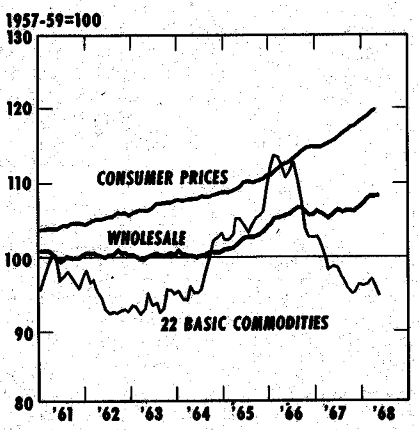
France last month. France, which more than any other country has sought to discipline the dollar, now faces a burst of inflationary pressures. There is, however, no room for satisfaction in this turn of events. Economic interdependence today makes economic imbalances in one country a problem for other nations. A strong France and a strong Europe are important to the well-being of our trade and foreign investment.

The Economic Consequences of De-escalation

The beginnings of negotiations with North Vietnam have provided hope for an end to that conflict, however far off it yet may be. The end of hostilities would be welcome on humanitarian grounds, and it might also bring welcome relief to problems of deficits in the Federal budget and the U.S. balance of payments. Neither problem would be solved, but their dimensions would be appreciably diminished. Negotiations are likely to be prolonged and a workable peace agreement uncertain. Even if a truce were worked out, the ensuing demobilization would be slow and cautious. Defense spending has risen $27.5 billion since mid-1965 and may go higher. Much of this rise is not easily reversed, since it reflects higher salaries and prices of defense goods. It has been estimated that the cutback, when it finally comes, will be half to two thirds of the rise, spread over as much as a year and a half after peace is restored.

In absolute terms, an overall decline of $15-20 billion in defense spending could provide considerable opportunity for tax reform, anti-poverty programs, and other constructive measures. Relatively, however, the cutbacks in defense would be only about 2 per cent of the gross national product. Even this decline would probably be offset in large part by the stimulus of an easier monetary policy and by a shift to other types of public and private spending. Such shifts in spending patterns would necessarily be accompanied by interindustry adjustments and added unemployment, but on a local, not a national, scale.



Changes in Consumer, Wholesale, and Basic Commodity Price Indexes

Source: U.S. Bureau of Labor Statistics. Latest figure shown for consumer price index is April; for others, preliminary May.

The general awareness that peace in Vietnam is constructive for the economy runs contrary to the opinion that high military expenditures are a necessary prop to this country's economic growth. At the end of World War II, there was a widespread belief that the economy, without huge military spending, would soon slip back into a depression. That view has not died easily. It was fairly prevalent in the Fifties, particularly when the Korean War came along to provide a new burst of demand. The extent to which we have moved away from the belief that the end of a war brings a recession is demonstrated by the more buoyant mood of businessmen and stock market investors with each step toward ultimate peace in Vietnam. Businessmen and investors are holding confidently to the view that the long-term problem is inflation and not deflation.

Today one frequently hears the comment that we cannot afford to have a business downturn because it would heighten social unrest. This implies we have achieved a high degree of precision in controlling our economic environment. However, there is still widespread disagreement over the causes of recessions. As long as this disagreement prevails, there is a chance that we can from time to time accidentally slip into a business downturn as we have four times since the end of World War II.

It is worth noting that the period in which industrial activity was stimulated by rapidly rising output of defense goods appears to have ended several months ago. The defense production figures implicit in the Federal Reserve index of industrial production have shown little change since last fall. One interpretation could be that the long supply pipelines are at last filled, and, barring further escalation, military demands for defense goods will henceforth be largely on a replacement basis.

At the same time, output of business machinery and equipment has shown very little change since the second quarter of last year. The dollar volume of capital spending has risen and further increases are anticipated, but most of this advance merely reflects higher prices.

The recovery in industrial output has been