment, they can get both accelerated depreciation and the restoration of the 7-percent investment credit.

This is likely to create a vacuum in the judgment of the experts in the machine tool industry. Why should anybody buy \$100 million worth of equipment which some of these big firms do, in October of 1966, if they can wait 3 months and get a \$7 million increase in their net profit by waiting that long. There doesn't seem to be any adjustment and any expectation that this is going to have much impact on the economy in the latter half of the year, and it seems to me it is.

You do say in the course of your statement that if the situation changes, you might request an earlier restoration of the investment credit. But you seem to make the assumption throughout that it is going to be restored on January 1, and there is no problem involved. Am I unfair?

Mr. TROWBRIDGE. Well, of course the current suspension, as approved by the Congress, if allowed to run its full course would carry the suspension through until January 1.

I have talked with a number of people in the machine tool industry, and they certainly reported to me as you have, that they are particularly concerned by holdup of potential orders that might come before the reinstitution of the 7-percent credit. But I have the feeling that there are lots of other factors that go into a business capital investment.

Chairman PROXMIRE. I am sure there are. Let me just interrupt to say that I understand there has already been some reduction attributable to the investment credit according to the McGraw-Hill study.

Mr. TROWBRIDGE. Yes.

Chairman PROXMIRE. But you would anticipate that that would be a lot less now than it is going to be later on?

Mr. TROWBRIDGE. Well, we have done some surveys on this, cooperating with the Securities and Exchange Commission, and our estimates of the impact so far that are reported by the business community as

a result of the 7 percent investment credit suspension, is that the total amount of deferred new capital investment is somewhere a little above \$2 billion, perhaps \$2.3 billion.

Chairman PROXMIRE. And you anticipate that that would be considerably greater if it is allowed to work its course, just because of the obvious commonsense of the businessman who says "Why should I kiss off 7 percent net profit when I can wait a little while?" And the wait is a lot shorter.

Now I can see why any prudent businessman would say, "We have made our investment plans. It is either good or it is not. This marginal difference isn't very great."

Mr. TROWBRIDGE. That is right.

Chairman PROXMIRE. The marginal difference would be enormous in terms of interest in the last 3 or 4 months of this period.

Mr. TROWBRIDGE. Correct. Well, that could well happen. I think the happy thing is that we have a flexibility built in here. If we see a real need to reinstitute, I think the administration would come up and ask to do so.

Chairman PROXMIRE. The trouble with that flexibility, it takes an act of Congress. Sometimes those acts seem easy and sometimes they are, and sometimes they are not.

Mr. TROWBRIDGE. That is right.

Chairman PROXMIRE. You can get a pretty stubborn Congress. You might get a political situation where we have imposed a surtax on individuals of 6 percent, to take something off a business, that makes it harder.

How about considering the possibility of restoring this on a 1 percent a month basis? If you do this, you see, you don't have the gap. You eliminate it.

You still have a retarding effect. You move into the January 1 situation on a gradual basis. Why wouldn't that be acceptable from the standpoint of keeping the slowdown in effect but easing it off so that you don't have the punch at the end?

Mr. TROWBRIDGE. It is a little hard to look down the pike that far in advance, and have a completely crystal clear crystal ball. But it seems to me that the administration should and would be willing to look at the alternatives necessary, under conditions where perhaps an easing into that situation would be very helpful.

Chairman PROXMIRE. You see, the thrust of my question is this. You anticipate, as I understand it, an increase in investment in plant and equipment, whether it would be 5 or 6 percent as compared to the 15 to 17 percent we have had in the last 3 years.

This is a big slowdown, and it is a slowdown not only from the standpoint of stimulating the economy, but it is a slowdown also in our potentiality of being able to produce more and being able to keep prices down. So I am very concerned with this aspect of the administration policy, because it would seem to me that this is a good notion of having an investment credit, we should certainly have it in effect at a time when business seems to be slowing down and there is every indication that it is slowing down considerably now.

Mr. TROWBRIDGE. Well, it seems to me, Mr. Chairman, it is important to remember that we are slowing down from an extremely high plateau.

Chairman PROXMIRE. Oh, yes, that is true. I think that is a good qualification.

Mr. TROWBRIDGE. I think when we get into this relativity area, we have to remember—

Chairman PROXMIRE. We still have 3 million people out of work. We are still operating below the optimum capacity for business; we are operating at 88 percent. What is the optimum capacity, about 91?

Mr. TROWBRIDGE. Economists generally say in the range of 90 to 91. This is the point where you are really bumping the ceiling.

Chairman PROXMIRE. We are below that.

Mr. TROWBRIDGE. We still are, however, with an unemployment rate of 3.7 percent as of January. There is bound to be some fluctuation in that as we move along. But I think that when I use the words "cautiously optimistic" here, I mean it.

This recognition of the high level of activity and the health of our economy is something we have to remind ourselves of pretty strongly. We are going to have some leveling off, and indeed I think we can stand some moderation, because it was pretty highly geared in the last portion of last year. Inventory accumulation was particularly strong. But it seems to me we are heading into a year where continued economic activity at a high rate is going to be seen.

Chairman PROXMIRE. My time is up. I will be back with some more questions.

Mrs. Griffiths?

Representative GRIFFITHS. I would like to ask you about the investment credit myself. Did you actually have two-tenths or three-tenths of a million orders that were not placed? Are the toolmakers still in business, still turning out tools?

Mr. TROWBRIDGE. The toolmakers are very much in business, Mrs. Griffiths. If I am not mistaken, recent press reports have indicated a slight reduction in the size of back orders, of unfilled orders. I think it was down from—don't hold me to this exactly—I recall 11 months, and down to 10. And this survey, which has been held, is not indicative fully, doesn't tell us exactly, where the decisions were deferred. I would like to ask Assistant Secretary Shaw, if I might, to comment on this point. He has a little closer knowledge of it.

Representative GRIFFITHS. I would like to hear him.

Mr. SHAW. Mrs. Griffiths, may I make two comments. First, in connection with this survey of business spending on plants, this figure of between \$2 and \$2.5 billion is an estimate made by the companies that do the capital spending. It represents the amount by which these companies stated they will reduce capital spending in 1967, as a result of the suspension of the tax credit.

My second point has to do with this problem of orders, and, if I might, I would like to read a few figures on new orders in the machinery and equipment industries. In December 1965 these new orders were approximately \$4.5 billion. Beginning with October 1966, and using figures on a seasonally adjusted basis, \$4.8 billion in October 1966, \$4.6 billion in November 1966, \$4.6 billion in December 1966.

In these figures there is as yet very little evidence that new orders have dropped off sharply—

Mr. TROWBRIDGE. In the machinery and equipment industries.

Representative GRIFFITHS. I would say that the work within those plants has dropped off even less. I was asked just the other day to

get 15 skilled workmen immediately for a Detroit plant. Now, I haven't been asked that before. So that I am sure that the toolmakers are still in business.

During the time that we discussed this on Ways and Means, I asked repeatedly what would be the effect of taking our goods in place and putting it back on orders, what the effect would be. That some of the largest concerns you would find on the first day of January 1968 would be able to buy fully equipped tools, and finally some manufacturer came in and said yes, he thought they would be.

You would have to place this in writing, to be able to walk in and buy it. But it would be made exactly to your plan.

In my opinion the suspension of investment credit really didn't do very much. The way it should have been suspended was to simply have repeal of the act, and when it was reinstituted it should have been based on orders, not on equipment in place.

Mr. TROWBRIDGE. I certainly can say my experience of the tightness of the skilled labor market in the machine tool industry—perhaps with your people, it is not as direct—that in the Department we have worked as closely as we could in trying to identify those areas where tightness in either raw materials or skilled labor was evident, and working with the industry and with the Department of Labor in manpower development work, it was very, very clear that the machine tool industry is one of the tightest; there is no question.

Representative GRIFFITHS. The staff would like to know now that the economy nears its potential, it seems essential to concentrate increasing attention on structural improvements. How are the area development programs of the Department of Commerce meeting this challenge?

Mr. TROWBRIDGE. The Economic Development Administration programs, which as you know have taken on the role once held by ARA, the Area Redevelopment Administration, are I think in good hands. They are working and are making good progress. There has been no question that in the period of adjustment, transition between the two administrations, that we have had to take care of and process a backlog of various projects that were under consideration.

A number of them did not get approved. A number of them couldn't be approved, because you can't fill all of the requests with the money available, and these resources were limited.

We have had about 565 areas, roughly 10 percent of the country's population, suffering from severe unemployment, and these areas will qualify for assistance in fiscal year 1968. The projection is that over 150,000 new jobs would have to be created simply to raise these areas to a minimal level of prosperity, and an additional 150,000 new jobs would be needed to match economic conditions in the rest of the country.

I think this gives an idea of the magnitude of the attempt. We have now established these regional economic development commissions. The chairmen of these commissions have been appointed, and they are in business. We look forward to a year in which we not only learn a lot but do a lot in the whole economic development area.

Representative GRIFFITHS. When you have identified these areas, what effort did you make to move the people out of the area or place some jobs in, or does this go to Secretary Wirtz only?

Mr. TROWBRIDGE. The movement of people?

Representative GRIFFITHS. Out of the area to where they—

Mr. TROWBRIDGE. I think the purpose really of the whole idea is to provide jobs in an area rather than move people out.

Representative GRIFFITHS. We have another program where we bring them out. That is over in the Labor Department.

Mr. TROWBRIDGE. I think it is.

Representative GRIFFITHS. If you identify the areas where there is high unemployment, maybe we can get the Secretary of Labor to move some of them out and make your job less. What have been the effects of the high interest rates on small business formations and failures, and what is the small business failure, bankruptcy rate now?

Mr. TROWBRIDGE. Mrs. Griffiths, I don't have those numbers. I would be very happy to supply them for the record.

Representative GRIFFITHS. Please do.

Mr. TROWBRIDGE. I know what one reads and what one hears, that the high interest rates have been particularly difficult for many people in the business community, housing being a prime example. But in all honesty, I don't know offhand what the rate of business failure is most recently. I can find out and will be glad to submit it to you.

(Tables below were subsequently supplied by Secretary Trowbridge:)

Interest rates and business failures, 1965-66

Year	Bank rates on short-term business loans in month preceding ¹	Number of business failures per 10,000 concerns ²	Index of net business formation (1957-59=100)
1965:			
1st quarter	5.00	53.1	106.4
2d quarter	4.97	51.7	105.4
3d quarter	4.99	56.5	106.1
4th quarter	5.00	52.4	106.2
1966:			
1st quarter	5.27	48.3	109.4
2d quarter	5.55	47.5	106.9
3d quarter	5.82	56.6	103.8
4th quarter	6.30	55.1	* 102.0

¹ Average for 19 cities.

² Seasonally adjusted annual rate.

* October-November average.

NOTE.—Statistics of business formation and failures by size of business are not available. It is known, however, that the vast majority are small businesses.

Source: U.S. Department of Commerce, Survey of Current Business and Business Cycle Developments,

Bank credit to manufacturing corporations, by size of company—Percent changes in total outstandings

	September 1964 to September 1965	September 1965 to September 1966	June 1966 to September 1966
Short term:			
All companies.....	25.7	40.5	7.7
Smallest size class (assets under \$1,000,000).....	5.4	18.8	11.9
Due in more than 1 year:			
All companies.....	35.5	30.9	.3
Smallest size class.....	3.1	25.2	3.3

NOTE.—It appears that small manufacturers expanded their bank borrowings relatively more than large manufacturers during the period when credit was tightest. A possible explanation: small banks, which lend mainly to the smaller businesses, commonly keep their reserves well above the required minima, and their lending power was therefore not so much affected by the pressure on reserves in the latter half of 1966.

Source: U.S. Federal Trade Commission and Securities Exchange Commission, quarterly financial report.

Representative GRIFFITHS. If the East-West trade bill passed, what would be your anticipation about our share of the market?

Mr. TROWBRIDGE. I don't believe that the mere passage of the East-West trade bill and the implementation of commercial agreements through it, is going to have a tremendous effect on the total level of trade between the United States and the Eastern European Communist countries right away.

I think it will, first, provide the framework in which this trade can expand over a period of time, by in effect doing away with what is a differential in discriminatory trade treatment.

Secondly, I think it will show our business community that the Government does believe that the opening up of peaceful trade with this area of the world is in our national interest, and that they will then go out and develop some parts of this market.

There is a growing awareness, I think, in the American business community not only of the value from the national point of view of developing these peaceful contacts, but also that there is a sizable market in the Eastern European area at the moment being filled by the Japanese, by the West Germans, and by the Italians, by the French, by the United Kingdom.

Our businessmen surely, as good competitors, would like to be in that market and would go forward perhaps with more confidence if the bill were passed, and if we proceeded to implement these agreements.

I think we have to recognize that the pattern of trade which the Soviet Union and other Eastern European countries generally follow is one of bilateral balancing. They try to export as much as they import from a given country, whereas we tend to try to triangulate our trade.

The ability of the Soviet Union and the Communist countries to export to this country and to market in our competitive market economy is going to be crucial to the growth of their exports, and hence the level of our exports to them.

I think it would be good, frankly, to have some of our marketing methods and our competitive world known to the economy of the Soviet Union and to the Eastern countries. I think it would be very salutary to put them in the midst of it and see how they make out.

Representative GRIFFITHS. Personally I think it is a shame driving around on Italian made tires, but I was told in England that 10 years later they have not made a single improvement, so you can sell them these improvements.

Chairman PROXMIRE. Congressman Rumsfeld?

Representative RUMSFELD. I have three or four questions. The President has made a proposal concerning the merger of the Department of Labor and the Department of Commerce. I might say parenthetically that I approach this in a very favorable frame of mind. As a member of the Government Operations Committee, which will review this reorganization plan, it strikes me that it might very well have a great deal of merit.

I would be interested to know, however, what your reaction might be to the counterproposal concerning the possibility of isolating out essentially economic functions and programs from a number of different agencies, and combining them into a Department of Economic Affairs. The problem comes up as to what the structure of the executive departments should be, and how we can best meet the problems of the country, and I am sure this was debated to some extent. Do you think this has merit, this counterproposal?

Mr. TROWBRIDGE. Well, actually, Congressman Rumsfeld, I think the basic proposal of the President, and as we are trying now to put some real meat on the bones, is that it makes a lot of sense. We are working hard on it right now. We hope to have the details of it available to discuss with you and other Members of the Congress in a short time.

The approach we are taking in implementing the President's proposal is not to build a holding company or a merged Commerce and Labor just the two Departments put together in some form.

We are approaching it really from the basis of what can we do to modernize, to pull together, to coordinate more effectively, to build a new Department in Government using Commerce and Labor Departments as they now exist as the base of it. But we have taken an inventory of other parts of the Government, other agencies, and other functions which they now carry out, and which would logically fit together with Commerce and Labor.

Representative RUMSFELD. Do you anticipate that some economic functions of other departments would be included in the proposed new Department?

Mr. TROWBRIDGE. I think so, yes. Our proposal is to try to pull together the logically related functions of Government in the economic development, manpower development, and economic analysis areas, and first of all we have to apply the criteria of logical fit. Can we put these things together and do they have a relation to each other?

Second, realistically can we propose this and get it approved. These are the tests we are trying to apply right now.

Representative RUMSFELD. I like to think if it is realistic it could be approved.

Mr. TROWBRIDGE. Yes, but everybody's definition of realism always isn't the same.

Representative RUMSFELD. Right. This same question of course came up when there was talk of creating a Department of Science and Technology, and I personally felt that would have been inadvisable;

that these problems do touch all aspects of Government, and that it would be far preferable to do what was done, to create an Office of Science and Technology in the Executive Office of the President to coordinate these types of functions in the existing agencies. I can see the merit in what the administration has proposed; namely, to merge these two Departments, to try and bring the functions that are easily brought in, but not to strip all economic function from the other departments necessarily.

Mr. TROWBRIDGE. Well, we hope to be able, as I say, to build on the basic building blocks of the two existing departments, and add to them in such a way as to get a very imaginative proposal, and one that is going to be one of consolidation of functions, and make the President's job a little bit easier in that he has got an awful lot of people reporting directly to him, and lots of conflicting voices that he has got to listen to. I think it would be better to have them under a roof where you can pull them together from the national viewpoint.

Representative RUMSFELD. Britain, of course, is making a strong bid to enter the Common Market. I get the feeling that they aren't terribly optimistic about entering within the immediate period, but that they are quite optimistic about the possibility of entering some time by 1970 or thereabouts, or somewhat before.

Let's assume that Britain does get in. What would be the short-run effect in 1 to 2 years on the United States, and the longer run effect, specifically say beyond 2 to 4 years?

Mr. TROWBRIDGE. Well, I think the short-run effect has to be measured really on the basis of how the Kennedy Round comes out, because if the United Kingdom joins with the Common Market she would presumably go through with the obligations of the Kennedy Round. The external tariff common to all countries would hopefully have been reduced by the Kennedy Round, and that our trade, or the trade barriers between us and them would be substantially reduced.

I think really we have approached this whole concept of a regional common market recognizing that there are going to be some additional tariff barriers and hurdles that our trade will have to overcome.

Representative RUMSFELD. What particular segments will be the hardest hit?

Mr. TROWBRIDGE. By the creation of the Common Market?

Representative RUMSFELD. By Britain's entry? What segments of our society would feel the greatest impact from this, on U.S. exports?

Mr. TROWBRIDGE. I find that a little hard to answer right offhand, Congressman. Could I ask my friend Mr. Robert McNeill to counsel me on that one or to make a comment?

Mr. McNEILL. I was afraid, sir, he was going to do that. We honestly don't know what the answer to your question is.

In terms of U.S. exports, it is likely that in a short run there would be certainly no major adverse impact that would be discernible to us. In the long run, in terms of U.S. exports, we think it perhaps would be beneficial for Britain to enter the Common Market with all that that would mean for expansion of that market, the generation of increased income, and therefore provide a larger magnet for imports from this and other countries.

Representative RUMSFELD. You don't see any harmful effects to the United States short run or long term from this possibility of Great Britain entering into the Common Market?

Mr. McNEILL. You are talking strictly about exports?

Representative RUMSFELD. Yes.

Mr. McNEILL. We looked at this quite carefully back in 1961-62, when Britain was negotiating access into the Common Market, and at that time were not able to come up with any judgments that we would be severely affected in terms of the drop in our exports to the United Kingdom.

Representative RUMSFELD. Turning to the other possibility, let's assume that the reasons why some countries are not very eager to have Great Britain in the Common Market aren't economic but are political, and they can't be worked out, and Britain doesn't go in. What is your Department's attitude on the possibility of creating a free trade area composed of some of the more developed countries, not just in the Atlantic area but possibly also Japan and others?

Mr. TROWBRIDGE. Are you suggesting a regional across-the-Atlantic free trade area kind of relationship?

Representative RUMSFELD. That is one possibility. However, ignoring Japan would be difficult, so, as I say, not just in the Atlantic but beyond.

Mr. TROWBRIDGE. Well, our approach to this, I think, historically has been the hope that multilateral tariff negotiations, such as the Kennedy Round, are going to be a lot more advantageous than the proliferation of regional trading blocks and preferential treatment between them. Mr. McNeill may want to add something to that?

Mr. McNEILL. If I may, Congressman, digress a little bit on the foreign policy objective of the United States in Europe, which basically is to bring together, as I understand the policy, the French and the German people, in a situation such as now exists of peace. Our postwar policy has been aimed toward that end.

Representative RUMSFELD. I wasn't asking you a foreign policy question.

Mr. McNEILL. I understand. I want to start there and then go to the answer.

Representative RUMSFELD. My question is as to the economic impact.

Mr. McNEILL. You would be negotiating for a free trade area, essentially, I suppose, for an economic purpose, which is what you have in mind. But the political implications of that would be quite serious, because it would involve turning somewhat away from Europe toward something else as the heart of Atlantic policy. By Europe I mean Common Market Europe, and that, I think, would be a very serious step that would have to be considered by the administration in any consideration of a free trade proposal.

Representative RUMSFELD. I am sure it would be. My time is up. I would like to ask one last question if I may?

Chairman PROXMIRE. You have unanimous consent. Go ahead, sir.

Representative RUMSFELD. This concerns the proposals that have been made recently to study the effect of the possible transition to the metric system. It is my recollection that the proposals didn't pass the Congress in the last session. Is the Department planning to pursue that this year? Will there be a message on that subject or a recommendation from the Department, do you know offhand?

Mr. TROWBRIDGE. Congressman, I am searching my memory as to where that does stand. I know that we were very active on that question in the last session.

You are correct in that it did not get approved here. I believe that we continued to support the idea of such a study. Whether or not there are plans to reintroduce the idea, the proposal in this session, I am frankly not aware, but I will be glad to comment on that subsequently.

Representative RUMSFELD. I think that very likely this ties into this question of trade.

Mr. TROWBRIDGE. Yes, it does.

Representative RUMSFELD. I think it has a bearing on it, and I am further of the opinion that the fact that Congress has not specifically requested such a study should be no inhibition or prohibition on the Department of Commerce to undertake a study on the possible advantages or disadvantages of U.S. use of the metric system. At least a better understanding of what advantages or disadvantages might accrue to this country as a result of such a study. I would hope the Department would take a good look at it.

Mr. TROWBRIDGE. We certainly will.

(The following statement was later submitted for the record:)

THE METRIC SYSTEM AND INTERNATIONAL TRADE

The Department of Commerce has consistently supported the various bills that have been before the 87th, 88th, and 89th Congresses to authorize a comprehensive study of the advantages and disadvantages of increased use of the metric system of measurement in the United States. While the Department has not proposed such legislation, it strongly favors the enactment of appropriate bills for this purpose such as S. 441, recently introduced in the 90th Congress by Senator Clairborne Pell, and H.R. 3136, introduced by Congressman George P. Miller.

During the 89th Congress, the Assistant Secretary of Commerce for Science and Technology discussed the many important needs for a metric system study when appearing before the Senate Committee on Commerce on July 14, 1965, in support of S. 774. Similar testimony was presented to the House Committee on Science and Astronautics on August 2, 1965, when that committee held hearings on H.R. 2626 which was superseded by H.R. 10329.

On these occasions, special attention was directed to the pressing need for a better understanding of the extent to which disparities in systems of measurement between the United States and metric-using countries may constitute a barrier to our international trade. It was emphasized that there has been an increasing trend over the last few years in various other countries not only to make the metric system their legal system of measurement, but to prohibit the use of any other system. The announcement of May 25, 1965, by the British Board of Trade of that country's intention to adopt the metric system was cited as a particularly significant development in this general trend which may have an important effect upon American industry and our foreign commerce.

The Assistant Secretary also stressed our general lack of factual information needed to guide decisions in both Government and private sectors concerning increased use of the metric system in this country. Our limited understanding of the interaction between measurement systems and the increasingly important international product standards, which establish preferred sizes, shapes, and other physical characteristics of the articles of international commerce, was noted as one example of the many complex problems that should be investigated.

The Department of Commerce is fully convinced of the need for a broad and comprehensive study of this subject to be initiated as soon as possible. We currently are considering various means to assist and encourage industry toward voluntary self-examination with respect to some of these matters. Such activities by the Department might help to increase the awareness of American business and industry to the problems posed by the increasing world-wide use of the metric system, and might help to identify voluntary actions that can be taken in various industrial areas to adjust to this trend.

We strongly believe, however, that our national interest requires a much broader study of this very complex problem to produce factual information for

the establishment of a national policy with respect to utilization of the metric system. This will require the full cooperation of industry, commerce, labor, science, consumers, and numerous other sectors of our society, and it will require the investment of significant Government resources in terms of manpower and money. We believe that the necessary national support for such an extensive and important study can only be assured through congressional endorsement and authorization. For this reason we strongly urge prompt enactment of the bills for this purpose that are currently before the Congress.

Chairman PROXMIRE. Senator Symington?

Senator SYMINGTON. Thank you, Mr. Chairman.

You mention tourism in your statement. The plan is still to have incentives for people to come over here as against any restrictions against the citizens of this country going abroad and spending over there, is that correct?

Mr. TROWBRIDGE. That is correct, Senator.

Senator SYMINGTON. Is there any contemplating of stipulating that our citizens use ships and airliners under the American flag?

Mr. TROWBRIDGE. Not as any particular rule or legal requirement. I think you are aware that as one of the techniques that we suggest to American companies, as they approach how they contribute to the balance-of-payments situation, is the use of American aircraft and flagships in the movement of their people and goods. This is a method rather than a requirement.

Senator SYMINGTON. Does the Department of Commerce believe that the 18-year continuing loss of gold—with the exception of 1957—is a serious matter?

Mr. TROWBRIDGE. Yes, it does, Senator.

Senator SYMINGTON. Tourism today is probably the greatest single antibalance-of-payments item, is it not?

Mr. TROWBRIDGE. At \$1.8 or \$1.9 billion, I think you are probably right, as a single element of the total picture.

Senator SYMINGTON. I am not sure, but believe so.

Mr. TROWBRIDGE. Yes, sir.

Senator SYMINGTON. You have said in your statement "We are ever mindful of the fact that voluntary programs are by no means a permanent solution." What would you see as a permanent, or semipermanent, solution to curbing the flow of investment dollars abroad to a reasonable level so as to improve our balance-of-payments position?

Mr. TROWBRIDGE. Well, of course our very real hope is that we won't need a permanent method of curbing investment outflow. We are hopeful that the stimulation of exports, the accumulation of earnings abroad and the use of those for reinvestment purposes, the borrowings abroad, these various features of our current program, will be continued by business.

We are particularly mindful that American investments abroad are a good thing, and our concern is how do we finance them.

Senator SYMINGTON. If the administration would come right out and say that actually it didn't make much difference whether we had adequate gold or not, that would be one thing; and it could be discussed with that premise. But each year, in all the years I have been interested in this subject, administration witnesses come down and say it is very serious matter, and they are going to correct it "next year." But they never do.

That is what worries me most. We have now about 10 percent of free nonmonetized gold available if we were called by these foreign

citizens and their central banks. Even if we abandon the pledged gold reserve against outstanding Federal currency, we wouldn't have half the gold now needed, if there were a mass call.

The administration is the one saying it is a serious matter; but they don't seem to be able to do anything about it, sort of like Mark Twain and the weather.

We have been getting these hopeful statements year after year. The operations may be successful, but the patient continues to die.

What do you think of a recent proposal to impose some sort of tax on U.S. businesses abroad, as a means of defraying part of the cost of the Federal Government, protecting, promoting, and defending those private investments overseas.

American companies probably make 10 times as much off a barrel of oil out of the Middle East than from a barrel of oil out of Oklahoma or Texas. On the other hand, if it were not for all the money we spend maintaining a position abroad, defense, foreign aid, et cetera, there wouldn't be much chance of all this business continuing the way it continues today.

Again, with the premise we are steadily losing our gold, what would be your reaction to our putting some form of tax on those companies abroad as a means of defraying part of the cost.

Mr. TROWBRIDGE. Yes. I wouldn't be very enthusiastic about that idea frankly. I feel that the American position around the world is one of heavy engagement because we have what we consider to be national policy reasons. We have national security reasons for our troops in Europe.

We have some very real programs of integrated defense and integrated political action with our allies through treaties and so forth. I think these are the reasons we are maintaining a large defense posture at all.

Senator SYMINGTON. We have a lot of integrated programs with them, presumable mutually advantageous.

Mr. TROWBRIDGE. Right.

Senator SYMINGTON. Now in recent years all the developed countries of the world have increased their reserves and gold holding, Spain over 600 percent, France over 500 percent, West Germany some 482 percent; that is, all but the United States, and we have lost some 45 percent of our gold and reserves in the last 10 years. How long can we have these cooperative agreements with these other countries whereby they end up with heavily increased reserves and gold, and we end up with heavily decreased reserves and decreased gold, if it is a serious matter. The Treasury is always saying it is serious, and I take their word for it.

Mr. TROWBRIDGE. Well, sir, I certainly agree as to it being serious. I can't quite see though that the factor of our defense interests and defense expenditures abroad can be characterized as being necessary, and in fact in place, to protect American business investments, and therefore the business involved should pay, through a tax, for these defense activities.

Senator SYMINGTON. There is more to it than just defense, including all the loan and grant aid programs.

Mr. TROWBRIDGE. Sure.

Senator SYMINGTON. Let's take the shoe business, which we in Missouri know something about.

We make a tremendous number of shoes over here, on fine shoe machinery. The Japanese and the Italians pay but a fraction of what we pay our workers. We ship shoe machinery over there, which they pay for, and that helps the export-import ratio; but ultimately of course that comes to an end.

Also we ship the original machinery to the foreign affiliates of our own companies. But is there a point of diminishing returns when they will no longer seek such goods from the United States, instead will be purchasing locally? Have we made any studies about that?

Mr. TROWBRIDGE. Well, I couldn't quote you a particular study, Senator, but I am quite sure that this is a continually evolving thing. I think it is somewhat like the argument over whether computers were going to really stimulate economic development or put a lot of people out of work.

It seems to me that the truth of the computer industry is that it has developed a whole series of new industries and a whole series of new jobs, and I think that the American overseas investment can be looked at in a very similar way. Where in one industry there may be a point of no more return as far as American machinery goes abroad to make a product, but there is another industry starting up tomorrow that is going to need more machinery, or there is a third industry that is setting up an assembly plant that is going to use semiprocessed goods or materials from the United States.

This is a very dynamic situation. The overseas business world is one which is growing tremendously, as you well know, there are opportunities for American business around the world for sensible investments, which will be supported by increased exports, and we do have studies which show that in the year 1964, I think that we had a level of roughly \$24 billion worth of exports, and about \$6 billion of that was directly tied to exports of commodities, raw materials, and machinery, from parent companies in the United States to their affiliates abroad, supported from American investments.

Senator SYMINGTON. Our excess of exports over imports has been dropping pretty steadily.

Mr. TROWBRIDGE. It has over a couple of years.

Senator SYMINGTON. On page 26 you point out something quite intriguing; namely, that trade between the free world and Eastern Europe, including the U.S.S.R. is \$12.5 billion, of which we do about \$277 million, or about 2 percent of the total.

Mr. TROWBRIDGE. This is 1965, right.

Senator SYMINGTON. For some reason all other developed countries, politically, seem to be becoming more nationalistic, but we maintain political internationalism.

But these same developed countries buy and sell a lot of military and other equipment from the countries behind the Iron Curtain. Now at the same time we promote and continue our international relationships politically, we maintain a position which is quite nationalistic in our economic approach. Even though we defend a very large percentage of these countries, and finance a large percentage through this tremendous dollar printing of paper gold, they do all the Iron Curtain trade they want, and we do very little. We maintain internationalism politically, nationalism economically. They are working toward more nationalism politically, and internationalism economically.

I asked Secretary of Commerce Hodges and Secretary of the Treasury Dillon if there was any developed country in the free world except the United States that wasn't doing its best to sell everything it could behind the Iron Curtain. The answer in both cases was no.

Mr. TROWBRIDGE. I think that is basically true.

Senator SYMINGTON. And so, from the standpoint of world trade. We are the only country that can't do a lot of things all other countries do. You mentioned that the President has clearly indicated he will seek authority to increase our East-West trade, to give our manufacturers an opportunity to get in on these tremendous new markets. When do you think that is coming up to the Congress?

Mr. TROWBRIDGE. The date of the submission I am not sure of, Senator. I am quite confident it will be along in a reasonably short time. There is of course the question of arranging the proper time for hearings and consideration by Congress. Chairman Mills has indicated that this will go forward.

To the best of my knowledge we have all intentions of proceeding as the President has outlined. Our hope is that we can present a very strong story of the need to use what I consider to be a dual track policy in this whole area.

On the one hand we have our Vietnam commitments, we have our determination that aggression won't pay, but on the other, we maintain peaceful contacts, and we build those contacts and we use them as a pressure release valve, and I think this East-West trade area is going to be very useful.

Senator SYMINGTON. Mr. Chairman, my time is up. I would make this observation. The diehards who now oppose East-West trade are striking a telling blow against U.S. capitalism. We all know an essence of capitalism is competition. We all know too, that the way you get a price is to sell at a profit, and profit is the guts of capitalism. We all know, too, that volume is essential to low cost. Therefore, those people in this country who, because they don't like other countries' religion, color, or something—I have never been sure just what—don't like to trade with these hundreds of millions of people, whereas all the countries we finance and defend, France, Germany, Great Britain, Japan, Italy, are doing as much as they can to sell to these countries behind the curtain, and buy from them. It seems to me these diehards over here are striking a telling blow against the very concept of capitalism. I wish you the best of luck in presenting this problem; hope it will get by the Congress.

Mr. TROWBRIDGE. Thank you, Senator.

Chairman PROXMIRE. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Trowbridge, it is certainly a privilege to have you with us this afternoon.

Mr. TROWBRIDGE. Thank you.

Representative WIDNALL. Mr. Wirtz testified that the increase in productivity this year would be at or a bit below the 2.8-percent increase in 1966. You said in your statement which I just read, "The increase this year may be somewhat higher than 2.8 percent." How do you reconcile the difference?

Mr. TROWBRIDGE. The differences I think are very, very small, productivity rates being, I think, not the easiest thing to gauge. The 1966

figure being 2.8, I think Mr. Wirtz may have been thinking in terms of 2.7 or 2.6, and I am thinking in terms of 2.9, so I don't think there is that much spread.

Representative WIDNALL. If they merge Labor and Commerce it will make no difference; is that the net gain?

Mr. TROWBRIDGE. We may come to the same numbers.

Representative WIDNALL. I am interested in your comments on tourism and the loss that we suffer each year in that connection. How much loss do we suffer each year in dollars through payments of social security and retirement benefits and other remittances overseas to both American citizens and non-American citizens? I think it is quite a substantial amount.

Mr. TROWBRIDGE. Congressman, I don't have those figures, but I would be very happy to try and submit them to you for the record as soon as I can get hold of them. I do know there are a number of commitments of different types for American citizens resident abroad, for veterans' agreements. Veterans' payments to the Republic of the Philippines would be an example of residual responsibilities which our Government has taken on.

I am sure that the amount of dollars that do flow out in compliance with these various programs is available. I don't happen to have them at the moment. I will be glad to submit them for the record.

Representative WIDNALL. I believe the last figures that I saw, they amount to hundreds of millions, and amount to a rather substantial outflow. You might submit those figures for the record, if they have not previously been submitted.

Mr. TROWBRIDGE. Yes, sir; I will be glad to get those.

(In response to the above question, the following information was supplied:)

Detail of U.S. Government pensions and other transfers, in the balance of payments, fiscal year 1966

	<i>Millions</i>
Total	\$321
Pensions and retired pay:	
Social security (OASDI) and railroad retirement.....	161
Defense and Veterans' Administration.....	82
Civil Service.....	11
Other	2
Grants:	
Education and cultural exchange (Fulbright).....	28
Research:	
National Institutes of Health.....	14
Other	13
Damage claims and miscellaneous.....	10

Source: U.S. Department of Commerce, Office of Business Economics, Balance of Payments Division.

Representative WIDNALL. Would you or the State Department have the figures on our counterpart funds accounts overseas?

Mr. TROWBRIDGE. The Department of the Treasury, if I am not mistaken, maintains records on those, and again I would be happy to get the latest accounting of those. They are quite substantial in certain countries, India, I believe Egypt, and some of the places where our agricultural sales have been particularly high.

(The following material was subsequently supplied for the record:)

The following three tables from *Special Analyses of the Budget of the United States*, pages 171, 173, and 175 show the foreign currency stocks now available to the United States and the current sources and uses of these.

TABLE L-1.—*Cash availability of foreign currencies*

[In millions of dollar equivalents]

	1966 actual	1967 estimate	1968 estimate
Currencies owned by the United States:			
For U.S. uses:			
Excess currencies.....	1,624	1,567	1,835
Nonexcess currencies.....	392	430	440
Subtotal for U.S. uses.....	2,017	2,006	2,275
For country uses.....	2,202	1,881	2,049
Amounts unfunded in Treasury accounts.....	-9	-54	-67
Total.....	4,210	3,835	4,257
Currencies held in trust.....	84	97	97

TABLE L-3.—*Summary of foreign currency transactions, U.S. uses*

[In millions of dollar equivalents]

	1966 actual	1967 estimate	1968 estimate
Cash balances brought forward:			
Excess currencies.....	1,345	1,221	1,464
Nonexcess currencies.....	91	61	66
Subtotal, cash balances brought forward.....	1,436	1,282	1,530
Collections:			
Public Law 480 sales.....	158	199	184
Foreign assistance programs (including special letters of credit).....	116	144	143
Interest on public deposits.....	26	25	25
Other nonloan collections.....	55	79	81
Loan repayments (principal and interest):			
Public Law 480 loans.....	110	134	163
Foreign assistance loans (including Development Loan Fund).....	142	152	160
Subtotal, collections.....	608	733	757
Net transfer to country use.....	-27	-10	-11
Total availabilities.....	2,017	2,006	2,275
Expenditures (deduct):			
Foreign currency expenditure authorizations.....	13	14	8
With dollar credits to—			
Foreign assistance programs (special letters of credit).....	113	140	140
Miscellaneous receipts of the general fund.....	136	141	142
Commodity Credit Corporation, Agriculture.....	133	140	117
Other.....	15	41	42
Deposits for replacement currencies.....	-3		
Subtotal, expenditures.....	409	476	450
Adjustments due to changes in exchange rates.....	-325		
Cash balances carried forward.....	1,282	1,530	1,826

¹ Excludes sales of country-use currencies, subject to later replacement, as follows: 1966, \$4,200,000; 1967 \$15,000,000; and 1968, \$5,000,000.

TABLE L-6.—*Summary of foreign currency transactions—country uses*

[In millions of dollar equivalents]

	1966 actual	1967 estimate	1968 estimate
Balances brought forward.....	1,384	1,008	1,197
Collections:			
Public Law 480 sales.....	789	857	833
Foreign assistance program.....	2	6	8
Subtotal, collections.....	791	864	841
Net transfer from U.S. uses.....	27	8	11
Total availabilities.....	2,202	1,881	2,049
Expenditures (deduct):			
Public Law 480 country loans and grants.....	736	641	685
Public Law 480 loans to private enterprise.....	37	36	36
Other foreign assistance programs.....	12	8	10
Subtotal, expenditures.....	786	684	614
Adjustments due to changes in exchange rates.....	-409		
Balances carried forward.....	1,008	1,197	1,436

Representative WIDNALL. I certainly feel that in the instances where they are very substantial, there ought to be a reassessment and an attempt to recoup in some way, because the original contracts in connection with the counterpart funds —

Mr. TROWBRIDGE. I might add, Congressman, that we in the executive branch of the Government, when we look at the programs we have overseas, for instance, our trade promotion programs in the Department of Commerce, we asked for permission from Congress and received it to use as much counterpart funds, local currency as we can, for the expenses involved in setting up trade promotion activities in given countries where these counterpart funds exist. But we do have a conscious program to try and use them wherever possible and wherever legally feasible.

Representative WIDNALL. In your statement under "Travel promotion" you say:

In countries such as Mexico and Greece they invest more than \$5 to attract each foreign investor. We spend 50 cents.

How do you break down the \$5 that they spend, and how do they attempt to attract visitors in a different way than we do? Is there any major difference in the promotion?

Mr. TROWBRIDGE. I think the techniques are probably about the same. The difference is in the total amount of expenditures, the total amount of national effort they put behind their national tourist bureau. They do a good deal more in terms of overseas, what to them would be overseas foreign offices located in the key centers, to attract the tourist directly and to work with the travel agents organizing package tours in their countries.

They do have I think a good many more programs which are government sponsored, and government generated, such as package tours and facilities, making facilities available to incoming tourists at perhaps subsidized rates. Of the various techniques, I think the basic ones are advertising and sales promotion, but they certainly do have more expenditure per visitor than we do.

Representative WIDNALL. At one time people traveled overseas to see the difference in culture, the difference in costume, and an entirely different tour of the land than does the United States. Today we probably have the greatest scenery in the United States. We don't have the oldest buildings. We have bulldozed them out of existence.

We manage to get rid of any culture we have in many instances, but today the main competition it seems to me between lands is who has the newest Hilton hotel. Actually you travel from one country to another and this is all you see, the Hilton hotel. The rates are the same wherever you go.

Now what is the difference in approach? We have the scenery and they have the oldest buildings. Now what is it that is attractive? Everybody dresses the same today.

Mr. TROWBRIDGE. Well, Congressman, I think there are a couple of obvious hurdles that our travel promotion people have to face. One is distance and transportation costs. There are, I think, a lot of people who feel that the U.S. Travel Service, trying to operate on \$3 million a year as far as the budget goes, is obviously limited in what it can do in promotion work.

The biggest appeal of this country is as you say, the tremendous expanse, the scenery, and excitement of watching this country at work.

I am encouraged by the way many of our travel industry have responded with things such as a bus ticket, on which a person with a passport from some other country can travel for I think 99 days for \$99 anywhere in this country. Another program is affiliation between various trunk airlines, so that someone coming in can go almost anywhere in the country for a flat sum.

The travel industry has responded very substantially to the need to make it more economical to see the size of this country and all of the exciting things we have in it.

The travel service has done a lot of work in trying to stimulate neighborhood reception for people from other countries. You may have heard of this program called "Company's Coming," in the attempt to get a welcome mat laid out in each community. But there is no doubt that a lot of people around the world have the feeling that it is terribly costly, probably a mistaken image of the cost of seeing our country.

We do have great success in visitors from Canada, Mexico, and nearby areas, and in the growth in visitors to our country, and I think the growth has been particularly significant since the U.S. Travel Service started work several years ago. It has been very encouraging. We had the millionth visitor last year, for instance, the first time we have ever had that.

Representative WIDNALL. I think they have done a tremendous job, and they are doing it right now and it is very noticeable. To what extent is the foreign traveler to the United States limited by the amount of money they take out of various countries?

Mr. TROWBRIDGE. In Europe, except for the United Kingdom, which does have a limitation per person on the amount they can take out, I don't believe that there are any restrictions on foreign currency. Japan still limits their citizens I think to \$500 per trip.

In Latin American countries, there may be differences between them. The OECD has tried to make it a universally accepted policy that

there will be I think a \$500 limit in cases where countries for balance-of-payments reasons have to restrict currency outflow. But the liberalization of this has been quite substantial in the last 5 or 10 years around the world.

Representative WIDNALL. We have succeeded to some extent in limiting the amount of goods brought in by American tourists from other countries which stops expenditure of dollars over there, but we certainly haven't limited the amount of dollars taken out of this country, and that is spent in other countries and kept there in these other countries.

Mr. TROWBRIDGE. That is quite true, sir.

Representative WIDNALL. I don't know that I would really want to suggest something like this, but certainly you have got every opportunity to spend thousands and hundreds of thousands of dollars overseas, without any limitation by the United States. You can't foresee any kind of reciprocal situation as far as the foreign countries are concerned.

Mr. TROWBRIDGE. Well, as I said in the statement here, we are basically trying to accentuate the positive when we look at this problem. It is a big one.

We have got a tremendous tourist gap, but we are faced with I think a fairly important principal, and that is the freedom of the American citizen to travel, and this administration has not tried to put limits on that freedom. We have somehow got to solve our problems, and if we can, keep that freedom at the same time.

Representative WIDNALL. Just one more question. If the British bid for the EEC membership fails, would the United States look favorably on promoting a trade area of those who are not members of the EEC? Did you go into that? I am sorry, I withdraw the question. My time is up.

Chairman PROXMIRE. Secretary Throwbridge, is the Department of Commerce studying methods by which the growth of our economy can be increased?

Mr. TROWBRIDGE. Yes, Senator, in many different ways.

Chairman PROXMIRE. What are these methods?

Mr. TROWBRIDGE. Well, I think the whole programing of the economic development administration, the attempt there to signal our areas which require stimulus for economic growth, job creation, new investment, public works, community action. I think there is a whole series of methods.

Chairman PROXMIRE. These are programs that have been passed. Congress has acted on them.

Mr. TROWBRIDGE. That is correct, sir.

Chairman PROXMIRE. I am talking about new programs.

Mr. TROWBRIDGE. We have a new program again approved, but a very recent one based on the Office of State Technical Services, the idea of using technology as a stimulus to economic growth. Our whole science and technology operation—

Chairman PROXMIRE. This is very good and I approve of that. I think that as President Johnson said, that was a real sleeper of the 89th Congress. It accomplished a lot, and that was kind of overlooked. You are talking about Senator Magnuson's bill?

Mr. TROWBRIDGE. That is correct, sir.

Chairman PROXMIRE. In addition to that you have the investment credit that was introduced a few years ago, and is coming back now we expect, and so on. I am talking about new ideas that we are looking forward to now.

We seem to be settling for a growth rate of only 4 percent, which we are told by the Department of Labor is not enough to sustain even the present level of employment or unemployment rate. I am wondering what new proposals we now are going to have to pick up our growth, other than the proposal of having an expansionary fiscal and monetary policy.

Mr. TROWBRIDGE. Well, Mr. Chairman, I would think that those are the really important tools to be used. I think it seems to me, in looking at this problem, that really Government has to set the framework in which economic growth comes, but it is the private sector that is going to do the job.

I personally tend to question the capability of the Government all by itself trying, through a series of programs, as well planned and defended as they might be, to solve all the problems. I think it is the job of Government to create that framework largely through monetary and fiscal policies, and let the business and labor communities get on with the job.

Chairman PROXMIRE. I understand that you have, that the Department of Commerce has a computer model of the U.S. economy. Would you tell us about that model, and whether or not you found it useful?

Mr. TROWBRIDGE. I would guess that you are talking about the input-output analysis that we have developed.

Chairman PROXMIRE. Yes.

Mr. TROWBRIDGE. I would like Assistant Secretary Shaw to comment on that. It is really a development in his part of the Department. I think it is a very exciting project and model, and we are currently bringing it more up to date, so it will be based on newer numbers. I would like Mr. Shaw to comment.

Chairman PROXMIRE. Mr. Shaw, before you do, let me say that I would like to know what that model shows for 1967 and what it shows as to the effect of the 6-percent surtax.

Mr. SHAW. Mr. Chairman, may I make several comments? First, I would like to correct one apparent misunderstanding, and that is that our goal is only 4 percent in real terms. That is a target for 1967. For the longer run, our goal, and I think the goal of others as well, would well be expressed as 4.5 percent or better than 4.5 percent, if we are to retain such goals.

With respect to these models, there are actually two sets of models. The first one to which Secretary Trowbridge referred is the input-output model, which is a structural model of the economy, and which basically, however, has to do with the past. We offer examples sometimes using coefficients in that model based on the data of several years back. We hope this year and next to update that particular model.

I think however, Mr. Chairman, the model to which you refer is our second model, which is an attempt to develop a series of equations which help us or should help us we hope get a better idea of what is likely to take place in the economy during the four quarters ahead.

My personal judgment as one in the forecasting business for many, many years, is that the use of models to date can be regarded as very helpful but nevertheless only as a supplement to good judgment, and that is the way in which we are presently making use of that model, which is in charge of the Office of Business Economics.

I might say as far as the 1967 period is concerned, the last results I saw of that model would come out with results not far from the judgment forecasts or projections that we have been discussing today.

Chairman PROXMIRE. By that you mean increase in the price level by 2.5 percent, unemployment of about 4.5 percent at the end of the year, and a growth of about 4 percent.

Mr. SHAW. Give or take a few tenths of a percent point in each case. I think we have to keep in mind here that when you are talking about the future, much less the present and the past, it is I think to some extent oversimplifying the situation to talk down to one-tenth of 1 percent.

Chairman PROXMIRE. We know it is not a crystal ball. It all depends on your estimates. Last year in December of 1965, one of the Governors of the Federal Reserve Board—not Mr. Martin obviously—told us they put the increase of the rediscount rate into a Brookings model and found that it increased the price level, not decreased it.

Mr. SHAW. May I comment on the second part of your question, Mr. Chairman, which had to do with the effect or possible effect of a tax increase on the outlook for 1967.

Chairman PROXMIRE. Right.

Mr. SHAW. I have not seen the results of the model of the Office of Business Economics. As a matter of fact, I am not sure whether that particular shift in equations has yet been run through. I have, however, seen several models, similar models developed outside the Government, some developed by individual industry firms, some the better known ones.

The ones that I have seen have indicated that the proposed tax, surtax increase of some 6 percent along with the remainder of the fiscal policy recommendations of the President, the difference between having that tax and not having that tax would not have a significant impact on the total demand in 1967.

Chairman PROXMIRE. That is very interesting. It will not have a significant effect on 1967?

Mr. SHAW. Not on 1967.

Chairman PROXMIRE. It might have it in 1968?

Mr. SHAW. Yes; the impact might have this in 1968.

Chairman PROXMIRE. Which is beyond what the crystal ball will show. You don't know what that will be?

Mr. SHAW. Yes, sir.

Chairman PROXMIRE. That is very interesting. Now let me ask this: You say, Mr. Trowbridge, that you expect in the second half of the year, defense spending will tend to ease off, the impact of defense spending will ease off, still at a very high rate, but that it won't be as stimulating as it has been or as it is now; is that correct?

Mr. TROWBRIDGE. You are referring to the statement "A tapering off in the rate of advance in defense purchases"?

Chairman PROXMIRE. That is correct.

Mr. TROWBRIDGE. Right.

Chairman PROXMIRE. Now taking a look at the situation in the last half of the year, we are going to have a tax increase which we have just been told will not have much effect on demand. If it has any effect, it would certainly be negative. At least that has been proposed. A slowdown in business investment because of the proximity of the resumption of the investment credit. We are going to have a slowdown in defense purchases.

You have indicated that we are going to have a profit, perhaps some profit squeeze. This will be true if the very large number of labor-management contracts are settled with the wage increases that we expect, and the difficulty for business to pass those on to the consumer.

On the other side we have only these factors; No. 1, a stepup in social security benefits. The testimony we had is that that is likely to have its main impact in increased demand for food, which is unlikely to be very inflationary, because food isn't too responsive on the demand side, production factors are more important, and possibly medical services. Also not demand sensitive.

Most of the elements in our economy, like home buying, automobile buying, won't be affected much by the increase in social security benefits.

And then No. 2, you are allowing the second biggest element in the latter half, a resumption of prosperity or at least some better conditions in homebuilding, in construction generally, because of lower interest rates.

Mr. TROWBRIDGE. Yes.

Chairman PROXMIRE. The testimony we had this morning was to me not very reassuring in that area. Chairman Martin indicated that there are many problems involved in getting at the long-term rate, bringing it down, and in doing much more than we have done on the short-term rate because of the international balance-of-payments situation. So under these circumstances, it would seem to me we have some pretty significant bearish elements in the second half of 1967, and the bullish elements are not very impressive.

Mr. TROWBRIDGE. Wouldn't you add, Mr. Chairman, to the bullish side of the equation the anticipated State-local government expenditures, which I think are projected to be at a higher level, whereas we say, "a tapering off in the rate of advance in defense purchases," it is most likely that those defense purchases still are going to be quite high.

Chairman PROXMIRE. But the advance is so important, because our whole economy is growing all the time, and our capacity to meet production improves every month, and improves so impressively, that unless the advance continues, we are likely to have even more slack in your resources.

Mr. TROWBRIDGE. I think there is some projection too as to the buildup of inventories, which at the end of 1966 was very high.

Chairman PROXMIRE. That is true, yes. The assumption there is that that will be taken care of in the first half of 1967. Why is that?

Mr. TROWBRIDGE. I think the projection is that the rapid or the tremendous buildup of inventories in the last quarter of 1966 will taper off, and in the first half of 1967. The resumption of an upswing though is projected in the second half, and I think this would be on the bullish side of the equation as well.

Chairman PROXMIRE. I know that that is the assumption, but why is it made? The Council of Economic Advisers has some conflicting evidence in their report.

They indicate that one of the reasons for the increase in inventory is because of goods in process expanding, because I suppose the impact of the Vietnam war is such that many of the things produced take 18 months or more to produce on the average, instead of 12 months. This obviously increases your inventory. Why would you have a very much different picture in the last half of the year on that?

Mr. TROWBRIDGE. On the last half or the first half?

Chairman PROXMIRE. Mr. Paradiso?

Mr. PARADISO. The picture would be different, Mr. Chairman, because in the last half we do expect a slowing down in the rate of defense expenditures, and this should not require the same degree of accumulation of raw materials and goods in process inventories as is the case in the last several quarters.

Similarly if we get a reduction in the rate of spending for capital goods, this should not require that kind of accumulation.

Now as we move into the second half of 1967, there are these stronger elements coming in. Nobody can say that social insurance benefits are going just for food. Generally I think they would go for non-durables and services, I agree, or not for durables.

So if we get an additional spurt beyond that which we would obtain with a normal rise in the personal income and higher employment, due to the increased social security benefits, in the nondurable goods area and services, this should require some additional inventories to support that higher rate of purchasing. Similarly if the housing picture changes—

Chairman PROXMIRE. Where do you see these increases coming?

Mr. PARADISO. For clothing? The food industry certainly increases its inventories. We see quite a bit of variation in that industry. All along the line that is so. In the drug area, in some of the service areas they will need some additional inventories to maintain a higher rate.

Chairman PROXMIRE. Aren't all of those inventories turned over a great deal faster than in durable goods?

Mr. PARADISO. They did turn over a good deal faster, but the level will rise. In other words, they get up to a higher level to support a higher level of purchasing.

In the housing case, I think the same thing is true, although their inventories are not very large. Nevertheless the housing picture I believe is going to turn around.

The amount of money available in the savings and loan associations is becoming much more normal in many areas. It isn't all the high interest rates. It is the availability of mortgage money which is a factor. And as we indicated earlier, the number of households is expected to accelerate this year in comparison with last year, and this should provide a stimulus to the housing industry later this year. I don't think we can pin it as to July or August, but sometime during this year there is bound to be some uptrend in the housing picture, which would have some influence on inventories.

Chairman PROXMIRE. I take it, Mr. Trowbridge—and Mr. Paradiso and anyone else that has a judgment on this—you would feel that it

would be wise for the President and for the Congress to wait as long as we can before July 1 to make our decision on the surtax increase rather than move now.

Would you agree that we can get a clearer picture of the economy 90 days from now than we can now, and would you also agree that in the event in our best judgment the economy leveled off or was turning down, it would be unwise to impose a surtax?

Mr. TROWBRIDGE. Mr. Chairman, speaking for myself, I think that the flexibility in the President's proposal is a very wise thing. Obviously 90 days from now we will know a good deal more about how the economy is going. I think Secretary Fowler has indicated that the decision as to whether to proceed full speed with this proposal will get looked at again both by the administration and obviously by Congress.

To the effect that a tax surcharge would help take out some of the heat that we do think is coming along in the second half of the year, I would think it would be very wise to go ahead and put it on.

Chairman PROXMIRE. Mr. Trowbridge, meet Mr. Shaw. Mr. Shaw has told us it is not. Maybe I misinterpreted Mr. Shaw. I understood you to tell me that it would not have any effect on 1967.

Mr. SHAW. Mr. Chairman, I said the model indicated that. Second, what I meant to say, and if I didn't say it, I would try to make it doubly clear at the moment, that what the model said was not merely in terms of the proposed tax increase, but in terms of the whole fiscal package proposed by the President, and that includes the passage of the increased social security benefits.

Chairman PROXMIRE. What they are saying is that this is a wash-out.

Mr. SHAW. The reason quite clearly why the model seems to come out that way is that in the second half of 1967, the proposed increase in personal income taxes would be just about offset by the proposed increase in social security benefits, in the second half of 1967.

Chairman PROXMIRE. Now let me say that is the trouble with models. That is the trouble with macroeconomics. When you break it down and determine what effect the social security benefits have specifically in particular areas, and what effect the surtax would have in specific areas, you find quite a different picture. As I said, the increase in food purchases is going to be heavy. On the other hand I doubt if the surtax increase is going to diminish food purchases at all. On the other hand, the surtax increase is going to have some effect very possibly on automobile sales. It is going to have some effect conceivably in construction, although maybe we could debate that.

At any rate, it is not going to have the same effect at all, the surtax, as the social security benefits. That is why looking at it in the overall is likely to give a distorted picture. At any rate, in view of the facts that we have almost an unlimited capacity to produce food, we have been spending money hand over fist to keep our farmers from producing more; we can easily meet the increased demands for food. And I doubt if we can do very much about the increased demand for medical services by any kind of a tax. It is not going to cut it down. So, therefore, it would seem to me that the notion that you are going to get a tradeoff, a balance here, isn't very sound in terms of using our resources as much as possible, or in terms of maintaining price stability.

Mr. SHAW. Mr. Chairman, first let me say that I agree with Mr. Paradiso in his statement that the proposed benefits, if enacted, will be spent on a much broader spectrum of goods and services than just food alone and medical supplies alone. I think clothing and textile products will benefit. I think a whole host of consumer services will benefit.

On this second question, Mr. Chairman, which is a key question which you have raised several times this afternoon, this question of whether or not we are going to have capacity and resources to do much more than is apparently implied by the 4-percent rate of real growth, which the Council has set forth, I would only say that here again in my judgment we must avoid just looking at its overall totals. We have an economy today which is pretty close to full employment, perhaps not quite where some of us would like to see it, but nevertheless which also has a number of imbalances and distortions, and we have to consider those imbalances and distortions in determining where and how fast we can go during the next 12 months.

As I pointed out earlier, this 4 percent is a rate of growth which is proposed only for the next 4 months. I don't think the Council, I don't think any of the other agencies would in any sense argue with you that we should be aiming for a higher rate of growth than 4 percent over the longer run.

Chairman PROXMIRE. It is just not clear to me, it hasn't been made clear why 4 percent is all right now but it is not good for the long run and why 4.5 percent would be all right in 1968, 1969, and 1970, unless you are arguing that with the Vietnam situation which is unproductive, when we take people into the Armed Forces, while it is an essential and vital service they perform for national security, they don't produce anything for the economy. Is that the reason why 4 percent is—

Mr. SHAW. No, I think my argument would be based more on the hope and expectation that we have that some of the keen balances which are present in today's economy would not be present as we go out of 1967.

Chairman PROXMIRE. We always have to balance this, Mr. Shaw.

Mr. SHAW. Yes, but they usually are not quite as heavy or as distorted as they are at the present moment.

Chairman PROXMIRE. Let me just ask a couple of quick questions.

Mr. TROWBRIDGE. Mr. Chairman, Mr. Paradiso had one comment.

Chairman PROXMIRE. Yes?

Mr. PARADISO. In arriving at a 4-percent rate of growth, basically you have to make some assumption with respect to what the productivity growth is going to be, what the increase in the labor force is likely to be, and on that basis, and of course, the rate of unemployment.

Now whether you get a 4-percent rate of growth or somewhat more for any year depends specifically on what you do with regard to your assumption about productivity. Therefore, if you assume that the productivity rate for 1967 is likely to be somewhat lower than 1966, and the number of entries into the labor force in 1967 is not likely to be as high as 1966, because the economy is not growing as fast as it did, you can derive a rate of growth which would be 4 percent and consistent with a 4-percent rate of unemployment.

Chairman PROXMIRE. Let me just interrupt Mr. Paradiso to say this is both circular and contradictory. It is contradictory because Mr.

Trowbridge told us the Department's position is that it would be better than 2.8. Is that correct or incorrect?

Mr. PARADISO. That is correct.

Chairman PROXMIRE. If you don't have a growth of more than 4 percent, you won't attract people into the work force. What attracts them into the work force is an expanding economy and a demand for people to come into it.

Mr. PARADISO. Well, when we are talking about a little more than 1966, as Mr. Trowbridge indicated, it is a question of a tenth of a point. However, if you assume that the rate of gain in productivity this year is not going to be 2.8 but 2.5, that the labor force growth is not going to be 1.8 million such as last year but only 1.6, then on the basis of those factors, you can derive a 4-percent rate of growth consistent with a 4-percent rate of unemployment. So the question is, what do you assume with regard to these crucial factors of labor force and productivity? That is the difference I think.

Chairman PROXMIRE. All right. I want to once again apologize to Mr. Rumsfeld. I won't take much longer.

In your statement, you make the favorable assumption that our trade balance, not the balance of payments but trade balance, will improve. I remember in 1964 and 1965 people were saying when we had this enormously beneficial balance of payments, but what has always struck me is the fact that we have such an overwhelmingly favorable balance of trade now, and our favorable balance of trade must be an unfavorable balance of trade for other countries and they must be striving desperately to have a favorable balance. Those countries are advancing and progressing. Those countries also have an economic situation now which seems favorable for improving their trade balance; that is, their unemployment is increasing somewhat. Their resources are more available than they have been. Under these circumstances it is realistic to assume that we can have an improvement in what is already a favorable balance of trade although not quite as favorable as it was a few years ago?

Mr. TROWBRIDGE. Well, the trade surplus which has gone down since 1964 from a level of about \$6.9 billion, I believe, to 1965, 5.1; 1966 it was 3.8, a substantial drop, has of course been caused by this tremendous surge in imports as our absorptive capacity is there to buy from all parts of the world.

We foresee in 1967 continued strong demand for our exports in Japan, France, Italy, Canada, probably less so than last year in the sizable markets of the United Kingdom and Germany. In other parts of the world, it is hard to paint a very broad brush picture, but in the bigger markets, there are signs of continued expansion and high demand for our exports.

At the same time we foresee a reduced capacity utilization—you mentioned this 88-percent figure—more flexibility for the American producer to produce both for domestic and export. We foresee and hope for continued expansion of more American companies getting into the export business.

Now, on the import side, we foresee a reduction in the inventory accumulation, where imports are particularly strong or were last year, in the first half of the year, and we feel that the overall demand, which will be slightly down from last year, will represent itself in lower imports, or a lower rate of import growth.

Now many countries around the world do have an imbalance of trade with us, but they offset much of that trade balance with tourism receipts of investment flows. Take a country like Spain. Spain has substantial imbalance of trade with the United States, but the investment flows going forward, plus tourism, plus other invisibles, their balance of payments with us is, I think, if I am not mistaken, fairly close.

Chairman PROXMIRE. Can we expect to have a greater degree of balance in all these individual elements of the balance of payments? In other words, trade is likely to be less favorable perhaps in the long run. Our tourism we hope as the affluence of other societies improve and so forth is likely to be coming in closer balance. We hope we will be able to reduce the number of troops we have abroad. We hope this isn't perpetual. That has been a great drain on our balance of payments so as we do that shouldn't we be more accustomed to recognizing maybe a healthy long-term situation cannot have this very strongly favorable balance of payments we have had in the past, we are going to have to adjust this situation of our exports to imports?

Mr. TROWBRIDGE. It may well be. Certainly the \$6.9 billion surplus level in 1964 probably reflects a very difficult situation for a lot of our trading partners, where they just didn't have the dollars coming from their exports to finance all of their trade. I think, though, that with our technological advantage, this gives us a very real competitive advantage in a lot of ways, and that we can expect our exports to stay in surplus. What the numbers are going to be—

Chairman PROXMIRE. But as we increase our capital exports and along with this export of American know-how so that we improve their efficiency and their amount of capital investment and their amount of technological progress, so that the end of that, the result is going to be a more efficient free world.

Mr. TROWBRIDGE. I think that is the long-term result, yes, of capital flows and technological transfers.

Chairman PROXMIRE. I am not saying it is bad. I am saying it is good. I am saying that, in my judgment it is something we ought to be accustomed to.

Mr. TROWBRIDGE. I do too.

Chairman PROXMIRE. And not single-mindedly constantly having a favorable balance.

Mr. TROWBRIDGE. I would say this, too, and as I said before, the transfer of the investment and the technology very often brings with it not only economic growth where located, but stronger continued follow-on exports of perhaps new commodities, new materials, but continued trade and expanded trade from the United States to the locale of the new plant.

Chairman PROXMIRE. I want to thank Congressman Rumsfeld for being so patient.

Representative RUMSFELD. On that point, can one assume that as that happened, as that progression took place, that the United States theoretically should be in position where they could then reduce some foreign assistance programs? While the favorable balance of trade lessened, wouldn't the balance of payments and the gold situation change for the better possibly as such programs were reduced?

Mr. TROWBRIDGE. I think so. I think you have to remember, though, that a great percentage now, and I think it is close to 90 percent of our procurement under the foreign aid programs, is tied to the United States. Your net loss factor there of the foreign aid program that may total in budget terms over \$2 billion has considerably less outflow as far as dollars go.

Representative RUMSFELD. Yes, but I am unconvinced on that. In the first place, the foreign assistance programs total overall a lot more than \$2 billion, and, in the second place, I am not persuaded that these programs do not have an effect on the gold situation and balance of payments overall. They do. They have to, even though it may be less than the total assistance figures.

Mr. TROWBRIDGE. Right, than the budget figures.

Representative RUMSFELD. I will grant that.

Mr. TROWBRIDGE. Yes.

Representative RUMSFELD. There was a question on which Mr. Paradiso made a comment. He said that you anticipated a slowing down of the rate of defense expenditures. Did you mean that or did you mean that you anticipated a slowing down of the rate of increase of defense expenditures?

Mr. PARADISO. It is a slowing down in the rate of increase.

Representative RUMSFELD. Of the rate of increase.

Mr. PARADISO. The rate of increase. I am sorry if I gave the other impression.

Representative RUMSFELD. How many years before you are going to be bringing that model before congressional committees to testify?

Mr. PARADISO. This model is still quite an experimental model. It is certainly for the Government. We don't want to put out any results from an econometric model which we haven't tested over a period, and there is still a considerable amount of research being done in getting much better relationships.

For example, two of the relationships that there is a great deal of work going on now are, what is a good relationship for inventories, and what is a good relationship for housing.

Representative RUMSFELD. And you are able to "war game" economic problems, is that right?

Mr. PARADISO. That is right. Once we are satisfied that we have had reasonably good results over a period of years, and these relationships stand up, then at that point we can say, "all right, here it is for public consumption," not before.

Representative RUMSFELD. Was this developed in the Department or contracted out?

Mr. PARADISO. No. This came about in the following way. Professor Klein, from the University of Pennsylvania, had been working on a very similar model for about 3 or 4 years. About 3 years—

Representative RUMSFELD. I don't need—

Mr. PARADISO. I will go very quickly. He gave it to us.

Representative RUMSFELD. So it was developed outside and brought in and adapted.

Mr. PARADISO. And brought into our office and we updated it and have worked on it since.

Mr. SHAW. May I add, Congressman—

Chairman PROXMIRE. Would you hold it for 1 minute, Mr. Shaw? I want you to hear this plug for Northwestern; it's a great institution.

Representative RUMSFELD. The chairman has a son there and the university happens to be in the 13th District of Illinois. They are working on simulators in connection with foreign policy and national security problems. I know there is a great deal of this going on in universities. That is the reason for my question. I was interested in seeing if there has been an exchange between groups in and out of government working on similar problems.

Mr. SHAW. I think we can say that the technicians of the Office of Business Economics do keep in close touch with the experts in the field. I merely wanted to add that I thought Mr. Paradiso was being a little bit modest about the Office of Business Economics. I think the model has been improved significantly since the time that we got it from the University of Pennsylvania, and Lawrence Klein.

Representative RUMSFELD. Mr. Shaw, in connection with this model, simulator or whatever it is, did you plug in to see whether or not there would be different effects depending on whether on the one hand the tax increase were adopted by the Congress, or on the other hand a comparable reduction in Federal expenditures was accomplished by the Government?

Mr. SHAW. I have not seen any recent plug-ins in the model so that I have to answer your question by saying that to my knowledge those have not been plugged in.

Representative RUMSFELD. Thank you. I am interested in this East-West trade question that Senator Symington brought up. I know it could take all day and I don't want to belabor it. It is late and I know you gentlemen have been hard at it. But let's consider your testimony. You made the comment that you can foresee substantial increases in our trade with Eastern Europe in goods and technology for peaceful uses.

Well, now, "goods and technology for peaceful uses." Who is to say what is the peaceful use of something? You can't know that. I can't know that. There have been those who during World War I, I recall, possibly it was Bernard Baruch, who said everything was strategic. Now I don't know that that is as applicable in an era of nuclear warfare, but the fact remains that it is difficult to draw a distinction. I will comment further on the reason for my mentioning that in a minute.

You say that you fully support the need for this authority that has been requested, and that you feel it will lead to worthwhile increases in peaceful trade.

Do you favor trade, just to explore this for a minute, by the United States with North Vietnam?

Mr. TROWBRIDGE. No, I do not.

Representative RUMSFELD. Right. Do you favor it with China?

Mr. TROWBRIDGE. No.

Representative RUMSFELD. Of course not. And this points up the communications problems we are having on this difficult question. You don't want to trade with North Vietnam, but not for economic reasons. For economic reasons you would favor trade with North Vietnam or China, if you were thinking only of economics, but you are not. You are plugging in some political and military considerations.

To try to argue the concept of East-West trade on purely economic bases is not going to result in a thoughtful dialog on the subject.

I was impressed with Senator Symington's comment about U.S. nationalistic approach to some extent with respect to economic question and U.S. international approach in other areas such as political and military matters. Yet the basic difference of opinion cannot be swept away with the kinds of comments that are in your statement, and I appreciate that your statement wasn't intended to exhaust the East-West trade question. Yours was a much broader subject, so I am certainly not being critical.

But they can't be swept away that simple. The difference of opinion that I sense in this country and to some extent among Members of Congress boils down to a difference in viewpoint as to the nature of the threat that exists in the world, and a difference in viewpoint as to the effect on that threat by increased East-West trade. One of the fundamental problems is that it is a difficult question to deal with in a broad way, because it seems to me that what is or is not desirable economically, politically, militarily, varies from country to country, from commodity to commodity, and sometimes from year to year. Therefore, I have trouble buying the argument that one must be for East-West trade or that one must be against East-West trade, because I believe one must look to the country and look to the commodity and look to the political and military and economic framework at the time that a decision is being made.

It would seem to me that we are going to have a more constructive dialog on this subject if the arguments are not based purely on economics, when the opposition is coming from people who recognize the economic advantages, but who are concerned more about the potential political and military disadvantages. Rather, the arguments must show specifically what we would gain economically in exchange for what we might be losing in terms of some potential political or military problems in the future.

Some argue, saying that the Communist countries are going to get the commodities anyway, from Britain, Japan, or from some other country. They further argue that therefore we should trade and get the economic benefits. Well, that has some merit economically, and it does eliminate one of the problems politically and militarily, but it doesn't solve the question because of the fact that the answer to it might be, well, why isn't this country exerting a little more pressure leadership in the world to try to develop support and cooperation from other nations, so that in the event a situation does develop with respect to a specific country or a specific commodity at a specific time, we could encourage other nations to see that they don't get it, instead of just throwing up our hands and saying they are going to get it anyway.

It reminds me of the story about the village where there was mud in the streets and the people who walked along the curb would get spat-tered with mud every time a cart went by. So the city fathers met and decided to work this out reasonably. They passed an ordinance saying that every time a cart came by everyone had to line up along the curb so they would all get sprayed with mud equally.

This has been a lengthy comment on a subject on which I need a great deal more information, but I would like to see a considerably

more precise and thoughtful discussion on this subject in the country by the administration. We are ultimately going to find the right posture for this country in the coming months only if we have such a discussion. I have not been terribly impressed with what I have heard thus far. Again, I don't mean your statement. I feel you have made a very fine statement here today, and I very much enjoyed your comments and responses to questions. I am referring to the administration generally.

Mr. TROWBRIDGE. Thank you, Congressman. I might comment briefly. There is no question the definition of the word "peaceful" or the definition of the word "strategic" is one of the toughest things in this whole argumentation.

We who have the Export Control Act responsibilities, in looking on these things on a case-by-case basis as we do, wrestle with these definitions all the time. I had a personal experience some time back which might illustrate the difficulty.

One day on a hillside in Korea a Chinese soldier threw a grenade in my direction. It didn't go off. I took it apart. I was curious. I looked in the handle, pulled something out. It was a piece of newspaper with gunpowder used as a fuse. I opened the newspaper and it was from Sacramento, Calif. That wasn't strategic as newspaper, but it sure felt strategic when I opened it up. The end use very often determines the problem here.

I think when we talk machine tools, are machine tools strategic or are they peaceful? Well, I happen to think that if the Soviet Union decides to go into the automobile industry in a big way, and devote very large resources to the creation of a private-automobile kind of economy, with roads and with repair shops and service stations and all the other things, I think this kind of development is the kind of use of their resources that is probably very good, from our point of view. I would rather see them creating that kind of consumer-goods economy than using it for strategic purposes. And for that reason I think we could and should sell them machine tools to go into a plant to make automobiles.

This is the kind of case-by-case determination that you come down to very often, and often this difficulty of semantics and determining really what the word means and what the end use is is a very real part of the problem, and I think we do have to talk this out.

We tend—we, the United States—tend to look at this question in the economic and political context. When it comes to our export controls we are a member of an international group that has decided upon a list of items. We have a second list which is our own unilateral control list, and we review that to see how realistic it is, but it is considerably more than the internationally agreed list.

We do work with basically the NATO allies group, to see to it that items on the international list are up to date, are added if we can convince them that this is a new element that really is strategic and should be controlled, or as they become less and less important, the opinion is we ought to take them off, to agree to taking them off. But these is the effort to work with our allies, to get a certain community approach as far as exports go.

I think we are going to hear a lot more about this whole question of trade contacts. I think there are some economic advantages. We are losing business in the competitive trade field. I think indeed there

can be, if we can develop the kind of trade contacts which are long term, some very good political results out of this, too.

Representative RUMSFELD. I suppose there are instances in history that show both ways.

Mr. TROWBRIDGE. Yes.

Representative RUMSFELD. We had pretty extensive trade relationships with Cuba.

Mr. TROWBRIDGE. Yes.

Representative RUMSFELD. So it can be argued both ways. I agree with you the contact in and of itself can be favorable and helpful rather than harmful and unfavorable. With that I will conclude.

Chairman PROXMIRE. Thank you very much, Mr. Rumsfeld.

Thank you, Mr. Secretary. This has been very enlightening and an informative day for me. You did a fine job, and I certainly very much appreciate your excellent comments and statement.

Mr. TROWBRIDGE. Thank you very much, Mr. Chairman.

Chairman PROXMIRE. The committee will reconvene Wednesday, February 15, to hear Walter Heller in the morning at 10 o'clock and Arthur Burns in the afternoon at 2 o'clock.

(Whereupon, at 4:25 p.m., the committee adjourned until February 15, 1967, at 10 a.m.)

