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Statement of

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before the

Ways and Means Committee

of the

House of Representatives

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Last September I was privileged to appear before this Committee in support of the President's proposals for reducing Federal expenditures and raising Federal income taxes. The need for such fiscal restraint was clearly evident then. It has become compelling now.

Inflation is no longer just a threat--it is a reality. Its pervasive effects are now spreading through many aspects of our economic life. The advance in prices has been rapid and widespread. Wage increases continue to be far in excess of productivity gains. Financial markets have become heavily congested and long-term interest rates have risen to the highest levels in decades, despite continued generous provision of reserves to the banking system. And our balance of international payments has continued in substantial deficit. Inflation is jeopardizing attainment of both our domestic and our international objectives.

The entire world is looking to the United States to see if it has the capability, the will, and the determination to preserve and maintain this period of prosperity which is now the longest in our history. In my judgment, the strategic element in demonstrating that determination will be our success in reducing the prospective deficit for fiscal 1968 and thereafter to more manageable levels.

I don't think any one here or abroad questions the ability of our country to pay whatever it costs to fight the war in Vietnam and to provide the essential public services the American public demands. But I think there are a great many persons--probably an increasing number, in fact--who question whether we have the will to pay these costs.

I am not opposed to government deficits, *per se*, in any sense, for there are occasions when they may be fully justified. At the same time, I am concerned lest there be acceptance of the idea that deficit financing is a way of life; and I am especially concerned when our government debt climbs at a faster rate than our economy as a whole--and this is the prospect we face unless our present fiscal course is altered.

The events of the past two weeks are sobering. Britain's international payments problems proved too large and too intractable to be resolved by partial solutions and emergency loans; drastic corrective measures were required. Along with the devaluation of the pound, the British public is bearing the burden of an 8 per cent Bank rate, severe restrictions on credit availability, an increase in taxes and higher costs of imports.

In our case the need for restraint does not rest primarily on balance of payments considerations, important though they are. Our economic discipline has slipped somewhat over the past two years, and this has cost us significantly in terms of domestic economic progress. The consequence of allowing inflationary pressures to get ahead of us in the latter half of 1965 and during 1966 was a near cessation of economic growth earlier this year, as the distortions and inventory excesses of last year were unwound. With the resumption of more rapid growth this summer, we have allowed price pressures to get ahead of us again. Nearly half of the increase in our Gross National Product in the third quarter of the year reflected rising prices, rather than growth in real output.

Increased prices are being reflected and embedded in higher wage contracts of long-term duration, and establishing precedents for the many important wage negotiations scheduled to come up in 1968. These price and wage developments fit closely the classic interaction of cost-push and demand-pull inflation. American businesses have experienced sharp increases in production costs over the past year and a half, increases which they began to pass on in the form of higher prices as soon as overall demands picked up during the summer. With experienced labor still in short supply, reduced rates of utilization of manufacturing capacity did not prove to be much of a deterrent to price advances, which accelerated sharply at both wholesale and retail.

This fall, the underlying strength of expansionary forces has been obscured by the effect of strikes in several major industries. Largely reflecting these strikes, industrial production dipped and business orders for durable goods declined. The unemployment rate also increased. Some of the edge has been taken off the economic exuberance evident earlier. The reduction in demands resulting from these factors has been confined to a few industries, however, and the pace of expansion in other sectors of the economy has continued rapid and prices have continued to rise.

Moreover, with the termination of some major strikes this month, industrial production is resuming its upward trend. In coming months, further acceleration in activity appears likely, as the automobile industry tries to catch up for output lost during the strikes, and as the steel industry tries to meet orders placed by customers beginning to stockpile in anticipation of wage negotiations next year.

Consumer incomes, augmented by the spurt in auto and steel production, are scheduled to receive additional boosts from proposed increases in social security benefits, higher Federal pay, and from the rise in minimum wages. The likely increase in consumer spending resulting from such a surge in income would add an extra fillip to business demands for inventories, and possibly to business spending for new plants and new processes. But even without resumption of an investment boom, the prospective rise in public and private demands for goods and services appears large enough to reinforce and amplify the upward pressure on prices generated by rising wage and material costs.

The prospect of continuing price pressures, together with heavy credit demands resulting from the large Federal deficit, have been reflected in congested financial markets and rising interest rates. In the spring, long-term interest rates began to rise under the impetus of corporate efforts to rebuild liquidity by borrowing in the capital markets. In short-term credit markets, however, interest rates continued to decline until about mid-year, as monetary ease permitted the banking system to acquire a large volume of liquid assets and as the Federal Government was able to retire a large volume of short-term debt. By mid-year, the cost of short-term financing to the Treasury was about 2 full percentage points below the peak of such costs in 1966.

But after mid-year, the Treasury had to return to financial markets as a large net borrower of funds. The volume of Federal cash borrowing in this half year has been substantially larger than in any comparable period since World War II, and has been reflected in a sharp rebound in short- and intermediate-term interest rates.

Along with the change in the Treasury's financial position, from that of a major supplier of funds in the first half of the year to a major borrower in the second half, came a further increase in business demands for long-term credit. With business activity picking up, and with mounting concern for the possibility of even greater stringency in credit markets, corporations have been willing to pay record prices to borrow longer-term funds. The volume of new corporate security issues this fall has been about two-thirds larger than last year, and interest rates on new corporate issues have risen substantially above the peaks of 1966.

The pressures that have developed in financial markets threaten to give rise, once again, to distortions in financial flows and in the structure of production such as marred our economic performance last year. For example, local governmental units are finding it harder to compete in credit markets with heavy business and Federal financing demands. In the past 6 months, over one hundred scheduled municipal bond issues, representing over three-quarters of a billion dollars, have been postponed or cut back in size.

And, once again, competing financing demands are beginning to curtail the availability of funds for home mortgage financing. Inflows to savings and loan associations and mutual savings banks, which had recovered to peak levels earlier in the year, have moderated in recent months as returns on Treasury securities and other market investments have risen. Upward pressure on home mortgage rates has intensified, with discounts on insured mortgages widening.

In the present situation financial market tensions cannot be tranquilized merely by increasing the supply of money. Indeed, the congestion in financial markets and the rise in interest rates since mid-year have occurred even though the reserves available to the banking system have been expanding rapidly. In the absence of fiscal restraint, continued provision of reserves at such a rapid pace would only reinforce market expectations and induce even more urgent demands for credit. Vigorous fiscal action to reduce the prospects of further inflation and of further large Federal demands on financial markets offers the best hope for alleviating the intense upward pressure on interest rates.

Fiscal action to reduce tensions in our financial markets and to cool off demand pressures would also be beneficial for our balance of payments problem. Our basic need, in this respect, is to sustain and improve our favorable trade balance in order to move towards equilibrium in our overall payments position. This entails both the avoidance of excessively rapid growth in our imports and the maintenance of competitive prices for our exports. And this, in turn, depends on our success in keeping the growth of our economy within the limits of our capacity to produce at reasonably stable prices.

It is clear, then, that our domestic economic needs and our international financial responsibilities call for the same policy prescriptions. Restraint on spending--both private and public--is essential to relieve financial market pressures, to restore sound economic growth, to pay for the war, and to protect the strength of the dollar at home and abroad. This restraint can be achieved most effectively and most equitably by a fiscal program which moderates both the rise in Government spending--through budget cuts--and the rise in private spending--through a tax increase.

Ours is the richest country that the world has ever known, and it is only fitting and right that we devote large sums to public endeavors. But in our governmental activities, as elsewhere, we must recognize--especially at a time when we are engaged in a major war effort--that our resources are not unlimited. And we must recognize also that we cannot keep on calling upon our governments--federal, state or local--to do things we are unwilling to pay for. If we are to achieve in fact the public goals we feel most useful and desirable, then we must, as a self-governing people, be willing to accept and adhere to some sensible order of priorities among them in accord with the national preferences.

It is neither my prerogative nor my competence to suggest where and by how much budget expenditures should be cut, nor what types or amounts of tax increase should be enacted. But it is my duty and responsibility to say that <u>some</u> combination of lower spending and higher taxes is urgently needed to maintain the value of the dollar and the social and economic progress that depend on a sound dollar. We simply cannot afford the risks inherent in a failure to bring our fiscal affairs into order.

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