EXECUTIVE
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See pg. 3
McNamara expects gradual and moderate buildup in Vietnam expenditures,
Super-confidential

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

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See Vietnam discussion of 4 as well

WHCF
Box 123

MEMORANDUM FOR THE PRESIDENT

Subject: Economic Aspects of Vietnam

Summary

The implications of the Vietnam situation for the economy appear to be these:

- It has affected, and may continue to influence, speculative commodity and financial markets.
- There are not likely to be significant effects on over-all prices, output, or employment in the next few months.
- If expenditures follow the path that Bob McNamara now visualizes as likely, they could provide a significant stimulus to economic activity during the first half of next year.
- We will need to intensify our concern about prices and wages.
- Budgetary and tax planning for fiscal 1967 will be affected.

Analysis

1. Our economy has lots of room to absorb a defense step-up.

There is still a \$15-\$20 billion margin of idle industrial capacity and excessive unemployment.

Our productive capacity is growing by \$25-\$30 billion a year (apart from any price increases), making room for both more butter and, if needed, more guns.

Apart from the defense effort, market demand would not be likely to grow as fast as productive capacity during the course of FY 1966, and unemployment would probably be creeping up.

2. The stock market is anxious about Vietnam news, because the financial community

   -- generally hates uncertainties which cloud the business outlook; and

   -- specifically fears that a major escalation could bring on increased taxes and wage and price controls.

3. Vietnam news has had an important influence on the stock market.

   . A 12 point drop in the Dow-Jones Index on July 20 is generally attributed to the Administration's appraisal of the war as "deteriorating."

   . Since your statement Wednesday noon, the market has been strong, with a gain of 14 points to today's close. On learning that no drastic measures were planned, "Wall Street heaved a sigh of relief," said the Times.

4. As the stock market rebounded on reassuring Vietnam news, speculative commodity markets retreated.

   . On Wednesday, copper futures fell sharply. In the previous 2 weeks, they had risen more than 10%.

   . Fortunately, many other commodity markets had topped out before the latest round of Vietnam news, and prices were not poised to leap ahead.

5. These markets will continue to reflect the ups-and-downs of military action and speculation. But there is no good reason for major flurries in the near future. Nobody can seriously expect that the kind of program you outlined is going to overheat the economy, strain industrial capacity, or generate a consumer buying boom. But speculative excitement inflames easily in the commodity markets, and we should be careful what we say and do.

6. The thought of direct controls on prices and wages is what frightens business most. The worry on this score is way out of proportion to the facts.

- Here are two examples on opposite sides in recent press comment. U.S. News reported -- before your press conference -- "If the Vietnam war continues to escalate . . . rising toward the scale of the Korean war, wage and price controls will return, many materials will be allocated, and an excess profits tax will again become a real possibility." But a knowledgeable broker argued in the Times, "Even if we assume the Vietnam war gets as big as the Korean war, this doesn't mean we would have to have excess profits taxes or commodity controls as we had them." Your Wednesday press conference should have been reassuring.

- We can say -- and perhaps should emphasize publicly -- that direct controls are simply not live possibilities.

- Only in the remote event that the Defense step-up for the near future got into the $10 billion range would we have to give serious thought to higher taxes, selective commodity allocations, or (last of all) to direct controls on wages and prices.

First warning!

7. The analogy with Korea simply does not hold water.

   - We started the Korean war with defense purchases running at a $12 billion rate; we doubled them in 9 months and tripled them in 15. Our defense capability is incomparably greater today.

   - Even so, the real reason for the surge in prices in late 1950 and early 1951 was not the pressure of defense orders or outlays. Many businesses made frantic efforts to pile up inventories, and consumers went on a buying spree. Consumer spending jumped 7-1/2% in the third quarter of 1950 and too another 5-1/2% jump in the first quarter of 1951; consumers virtually stopped saving. Fresh memories of wartime rationing and shortages drove households into a hoarding binge. The consumer has been living in a world of plentiful supplies and well-stocked shelves for a dozen years now. He is not about to panic.

8. The current thinking in DOD, as relayed to me by Bob McNamara on a super-confidential basis points, to a gradual and moderate build-up of expenditures and manpower.

- In the closing months of 1965, when the reduction of steel inventories will be holding down our economic advance, the defense step-up will be small and any influence it has will be in the right direction.

- In the first half of 1966, the impact on output and employment will be more significant. But it means extra insurance against slowdown or recession during that period (when payroll taxes will jump) -- not a threat of overheating.

9. We are certainly not saying that a Vietnam crisis is just what the doctor ordered for the American economy in the next 12 months. But, on a coldly objective analysis, the over-all effects are most likely to be favorable to our prosperity.

10. We were probably heading into a period of a slightly faster creep of wages and industrial prices without Vietnam. The new uncertainties will probably strengthen that tendency.

    - This underscores the importance of Government-wide emphasis on the guideposts.

    - It also means we should go slow on measures that will raise business costs -- like higher minimum wages.

    - And we may need to have larger stockpile releases, if commodity markets start to misbehave.

11. Vietnam will pose fiscal problems in our budget planning for FY 1967.

    - Added defense outlays will take a chunk of the $7 billion normal year-to-year growth of tax revenues that we have to use in order to avoid a fiscal drag. The bigger the defense chunk has to be, the less room for domestic civilian programs or tax cuts.

    - The uncertainties about defense needs, private demand, and Federal civilian programs prevent any conclusions as yet. It is now less likely that you will want to recommend a tax cut next year. But it remains a possibility that shouldn't be ruled out.

Gardner Ackley