

STATEMENT BY WILLIAM McCHESNEY MARTIN
BEFORE THE SUBCOMMITTEE ON DISARMAMENT
OF THE
SENATE COMMITTEE ON FOREIGN RELATIONS, MARCH 7, 1957

Mr. Chairman and members of the subcommittee:

It is something of a novelty and a relief to appear before a committee of Congress in my individual and not in an official capacity. Your chairman, in his letter to me of January 7, addressed me not in my official role but, I gathered, as one who has been interested in economic studies for a good many years--though of course I do not profess to be an expert in these vast fields that you are exploring.

Your chairman's very interesting letter said that "in order to obtain some understanding of possible effects of a reduction in armaments, I would like to pose a few questions on the assumption that the defense budget was reduced by an across-the-board cut of fifty per cent."

As you are aware, that is a hypothetical proposition that would be affected by many unforeseeable possibilities--the timing of such a cut, whether it was brought about gradually or abruptly, the state of the economy at the time, the needs of the country for all manner of goods and services, housing, roads, schools, and so on. The labor force available would be a very important factor.

Despite these imponderables, it seems to me very worth while to make certain assumptions, as you have done, and then to explore the possibilities--if not the probabilities. One's view of the future depends largely on his own state of mind, his confidence in the vitality and adaptability of our economic system and institutions. I am an optimist.

Experience of the not distant past has, I think demonstrated the extraordinary capacity of this country to adjust to radically different environments--from slack times, to preparedness, to all-out war, to a period of postwar transition that did not bring about the heavy tide of unemployment that was almost universally feared and predicted.

Being an optimist about our future, I do not accept the belief that prosperity rests upon indefinite continuance of vast government expenditures for arms. The diversion to private consumption or other public uses of the great resources of manpower and materials at our disposal could, I believe, add immeasurably to our standard of living without grave economic dislocation. We could, of course, so mismanage our affairs that transitions would be wasteful, painful, and needlessly severe. I have a high degree of confidence that we will not bungle that badly.

I wanted to make these few prefatory remarks in presenting two memoranda prepared by our staff people at the Board of Governors as informal studies, based on your hypothesis and not in any sense as Board statements. Both were prompted by suggestions emanating from your sub-committee. One discusses "Control of Armament Reduction Through Budgetary Inspection." The other is entitled "Comments on the Economic Significance of a Fifty Per Cent Cut in Security Expenditures."

March 7, 1957.

Control of Armament Reduction Through Budgetary Inspection*

Proposals to ensure international compliance with scheduled armament reductions through periodic inspection of governmental budgets assume that budgetary appropriations can be brought--by relatively simple regulations--to reflect accurately actual levels of military expenditure. Numerous difficulties, both technical and in respect to enforcement, raise serious doubts whether this can be done.

At the technical level, the difficulties of identifying and measuring provisions for military expenditure under a variety of dissimilar budgetary procedures should not be minimized. The experience of domestic agencies in establishing and enforcing uniform accounting methods for regulated industries may give some idea of the complexity of the problems presented. Price level fluctuations, moreover, raise a basic difficulty. It seems unlikely that any simple coefficient applied to the monetary unit from year to year, as suggested in the proposal, would compensate for the impact of price changes on the real rate of military outlay. Military expenditures do not represent an unchanging "package" of component goods and services, and movements in individual prices are likely to diverge widely--especially where these may be subjected to various measures of selective control.

Fundamental differences in methods of capital accumulation between socialist and capitalist economies further complicate the problem of defining military expenditure. Any defense program is concerned not merely with maintaining armed forces in being but with expanding productive capacity in defense related industries, transportation, and power facilities. Under a capitalist system, the government may encourage private investment along these lines through tax relief, military contracts, stockpiling commitments,

* Prepared by the Division of Research and Statistics, Board of Governors, Federal Reserve System.

or direct subsidy; any or all of these might be classified as military expenditures by an international authority. In a socialist economy, on the other hand, provision for all types of economic expansion may be made through the government's budget and, where alternative civilian applications exist, could hardly be questioned.

Aside from technical questions of classification and measurement--which despite their complexity might, in theory, be determined equitably by international experts--it seems unlikely that deliberate falsification could be detected from a study confined to the official budgets themselves. It would, accordingly, probably be necessary to police a system of control over budgetary appropriations by the same physical inspection of productive and stockpiling activity that would be required by a system based directly on such controls.

March 7, 1957

COMMENTS ON THE ECONOMIC SIGNIFICANCE OF A FIFTY
PER CENT CUT IN NATIONAL SECURITY EXPENDITURES*

National security expenditures have increased to a rate of about \$44 billion since last summer, following a two year period of stability at a rate of about \$41 billion. The current level represents 10 per cent of the market value of our total annual production--the same as in 1956. It is the lowest percentage absorbed by defense requirements since early in the period of expansion in security outlays stimulated by the outbreak of hostilities in Korea. Over \$9 billion is for pay to the Armed Forces. Roughly \$25 billion of security expenditures is for purchases of goods (including construction) which compares with private business expenditures for producers' durable equipment of about \$32 billion, total new business and residential construction of \$33 billion, and consumers' expenditures on durable goods of \$35 billion. While defense spending has been large, it has not contributed directly to the expansion in economic activity since early 1954. In this period, Gross National Product has increased one-fifth, while national security expenditures have changed relatively little.

The impact of a 50 per cent cut in defense spending, which would amount to about \$22 billion at current expenditure rates, is difficult to assess since defense outlays have had pervasive effects throughout the economy. The nature and extent of adjustments which undoubtedly would be necessitated in a period of transition would depend largely on the economic climate of the time, the length of the period during which the reduction is effected, the specific expenditures affected by the cut, the relative importance of the defense program at that time, and the types

* Prepared by the Division of Research and Statistics, Board of Governors, Federal Reserve System.

of action undertaken by the Government to ease the transition. These circumstances, indeed, are of such over-riding importance that past experiences with demobilization are of limited value in anticipating the effect of a cutback at the present time.

This was illustrated by the situation at the end of World War II, when military expenditures reached a peak annual rate of about \$90 billion and accounted for two-fifths of the Gross National Product. During four years of war, a backlog of demands and financial liquidity had accumulated, and when security outlays were sharply reduced, total output of goods and services declined only briefly, and the large scale unemployment that many observers predicted did not develop.

More closely comparable to the currently proposed cutback in military outlays is that which occurred after the Korean War. From mid-1953 through the third quarter of 1954, the annual rate of defense expenditures fell by \$11 billion from a level of \$53 billion; this reduction in the national security component amounted to 3 per cent of the Gross National Product. A \$22 billion reduction in defense spending would amount to 5 per cent of the current level of the Gross National Product.

In the post-Korean experience, the initial defense cutback--during the second half of 1953--reduced the annual rate of national security outlays by \$4 billion; over the same period, total output of goods and services declined about \$10 billion. A shift from business inventory accumulation at a rate of \$3.1 billion to liquidation at a rate exceeding \$5 billion largely accounted for this decline. At the same time, disposable personal income did not decline but only leveled off, in part reflecting a significant increase in unemployment payments both to veterans

and to non-veterans, and consumer purchases declined only slightly; State and local government expenditures increased.

Despite an additional decline of \$7 billion in the annual rate of national security outlays and some reduction in purchases of producers durable equipment during the first three quarters of 1954, other expenditures, particularly residential construction, State and local expenditures and consumer outlays, all rose. These increases were reflected in a reduction in the rate of inventory liquidation and formed the basis for economic expansion in 1955. Vigorous use of fiscal and monetary policies, including the reduction in personal income tax rates in 1954 and a policy of active monetary ease, contributed to the recovery.

From the second quarter of 1953 to the third quarter of 1954 the Armed Forces were reduced by 300,000 and nonfarm employment fell by almost 2 million. Unemployment increased from about 1.5 million persons, or 2.5 per cent of the labor force, to about 3.5 million, or 5.5 per cent of the labor force. Most of the decline in employment was concentrated in durable goods manufacturing industries, but work forces were also reduced in nondurable goods manufacturing, in the Federal Government and in the railroad and mining industries. In the same period, however, almost 500,000 were added to the payrolls of the finance and service industries and State and local governments. Part of the downward adjustment was reflected in a reduction in hours of work.

By mid-1955, however, an expanding labor market had largely absorbed earlier declines. Employment was at record levels and unemployment was again low. In 1956 unemployment averaged less than 4 per cent of a labor force of 70 million persons, 3.5 million more than in 1953.

It is evident from this review that both the initial impact of the post-Korean cutback and the rate of readjustment depended on underlying economic conditions at that time, and on the governmental policies adopted during the transition. Similarly, the impact of defense cutbacks in the near future can only be gauged in terms of the underlying economic conditions likely to prevail when it occurs. The current situation is one of general economic strength. Some areas of the economy are less buoyant than others, but in general demands for goods, services and credit remain high. Defense expenditures, while an important component of total activity, have contributed little to the rise in activity since mid-1954. Some aspects of the defense program, such as stockpiling and defense plant expansion, have been exerting a diminishing pressure on resources.

In the latter part of 1956, there were about 2.8 million men in the Armed Forces compared with about 3.5 million in mid-1953. It is estimated that national security expenditures for supplies, equipment and construction had declined to about 10 per cent of the physical volume of industrial production, as measured by the Board's index. This compares with 20 per cent in early 1953, before the 1953-54 reduction in defense production, and 13 per cent in late 1954. Perhaps 17 or 18 per cent of total industrial activity in late 1956 in durable goods industries was directed to the defense effort in the form of output of ordnance, military aircraft and ships, radar, trucks and locomotives, and other end-products and in the form of aircraft parts, electric motors, steel, aluminum, etc., as compared with 5 per cent or less for nondurable goods.

Expenditures for stockpiling of strategic materials have also been of declining over-all economic significance. In the first half of 1956 deliveries to the stockpile amounted to \$145 million, half the value

of deliveries in the first half of 1955 and one-third the rate in 1952 and early 1953. Through loans and long-term purchase agreements, the stockpiling program stimulated expansion in capacity for several basic materials. In the past few years of high level economic activity the additional supplies thus made available have been largely absorbed by industrial demands. In the event of a one-half curtailment in defense expenditures, the quantities of these supplies the Federal Government would be obligated to acquire under the terms of these contracts would depend on the strength of civilian demands.

Another facet of the defense effort has been encouragement of increases in productive capacity of defense related industries through an accelerated amortization program. As in the case of stockpiling, the peak impact of this program has long since passed. Since 1950, certificates of necessity have been granted for the purpose of expanding productive facilities in 225 strategic industry groups to meet specified capacity goals. To date, projects constructed under this program have amounted to \$37 billion, on which accelerated amortization has been applied to about \$22 billion. The total outlay on these projects represents about one-fifth of all business expenditures for new plant and equipment during the seven year period from 1950 through 1956. The degree to which the stimulus to investment has been concentrated on certain industry groups is indicated by the fact that public utility, rail and primary metal expansion accounted for half the value of all projects certified.

The accelerated amortization program probably had only slight influence on business capital expenditures in 1956. Measured by project

costs, two-thirds of all outstanding certificates of necessity had been issued by the end of 1952, with the bulk of expenditures presumably taking place in the years immediately thereafter. The proposed outlay on projects covered by certificates of necessity issued during 1956 was less than \$3 billion, little more than eight per cent of the current annual rate of corporate spending on plant and equipment. Even if the defense program were to be sustained at its present level, future increases in capacity will probably be geared primarily to the needs of the civilian economy.

Although defense expenditures are no longer providing much, if any, stimulus to economic expansion, they are absorbing large amounts of human, material and financial resources. Consequently, a fifty per cent reduction in defense outlays would confront specific industries and geographical areas--and through these, the economy as a whole--with serious immediate problems. In the longer run, however, it would free manpower and industrial resources to meet a broad range of human needs both here and abroad. The defense program itself has generated several forces which may be expected to ease the transition.

Military outlays for scientific research and development in recent years have been large, totaling about \$1-1/2 billion last year. Many of the military research developments made or in process have major, but as yet unexploited, civilian applications. If these developments, and the scientific and technical skills concentrated in defense activities could be released for peacetime applications, significant progress in raising living standards might be achieved. Technological development would open new investment outlets and could stimulate demand, thereby providing a major impetus toward sustained economic expansion. An easing

of market pressures would also permit more rapid progress in meeting the backlog of demand for schools, water and sanitary facilities, hospitals, and other community services by State and local governments. Reduced military requirements would likewise facilitate progress in meeting major goals for highway construction.

Just as a reduction in military outlays presents problems and challenges to our own economy, it would present similar problems and opportunities in many other countries. U. S. defense expenditures abroad, including also expenditures of the U. S. Armed Forces stationed in foreign countries, amounted to \$3.2 billion in fiscal 1956. This sum was equal to about 14 per cent of all foreign payments made by the United States. For some countries, however, receipts of U. S. defense expenditures represented a relatively more important source of dollars. Less highly industrialized countries mainly in the Near East and Far East, who received about one-seventh of our defense expenditures abroad in fiscal 1956, would probably be most seriously affected by a reduction in U. S. outlays. On the other hand, there are a number of countries--such as Belgium, Germany, the Netherlands, and Canada--whose balance of payments situation is so strong that they may be expected to weather a reduction of one-half in U. S. defense expenditures without serious drain on their gold and dollar reserves. These countries receive about one-fifth of our total defense outlays abroad.

The bulk of our foreign defense spending went to countries whose gold and dollar reserves might be seriously affected, but who should be able to adjust successfully if the reduction in spending was not made too rapidly. This group includes countries such as France, Denmark, Italy, Norway, the United Kingdom, and Japan.

Although these countries might face complex problems of adjustment, it should be noted that a cut in our defense expenditures abroad would not automatically mean a corresponding decrease in their

dollar receipts. In contrast to outright financial aid, our defense expenditures abroad are not free gifts: the recipient countries are required to use the equivalent of these funds for purchasing or producing goods and services for their own defense, for our mutual Allies, and for our Armed Forces. The recipient countries therefore must utilize productive resources for defense purposes, resources which would be set free to the extent that our defense expenditures would be curtailed. Given enough time to effect the necessary readjustments, it should generally be possible to re-employ the productive resources of those countries in such a way as to make good the loss of dollar revenue: say, by increasing the production of goods and services for export. Some problems, particularly in retraining labor and securing capital for expanding production of export goods, and in finding export markets, may have to be solved in the period of transition.

A major contribution to the solution of the problem which may be faced by foreign countries would be the maintenance of a strong domestic economy in the United States. Toward this end, governmental policies would need to be directed to the easing of the impact of disarmament on specific industries or areas and to the preservation of confidence in over-all economic prospects. Existing Government programs that would promote a smooth transition, such as veteran benefits and unemployment compensation, might be re-examined in order to insure their maximum contribution. Reductions in Federal taxation made possible through savings affected by disarmament would permit and encourage expansion of private spending now limited by the defense program's drain on financial and physical resources. Industry would be encouraged to

exploit more promptly the technological developments of recent years. Well-timed reductions in personal income taxes would help to make effective underlying consumer demands for goods and services, which in turn would promote further expansion of productive capacity.

If a smooth transition could be provided between a cold war economy and a peacetime economy, there would be little doubt that potential civilian demands exist here and abroad which would be ample to utilize and even to strain our productive facilities and expanding labor force. During the transition itself, however, uncertainty throughout the economy could lead to cumulative repercussions beyond the industries directly affected by military cutbacks. If broader dislocations and a significant rise in unemployment are to be avoided, public confidence in over-all economic prospects must be preserved. It is of the utmost importance that the Government be prepared to act quickly to meet any developments and that this determination be generally understood.