ANNUAL REPORT ON THE FINANCES

TREASURY DEPARTMENT,
Washington, May 9, 1966.

SIRS: I have the honor to report to you on the finances of the Federal Government for the fiscal year 1965. Details on Treasury operations and administrative reports for the fiscal year 1965 will be found in the full text of this report. This introduction will be concerned with major fiscal and financial developments during the calendar year 1965 and the early part of 1966.

Overall Review

The period under review was one of challenge and accomplishment, both domestically and internationally. At home a continuing expansion in production and incomes, unparalleled in our peacetime history, carried us closer to the goals of a Great Society. Although margins of unutilized industrial capacity and unemployed labor remained by the end of 1965, they had been narrowed significantly by the pace of steady expansion, supported by an act of Congress in June eliminating most excise taxes and reducing others. But, as 1965 drew to a close, it was becoming apparent that our steadfast commitment to the cause of freedom in Viet Nam would entail a much larger claim upon the nation's resources, both material and human. The new economic challenge was to insure the balanced growth of a nearly fully employed economy, free from inflationary excesses, while providing all that our commitments in Southeast Asia and elsewhere might require.

There was every reason for confidence that the vast productive power of our economy, strengthened during recent years by tax reduction and high rates of investment, would be equal to the foreseeable demands that might be placed upon it. But, it was essential, if serious inflationary strains were to be avoided, that the Federal fiscal influence should shift from one of steady stimulus to aggregate demand to one of moderate restraint. Therefore, the President's January 1966 budgetary recommendations combined strict economy in nondefense expenditure programs with proposals for further tax action to augment the increases in social security and medicare taxes already going into effect at the beginning of 1966. Prompt congressional enactment of that further tax action, in almost the exact form requested, was an impressive demonstration of the flexibility of fiscal policy, and of the willingness of the Congress to act promptly to prevent overstraining the economy. Whether further fiscal action

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would be required was uncertain, but the President had made it amply clear in his Budget Message that:

> "if . . . events in Southeast Asia so develop that additional funds are required, I will not hesitate to request the necessary sums. And should that contingency arise, or should unforeseen inflationary pressures develop, I will propose such fiscal actions as are appropriate to maintain economic stability."

In our international financial relations, the challenge at the beginning of 1965 was twofold. First, it was essential to reverse the worsening in our balance-of-payments position that had developed in late 1964 and to move promptly toward a secure equilibrium in our international accounts. Second, beyond that immediate necessity, there was the very great desirability of making timely progress toward agreement with other nations on the form that improved international monetary arrangements should take.

The President's comprehensive voluntary balance-of-payments program announced February 10, 1965, and further tightened in December 1965, was chiefly responsible for an approximate halving of our 1964 balance-of-payments deficit as measured on the liquidity basis. The goal of the Administration was to cover the remaining distance to payments equilibrium by the end of 1966, although it was recognized that the direct and indirect impact of Viet Nam might temporarily delay achievement of that goal.

Following a series of bilateral talks with the financial officials of a number of other countries, new negotiating machinery was established in September 1965, to achieve improvements in the international monetary situation. The major objective is to arrange for dependable new sources of liquidity as required in the future to finance growing international trade in the absence of dollar deficits. Negotiations have been pursued actively and progress is being made toward reaching a consensus on the essential features of an international system for creating reserves.

Treasury debt management faced new challenges in the past year even though the Treasury's net cash borrowings were relatively modest. The rise in longer term interest rates after mid-1965 was the first significant upturn during the present extended period of prosperity and created a new environment for debt management. As described below and discussed more fully in the text of this report, financing operations were successfully adjusted to the changing market situation, and continued to serve the overall objectives of economic policy.

In addition to these major domestic and international financial developments, the past year was an active and important one for the Treasury in many other respects, a few of which are noted below.

At a conference in Manila in early December 1965, the United States and 21 other countries signed the charter of an Asian Develop-

ment Bank with an authorized capital of $1 billion, of which the U.S. subscription is $200 million. Nine other countries became charter members by signing and making a pledge by January 31, 1966. In his Message to the Congress recommending approval of U.S. participation, President Johnson pointed out that the new Bank "is the product of Asian initiative, and it offers the nucleus around which Asians can make a cooperative response to the most critical economic problems—national and regional." The Congress approved the enabling legislation and it was signed by President Johnson on March 16, 1966.

As an outgrowth of action initiated at the September 1964 meeting of the International Monetary Fund, the Congress authorized an increase of $1.035 billion in the U.S. quota in the International Monetary Fund in June 1965. The U.S. action was part of a general increase by all of the participating countries in their respective Fund quotas, to become effective upon ratification by members holding two-thirds of present quotas. This point was reached on February 23, 1966. The quota expansion had been strongly supported by President Johnson and by his National Advisory Council on International Monetary and Financial Problems.

The realities of the silver supply situation made it impossible to continue indefinitely the production of high-content silver coins. Therefore, a necessary change in our coinage system was made with the passage of the Coinage Act of 1965 which removed silver from the dime and quarter and reduced the silver content of the half dollar to 40 percent. New coinage alloys, reflecting the latest developments in modern technology, insured the consistent operation of the new dimes, quarters, and half dollars in all of our millions of coin-operated machines. Late in 1965, the new quarters began to go into circulation, followed by the dimes and half dollars in early 1966. Details of the new coinage system and a description of the successful efforts of the Bureau of the Mint in overcoming recent coin shortages will be found in the accompanying report (pages 131–4).

A comprehensive study, initiated in 1963, on the mission, organization, and management of the Bureau of Customs was released in March 1965. At the same time, President Johnson announced a major program, under the terms of Reorganization Plan No. 1 of 1965 which became effective May 25, to make maximum use of the skill and talent of the career employees of the Customs Service and to achieve annual savings estimated at $9 million. Major management improvements in other Treasury agencies and bureaus are described in the accompanying report.

Tax Policy

The economic expansion that began in early 1961 continued strongly through calendar year 1965 and into 1966. National output rose 5½

percent in real terms during 1965 and our record of cost-price stability remained superior to that of any other major industrial nation, despite growing pressures by the end of the year. Unemployment was reduced to just over 4 percent by the end of 1965 and declined further in early 1966.

Tax reduction and reform was again a central element in overall economic policy. Forward impetus was provided to the economy by the second-stage tax reductions of the Revenue Act of 1964, which has convincingly demonstrated its success, and by the first stage of the Excise Tax Reduction Act of 1965, signed into law by President Johnson on June 21, 1965.

Very general agreement had developed that many of our excise taxes had no place in a permanent tax system. Extensive hearings had been held on excise tax reduction before the House Ways and Means Committee in the summer of 1964 preparing the way for prompt action in 1965. The President stated in his Budget Message of January 25, 1965, that attention should now be given to the repeal of some excise taxes and the reduction of others. Such action would provide further aid to economic growth and minimize the burden on consumers and business resulting from taxes which were often costly and difficult to administer and which frequently distorted consumer choices as among different goods. On May 17 the President sent a message to the Congress with the details of an excise tax reduction program, modified in the light of the current and prospective economic situation, and totaling $3.9 billion at estimated fiscal 1966 levels of income. To insure the maximum contribution to continued price stability and balanced prosperity, the President requested that business promptly pass forward to consumers the full amount of excise tax reductions. This request was emphasized again when he signed the bill on June 21, and, by and large, was carried into effect in ensuing months.

The tax repeals or reductions under the final legislation amounted to $4.7 billion at fiscal 1966 levels of income, rather than the $3.9 billion recommended by the President. This resulted chiefly from eventual reduction of the tax on passenger automobiles to one percent, rather than five percent as recommended, and to a lesser extent from minor changes which are detailed later in this report (pages 37–40). Of the total $4.7 billion, about $1.75 billion became effective on June 22, 1965, and an approximately equal amount became effective on January 1, 1966, with additional reductions to be effective in three stages, on January 1, 1967, 1968, and 1969.

Another taxation development during 1965 that deserves mention here was the modification of the depreciation guideline procedures initiated in 1962. Those 1962 procedures were instituted as part of a thoroughgoing depreciation reform designed to encourage the use of more rapid equipment modernization in industry. At that time,

taxpayers were allowed a three-year transitional period. Study of the depreciation practices of several hundred large firms conducted at the request of the Treasury in 1964 by the National Industrial Conference Board and independent studies by the Internal Revenue Service suggested that some liberalization of guideline procedures was necessary if businesses were to obtain full benefit from the 1962 depreciation reform. At the same time, the Treasury recognized the need to apply limitations in the use of certain accounting techniques found to be incompatible with the guideline procedure. The combination of the new liberalized rules and the new limitations was estimated to result in increasing depreciation tax benefits during 1965 by some $600 million–$800 million over what they would have been if the 1962 reform had not been modified.

The overall fiscal position in late 1965 and early 1966 was substantially influenced by the amendment of the Social Security Act in July 1965, in line with recommendations by the President. Old age benefits were liberalized retroactively to January 1, 1965, with disbursement of the retroactive portion made in September 1965. However, the increase of some $2 billion annually in transfer payments was to be more than offset by the increase in social security and medicare payroll taxes of $6 billion, annual rate, going into effect January 1, 1966. With medicare payments not beginning until the second half of 1966, the net effect would be some increase in fiscal restraint in the first half of 1966 because of the higher payroll taxes.

Late in 1965 it became apparent that the increased commitment in Viet Nam might be sufficiently large to require offsetting fiscal action, beyond that which would result from the higher payroll taxes and rigorous control of nondefense expenditures. In his Budget Message of January 24, 1966, President Johnson announced that apart from the special military and economic assistance costs in Viet Nam, expenditures for the regular programs of the Federal Government in fiscal 1967 were estimated at $102.3 billion, a rise of $0.6 billion from fiscal 1966, only six-tenths of one percent. But, because increased special costs associated with Viet Nam would add an estimated $4.7 billion in fiscal year 1966 expenditures and $10.5 billion in fiscal year 1967 expenditures over the amounts estimated in January 1965, it would be necessary to raise additional revenues.

As the President had expressed the matter on January 19, 1966:

"Under these circumstances, I was faced with three choices:

—A deficit in excess of $6.5 billion, which would require the Government to borrow the additional money.

—An increase in corporate and personal income tax rates, or other new taxes.

—Temporary restoration of certain excise taxes, and adoption of graduated withholding of individual income taxes and current payment of corporate income taxes—to put the American

people on a pay-as-you-go basis without increasing the total tax bill due.

"Over the past several weeks I discussed these alternatives and countless variations of them with my advisers. I made two decisions.

"First, we could raise revenue or borrow it. I chose to raise the money.

"Second, I chose to raise that money without any increases in personal and corporate income tax liabilities, but through changes that affect only the timing of tax payments and the temporary restoration of certain excise taxes on telephones and automobiles."

Therefore, the President recommended tax legislation involving (a) temporary restoration of the rates of excise taxes on automobiles and telephones that were in effect at the end of 1965 and (b) the adoption of collection procedures which would put income and self-employment tax payments closer to a pay-as-you-go system, thereby increasing current revenues without changing income tax rates and without changing anyone's final tax liabilities. It took only about 60 days from the time the tax program was outlined in mid-January for it to be enacted, essentially in its original form as regards the impact on fiscal years 1966 and 1967, as the Tax Adjustment Act of 1966. That legislation was expected to generate approximately $6 billion extra revenue in the 15 months following its enactment—through fiscal year 1967. In terms of cash payments, the changes in the new law were estimated to take about $2.7 billion out of the individual and corporate spending stream in calendar 1966.

Whether the degree of fiscal restraint embodied in the Tax Adjustment Act of 1966 would prove sufficient, or whether further fiscal or other action would be required, could only be determined with the passage of time. Full effects of the Federal Reserve's monetary tightening signaled by the December 1965 increase in the discount rate were yet to be registered, and further evidence was needed on the strength of private spending plans. It was clear, however, that the flexible adaptation of fiscal policy to changing needs had already been convincingly demonstrated.

In the recent past, tax reduction actions had included the investment credit in the Revenue Act of 1962, the individual and corporate income tax reductions in the Revenue Act of 1964, the Excise Tax Reduction Act of 1965, and the administrative depreciation reforms of 1962 and 1965. Despite tax reductions that cut the burden of taxes by some $20 billion at current levels of income, revenues were estimated at $21 billion higher in fiscal year 1966 than in fiscal year 1961. This contrasts with a growth in receipts of only $10 billion in the 5 years preceding 1961, a period in which there was no significant tax reduction.

In commenting upon this remarkable growth in revenues in his January 24, 1966, Budget Message, President Johnson noted that we

have had a clear illustration of the direct relationship between tax policies, economic growth, and Federal revenues. He went on to observe that: "Tax policy, however, must be used flexibly. We must be equally prepared to employ it in restraint of an overly rapid economic expansion as we were to use it as a stimulus to a lagging economy. The current situation calls for a modest measure of fiscal restraint."

Balance of Payments

The U.S. balance-of-payments deficit increased sharply during the last half of calendar 1964, reaching an annual rate of $5.5 billion in the fourth quarter (liquidity basis), primarily because of a substantial increase in net outflows of U.S. private capital. By leading to temporarily excessive increases in foreign dollar holdings the larger deficit was aggravating the gold outflow problem. Therefore, President Johnson announced a comprehensive balance-of-payments program on February 10, 1965. The program was the result of a careful review of the situation by the Cabinet Committee on the Balance of Payments, chaired by the Secretary of the Treasury. The essentially new element in the program was its reliance upon the voluntary cooperation of the commercial and financial community.

U.S. banks were asked to hold total claims outstanding on foreign residents to 105 percent of the level at the end of 1964. Guidelines developed by the Board of Governors of the Federal Reserve System for implementing this program were designed to assure that credits to finance U.S. exports, and loans to less-developed countries, could be adequately met. In addition, consideration for the special positions of Canada, Japan, and the United Kingdom was requested. Within these broad guidelines each bank was to decide the direction of its particular overseas activities. A similar approach was permitted nonbank financial institutions in their foreign lending and investing activities.

U.S. industrial corporations also were asked to improve their individual balance-of-payments accounts, combining all transactions such as exports, dividend income, royalties, fees, and capital outflows from the United States. The objective was to leave the corporations free to adjust these components of their individual payments accounts while achieving a significant net payments improvement.

To reduce the tourist deficit, Americans as well as foreigners were encouraged to travel more in this country. Legislation was recommended and subsequently enacted on June 30, 1965 (Public Law 89–62), reducing the duty exemption on purchases made abroad by returning U.S. residents.

The February 10 program also called for extension of the interest equalization tax for two years beyond December 31, 1965, broadening its coverage to include nonbank credit of one-to-three year maturity,

and activation of the Presidential authority under the Gore Amendment to the act to apply the interest equalization tax to bank loans of one year or more. (The Interest Equalization Act was broadened in coverage and extended to July 31, 1967, by Public Law 89–243, October 9, 1965.) To stop any excessive flow of funds to Canada under its special exemption from the interest equalization tax, the President sought and received firm assurance that the policies of the Canadian Government would be directed toward limiting borrowing in the United States to the maintenance of a stable level of Canada's foreign exchange reserves. The program also called for an intensification of U.S. Government efforts to minimize the foreign exchange costs of our defense and aid programs; an increase in our efforts to promote U.S. exports; and, finally, encouragement of more investments from abroad, by increasing, through new tax legislation, the incentive of foreigners to invest in U.S. securities.

The program of voluntary cooperation that President Johnson called for in his Balance-of-Payments Message of February 10, 1965, proved to be highly effective. For the year 1965, there was a $1.5 billion net reduction in the payments deficit on a liquidity basis despite heavy outflows on private capital account during the early months and despite setbacks for the year as a whole in trade and other accounts. The $1.3 billion deficit in 1965 was the smallest since 1957 and less than half the size of our deficits of $2.8 billion in 1964 and $2.7 billion in 1963. On the other principal accounting basis, official reserve transactions, our deficit in 1965 was also $1.3 billion, about the same as the 1964 deficit on that basis.

Gold outflows rose sharply to $1.665 billion for the year as a whole. However, there was a pattern of steady improvement during the course of the year. From a high of $832 million in the first quarter, the outflow declined to $590 million in the second quarter (including a $259 million payment of the gold portion of the increased U.S. subscription to the IMF), and fell further to $124 million in the third quarter, and $119 million in the fourth quarter.

Late in 1965, at the request of the President, the Cabinet Committee on the Balance of Payments, under the chairmanship of the Secretary of the Treasury, conducted an intensive review of the U.S. balance-of-payments situation. The recommended measures for 1966 involve, essentially, a sharpening and reinforcing of the 1965 program with continued emphasis upon its voluntary, comprehensive, and balanced character.

Corporations are requested, through a strengthened Commerce Department Program, to meet overall balance-of-payment targets similar to those of 1965; and also to meet specific targets for direct investment which are expected to result in balance-of-payments savings of up to $1 billion in 1966. Ceilings on lending under the Federal Reserve voluntary program are to rise by the end of 1966 to

109 percent of the December 1964 base for banks and nonbank financial institutions and small banks will be permitted to increase their loans somewhat more than this. These changes recognize the outstanding contribution of banking institutions to the 1965 program, and will help to insure more fully the adequacy of credit for financing of U.S. exports and the achievement of other desired objectives. Other important features of the program include an intensified effort to hold down the balance-of-payments cost of Government programs, encouragement of both foreign and domestic tourism in the United States, stepped-up effort to expand U.S. export trade, and the recommendation that legislation to encourage foreign investment in the United States now before the Congress be enacted as soon as possible.

The main balance-of-payments imponderables in early 1966 were the exact extent to which there would be rising balance-of-payments costs in Southeast Asia in both the military and aid programs and the direct and indirect impact of Viet Nam on the domestic economy and the balance of trade.

International Financial Arrangements

A summary of a wide range of developments in international financial affairs will be found in the text of this report (pages 49–65). The discussion here will be limited to a brief review of the major steps taken during the calendar year 1965 to achieve further progress toward improved international monetary arrangements.

The need for improved arrangements arises from the fact that growth in international monetary reserves—primarily gold and dollars—has been largely dependent over the past decade upon increases in official foreign dollar holdings. New gold supplies moving into monetary use have been accounting for a relatively small proportion of total reserve growth. Therefore, as the U.S. payments deficit is removed, the major source of recent growth in international liquidity will also be removed. To assure ample world liquidity for the years ahead—when U.S. payments will not be in chronic deficit—the United States, in cooperation with other leading financial countries, is seeking workable ways of strengthening and improving international financial arrangements.

In a Ministerial Statement of August 1964, the Group of Ten countries—Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States—stated that while supplies of gold and reserve currencies are fully adequate for the present and are likely to be for the immediate future, the continuing growth of world trade and payments is likely to require larger international liquidity. It was recognized that world liquidity needs might be met by larger credit facilities or might call for some new form of reserve asset. Therefore, a Study Group was set up "to examine various proposals regarding the creation of reserve assets

either through the IMF or otherwise." Their valuable study—the so-called Ossola Report—was submitted to the Group of Ten on June 1, 1965, and was published later.

By mid-1965 with this and other technical studies completed and with the U.S. balance-of-payments program demonstrating its effectiveness, it was appropriate to press forward toward a stage of more conclusive negotiations. Therefore, on July 10, 1965, the Secretary of the Treasury announced his intention of conducting a series of informal discussions with ranking financial officials of other Group of Ten countries to ascertain firsthand their views on the most practical and promising ways of furthering progress toward improved international monetary arrangements. In that statement, it was made clear that the United States was prepared to participate in an international monetary conference at some appropriate future time. It was also pointed out that before such a conference took place, there should be reasonable certainty of measurable progress through prior agreement on basic points.

It was announced at the same time that President Johnson had approved the recommendation of the Secretary of the Treasury and had created an Advisory Committee on International Monetary Arrangements, chaired by the former Secretary of the Treasury, Douglas Dillon. The Advisory Committee membership includes: Robert V. Roosa, former Under Secretary of the Treasury for Monetary Affairs; Kermit Gordon, former Director of the Bureau of the Budget; Edward Bernstein, economic consultant specializing in international monetary policy; Andre Meyer, of the investment banking firm of Lazard Freres; David Rockefeller, President of the Chase Manhattan Bank; Charles Kindleberger, Professor of Economics at Massachusetts Institute of Technology; Walter Heller, former Chairman of the Council of Economic Advisers; and Frazar Wilde, Chairman of the Board of Trustees, Committee for Economic Development.

In September, following a series of bilateral talks between the Secretary of the Treasury and foreign financial officials, new negotiating machinery was established at the time of the annual meeting of the International Monetary Fund. The Finance Ministers of the Group of Ten countries instructed their Deputies to seek a basis of agreement on the improvements needed in the international monetary system, including arrangements for the future creation of reserve assets. It was further provided that once a basis for agreement on essential points was reached, it would be necessary to proceed from this first phase to a second phase, involving a much larger group of countries.

At the same time, the Managing Director of the IMF, who participates in the ministerial meetings of the Group of Ten, indicated that the Fund would pursue its own investigation of the ways and means of creating international reserves. Since last fall, negotiations have

been pursued actively. The Deputies are proceeding to draft their report to the Ministers, which it is hoped will show considerable progress toward a consensus on the essential features of an international system for creating reserves.

Debt Management

During the course of calendar 1965, record flows of funds moved through our domestic financial markets but at higher rates of interest. For short-term rates, this marked a continuation of the more or less steady advance dating from the beginning of the current expansion in early 1961, which has made our own short-term rates more competitive with key rates abroad. For longer term rates, the rise after mid-1965 was the first significant upturn since the present expansion began.

Yields moved upward in all maturity ranges of Treasury securities from mid-1965 until early December, and then rose sharply following the December 6 increase in the Federal Reserve discount rate (yields from 1960 to mid-1965 are shown in chart 3, page 18 of the accompanying report). The yield on 3-month bills advanced from about 3.80 percent at mid-1965 to 4⅛ percent in early December, rose sharply to about 4½ percent by the end of the year, and worked its way irregularly higher in early 1966. Treasury coupon issues in the 5-year range, which were a bit above 4⅛ percent at midyear, rose to about 4½ percent by early December, and 4⅞ by yearend. Longer term yields in the 20-year range moved from a little below 4¼ percent at mid-1965, to around 4½ percent by the end of 1965. This background of rising rates, which continued into early 1966, formed the environment for Treasury debt management operations after mid-1965. (A detailed review of public debt management and ownership developments during fiscal 1965 is provided on pages 17–34 of the accompanying report.)

Following an August 1965 refunding operation, the Treasury conducted the bulk of its financing for the rest of the year in the form of tax anticipation bills. A $4 billion tax anticipation bill package in September was followed by a November auction of another $2.5 billion in tax bills. On October 27 the Treasury announced the terms for refinancing $9.7 billion of notes maturing November 15. The refinancing took the form of a cash offering of a new 18-month, 4¼ percent note, priced to yield about 4.37 percent. At the end of 1965 the average length of the marketable interest-bearing public debt was 5 years, the same as a year earlier but 4 months shorter than the average maturity at the end of fiscal 1965 which had reflected the lengthening impact of an advance refunding in January 1965.

In early 1966, after a $1.5 billion cash offering and $1 billion in additional tax anticipation bills in January, the Treasury took advantage of favorable market conditions in February to achieve some

moderate but useful debt lengthening, and also to lighten the task of refunding issues that would be maturing later in the year. The successful February operation was a combined refunding of February 15 and April 1 debt maturities into 18-month or 4¾ year notes, along with a prerefunding of issues maturing in May and August into the 4¾ year option. With its completion, Treasury financing operations for the fiscal year were virtually completed, except for routine rollovers.

The savings bond program received an important stimulus early in 1966 when President Johnson announced an increase in the rate to 4.15 percent from the previous 3.75 percent effective from December 1, 1965. The Presidential action also raised the earnings after December 1, 1965, of outstanding Series E and H savings bonds. The new, higher rate was clearly justified not only in view of the higher rates available on various private savings accounts, but also in the light of current needs to sustain vigorous noninflationary growth and manage the public debt soundly. Corporate and Federal campaigns to increase participation in the payroll savings plan were being pressed intensively and substantial results were expected.

HENRY H. FOWLER,
Secretary of the Treasury.

TO THE PRESIDENT OF THE SENATE.
TO THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

ANNUAL REPORT ON THE FINANCES

TREASURY DEPARTMENT,
Washington, March 1, 1967.

SIRS: I have the honor to report to you on the finances of the Federal Government for the fiscal year 1966. The main text of this report consists of a detailed review of Treasury fiscal operations and administrative reports of the offices under my supervision during the fiscal year 1966, along with supporting exhibits and statistical material. This brief general introduction reviews the major fiscal and financial developments that have taken place since the time of my last report in early 1966.

Overall Review

During the calendar year 1966, the Federal finances were strengthened by a sixth successive year of economic expansion. Gross national product—our most comprehensive measure of economic activity—increased by more than 8½ percent over 1965, reaching a rate of about $760 billion by the fourth quarter of 1966. After allowance for rising prices, the advance in gross national product between 1965 and 1966 was nearly 5½ percent.

In contrast to the 1961–65 period, prices rose appreciably during 1966. But, by yearend, the price situation was much improved. Wholesale prices had fallen back from the peaks reached in late summer and the rate of increase in consumer prices had slackened. The year-to-year increase in consumer prices was slightly less than 3 percent, far less than the 8 percent between 1950 and 1951 during early stages of the Korean defense buildup, and even less than the 3½ percent between the peacetime years 1956 and 1957. Nonetheless, an early restoration of the 1961–65 pattern of cost-price stability is a major policy objective.

Despite the direct and indirect impact of Vietnam on the U.S. balance of international payments, the 1966 results were encouraging. On the liquidity basis, the deficit was estimated near $1.4 billion, only slightly above the $1.3 billion deficit in 1965. On an official reserve transactions basis, our international accounts actually recorded a small surplus, the first since the accounts have been kept on this basis. The 1966 gold loss was cut more than 50 percent relative to 1965. And, during 1966, significant progress was made toward strengthening the international monetary system.

Domestically, the period under review was one of difficult but successful transition. A year ago, the economy had reached virtual full employment and faced the task of meeting the requirements of a rapidly expanding defense effort. Therefore, a measured shift in economic policy from stimulus to restraint was essential. On the fiscal side, that shift was reflected in the movement of the Federal budget on national income account from deficit in the second half of calendar 1965 into sizable surplus during the first half of calendar 1966. On the monetary side, a shift in policy was signaled by the Federal Reserve's December 1965 increase in the discount rate. Monetary restraint, at first reflected primarily in rising interest rates, led to a sharp reduction in the pace of credit expansion after mid-1966.

The shift to a more restraining economic policy helped to relieve much of the industrial price pressure induced by the heavy demands of the defense buildup and business capital spending programs. Growth in total demand was brought into reasonable correspondence with growth in productive potential by the second quarter of 1966, and the pace of expansion—as reflected in quarterly increments in gross national product—became more moderate than in late 1965 and early 1966. During the rest of the year, unemployment and industrial utilization rates were relatively stable and the rate of price increase began to taper off.

While the policy of overall restraint achieved its major objectives rather promptly, some strains and imbalances did develop during the course of the year. These primarily took the form of selective pressures on productive capacity and a growing imbalance in credit flows. By late summer, interest rates had reached their highest levels in four decades and steps had to be taken to insure the continued orderly functioning of financial markets.

With the announcement of the President's September 8 anti-inflationary program and the benefit of subsequent steps taken by the Congress and the financial regulatory agencies, a concerted easing of interest rates was set in motion. Temporary suspension of the investment tax credit and accelerated depreciation reduced selective pressures in certain areas of the economy and helped ease the strain on financial markets. The financial environment improved steadily throughout the balance of the year, aided by a shift toward monetary ease set in motion by the Federal Reserve during the autumn.

The heaviest burden of adjustment during the year fell on the home-financing and residential-construction sectors. Rising interest rates and aggressive competition for savings led to a sharp contraction in the availability of mortgage funds. Net savings flows to savings and loan associations and mutual savings banks in 1966 were only

about one-half as great as in 1965 and loan commitments were cut back sharply. Tight money and competing demands for funds also reduced the flow of money into mortgage markets from insurance companies and commercial banks. Because of the sharp reduction in the availability of mortgage funds, residential construction activity fell off substantially. By late summer and early fall, the seasonally adjusted rate of new private housing starts had fallen by about one-third.

A range of special measures was taken to ease the burden of adjustment in home financing and residential construction. Liberal advances by the Federal Home Loan Bank System and an expanded scale of mortgage purchases by the Federal National Mortgage Association helped cushion the financial impact of monetary stringency. Congressional legislation provided an extra potential of $4.8 billion for FNMA operations. In addition, legislation enabled the financial regulatory authorities to set maximum rates with greater flexibility on time and savings accounts. This dampened the aggressive competition for savings which had been contributing to an overall escalation of interest rates and to the shunting of funds away from the mortgage markets. By the end of 1966, savings flows to thrift institutions were improving and a revival of residential construction activity was in prospect.

It is a major objective of economic policy during 1967 to restore the balanced character of the expansion while keeping the economy moving ahead steadily and safely. This would mean a rate of growth in real output somewhat below that averaged in recent years, and nearer to the 4 percent or so estimated to be the current growth potential of the economy at full employment. Very high real rates of growth—averaging more than 5 percent during the current expansion—have been achieved by putting to productive use not only new capacity and new entrants into the labor market, but also idle capacity and the unemployed. With most of this slack removed, the economy's rate of growth would increasingly come to depend almost entirely upon the rate of growth, in quantity and quality, of new capacity and new manpower.

The importance of insuring a smooth transition from cyclical expansion to balanced growth at full employment had been well appreciated prior to mid-1965, and policies were consciously shaped to facilitate just such a transition. But, with the intensification of hostilities in Vietnam, the transition to a full employment economy was further complicated by the need to expand defense production at an accelerating rate. Two separate, but related, adjustments in the growth and pattern of output were taking place in the latter part of 1965 and throughout much of 1966. The economy was adjusting to the

growth constraint imposed by the attainment of near full employment at the very time that an increasing proportion of extra output was being shifted to military use.

Under the circumstances, economic policy faced a new and difficult situation, requiring the flexible adaptation of policy tools. It was obviously essential to moderate the pace of the economy to avoid serious inflationary pressures, and signs that this objective was being successfully achieved were apparent fairly early in the year. But, it was also essential—if the transition to a full employment economy were actually to be achieved—to avoid an excessive degree of total restraint during the period in which a concerted effort at monetary tightening was taking place. Therefore, a moderate degree of restraint was applied from the fiscal side. Supplemented by the selective anti-inflationary program announced in September 1966, this pattern of fiscal action was successful in averting the threat of excessive demand, while avoiding the much harsher restrictions that could have sent the economy on to a downward path.

As 1966 drew to a close, the economy had remained reasonably well on target. Between the second and fourth quarters of 1966, growth in gross national product in real terms was just a shade over 4 percent at an annual rate, and price pressures were moderating. Strains and imbalances had developed during the year, but seemed to be lessening, or in the process of removal, by yearend. All things considered, a difficult period of transition had been completed with remarkably few lasting difficulties. An economy, already nearing full employment, had met the demands of a sharply increasing defense effort without resort to controls, while a measured degree of restraint brought its overall rate of growth closely into line with its longer run potential.

Tax Policy

Late in 1965 the possible need for a shift toward fiscal restraint became increasingly apparent. The commitment to the defense of freedom in Southeast Asia would inevitably bring a substantial rise in defense expenditures. Business intentions to spend on plant and equipment, as revealed in private and official surveys, were showing unexpected strength, and other sources of demand were buoyant.

A major element of uncertainty was the amount and duration of the extra defense expenditures that would be required. This was an uncertainty which, by the nature of things, only the passage of time could resolve. Defense expenditures could only be projected on the basis of assumptions as to the intentions of our adversaries in Vietnam, and, obviously, any such assumptions were subject to error.

Because the required amount and duration of defense expenditures was inherently uncertain, the move to fiscal restraint was deliberately

of temporary character and limited in overall extent. Some restraint was to occur in any event in early 1966 through the increase in social security and medicare payroll taxes of $6 billion, annual rate, going into effect January 1, 1966, with medicare payments not beginning until the second half of 1966. In addition, in his January 1966 budget message, President Johnson recommended the enactment of new tax legislation designed to raise additional revenues. These tax proposals were promptly considered by the Congress and enacted, essentially in their original form, as the Tax Adjustment Act of 1966.

The main elements in this program were the temporary restoration of the rates of excise taxes on automobiles and telephones that were in effect at the end of 1965, and the adoption of collection procedures putting income and self-employment taxes closer to a pay-as-you-go system. (For details of the legislation, see pages 36–43 of the accompanying report.) In terms of cash payments, the changes in the new law were estimated to take about $2.7 billion out of the individual and corporate spending stream in calendar 1966.

In assessing the economic effectiveness of fiscal policy in 1966, the most meaningful record is in the surplus or deficit position of the Federal sector in the national income accounts. The administrative and cash budget positions, while important from some standpoints, do not provide an accurate reflection of current spending on the output of the economy. The shift toward fiscal restraint in early 1966 is clearly mirrored in the behavior of the national income budget. During the second half of 1965, the Federal budget on the national income accounts basis was running an average deficit of about $1.4 billion, annual rate. As the new fiscal restraints went into effect, the national income budget swung into surplus, at an average annual rate of more than $3 billion during the first half of 1966.

During the first half of 1966, with the swing into budget surplus, the overall advance of the economy slowed to a more sustainable pace. This moderated rate of advance continued in the third quarter—when the Federal budget on a national income basis moved to a small deficit position. While there was by this time no need for further measures of general fiscal restraint, there were developing pressures and imbalances which required selective action.

On September 8, President Johnson announced additional steps that were considered necessary to assure the continuing health and strength of the economy. These included: reduction in lower priority Federal expenditures, a proposed temporary suspension of the 7-percent investment tax credit and accelerated depreciation, and special efforts to lower interest rates and to ease the inequitable burden of tight money. (The favorable effect of these steps on the financial markets is described in a later section of this introduction.)

The temporary suspension of the investment tax credit was recommended because the combination of a rapidly expanding civilian economy and special defense needs made such a course compelling. This combination of circumstances was unique and quite unforeseeable at the time the credit was adopted and stress was put on its permanent character. Temporary suspension, rather than repeal, of the investment credit was the appropriate action, since the investment credit continues to be regarded as a valuable, permanent structural component of the tax system. Prompt congressional action followed, along the lines of the President's recommendations, and the special investment incentives were temporarily suspended under the terms of Public Law 89–800, effective October 10, 1966. Under the law, the suspension remains in effect through December 31, 1967.

During 1966, there had been a significant shift away from the stimulative fiscal policies of earlier years. As President Johnson had noted in his January 24, 1966, budget message:

> "Tax policy, however, must be used flexibly. We must be equally prepared to employ it in restraint of an overly rapid economic expansion as we were to use it as a stimulus to a lagging economy."

In 1966, tax policy responded flexibly and effectively. Through the shift from a stimulative fiscal policy to one of moderate restraint, $10 billion of excess purchasing power was siphoned off during calendar year 1966:

—$6 billion through increased payroll taxes for social security and medicare.

—$1 billion through restored excise taxes.

—$1 billion through graduated withholding of individual income taxes.

—$1 billion through the speedup in corporate tax payments.

—$1 billion through an administrative acceleration of tax payments.

By late 1966, it became clear that many of the heavy pressures on the economy had abated. Although unemployment remained low, construction, particularly housing, was declining. In addition, sales and production increases slowed, larger inventory increases occurred, and surveys indicated a slower growth of investment. Consequently, it appeared that during the first half of 1967 there would be a need to complement a continuation of monetary ease with a moderate degree of fiscal support.

By the second half of 1967, however, the economy is expected to be in much less need of any fiscal push. On current estimates, Federal expenditures for Vietnam and other defense outlays, as measured in the national income accounts, would rise by another $5.8 billion in

the fiscal year beginning July 1967. Therefore, the President's fiscal program for calendar 1967 has been carefully designed to provide maximum flexibility. The President has recommended a 6-percent surcharge on both corporate and individual income taxes to be effective at midyear and to last for 2 years or for so long as the unusual expenditures associated with our efforts in Vietnam continue. The revenue effect of the proposed surcharge would increase calendar year 1967 tax liabilities by $2.8 billion—$1.9 billion individual and $0.9 billion corporate. In calendar year 1968, tax liabilities would be increased by $5.8 billion—$3.9 billion individual and $1.9 billion corporate. In addition, legislation is recommended to provide a further acceleration of certain corporate tax payments commencing in calendar 1968.

In view of the mixed behavior of economic indicators in late 1966 and early 1967, the prudent course would be to maintain a maximum degree of flexibility to meet unforeseen developments. It appeared, however, that the moderate tax increase the President had proposed would be consistent with the needs of the economy in order to prevent any resurgence of inflationary pressures. Furthermore, that increase would meet the fiscal 1968 increase in defense costs, keep the cash and administrative deficits within reasonable bounds, and provide extra leeway for a continued easing of money and credit, giving some insurance against a return to the monetary stringency of 1966.

Balance of Payments

By mid-1965, the goal of balance-of-payments equilibrium seemed to be within sight. Since then, the Vietnam conflict has, of course, had a significant adverse impact. There has been a direct impact in the form of a higher deficit on defense account in the balance of payments. And there has been an indirect impact primarily in the form of larger imports. Despite these extra drains, there was no significant widening of the deficit during 1966. Although the attainment of equilibrium has been delayed, certain underlying forces continued to help the United States in bringing its foreign exchange transactions into sustainable equilibrium in more normal circumstances.

In calendar 1966, the balance-of-payments deficit on the liquidity basis was at $1.4 billion, about $100 million above the 1965 deficit. (Detailed discussion of balance-of-payments results, through the first half of calendar 1966, will be found in the accompanying report, pages 50–55.) This relatively small increase in the deficit should be viewed in the perspective of a much greater increase during the year in the direct-foreign-exchange costs associated with Vietnam, and an additional increase in indirect-balance-of-payments cost resulting from higher defense spending at home.

On the official-reserve-transactions basis, there was a 1966 surplus of $0.3 billion, compared to a deficit of $1.3 billion in 1965, and deficits of $1.5 billion and $2 billion in 1964 and 1963, respectively. (The liquidity balance is measured by changes in U.S. reserve assets and in liquid liabilities to all foreign residents and international organizations. The official-reserve-transactions balance differs from the liquidity balance by excluding changes in liquid dollar holdings of private foreigners, and including changes in certain of our nonliquid liabilities to foreign official institutions which are not part of the liquidity deficit.)

The surplus on the official-reserve-transactions basis in 1966 was due to some extraordinary factors which are not likely to be present to the same degree in 1967. There were heavy borrowings from abroad by U.S. banks and a consequent accumulation of liquid-dollar claims by foreign commercial banks, including foreign branches of U.S. banks. This reflected the very tight credit situation in this country and the unsettled condition of sterling during part of the year. Under more ordinary circumstances, a larger proportion of these dollars might have been expected to move into official hands.

Gold losses during 1966 amounted to $571 million in contrast to $1,665 million in 1965, including a $259 million payment in connection with an increase in IMF quotas. The overall reserve loss in 1966—gold, convertible currencies, and IMF gold tranche position—was $568 million in contrast to $1.2 billion in 1965. Despite the surplus on the official-reserve-transactions basis in 1966, our net reserve position showed a decline, due mainly to continued heavy conversions of gold by France during the first 8 months of the year.

In very broad terms, the 1966 payments results featured a worsening in the trade and military expenditure accounts offset by unusually large receipts of foreign capital. On trade account, nonmilitary exports for the year were $29.2 billion, up more than 11 percent from 1965. This was a substantially greater percentage rise than in any of the past 5 years, except for 1964. But imports rose to $25.5 billion, up almost 19 percent from 1965. As a result, the merchandise trade surplus narrowed by $1.1 billion, averaging $3.7 billion for 1966 as a whole.

The large advance in imports appeared to be primarily due to:

—the rapid rise in gross national product.

—near-capacity operation in some sectors of the economy, and selected shortages of skilled labor.

—a high level of military orders for specialized items.

—certain special situations such as that arising from the elimination of duties on automobiles produced in Canada under the recent U.S.-Canadian auto agreement.

With the economy moving ahead at a more moderate pace and selective pressures reduced, imports were expected to grow more slowly in 1967. While a longer period of time would be needed to establish any trend, it was encouraging that by the end of 1966 imports were reflecting the slower rate of GNP growth that began in the second quarter. On the export side, the U.S. competitive position appeared to have been maintained. However, in order to insure progress toward a balanced payments position, an early return to the 1961–65 pattern of cost-price stability is essential.

Data on capital flows during 1966 are not yet complete. Available information suggests that the outflow of U.S. private capital apparently continued at roughly the 1965 level of about $3½ billion, compared to a range of $4½ to $6½ billion in the years 1963 and 1964. This showing undoubtedly reflected the tight credit situation in the United States during 1966; but it also reflected the sharpening and reinforcement for 1966 of the voluntary cooperation program for business corporations and financial institutions.

The major change in 1966 was a large increase in receipts of foreign capital. In the long-term area, there were investments of over $400 million by international lending institutions in long-term certificates of deposit and in U.S. agency issues, and investments of over $700 million by foreign official agencies in long-term certificates of deposit. Tighter monetary conditions domestically also induced an unusually large accumulation of liquid dollar holdings by private foreigners, mainly banks, including foreign branches of U.S. banks. Much of this accumulation reflected the borrowing abroad by U.S. banks during the period of monetary tightness in this country.

Extension and reinforcement of the voluntary restraint programs for corporate investment abroad and for foreign lending abroad was announced in December 1966. The overall balance-of-payments objective in 1967 is to continue to move toward balance-of-payments equilibrium as fast as the continuing foreign exchange costs of Vietnam would permit. In his Economic Report to the Congress in January 1967, President Johnson made additional recommendations designed to promote the achievement of that objective. The President's recommendations included:

1. Extension of the Interest Equalization Tax, in strengthened form, to July 31, 1969. Under the proposed legislation, the President would be given the authority to vary the level of tax rates so that the effective annual interest cost to foreign borrowers in the United States could be increased by an amount ranging from zero to approximately 2 percent.

2. Establishment of a special industry-Government task force to make specific recommendations as to how best to stimulate and encourage foreign travel in this country.

3. Continuation and expansion of Export-Import Bank lending authority to support the expansion of exports, and efforts, in cooperation with other countries, to develop better means of sharing the costs of common defense and foreign assistance efforts.

4. Stimulation of exporters' interest in supplying foreign markets, enlistment of the support of the financial community in attracting foreign investment in the United States, and encouragement of further development of foreign capital markets.

It was widely recognized that the capital account of the U.S. balance of payments was unlikely to benefit as much during 1967 as it had in 1966 from the inflow of foreign capital. On the other hand, the U.S. trade surplus was expected to improve substantially from its 1966 level. In general, the amount of further progress that could be made in 1967 toward equilibrium seemed likely to depend upon the direct and indirect impact that the Vietnam effort would be exerting upon the balance of payments.

International Financial Arrangements

A summary of a wide range of developments in international financial affairs through mid-1966 will be found in the text of this report (pages 56–71). The coverage here will be limited to brief comment on the major developments during the year in the area of improved international financial arrangements.

During the past year, the process of international balance-of-payments adjustment was examined in depth by representatives of 10 major industrial countries, and the results of this work were made public in a report by Working Party 3 of the OECD. The report pointed to the extremely complex character of the adjustment process under modern conditions and stressed the need for strengthened tools to carry out national economic policies. It emphasized the responsibility of both surplus and deficit countries for proper international adjustment and the special need for international consultation in the field of monetary policy to avoid undesirable levels of interest rates. In recognition of the latter objective, I met in early 1967 with the Finance Ministers of the United Kingdom, West Germany, France, and Italy to determine how interest rate policies might be better coordinated, and particularly to deescalate interest rates on an international scale.

In his Economic Report, the President directed attention to the significant progress made during 1966 toward strengthening the international monetary system. Early in the year, the enlarged quotas of the International Monetary Fund became effective, raising its total resources by a little more than 25 percent to a total of over $20 billion.

Also, the supplementary resources which the Fund may call upon under the General Arrangements to Borrow were extended for an additional 4-year period, beginning October 1966. Finally, the network of bilateral swap arrangements between monetary authorities of the United States and other leading countries was enlarged from a total of $2.8 billion to $4.5 billion. Taken together these actions have broadened and strengthened the credit facilities that may be called upon to meet payments imbalances.

In addition to strengthening existing arrangements, negotiations went forward during 1966 toward agreement on a contingency plan for the adequate and orderly growth of world monetary reserves. The first major step was to reach a wide consensus on basic principles for creating reserves, as set forth in the Report of the Deputies of the Group of Ten leading industrial countries, in July 1966, and the Ministerial Communique of July 26, 1966. The other major step during the year was the broadening of the negotiations to include all members of the IMF through joint meetings between representatives of the Group of Ten major industrial countries and the Executive Directors of the IMF. The first joint meeting was held in Washington at the end of November, and the second took place in London on January 25 and January 26, 1967. The outlines of a contingency plan were beginning to emerge and it was hoped that the major provisions and structure of a specific plan would become sufficiently clarified for them to be presented to the annual meeting of the IMF Board of Governors in Rio de Janeiro in September 1967.

Debt Management

Debt management operations during the first two-thirds of calendar 1966 were conducted within a market environment in which extraordinarily heavy private demands for credit were pushing against an increasing degree of monetary restraint.

The heavy credit demands of 1966 came mainly from the private sector. Business borrowing, especially, made huge claims on the capital markets. For the year as a whole, net debt and equity issues of corporations came to an estimated $12½ billion, while business borrowing from banks rose $10 billion. State and local debt rose $7 billion, and mortgage debt by $25 billion, although this was $5½ billion less than in 1965. Federal credit demands on the private sector (netting out purchases by the Government investment accounts and the Federal Reserve) came to just $3 billion, as a $2 billion decline in Treasury issues in the hands of the public partly offset the $5 billion increase in Federal agency debt and participation certificates.

Throughout the first two-thirds of the year, key interest rates pushed steadily higher. From early December 1965—just before

the discount rate rise—to the August–September 1966 peaks, 3-month Treasury bills rose by nearly 1½ percentage points and long-term issues also rose substantially. New issues of AA-rated corporate bonds rose about 1½ percentage points, reaching almost 6⅜ percent. The commercial bank prime lending rate also rose 1½ percent. Yields on new municipal bonds advanced about three-fourth percent. Rates on conventional new home mortgages as reported by FHA also rose about three-fourth percent, and the availability of funds to the mortgage market was drastically reduced.

The announcement of the President's September 8 anti-inflationary program and prompt action by the Congress and the financial regulatory agencies led to a much better financial environment. Credit became more readily available and interest rates receded rapidly from their peaks. Despite some interruptions, the downward trend in interest rates continued into the early part of 1967. As part of the September 8 program, it was decided to reduce substantially the contemplated offerings of participation sales and Federal agency securities and to hold those offerings to a minimum for the remainder of calendar year 1966. Credit demands by Federal agencies had led to $5 billion of new agency borrowing in the first half of calendar 1966. Temporarily, the absorptive capacity of the markets for further agency issues and participation certificates had been strained. But with the return of an improved market atmosphere, Federal agencies were able to borrow on much more attractive terms in early 1967 and the marketing of participation certificates was resumed.

The Treasury's own cash needs in the last half of calendar 1966 were met through additions to regular bill issues and sales of tax anticipation bills. (A detailed review of public debt management and ownership developments during fiscal 1966 is provided on pages 19–36 of the accompanying report.) Following an August 1966 refunding operation, the Treasury invited tenders on August 11 for $3 billion in tax anticipation bills. Additional auctions of tax bills consisted of $3.5 billion offered in early October and a further $800 million issued in early December. Improving market conditions contributed to a highly successful November refunding operation to retire $4.1 billion in issues maturing November 15. As market conditions improved further in early 1967, the Treasury was able to conduct a $7.5 billion refunding operation at the lowest interest rates offered in refunding a coupon issue since November 1965.

HENRY H. FOWLER,
Secretary of the Treasury.

TO THE PRESIDENT OF THE SENATE.
TO THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

ANNUAL REPORT ON THE FINANCES

TREASURY DEPARTMENT,
Washington, May 15, 1968.

SIRS: I have the honor to report to you on the finances of the Federal Government for the fiscal year 1967. The main text of this report consists of a detailed review of Treasury fiscal operations and administrative reports of the offices under my supervision during the fiscal year 1967, along with supporting exhibits and statistical material. This brief general introduction reviews the major fiscal and financial developments that have taken place since the time of my last report in early 1967.

Overall Review

During the calendar year 1967, the economy successfully weathered a sizable inventory adjustment and resumed its rapid rate of advance. By early 1968, the economy was entering its eighth successive year of expansion—the longest in our history. There was every indication that this unparalleled advance could be sustained. However, it was increasingly clear that an additional degree of fiscal and financial restraint would be required in order to insure the continued strength of the dollar at home and abroad. A major objective of policy would be to reverse decisively the trend toward larger deficits in our internal budget and in our international balance of payments.

Delay in enacting the President's tax program threatened to swell the Federal budget deficit to inappropriately high levels. In terms of the new unified budget concept, the fiscal 1968 deficit was estimated in January 1968 at $22.8 billion in the absence of tax action. It was further estimated that the fiscal 1969 deficit would decline only slightly to $20.8 billion if no tax action were taken. With the economy at a high level of employment and showing strong inflationary tendencies, it was clear that back-to-back budget deficits in excess of $20 billion could exert a seriously destabilizing influence. Therefore, the January 1968 budget included legislative proposals to raise an additional $16 billion in revenue during fiscal 1968 and fiscal 1969. This would reduce the fiscal 1968 deficit to $19.8 billion and the fiscal 1969 deficit to $8 billion.

The other deficit requiring corrective action is in our international balance of payments. During 1965 and 1966 the payments deficit was held below $1.5 billion despite the drains occasioned by our expanded commitment to the defense of freedom in Southeast Asia.

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In 1967, the deficit widened, particularly in the fourth quarter, and reached $3.6 billion for the calendar year on the liquidity basis. Prompt action was needed—and is being taken—to shrink the deficit. The action program announced by President Johnson on January 1, 1968, was designed to achieve balance-of-payments savings of up to $3 billion.

Domestically, there was a marked contrast in the pace of economic advance between the first and second half of calendar year 1967. In the first half of the year, inventory investment fell from an annual rate of $18½ billion to nearly zero, but final sales rose strongly and prevented the inventory adjustment from causing a downturn. In the second half of the year, with the inventory adjustment completed and housing continuing its recovery, the economy moved ahead briskly. Growth in production was interrupted only temporarily by work stoppages.

This pattern of a relatively slow first half year followed by a much stronger second half had been anticipated and plans were made accordingly. In the first half of calendar year 1967, a policy of monetary ease, instituted late in 1966, was complemented by a degree of fiscal support. The moderate tax increase proposed by the President in January 1967 was not to be effective at once but only after the first half of 1967. As the pace of the economy slowed in the first half of 1967, the Federal budget swung into a deeper deficit position. This stimulative effect of a larger deficit was temporarily desirable in view of the sharply declining pace of the economic advance. Rising levels of Federal expenditure bolstered final sales while the steep inventory adjustment downward was running its course.

Ideally, there would have been a sizable swing back toward fiscal restraint in the second half of the calendar year as the economy began to move ahead more rapidly. Tax action was recommended by the President early in August 1967, with the increases to be effective from midyear, but there was no congressional action on the President's proposals. Late in the year, expenditure cuts in specific programs totaling $4.3 billion were achieved, as a result of joint congressional and executive action. But, in the absence of congressional action to raise taxes, the budget continued to run in heavy deficit in the second half of 1967 and early 1968, at a time when the economy was not in need of fiscal stimulus but would have benefited greatly from a shift toward restraint.

The resumption of strong growth in the second half of 1967 was accompanied by a sharp advance in prices. For example, the comprehensive GNP price deflator rose at a 3.8 percent annual rate in the second half of the calendar year, in contrast to about 2½ percent in the first half. The rise in the consumer price index followed a similar pattern.

On a year-to-year basis, the price record appeared more favorable, with consumer prices actually rising slightly less in 1967 than in 1966. However, the faster rise in prices during the second half of 1967, which continued in early 1968, was definitely cause for concern. It threatened to disrupt the domestic expansion and to impair our international competitive position. In his February 1968 *Economic Report*, President Johnson emphasized the need to make a decisive turn back toward price stability and stated:

"Therefore, in addition to urging prompt action by the Congress on my tax proposals, I must again urge—in the strongest terms I know—that unions and business firms exercise the most rigorous restraint in their wage and price determinations in 1968."

Both cost and demand pressures were contributing to the faster advance in prices in late 1967 and early 1968. The strengthening of demand in the second half of 1967 was clearly mirrored in an upward movement of prices. From the cost side, strong pressures were being exerted by a faster pace of advance in hourly compensation than in productivity. In turn, this reflected the earlier upsurge of demand in late 1965 and 1966 which upset the balance of the expansion.

From 1961 to 1965 the rise in average hourly compensation in the total private economy only slightly exceeded the gain in output per manhour and unit labor costs were relatively stable. In manufacturing there was actually a downward drift in unit labor costs as productivity gains exceeded the rise in employee compensation. This pattern was broken after 1965. During 1966, when total demand pressed heavily against the economy's short-run productive capacity, there was a sharp rise in hourly compensation of nearly 7 percent. In 1967, the average rise fell back slightly to about 6 percent but productivity gains slowed abruptly to around 1½ percent. As a consequence, between 1966 and 1967 there was a rise in unit labor costs of roughly 4½ percent for the total private economy and of about 5 percent for the manufacturing sector.

In the presence of these cost increases, it would be particularly important during 1968 and beyond to insure that the situation was not further aggravated by an excessively strong rise in demand. Another burst of demand could further prejudice the prospects for an early return to relatively stable prices and seriously impede progress toward balance-of-payments equilibrium. As it was, an earlier pattern of cost-price stability had been temporarily disrupted and the potential for further inflationary developments had been increased.

The U.S. balance-of-payments position and the continued stability of the international financial system were becoming increasingly important factors in the determination of U.S. fiscal and financial

policy. Both our international and domestic financial positions would be strengthened through the application of an extra degree of fiscal restraint. There was no conflict between the policy prescription for the domestic economy and the balance of payments. In each case, the situation called for higher taxes and further deferment and reduction of lower priority Federal expenditures.

Tax Policy

The major tax developments since the time of my last report have been the restoration of the investment tax credit and a continuing effort to obtain legislative approval of a temporary increase in income taxes. Fuller details on these and other developments in tax policy during the fiscal year 1967 are provided on pages 28–39 of the accompanying report.

Temporary suspension of the investment tax credit was a key element in the President's anti-inflationary program presented in a special message to the Congress on September 8, 1966. Rapid expansion of plant and equipment programs had led to growing order backlogs and heavy pressure on the financial markets. The September 8 program included the following steps: Reduction in lower priority Federal expenditures; a proposed temporary suspension of the 7-percent investment tax credit and accelerated depreciation; and special efforts to lower interest rates and to ease the inequitable burden of tight money. The announcement of this program and prompt action by the Congress and the financial regulatory agencies led to a much better financial environment. The special investment incentives were temporarily suspended under the terms of Public Law 89–800, effective as of October 10, 1966.

While temporary suspension of these investment incentives was essential under the special circumstances of late 1966, it was made clear at the time of their suspension that they continued to be regarded as a valuable permanent structural component of the tax system and would be restored as soon as possible. On March 9, 1967, President Johnson did request the restoration of the investment tax credit and the use of accelerated depreciation for buildings, pointing out that in the previous 6 months the temporary suspension had done the job it was designed to do.

Legislation restoring the investment incentives was passed by the House of Representatives on March 14. There was protracted debate on the Senate floor, not on restoration of the investment incentives, but on proposed amendments to the Presidential Election Campaign Fund Act of 1966. The bill was finally passed by the Senate on May 9 and signed by the President on June 13, 1967, with restoration of the

credit effective as of March 10, 1967. Details of the legislation are discussed on pages 29–31 in the main text of this report.

The initial proposal for a general increase in income taxes was made by President Johnson in his state of the Union message of January 10, 1967. He called for a surcharge of 6 percent on both individual and corporate income taxes to last for 2 years or so long as the unusual expenditures associated with our efforts in Vietnam continue. The temporary surcharge was to be effective from July 1, 1967.

As revised estimates of revenues and expenditures made it clear that the budget deficit would be much larger than had been anticipated in early 1967, President Johnson requested on August 3, 1967, that the surcharge be raised from 6 percent to 10 percent. Aside from the recommendation for a 10 percent surcharge, the President repeated his January 1967 recommendations for a further speedup of corporate tax collections and a postponement of scheduled reductions in excise taxes. In addition, the President urged the Congress to exercise the utmost restraint and responsibility in the appropriations process and to make every effort not to exceed the January budget estimates. For its part, the executive branch promised to take every proper action within its power to reduce expenditures in the January budget.

The House Ways and Means Committee held hearings on the tax proposals in August and September but voted to table immediate consideration. Difficulty in arriving at procedures to implement expenditure reductions was apparently a major factor in the Ways and Means decision to defer action. After the devaluation of sterling in November, the Ways and Means hearings were reopened. At that time the administration presented a two-part plan: The tax proposals and a specific statutory plan for expenditure reduction in fiscal 1968 from the levels then in prospect. While the Ways and Means Committee did not take favorable action on the proposals, the expenditure reduction part of the plan was implemented by joint congressional and executive action late in calendar 1967. On December 18, 1967, President Johnson signed Public Law 90–218, which, together with previous congressional actions, provided that "Federal obligations and expenditures in controllable programs for the fiscal year 1968 should be reduced by no less than $9 billion and $4 billion, respectively, below the President's budget requests."

On January 22, 1968, the House Ways and Means Committee resumed its hearings on the President's tax proposals. The committee took favorable action on the corporate tax acceleration and excise tax components of the tax package, but not on the proposed 10-percent surcharge on individual and corporate income tax liabilities. The corporate tax acceleration and the postponement of scheduled

excise tax reductions were passed by the House of Representatives on February 29, 1968.

The scene then shifted to the Senate. The Senate Finance Committee approved action on excise taxes and the corporate tax acceleration but decided, by a 9–8 vote, against the proposed 10-percent surcharge. On the floor of the Senate, however, the 10-percent surcharge and a ceiling on Federal expenditures, along with a number of other amendments, were added to the excise tax and corporate acceleration legislation. The exact pattern that legislative developments might follow from that point was uncertain, but the prospects for action on a program of fiscal restraint appeared to have improved.

Financial Policies and Debt Management

In the domestic financial area, the past year has been one of strong demand pressures in our money and capital markets. Longer-term interest rates dipped only temporarily in early 1967 when the pace of economic expansion slowed and long-term rates then rose during the balance of the year. In the first half of calendar year 1967, short-term interest rates did decline from the peaks that had been reached in the late summer and early fall of 1966. After midyear, however, money market rates moved up rather steadily. Monetary ease, which had commenced in late 1966, continued through most of 1967 but interest rates rose in response to heavy financial demands.

At the close of 1967, short-term rates remained below the peaks of August–September 1966, but longer term rates had, in some cases, pushed well beyond the earlier highs. Three-month Treasury bills were yielding a shade more than 5 percent at the end of 1967, still about one-half of one percent below the peak yields in 1966. Longer bills and short- to intermediate-term coupon issues also remained below their 1966 peaks. Longer-term governments and new issues of corporate and municipal bonds had moved beyond the earlier highs by the end of the calendar year 1967, while mortgage rates were just about at the earlier levels. Between the end of 1966 and 1967, rates on new Aa-rated corporate bonds rose by almost a full percentage point and neared 7 percent while rates on new tax-exempt securities rose by more than five-eights of one percent. These very sizable increases in corporate and municipal rates reflected the particularly heavy volume of financing in those areas.

Despite the slackening in the pace of economic activity in early 1967, private financial demands were heavy throughout the entire year. As an aftermath of the credit squeeze of 1966, efforts were made throughout the private sector to rebuild liquidity and in some cases to make advance provision for possible future credit needs. Furthermore, there was general belief in the business and financial

community that the slowdown in the economy was likely to be temporary in duration and would be followed by a period of more rapid expansion. As the year progressed, an upturn in planned business plant and equipment expenditures and a rise in inventory investment were, indeed, adding to corporate financial requirements. In addition to normal requirements, municipal financing was swollen by issues postponed from 1966 and by an abnormally large volume of industrial revenue bonds, since the future of the tax-exempt status for new issues of industrial revenue bonds appeared increasingly uncertain.

For the year as a whole, corporate long-term security offerings and placements (including refundings) totaled $24.6 billion, about 40 percent more than in 1966. State and local issues reached $14.5 billion, up from $11.3 billion a year earlier. Net additions to mortgage debt of $22 billion were only slightly above the 1966 total but were rising throughout the year as savings inflows to mortgage lenders continued in large volume. With private credit demands strong throughout the entire year, the major change occurred in the Federal sector where there was a marked change between the first and second half of calendar 1967.

In the first half of 1967, the Federal sector exerted a relatively small impact on the credit markets. Indeed, there was actually a larger net repayment of debt than that which had taken place in the first halves of 1965 and 1966. In the second half of 1967, however, the Federal sector made a sizable net credit demand, sharply above the levels of earlier years. This combination of heavy private and Government demands for credit exerted strong upward pressure on interest rates during the second half of 1967. Despite these upward rate pressures, there was no serious disruption of the flow of funds to various sectors and credit was readily available, although expensive by historical standards.

The outlook for financial markets in 1968 and beyond depends very much on the outcome of the President's fiscal proposals. In the absence of tax and expenditure action, the Federal sector would be making a sizable contraseasonal credit demand in the first half of calendar 1968, and the fiscal 1969 deficit on the new unified budget basis would exceed $20 billion. This would require roughly that amount of new borrowing. (There would be some additional requirements of those agencies—chiefly the Federal home loan banks and the Federal land banks—not included in the new budget's concept of net borrowing requirements.) Borrowing of this magnitude at a time when the economy was advancing rapidly could seriously overstrain the capacity of the financial markets, divert credit flows, and threaten to drive interest rates still higher. Therefore, the prompt application of fiscal

restraint, so necessary on other grounds as well is viewed as essential from the standpoint of the domestic financial markets.

Debt management activities have been conducted successfully during the past year despite the relatively difficult financial environment. An intensive savings bond campaign has played a major part by encouraging additional savings and reducing the amount of market financing otherwise required. (A detailed review of public debt management and ownership developments during fiscal 1967 is provided on pages 12–28 of the accompanying report.)

In the first half of calendar 1967, after a refunding operation in February that received a very favorable reception, the balance of Treasury cash needs were met in March by an additional $2.7 billion of June 1967 tax anticipation bills. In the second half of the year, the Treasury did a bit more than $16 billion of new money borrowing through the issuance of marketable securities.

The bulk of the financing in the second half of the year was done in the bill area through additions to the regular auctions and through the use of tax anticipation bills. Outside of the bill area, there were several major financings. Following a $9.9 billion refunding operation, $2½ billion in cash was raised in August through the issuance of a 3½-year Treasury note priced to yield 5.40 percent. In November, a little over $2 billion in additional new cash was raised in conjunction with the refunding of $10.2 billion of November maturities. In this operation, the Treasury made initial use of the authority granted by Congress earlier in the year to issue Treasury notes of up to 7-year maturity. Nonetheless, there was a substantial shortening of the average maturity of the marketable interest-bearing public debt during the course of calendar year 1967. By the end of the year, the average maturity was 4 years and 1 month in contrast to 4 years and 7 months at the end of calendar year 1966.

There were two sizable Treasury financing operations in early 1968, both of which were well received. At the end of January, the Treasury announced an exchange offering of 7-year, 5¾ percent notes for notes maturing February 15, 1968, and for notes and bonds due August 15 and November 15, 1968. The successful completion of this operation led to a modest degree of debt lengthening and a useful reduction in the sizable financing task that would have to be faced in the second half of the year. In a separate operation during February, there was a $4 billion cash offering of 15-month, 5⅝ percent Treasury notes.

International Financial Affairs

A summary of a wide range of developments in international financial affairs through fiscal 1967 will be found in the text of this report (pages 39–53). Attention will be confined here to major develop-

ments during the year in the U.S. balance of payments and the progress made toward improved international financial arrangements.

Balance of Payments

During calendar year 1967, and particularly in the fourth quarter, the U.S. balance-of-payments deficit widened appreciably, only partly because of special factors. The widening of the deficit made it necessary to take prompt corrective action. A new balance-of-payments action program was announced at the beginning of 1968 designed to shrink the deficit by as much as $3 billion. The worsening of the payments position in 1967 had come after 2 years in which the deficit had been held to relatively low levels, considering the direct and indirect balance-of-payments drains associated with the Vietnam effort.

In calendar year 1966, the U.S. balance-of-payments deficit on the liquidity basis was $1.4 billion, about the same as in 1965, and about one-half the size of the deficits in 1963 and 1964. On the official reserve transactions basis, there was a 1966 surplus of $200 million, compared to a deficit of $1.3 billion in 1965, and deficits of $1.5 billion and $2 billion in 1964 and 1963, respectively. (The liquidity balance is measured by changes in U.S. reserve assets and in liquid liabilities to all foreign residents and international organizations. The official reserve transactions balance differs from the liquidity balance by excluding changes in certain of our nonliquid liabilities to foreign official institutions which are not part of the liquidity deficit.)

In 1967, the deficit on the liquidity basis reached $3.6 billion and returned near the deficit levels of 1959 and 1960. On the official reserve transactions basis, the deficit for calendar 1967 was $3.4 billion. U.S. gold losses in 1967 rose to $1.170 billion, about double the $571 million loss in 1966. Much of the deterioration occurred in the final quarter of the year when the liquidity deficit reached an estimated $1.85 billion on a seasonally adjusted basis and gold losses exceeded $1 billion. The heavy pressure in gold markets continued in early 1968 until it was checked by international agreement on new arrangements with respect to private gold markets.

Some part of the large fourth-quarter balance-of-payments deficit was due to temporary factors. The weakness of sterling, which finally led to its devaluation in November, caused the United Kingdom to liquidate its portfolio of U.S. corporate securities and U.S. Government agency bonds, with adverse effect on the liquidity balance. On trade account, U.S. imports were boosted by a copper strike and the prospect of a steel strike in 1968. Even after allowance for these and other special factors, however, it was clear that there had been a significant worsening of the deficit during 1967 and that a tightening

of the balance-of-payments program was essential under the circumstances.

President Johnson announced the details of the new balance-of-payments program in a special message on January 1, 1968. The program was designed to bring the balance of payments to, or close to, equilibrium. President Johnson emphasized the close relationship between the domestic economy and the balance of payments. In his January 1, 1968, message he stated:

"The first line of defense of the dollar is the strength of the American economy.

"No business before the returning Congress will be more urgent than this: To enact the anti-inflation tax which I have sought for almost a year. Coupled with our expenditure controls and appropriate monetary policy, this wi l help to stem the inflationary pressures which now threaten our economic prosperity and our trade surplus."

The new balance-of-payments program embodied a comprehensive approach to the problem with savings sought in all major areas of the balance of payments. It was evolutionary in the sense of building upon the experience gained from previous balance-of-payments programs, but also included new techniques designed to achieve effective control of direct investment and the expenditures of U.S. tourists. The main elements of the new program were the following:

—a mandatory program, administered by the Department of Commerce, to restrain direct investment abroad. By Executive order and regulations issued under the Banking Law a limit would be placed upon direct investment by U.S. companies in foreign affiliates. Key features of the direct investment program are a temporary moratorium on any new capital outflow from the United States to the highly developed countries, principally in continental Western Europe, and special regulations governing the repatriation by U.S. companies of foreign earnings and permissible levels of short-term financial assets held abroad. (In March, Canada was exempted from the balance-of-payments measures affecting capital flows that are administered by the Department of Commerce and the Federal Reserve Board. An exchange of letters between the United States and Canadian Governments described the steps that would be taken to insure that the U.S. balance-of-payments position would not be impaired as a consequence.)

—revised guidelines by the Board of Governors of the Federal Reserve System to reduce foreign credits from U.S. banks and other financial institutions. The new guidelines, which are substantially more restrictive than those issued in November 1967, are designed to achieve a net inflow of at least $500 million in 1968. The Board pointed out that the guidelines have been designed to focus the major effect of

the reduction on the developed countries of continental Western Europe without adverse effects on credits necessary to finance U.S. exports or on credits to developing countries.

—encouragement of foreign travel in the United States and temporary measures to restrain the volume of U.S. travel expenditures outside of the Western Hemisphere. In view of the increase in the U.S. travel deficit to an estimated $2 billion in 1968, some action in this area was obligatory. The permanent and long-run part of the program is an effort to increase the number of foreign travelers in this country. In addition, the administration proposed customs and temporary tax measures, including a graduated tax on expenditures incurred in connection with trips outside the Western Hemisphere, to reduce U.S. tourist expenditures with the least possible reduction in the number of U.S. travelers.

—further reductions in the balance-of-payments impact of Government expenditures overseas.

—a long-term export expansion program, including intensified promotional efforts and enlarged facilities for export insurance, guarantees, and financing.

—consultation with foreign countries to minimize the disadvantages to our trade which arise from differences among national tax systems.

—further efforts to attract greater foreign investment in U.S. corporate securities, carrying out the principles of the Foreign Investors Tax Act of 1966.

The full effect of the recommended measures would not be felt immediately. Some elements of the program, e.g., the graduated tax on U.S. tourist expenditures, required congressional approval which might not be forthcoming. Short-run improvement of the trade balance would depend upon a moderation of the very rapid pace of the domestic economic advance as well as upon business conditions abroad. There were some uncertainties as to the immediate impact of other features of the program. But, even so, there was every prospect that the new balance-of-payments program would be promptly successful in reversing the trend toward larger deficits that had reappeared in 1967.

International Finance

There have been two major developments in the international financial area since the time of my last report. The first was the devaluation of sterling in November 1967 and the heavy speculative activity in private gold markets that followed. In March 1968, agreement was reached among the central banks cooperating in the gold pool on new arrangements. This restored a calmer atmosphere to gold and exchange markets. The second major development was the further

progress made toward implementation of the plan for creation of special drawing rights in the International Monetary Fund.

During early 1967, there was an improving trend in international financial markets. Sterling seemed to be making a successful recovery and there was relatively little speculative activity in gold markets. With the outbreak of the crisis in the Middle East in June, this better atmosphere evaporated quickly. Gold and foreign exchange markets were subjected to temporarily heavy pressures. While these pressures abated somewhat during the summer, the position of sterling remained precarious. After a continuing defense of the existing parity during the early fall, the decision to devalue the pound by 14.3 percent to $2.40 was announced on Saturday, November 18, 1967. International cooperation confined the exchange rate adjustment to sterling and a few closely related currencies.

In the aftermath of sterling devaluation, there was a heavy run on gold in private markets abroad. A statement by the gold pool contributors which was made in Frankfurt the weekend after devaluation calmed the market for a time. Rumors again flooded the market, but a further statement in December by me as Secretary of the Treasury and by the Chairman of the Federal Reserve Board (made with the support of the other gold pool members) again restored comparative calm. The announcement on January 1, 1968, by President Johnson of the new U.S. balance-of-payments program further improved the situation. Although the speculative activity in private gold markets more directly reflected uncertainty over the price of gold in terms of all currencies, rather than the strength of the dollar and the short-term U.S. balance-of-payments position, the announcement of the new balance-of-payments measures was helpful. After a period of relative quiet, there was a renewed surge of speculation in foreign gold markets beginning in late February and early March.

Effective action was taken to cope with the threat to international financial stability. The U.S. Congress completed action on legislation removing the 25-percent gold backing requirement for Federal Reserve note liabilities, thus showing renewed determination to defend the value of the dollar. The representatives of the central banks that were cooperating in the gold pool arrangements met in Washington over the weekend of March 16 and 17, 1968. The Governors of the Central Banks of Belgium, Germany, Italy, the Netherlands, Switzerland, the United Kingdom, and the United States announced after their meeting that:

". . . henceforth officially-held gold should be used only to effect transfers among monetary authorities and, therefore, they decided no longer to supply gold to the London gold market or any other gold market. Moreover, as the existing stock of monetary gold is sufficient

in view of the prospective establishment of the facility for Special Drawing Rights, they no longer feel it necessary to buy gold from the market. Finally, they agreed that henceforth they will not sell gold to monetary authorities to replace gold sold in private markets."

The effect of these steps was a separation of the private and official markets for gold. In official transactions among monetary authorities, gold would continue to be bought and sold at the existing $35 an ounce price. But, the abstention of the cooperating monetary authorities from dealings in gold in private markets would mean that the price of gold in private markets could diverge from the monetary valuation of $35 an ounce. The drain from monetary gold stocks into private holdings was halted by this action and the prospects for international financial stability were greatly improved. With the removal of the threat to international financial stability that had been posed by the gold situation, the world's monetary authorities could proceed with their plans to provide for an assured and orderly growth in international reserves.

A milestone in international monetary cooperation was passed in September 1967 with the unanimous endorsement of the outline plan for international monetary reform at the annual meeting of the IMF in Rio de Janeiro. Under the plan, the problem of inadequate growth of international monetary reserves would be met by creating Special Drawing Rights (SDR's) in the International Monetary Fund. At a Ministerial Meeting of the Group of Ten, March 29–30, 1968, in Stockholm, general agreement was reached—with the French delegation abstaining on some points—on the Amendment to the Articles of the International Monetary Fund necessary to carry the SDR plan into operation. Subsequently the Executive Board of the International Monetary Fund drafted the necessary technical language and submitted it to the Fund's Board of Governors for their approval. The next step would be actual ratification of the plan by the member governments.

The agreements reached at Rio de Janeiro and Stockholm were the culmination of years of intensive study and negotiation. Acting in concert, the world's leading nations had taken a long step toward the provision of an international monetary system in which reserve needs would be met through conscious and deliberate action. As President Johnson indicated, the Rio agreement constituted the greatest forward step in the improvement of the international monetary system since the creation of the International Monetary Fund itself.

HENRY H. FOWLER,
Secretary of the Treasury.

TO THE PRESIDENT OF THE SENATE.
TO THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

ANNUAL REPORT ON THE FINANCES

TREASURY DEPARTMENT,
Washington, December 9, 1968.

SIRS: I have the honor to report to you on the finances of the Federal Government for the fiscal year 1968. The main text of this report consists of a detailed review of Treasury fiscal operations and administrative reports of the offices under my supervision during the fiscal year 1968, along with supporting exhibits. This general introduction reviews the major fiscal and financial developments that have taken place since the time of my last report in May of this year. Also, since this is my final report as Secretary of the Treasury, I will take the liberty of commenting briefly upon some of the accomplishments of recent years and the problems that remain.

Overall Review

It has been a major objective of policy during the past year to reverse decisively the trend toward larger deficits in our internal budget and in our international balance of payments, while continuing to sustain the current economic expansion. Despite the delay in enactment of the fiscal restraint program until late June, encouraging progress has been made toward the achievement of a better degree of financial balance and the economy continues to expand vigorously.

Enactment of the fiscal restraint package in late June marked a significant change in the national financial position. The budget deficit, which had become excessively large, was turned decisively in the direction of balance. Internationally, the enactment of fiscal restraint greatly strengthened foreign confidence in the dollar. Our balance of payments has shown steady improvement during the course of the year and a small surplus was actually registered on the liquidity basis during the third quarter—the first such quarterly surplus in 3 years.

During the calendar year 1968, the economy continued to grow at a relatively rapid pace. Delay in enactment of the fiscal restraint package contributed to the rapidity of the advance and led to some intensification of inflationary pressures. During the first half of the year, gross national product in constant prices rose at more than a 6 percent annual rate—appreciably above the approximately 4 percent trend rate of growth in capacity. This more than 6 percent rate of growth in real output represented a significant acceleration from a rate slightly below 4 percent in the second half of calendar 1967.

The upward movement of prices, which moderated during the first half of 1967, had already stepped up by the second half of 1967. The further quickening in the pace of expansion in the first half of calendar 1968 added to inflationary pressures. Therefore, a shift to fiscal restraint was badly needed in order to bring inflationary tendencies under better control and to start a movement back toward relative price stability. This was recognized as essential for the continued strength and stability of the dollar at home and abroad.

During the second half of calendar 1968 the expansion of the economy gradually began to show some moderating tendencies. Fiscal restraint did not have a strong, immediate effect upon the overall pace of economic expansion, nor was it expected to. But, the rise in gross national product in the third quarter was somewhat below the faster pace of the first half, although final sales were very strong. Moderate easing of the pace of expansion appeared to be probable in the period ahead, but there were no signs of the fiscal "overkill" that some had feared at the time the need for fiscal restraint was being debated.

The budget deficit on national income account fell sharply from a rate of about $10 billion to a rate of $3 billion by the third quarter of 1968. The move toward fiscal restraint will be continuing in the first half of calendar 1969 when the national income budget is expected to swing into surplus. On a unified budget basis, the deficit had soared to $25.2 billion in fiscal 1968 when legislative delays were encountered in implementing fiscal restraint. In the early parts of fiscal 1969 the deficit position on the unified basis began to narrow quickly. While a final assessment will necessarily await the January budget, it appeared that the budget results for fiscal 1969 would be greatly improved from the $5 billion deficit estimated in the midyear budget review of September 1968.

Immediate and substantial relief on the price front could not be expected. While there were some encouraging signs in the second half of calendar year 1968, it would take a considerable period of time for a noninflationary pattern of expansion to be reestablished. The strength of inflationary tendencies in late 1968 only underlined the importance of the move toward fiscal restraint begun at mid-1968. In the absence of that fiscal move, there would have been serious risk of an inflationary breakout of prices. This would have threatened the current expansion and delayed unduly the achievement of balance-of-payments equilibrium. While the fiscal action was long delayed, it was taken in time to avert these serious consequences.

With demand pressures easing a little and a period of somewhat moderate growth in prospect for the first half of calendar 1969, some improvement in price performance was a reasonable expectation. How-

ever, cooperation and restraint on the part of both business and labor would be vitally important to the early restoration of a more stable cost-price relationship.

The improved Federal budgetary outlook was already becoming an important influence in the money and credit markets in the second half of calendar 1968. During the third quarter the net market impact of Federal finance was little changed from the corresponding period a year earlier. But by the fourth quarter there was a significant decline in Federal financial requirements relative to a year earlier.

In the first half of calendar 1969, the Federal financial sector will return to the traditional seasonal pattern of sizable repayment of debt. The net effect would be a very appreciable reduction of pressures from this source on the money and capital markets. However, private demands for credit were still running at a relatively high rate in the second half of 1968. After some initial easing in response to passage of the Revenue and Expenditure Control Act of 1968, interest rates rose irregularly during the late summer and into the autumn.

On the international side, substantial progress was made during 1968 toward achieving equilibrium in the balance of payments. A huge deficit in the fourth quarter of 1967 was reduced sharply in the first quarter of 1968 as the Action Program announced by President Johnson on New Year's Day got underway. In the second quarter, the liquidity deficit declined further and actually moved into a small surplus position in the third quarter. On the official settlements basis, results were equally impressive.

This sharp improvement in the balance of payments was extremely welcome. However, transitory elements were responsible for some of the improvement. Furthermore, the composition of the balance was far from ideal. A large part of the improvement was attributable to foreign capital inflows whose continuation on that scale was far from assured. The trade account did begin to show signs of improvement after the second quarter but was still at very low levels. It was clear that a prolonged effort would be required to rebuild the trade surplus to a satisfactory level. A period of moderate domestic growth and a return to a less inflationary environment would be of great help in strengthening the trade position.

The notable balance-of-payments progress achieved in 1968 had necessarily relied primarily on temporary measures. The long term measures to increase exports, to reduce nontariff barriers and to increase foreign investment and travel in the United States have only begun to have an impact. Moreover, the continuation of a high level of military expenditures in the Far East has limited our ability to neutralize Government expenditures abroad. Certainly, until the full effects of longer run measures materialize, we cannot safely abandon the tem-

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porary measures, particularly the restraints over U.S. capital outflow, which are accountable for so much of the recent improvement.

In the international financial area, the past year has seen a number of important developments. Two major threats to the continued stability of the international financial system were dealt with effectively by cooperative action. The first occurred early in the year and centered around speculative activity in the gold market. The second occurred late in the year and involved special measures to deal with the international financial repercussions of large speculative capital inflows to West Germany. In each case, multilateral consultation and discussion among the major financial nations led to an agreed upon course of action and at least a temporary resolution of the problems encountered.

Against a background of multilateral cooperation, further progress was made during the year toward the activation of the Special Drawing Rights machinery to provide by deliberate decision over the years ahead new reserve assets supplemental to gold and dollars. On June 19, 1968, President Johnson signed the bill authorizing U.S. participation in the Special Drawing Rights Plan. The U.S. acceptance of the proposed amendment to the Fund's Articles of Agreement and certificate of participation were then transmitted to the Fund. The United States was the first Fund member to complete both steps. As I indicated in my remarks at the Annual Meeting of the Fund and the World Bank, the U.S. Government was proud to act promptly both to ratify the amendments establishing the Special Drawing Rights facility and to deposit its instrument of participation.

Tax Policy

The major tax development since the time of my last report was the Revenue and Expenditure Control Act of 1968 (Public Law 90–364) which was approved by President Johnson on June 28, 1968. This measure not only increased taxes but also required reduction in Federal spending and employment and amended the Social Security Act. Fuller details on this and other developments in tax policy during the fiscal year 1968 are provided on pages 25–37 of the accompanying report.

Since there was lengthy legislative delay in enactment of the fiscal restraint package, a brief review of the events leading up to its final passage may be useful. The initial proposal for a general increase in income taxes was made by President Johnson in his state of the Union message of January 10, 1967. He called for a surcharge of 6 percent on both individual and corporate income taxes to last for 2 years or so long as the unusual expenditures associated with our efforts in Vietnam continue. The temporary surcharge was to be effective from July 1, 1967.

As revised estimates of revenues and expenditures made it clear that the budget deficit would be much larger than had been anticipated in early 1967, President Johnson requested on August 3, 1967, that the surcharge be raised from 6 to 10 percent. Aside from the recommendation for a 10-percent surcharge the President repeated his January 1967 recommendations for a further speedup of corporate tax collections and a postponement of scheduled reductions in excise taxes. In addition, the President urged the Congress to exercise the utmost restraint and responsibility in the appropriations process and to make every effort not to exceed the January budget estimates. For its part, the executive branch promised to take every proper action within its power to reduce expenditures in the January budget.

Hearings were held on the tax proposals at the House Ways and Means Committee in August and September and again in November 1967 following the devaluation of sterling. At the November hearings the Administration presented a two-part plan: the tax proposals and a specific statutory plan for expenditure reduction in fiscal 1968 from the levels then in prospect. While the Ways and Means Committee did not take favorable action on the proposals, the expenditure reduction part of the plan was implemented by joint congressional and executive action in December 1967.

On January 22, 1968, the House Ways and Means Committee resumed its hearings on the President's tax proposals. The committee took favorable action on the corporate tax acceleration and excise tax components of the tax package, but not on the proposed 10-percent surcharge on individual and corporate income tax liabilities. The corporate tax acceleration and the postponement of scheduled excise tax reductions were passed by the House of Representatives on February 29, 1968.

The scene then shifted to the Senate. The Senate Finance Committee approved action on excise taxes and the corporate tax acceleration but decided, on a close vote, against the proposed 10-percent surcharge. On the floor of the Senate, however, the 10-percent surcharge and a ceiling on Federal expenditures, along with a number of other amendments were added to the excise tax and corporate acceleration legislation.

The bill went to conference in early April but further delay ensued. The House finally agreed to the conference report on June 20 and the Senate on June 21. The Revenue and Expenditure Control Act of 1968 (Public Law 90–364) was signed by the President on June 28, 1968. In addition to its tax provisions and the amendment of certain provisions of the Social Security Act, the final legislation provided limitations on 1969 budget authority and outlays of $10 billion and $6 billion, respectively, below the levels estimated in the 1969 budget with certain

specific exceptions. It also required specific recommendations by the President in the budget message for fiscal 1970 for rescinding $8 billion of carryover obligational authority.

At the time of final congressional action, I indicated my belief that the decisive vote increasing taxes and decreasing projected public expenditures—both unpopular measures in an election year—should go far to sustain confidence in the dollar, the economy on which it is based, and our system of government. The favorable congressional action was a momentous decision—to pay our nation's bills and order our economic and financial affairs in such a manner as to reduce sharply the twin deficits in our budget and international balance of payments. Events since June 1968 have only served to reinforce my belief that the passage of the Revenue and Expenditure Control Act of 1968 was a crucial step, marking a decisive improvement in our financial affairs.

Financial Policies and Debt Management

In the domestic financial area, the past year has been one of continuing strong demands in our money and capital markets. During the first part of calendar 1968, the Federal Reserve was applying some monetary restraint. Following the devaluation of sterling in November 1967, the discount rate was raised from 4 percent to 4½ percent. In early 1968, with little apparent progress being made toward the enactment of a fiscal restraint program, the discount rate was raised in two further one-half point steps (March 15, 1968, and April 19, 1968) to a level of 5½ percent. In January reserve requirements on demand deposits in excess of $5 million were raised by one-half of one percent and in April the maximum rates payable on certificates of deposit were raised to 6¼ percent on the longest maturities. Total and nonborrowed reserves increased substantially in January and February but then remained about flat through the middle of the year.

Both short and long term interest rates on Government securities dipped early in 1968 after rising steadily in the last half of 1967. Three-month Treasury bills averaged a bit less than 5 percent in February 1968 after edging above 5 percent earlier in the year. Interest rates on Government securities then rose until late May when the expectation of imminent fiscal action sponsored an easing trend. At the high point in late May, 3-month Treasury bills reached 5.92 percent and longer bills edged above 6 percent. Intermediate coupon rates moved up about one-half of one percent in this period. High grade corporate and municipal bond yields also moved higher.

An easing trend in interest rates began before the passage of the Revenue and Expenditure Control Act of 1968 and was accommodated by monetary policy during the summer. In August the discount rate was reduced from 5½ percent to 5¼ percent. The Board of Governors

of the Federal Reserve System stated that the change was primarily technical, to align the discount rate with the change in money market conditions which had occurred chiefly as a result of the increased fiscal restraint and a lower Treasury demand for financing resulting from the enactment of the tax increase and its related expenditure cuts.

With the economy moving ahead rapidly and private demands for credit continuing to be strong, interest rates began to move back up again by early autumn. Three-month Treasury bills which averaged 5.10 percent in August were near 5½ percent by late November. Most other interest rates rose during this period and yields on some private securities were not far below their highs for the year. New Aa-rated corporate bonds were slightly above 7 percent, new municipal bonds were at 4⅝ percent and new home mortgages were about 7¼ percent. Most rates rose further in early December.

A relatively large volume of private securities had been offered for sale during the course of the year, partly accounting for the continuing high level of interest rates. Gross corporate offerings appeared likely to total some $21 billion for the year—only slightly below the record 1967 total of $24 billion. State and local offerings in 1968 were running about 13 percent above the 1967 rate and would probably reach some $16½ billion for the year as a whole.

While private demands for credit appeared likely to remain relatively strong, there had been a pronounced alteration in the Federal financial position with the passage of the tax and expenditure legislation. Federal demands continued to run at a fairly high level in the third quarter of 1968 but then began to fall off very appreciably. This was readily apparent from a comparison of prospective Federal market impact for the final three quarters of fiscal 1969 with the corresponding period of fiscal 1968. In the earlier period—the last three quarters of fiscal 1968—there was a net market demand by the Federal sector of about $9 billion. This was after adjustment for Treasury cash, purchases of Government Investment Accounts and the Federal Reserve, sales of nonmarketable issues, and included all direct Treasury finance plus all agency borrowings. The final three quarters of fiscal 1969 were expected to result in a net market paydown of about $7 billion on the same basis. The swing of some $15 billion in Federal financial requirements was an extremely important development.

The bulk of Treasury cash requirements between mid-1968 and the end of the calendar year was met through the issuance of tax anticipation bills which helped to insure a minimum market impact. (A full discussion of debt management activities during the fiscal year 1968 will be found in the body of this report, pages 11–25). A $4 billion offering of March and April 1969 tax anticipation bills in early July began the Treasury's financing operations in the second half of calendar

1968. Approximately $5 billion more of tax bills were sold in the balance of the year—$3 billion in October and the final $2 billion at the end of November.

Major financing operations were conducted in August and again in late October. The books were open on August 5 for a cash offering of 5⅝ percent, 6-year notes, priced to yield about 5.70 percent. This issue raised some new cash but the bulk of the proceeds was used to pay off issues maturing at mid-August. In late October the books were open for an exchange offering. The holders of November 15 and December 15 maturities were offered an exchange into either a 5⅝ percent, 18-month note, priced to yield 5.73 percent or a 6-year 5¾ percent note, originally issued as a 7-year note on November 15, 1967.

The financing operations in the second half of calendar year 1968 were conducted smoothly and successfully. With the peak period of Federal demand in the past and the budget moving toward balance, the Government's financial outlook was greatly improved.

International Financial Affairs

A summary of a wide range of developments in international financial affairs through fiscal 1968 will be found in the text of this report (pages 37–55). Attention will be confined here to major developments during the year in the U.S. balance of payments and the progress made toward improved international financial arrangements.

Balance of Payments

During the first three quarters of calendar year 1968 steady improvement was registered in the U.S. balance of payments. The impetus for this improvement was provided by President Johnson's Action Program for the balance of payments announced on January 1, 1968. In 1967, the deficit on the liquidity basis reached $3.6 billion and returned near the deficit levels of 1959 and 1960. On the official reserve transactions basis, the deficit for calendar 1967 was $3.4 billion. U.S. gold losses in 1967 rose to $1,170 million, about double the $571 million loss in 1966. Much of the deterioration occurred in the final quarter of the year when the liquidity deficit reached $1,742 million and gold losses exceeded $1 billion. The heavy pressure in gold markets continued in early 1968 until it was checked by international agreement on new arrangements with respect to private gold markets.

Some part of the large fourth-quarter 1967 balance-of-payments deficit was due to such temporary factors as the weakness of sterling and the effects of work stoppages in this country. Even after allowance for these and other special factors, however, it was clear that there had been a significant worsening of the deficit during 1967 and that a tightening of the balance-of-payments program was essential under the circumstances. President Johnson announced the details of the new

balance-of-payments program in a special message on January 1, 1968. Major emphasis was placed on the close relationship between the domestic economy and the balance of payments. The Presidential statement stressed the need for fiscal restraint and called on business and labor to exercise the utmost responsibility in their wage-price decisions.

The new balance-of-payments program consisted of temporary measures in the areas of direct investment, lending by financial institutions, foreign travel, and Government overseas expenditure. In addition, long term measures were proposed to increase U.S. exports, deal with the problem of nontariff barriers, and encourage foreign investment and travel in the United States. The program embodied a comprehensive approach to the problem with savings sought in all major areas of the balance of payments. It was evolutionary in the sense of building upon the experience gained from previous balance-of-payments programs, but also included new techniques designed to achieve effective control of direct investment and the overseas expenditures of U.S. tourists.

The main specific elements of the new program were:

—a mandatory program, administered by the Department of Commerce, to restrain direct investment abroad

—revised guidelines by the Board of Governors of the Federal Reserve System to reduce credits from U.S. banks and other financial institutions

—encouragement of foreign travel in the United States and proposed measures to restrain the volume of U.S. travel expenditures outside the Western Hemisphere

—further reductions in the balance-of-payments impact of Government expenditures overseas

—a long-term export expansion program, including intensified promotional efforts and enlarged facilities for export insurance, guarantees, and financing

—consultation with foreign countries to minimize the disadvantages to our trade which arise from differences among our national tax systems

—further efforts to attract greater foreign investment in U.S. corporate securities, carrying out the principles of the Foreign Investors Tax Act of 1966.

Some parts of the program, such as those designed to help rebuild the trade surplus, were longer run measures and did not exert much immediate effect during 1968. The proposal to impose a temporary tax on foreign travel expenditures outside the Western Hemisphere did not receive congressional approval during 1968. But in the areas where it was carried into effect, the January 1968 program was extremely successful.

For three successive quarters, the deficit of the United States moved toward equilibrium. The huge deficit of $1,742 million (liquidity basis) in the fourth quarter of 1967 was reduced to $680 million in the first quarter of 1968 as the program got underway, moved downward to $160 million in the second quarter, and then into a small surplus, on the basis of preliminary figures, in the third quarter.

On the official settlements measure, the deficit had reached the very high level of $1,082 million in the fourth quarter of 1967. After the new action program, the deficit declined to $552 million in the first quarter of 1968. Surpluses of $1,523 million and $439 million were registered in the second and third quarters.

U.S. gold losses were checked after the first quarter by the separation of the private and official markets. In the first quarter of 1968, U.S. gold losses soared to $1,362 million. In the second quarter losses were only $22 million and in the third quarter there was a net gain of $73 million.

The dramatic improvement in the balance of payments was, of course, extremely welcome. However, the composition of the accounts was somewhat unbalanced with the trade surplus at abnormally low levels. Furthermore, it had to be recognized that there were transitory elements accounting for some of the recorded improvement. There would be a need to guard against any overconfidence and to recall that setbacks had previously been encountered when the balance of payments was showing an improving trend. Clearly, it would be essential to carry through vigorously on the balance-of-payments program until equilibrium had been established on an enduring basis.

International Finance

Events since the time of my last report have demonstrated once again the value of cooperative multilateral action in international financial affairs. Early in the year, the international financial system was still unsettled by heavy speculative activity in gold markets as an aftermath of the sterling devaluation in November 1967. After a period of relative calm following the announcement of the January 1, 1968, U.S. balance-of-payments program, there was a renewed surge of speculation in foreign gold markets.

The representatives of the central banks that were cooperating in the gold pool arrangement met in Washington over the weekend of March 16 and 17, 1968, and developed the plans for what has come to be known as the two-tier gold system. As a result of the agreements reached at this meeting, the drain from monetary gold stocks was halted and the private and official gold markets were effectively separated. The transition at mid-March took place with remarkable smoothness, considering the tense atmosphere that had preceded it, the abrupt change in conditions, and the inevitable doubts and uncertainties about anything new or unknown in the international

monetary field. The new system has worked very well. It has provided additional assurance that the present $35.00 an ounce price of gold will be maintained in official transactions.

Despite the successful resolution of the gold market problem, the course of international financial developments was far from smooth during the balance of the year. After a brief period of comparative calm, the outbreak of student rioting and labor strikes in late May turned speculative pressure on the French franc. Prompt and coordinated international action was successful in dealing with the speculative pressure and the franc improved gradually during the summer. By late summer, the gold and foreign exchange markets had settled down to orderly trading in a reasonably calm atmosphere.

In early September 1968 the French authorities announced the lifting of the exchange controls that had been imposed in late May. At about the same time, the Bank for International Settlements and a group of 12 central banks announced that they would provide a $2 billion medium term credit to the United Kingdom to offset reductions in the sterling balances of overseas sterling countries. By mid-October the gold and foreign exchange markets were more settled and orderly than in many months.

In November 1968 a wave of currency speculation developed. Continued large surpluses by West Germany encouraged a belief that the mark might be revalued. This reacted adversely on both the French franc and the pound sterling. The possibility of an unsettling series of exchange rate adjustments was a clear threat to the stability of the international financial system. A meeting of representatives of the Group of Ten nations was held at Bonn, West Germany, between November 20 and 22. The outcome was special border tax and other measures by West Germany instead of a revaluation of the mark. Both the United Kingdom and France took measures of additional budgetary restraint. Despite widespread expectations to the contrary, the French franc was not devalued.

The Bonn meeting represented a further recognition of the principle of cooperative multilateral action in financial affairs affecting major countries and major currencies. The approach to the problem was multilateral and every effort was made to concert rational policies and reach common decisions with financial partners. This was another step away from a narrow, nationalistic view of international finance and toward the multilateral, cooperative approach.

While turbulent events in the gold and foreign exchange markets have claimed much of the attention of the financial world during the past year, the extension of the principle of multilateral cooperation seems sure to be the development of lasting significance. Acting in concert, the major nations had staved off threats to the stability of the international monetary system and proceeded with the plans for an orderly evolution of existing arrangements.

During the year further progress was made in implementing the Special Drawing Rights plan. The ratification of the amendment to the Articles of Agreement of the International Monetary Fund establishing this facility is proceeding satisfactorily, and when, in 1969, this process has been completed and drawing levels determined, the world will have taken the most fundamental progressive step in monetary affairs since Bretton Woods. For the first time in the world's history we shall be looking to the leadership of an international institution to provide conscious direction in recommending the amount of growth in world reserves which the international community needs to facilitate trade and development.

Summary

Since this is my last Annual Report as Secretary of the Treasury, I will supplement my usual review of recent developments with brief comment on some of the major achievements of recent years in areas of Treasury interest and responsibility. While the future will bring new problems requiring new solutions, there is a continuity in economic and financial events and in established national objectives. Therefore, a review of recent experience may be of some value in pointing to some of the lessons that have been learned and the tasks that remain.

An important lesson of the 1960's is the enormous difference that public policies can make in creating an atmosphere within which the private economy can flourish. From early 1961 to the present, the national growth rate—in terms of real gross national product—has averaged more than 5 percent per annum. This longest economic expansion in our nation's history—nearing the end of its eighth year—has raised our annual total real output as much as in the previous 20 years. The increase in the value of our annual production during the current expansion is roughly equivalent to the total annual output of the European Economic Community or the Soviet Union in a recent year.

Until late 1965, this immense productive achievement featured stable costs per unit of output. Within the last 3 years, costs and prices have risen too rapidly, triggered by the rapid buildup of the war in Southeast Asia after mid-1965. Even so, the United States still has the best overall record of price stability since 1960 of any of the major industrialized nations. But, it is all too clear that our recent price record must be improved. It is a major challenge for future U.S. domestic policy to maintain a healthy rate of growth in production and employment while moving back to a noninflationary environment. The efforts of the incoming Administration in this area deserve, and should receive, full support and cooperation.

Economic growth—even in a noninflationary environment—will certainly not solve all of our domestic problems. But the recent record demonstrates clearly that vigorous economic growth remains the most

powerful social weapon at our disposal. The economic gains of recent years have brought substantial gains to minority groups and given an added degree of dignity and security to millions of Americans. And, in an interdependent world economy, the better U.S. economic performance has also had dramatic effect internationally. The growth of the entire free world has picked up in this decade and the volume of trade has increased impressively.

Experience has proven the value of the use of a range of key policy tools in the pursuit of economic growth and social progress. Suitably adapted to changing circumstances, and supplemented by new techniques, these policy tools can continue to make a distinctive contribution to the promotion of our economic welfare. The major tools which have proven their value can conveniently be summarized under the following headings: structural policies, flexible and coordinated fiscal and monetary policies, cooperation between labor, management, and government, and international policy coordination and cooperation.

Structural policies in the tax area have greatly strengthened investment incentives since the early 1960's and promoted a more rapid rate of growth in productivity. Even with the recently enacted surcharge, Federal income tax rates are much lower than at the beginning of this decade. Tax reform has continued to be a major and continuing objective.

Structural policies outside the tax area also hold great promise. In recent years, the development of intensified public policy and imaginative efforts in private industry in manpower training have mounted a concerted attack on structural unemployment. Sizable investment in these activities and the underlying educative capacity that makes manpower training meaningful, coupled with the investment in tools of production, have become recognized as essential to the successful pursuit of the economies of growth.

Flexible and coordinated fiscal and monetary policies will continue to be major instruments of national economic policy in the years ahead—as they have been in this decade. During recent years it has been shown that fiscal policy can be used to restrain as well as to stimulate. The long delay in the application of fiscal restraint was unfortunate. It may point to the need for some procedures whereby the fiscal position can be adjusted more smoothly and promptly. This is a matter of major importance since an appropriate degree of fiscal stimulus or restraint, combined with a flexible and responsive monetary policy, can help insure that growth in total spending and productive capacity will be kept in reasonable correspondence, thereby avoiding the waste of unemployment and the inequity of inflation. In the absence of a coordinated and stabilizing response from fiscal and monetary policy, we run the risk of returning to the old cycle of expansion and contraction—boom and bust.

In recent years, a remarkable degree of cooperation, understanding, and mutual confidence has gradually emerged between business and labor and Government. Business and labor and Government have moved together in a growing partnership for progress. A key problem remains to be solved: wage-price stability at high levels of employment. Even with sound monetary and fiscal policies, wage-price stability depends upon the determination of American business and American labor to avoid wage rises that outdistance our gains in productivity and to take the national interest into account in pricing decisions. Wage and price stability is vital to both our balance of payments and our domestic progress—business and labor and Government have a joint responsibility to cooperate in its achievement.

In the area of international financial policy coordination and cooperation, great progress has been made in recent years. This progress has been achieved during a period of formidable pressures on the international financial system and on our own balance of payments. Increasingly, the major countries are sharing the responsibility on a multilateral free world scale for an improved trade and payments system, mutual security arrangements that are soundly and fairly financed, and an expanding system of development aid and finance. The landmark agreement on the Special Drawing Rights Plan to provide for orderly growth in world reserves is but one indication of the cooperative approach in international financial affairs.

In all of these areas of domestic and international economic policy, there are common objectives and a growing consensus as to the means of achieving them. While there are differences of opinion and shadings of emphasis, there is also a considerable area of agreement on national economic objectives. We must keep the economy growing and productive, the nation's finances in reasonable balance, and the dollar sound and respected.

HENRY H. FOWLER,
Secretary of the Treasury.

TO THE PRESIDENT OF THE SENATE.
TO THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

Secretary, Under Secretaries, General Counsel, Assistant Secretaries, and Deputy Under Secretaries for Monetary Affairs, Serving in the Department of the Treasury from January 21, 1969, through November 1, 1969 [1]

Term of service		Officials
From	To	
		Secretary of the Treasury
Jan. 22, 1969		David M. Kennedy, Illinois.
		Under Secretary
Jan. 27, 1969		Charls E. Walker, Texas.
		Under Secretary for Monetary Affairs
Jan. 27, 1969		Paul A. Volcker, New Jersey.
		General Counsel
Apr. 1, 1969		Paul W. Eggers, Texas.
		Assistant Secretaries
May 15, 1968		John R. Petty, New York.
Mar. 11, 1969		Edwin S. Cohen, Virginia.
Apr. 1, 1969		Eugene T. Rossides, New York.
June 23, 1969		Murray L. Weidenbaum, Missouri.
		Deputy Under Secretaries of the Treasury for Monetary Affairs
Feb. 12, 1968	Mar. 31, 1969	Frank W. Schiff, New York.
Apr. 1, 1969		Bruce K. MacLaury, New Jersey.
		Fiscal Assistant Secretary
June 15, 1962		John K. Carlock, Arizona.
		Assistant Secretary for Administration
Sept. 14, 1959		A. E. Weatherbee, Maine.

[1] For officials from Sept. 11, 1789, to Jan 20, 1969, see exhibit 64.

PRINCIPAL ADMINISTRATIVE AND STAFF OFFICERS OF THE DEPARTMENT OF THE TREASURY AS OF NOVEMBER 1, 1969

Secretary of the Treasury	David M. Kennedy
Assistant to the Secretary	Donald A. Webster
Under Secretary of the Treasury	Charls E. Walker
Assistant to the Under Secretary	Edward J. Gannon
Staff Assistant to the Under Secretary	Richard D. Chotard, Jr.
Under Secretary for Monetary Affairs	Paul A. Volcker
Deputy Under Secretary for Monetary Affairs	Bruce K. MacLaury
Special Assistant to the Secretary (Debt Management)	Edward J. Geng
General Counsel	Paul W. Eggers
Deputy General Counsel	Roy T. Englert
Assistant General Counsel and Chief Counsel, IRS	K. Martin Worthy
Assistant General Counsel	Charlotte Tuttle Lloyd
Assistant General Counsel	Michael Bradfield
Assistant General Counsel	Hugo A. Ranta
Assistant General Counsel	Donald L. E. Ritger
Director of Practice	William H. Sager
Director, Office of Equal Opportunity Program	David A. Sawyer
Assistant Secretary (Tax Policy)	Edwin S. Cohen
Deputy Assistant Secretary	John S. Nolan
Deputy Assistant Secretary and Director Office of Tax Analysis	Vacancy
Associate Director Office of Tax Analysis	Gerard M. Brannon
Assistant Director	Richard E. Slitor
Assistant Director	Thomas F. Leahey
Assistant Director Office of Tax Analysis and Director Office of International Tax Affairs	Nathan N. Gordon
Assistant Director	Gabriel G. Rudney
Chief Excise Taxation Staff	John Copeland
Chief Business Taxation Staff	Seymour Fiekowsky
Chief Aggregate Economic Forecasting Staff	Ralph B. Bristol
Tax Legislative Counsel	Meade Whitaker
Deputy Tax Legislative Counsel (International) and Special Assistant to Assistant Secretary	Robert T. Cole
Deputy Tax Legislative Counsel	Daniel I. Halperin
Associate Tax Legislative Counsel	John E. Chapoton
Associate Tax Legislative Counsel (International) and Deputy Special Assistant to Assistant Secretary	Robert J. Patrick, Jr.
Assistant Secretary (Economic Policy)	Murray L. Weidenbaum
Assistant to Assistant Secretary	Robert L. Joss
Director, Office of Domestic Gold and Silver Operations	Thomas W. Wolfe
Director, Office of Financial Analysis	John H. Auten
Director, Office of Debt Analysis	Edward P. Snyder

Assistant Secretary (Enforcement and Operations)	Eugene T. Rossides
Deputy Assistant Secretary	William L. Dickey
Deputy to the Assistant Secretary (Customs)	Matthew J. Marks
Special Assistant (Secret Service)	John T. Sherwood
Special Assistant (Organized Crime)	G. Gordon Liddy
Law Enforcement Coordinator	Thomas Lumbard
Interpol Chief	Kenneth S. Giannoules
Director, Law Enforcement School	John S. Stemple
Assistant Secretary (International Affairs)	John R. Petty
Deputy Assistant Secretary	Vacancy
Deputy to Assistant Secretary for International Monetary Affairs	George H. Willis
Deputy to Assistant Secretary for International Financial and Economic Affairs	Ralph Hirschtritt
Director, Office of Latin America	E. Jay Finkel
Director, Office of Industrial Nations	F. Lisle Widman
Director, Office of Developing Nations	Sam Y. Cross
Director, Office of Balance of Payments Programs, Operations and Statistics	Philip P. Schaffner
Director, Office of International Financial Policy Coordination and Operations	Charles R. Harley
Director, Office of International Gold and Foreign Exchange Operations	T. Page Nelson
Director, Office of International Economic Activities	Robert G. Pelikan
Director, Office of Administration	Leonard S. Dixon
Director, Office of Foreign Assets Control	Mrs. Margaret W. Schwartz
Fiscal Assistant Secretary	John K. Carlock
Deputy Fiscal Assistant Secretary	Hampton A. Rabon
Assistant Fiscal Assistant Secretary	Boyd A. Evans
Assistant to Fiscal Assistant Secretary	Sidney Cox
Assistant Secretary for Administration	A. E. Weatherbee
Deputy Assistant Secretary and Director, Office of Budget and Finance	Ernest C. Betts, Jr.
Director, Office of Planning and Program Evaluation	Benjamin Caplan
Director, Office of Personnel	Amos N. Latham, Jr.
Director, Office of Management and Organization	J. Elton Greenlee
Director, Office of Administrative Services	Paul McDonald
Director, Office of Security	Thomas M. Hughes
Special Assistant to the Secretary (Public Affairs)	Dixon Donnelley
Deputy Special Assistant to the Secretary	Calvin E. Brumley
Special Assistant to the Secretary (National Security Affairs)	Anthony J. Jurich
Deputy Special Assistant to the Secretary	John J. McGinnis
Special Assistant to the Secretary (Congressional Relations)	James E. Smith
Deputy Special Assistant to the Secretary	Benjamin L. Brown
Deputy Special Assistant to the Secretary	Gene A. Knorr
Senior Consultant	Henry C. Wallich
Deputy Assistant to the Secretary (Director, Executive Secretariat)	Paul R. Beach

BUREAU OF ACCOUNTS

Commissioner of Accounts	Sidney S. Sokol
Assistant Commissioner	L. D. Mosso
Comptroller	Steve L. Comings
Chief Disbursing Officer	Lester W. Plumly
Director, Government Financial Operations	Sebastian Fama

BUREAU OF CUSTOMS

Commissioner of Customs	Myles J. Ambrose
Deputy Commissioner of Customs	Edwin F. Rains
Assistant Commissioner, Office of Administration	Glenn R. Dickerson
Assistant Commissioner, Office of Investigations	Vacancy
Assistant Commissioner, Office of Operations	David C. Ellis
Assistant Commissioner, Office of Regulations and Rulings	Robert V. McIntrye
Chief Counsel	Alfred H. Golden

BUREAU OF ENGRAVING AND PRINTING

Director, Bureau of Engraving and Printing	James A. Conlon
Deputy Director, Bureau of Engraving and Printing	Donald C. Tolson

BUREAU OF THE MINT

Director of the Mint	Mrs. Mary T. Brooks
Deputy Director of the Mint	Frederick W. Tate

BUREAU OF THE PUBLIC DEBT

Commissioner of the Public Debt	Donald M. Merritt
Assistant Commissioner	H. J. Hintgen
Deputy Commissioner	J. J. Lubeley
Chief Counsel	Thomas J. Winston, Jr.
Deputy Commissioner in Charge, Chicago Office	Michael E. McGeoghegan

INTERNAL REVENUE SERVICE

Commissioner of Internal Revenue	Randolph W. Thrower
Deputy Commissioner	William H. Smith
Assistant Commissioner (Administration)	Edward F. Preston
Assistant Commissioner (Inspection)	Vernon D. Acree
Assistant Commissioner (Compliance)	Donald W. Bacon
Assistant Commissioner (Data Processing)	Robert L. Jack
Assistant Commissioner (Planning and Research)	Albert W. Brisbin
Assistant Commissioner (Technical)	Harold T. Swartz
Chief Counsel	K. Martin Worthy

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Comptroller of the Currency	William B. Camp
First Deputy Comptroller	Justin T. Watson
Administrative Assistant to the Comptroller	John Nicoll
Deputy Comptroller	John D. Gwin
Deputy Comptroller	Thomas G. DeShazo
Deputy Comptroller for Economics	David C. Motter
Chief National Bank Examiner	F. H. Ellis
Deputy Comptroller (Mergers and Branches)	R. J. Blanchard
Deputy Comptroller (Trusts)	Dean E. Miller
Deputy Comptroller (FDIC Affairs)	Albert J. Faulstich
Chief Counsel	Robert Bloom

OFFICE OF THE TREASURER OF THE UNITED STATES

Treasurer of the United States	Mrs. Dorothy A. Elston
Deputy Treasurer	William T. Howell
Assistant Deputy Treasurer	Willard E. Scott

U.S. SAVINGS BONDS DIVISION

National Director	Elmer L. Rustad
Assistant National Director	Thomas Hughes

U.S. SECRET SERVICE

Director	James J. Rowley
Deputy Director	Rufus W. Youngblood
Assistant Director (Administration)	Phil W. Jordan
Assistant Director (Investigations)	Burrill A. Peterson
Assistant Director (Protective Forces)	Lilburn E. Boggs
Assistant Director (Protective Intelligence)	Thomas J. Kelley

COMMITTEES AND BOARDS

Chairman, Treasury Management Committee	A. E. Weatherbee
Chairman, Treasury Awards Committee	Amos N. Latham, Jr.
Principal Compliance Officer	Paul W. Eggers
Equal Employment Opportunity Officer	Paul W. Eggers
Chairman, Advisory Committee on Ethical Standards	Paul W. Eggers

ORGANIZATION OF THE DEPARTMENT OF THE TREASURY

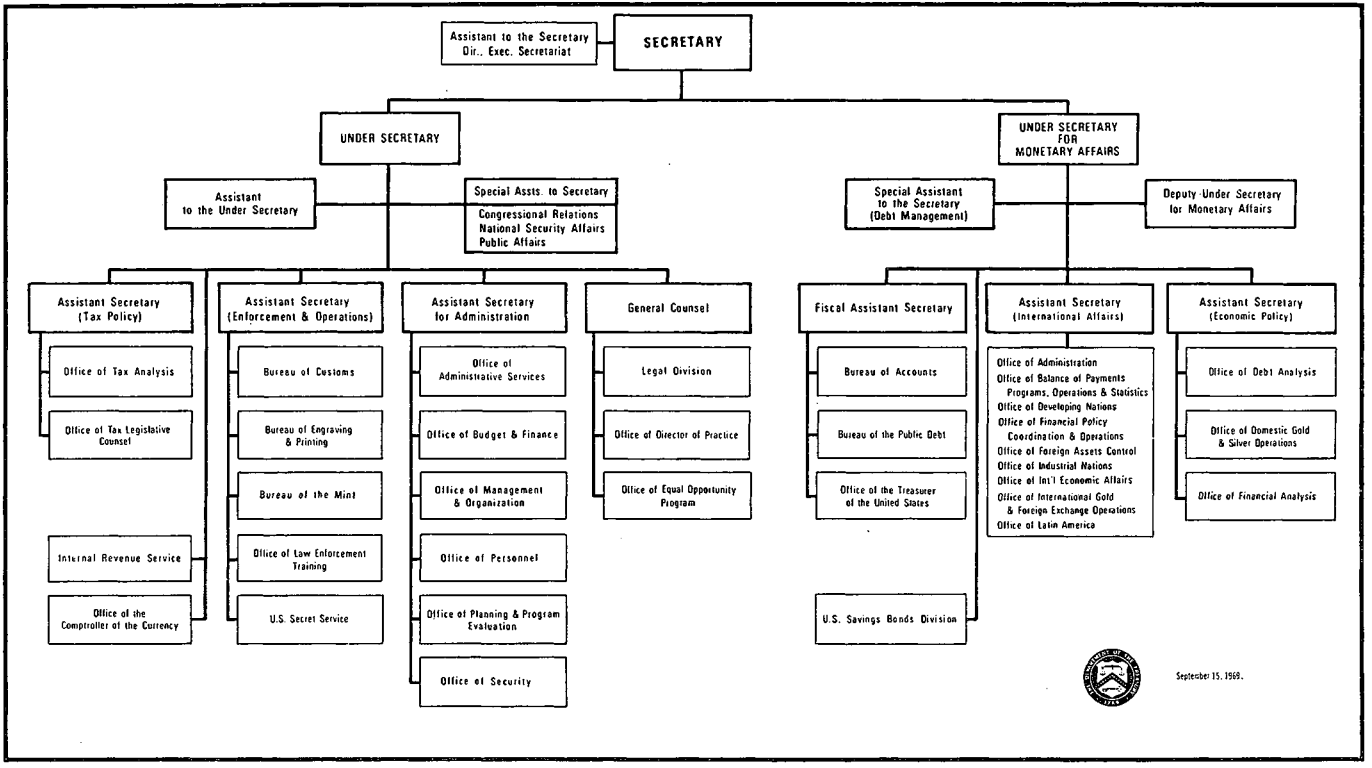

CHART 1

Fiscal Year Ended June 30, 1969

ANNUAL REPORT ON THE FINANCES

TREASURY DEPARTMENT,
Washington, February 4, 1970.

SIRS: I have the honor to report to you on the finances of the Federal Government for the fiscal year 1969, pursuant to the requirements of 31 U.S.C. 1027. The main text of this report and its supporting exhibits provide detailed information on Treasury Department operations and administrative activities during the fiscal year. The supporting tabular data will follow in the separate "Statistical Appendix" to this annual report. This brief introduction discusses major developments since the present administration assumed office in January 1969.

The most immediate domestic problem facing the incoming administration was an accelerating rate of inflation. Already rapidly rising prices had eroded the purchasing power of millions of Americans who counted on their Government to provide sound money. Internationally, the dollar remained strong but continued inflation at home would eventually undercut the position of the dollar abroad. Therefore, the situation in the early part of calendar year 1969 clearly required the firm application of fiscal and monetary restraint.

The administration held no illusions as to the quick and easy success of an anti-inflationary policy. By early 1969, the Consumer Price Index was rising at more than a 5-percent annual rate and inflationary expectations were widespread. To some considerable extent, the course of the economy for the calendar year 1969 was already set. There are lags in the operation of fiscal and monetary policies, and restraint applied early in 1969 could only be expected to exert its effects gradually, over time. But a policy of fiscal and monetary restraint, persistently applied, could bring the economy back onto a noninflationary course.

It was recognized that there were risks in seeking to halt the inflation abruptly. Very harsh and restrictive measures could have disrupted productive expansion and caused a prohibitive increase in unemployment. Even though the inflationary psychology might have been broken, the cost would have been too great. It was equally clear that there were risks in doing too little. The experience of 1967 and 1968 had shown that insufficient and temporary restraint would only be followed by the resurgence of inflationary pressures. Inflation had been allowed to build up a great deal of momentum by the beginning of 1969. There-

fore, it was essential that the economy be placed under firm restraint until there were unmistakable signs that stability had been restored.

This meant that the Federal budget should move into surplus while the Federal Reserve pursued appropriate complementary policies in the monetary area. The Federal budget surplus of $3.2 billion for the fiscal year 1969 was the first since fiscal year 1960 and the largest since fiscal year 1957. It marked a welcome contrast to the massive $25.2 billion deficit of fiscal 1968. Coupled with a shift to monetary restraint, the improved fiscal position helped to slow the rapid rise of the domestic economy. By mid-1969 the economy was growing in real terms at a 2 percent to 2½ percent annual rate in contrast to the clearly unsustainable pace of a year earlier.

Nevertheless, cost and price pressures continued to be very strong. The desirability of a Federal budget surplus in fiscal year 1970 was readily evident. The administration recommended that Congress: Extend the income tax surcharge at the full 10-percent rate through the first half of fiscal 1970 and at 5 percent through the remainder of the fiscal year; postpone the scheduled reductions in excise taxes on automobiles and telephone services; and repeal the 7-percent investment credit. Along with proposed user charges, these legislative steps would increase 1970 fiscal year budget receipts by an estimated $4 billion.

On the expenditure side, a determined effort was made to hold the line. In mid-April, expenditure reductions of $4.0 billion were announced from the corrected January budget totals. The summer review of the fiscal 1970 budget, completed by mid-September, called for an additional $3.5 billion in reductions. In addition, the administration directed a deferral of 75 percent of all new direct Federal construction projects and requested the cooperation of State and local governments in helping to reduce sectoral inflationary pressures in construction activity.

Expenditure restraint and congressional approval of the administration tax recommendations were counted on to produce a budget surplus in fiscal 1970—estimated during the summer at just under $6 billion. Despite deep cuts in controllable areas of expenditure, it unfortunately proved impossible to achieve a surplus of this size. Overruns in uncontrollable areas pushed expenditures higher and trimmed the estimated surplus for the fiscal year down to $1.5 billion. Even so, fiscal policy had exercised an appreciable degree of restraint throughout the year.

The combination of fiscal and monetary restraint began to show signs of increasing effectiveness during the second half of calendar 1969. Real economic growth continued to run well below the basic trend rate of capacity growth. The statistical picture was somewhat mixed but the near term outlook seemed to be one of very moderate

growth in real terms. However, relief from rising prices was slow in coming. Total demand was no longer excessive but costs and prices were still rising in response to the earlier pressures.

The delayed response in costs and prices was by no means unexpected. Previous experience suggested that costs and prices would be near the end of the chain of cause and effect after a policy of restraint had been applied. It would be important to insure that cost-price pressures were not self-reinforcing during the period while restraint was becoming effective. Total demand would have to be held below the levels that would permit markets to clear themselves at steadily rising costs and prices.

Other major developments in the fiscal area were the progress made toward tax reform and the development of administration proposals for revenue sharing. After only 3 months in office, the administration presented a set of tax reform recommendations to the House Ways and Means Committee as a first step in a thorough review of the Federal tax system.[1] These Treasury tax reform recommendations were largely independent of the efforts to cool down the overheated economy since the revenue gains and losses were essentially balanced. The approximately $4 billion in revenue gained by repeal of the investment credit, enactment of a limit on tax preferences, and correction of tax abuses would have been approximately offset by the January 1, 1970, phase-down of the surcharge, enactment of a low income allowance, and funding of revenue sharing and tax credit proposals.

The tax reform legislation developed by the Committee on Ways and Means and approved by the House of Representatives in August went somewhat further. In the House version, reform provisions adding $8.1 billion in longrun revenues would have been more than offset by $10.5 billion of rate reduction and relief provisions, thereby producing a longrun revenue loss of $2.4 billion. Subsequently the Senate Finance Committee conducted its own hearings on the proposed legislation and recommended a number of changes in the legislation. In terms of longrun revenue loss, the Senate Finance Committee bill was similar to that passed by the House. During the course of consideration on the Senate floor, however, the legislation was amended in a number of respects. The collective effect of these changes threatened to have a fairly immediate and highly inflationary impact. In the House–Senate conference, changes were made which reduced the threatened inflationary impact in fiscal 1971 by some $6 billion. President Nixon indicated that it was this action that made it possible for him to approve the legislation. The bill was signed into law on December 30, 1969 (Public Law 91–172).

[1] See exhibits 27–30.

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Another major development in the fiscal area was the administration proposal for sharing of Federal revenues with State and local governments. The details of the program were developed after close consultation with Members of the Congress, Governors, mayors, and county officials. In mid-August, President Nixon sent a special message to the Congress describing the plan. Four major features of the program were:

—The size of fund to be shared would be a stated percentage of personal taxable income;
—the allocation would be made on the basis of the State share of population, adjusted for the State's revenue effort;
—within each State the amount a local unit received would be based on its share of total local government revenue raised in the State; and
—administration requirements would be kept to a minimum.

Given the near term budget outlook, it was essential to limit very closely the amounts of funds for revenue sharing in the next few years. Under the administration proposal the fund would rise gradually from $0.3 billion in fiscal 1971 to $5.1 billion by fiscal 1976, when it would amount to 1 percent of the taxable income base. Thereafter, the fund would grow in proportion to growth in the taxable income base.

In the domestic financial area, Treasury debt management operations were conducted within an environment of rising interest rates during much of the year. Short term interest rates fluctuated narrowly from the beginning of the year until mid-May and then rose sharply until early October. After a brief respite, rates rose even further. Three-month Treasury bills were 6.14 percent at the beginning of the year, 6.10 percent at mid-May, and rose to 7.17 percent in early October before receding somewhat. By the end of November, the 3-month bill was about 7½ percent. Market yields on long term governments, corporates, and municipal securities rose fairly steadily from the beginning of the calendar year to a temporary peak in early October and were rising again in November. The upward movement in the entire rate structure during the year reflected strong private demands for credit, continuing inflation, and the effects of monetary restraint.

In contrast to some other recent periods of rising interest rates, the Federal budget did not give rise to heavy financing needs. During the first 6 months of the calendar year, there was actually a net repayment of debt to the public on the unified budget basis of $12.4 billion. This reflected the swing of the Federal budget into surplus as well as the normal seasonal pattern of debt repayment during the first half of a calendar year. Seasonal borrowing in the second half of calendar 1969 took the form of additions to the regular bill strips as well as sales of tax anticipation bills.

While the swing into budget surplus had removed the need for the Treasury to make net demands on the financial markets, it was still essential to manage the existing debt in a noninflationary manner. This meant paying the going market rate of interest and placing some amount of debt outside of the very short term area. Additional complications were introduced by the need to avoid competing too closely with savings institutions which were already under pressure from rising market rates of interest.

Financing operations were conducted successfully despite the general environment of rising interest rates. As would be expected in such an environment, a somewhat higher than normal proportion of public holdings was presented for cash redemption in the exchange offerings. For a detailed discussion of Treasury financing operations during the fiscal year 1969 see pages 11–23.

The savings bond program continued to be a key element in the sound management of the public debt. In July the Treasury announced that legislative action would be requested to permit payment of a 5-percent rate of interest on savings bonds because the existing 4¼-percent return was not competitive with other investment and savings opportunities. It was announced at the same time that the administration would seek the removal of the 4¼-percent interest ceiling on all Treasury bonds, including marketable issues. Since 1965, interest rates on longer term Government securities have continuously been above the ceiling level and the Treasury has been limited to shorter term securities such as bills and notes in its market financings. Removal of the ceiling would enable the Treasury to conduct debt management operations much more flexibly and efficiently. Congress approved only the increase to 5 percent in the rate of interest on savings bonds which was signed into law by the President on December 1, 1969.

In the international area, the year saw further evolutionary improvement of the international monetary system. Final steps were taken to establish the Special Drawing Rights facility in the International Monetary Fund. At the time of the Fund and Bank meetings in late September, general agreement was reached on the initial amounts of drawing rights to be activated. Over the next 3 years, the sizable volume of $9.5 billion of drawing rights will be created. In due course, the new asset will take its place alongside gold and reserve currency holdings in international reserves. The international community of nations will act in concert to create reserves by collective action, rather than relying on the vagaries of gold production or the continuance of deficits by reserve currency countries. The final agreement on the Special Drawing Rights, following years of painstaking study and negotiation, was a landmark in international financial cooperation.

At the same time, the major nations reached general agreement on the desirability of an increase in IMF quotas. While some details remained to be worked out at the time of this writing, there is every prospect that an increase of appropriate magnitude and distribution will be achieved. Any specific proposal for an increase in the U.S. quota will be submitted to the Congress for its consideration.

Taken together, the activation of Special Drawing Rights and a suitable increase in IMF quotas will insure that growth in international reserves and conditional credits will continue to support an expanding volume of world trade. Another forward-looking step was the decision by major countries to study, within the International Monetary Fund, the possible usefulness of introducing a somewhat greater degree of flexibility into the exchange rate mechanism.

During the course of the year, the exchange markets were subject to rather severe strains. Two major exchange rate adjustments occurred. In August the French franc was devalued by 11.1 percent. In late September and early October, during the period between an election and the installation of the new Government, the German mark was allowed to float. When the new Government assumed office, a new parity for the mark was established with the eventual revaluation amounting to 9.29 percent. As a result of these exchange rate adjustments, the international monetary system appeared to have been placed on a more secure footing. (A fuller discussion of international financial affairs during fiscal 1969 will be found on pages 36–55.)

Despite the sometimes unsettled character of the exchange markets, the two-tiered gold system continued to function very successfully during the year. A pronounced downward price trend developed late in the year in the major private gold markets. In the London market, the gold price rose from a little over $39 in the fall of 1968 to about $43.50 by the late spring of 1969. With the general improvement in the international monetary atmosphere, the free market price of gold fell, gradually at first, and then rather sharply. By the end of the year, the London gold price had fallen to the levels ruling before the establishment of the two-tiered market.

By the end of the third quarter of 1969, the U.S. gold stock stood at $11.164 billion. There was a rise of $272 million in the U.S. gold stock during the first three quarters of 1969 in marked contrast to the $1.310 billion drop during the same period of 1968.

While the dollar remained strong during the year, progress toward the achievement of a basic and lasting equilibrium in the U.S. balance of payments remained disappointingly slow. In early 1969 the administration liberalized the controls over capital transactions that had been imposed in prior years. Further progress along those lines is desirable when the balance-of-payments position permits.

In the first 6 months of the year, there was a seasonally adjusted surplus of $2.4 billion on the reserves transactions basis but a deficit of $5.5 billion on the liquidity basis. The large divergence between these measures was primarily due to the resort of U.S. banks to the Euro-dollar market under the pressures of domestic monetary restraint. The resulting flows tended to exaggerate both the official settlements surplus and the liquidity deficit, leaving neither as an entirely satisfactory measure of the underlying position. (U.S. balance-of-payments developments through mid-1969 are examined in some detail on pp. 36–41.)

Preliminary data for the third quarter 1969 showed a decline from the first half rate of deficit on the liquidity basis but a swing from surplus into deficit on the official settlements basis. Some improvement in the trade balance was evident by the third quarter and was expected to continue into 1970. The general balance-of-payments pattern for the year had been one of a weak trade balance position offset to some degree on capital account by the effects of domestic monetary tightening. The restoration of a strong trade balance will be fundamental to a satisfactory structure of the U.S. balance of payments.

From the standpoint of both the balance of payments and the domestic economy, the control of inflation remained the chief policy objective as 1969 drew to a close. Some welcome signs of progress were evident. But full success was yet to be achieved. Restraint must be continued until there are clear signs of return to a noninflationary environment.

DAVID M. KENNEDY,
Secretary of the Treasury.

TO THE PRESIDENT OF THE SENATE.
TO THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.