

William McChesney Martin, Jr., Papers

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Series V, Subseries D

Hearings, January-July 1962

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JOINT ECONOMIC COMMITTEE

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Vice Chairman--Paul H. Douglas (Illinois)

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Jacob K. Javits (Senator from New York)
Richard Bolling (Representative from Missouri)
Hale Boggs (Representative from Louisiana)
Henry S. Reuss (Representative from Wisconsin)
Martha W. Griffiths (Representative from Michigan)
Thomas B. Curtis (Representative from Missouri)
Clarence E. Kilburn (Representative from New York)
William B. Widnall, Representative from New Jersey)

Representative Bolling. Mr. Martin, the reason for this question is sheer ignorance and the purpose is information. There is no other purpose to this. At the bottom of page 10 you say "The Stabilization Fund has acquired holdings of some major European countries, and undertaken transactions in the market with the aim of defending the dollar from speculative forays".

On page 11, the third paragraph says "As one step in such cooperation, the System is now prepared in principle and in accordance, " et cetera,

I would like to know what kind of transactions in the market with the aim of defending the dollar they are. What kind of transaction is it? What happens?

Mr. Martin. I think it has to be looked at on an ad hoc basis. I want to make it clear, Mr. Bolling, that the Federal Reserve is not anxious to engage in this type of activity. It is only because we feel we have a responsibility. With convertible currencies as they are today, currency values -- including that of the dollar--are more subject than for a long time to speculative movement. I used here a term that I happen to like, forays. If we held some of these currencies (and the amounts and variation in them would have to be on an ad hoc basis), we might be able, by disposing of the currencies, to minimize or offset these temporary speculative movements. The Treasury Stabilization Fund has experimented with this kind of operation since March of this year, in a very small way, and we have come to the view that however we should acquire these currencies -- and it is not possible to spell it out here -- what we are aiming our activities at is to keep the speculators from unseating us, to try to minimize speculative movements. We would need to operate in a variety of ways. But we have resources in addition to what the Stabilization Fund has. We do not claim that this is going to correct our basic deficit. You will notice I went out of my way to state that.

Representative Bolling. I understand, but I mean exactly what I said at the beginning. I do not understand how this works. I do not want you to say anything you should not say, but I want to know what you do, within the bounds of what you should or should not say.

Mr. Martin. Well, we could open an account with some foreign central bank and hold in that account either pounds, lire, francs, or other currencies, depending on the circumstances. That would put us in a position to dispose of them if there was a sudden need for them. That is a simple type of operation. Another possibility would be for us to make reciprocal currency transactions with foreign central banks; in the language of the street, these are "currency swaps." Last March and April the pound sterling had quite a problem at the time of the re-evaluation of the guilder and deutschmark. There were a lot of movements and the central banks did cooperate at that time to minimize the impact of that in a variety of ways. I do not think you can spell out in advance precisely what you might do, nor ought we to spell out magnitudes for this type of operation because we are operating in a goldfish bowl. We would report what we do in our Federal Reserve statements from time to time but we ought not to be indicating ahead of them what the limits are or what we are going to do. If you do that, then you are inviting the speculator to take advantage of your operations.

Representative Bolling. I think that answers my question. I just wanted to be sure that I understood. Thank you.

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For release on delivery

Statement of

William McChesney Martin, Jr.

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

January 30, 1962.

Mr. Chairman:

My comments today on economic and financial developments will be directed toward the two central problems on which the nation's efforts should be focused in 1962. One is domestic; the other, international. The first problem is to move economic activity higher and unemployment lower. The second is to strengthen our position for dealing with the adverse balance of international payments of the United States.

For the time being, at least, some of the requirements for dealing with these two problems may seem to be in conflict. But for the long pull, the more basic needs are the same, because they are the fundamentals on which all enduring economic growth must be based.

The prime need is a steady increase in productive efficiency. But achieving it carries other requirements. Among them are investment in new and improved plant and equipment to turn out better products at lower costs; savings, to facilitate that investment; and stability in the value of our money, to induce those savings.

That, of course, is just part of the chain reaction that can be set into motion by progress in meeting these needs.

The surest way to get sales expansion leading to expansion of output, and output expansion leading to expansion of job opportunities, is to give the consumer a break by offering him more for his money.

In my judgment, much of our postwar economic trouble has been brought about by pricing consumers out of the market instead of into it. Increasing our productive efficiency offers the most promising avenue for correcting that process by providing a gain for business and labor to share with the consumer--as business and labor should do, in their own long-term interests.

These are matters that seem to me worth bearing in mind in considering the problems and performance of the economy, domestic and international, in recent times.

Taken as a whole, 1961 was a year of vigorous economic advance--happily free from an accompanying upswing in general prices, a fact that bolsters prospects for further growth.

Total economic activity, as measured by gross national product data, and industrial production both moved into new high ground. Gross output rose about 7-1/2 per cent from the fourth quarter of 1960, and 8 per cent from 1961's first quarter low. Industrial production advanced 12 per cent over the year, and 13 per cent from the February low. The consumer price index moved up approximately one-half of one per cent, but wholesale price indexes dipped below their year ago levels.

Meanwhile, credit expansion in general was greater than in any previous year except 1959. Funds advanced in credit and equity markets totaled about \$50 billion, well above the \$40 billion of 1960 although far below the \$61 billion of 1959, a year of record-breaking credit demand. Interest rates moved within a relatively narrow range.

Credit expansion by commercial banks approximated \$15 billion, a record surpassed only in 1958, and then by a narrow margin. Loans accounted for some \$6 billion of that total, although loan demands were moderate as they usually are in the early phases of an economic recovery. Investments, also following a characteristic course, increased about \$9 billion.

But even though the number of people holding jobs rose again to record level, unemployment failed to respond to general improvement in demand as rapidly or as greatly as had been hoped. Not until near the end of 1961 did unemployment show an encouraging drop, to about 6 per cent of the labor force from the 7 per cent level at which it had held for almost a year. Even so, the number of long-term unemployed continued relatively large, totaling about 1.5 million in the seasonally adjusted figures at the end of the year.

With the rising levels of income and business activity now taking place, total employment should expand further this year and absorb into gainful activity many of those currently classified as unemployed as well as new entrants into the labor force. To assist this process, we must stay attentive to changes in the composition of the working force, a matter to which your Committee is alert, as demonstrated by the development of much pertinent new information at recent hearings of your Subcommittee on Economic Statistics.

In 1961, from the recession's February low to the end of the year, about one million persons were added to nonfarm payrolls. This

virtually restored the level of nonfarm employment to the pre-recession high. Yet in manufacturing industries, although employment in December 1961 was well above the low point of the previous winter, there were one-half million fewer factory workers than when the recession began in the spring of 1960. At the same time, industrial production was greater than ever before in our history.

Thus some of the employment patterns of the recession and recoveries since 1953 seem to be repeating themselves. After each recession, total employment has rebounded to new record levels, but fewer factory workers have been needed to produce an increased volume of goods. The decline in the number of blue-collar job opportunities even while white-collar job openings were increasing has been an important factor causing the rise in persistent unemployment since 1953. If we are to realize the full benefits of our increasing productivity, we must solve the difficult problems of transition and adjustment for the displaced workers, many of whom lack the skills and training required in the expanding sectors of the economy.

The fact that long-term unemployment has been disturbingly large over the last decade, even during periods of high-level activity and rising prices, indicates that the problem it poses is too complex to be solved by any single or simple approach.

It is evident that our economy requires continuing, sustainable growth, attended by an ever-rising level of overall demand to provide an ever-rising number of job opportunities for our steadily growing

population. But it seems equally evident that we require specific steps to make headway against the problems posed by certain types of structural unemployment that are not readily responsive to general monetary and fiscal measures. Special programs to increase occupational and geographical mobility are necessary for this purpose. Training and retraining under management, labor and Government supervision would greatly benefit workers who need new skills to adapt more readily to changing technology. Both employers and employees would gain from better provision of information on the current and prospective job market-- that is, where job openings may be found, and where qualified workers can be located.

Let me turn now to the second problem cited at the start. The deficit in the balance of international payments, although much reduced from that of the preceding years, rose again in the last part of 1961.

In the first half of the year, the payments deficit had shown encouraging shrinkage. Net sales of gold from U.S. reserves were only \$200 million. The main reasons for this fairly good result were clear, even at that time: a low level of imports occasioned by slack demand because domestic business activity was low; an advance debt repayment to us, by Germany, of more than half a billion dollars; and a strengthening of confidence in the U. S. dollar in the wake of a declaration by the President that the Administration was determined to defend the international value of the dollar.

Nevertheless, it was also clear, even at the time, that we could not be complacent. To have the balance of payments in reasonable equilibrium on the average over a period of years means that we need to have a balance

of payments surplus, not merely a reduced deficit, at certain times. The first half of 1961, when imports were low, was a time when a payments surplus would have been appropriate. I do not say that this was a realistic possibility in 1961. The point is simply that the good results of the first half of the year were not good enough, considering the low level of import demand at the time.

Balance of payments pressures again turned adverse in the second half of 1961, when the deficit began to rise again. Net sales of gold during the half rose to some \$650 million. They might have gone much higher if there had not been a big increase in foreign holdings of dollar reserves, working balances, and short-term investments in the United States.

The increase in the overall payments deficit in the second half of last year also had its special causes. Confidence in the dollar has been well maintained, and that was not the trouble. The causes of the rise in the deficit lay elsewhere.

For one thing, imports rose sharply from their abnormally low level in the first half of 1961, advancing to levels about in line with the level reached by the Gross National Product in the latter part of the year. Exports held steady: while those exports financed by aid programs increased, commercial exports not financed by Government grants and credit fell short of their mid-1960 level. The failure of commercial exports to increase in 1961 tied in with the slowing down last year of European economic expansion. In Europe, there was an especially noticeable reduction in buying of materials and semi-finished goods for inventory.

It is quite possible that imports will rise further, as business activity increases here. However, we can also fairly expect that growth in exports will resume. In fact, the latest export figures, for October and November, were higher than for any pair of months earlier last year.

Sooner or later, we need to get a large increase in our export surplus. To make this increase in the export surplus come sooner rather than later, and to make it big enough to count, let me emphasize again the necessity that we preserve a competitive climate of business in this country, raise our productivity, hold down costs, and see to it that our prices are not out of line with those of other producing countries.

We must also put ourselves into a position to negotiate with our principal trading partners so as to minimize trade barriers that might otherwise keep us from achieving this needed increase in our exports. The task of correcting our balance of payments deficit would become far more difficult if the countries in the European Common Market were to maintain high tariff walls against our goods while progressively moving toward free trade within the Common Market.

In our balance of payments difficulties, however, exports and imports are not the whole story. The essence of the problem is that we have not had a big enough export surplus to cover our commitments on economic aid and military expenditures abroad, and our outflow of private loans and investments abroad. To cover the deficit, we have

been called on to sell some gold, and we have had to increase our short-term liabilities to foreigners. This increase in short-term liabilities is dependent upon the willingness of foreigners to build up dollar reserves, working balances, and short-term investments in this country. In reality, it constitutes foreign lending to the United States. We cannot count forever and without limit on that sort of lending to support the position of the U. S. dollar. That is why we must get a better balance between the export surplus and our outpayments for economic aid, for military expenditures, and for private capital outflow from the United States.

In reference to our economic aid commitments and U. S. military expenditures abroad, let me note that a large part of aid is being linked to exports, and ways to obtain offsets for part of the military expenditures abroad are being sought. We must continue to make every effort to get other countries to take a fair share of the burden of these costs. Whatever part of these expenditures cannot be linked or offset must be covered by net earnings in purely commercial trade, investment income, and other private transactions.

So far, I have said very little about private capital movements, apart from the buildup of foreign liquid assets in the United States. One of the big difficulties in the U. S. balance of payments in 1961 was that outflows of long-term and short-term capital were still very large, even though the kind of volatile movement we had in the latter part of 1960 was not much in evidence in 1961.

In fact, net outflows of long-term and short-term capital seem to have been even larger in the second half of last year than they were in the first. Here I am talking mainly about bank loans and acceptance

credits, corporate investments in subsidiaries, new foreign issues, and purchases of outstanding foreign securities that offset foreign purchases of U. S. corporate securities. Along with these, there were trade credits, and also some "movements of funds" in the sense of acquisitions of liquid investments or balances abroad, particularly in Canada.

All told, the net outflow of all the various types, including a guess for unidentified movements, seems to have approached \$4 billion in the year 1961. This was only moderately less than the outflow in 1960, and it was more than the overall deficit in our balance of payments in 1961. While the deficit in the balance of payments cannot be related to any one single class of outpayments, clearly the capital outflow was an important factor.

Restraining these capital outflows is particularly difficult because they represent various normal kinds of lending and investing. These outflows reflect the ready availability of credit in U. S. markets. Only in part can they be influenced by the level of short-term interest rates. By and large, such differences as did develop last year between money rates here and abroad do not appear to have been a primary determinant of capital movements either from or to the United States. On the other hand, the ready availability of credit at rates competitive with other markets may have exerted an important influence.

In the circumstances prevailing today, the Federal Reserve has found it necessary to balance domestic and international factors in arriving at policy decisions. The System's responsibility for the value of the dollar extends beyond domestic price stability to the value of the

dollar in terms of gold and of other convertible currencies. This is partly a matter of restoring basic equilibrium in the balance of payments, and partly a matter of preserving stability in exchange rates in international markets.

Until recently official operations by the United States to maintain the exchange value of the dollar have been limited to purchases and sales of gold by the Treasury's Stabilization Fund--at \$35 an ounce--to foreign monetary authorities for monetary purposes. Recent developments, however, have made it desirable for the United States to play an active role in exchange markets themselves.

Persistent deficits in our international payments have put very large amounts of dollars into the hands of foreign holders. This has made the dollar both susceptible and vulnerable to large and sudden movements of funds. Movements of this kind can be touched off by international political uncertainties, or by bearish or bullish reports and rumors about economic and financial developments at home or abroad. With the pound sterling and the main other European currencies again convertible, to a large extent, funds now can move freely and in large volume between New York, London, and the financial centers of continental Europe.

For these reasons, the Secretary of the Treasury decided last March to use the Stabilization Fund for operations in foreign convertible currencies, for the first time since the Second World War. The Stabilization Fund has acquired holdings of some major European currencies, and undertaken transactions in the market with the aim of defending the dollar from speculative forays.

These operations have been conducted on a fiscal agency basis by the Federal Reserve Bank of New York for the account of the Stabilization Fund. The resources of the Stabilization Fund for these purposes are, however, quite limited.

The Federal Open Market Committee and the Board of Governors are fully cognizant of the increasing importance of international financial relations for the working of our domestic monetary system. We further recognize that, under present-day conditions, maintenance of an efficient international payments system based on the interconvertibility of currencies requires close cooperation among the central banks of major industrial countries and with established international financial institutions.

As one step in such cooperation, the System is now prepared in principle and in accordance with its present statutory authority to consider holding for its own account varying amounts of foreign convertible currencies. Towards this end, we are now exploring, in consultation with the Secretary of the Treasury, methods of conducting foreign exchange operations in convertible currencies with ^{and full} due regard for the foreign financial policy of the United States.

These System operations, along with those conducted by the Stabilization Fund, would have the primary purpose of helping to safeguard the international position of the dollar against speculative flows of funds. They would not and could not serve as substitutes for more basic action to correct the deficit in this country's balance of international payments.

The problems I have been discussing have weighed heavily with those of us in the Federal Reserve in our endeavors over the last year to keep credit conditions attuned to national needs.

On the domestic side, to help bring about recovery, expansion and sustained growth in production and employment, the Federal Reserve has been operating to bolster the banking system's ability to meet all reasonable borrowing needs.

On the international side, to help hold down the outflow of capital and gold prompted by the continuing balance of payments deficit, the Federal Reserve has been operating to minimize drains stemming from international differentials in interest rates.

Activities in pursuit of these dual objectives were carried out in the open market for United States Government securities. Before taking up these operations, however, I would like to mention one other recent Federal Reserve action.

On December 1, the Board and the Federal Deposit Insurance Corporation announced an increase in the maximum rates that banks may pay--if they choose--on savings and time deposits. The change became effective on January 1 of this year. In general terms, the action authorized banks to pay 3 1/2 per cent on any savings deposit, and 4 per cent on those left in the banks for a year or more; also, to pay 3 1/2 per cent on time deposits with a maturity of 6 months to one year, and 4 per cent on those with a maturity of a year or longer. There are some 50 million of these savings and time accounts in the 6,100 member banks of the Federal Reserve System alone.

This action was taken after extensive study and consideration. In arriving at its decision, the Board was influenced by a variety of factors. One of considerable weight was the fact that some short-term balances were being attracted away from American banks by higher rates paid on such balances in other parts of the world, and that this process contributed, in some measure, to our continuing balance of payments problem. Another was the question of whether there could be any longer any justification for restricting the rate of interest that commercial banks may pay on savings deposits to a level substantially below that paid by other institutions on similar accounts. Finally, but by no means less importantly, we were concerned over the longer run impact of a maximum rate that might limit artificially the rewards received by small individual savers, whose saving, as I have said before, plays such an important role in financing the investment vital to our economic growth.

The changes that have been made in rates offered by the banks since the action took effect have been designed, for the most part, to encourage genuine saving. If this continues to be the case, the result should be an increase in the volume of funds available for long-term investment in mortgages, in State and local securities issued to finance expanded community facilities, and in securities issued by business to finance expansion of productive resources.

Your Committee may be interested in the results so far of the authorization for payment of higher rates on savings. Based on a survey

in mid-January of a sizable sample of Federal Reserve member banks, it appears that about two-thirds of all member banks are offering some rate in excess of the 3 per cent maximum rate previously in effect.

Regular or passbook savings accounts represent about three-fourths of total time and savings deposits at member banks. Some 40 per cent of the banks, holding 70 per cent of total time and savings deposits, raised their rates on regular savings accounts above 3 per cent. About half of these banks, or 20 per cent of the total, went to the newly authorized 4 per cent for deposits held over one year. The other half, generally, are paying 3-1/2 per cent on savings accounts.

With respect to time certificates of deposit and other time deposits, arrangements vary widely from bank to bank. But many banks are now offering up to 4 per cent on one-year certificates, including a sizable number which have not moved up to the 4 per cent rate on savings accounts. Rates of 3 to 3-1/2 per cent are being offered on six-month deposits, including the negotiable certificates offered by many of the larger banks.

Some 60 per cent of the member banks still pay rates on regular savings accounts of 3 per cent or less. If experience with a previous change in permitted maximum rates can be used as a guide, any further move toward increased rates on these accounts is likely

to be gradual, as it was after the preceding change in 1957.

Now I should like to devote the rest of my remarks primarily to Federal Reserve operations in the Government securities market during 1961.

To assure ready availability of credit in the American economy, the Federal Reserve supplied the banking system in 1961 with reserves in amounts sufficient not only to offset the credit-tightening effect of gold drains and currency withdrawals but also to provide additional reserves to meet requirements against expanding deposits. Member bank required reserves increased in 1961 by about \$1 billion, while Federal Reserve holdings of Government securities increased by \$1.5 billion in consequence of open market purchases. The reserves thus supplied made possible the near-record expansion of bank credit in 1961.

As a result of that expansion and of increased financial saving by the public, liquid assets held by consumers and business increased substantially in 1961. In consequence, the overall liquidity of the economy showed an increase about in line with the expansion in overall economic activity. Although total liquid assets of the public increased by about 6-1/2 per cent during 1961--compared to the 7-1/2 per cent increase in Gross National

Product--demand deposits and currency, the more active elements that usually are termed the "money supply," increased by only about 3-1/2 per cent. The pace of increase in the money supply, however, accelerated substantially in the latter part of the year.

The stability that prevailed in interest rates was one of the striking parts of the financial scene. Interest rates showed only a moderate increase in the 1961 business upturn, just as they had shown only a moderate decline during the downturn that began in the spring of 1960. Accordingly, since mid-1960 interest rates have moved within a relatively narrow range well above the low levels reached in 1958 and below the high levels reached in late 1959. To some extent, Federal Reserve policies and operations, in addition to Treasury operations, were responsible for this stability. Although the Federal Reserve supplied reserves adequate to enable expansion of bank credit on the scale earlier described, it sought to avoid downward pressure on short-term interest rates. The Treasury, a heavy borrower, obtained most of its new money in the short-term sector of the market, thereby putting upward pressure on short-term rates.

Let me note that factors other than official monetary and debt-management policies played an important part in keeping the general level of interest rates during the 1960-61 recession above levels reached in earlier recessions. These factors included the mildness of the latest recession and the large volume of new security issues floated

by corporations and State and local governments in the first half of 1961. Although 1961 did not witness as great a decline in interest rates-- at least in long-term rates--as 1958, neither did it witness a sharp speculative rise and subsequent fall such as that which characterized 1958.

I should like to add, at this point, something on the way the Federal Reserve System went about supplying bank reserves. Because of the nation's international payments problem, the System sought to provide these reserves in a manner that would minimize their effect upon short-term rates, to which international money flows are particularly sensitive.

To this end, the Federal Reserve in early 1961 extended the area of its open market operations to include purchases of longer-term securities as well as short-terms, in which open market operations formerly had been confined as a general rule. The purchase of long-- instead of short-term securities, when circumstances warranted, served at least to relieve the short-term market from the direct impact of these purchases on yields, and transfer that direct impact to the longer-term area.

The \$1.5 billion addition to Federal Reserve holdings of Government securities that I mentioned earlier reflects merely the net result of gross transactions totaling vastly more. Most purchases or sales, in fact, are made to adjust the availability of bank reserves in accordance with temporary variation in needs, chiefly of seasonal character.

In its gross transactions over the course of 1961, the Federal Reserve purchased about \$7 billion of Treasury bills and other issues maturing in less than two years, not including those acquired for brief periods under repurchase contracts. Over the same period, it sold or redeemed at maturity a slightly larger amount of such issues. Purchases of issues maturing within two to five years aggregated about \$1.5 billion, while purchases of those maturing in over five years amounted to nearly \$800 million, nearly all in the five-to-ten-year area. Sales of issues in these groups were negligible. The System also acquired some securities maturing in over a year by participating in refunding offers of such securities in exchange for maturing issues, but the effect of any such shifts upon the maturity distribution of the System portfolio was more than offset by the approach to maturity of other issues held.

Treasury purchases of long-term Government securities for investment accounts exceeded in amount those by the Federal Reserve. They were, mostly, of issues maturing in over 10 years. The Treasury, in addition, borrowed much of its new money in the short-term area, thus helping to maintain short-term interest rates and minimize the flow of short-term funds abroad.

Most of the purchases of longer term securities by the Federal Reserve and the Treasury were made during March, April and May, when aggregate new issues of securities by corporations and by State and local governments were in heavy volume. Official (Federal Reserve and Treasury) operations in that sector of the market doubtless helped to

keep interest rates from rising in the face of large demands, and thus to facilitate the flotation of these corporate, State and local issues.

The significance of these operations from the standpoint of market impact may be indicated by relating their volume to total market transactions in each maturity category of Government securities. Official market purchases of Treasury bills and other issues maturing in less than one year, although making up the bulk of Federal Reserve and Treasury operations, comprised in 1961 only about 4 per cent of total dealer sales of such securities (excluding those to other dealers). The proportion for issues maturing in one to five years averaged 9 per cent for the year, although in some months official purchases exceeded 30 per cent of dealer sales in this area. In the five-to-ten-year area, the proportion amounted to more than 20 per cent for the year as a whole and in the period from March through July was more than a third of the total. For securities maturing after 10 years, official purchases comprised over 30 per cent of all market purchases for the year and nearly two-thirds of total purchases in the second quarter, when the bulk of the official purchases were made.

In conclusion, I should like to stress that, along with its problems, 1962 also brings us opportunities. Foremost among them is the opportunity to achieve further progress toward higher economic activity, lower unemployment, and restored equilibrium in our international balance of payments.

We can make the most of that opportunity by working--all of us-- to bring about conditions that will generate the chain reaction that I described at the outset--a process that leads from dollar stability to savings, investment, rising productive efficiency, lower costs, better prices, greater buying demand, increased production, and expanding employment. The prospects for progress are excellent. Let us apply ourselves to the realization.

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*Replies to questions of Congressman Press
at J.E.C. Hearing on President's Economic
Report, & Released to Press by Mr. Carlson in
February.*

Question 1: Has it really been demonstrated that there is an invariable relationship between the relative interest rates among developed countries and short-term capital movements? Has a thorough study been made of this subject, and, if so, can this committee have it?

Answer: Interest rates represent a cost of money to the borrower and a return on money to the lender. They are necessarily a factor affecting the movement of funds--short-term and long-term--between the money markets and capital markets of developed countries. There is, however, no invariable relationship between relative interest rates in such markets and capital movements. While interest differentials can be an important factor in movements of capital, other factors also exert a conditioning influence. These other factors include the availability of credit, the supply of credit instruments of ready marketability, the demand for credit for borrowers of good standing, and--of predominant importance at some times--expectational and confidence factors.

Capital movements are sometimes viewed in the narrow context of funds seeking liquid investment in prime market paper of short maturity. The differences that existed last year between money rates here and abroad on this kind of paper do not appear to have been a primary determinant of international movements of funds of this type. Interest rates in the U. S. markets on this kind of paper were relatively attractive during most of last year, especially if it is taken into account that funds placed in sterling in London, where rates were high, had to incur either exchange risks or a cost of forward cover that was equivalent most of last year to 2 per cent per annum or more.

The forward exchange mechanism functions as a kind of buffer that allows interest differentials to persist between international markets on highly liquid paper. For example, if rates in London applicable to prime short-term market paper

are 5 per cent and in New York are 3 per cent, the forward rate for sterling will tend to be at a discount of 2 per cent (per annum) from the spot rate. If it is less than 2 per cent, there is an incentive for liquid funds to move from New York to London on a covered basis to gain whatever interest advantage there may be as against prime short-term investment in New York. On the other hand, if the discount exceeds 2 per cent by a sufficient margin, short-term funds will find an incentive to move to New York with exchange risk covered.

In other words, when foreign exchange for future delivery sells at a significantly different rate from its interest equilibrium level, funds may even move from a country with high interest rates to one with lower rates if the gain from selling the currency of the latter at a premium for future delivery more than offsets the loss from the lower interest rate return on the investment. (In the example given the forward dollar is at a premium in relation to forward sterling.)

The point, for present purposes, is that forward "cover" of an asset or obligation in foreign exchange may involve either a cost or a profit, and investors of short-term funds usually take this into account in deciding in which international financial center they should invest their funds. Gross differences in the levels of interest rates in different financial centers therefore do not tell the whole story.

While there is a tendency for movements in forward exchange rates to eliminate or at least to reduce the net incentive to move liquid funds from one center to another, the fact of different structures of interest rates among international markets is also part of the story. With different structures of interest rates--of money market rates, of bank deposit rates, and of bank lending rates--in different countries, it is unlikely that at any one time all interest rates and

all forward discounts and premiums will be in such relation to each other as to eliminate all incentives for international movements of funds. Moreover, it must be stressed that forward exchange discounts and premiums are affected not only by international short-term investment movements, but also by commercial demand and supply in spot and forward exchange markets. They may also be influenced by official intervention as well as by free market forces. Since the latter part of 1960, for example, the German central bank has provided special inducements to encourage outflow from Germany of liquid secondary reserve funds of German commercial banks.

Although the forward exchange rate has an important influence on short-term movements of liquid funds, it should be recognized that many short-term capital transactions between markets take place without forward cover. The incentive or necessity to move funds without forward cover will increase as maturity of the transaction is extended and its liquidity reduced. In these cases, absolute interest-rate differentials play an important role, together with other factors such as the availability of credit and conditions with regard to credit risks.

A very important category of short-term capital movement takes the form of lending by U. S. lenders to foreign businesses, banks and governments, in some cases in nonindustrial countries. This kind of capital movement depends on various factors, including the changing needs of borrowers for such accommodation, the nature of bank-customer relationships, and the availability of bank credit here and elsewhere. With regard to this type of capital movement, it is important not to overemphasize the role of interest rates per se. Nevertheless, it is important to recognize that if U. S. interest rates are competitive with those abroad and other factors are operating to make the services offered by U. S. lenders attractive to foreign borrowers, short-term capital outflow will take place. Such conditions obtained in 1961.

Investors motivated by speculative objectives may move funds internationally not only in short-term forms but also for the purchase of long-term securities and equities on a temporary holding basis. Such holdings are to be sold when short-term capital gains are realized or if capital losses are experienced. Accordingly, expectations of changes in long-term interest levels and market prices of bonds or in prices of equities may contribute to international capital flows that are essentially short-term but not necessarily closely related to short-term interest-rate differentials.

Movements into liquid investments by U. S. nonfinancial corporations may also vary with changes in corporate policies related to their liquidity positions. Moreover, some movements may be influenced by tax considerations primarily.

As a continuing assignment for the information of the Board of Governors, the Board's staff analyzes currently international movements of short-term funds with a view to assessing the various forces affecting them. The period over which such analysis has been pursued is necessarily relatively short since the major European countries did not attain full external convertibility until the end of 1958. Also, the influence of interest-rate differentials on the movement of short-term and other funds during this period has been obscured at times by such developments as the repercussions on the exchange markets of the upward revaluation of the German mark and Dutch guilder in March 1961 and by market uncertainties regarding the dollar and sterling associated with the balance-of-payments problem of the United States and the United Kingdom. The continuing staff analysis of these factors has not been brought together in a single study suitable for submission to the Committee and it would be premature to do so at this stage. It is believed, however, that the foregoing discussion outlines the considerations involved in the analysis in a manner responsive to the question asked.

Question 2: To the extent that it is felt that short-term capital in this country goes overseas because of higher short-term interest rates abroad, to what extent are we now, at the highest diplomatic and financial levels, trying to get the other great trading nations of the world and of Europe, particularly, to do what we are apparently doing here in this country, namely, using fiscal means, spending and taxing, as a primary method of fighting inflation, thus putting less of a burden on monetary policy and requiring lower interest rates than otherwise would be the case?

Answer: As Secretary Dillon has already indicated, effective international cooperation to prevent or limit excessive capital and monetary reserve movements has been one of the dominant themes underlying the financial discussions in recent months in the OECD in Paris, and in the periodic discussions among central bankers at the monthly meetings of directors of the Bank for International Settlements in Basle. In all these discussions, the effects of differences in levels of short-term interest rates prevailing in different countries, desirable and undesirable, has been one of the subjects receiving attention. The desirability of some coordination between countries of fiscal and monetary policies with a view to developments in other countries is increasingly recognized as a necessary condition for a viable system of inter-convertible currencies. Indicative of this development, several European countries, starting as far back as the fall of 1960, made deliberate efforts to reduce the levels of their short-term rates-- partly in consideration of our problems, but more immediately because large-scale inflows of funds were tending to defeat the aims of their own domestic stabilization policies.

Nevertheless, the fact that, for reasons already given, the interrelation of interest rates and short-term capital movements is not clear cut indicates that there is no strong case for urging on other countries a priority for fiscal policy

over monetary policy as a means of influencing their internal situations. Moreover, while a stronger fiscal policy should normally make possible a somewhat easier task for monetary policy, the two are not completely substitutable one for the other. An effective stabilization program requires both types of policy. Particular countries will undoubtedly find it necessary to adapt their policy mix in accordance with the shifting internal and external problems they individually confront, though at all times giving account to their longer run stabilization and growth objectives.

Undue stress by other leading countries on fiscal policy might produce results fully as unsatisfactory, from the standpoint of maintenance of their maximum employment and their contribution to international payments equilibrium, as those that would be brought about by undue stress on monetary policy.

Question 3: Is there not an important difference between the so-called basic items in a balance of payments--trade, services, military expenditures, government investments and private capital investment--and those items reflecting short-term capital movements? Is not a flight of short-term capital due to discrepancies in interest rates a different kind of money movement not necessarily reflecting fiscal or monetary irresponsibility on the part of the country having somewhat lower interest rates? If this is so, might it not be worth while to see if we could not erect a new principle of international monetary morality along the following lines: Central bankers are welcome to demand gold for any of the deficits caused by basic structural shifts, but, if the deficit is caused, and to the extent that it is caused, by one of these innocent short-term capital outflows, central bankers should not, in the interest of the free world monetary system, demand gold in the same amounts and quantities as they otherwise might.

Answer: The discussion of the first question indicated that international movements of short-term funds respond not only to interest-rate influences but are also affected by various other factors. It was noted that movements of short-term credit are influenced by borrowers' demands and by the availability of credit in one lending country or another as well as the competitive cost of credit as between countries. While movements of funds for short-term investment in liquid forms are naturally affected by interest-rate differences among developed countries, the influence on such fund movements of the interest-rate differences is modified by the action of forward exchange markets. Finally, expectational and confidence factors at times give rise to large-scale speculative movements of funds that are committed on a short-term basis.

In the answer to the second question it was noted that international discussions of the effects of national policies on international payments have given due attention to interest-rate relationships, but have also concerned other influences affecting international payments flows. National policies in other countries, it was suggested, may influence the U. S. balance of payments in various ways. Short-term capital movements, therefore, cannot be viewed in isolation from other forces shaping a country's balance of payments.

Progress has been made in the past year toward effective measures of international cooperation to deal with emergency or temporary situations that might threaten the stability of the international payments mechanism. The principle underlying such cooperation is not that short-term capital movements, per se, call for a special kind of treatment. The principle is rather that any large and sudden drain on a major country's monetary reserves represents a threat to the functioning of the international monetary system, and that all countries have an interest in forestalling or coping with such threats to the system.

Short-term capital movements, partly motivated by confidence factors, are characteristically an important contributory cause of the large and sudden drains on a country's monetary reserve position that are here in question. Such adverse changes in reserve position are less likely to occur when a major country's fiscal and monetary conditions are in approximate equilibrium with those of other countries and when its international payments on current and long-term capital accounts are in sustainable balance.

The Basle arrangements of March 1961 to help the United Kingdom cope with a sudden and wholesale outflow of short-term funds, and equally the recently concluded agreement between ten industrial countries to stand ready to lend their currencies to the International Monetary Fund under certain circumstances, are evidence of a spirit of international cooperation and inter-responsibility in making the mechanisms of international payments work satisfactorily. But the viability of this kind of international cooperation depends very much on the ability and determination of countries that receive assistance to play their full part, through appropriate domestic and foreign economic policies, in bringing their own international payments into reasonable and durable equilibrium.

While these arrangements do make for economy in the world's use of gold as a means of final settlement in international payments, there is no way under the existing organization of monetary systems among the major countries to obviate, automatically, demands for final settlement in gold. Gold has a statutory role assigned to it in the monetary systems of these countries; it is a means of international settlement that in fact has general acceptability; and it has the prestige of long tradition in performing international settlement functions. The monetary authorities of each country, in the light of their trusteeship responsibilities, are obliged to give account to the allocation of their reserve resources between gold and other assets eligible to meet reserve needs.

A country whose payments are in deficit on current and long-term capital accounts cannot safely disregard short-term capital outflows as an additional element magnifying its over-all deficit and affecting its monetary reserve position. Nor can it ask other countries to abstain from converting to gold those accretions to their reserves that are related to the capital outflows--even if it were conceivably possible to determine that certain capital flows had resulted from interest-rate differences. Consistent application of a principle that gold should not move with short-term capital flows would work to the disadvantage of a deficit country in some circumstances, as for example at a time when it might need to attract inward movements of capital as one way of overcoming its deficit in international payments.

APR 17 1962

The Honorable Paul H. Douglas,
United States Senate,
Washington 25, D. C.

Dear Senator Douglas:

During my appearance before the Joint Economic Committee on January 30, 1962, you raised with me the following question:

"Instead of having fixed exchange rates, why would it not be a good thing for the western world to adopt a fluctuating exchange rate? Then you wouldn't have to worry about your balance of payments or gold reserves. You would have exchange rates fluctuate according to the relative balance of imports and exports, claims and debits, and you would get an automatic adjustment."

After some exchange between us, you requested that the staff of the Board of Governors prepare a memorandum on the subject for the benefit of the Committee.

I am herewith transmitting the requested paper. It was prepared under the general direction of Dr. Ralph A. Young, Adviser to the Board and Director, Division of International Finance. Mr. Robert L. Sammons, Adviser in that Division, had responsibility for sifting and digesting the professional literature which advances a case for a system of flexible exchange rates. Dr. J. Herbert Furth, also Adviser in our Division of International Finance, carried main responsibility for preparing a critical evaluation of the arguments against flexible exchange rates, and by implication expressing the case for fixed exchange rates. The product of their respective analytical work has been merged into a single paper. The case for and against a system of fixed exchange rates was not prepared separately, because the arguments would have been repetitive.

The problems encountered in dealing with the many-sided question you raise are necessarily complex and an answer to it needs to be formulated with care and balance. Consequently, the paper has taken a considerably greater amount of time and effort than either you or I originally planned for it. In view of your long experience as an economic scholar, I know that you fully appreciate the analytical difficulties of the task, which account for the time taken in its preparation.

The Honorable Paul H. Douglas -2-

The nature and purpose of the paper made it necessary to summarize the arguments in terms of their practical applicability, rather than to pursue their theoretical foundations. In any case, rigorous theoretical treatment would have required a much more elaborate and time-consuming effort.

The paper will be studied with interest by the members of the Board of Governors, and will be made available to a broader audience by publication in an early issue of the Federal Reserve Bulletin. But, as you requested, it is submitted strictly as a staff memorandum. Its single objective is to illuminate the issue of flexible vs. fixed rates of foreign exchange as a matter of national policy.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.

Enclosure

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

April 17, 1962

The Honorable Wright Patman,
Chairman, Joint Economic Committee,
Washington 25, D. C.

Dear Mr. Chairman:

During my appearance before the Joint Economic Committee on January 30, 1962, Senator Douglas raised with me the following question:

"Instead of having fixed exchange rates, why would it not be a good thing for the western world to adopt a fluctuating exchange rate? Then you wouldn't have to worry about your balance of payments or gold reserves. You would have exchange rates fluctuate according to the relative balance of imports and exports, claims and debits, and you would get an automatic adjustment."

After some discussion, Senator Douglas requested that the staff of the Board of Governors prepare a memorandum on the subject for the benefit of the Committee.

I am herewith transmitting, for the use of the Committee, twenty copies of the requested paper. It was prepared under the general direction of Dr. Ralph A. Young, Adviser to the Board and Director, Division of International Finance. Mr. Robert L. Sammons, Adviser in that Division, had responsibility for sifting and digesting the professional literature which advances a case for a system of flexible exchange rates. Dr. J. Herbert Furth, also Adviser in our Division of International Finance, carried main responsibility for preparing a critical evaluation of the arguments against flexible exchange rates, and by implication expressing the case for fixed exchange rates. The product of their respective analytical work has been merged into a single paper. The case for and against a system of fixed exchange rates was not prepared separately, because the arguments would have been repetitive.

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The Honorable Wright Patman

-2-

The paper will be studied with interest by the members of the Board of Governors, and will be made available to a broader audience by publication in an early issue of the Federal Reserve Bulletin. But, as Senator Douglas requested, it is submitted strictly as a staff memorandum. Its single objective is to illuminate the issue of flexible vs. fixed rates of foreign exchange as a matter of national policy.

I am sending a separate letter to Senator Douglas, together with a copy of the paper.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.,
Chairman.

Enclosures.

A SYSTEM OF FLEXIBLE EXCHANGE RATES: PRO AND CON

Reconstruction of the international payments mechanism following World War II was based, and continues to be based, on a system of fixed par values for all major currencies. The International Monetary Fund, established under the Bretton Woods Agreements of 1944 "to promote international monetary cooperation," was founded on this principle. Any change in the system would have sweeping consequences for international economic relations and through them for the domestic economies of the free world. Nevertheless, advantages and disadvantages of flexible versus fixed rates have continually been discussed inside and outside of academic circles.

Advocates of a system of flexible exchange rates argue that it would provide each major country with a mechanism for prompt and sensitive international payments adjustment. They believe that this mechanism would greatly reduce -- but not entirely eliminate -- the constraints on domestic financial policies imposed by a system of fixed rates of exchange. The adjustments in the balance of payments that would occur under flexible rates would be more efficient and less likely to have adverse side effects than adjustments under a fixed rate system, they contend.

Opponents of a system of flexible exchange rates maintain that the system would have serious disadvantages rather than advantages. They believe that such a system would require more rather than less restrictive domestic financial policies in order to achieve sustained economic progress. Unless countries paid close attention to their balance of international payments, exchange rates would fluctuate violently,

disrupting international commerce and investment. If applied to key currencies, a system of flexible rates would eliminate these currencies as means of international payments and as reserve assets.

According to classical economic theory, a major advantage of the pre-1914 gold standard was that it provided an effective, although slow, mechanism of adjustment for the balance of payments through the fairly direct tie between the amount of a country's gold holdings and its supply of bank credit and money. A country with a balance of payments surplus received gold, its bank credit and money expanded relative to the gold-losing deficit countries, and its money incomes and prices tended to rise. While this adjustment was taking place, an equilibrating movement of short-term capital also tended to occur, because interest rates tended to rise in the deficit countries, thus attracting funds from the surplus countries.

After a time imports in the surplus country would tend to rise and exports to fall; the reverse would take place in deficit countries. Balance in international payments would thus be restored.

Under modern systems of managed currency convertibility, so the argument of the advocates of a system of flexible exchange rates runs, this mechanism of adjustment does not have its former effectiveness because of the tendency of prices and wages to resist downward adjustment. And monetary authorities pursue policies geared to full employment, economic growth, and domestic price stability, while tempering, cushioning, or offsetting balance of payments developments that might frustrate the achievement of domestic stabilization objectives.

This line of reasoning leads to the conclusion that balance of payments equilibrium no longer is brought about by quasi-automatic economic forces, nor is it considered an economic policy aim of first importance. It is taken into account only as a limiting condition of domestic policy that has to be met if a country is to maintain a stable value for its currency in terms of gold and other convertible currencies. In this context, it is argued that a system of flexible exchange rates would offer more freedom to pursue the major domestic goals of economic policy without incurring unduly adverse international effects.

In this paper the mechanism of international adjustment under a system of flexible exchange rates participated in by the major industrial countries, including the United States, is evaluated. First a system of flexible exchange rates free of any official intervention and with no limits as to the possible range of exchange rate fluctuation is described. Then a modified system in which official governmental intervention to temper or limit exchange rate fluctuations would be in operation is considered. Finally, the case against any system of flexible exchange rates is presented. The major premises and arguments of the case for such a system are critically assessed, with special attention to the consequences it would have for the dollar.

The Case for Flexible Exchange Rates

Two assumptions underlie the case for flexible rates: First, that the participating countries will be able to pursue domestic financial policies -- fiscal and monetary -- that sustain high levels of domestic economic activity, balanced economic growth, and relative stability of domestic price levels. Second, that each country in the system will permit others to adjust their balance of payments by changing exchange rates without resorting to exchange controls, to protective trade measures, or to competitive exchange rate adjustment in defending its economy against any unfavorable effects of any changes in the foreign exchange values of other currencies.

The Foreign Exchange Rate as a Price

The theoretical case for the superiority of completely flexible rates over fixed rates rests on simple postulates. The foreign exchange rate is a price that should be permitted to perform the normal functions of a price. Its immediate function should be to balance supply and demand in the foreign currency market. In doing so, it would establish a relation between domestic and foreign prices and costs that would induce longer run changes in the production, investment, and consumption of goods moving in international trade in a way that would foster and maintain balance in external payments.

In any market, there is some price that will clear the market, in the short run. In markets where supply or demand is unresponsive to price change in the short run, price fluctuations may sometimes be more violent than is necessary to restore or maintain long-run equilibrium.

Price changes may also be destabilizing if demand and supply are strongly sensitive to expectations about future influences on the market. Thus, a price decline may reduce demand (and increase supply) if a further decline is anticipated.

The price of foreign exchange differs from the price of a single commodity in that it represents to both buyers and sellers command over a whole basket of goods, services, real capital assets, and claims payable in a foreign or the domestic currency. Thus, the demand or supply of a foreign currency is derived from many specific needs or motivations. As a composite demand or supply, each will be responsive to small changes in price.

Consequently, changes in foreign currency prices under a flexible exchange rate system could be expected to produce relatively prompt adjustment in the supply of and demand for foreign exchange and thus in the balance of payments. If balance of payments adjustment could be achieved under a flexible rate system without interfering with domestic stabilization policies or unduly burdening other trading countries, such a system would have advantages greater than any possible disadvantages attributable to the rate changes themselves.

The Mechanism of Adjustment

The mechanism of adjustment under a system of exchange rates that would be permitted to fluctuate freely, without government limitation or intervention, involves two major types of international transactions -- the movement of goods and services, mainly merchandise, and the movement of capital, mainly short-term. The theoretical effects on merchandise trade will be treated first. For simplicity, the adjustments of a deficit

country will be used as an illustration. (The adjustments necessary for a surplus country under a flexible rate system would be the reverse.)

Unless the governmental authorities supported the rate by selling gold or foreign exchange, a deficit country would find its currency becoming less valuable in relation to other currencies, the demand for it falling relative to the supply of it. What changes in prices would result would be influenced by the elasticities of supply and demand, and by the importance of the deficit country as a world supplier or purchaser of specific commodities. But in general, price movements along the following lines might be expected.

Effects on imports. The prices of the deficit country's imports, in terms of its own currency, would tend to rise. This rise would reduce its purchases of imported goods. How great the reduction would be would depend on the price elasticities of demand for such goods and the elasticities of domestic supply of competitive goods.

The higher prices for import goods would encourage the expansion of domestic production of competitive goods, insofar as domestic goods were substitutable for imports, and thus reduce imports even if total demand for these goods were not reduced by the increase in prices. The rapidity and extent of the response would depend on how widely elasticities varied from commodity to commodity. Elasticities would also vary with the state of the business cycle -- especially with the presence or absence of unutilized capacity in the import-competing industries. Responsiveness to import price changes would be specially affected by the length and complexity of the production process for the competing domestic goods.

If foreign exporters were able and willing to reduce their prices in terms of foreign currencies (maintain their prices in terms of the depreciating currency) in order to keep their import markets, adjustments would be less. But there would still be some reduction in foreign exchange expenditures, even if the quantity of imports did not fall.

Economists differ on whether the effects on imports of exchange depreciation under a flexible rate system would vary from the effects on imports of outright devaluation under a fixed rate system. Expectations about further exchange rate changes would be very different in the two situations, and the effects of the different expectations are difficult to predict. But if one opposes flexible rates on the grounds that they would not affect foreign exchange expenditures on imports, one must also argue that exchange devaluation could never be justified for a similar reason.

Effects on exports. Effects on the exports of the deficit country would depend on the organization and structure of its production and the competitive position of its export products in world markets. For one-product countries facing relatively inelastic demand schedules, especially for principal exporters of the particular commodity, exchange depreciation might reduce the foreign exchange proceeds of exports. But for industrialized countries, with diversified exports competitive with similar products of other industrialized countries, the result would probably be some increase in exports. The increase would be the larger, the greater the underutilization of existing capacity.

The effect on prices of export goods in terms of domestic currency would vary from commodity to commodity. Probably export prices

in terms of domestic currency would rise, on the average, but not by so much as the depreciation in the external value of the currency.

For internationally traded export commodities, the price rise would be inversely proportional, or nearly so, to the reduction in the external value of the currency. For other commodities, the price rise would depend on the relative importance of exports to domestic demand.

If the price rise for export goods fully offset the depreciation in the value of the currency, the effect would be two-fold. Unless the domestic demand for such goods were completely inelastic, the amount sold at home would fall, thus freeing more production for export. It seems reasonable to assume that such an adjustment would come rapidly. But even if it were delayed, profits in the export industries would rise, and enterprises in these industries would bid actively for resources for export production with eventual beneficial effect on the balance of payments.

On the other hand, if the rise in price did not fully offset the depreciation in value of the currency, foreign buyers would enjoy a lower price in terms of their currencies, and domestic producers would thus enjoy an increase in foreign orders. How large the increase would be would depend on whether competitive foreign producers would accept the situation without lowering their own prices. If prices declined all around in international markets, and world demand was price elastic, the total market would expand and the exports of the depreciating country would presumably rise pari passu with such expansion.

The speed of adjustment on the export side would thus depend on (1) the extent of the rise in domestic prices of export goods, (2) the rapidity with which domestic production could be expanded (clearly greater in a recession than in a boom), (3) the elasticity of domestic demand for export goods, and (4) the response of foreign competitors to any reduction of prices in terms of foreign currencies. It seems reasonable to assume, however, that significant marginal adjustments would respond with workable promptness to small changes in exchange rates. Such adjustments might also lead to the exportation of products not previously exported.

The structure of production and foreign trade is constantly changing. Thus data on past effects of exchange rate changes on exports is not particularly helpful in trying to predict what would happen under a generally applicable flexible rate system. Advocates of such a system must generally resort to a priori inductive reasoning and thus must also believe that the price mechanism for goods and services will work through the foreign exchange mechanism, as it does admittedly -- although not always to everyone's satisfaction -- in a domestic market for goods and services.

Countercyclical effects. If a country committed and accustomed to a flexible exchange rate mechanism were to experience a balance of payments deficit and domestic recession simultaneously, depreciation of its currency internationally could result in special advantages. In a recession, the possible effects of depreciation on both exports and imports would tend to stimulate total effective demand at home. Domestic production of import-competing and export goods would be directly stimulated, and purely domestic output would receive a secondary stimulus.

An adverse effect of the currency depreciation would be to alter the terms of international trade -- making it necessary for the deficit

country to give up more of its own output in exchange for a given quantity of imports. The expansion in domestic output induced by the currency depreciation, however, would tend to counter adverse effects on domestic standards of living.

A general system of flexible exchange rates would not automatically result in currency depreciation if a recession of about equal amplitude hit all countries at the same time. In this situation exports and imports would drop in approximately the same proportion. Thus exchange rates would tend to remain unchanged, and the effect of the recession would be the same as it would be under a system of fixed exchange rates.

Effects on capital movements. Even if it be granted that under flexible rates the balance of payments would be adjusted through changes in the trade account, there remains the problem of capital movements. Would not the currency depreciation generate expectations of further depreciation and thus set in motion capital movements that would in themselves produce such further depreciation? Would not this, in turn, lead to unwarranted, unneeded fluctuations in exchange rates and to a loss of confidence in future exchange values with a consequent disruption of the processes of international trade and investment? The proponents of a flexible exchange rate system argue that these consequences would not follow.

Admittedly, volatile capital movements are greatly influenced by psychological and expectational factors. The only experience the world has had with flexible rates has been under an international currency system where flexible rates were the exception rather than the rule. There has always been at least one currency, the dollar, freely convertible into

gold at a fixed rate, except for a brief period in 1933-34. For this reason, it is impossible to guess what might have happened in a world of flexible rates.

If the principal countries promoted a reasonable degree of stability in economic activity and prices, ^{1/} and there were no significant direct controls, wide fluctuations in exchange rates would not be expected to occur. So long as a currency was freely convertible into goods and services for export, at relatively stable prices, it could not depreciate far before it would begin to appear a bargain both to traders and speculators in property values. At this point, some stabilizing speculative trade and capital flows could be expected to set in. If these developments failed to occur, it would be because the speculators distrusted the fiscal and monetary policies of the government or the basic economic forces shaping the internal structure of the economy.

Large flows of volatile speculative capital occur even under the present fixed rate system, notably when a large part of the market believes that a specific exchange rate is overvalued or undervalued and hence cannot be or will not be long maintained. If determination of the exchange rate were left to the market, speculators would have to analyze all the factors entering into the demand for and supply of exchange. Market opinion might then not be nearly so unanimous as it sometimes seems to be at present. Moreover, any movement into a currency would begin immediately to increase the cost of that currency, thus raising the possibility of loss as well as gain in the minds of the speculators.

^{1/} In the absence of such policies, any system of exchange rates -- fixed or flexible -- would tend to break down.

Under a system of fixed exchange rates with narrow spreads, the possibility of loss is present but much less so. If apprehension of risk turned out to be the market reaction, such a response would tend to dampen, and eventually reverse, any speculative movement of funds between international money and capital markets not warranted by relative price changes.

A Modified System of Flexible Rates

Up to now a completely flexible rate system has been discussed. It has been assumed that there would be no intervention in the exchange markets by the authorities, and hence no need for official reserves of gold or foreign currencies. However, such a system is hardly realistic. Proponents of flexible rates usually acknowledge that they would allow for some official intervention to smooth out short-run fluctuations or to provide for some stability in the flow of import payments and other payments to foreigners in the event of unpredictable or unavoidable short-run fluctuations in foreign exchange receipts. Such a modified system of flexible exchange rates would, however, be faced with two problems.

First, what assets would be used as monetary reserves? The key trading countries might want to use only gold, believing gold would be more likely to retain its value in relation to the domestic currency and to the currencies of other industrial countries. However, countries might be willing to hold reserves in other important currencies which have proved stable enough to inspire confidence that this stability would continue. Or if central banks would not hold reserves in foreign currencies as a regular matter, they might still, as a matter of central bank cooperation, engage in reciprocal currency transactions temporarily to enable the participating central banks to intervene in the foreign exchange market in behalf of their currencies.

Second, would not there have to be some rules of the game for official intervention, especially for actions to avoid competitive depreciation?

If these problems could be solved, an international system of modified flexible rates might offer not only the advantages discussed earlier, but also the following advantages:

Changes in Rates vs. Changes in Reserves

With flexible rates, a country could let flows of volatile short-term capital affect the exchange rate instead of affecting its international monetary reserves. Changes in reserves stemming from international capital flows, even if a central bank offsets their impact on domestic credit by open-market operations, may undermine public confidence in the monetary system and consequently upset the credit and exchange markets. As things are, changes in exchange rates within moderate limits might be preferable to changes in reserves.

Management of Reserves

Under a system of flexible exchange rates, the monetary authorities of a country could regulate their reserve holdings on the basis of the economy's financial needs. They could buy or sell gold or foreign exchange (if they continued to hold foreign currency reserves despite exchange risks) whenever they thought it appropriate and advantageous without regard to effects on the exchange rate. However, if the operations were interpreted as official efforts deliberately to depreciate a country's currency, other countries participating in the flexible currency system might retaliate.

Speed of Adjustment

With flexible exchange rates, monetary authorities would not be so tempted to defend an overvalued or undervalued currency and thus delay a necessary rate adjustment. Such delays tend to impair a country's monetary reserves and slow the adaptation of its domestic economy to the requirements of external balance. Under a fixed exchange rate system, the exchange rate becomes a symbol of national prestige. A devaluation is considered as evidence of some failure of the government's economic policy and as a breach of faith with the public. Consequently, devaluing or revaluing a currency in terms of gold and other currencies becomes a last resort, to be resisted as long as possible. Sometimes countries have imposed, or reimposed, or tightened exchange controls rather than devalued the currency. When devaluations or revaluations occur in major countries, they tend to be a disruptive factor in international trade and finance. Under a flexible exchange rate system, if a currency was overvalued or undervalued, depreciation or appreciation of the rate would come soon and, unless there was speculation, would have a chance of being moderate.

Size of Reserves

If a system of flexible exchange rates were universally adopted, many countries could operate with smaller international monetary reserves in gold or foreign currencies than they presently hold. For a country would not have to protect its monetary system against a persistent, large-scale reduction in the volume of its reserves. If exchange rate adjustments could take care of most fluctuations in its balance of payments, more of a country's national wealth could be invested in domestic production rather than in holdings of gold or short-term claims on foreign countries.

Such a change would be particularly important for less developed countries. They would no longer need to grant credit to the United States and the United Kingdom by holding more monetary reserves than they needed for working balances in dollars and in sterling.

The Case Against the System in Either Form

The arguments for a flexible exchange rate system need critical evaluation, particularly on the possible effects on the dollar. Such an evaluation leads to the following main conclusions.

1. The rigidities of the present economic system are not so pervasive that modern economies cannot, within reasonable periods, adjust to temporary disequilibrium in the balance of international payments under a system of fixed exchange rates.

2. A system of flexible exchange rates would not free participating countries from having to watch their balance of payments and monetary reserves. In fact, because of the uncertainties of exchange rate fluctuations and instabilities, they would have to pay more attention to them than under a system of fixed exchange rates.

3. Whatever advantages may be claimed for flexible exchange rates, they would be more than offset by disadvantages if the system were applied to currencies widely used as means of international payments and as international reserve assets.

4. Flexible exchange rates would involve a serious risk that destabilizing forces generated by exchange rate fluctuations would become uncontrollable.

5. Flexible exchange rates would make international trade and investment transactions more uncertain and hence more costly.

6. By impeding the international division of labor, the system would retard economic growth throughout the free world.

7. The limited supply of gold and the risks of keeping monetary reserves in foreign currencies of fluctuating value would hamper the intervention needed to make a modified system of flexible exchange rates workable. Reaching agreement on effective rules of the game would also be difficult.

Role of Economic Rigidities

The contention that the present economic system has become inflexible from cumulating rigidities is exaggerated. Downward adjustment of average prices and wages do encounter resistance. But international imbalance generally arises from price and cost differentials in particular export or import industries. Individual prices and, to a lesser degree, earnings still fluctuate downward as well as upward.

Quite recently, the impact of increased imports on U.S. prices and wages has been important in helping to restore competitiveness in various branches of U.S. industry, in curbing inflationary tendencies, and in strengthening the U.S. balance of trade. This experience shows that there continues to be a powerful mechanism of international payments adjustment under modern convertible currency conditions generally comparable to that which existed under the old gold standard.

Domestic Policy Constraints

Arguments that flexible exchange rates would tend to produce adjustments in line with sustained economic activity and relatively stable prices always assume that exchange rates would fluctuate only moderately because the principal countries participating in the system would successfully pursue policies to achieve stability. But if they tried to do so, the countries would still have to watch their balance

of payments and monetary reserves. They could not disregard limitations imposed by adverse international payments flows any more than they can under a system of fixed exchange rates. Indeed under a system of flexible exchange rates, ignoring adverse flows would risk even more serious effects than under a system of fixed exchange rates.

Even if a country followed appropriate domestic stabilizing policies, flexible exchange rates would make all international trade and investment commitments uncertain. For reasons connected with temporary, cyclical, or even seasonal movements in international payments, exchange rates might at any time break out of their established range. The full faith and credit of governments would no longer stand behind currency values, and confidence that any breakout of an established range would result in a quick return to that range would be lacking. International traders and investors, therefore, would need to incur a speculative risk in all transactions. The costs of such risks would have to enter into prices of exports and imports and into calculations of expected returns on investments.

A system of fixed exchange rates, with narrow fluctuations about parities, can be supported by the same policies for economic stability that advocates of a flexible rate system claim would result in a limited range of exchange rate fluctuation. Since the full faith and credit of governments are pledged in support of currency values, international traders and investors can act in full confidence and with least fear of risk in currency values.

Special Hazards for Key Currencies

International economic activity need not be seriously affected if a currency that is little used or held by foreign traders and investors fluctuates. The country having such a currency and its trading partners will, however, tend to carry on international trade and finance in foreign currencies with fixed currency values, if such currencies are available. The fact that the value of its own currency is unstable will handicap the country in the development of its trade and financial institutions, and lead to a distribution of economic activity between domestic and foreign trade geared to internationally changing currency values. These effects would be much more disturbing if the key currencies also fluctuated.

If a key currency fluctuated freely in relation to gold as well as to other currencies, it could no more function as a standard of economic calculation and as a store of value. Other countries with fluctuating currency values would lose their yardstick for the conduct of foreign trade and finance. Their businessmen, investors, and public administrators would face a double handicap: there would not only be uncertainty about the value of their domestic currency, they would also risk more in their international transactions.

If international currency values should fluctuate, private and public transactors might turn to gold as the standard for economic calculation and for storing value. This development would put great pressure on the limited market supply of gold. The supply not only is small in relation to the demands that might be generated; it also cannot be adjusted to the needs of international commerce and investments as the supply of dollars and sterling can.

The large amounts of dollars and sterling that foreign monetary authorities now hold as reserves and as working balances would become subject to uncertain exchange risk. Even if private transactors would keep their holdings, foreign monetary authorities could hardly do so. The period of transition to a system of fluctuating exchange rate for key currencies would bring danger of a scramble for gold. The system would be put under great pressure from flows of volatile funds, with the price of gold bid up to unforeseeable levels.

Uncontrollable Destabilizing Forces

Advocates of flexible exchange rates underrate the risk involved in permitting rate fluctuations without clearly defined limitations.

What might happen if the United States, with its present large international payments deficit, adopted a flexible exchange rate system? If it did not continue to pursue stabilizing domestic policies, or if its price and cost structure were seriously out of line, the dollar would tend to depreciate continuously instead of fluctuating within a narrow range about a stable value.

Even if the United States tried to stabilize its domestic economy, and its prices and costs were not too rigid, the economic and financial forces generated by flexible rates would make it uncertain whether this effort could be realized. When the dollar exchange rate began to deviate considerably from its customary level, the market might well no longer expect a return to that level but rather would count on progressively wider deviation. Once market behavior became geared to such expectations, it could easily give rise to cumulative movements in financial markets far more difficult to contain than under a system of fixed exchange rates.

Thus, the dollar would tend to depreciate despite efforts to pursue stabilizing policies. Continuous depreciation could lead to speculation against the dollar, which in turn would accelerate the decline in the dollar exchange rate.

In this event, markets for internationally traded commodities would become highly speculative, because with each further decline in the exchange value of the dollar their prices in terms of dollars would rise. The increase in the costs of foreign raw materials would raise costs in domestic industry. In addition, industries producing both for domestic and foreign markets would feel the pressure of increased foreign purchases at bargain dollar prices. A cost-push, demand-pull inflation would start. Speculative activity in the stock market would rise, credit demands would expand, and interest rates would come under sharp pressure.

Domestic inflationary pressures would increase as holders of foreign dollar assets tried to liquidate their holdings before the depreciation of the dollar in terms of foreign currencies progressed. They could do so only by converting their assets, as fast as possible, first into money and then into exportable goods. They would thus add to the upward pressures on interest rates as well as on prices.

Expectations of a continued accelerating decline in the dollar exchange rate would presumably lead to hoarding of foreign currencies by domestic traders and speculators. The hoarding would depress the dollar in terms of foreign currencies even faster than it would reduce the domestic purchasing power of the dollar.

In consequence, exports would be sold at bargain rates. Although the volume of exports in terms of domestic resources would increase sharply,

export proceeds in foreign exchange would increase much less and might even fall. Payments balance would therefore have to come primarily through the drop in the volume and foreign exchange value of imports. This drop in imports, together with the deterioration in the terms of trade, would hurt domestic consumers. Moreover, the drop in imports of producers' goods would handicap the expansion of domestic production.

These disturbances would arouse inflationary processes at home. They might set in motion a self-propelling inflationary spiral, with any increase in inflationary tendencies tending to lead to a further decline in the external value of the dollar. This in turn would further strengthen internal inflationary pressures.

Two special elements of the U.S. balance of international payments would add to the harmful effects of a depreciation of the dollar. First, while the current merchandise balance might improve, depreciation of the dollar would increase the burden on the Federal budget and on the domestic economy generally of those payments abroad for military expenditures and economic aid that must be converted into foreign exchange. Second, continuous depreciation of the dollar might make it ever more attractive for foreigners to borrow in the United States, less attractive to invest in dollar bonds. Thus, the net outflow of long-term capital, at present already a major factor in unbalancing our international payments, would be further stimulated.

Costs of International Commerce

A system of fluctuating dollar exchange rates would also harm other countries of the free world. For a fluctuating rate would in many ways increase the costs and risks of international commerce.

Instead of being able to conclude international transactions on the basis of a stable key currency, everyone engaging in a trade or investment transaction would need to speculate on a possible change in the value of the dollar between the time a commitment was initiated and the time it was concluded. Compared with a fixed parity system with narrow fluctuations (1-1/2 - 3 per cent around par) the transactions risk of this system would be much greater.

For transactions to be consummated quickly the exchange risk could usually be avoided by arranging for forward cover. But the cost would be high because a system of flexible exchange rates would probably bring expectations that fluctuations in currency values would be fairly wide and continuous, and thus lead to high forward premiums or discounts. There are well developed forward markets in only a few currencies. Some international trade and credit transactions would have to be on an uncovered basis if undertaken at all.

For long-term transactions, forward coverage would not be available. Nonspeculative long-term credit transactions would, therefore, be severely handicapped by the risk of fluctuating currency values and so might become virtually impracticable.

Handicaps to Economic Growth

More basically, our objective of advancing prosperity at home and abroad through world trade based on the best international division of labor would be significantly handicapped.

Under a system of freely fluctuating exchange rates, international price relationships would tend to vary more. It would become difficult to rely on international price comparisons in making long-range

investment plans for allocating resources between industries producing for the domestic markets and for exports. Even small changes in exchange rates, say, about 10 per cent, would upset any estimate of relative cost and price advantages in different countries, especially since the changes might be quite unpredictable.

Insofar as extreme fluctuations in industrial output and employment caused by sudden reversals of international competitive positions could be overcome by protectionism, pressures for such protectionism would develop and appear compelling. But if instituted, the trade barriers could only result in slowing economic development and growth internationally.

Possibilities of Intervention

Advocates of a system of flexible exchange rates usually concede the desirability of some official intervention to influence the abruptness and degree of fluctuation in international currency values. But intervention presupposes the availability of monetary reserves in foreign currencies. Unless monetary authorities of different countries would incur the risks associated with a flexible exchange rate system, only gold and currencies borrowed from other reserve banks could be used for such intervention. If reserve or central banks were not willing to enter into cooperative arrangements, only gold sales and purchases would remain. Without enough gold, the system would be without adequate facilities to moderate exchange rate fluctuations in response to volatile and speculative flows of payments.

Concluding Remarks

No responsible government would or could long permit its economy and its international relations to incur the adverse effects that are more likely to occur under flexible than under fixed exchange rates without trying to take preventive or corrective action. Sooner or later it would be involved in efforts to reestablish monetary stability, both internally and externally -- even in an effort to return to a mechanism of fixed rates.

These efforts would eventually mean abandonment of automatic exchange rate adjustments. Both alleged advantages of a system of fluctuating rates -- the advantages of automatic balance of payments adjustments and the advantage of making domestic policies independent of balance of payments and monetary reserve considerations -- would thus have proved illusory.

Board of Governors of the Federal Reserve System,
Division of International Finance,
April 13, 1962



March 27, 1962

The Honorable Wright Patman,
Chairman, Joint Economic Committee,
Washington 25, D. C.

Dear Mr. Chairman:

During your Committee's recent hearings on the President's Economic Report, Senator Proxmire asked me to supply for the use of the Committee a memorandum on structural unemployment. I am enclosing 20 copies of a memorandum on this subject, prepared by Murray Wernick, a senior economist in the Board's Division of Research and Statistics.

I am sending a copy of this letter and the enclosed memorandum to Senator Proxmire.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.]

Wm. McC. Martin, Jr.

Enclosures

cc: The Honorable William E. Proxmire
United States Senate
Washington 25, D. C.

Some Aspects of Structural Unemployment

Much of the recent controversy relating to the causes of unemployment has largely been concerned with definitions, measurements and the time periods to be used in evaluating the impact of structural, frictional, and cyclical factors on changes in unemployment. A major difficulty and one which has resulted in differences of opinion is the inadequacy of the current labor force statistical series as a measure of the amount and changes in structural unemployment. While the available data do provide substantial information on trends, levels, characteristics of the employed and unemployed, they do not directly indicate the causes or forces which make for unemployment.

Also, as has been well documented in the Bureau of Labor Statistics recent study on Terminology, Measurement and Analysis of Unemployment, presented to the Subcommittee on Economic Statistics of the Joint Economic Committee, the specific meaning of structural unemployment is extremely vague and has a variety of definitions. At times, structural unemployment has been identified with long-term unemployment; some experts have identified it with technological change, others with shifts in consumer demands, international competition, or changes in the composition of the labor force. It is little wonder, with uncertainty as to definitions and inadequate data to measure these definitions, that differences in judgment as to the magnitude of structural unemployment have occurred among those who are concerned with the policies required to alleviate unemployment.

Fortunately, however, there is more agreement and less dispute at the policy level. Where misunderstandings have arisen they have usually been due to a tendency to approach the problems of unemployment from different starting points which often are thought to lead to clear-cut alternative policy choices. However, when the various approaches are examined in this complex area there are fewer choices than appeared to be the case at first glance. For instance, it has frequently been emphasized that the problem of increasing the mobility of labor by a better functioning of the labor market could be handled more easily under conditions of expanded over-all activity. This is undoubtedly true. The Board of Governors of the Federal Reserve System is and has been pursuing a monetary policy which has as one of its major aims the maximum utilization of our growing industrial and manpower resources.

The opposite side of the coin also has validity. It would, under current conditions, be much easier to achieve maximum employment with a relatively stable price level, if we were able to remove limitations which handicap the ready flow of the unemployed worker into useful job opportunities. Such action would unquestionably help prevent inflationary pressures developing short of our desired goals. The threat of inflation and the inadequacy of broad monetary and fiscal policies to curtail unemployment which is selective or structural in nature have been major obstacles to the reduction of persistent unemployment.

Measures continue to be required to reshape and increase the mobility of certain groups in the labor force. These conclusions are not new but have been frequently stated by a large majority of those in labor, management and Government who have expressed opinions on this subject in recent months.* (See attachment)

If we take the appropriate measures based on the broad consensus which now exists on policies to be directed toward the elimination of the causes of persistent unemployment, rather than to overplay differences of emphasis of measurements and definitions, we could well be on our way toward reaching our goals of full employment and price stability simultaneously.

Evidence of substantial structural shifts in occupations and industries in recent years has been extensively reported to the Joint Economic Committee, and many other committees of Congress. Mr. Ewan Clague, the Commissioner of Labor Statistics, only recently, and in considerable detail, gave testimony to the Subcommittee on Economic Statistics on December 18, 1961, to the effect that "In recent years there has been a dramatic shift in the pattern of employment in the United States." These shifts have resulted in a substantial rise in persistent unemployment in the postwar period evident in both good and bad times.

Of course, changes in the structure of industry and occupations are nothing new. What is new in the recent situation is the large absolute decline in employment since 1953 of almost 3 million industrial blue-collar workers; while employment in services, trade and Government,

mostly white-collar groups, rose by 7 million. There has not been as large and as absolute a displacement of workers in industrial employment or a shift away from blue-collar employment at any other periods of our history when over-all employment was rising.

Mining and railroad employment began to decline soon after the end of World War II and in manufacturing industries the decline became evident after 1953. By early 1962 production worker employment had declined by over 2 million workers or one-sixth although manufacturing output rose about one-fifth.

Immediately after the Korean hostilities it was thought that the decline in factory employment was temporary and mainly due to the curtailment in defense industries. There was, therefore, little general concern in the sharp expansionary period in 1955 and 1956 when factory worker employment failed to return to the previous postwar highs of 1953 and unemployment among workers from these industries increased. Nonindustrial employment was rising very rapidly, and was accompanied by one of the sharpest increases in the civilian labor force for a two-year span on record, as workers entered the labor market to fill the new white-collar job opportunities. But when in the recovery period of 1959 and 1960, the unemployment rate did not go below 5 per cent and industrial employment again fell below prerecession 1957 levels, there was more widespread recognition and concern of the significance of the selective declines in employment which were so heavily concentrated among certain semiskilled and unskilled occupations in an exceedingly important sector of the economy.

It was the judgment of many informed observers the forces making for higher unemployment could not be wholly explained by an insufficiency of aggregate demand. In 1959, consumer demands were high and the economy was being excessively stimulated, by a rapid run-up in inventories before the steel strike, and again in early 1960 when inventories were being replenished.

The employment patterns of recession and recovery obvious since 1953 seem to be repeating themselves again this year. In February 1962, although industrial production and GNP were at about the highest levels in history, following a vigorous recovery, there were 600,000 fewer factory workers employed than when the recession began in the spring of 1960.

A critical aspect in measuring the magnitude of structural unemployment is to know what has happened, on net, to the over 2 million production workers who were displaced in manufacturing activities between 1953 and 1962. This is impossible to answer accurately at present because our current statistics primarily give us a cross-sectional view of the labor force and unemployment at a given point in time. We would know much more about the various causes of unemployment if we were able to trace the flow of displaced workers as they moved into other jobs, unemployment, or outside the labor force. This can now be done only in a very indirect way.

The decline in industrial employment, as best we can tell, has resulted in a substantial rise in unemployment among experienced workers who were previously employed in factories and related activities

as well as some withdrawal from the labor force. Because of their specialized skills, previous experience, and geographical location, only a small proportion of these workers have been readily absorbed into the expanding industries. The available statistics do show that characteristics and employability of workers released from the declining industries is substantially different from the new entrants and re-entrants into the labor market. They have been mainly adult males, a high proportion of whom are heads of families and were formerly employed in semiskilled occupations. Once unemployed their spells of unemployment tend to be relatively long.

Secretary of Labor Goldberg, in his testimony before the Joint Economic Committee on January 31, 1962, pointed out that the long-term unemployed were concentrated in several groups out of proportion to their number in the labor force. In 1961 the long-term unemployed, those unemployed 15 weeks or more, averaged 1.5 million and was the largest number in over 2 decades. The problem involves, he testified:

"1. Men 45 years of age and over who represented 1/3 of the very long-term unemployed, even though they accounted for only 1/4 of the total labor force.

"2. Workers from durable goods industries accounted for 14% of the labor force and 25% of the long-term unemployed.

"3. Negroes accounted for 24% of persons jobless for over six months and only 11% of the civilian labor force.

"4. Semiskilled operators and unskilled laborers represented 45% of the very long-term unemployed compared to only 24% of the labor force. In contrast, professional workers made up less than 3% of the very long-term unemployed even though they account for 11% of the labor force.

"5. Persons with no previous work experience, who accounted for less than 1% of the civilian labor force, made up 9% of the persons looking for work for over six months. These were chiefly young workers in search of their first job."

The growth in the number of workers reporting long duration of unemployment, and the fact that the hardest hit have been unskilled and semiskilled males in the middle age groups, indicated by the Secretary of Labor, confirm other findings that those who were displaced because of structural factors have had a more difficult time in adjusting to new employment opportunities. They have contributed significantly to the rising levels of long-term unemployment in recent years. Their job needs as heads of families and their limitations in making a rapid transition to new skills or different geographical areas has resulted in real hardship. Measures to reduce unemployment in these groups is especially urgent.

There has also been an increase in recent years in unemployment of workers who report that their last job was in nonindustrial activities. In part this is a statistical classification problem. A worker whose lifelong or major experience has been in a declining industry will, nevertheless, be classified as unemployed in, say, trades and services

if that was the industry in which he held his last job, even if it were only of short duration or part-time job.

The greatest cause of unemployment, aside from layoffs in declining industries, appears to have been the rapid rise in the number of new entrants or re-entrants into the labor force in recent years. These unemployed are more diffuse in origin and not as concentrated geographically. An important distinction is that the characteristics of these unemployed in respect to age, sex, skill, educational background and duration of unemployment is substantially different from those whose loss of jobs can be related to structural factors. The unemployed who are associated with the expanding industries tend to consist mainly of secondary workers; mainly youths and married women, many of whom supplement family income. They may have had some work experience but their spells of unemployment are relatively short. If they fail to find jobs, they are likely to withdraw from the labor market. They almost always seek work in nonindustrial activities such as trade or services which employ persons with entirely different occupational and demographic characteristics than those of the laid-off factory workers.

Recent analysis of labor force movements indicate there are large potential resources of manpower now classified outside the labor force. Knowledge of the complex relationships between changes in output, labor force and unemployment are uncertain. It is entirely possible, under present labor market conditions, for any increase in demand for labor, more than cyclical in nature, to be largely met by a

flow of persons into the labor force rather than in a reduction in high levels of persistent unemployment. It is therefore a mistake to think there are simple or precise solutions of our persistent unemployment problems.

Our best judgment continues to be that structural unemployment has increased over the last decade as reflected in the sharp decline in industrial employment and an increase in persistent unemployment which has not been responsive to general monetary and fiscal measures even during periods of high level of activity and rising prices.

* The Report of the Commission on Money and Credit, Prentice-Hall, Inc., 1961, pp. 27, 29-30, 35.

"Despite the wealth of detail available on the characteristics of the unemployed, there are no reliable ways of determining from current figures how many are unemployed as a result of which cause. . . .

"What is the prospect for future levels of unemployment? Unfortunately the trend of unemployment has not been improving. Not only were unemployment rates higher in 1959 and early 1960 than in earlier recovery periods, but the proportion of long-duration unemployment has been higher. This long-duration unemployment continues to be serious in depressed areas, and it has become more widespread. Technological displacement of workers in manufacturing and agriculture has been heavy, and the total number of jobs in those sectors as a percentage of total employment has been decreasing.

"Two factors of special importance may make more difficult the achievement of low-level unemployment in the decade ahead. First, the expected rate of growth in the labor force increases sharply in the sixties, compared to the fifties, as the population bulge reaches the employable age. Many more jobs per year will be required to keep the unemployment rate low. Second, the pace of technological change, typified by the term automation, shows no sign of abating; on the contrary it may be increasing. Whether technological change will create new job opportunities as rapidly as it displaces other workers is not predictable. In addition, there are the problems of obsolete skills of some workers and resistances to labor mobility flowing from such things as nontransferable pensions and labor union restrictions on entry into some occupations.

"The employment problem ahead is formidable. It calls for effective use of monetary, credit, and fiscal policies to induce adequate levels of demand and to stimulate economic growth. It also requires new and imaginative programs to deal directly with structural unemployment--programs for distressed areas, education and training of new and displaced workers, an improved job information service. Action is also needed to ease the burdens of the technologically unemployed lest restrictive work practices develop which will inhibit productivity gains.

"Measures which improve the efficiency of labor will also contribute to growth. Incentives for advancement in income and job responsibility, effective employment services, retraining programs for workers displaced by technological change, programs to help move workers from depressed areas and industries into others, policies to move marginal farm workers into more productive nonfarm employment, elimination of redundant workers--all are measures that have favorable effects upon the growth rate."

President's Advisory Committee on Labor-Management Policy, January 11, 1962, pp. 2-3.

"While advancing technology has given rise to new industries and jobs, it has also resulted in employee displacement; the fact that new work opportunities are eventually created is no comfort or help to the displaced individual who cannot, for one reason or another, secure comparable or any employment. . . .

"Regarding technological advance in unemployment, it is clear that unemployment has resulted from displacement due to automation and technology. It is impossible, with presently available data, to isolate that portion of present unemployment resulting from these causes. Whether such displacement will be short-run depends to a considerable extent on our ability to anticipate and plan for programs involving technological change and to make better use of various mechanisms for retraining and relocating workers who find themselves unneeded in their former occupations."

Ewan Clague, Commissioner of Labor Statistics, Testimony before the Subcommittee on Economic Statistics, Joint Economic Committee, December 8, 1961.

"Some analysts believe that the current high rate of unemployment is entirely a function of inadequate aggregate demand. This analysis discounts the apparent uptrend in unemployment rates at the end of World War II to about 1956 and places all the emphasis on the rise in unemployment that has occurred in the last 4 years. . . .

"The other point of view is that structural changes which have taken place in recent years have had some influence in causing higher rates of unemployment. In my judgment, this is a factor which cannot be ignored."

Arthur J. Goldberg, Secretary of Labor, Testimony before Joint Economic Committee, January 31, 1962.

"Again, to say that we can put all of our people to work in useful and satisfying activities only or mainly by upsetting our monetary system, or by massive intervention of the government into the millions of free decisions which are the basic essence of our economic system--to say these things is to demonstrate a lack of understanding of our dynamic system. We do not advocate growth for growth's sake, nor can we advocate stability for stability's sake. We need both. . . ."

Stanley Ruttenberg, Research Director, AFL-CIO. Paper presented at
the Annual Meetings of the American Statistical Association,
December 29, 1961.

"It is unfortunate that the problem of our persistent high levels of unemployment has been framed by some very well-intentioned people on an 'either-or' basis--that is, that our problem is one of aggregate demand rather than structural unemployment. In my view, it is not 'either-or'; it is both.

"To achieve full employment we must simultaneously increase aggregate demand and address ourselves to the structural problems. Neither one alone will attain our objective in the years immediately ahead."

Miss Muehlhaus

FEB 19 1962

The Honorable Wright Patman,
Chairman, Joint Economic Committee,
New Senate Office Building,
Washington 25, D. C.

Dear Mr. Chairman:

When I appeared before your Committee during the recent hearings on the President's Economic Report, I was asked to supply for the use of the Committee memoranda on two subjects. The first, requested by Senator Douglas, related to the advantages and disadvantages of flexible exchange rates in international finance. The second, requested by Senator Proxmire, related to structural unemployment.

The Board's staff is preparing the two memoranda, and they will be furnished as soon as possible, but, as I understand the transcript of the record of the hearings is about to go to press, they will not be completed in time to be included in the printed record of the hearings.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.

RLC:ac

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Article Title: Cure for Unemployment

Journal Title: The Washington Daily News

Date: February 3, 1962

*Copy from Joint Economic
Committee testimony 1/30/62*

Representative Bolling. Mr. Martin, the reason for this question is sheer ignorance and the purpose is information. There is no other purpose to this. At the bottom of page 10 you say "The Stabilization Fund has acquired holdings of some major European countries, and undertaken transactions in the market with the aim of defending the dollar from speculative forays".

On page 11, the third paragraph says "As one step in such cooperation, the System is now prepared in principle and in accordance," et cetera.

I would like to know what kind of transactions in the market with the aim of defending the dollar they are. What kind of transaction is it? What happens?

Mr. Martin. I think it has to be looked at on an ad hoc basis. I want to make it clear, Mr. Bolling, that the Federal Reserve is not anxious to engage in this type of activity. It is only because we feel we have a responsibility. With convertible currencies as they are today, currency values--including that of the dollar--are more subject than for a long time to speculative movements. I used here a term that I happen to like, forays. If we held some of these currencies (and the amounts and variation in them would have to be on an ad hoc basis), we might be able, by disposing of the currencies, to minimize or offset these temporary speculative movements. The Treasury Stabilization Fund has experimented with this kind of operation since March of this year, in a very small way, and we have come to the view that however we should acquire these currencies--and it is not possible to spell ^{it} out here--what we are aiming our activities

at is to keep the speculators from unseating us, to try to minimize speculative movements. We would need to operate in a variety of ways. But we have resources in addition to what the Stabilization Fund has. We do not claim that this is going to correct our basic deficit. You will notice I went out of my way to state that.

Representative Bolling. I understand, but I mean exactly what I said at the beginning. I do not understand how this works. I do not want you to say anything you should not say, but I want to know what you do, within the bounds of what you should or should not say.

Mr. Martin. Well, we could open an account with some foreign central bank and hold in that account either pounds, lire, francs, or other currencies, depending on the circumstances. That would put us in a position to dispose of them if there was a sudden need for them. That is a simple type of operation. Another possibility would be for us to make reciprocal currency transactions with foreign central banks; in the language of the street, these are "currency swaps". Last March and April the pound sterling had quite a problem at the time of the re-evaluation of the guilder and deutschmark. There were a lot of movements and the central banks did cooperate at that time to minimize the impact of that in a variety of ways. I do not think you can spell out in advance precisely what you might do, nor ought we to spell out magnitudes for this type of operation because we are operating in a goldfish bowl. We would report what we do in our Federal Reserve statements from time to time but we ought not to be indicating ahead of them what the limits are or what we are going to do. If you do that, then you are inviting the speculator to take advantage of your operations.

Representative Bolling. I think that answers my question. I just wanted to be sure that I understood. Thank you.

Airmail

February 8, 1962.

Dear Mr. Cameron:

Thank you for your nice letter of February 6 and I am always pleased to accede to requests for copies of my statements, and hope they will prove useful.

It was good to visit with you and I will look forward to the next opportunity to do so.

With all good wishes,

Cordially yours,

Wm. McC. Martin, Jr.

**Mr. A. H. Cameron,
Saunders Cameron Limited,
55 Yonge Street,
Toronto 1, Canada.**

SAUNDERS CAMERON LIMITED

FIFTY-FIVE YONGE STREET

TORONTO 1, CANADA

EMPIRE 6-8601

E. M. SAUNDERS
A. H. CAMERON

February 6, 1962

Mr. Wm. McC. Martin, Jr.
Chairman
Board of Governors
of the
Federal Reserve System
Washington, D. C.

Dear Mr. Martin:

Thank you for your letter of January 31. I would also like to tell you how much I enjoyed our visit.

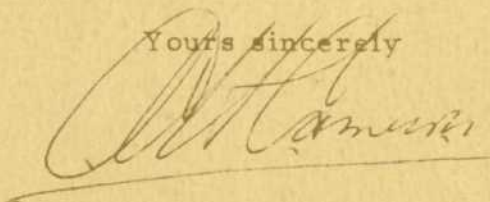
I would like to ask a favor of you -- would it be possible to have someone send me six (6) copies of your testimony before the Joint Economic Committee on January 30.

It has long been my contention that our rotten long term bond market in Canada results in large part from the domination in the volume of trading by the activities of the Central Bank for it's own account and for government funds.

We are going to have a Royal Commission going into a number of matters and I thought your remarks of this date, following on a departure from the old "Bills preferably" policy, could be used to supplement the papers written by Winfield Riefler in November, 1958, and Ralph Young and Charles Yager in August, 1960.

Thanking you, I am

Yours sincerely



AHCameron
/mfo

Airmail

February 8, 1962.

Dear Jean:

I was sorry you got away before we could have our dinner and Cynthia too was sorry to miss you. However, I did write our mutual friend, Jacques Rueff, and I had been hoping to visit with both him and you the latter part of this month in Paris. Unfortunately, I now find I can't get away at this juncture so will have to postpone this pleasure until a later date.

I thought you might be interested in my testimony before the Joint Economic Committee, particularly the references to foreign exchange, so am enclosing a copy.

With all good wishes,

Cordially yours,

Wm. McC. Martin, Jr.

Enclosures

Testimony & report re Foreign Exchange

**Mr. Jean Monnet,
83 Avenue Foch,
Paris XVIe, France.**

WRIGHT PATMAN, TEX., CHAIRMAN
RICHARD BOLLING, MD.
HALE BOGGS, LA.
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EXECUTIVE DIRECTOR

Congress of the United States


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January 19, 1962




Mr. William McChesney Martin, Chairman
Board of Governors
Federal Reserve Board
Washington 25, D. C.

Dear Mr. Martin:

Enclosed is a copy of the Committee's full
agenda of the hearings on the President's Economic
Report.

We shall be looking forward to hearing your
testimony.

Sincerely,



Wm. Summers Johnson
Executive Director

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

Representative Wright Patman (D., Texas), Chairman of the Joint Economic Committee, today announced the Committee's schedule of hearings on the President's Economic Report as follows:

SCHEDULE OF HEARINGS ON THE
ECONOMIC REPORT OF THE PRESIDENT - 1962

**Jan. 25 (Thurs.)	10:00 A.M.	Council of Economic Advisers
*Jan. 26 (Fri.)	10:00 A.M.	Director, Bureau of the Budget
*Jan. 30 (Tues.)	10:00 A.M. 2:00 P.M.	Secretary of the Treasury Chairman, Federal Reserve Board
*Jan. 31 (Wed.)	10:00 A.M. 2:00 P.M.	Secretary of Labor Secretary of Health, Education and Welfare
**Feb. 1 (Thurs.)	10:00 A.M.	Secretary of Commerce
*Feb. 2 (Fri.)	10:00 A.M.	<u>A panel of economists on "Wages and Prices":</u> Prof. Otto Eckstein, Harvard University Prof. Ben William Lewis, Oberlin College Dr. Gardiner C. Means, Economic Consultant, Vienna, Va.
*Feb. 5 (Mon.)	10:00 A.M.	<u>A panel of economists on "Fiscal and Monetary Policies":</u> Dr. Edward M. Bernstein, Edward M. Bernstein Associates, Washington, D. C. Prof. John G. Gurley, Stanford University Prof. Richard A. Musgrave, Princeton University Prof. Raymond J. Saulnier, Barnard College, Columbia University
	2:00 P.M.	<u>A panel of economists on "Investment and Growth":</u> Dr. Gerhard Colm, National Planning Association, Washington, D. C. Prof. Raymond W. Goldsmith, Yale University Prof. Daniel Hamberg, University of Buffalo Dr. Leon H. Keyserling, Conference on Economic Progress, Washington, D. C.

** - Room 1202, New Senate Office Building

* - Room P-63, Capitol Building, Old Supreme Court Chamber

(MORE)

*Feb. 6 (Tues.)	10:00 A.M.	A "Summary" panel of economists: Prof. Alvin H. Hansen, Visiting Professor, Yale University Prof. Theodore W. Schultz, University of Chicago Prof. Henry C. Wallich, Yale University
*Feb. 7 (Wed.)	9:30 A.M.	National Association of Manufacturers Chamber of Commerce Committee for Economic Development (CED)
	2:00 P.M.	AFL-CIO
**Feb. 8 (Thurs.)	10:00 A.M.	American Farm Bureau Federation National Grange Farmers Union

** - Room 1202, New Senate Office Building

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* * * *

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Article Title: Add Dillon: Treasury Secretary Dillon Hinted to Congress That the Administration Would not Oppose an Increase in the Federal Reserve System-s Discount Rate if Necessary to Halt a Further Flow of Gold and Dollars Abroad

Journal Title: Dow Jones Ticker

Date: January 30, 1962

February 6, 1962

To Chairman Martin
From Robert L. Cardon

Subject: Testimony of Professor
John G. Gurley before Joint
Economic Committee on February 5.

In view of the frequent assertions that the recent changes in Regulation Q will raise interest rates, members of the Board may be interested in the following extract from testimony by Professor John G. Gurley, of Stanford University, before the Joint Economic Committee on yesterday morning:

"* * * My feeling is that this will not have much upward pressure on the general level of interest rates, and it might even tend to lower interest rates on the average.

"If the extra demand for time deposits is at the expense of the demand for money holdings--checking deposits and currency--then there will develop an excess demand for prime securities, for bonds and other types of primary debt, because commercial banks will have additional excess reserves to demand primary securities, without there being an extra desire by anyone else to sell securities. The excess demand for securities would tend to lower the general level of interest rates.

"However, if the additional demand for time deposits is at the expense of the public's demand for primary securities themselves, or for claims on other financial institutions, the extra demand for these securities by commercial banks will be more than offset by an additional support of securities coming either directly from the public or from financial institutions which have suffered withdrawals of funds. This would tend to raise the general level of interest rates.

"But it can be shown that, for every dollar involved, this latter effect is significantly smaller than the former one, so that if the funds going into time deposits come fairly evenly from money balances, primary securities, and claims on other financial institutions, the net effect is very likely to be downward pressure on interest rates generally or at least little effect one way or the other.

"Moreover, if the funds going into time deposits represent an increase in planned saving, further downward pressure will be exerted on interest rates generally.

"It might well be that savings and loan associations and other financial institutions will raise their deposit rates.

"Some already have. One effect of this, however, is to increase the probability that funds flowing into time deposits come from money balances which earn no interest at all, in which case interest rates on securities would tend to fall.

"It is also possible that commercial banks and other lenders will raise interest rates on certain types of loans which are negotiated in monopolistic markets. If so, the likely net effect, considering all the factors I have mentioned, is some change in the structure of interest rates without much, if any change in the general average of interest rates."

cc: Each Board Member
Messrs. Young, Thomas, Molony, Fauver, Knipe, Sherman,
Noyes, and Hackley.

February 5, 1962

To Chairman Martin
From Robert L. Cardon

Subject: Hearings before Joint
Economic Committee on the President's
Economic Report.

The Joint Economic Committee this morning heard from a panel of four economists, discussing fiscal and monetary policies. One point in the discussion may be of special interest to the Board of Governors.

Professor Raymond J. Saulnier registered "dismay" at the proposal in the President's Economic Report to synchronize the term of office of the Chairman of the Board of Governors with that of the President. His formal statement contains the following comments on this proposal:

"The principle that should guide us in these matters is that our central banking system should be in the hands of men who are both technically competent and who will perform their vitally important duties without reference to political considerations. I believe the present arrangement affords greater assurance of achieving these ends than would the arrangement which the President desires. Under our system of government the President heads a political party and he is pledged to give effect to a political program adopted in a party convention. How could a non-political administration of our central banking functions be maintained under a system which would virtually guarantee a change in the Chairmanship with every change in the Presidency and would time this change so as to occur in the atmosphere of our most partisan political discussion. Speaking quite respectfully, I must say that this would be a very great mistake."

cc: Each Board Member
Messrs. Young, Thomas, Molony, Fauver, Knipe, and Sherman

January 31, 1962

To Chairman Martin
From Robert L. Cardon

Subject: Testimony of Secretary of Labor Goldberg before the Joint Economic Committee on the President's Economic Report, this morning.

Secretary Goldberg departed from text to appeal for an early settlement of negotiations between management and labor in steel, ahead of expiration date of current contract. He welcomed union's decision to call policy committee together early next week and Mr. Blough's statement yesterday that he was ready to cooperate. He emphasized early settlement is vital to avoid inventory accumulation and purchases of steel from foreign sources. He pointed out that foreign producers may agree to supply steel only if U. S. steel users agree to long-term purchase contracts.

Secretary Goldberg also emphasized labor's interest in price stability (see also pp. 6 and 7 of attached statement) and appealed for "statesmanship" in the steel negotiations.

In response to questions from Senator Javits, Secretary Goldberg said he felt the atmosphere is now conducive to settlement without a strike.

The formal statement (on page 19) also contains the following comment, which may particularly interest Board members:

"Again, to say that we can put all of our people to work in useful and satisfying activities only or mainly by upsetting our monetary system, or by massive intervention of the government into the millions of free decisions which are the basic essence of our economic system--to say these things is to demonstrate a lack of understanding of our dynamic system."

cc: Each Board Member
Messrs. Young, Thomas, Molony, Fauver, Knipe, Noyes, and Sherman

January 26, 1962

To Chairman Martin
From Robert L. Cardon

Subject: Testimony of Budget Director
Bell before Joint Economic Committee
on January 26.

1. Monetary Policy. In discussing whether the modest surplus in the budget submitted for fiscal 1963 might "pinch off" the current recovery, Mr. Bell gave two reasons why he does not believe this will happen. His first reason was that the shift from a budget deficit to a budget surplus will not be as sharp as in the recovery from the 1958 recession. His second reason was: "there is no reason to expect the sharp change towards a tight money policy that took place in the last expansion. With the good record on price stability so far in this recovery, and with the absence of any indication of an early resumption of inflationary pressures, the monetary authorities, within the constraints imposed by balance of payments considerations, should be in a better position to continue their policy of monetary ease than they have been in previous postwar recoveries."

Chairman Patman referred to the portion of the statement quoted above after Mr. Bell had finished his presentation. Chairman Patman's reaction was that the best reason for not expecting a return to a tight money policy is that we are already following a tight money policy, tighter even than in the Eisenhower Administration. As evidence, he cited figures showing both short-term and long-term interest rates higher than in certain periods of the Eisenhower Administration. Mr. Bell differed with this conclusion, saying that monetary policy "continues to be one of relative ease".

2. Balance of Payments. Senator Bush asked Mr. Bell whether the precarious balance in the proposed new budget might not contribute to our balance of payments difficulties. Mr. Bell answered that confidence in our economic policies rests not so much on whether we have a big budget surplus as on whether we are following policies leading to reasonably full employment and price stability. Senator Douglas took the position that our balance of payments difficulty can be solved by persuading the other developed countries to carry a bigger share of defense costs and foreign aid and by persuading the wealthy classes in underdeveloped countries of Latin America to assume their proper share of the responsibility for developing their own countries. He expressed the hope that "international bankers" would persuade their own governments to meet these responsibilities rather than "wringing their hands" over our economic policies.

3. Unemployment. Senator Proxmire again developed his position that we should not rely too heavily on fiscal policy to solve

our unemployment problems. Mr. Bell agreed that we cannot simply rely on increased Government spending to lower the unemployment rate and indicated that measures tailored specifically to meet unemployment, such as the Area Redevelopment Act and the President's proposals on training programs, are the best solutions to the problem.

4. Regulation Q. Senator Sparkman again expressed concern over whether the recent change in Regulation Q, relating to the interest ceiling on time and savings deposits, will have an adverse effect on home building. Mr. Bell pointed out that it had not yet resulted in increased mortgage rates and expressed the hope that the continued availability of mortgage funds would operate to keep mortgage rates from going up. Senator Sparkman indicated he did not mean to be critical of the change in Regulation Q but urged Mr. Bell to watch the situation carefully, and Mr. Bell agreed to do so.

cc: Each Board Member
Messrs. Thomas, Young, Molony, Fauver, Knipe, Sherman, and Noyes

January 26, 1962

To Chairman Martin
From Robert L. Cardon

Subject: Questioning of Council
of Economic Advisers by Joint
Economic Committee at afternoon
session on January 25.

1. Monetary Policy. Congressman Patman cited figures from Table B-47 in the Annual Report of the Council of Economic Advisers to show that yields on AAA corporate bonds rose from 3.20 in 1953 to 3.60 in 1955, to 3.89 in 1957, to 4.41 in 1960, and dipped slightly to 4.35 in 1961. He asked how the Council could conclude that an easy money policy was in effect in 1961 with interest rates remaining so high. Mr. Tobin answered that the availability of bank reserves made conditions "relatively easy" and that expectations of inflation tended to hold interest rates up. He indicated that these expectations are being dissipated and he hopes that this will tend either to lower long-term rates or at least to prevent a rise as the recovery quickens.

Senator Proxmire used several arguments to support the conclusion that monetary policy is still too restrictive. He contrasted the 3-1/2 per cent increase in the money supply between 1960 and 1961 with the 8 per cent increase in gross national product. He was prepared to concede that a 3-1/2 per cent increase in the money supply would correspond roughly with proper long-term growth rate and that therefore monetary policy was neutral from a long-range standpoint, but he argued that it was actually restrictive from the short-range point of view during the recovery in 1961. He also argued that interest rates have stayed high and that this is a common-sense test of whether monetary policy is too restrictive. He also argued that, in evaluating the portfolio of the Federal Reserve Banks from the standpoint of whether purchases of longer-term obligations were made in a degree sufficient to permit reductions in long-term rates while maintaining relatively high short-term rates, a comparison should be made of holdings of five years and over rather than one year and over. He alleged that a comparison on that basis would show that the System has not been "going all out" to achieve the greatest possible degree of monetary ease consistent with our balance of payments situation. All of these arguments were directed at the basic proposition that Senator Proxmire is ~~not~~ ^{NOT} prepared to support attempts to achieve economic growth through fiscal policy unless he is convinced that monetary policy is being fully utilized to accomplish this purpose.

2. Taxation of Savings and Loan Associations. Congressman Patman indicated that the proposals to change the tax treatment of savings and loan associations is an effort of the commercial banks to destroy institutions which fill a social need that the banks, themselves, have failed to meet. He said that savings and loans are at a competitive disadvantage with banks in that savings and loans must maintain in effect a 100 per cent reserve and that they cannot create the money they lend, as can banks. Mr. Tobin disagreed on these two points. Congressman Patman, however, asked the Council to consider the desirability of prohibiting commercial banks from making real estate loans and

indicated that he cannot understand the reasoning which apparently has led the Administration to help the banks in their effort to "muscle in" on the savings and loans. Chairman Heller indicated that he expected the savings and loan associations will continue to be the most important source of funds for housing and should not be "shielded from competition".

Senator Bush argued with the proposition that individual commercial banks can create money and sought to correct the impression that the banking system, as a whole, can create money beyond the limits established by the Government through the Federal Reserve System's control over bank reserves. This generated a discussion of whether banks should be permitted to hold U. S. obligations, with Senator Bush taking the position that it would seriously hurt the marketing of these obligations if the banks did not take them, Mr. Tobin saying that this was not necessarily the case, and Congressman Patman contending that banks should be prohibited outright from buying obligations with "money they create". Congressman Patman suggested that the Federal Reserve Banks should buy the obligations instead of member banks.

In the course of this discussion, Congressman Patman again advocated repealing the prohibition against commercial banks paying interest on demand deposits, and Mr. Tobin indicated there might be some merit in Congressman Patman's suggestion.

3. President's Trade Program. Senator Pell asked whether the brief discussion of the trade adjustment program in the Economic Report and in Chairman Heller's statement indicated any feeling that the program was not of major importance. Chairman Heller said, "No", that this was just done in the belief that the President's message to Congress (transmitted on January 25) would be a better place to explain the program.

Congressman Curtis warned that we must be careful not to bargain for mutual tariff concessions only to discover that they may be rendered meaningless by the imposition of trade quotas. He feels the President's message failed to make this clear.

4. Balance of Payments. Senator Bush indicated he considers our balance of payments problem to be of "overriding importance", more important than balancing the budget. He pressed Chairman Heller for estimates of our balance of payments and our trade balance in 1962. Chairman Heller and Mr. Gordon indicated they are making every effort to develop reasonable forecasts but held out no hope of achieving accurate forecasts very soon. Mr. Gordon did express the view that one factor operating to improve our margin of exports over imports will be improvement in our price levels compared with those of our principal competitors. He feels that ours have been stable since 1958, while our competitors' have been going up.

cc: Each Board Member

Messrs. Thomas, Young, Molony, Fauver, Knipe, Sherman, and Noyes

January 25, 1962

To Chairman Martin
From Robert L. Cardon

Subject: Testimony of Council of
Economic Advisers before Joint
Economic Committee this morning
on President's Economic Report

1. Monetary Policy. Two features of Chairman Heller's statement, itself, may be worth noting. First, on page 2 and on page 8, monetary policy is treated as part of the Administration's program, rather than as an independent function of the Board. Secondly, the statement appears on page 6 that "Since the stimulus of rising government expenditure will be moderate and declining, government monetary and credit policies can appropriately maintain conditions favorable to private borrowing and spending."

Senator Douglas asked Chairman Heller what plans the Administration has in reserve to deal with unemployment in case the forecasts in the Economic Report for economic recovery are not realized. Chairman Heller replied that the Administration has no secret weapon up its sleeve but will rely on the usual tools available, citing, as an example, a policy of monetary ease. When Senator Douglas asked whether the Federal Reserve Board had contributed to monetary ease in 1961, Chairman Heller answered, "Yes," that this had been done by holding free reserves at a level of \$500 million and by open market purchases throughout the maturity range.

Senator Douglas commented that the success in achieving price stability in 1961 indicated that many people hold unreasonable fears about inflationary effects of monetary policy.

Amendment to Regulation Q. Senator Sparkman expressed concern about the recent change in Regulation Q, increasing the maximum permissible interest rates on time and savings deposits. He said that he had heard that many savings and loan associations are raising their dividend rates as a result of this change, particularly on the West Coast, and he asked Chairman Heller whether this would not result in a general increase in mortgage rates, with a consequent adverse affect on housing. Chairman Heller replied that the change should stimulate savings, that there is some indication that commercial banks which are paying higher rates on time and savings deposits are more aggressively moving into mortgage loans, and that this will tend to maintain stability in mortgage rates. He pointed out that some economic choices are hard to make and that one factor in this change was the necessity for trying to retain foreign balances in commercial banks. He expressed the hope that this aim can be harmonized with the goal of maintaining a strong housing industry, and he agreed, at Senator Sparkman's request, to watch the situation carefully as it develops.

Congressman Widnall later asked whether the change in Regulation Q would not hurt the sale of Government bonds. Chairman Heller replied that this would not necessarily result in any over-all increase in interest rates, that all it did was to narrow the gap between rates paid by savings and loan associations and commercial banks.

President's Trade Program. Senator Bush asked whether any reciprocal cuts in tariffs by the European Common Market and the United States would hurt our balance of payments situation by stimulating imports into the United States. Chairman Heller replied that he felt that reciprocal reductions would boost our exports more than our imports. Mr. Kermit Gordon added that, if we do nothing, the discrimination against United States' exports into the Common Market will steadily increase, as their external tariff would remain static while their internal tariffs went steadily down. He said, also, that, if nothing is done, United States' manufacturers would enter the European Common Market through direct investment rather than through exports.

Amendment to Employment Act of 1946. Senator Bush asked Chairman Heller whether he would favor amending the Employment Act of 1946 so as to specify price stability as a national goal. Chairman Heller replied that he felt that the importance of achieving price stability is implicit in the Act and that amendment is not necessary; that he would neither oppose it nor endorse it.

Congressman Bolling later said that he was "restraining himself" from pushing an amendment to specify economic growth as a goal and asked Chairman Heller if he felt that was also implicit in the Act, and Chairman Heller replied that he did.

The hearings recessed to resume at 2 P.M. Of course, this memorandum is not intended to cover everything that was said this morning but just those points that seemed of particular interest to the Board.

cc: Each Board Member
Messrs. Thomas, Young, Molony, Fauver, Knize, Sherman, Noyes.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D. C.

FOR RELEASE
THURSDAY
JANUARY 25, 1962

STATEMENT OF WALTER W. HELLER, CHAIRMAN
ACCOMPANIED BY
KERMIT GORDON AND JAMES TOBIN, MEMBERS

BEFORE

THE JOINT ECONOMIC COMMITTEE

January 25, 1962

In testifying on the Administration's first Annual Economic Report, I should perhaps open with a few words on its approach and composition -- what the President's Report and the Council's Report are trying to do and say. You will have noted that the report has been split into two separate parts. This follows essentially the practice of the early 1950's in contrast with the single Presidential report in recent years. The two parts are:

1. The President's Report: This is a broadsweep statement of economic policy, performance, prospects, potential, and program -- a report by President Kennedy to the Congress in compliance with the requirements of Section 3 of the Employment Act of 1946. In it, the President spells out in considerable detail his legislative recommendations in the field of economic policy.
2. The Council's Report: This is a searching -- but we hope not forbidden^{ing} -- examination of the rationale of this Administration's economic policy -- its factual, philosophical, and analytical foundations, its accomplishments to date, its expectations, and its complex challenges for the future.

My brief opening statement is designed, not to summarize the two Reports, but to focus the Committee's attention on a few of the principal facts and issues which shape economic prospects and policies in 1962.

Recovery in 1961

A year ago, the economy was still in the grip of its second recession in three years. Nearly 7 percent of our labor force and 20 percent of our industrial capacity were idle. Actual output was running about \$50 billion -- or 10 percent -- short of the economy's potential. The case for expansionary policy measures was clear and compelling.

To provide stimulus and substance for the recovery, the Administration early in 1961: (1) successfully sought the cooperation of Congress in enacting legislation to expand purchasing power and create jobs; (2) accelerated Federal orders and payments on a wide front; (3) pursued policies to ease money and credit; and (4) followed an expansionary budget policy.

With this well-timed and forceful support from Government policy, the U.S. economy again demonstrated its resiliency in a vigorous recovery. By the end of the year, new records were set in production and income (all figures at annual rates):

1. From a recession low of \$501 billion in the first quarter, gross national product rose to \$542 billion in the fourth quarter. Inventories, government purchases, and fixed investment (including residential construction) each rose by \$8 billion; consumer expenditures rose by \$18 billion; only net exports fell (by \$1 billion).
2. The industrial production index (1957=100) rose from 102.1 in February to 115.2 in December.

3. Per capita disposable income rose from \$1940 in the first quarter to \$2032 in the fourth, crossing the \$2000 mark for the first time.
4. Wages and salaries and other labor income increased from \$281 billion in the first quarter to just over \$300 billion in the fourth.
5. Profits before taxes increased from \$39.6 billion in the first quarter to an estimated \$50-billion-plus in the fourth.
6. Farm income (operators' net income from farming) increased from \$12.0 billion in 1960 to \$13.1 billion in 1961, an average rise of nearly \$350 in net income per farm.

The seasonally adjusted rate of unemployment fell from 6.8 percent in February to 6.1 percent in December, and the number of areas of substantial labor surplus, from 101 in March to 60 in December (out of a total of 150).

Prices, over-all, remained remarkably stable for a period of vigorous recovery. For the first time in any postwar recovery wholesale prices fell (by 0.7 percent) in the first 10 months of recovery. The consumer price index rose only 0.6 percent from February to November.

Finally, confidence in the dollar was restored. In 1961, the over-all deficit in our international accounts was cut by about one-third from 1960's level of \$3.9 billion, and the deficit in basic international transactions was cut by about two-thirds. Gold losses of \$1.7 billion in 1960 were cut in half in 1961.

The Unfinished Business of Economic Policy

Yet, satisfaction with our progress to date is tempered with concern over the important unfinished business of economic policy.

First, recovery has carried the economy only part of the way to the Employment Act's goal of "maximum production, employment, and purchasing power." Even at \$542 billion, production is still 5 percent below the economy's potential; unemployment is intolerably high; and the Nation's purchasing power, or real income, falls correspondingly short. A recovery that carries the economy to full employment and cuts deeply into the bitter core of depressed areas and displaced workers -- at the same time continuing to maintain reasonable price stability -- is the first order of business of economic policy. Indeed, it is the indispensable first step toward our other economic objectives.

Second, beyond full recovery lies the recurrent risk of recession. The uncomfortable facts of economic history bear witness: our postwar record -- though incomparably better than that of the 1930's -- has been marred by four recessions, three of them in the brief span of seven years. More than \$200 billion of potential output has been lost in our postwar recessions. To avoid such losses in the 1960's and beyond -- to keep recessions short and shallow if they occur -- the President has called for stand-by programs of accelerated capital improvements and temporary income tax cuts and a strengthened unemployment compensation system.

Third, while moving toward full and sustained use of the economy's present productive capacity, we must also take other steps to expand its future potential. The rate of growth of the U.S. economy in recent years has lagged not only behind its early postwar pace but behind the growth of the world's other major industrial countries. We must make the 1960's a decade of faster economic growth so that we may improve the quality of life at home and meet our responsibilities of leadership abroad. A growth

rate exceeding 4 percent will be needed in the 1960's merely to absorb into effective employment the net additions to our labor force. A rate of 4-1/2 percent lies within the reach of private and public policy in this decade.

Fourth, persistent international payments deficits and gold outflows have brought the balance of payments to the forefront of economic policy. We must attain a balance in our international transactions which enables us to meet our heavy obligations abroad without continued depletion of our gold reserves. Simultaneously, we must continue to reduce barriers to international trade and increase the flow of resources from developed to developing countries.

Full recovery without inflation; stronger defenses against future recession; faster growth; balance-of-payments equilibrium and further trade liberalization -- achieved with equity and "in a manner calculated to foster and promote free competitive enterprise and the general welfare," as the Employment Act wisely requires -- these are the guideposts of ~~my~~ economic policy for 1962.

The Prospect for 1962

We look for a further strong economic advance in 1962. Expansion in the first half of the year, supported by inventory accumulation and rising government expenditures, should be sustained after the middle of the year by a quickening pace of business plant and equipment investment. Unemployment will fall, and profits and labor incomes will rise, as the economy narrows the gap of unused capacity. The year 1962 should see a GNP of \$570 billion -- a \$50 billion gain over 1961.

Policy and Program in 1962

Economic recovery to date has been strong, and the outlook is favorable. But to achieve the goals of full recovery, growth, and balance in international payments, the United States economy needs (1) more demand now and more stable demand in the years ahead, (2) more investment, and (3) continued price stability. In the rest of my statement, I shall examine the broad outlines of economic policy and program for 1962 in terms of these three requirements. Specific recommendations to carry out this policy and program are listed in the attached summary: "Legislative proposals in the Economic Report of the President."

1. The United States economy needs more demand now and more stable demand in the years ahead. Today business needs more orders, and workers more job opportunities. Both plant capacity and labor are available to produce more goods and services if only there were customers willing and able to buy them. In the next eighteen months, an expansion of about 10 percent in total demand will be needed if we are to close today's gap in our economic performance and catch up with the economy's ever-growing capacity to produce.

For this expansion we can and must, of course, rely principally on consumers and business firms. But it is the task of government fiscal and monetary policy to support and facilitate the expansion of private demand. Federal expenditures will increase moderately, though at a slower pace than in the early phases of recovery. This is appropriate because the very momentum of the upswing now gives private demand greater strength. Since the stimulus of rising government expenditure will be moderate and declining, government monetary and credit policies can appropriately maintain conditions favorable to private borrowing and spending.

Expansion of production beyond the current recovery requires more than the expansion of demand. The economy's capacity to produce must be enlarged, by investment and other measures to increase productivity. Yet demand must grow too, roughly keeping in step with the growth of potential output -- neither outpacing it to cause inflation nor lagging behind it to cause recession and unemployment. This is the long-run task of public policy for economic stabilization. In our view, it is in present circumstances consistent with this criterion to aim at a moderate surplus in the Federal budget when the economy is operating at full potential.

It is not easy to steer the middle course of stability between too rapid and too slow expansion of demand. In our free economy fluctuations in private spending are bound to occur. To offset these swings, or even to arrest and reverse them before they become cumulative, fiscal and monetary policy must be prompt and flexible. The President has made three proposals of the greatest importance to the future stability of the economy: (1) a stand-by program of public capital improvements to combat unemployment, (2) a procedure for temporary partial suspension of income taxes to buttress private purchasing power when recession threatens, and (3) permanent strengthening of unemployment insurance. (See items I-1, I-2, and I-3 of the attached summary: "Legislative Proposals in the Economic Report of the President.") The gains from greater stability of the economy are not simply the production and employment which would otherwise be lost in recessions, great as these losses are. Instability also deters future growth by dulling incentives for investing in new and more efficient capacity.

2. The United States economy needs more investment. Private investment in plant and equipment in 1962 is a key element in the economic outlook -- for full recovery, for economic growth, for improvement in the balance

of payments. That is why major policies and proposals of the Administration are designed to stimulate investment: enactment of the proposed tax credit for new investment in equipment with an effective date of January 1, 1962 (Item IV-1 of the "Legislative Proposals"); revision of the Treasury's guidelines for depreciation for tax purposes; and maintenance of monetary and credit conditions favorable to the financing of investment.

(a) Full recovery. To the saving of individuals from higher personal incomes and of corporations from increased profits, the Federal Government in fiscal 1963 will add a surplus of \$4-1/2 billion in its budget on national income account. At full employment this surplus would be doubled. Expansion in 1962 toward full employment in mid-1963 will require sufficient strength in investment demand to use the saving which higher personal, business, and government incomes will generate.

Of the \$50 billion increase in GNP projected for calendar year 1962 over 1961, about half will be purchased by consumers and another fifth by Federal, State, and local governments. The remaining 30 percent will be available for increased investment in inventories, housing, plant and equipment, and the like. An expansion of fixed investment outlays will be particularly important in the second half of 1962, when inventory building and Federal expenditure are expected to be contributing less to growth of demand than in the first half of the year.

Recovery itself will powerfully increase incentives for investment, by whittling away at excess capacity and by demonstrating the profitability of new capacity in a fully operating economy. At the same time, positive policy is essential to assure that the high potential saving of the economy is used in productive investment, not wasted in incomplete recovery and prolonged unemployment. If such policy is successfully adopted, the current

recovery will pave the way for a higher trend rate of economic growth over the years ahead.

(b) Economic growth. Once our idle manpower, machinery, and plant are drawn fully into productive use, growth of production will depend upon growth in our capacity to produce. We will need an expanding stock of plant and equipment to give a rapidly growing labor force the tools to do their jobs. Indeed we will need more than that. Faster growth in per capita income requires faster growth in the productivity of labor. This requires not only more, but better, machinery and equipment to embody in industrial practice the fruits of research and development. And it demands that we provide the improved general education and specific training of our youth, and of many adults, which will equip them for the jobs that technological advance makes available. (Items III-1, III-2, and V-3 of the "Legislative Proposals"). Without investment in human talent, investments in technological progress and physical facilities cannot yield their full potential return to the Nation.

(c) Improvement in the balance of payments. The United States must pay its way in the world by earning in international competition a large enough trade surplus to meet our overseas commitments and capital investments. We can earn the required trade surplus only if our products are competitive in price and in quality. Rapid advance in productivity is the ultimate key. Research and investment can keep our products in the vanguard of the technological race, and keep our costs at levels which enable our firms to compete while real wages in the United States steadily advance. But our balance of payments position will be damaged if our productivity lags, or if the competitive advantage which gains in productivity might yield is dissipated in excessive increases of money costs.

At present the balance between investment overseas and investment at home is tipped too heavily in favor of foreign investment. One source of this imbalance has been the contrast between excess capacity and correspondingly low profits at home and sustained rapid economic growth abroad. Full recovery in the United States will go far to correct this source of imbalance. The Administration's tax proposals and the new trade program are designed to overcome other handicaps which investment at home has been suffering in relation to investment in Europe. (Items IV-7 and V-2 of the "Legislative Proposals.")

3. The United States economy needs continued price stability. The price record of the current recovery is so far excellent. Demand and production are increasing at a rate which is narrowing the gap of unused potential, without giving rise to bottlenecks, specific shortages, and upward pressures on prices and costs. The budget is appropriately paced for an orderly expansion, with time for the economy's reserves of industrial capacity and manpower to respond to the pattern of rising demands. If private demands should, contrary to expectation, threaten to outrun the capacity of the economy to meet them, monetary and fiscal policies can and will hold the expansion within reasonable speed limits. The Administration's programs of area redevelopment, manpower training and development, and youth employment opportunities will help to avert specific bottlenecks and shortages, by trying to provide in advance plant capacity and skilled labor to do the jobs which an expanding economy will require. (Items III-1 and III-2 of the "Legislative Proposals.")

In a free economy, the course of the price level depends not only on government policy but also on the decisions and negotiations of business

firms and labor unions. The President has repeatedly asked that these decisions and negotiations give full weight to the national interest in price stability. Success in stepping up productivity and maintaining price stability can clear the path for solving our balance-of-payments problem in the framework of an expanding economy and capitalizing on the great opportunities and benefits of full recovery and economic growth.

January 25, 1962

Legislative Proposals in the Economic Report of the PresidentI. Strengthening Our Defenses Against Recession

1. Provide stand-by authority for the President to make temporary (six months) reductions of up to a maximum of 5 percentage points in all individual income tax rates, subject to Congressional veto.

2. Provide stand-by authority for the President to initiate and accelerate up to \$2 billion of spending on capital improvements--Federal, State, and local--such authority to be "triggered" by persistent and substantial increases in the unemployment rate.

3. Strengthen the unemployment insurance system by providing for an extended benefit period for experienced workers at all times and for all workers in times of high unemployment, by providing incentives to States to increase benefits, by extending coverage to three million additional workers, and other measures.

II. Strengthening the Financial System

1. Revise the terms of the officers and members of the Board of Governors of the Federal Reserve System, so that the four-year term of the Chairman will coincide with that of the President, so that the terms of members begin and end in odd years instead of even years.

2. Raise salaries of members of the Board of Governors of the Federal Reserve System.

3. Repeal the Acts relating to silver of June 19, 1934, July 6, 1939, and July 31, 1946, thus freeing the Treasury from any obligation to support the price of silver.

4. Repeal the 50 percent tax on transfers of interest in silver, thus fostering orderly price movements by encouraging the establishment of a future market in silver.

5. Authorize the Federal Reserve System to issue Federal Reserve Notes in denominations of \$1, thus making possible the gradual withdrawal of silver certificates in the denominations of \$1 and \$2 and the use for coinage purposes of the silver thereby released.

III. Strengthening our Manpower Base

1. Provide federal aid for training and retraining of unemployed workers. (Passage of proposed Manpower Development and Training Act.)

2. Establish pilot programs to expand employment opportunities for young people, including training, employment in public service jobs, and employment in a newly established Youth Conservation Corps. (Passage of proposed Youth Employment Opportunities Act).

3. Increase appropriation for the U.S. Employment Service, to enable that agency to better fulfill its function of matching available jobs and workers.

4. Amend the Welfare and Pension Plans Disclosure Act so as (a) to provide adequate penalties for embezzlement and (b) to vest authority in a responsible Federal agency to enforce the statute by issuing binding regulations, prescribing uniform reporting forms, and investigating violations.

IV. Strengthening Our Tax System

1. Provide a tax credit equal to 8 percent of gross investment in eligible machinery and equipment, thus stimulating investment in capacity expansion and modernization by reducing the net cost of acquiring new equipment.
2. Make dividend and interest income subject to withholding.
3. Repeal the \$50 dividend exclusion and the 4 percent dividend credit.
4. Revise tax treatment of business deductions for entertainment, gifts, and other expenses, to stop abuses of "expense-account living."
5. Eliminate the special tax preference for capital gains from the sale of depreciable property, real and personal.
6. Remove unwarranted tax preferences to (a) cooperatives, (b) mutual fire and casualty insurance companies, and (c) mutual savings banks and savings and loan associations.
7. Revise tax treatment of foreign income, to remove unwarranted incentives to the export of capital.
8. Extend the corporate income tax and certain excise taxes for another year beyond June 30, 1962, except that certain taxes and charges related to the use of airways and waterways should be revised so that users of these facilities carry a larger share of the costs.

V. Other Legislative Action Urged in the Economic Report

1. Enact enabling legislation for U. S. participation in the recent agreement among ten major industrial countries to lend specified amounts of their currencies to the International Monetary Fund when necessary to cope with or forestall pressures which may impair the international monetary system.

2. Enact new trade legislation to facilitate negotiation of reciprocal tariff reductions with the European Common Market.

3. Provide Federal aid to education, including assistance to States for provision of more adequate public school facilities and higher teachers' salaries and -- at the higher education level -- loans for construction of facilities and for scholarships to able students who need help.

TREASURY DEPARTMENT
Washington

FOR RELEASE ON DELIVERY

70
STATEMENT OF THE HONORABLE DOUGLAS DILLON
SECRETARY OF THE TREASURY
BEFORE THE
JOINT ECONOMIC COMMITTEE
TUESDAY, JANUARY 30, 1962, 10:00 A.M., EST.

Mister Chairman and Committee Members:

The past twelve months have been an active, and I think fruitful, period in terms of our economic policy. In many ways, remarkable progress has been evident. Nevertheless, urgent problems remain. I am grateful for this opportunity to review with you today both our recent experience and our plans for meeting the needs of the future.

Progress and Problems

Last year began in recession, but closed with output and income at new record highs. The personal hardship and economic waste of unemployment were reduced. Nearly a million workers were added to non-farm payrolls. Industry, while working longer hours at higher pay, is also earning greater profits. And, while providing a higher standard of living for our citizens, we have strengthened our military defenses and contributed further to the economic progress of other, less fortunate nations.

This progress was achieved within a context of general price stability. On that solid base, exports reached a record volume, contributing to a significant reduction in our basic balance of payments deficit. At the same time, defenses against potentially disturbing short-term capital movements are being greatly reinforced. As a result, confidence in the dollar has been strengthened.

D-376

However, the economy is still operating well below its full potential. Our growth rate over recent years has hardly been satisfactory. Unemployment is still at an unacceptably high level. The deficit in our international accounts, while smaller, remains troublesome. And, the very progress of the past year, not only in this country but in other parts of the free world, has brought with it new problems to which we must find solutions.

Financial Policies in 1961

There is no single, easy explanation for our progress during 1961. A large part of the answer lies in the natural vitality of our type of market economy operating under conditions of overall price stability -- the fundamental prerequisite for all our attempts to achieve faster growth at home while simultaneously working toward a sustainable balance in our international accounts. That price stability, in turn, can be traced primarily to sharp gains in industrial efficiency and worker productivity as output expanded from its recession level -- gains that enabled industry to pay higher wages and to increase profits without raising prices.

Government policy supplied another large part of the answer. First, there was the psychological, but nonetheless real, reaction that flowed from President Kennedy's earliest statements and programs. At home, the President's clear intent to deal with the recession promptly and effectively helped restore confidence in the economic outlook, encouraging expanded investment and spending. Similarly, the President's expressed determination to maintain the strength of the dollar internationally without resort to protection, controls, and restraints met with a prompt response. The speculative capital outflow subsided and the gold drain was sharply reduced.

This positive approach entailed, under the particular circumstances then prevailing, acceptance of a sizable budgetary deficit -- which was further enlarged by the higher levels of defense spending called for by the Berlin crisis. At a time when human and industrial resources were readily available to expand output, the rising trend of Government outlays and the consequent deficit were important factors in speeding the recovery without creating pressures on the price structure.

The stimulating effects of the budget were reinforced by monetary and credit policies. Throughout the past year, the credit markets have had ample funds to meet the combined demands of businesses, individuals, and the various levels of government -- thus facilitating a revival in capital outlays, higher levels of home building, and steady progress toward meeting the accumulated needs of local governments. In sharp contrast to other recovery periods since World War II, lending rates have held almost steady, particularly in the long-term area. Both corporations and state and local governments can still raise funds at virtually the same cost as a year ago. Mortgage rates, after declining in the early part of 1961, have been substantially unchanged since last spring. This stability was particularly striking in a year when the total funds raised in the capital markets by corporations, home-buyers, and state and local governments, reached a new all-time peak.

All this was accomplished without permitting rates for short-term money market instruments to drop to the extremely low levels characteristic of earlier periods of easy money and recession. That was a significant achievement, for short-term

rates, while less important in influencing investment activity at home, can play a critical role in directing the flow of liquid capital between the financial centers of the world. Here, Treasury debt management policy, as well as greater flexibility in the day-to-day conduct of open market operations, was an important factor.

Working in close cooperation with the Federal Reserve, the Treasury, in financing the deficit, increased the outstanding total of securities maturing within a year by more than \$10 billion. At the same time, there was no shortening of the average maturity of the marketable public debt, largely as a result of the continued use of the "advance refunding" technique. This type of financing involves the exchange of outstanding issues for longer maturities, with a minimum impact on market conditions and flows of funds into productive investment.

This combination of a budgetary deficit with flexible monetary and debt management policies, carefully attuned to the realities of the balance of payments as well as domestic needs, was appropriate both in terms of magnitude and timing. The extremes of the 1958 recession -- when the deficit reached nearly \$12-1/2 billion and interest rates dropped sharply, only to surge abruptly higher as recovery started -- were successfully avoided. Financial policies were stimulating without being inflationary; the threat of disturbing short-term capital outflows was ameliorated. Moreover, business expansion has proceeded in orderly fashion. Today, signs of the sort of excesses that breed instability and require sudden changes in policy are notable for their absence.

Our Basic Goals

This does not mean, of course, that all the policies appropriate to the past twelve months are suitable for meeting the challenges of 1962. With recovery largely completed, the domestic focus must now be on maintaining forward momentum while guarding against inflationary pressures as our resources are more fully utilized. Confidence in the dollar has been maintained. To sustain that confidence, further progress toward a long-run equilibrium in our basic international accounts is a necessity.

Our fundamental objectives -- domestic growth and a payments balance -- must be pursued together, within the framework of free markets. All Administration policy is pointed toward that end.

We reject policies that presume irreconcilable conflict between our objectives; policies that attach sole priority to growth, or sacrifice growth to external equilibrium. These purported solutions are both unacceptable and unworkable in a world in which our capacity to grow is being challenged and our allies in freedom need the strength and stability assured by a solid dollar.

Success in reaching our twin objectives will require hard decisions, not only by those who shape the financial policies of Government, but also by those who set price and wage policies for management and labor.

A Balanced Budget

The President's Budget Message is a financial reflection of our national needs and priorities. Expenditures will rise moderately in fiscal 1963, almost entirely because of defense needs and despite painstaking elimination of non-essential spending, both military and civilian. These expenditures can and should be supported by a growing economy. In the light of past experience and current trends, the

projections of a further rise in the Gross National Product to \$570 billion in 1962 that underlie the revenue estimates are entirely reasonable. Without raising tax rates an advance of this sort will generate revenues slightly larger than expenditures. Under the economic conditions we foresee, the achievement of such a balance is highly important in avoiding inflationary pressures as the economy moves closer to its full potential.

One result of this budget will be to reduce the possibility of severe strains on the monetary system as the economy expands -- strains that could bring sharp and sudden increases in interest rates and unsettling market reactions that impede the flow of savings into productive investment. In 1956 and 1957, and particularly in 1959, strains of this sort appeared to be developing at a time when too much of the burden of maintaining balanced growth and curbing excesses was thrust upon the monetary authorities. Monetary policy is an essential and powerful tool for facilitating appropriate adjustments in the economy. But unless it is supported by appropriate budgetary policy, the results can be capricious and unpredictable, contributing too little to either stability or growth.

The Debt Ceiling

The President's recent request to raise the temporary debt limit to \$308 billion is the result of an unavoidable concentration of revenues in the final half of fiscal 1963 -- a concentration that stems largely from the normal recurring seasonal pattern of tax receipts. Borrowing of about \$9 billion will be necessary between the end of this fiscal year and the principal tax payment dates in fiscal 1963 -- even though the budget for the fiscal year as a whole is balanced. Moreover,

while we anticipate that the total debt on June 30 of this year will be somewhat lower than the current figure of over \$297-1/2 billion, prompt enactment of an increased ceiling is needed to restore some margin for flexibility and unforeseen contingencies -- a margin that has been virtually exhausted by the higher defense expenditures required to meet the Berlin crisis, which developed after the enactment of the current limit of \$298 billion.

Measures to Encourage Investment

A balanced budget in times of relative prosperity means that the Federal government on an overall basis does not draw on the national flow of savings available for investment. Thus a balanced budget in these circumstances promotes the flow of private investment.

Why is an increase in such investment so important to us today?

At the heart of the matter is the fact that it makes possible greater productive efficiency. Gains in efficiency are necessary for growth at home, for price stability, and for aggressive penetration of foreign markets. Thus, increased investment is the key to achieving our major objectives -- growth and external balance -- simultaneously in the years ahead. And, this is where the American economy has fallen furthest behind in recent years.

Since the mid '50's investment in capital equipment in the United States has averaged less than 6 percent of the Gross National Product as compared to about 7 percent during the earlier postwar years. By contrast, German investment has been averaging about 12 percent of G.N.P. during recent years, French between 8 and 9 percent, and the Common Market countries as a group about 10 percent. It is not a coincidence that these countries have been

growing by roughly 5 percent per year, while generally maintaining a strong external payments position. Nor is it mere happenstance that some other countries, where productive investment has been a relatively small proportion of G.N.P., have had to cope with relatively slow growth and recurrent payments difficulties.

Certainly growth alone, or larger investment by itself, is no guarantee of external balance. But foreign experience strongly suggests that our twin objectives can be not only compatible, but mutually reinforcing.

In our economy, investment in plant and equipment is properly the province of private businesses, individually responding to the profit motive and competitive pressures by increasing production efficiencies and seeking out new markets. The Government nevertheless has an essential role to play in maintaining an economic climate that will encourage and facilitate the investment process.

I have mentioned the role of budgetary policy in this regard. But a balanced budget alone cannot meet our urgent need to increase our rate of investment in productive capital equipment. It is also vitally important that our tax system should recognize the need to accelerate the modernization of our physical plant and equipment.

This is why the Administration has attached first priority, among tax reform measures, to the investment credit and the related revision in depreciation schedules. The first steps toward depreciation reform have already been taken with the new depreciation allowance guidelines for most of the textile industry. Revisions in guidelines for other industries will be announced this spring.

Based on exhaustive statistical and engineering studies, these administrative actions, consistent with the present law, recognize past experience and practices as well as the impact of technological advances and other factors on the economic life of plant and equipment. They will provide a much more realistic basis for taxation, and will stimulate business modernization and expansion. They can not alone, however, assure the necessary flow of funds into new productive facilities, nor will they place American firms on an equal footing with their competitors abroad, where special incentive allowances are commonplace. To achieve this, revision of depreciation guidelines must be accompanied by the proposed investment credit. These coordinated reforms go together and should not be separated.

In enacting the investment credit, we must also recognize the need to avoid a loss of revenue that could jeopardize the prospects for a vigorous recovery with stable prices. It is for this reason that the President is urging the simultaneous enactment of tax reforms that will balance the cost of the investment credit and at the same time eliminate certain defects and inequities in our tax structure.

Meanwhile the Treasury is continuing its intensive review of the broad issues of tax reform, including the structure of the personal income tax. Fundamental changes of this sort inevitably require careful preparation, and close analysis of a welter of detail. In the end, Congressional hearings will provide the best assurance of a full and fair appraisal of the implications of any basic change in the tax laws. The President plans to submit to the Congress later in this session a broad program of tax reform so that this process of public scrutiny can get underway promptly, looking to enactment of the reform in 1963. Any comment now on

the nature of these proposals would be premature, but a thoroughgoing reform of this type will almost certainly entail some adjustments in the basic individual tax rates.

Toward Payments Equilibrium

Tax reform to stimulate modernization of our industrial equipment provides a foundation for other efforts to improve our balance of payments position, including measures aimed directly at increasing exports to the large and rapidly growing markets of Europe and other developed countries. The Administration is pursuing with vigor its program to make more American businesses aware of the opportunities in foreign markets, to familiarize those markets with American products, and to enlarge and speed the flow of information between American producers and their potential markets. A new and comprehensive program of export credit insurance, undertaken by the Export-Import Bank in cooperation with private insurance companies and banks, is now ready and will provide simplified procedures and comprehensive risk guarantees fully equivalent to those long available to most of our competitors abroad.

In today's world, export markets are highly competitive. The rapid growth and consolidation of the European Common Market, creating a free internal market but protected from outsiders by a wall of uniform tariffs, poses a serious problem -- but it also presents a great opportunity. The problem is that we must assure ourselves of access to the richest of our foreign markets -- a market to which we export almost \$3-1/2 billion per year, a far larger amount than we import from the same area. The opportunity lies in the mutual negotiation of lower tariffs on a reciprocal basis for broad groups of products, at one and the same time

expanding our export potential and forging a strong Atlantic trading partnership. To seize this opportunity, President Kennedy has sent to Congress a new Trade Expansion Act.

Increased exports are, over the long run, the most effective means of eliminating our basic balance of payments deficit in a manner consistent with our other objectives and responsibilities. But because of our current position, other efforts to reduce the drains directly related to our overseas commitments must be continued and reinforced.

One of the most important is the negotiation of arrangements with certain of our allies to offset the dollar outflow arising from maintaining our military forces overseas. In addition, a large portion of our economic assistance is being tied to purchases in this country. And, the proposed legislation to equalize the impact of the corporate income tax on business operations at home and in developed countries abroad would eliminate a special stimulus to investment in industrialized nations.

The Balance of Payments in 1961

Although some of these measures have been in effect for only a limited period of time and others are yet to be undertaken, our balance of payments showed substantial improvement for 1961 as a whole. While firm data are still not available, current indications are that the basic deficit -- the net of all our recorded transactions except volatile short-term capital flows -- declined to roughly \$600 million, as compared to almost \$2 billion during 1960. A part of this improvement -- almost \$700 million -- can be credited to advance repayments by foreigners of long-term Government loans. Nevertheless, the improvement in the remainder of the basic account was substantial. Preliminary figures point

to an overall deficit -- including short-term capital outflows -- approximating \$2.5 billion, down from \$3.9 billion in 1960 and from an average of \$3.7 billion over the three years 1958-1960.

Much remains to be done before equilibrium is restored. Some year-end figures now becoming available and tentative data for the fourth quarter emphasize the need for caution. The over-all deficit appears to have risen to well over \$1 billion in the final quarter, considerably above the average for the first three quarters of the year.

The increase in the deficit from the third to fourth quarters appears to have been entirely a matter of short-term capital outflows -- one of the most elusive items to pin down statistically. Estimates now at hand suggest that these flows, for the year as a whole, were almost as large as in 1960.

There were, however, clear and significant differences in the character of these outflows. In 1960, reflecting some uncertainty over the stability of the dollar, the outflow had been in considerable part of a speculative character, and the flows were quickly translated into a drain of gold. This disruptive speculation ceased early in 1961. There was, however, a continuing outflow of short-term funds over the first three quarters of 1961, related largely to an increase in the financing of foreign trade by American banks.

In the fourth quarter, a further outflow from this source was coupled with large shifts of liquid funds to foreign markets -- partly in response to interest rate differentials, and partly related to certain quirks in the impact of domestic and foreign tax treatment of earnings of American companies with operations in Canada resulting from changes made in Canadian tax laws during the

year. Some shifts recorded as an outflow were apparently promptly reinvested in the New York market by agencies of foreign banks. This again seems to be the case particularly with Canadian banks and their agencies. We cannot as yet pinpoint the relative weight of all these factors. There are serious questions whether our conventional classifications of short-term capital flows accurately reflect their true significance for the balance of payments. This difficult subject is presently a matter of intensive study.

Certainly, the fact that the exchange markets have been calm for months belies any implication that these recent outflows are a symptom of concern about the dollar. So does the fact that a much smaller proportion of the dollars flowing abroad was converted into gold during 1961. In addition early and necessarily fragmentary data for January indicate that these unusual outflows have ceased.

Strengthening the International Monetary System

Whatever their cause, the large flows of short-term capital since the institution of currency convertibility by major foreign countries provide evidence of the need to bulwark the dollar and the whole international payments mechanism against their potentially disturbing impact. In a world of convertible currencies and free markets, sizable flows of liquid funds between markets can be expected as a natural response to myriad changes in both our own and foreign economies. The danger is that, under certain circumstances, they may set off self-propelling speculative movements.

During the past year, we have used three approaches in dealing with this problem:

For many months, the Treasury, operating within the framework of the newly created Organization of Economic Cooperation and Development, has been conducting fruitful consultations with other

financial powers on a periodic basis. These discussions have laid the foundation of common understanding and cooperation that is a prerequisite for effective international action to prevent, limit, or offset currency movements that could undermine a stable monetary system. They have been supplemented by Federal Reserve participation in the regular meetings of European central bankers at Basle, and by bilateral consultations with our principal financial partners.

The Treasury also has undertaken the purchase and sale of foreign currencies for the first time in a generation. These operations helped at certain critical periods to reduce incentives to shift funds abroad on a speculative basis or to take advantage of temporary differentials in the exchange markets. The Federal Reserve has also recently decided to undertake operations in foreign currencies, a development which we in Treasury regard as highly promising. Chairman Martin will be elaborating further on this approach during his testimony this afternoon. I look forward to our continued cooperation with the Federal Reserve in the international field, just as in the domestic area.

Finally, and most significant for the strengthening of the international monetary system, is the agreement reached among ten of the major industrialized countries to buttress the resources and capabilities of the International Monetary Fund by lending it specified amounts of their own currencies when necessary to cope with temporary stresses. This \$6 billion of standby facilities, including almost \$2-1/2 billion of European Common Market currencies, will both reduce the likelihood of a "run" on any member currency and provide the means to withstand the impact of a speculative attack should one develop. The new arrangements

will powerfully reinforce the effectiveness of the Fund, and could be of great assistance to the United States. Enabling legislation will be submitted to the Congress shortly.

Economic Security and Stabilization

The President has proposed a series of measures to promote greater economic security for all our people, to permit more of our citizens to share fairly in the growth of the economy, and to reduce the hardships and waste of recurrent recessions. Aid to depressed areas and worker retraining can help speed growth and eliminate pockets of hardship. Broadened unemployment insurance can both reduce personal misfortune and strengthen the "automatic stabilizers" that have helped prevent our postwar recessions from turning into full scale depressions. And, a reserve shelf of public works will strengthen our defenses against a possible future recession.

The President has also set before you a carefully devised plan for introducing an element of flexibility into our tax structure. The measure would facilitate a timely, but temporary, reduction in personal income tax rates, at his initiative, in the event of a serious business downturn. Its significance lies in the fact that a reduction in personal tax rates could speedily give a powerful boost to consumer spending power at critical junctures, when delay might permit cumulative downward forces to take hold. Adequate safeguards are provided, including strict limits on the amount and duration of any such tax reduction. This carefully circumscribed delegation of authority to the President, always subject to Congressional veto, would be a significant addition to our arsenal of anti-recessionary weapons.

The Continuing Challenge

The continuing economic challenge before us is clear: we must fashion the most effective arrangements possible to assure that our free economy will reach its unrivalled potential and enable us to fulfill our responsibilities for leadership in the free world. In meeting that challenge, we are acting in those areas where Government can appropriately and helpfully initiate new programs and policies. Equally important, we have tried to be conscious of those things Government cannot do, or that the private sector of our economy can do better.

The essential and unique characteristic of the American economy is the strength it derives from individual freedom for all of us -- as workers, employers, owners, and consumers. In shaping our program for the years ahead, we are working toward the sort of environment that will strengthen and preserve that precious heritage.

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EXECUTIVE OFFICE OF THE PRESIDENT
BUREAU OF THE BUDGET
Washington 25, D. C.

FOR RELEASE ON DELIVERY
Expected at 10:00 a.m.
Friday, January 26, 1962

STATEMENT OF DAVID E. BELL
DIRECTOR OF THE BUREAU OF THE BUDGET
BEFORE THE JOINT ECONOMIC COMMITTEE
ON THE BUDGET FOR FISCAL YEAR 1963

Mr. Chairman and Members of the Committee:

It is a pleasure to appear before you today to discuss with you the budget recently transmitted by the President for fiscal 1963.

Economic basis for the budget

The balanced budget transmitted for 1963 accords with our expectations with respect to the state of the economy. Specifically, we expect that the expansion which has already lifted the rate of gross national product by over \$40 billion since the first quarter of calendar 1961 will continue through the current year and beyond, carrying the gross national product during calendar 1962 to a record of \$570 billion. Personal incomes are expected to reach \$448 billion in calendar 1962, up \$30 billion from a year earlier, and corporate profits \$56½ billion, an increase of \$10½ billion.

The increase in the gross national product from the first to the fourth quarter of 1961 averaged well over 2½ percent per quarter. Our assumptions for 1962 will be realized even if the expansion slows down to an average quarter-to-quarter increase of 2 percent. Steady expansion at a rate of 2 percent per quarter should bring the rate of unemployment down

from its present rate of over 6 percent to about 4 percent by the end of fiscal 1963.

The current budget outlook

Under the President's recommendations, budget expenditures for fiscal 1963 will increase by \$3.4 billion over the level estimated for the present fiscal year, to \$92.5 billion.

TABLE 1. BUDGET SUMMARY
(Fiscal years. In billions of dollars)

Description	1961 actual	1962 estimate	1963 estimate
Budget expenditures:			
National defense.....	47.5	51.2	52.7
International affairs and finance.....	2.5	2.9	3.0
Space research and technology.....	.7	1.3	2.4
Subtotal.....	50.7	55.4	58.1
Interest.....	9.0	9.0	9.4
Domestic civil functions:			
Agriculture and agricultural resources.....	5.2	6.3	5.8
Natural resources.....	2.0	2.1	2.3
Commerce and transportation.....	2.6	2.9	2.5
Housing and community development....	.3	.5	.8
Health, labor, and welfare.....	4.2	4.7	5.1
Education.....	.9	1.1	1.5
Veterans benefits and services.....	5.4	5.6	5.3
General government.....	1.7	1.9	2.0
Subtotal, domestic civil functions.....	22.4	25.3	25.4
Civilian pay reform.....	-	-	.2
Allowance for contingencies.....	-	.1	.2
Deduct interfund transactions.....	.7	.7	.7
Total.....	81.5	89.1	92.5
Budget receipts, total.....	77.7	82.1	93.0
Budget surplus (+) or deficit (-).....	-3.9	-7.0	+5
Public debt, end of year.....	289.0	295.4	294.9

More than three-quarters of the increase in budget expenditures, or approximately \$2.7 billion, is accounted for by national security and space activities. Most of the remainder will be required for interest charges on the public debt. In total, budget expenditures for civilian programs for fiscal 1963 are virtually unchanged from fiscal 1962. The President is recommending increases in a number of areas, such as education and health, that will be valuable in terms of productivity of our human resources and long-run growth of the economy. This is made possible, with almost no increase in total civilian expenditures, by holding down or cutting back on some less urgent outlays.

Budget receipts in fiscal 1963 are estimated to total \$93 billion, an increase of \$10.9 billion over the recession-affected level of the present fiscal year. These receipts estimates assume extension of corporation income taxes and most excise taxes at present rates as well as the economic expansion described above.

The administrative budget for 1963 thus shows a modest surplus of about \$500 million. As a result, the public debt on June 30, 1963, is expected to be \$294.9 billion compared with \$295.4 billion at the end of the current year, furthering the decline of the outstanding debt relative to the gross national product, which has been going on since the end of World War II. The public debt, far from being an increasing burden on our economy, has declined steadily from the equivalent of about 130 percent of the GNP at the end of the fiscal year 1946 to a little over half the GNP at present.

Outside the administrative budget, trust fund expenditures are estimated to increase by about \$1 billion in fiscal 1963 (Table 2 attached). The largest increase is for benefit payments under old-age and survivors insurance, up about \$1 billion. Proposed legislation for medical care for the aged through the social security system is not estimated to take effect in time to affect 1963 expenditures. Regular unemployment insurance benefits from the trust fund will decline with economic recovery, and budget expenditures for temporary extended unemployment compensation are terminating. Outlays under proposed legislation for permanent improvements in unemployment compensation, however, are estimated to begin in 1963.

Trust fund receipts for fiscal 1963 are estimated at \$27.5 billion, or approximately \$3 billion more than in fiscal 1962. About two-thirds of this increase will be accounted for by the higher collections anticipated from higher payrolls and increased tax rates for Federal old-age and survivors insurance.

Federal accounts on the basis of the consolidated cash statement-- combining the administrative budget and trust fund programs along with certain other Federal transactions, and eliminating intragovernmental transactions--show an estimated increase in expenditures of \$3.7 billion and a \$14 billion increase in receipts, with an excess of receipts from the public of \$1.8 billion over payments to the public in 1963. This compares to an excess of payments over receipts of \$8.5 billion in fiscal 1962 (Table 3 attached).

Fiscal policy considerations

Federal receipts and expenditures on a national income account basis are summarized in Table 4 (attached).

Viewing the expenditure side first, several points might be made in assessing the impact of the 1963 budget on the economy. First, the projected increase in total spending of just under \$6 billion in fiscal 1963 follows on the increase of \$9 billion expected for the current fiscal year. Only a part of the latter increase has so far taken place.

The \$15 billion increase for the two fiscal years combined, for which expanded defense and space programs are in large part responsible,

represents half-again as rapid a rate of growth in Government spending as we have had on the average over the six years preceding. Second,

Federal purchases of goods and services are scheduled to rise more

rapidly than total spending, reflecting the proposed reductions in

postal and farm subsidies on the one hand and the increase in goods

bought for defense and space activities on the other.

The increase in purchases of goods and services as a percent of total

Federal spending reverses a steady downtrend that has characterized the

Federal budget ever since the end of the Korean conflict (Table 5

attached). While this change in the composition of Federal expenditures

is the net result of individual program decisions rather than any

deliberate effort to increase the fraction of the budget going into the

purchases of goods and services as such, it does have significance for

the economy. Other things being equal, purchases of goods and services

probably have a more direct impact on aggregate demand and a larger

total economic impact per dollar of Federal outlay than other categories of spending.

However, a greater economic impact per dollar does not necessarily mean that the purchase of goods is the most appropriate kind of expenditure for an anti-recession program. For such periods, as was the case in 1961, certain categories of transfer payments, such as extended unemployment benefits, may be easier to start quickly, may make their economic impacts more promptly, and relieve hardship more directly and equitably.

Turning to the other side of the ledger, Federal receipts in the national income accounts, since they are recorded on an accrual basis, respond more promptly than receipts in the administrative budget or consolidated cash statement to changing levels of income in the private sector. Thus, the rise in corporate profits tax accruals since the first quarter of 1961 has already wiped out most of the Federal deficit on a national income basis that was occurring at the trough of the recession.

In national income terms, we estimate a Federal deficit of only \$0.5 billion in 1962, compared to deficits of \$7.0 and \$8.5 billion in the administrative budget and consolidated cash statement, respectively. For fiscal 1963, the estimated national income surplus of \$4.4 billion compares with much smaller surpluses of \$0.5 billion and \$1.8 billion on the administrative budget and consolidated cash bases.

I have been asked from time to time whether the switch from Federal deficit to surplus with economic recovery will not "pinch-off" the

recovery short of full employment, as is generally agreed among economists of a variety of persuasions to have happened on the road to recovery from the 1958 recession. We do not believe this will happen this time, and there are two points I would like to make in this connection. First, the turn-around in fiscal policy will not be as sharp as in the last recovery. The "pinch-off" in 1959 and 1960 was not wholly a matter of automatic built-in stabilizers. It also involved a cutback in defense and other Federal spending, and increased tax rates for gasoline and for social security payroll taxes. Administrative budget outlays fell by almost \$4 billion in fiscal 1960. By contrast, fiscal 1963 budget expenditures will be \$3.4 billion higher than in fiscal 1962. The consolidated cash statement swung from a deficit of \$13.1 billion in fiscal 1959 to a surplus of \$0.8 billion in fiscal 1960--a net change of just under \$14 billion. This time, the total swing from deficit in 1962 to surplus in 1963 is estimated at \$10.3 billion on a consolidated cash basis.

Second, there is no reason to expect the sharp change towards a tight money policy that took place in the last expansion. With the good record on price stability so far in this recovery, and with the absence of any indication of an early resumption of inflationary pressures, the monetary authorities, within the constraints imposed by balance of payments considerations, should be in a better position to continue their policy of monetary ease than they have been in previous postwar recoveries.

With both fiscal and monetary actions expected to be less restrictive on the economy in the coming year than they were during the previous economic recovery, the 1963 budget can be characterized as expansionary without being inflationary. An increase in Federal spending is in prospect, but the annual budget figures do imply a slowdown in the rate of increase sometime in calendar 1962. In addition, the payroll tax rates under the old-age and survivors insurance program will be increased under present law by an annual rate of approximately \$2 billion on January 1, 1963, and this will have a restraining effect on private demand.

Although the administration is rather confident about the economic outlook and the economic assumptions underlying the budget, we cannot be dogmatic about such matters. The possibility of a more vigorous or a less vigorous expansion cannot be ruled out. Perhaps the most important factor in our confidence about the performance of the economy in the long run is the fact that the present administration remains alert to developing economic trends, and stands ready to change its policies when the evidence shows this is appropriate.

As you know, the President has requested three major steps to increase the built-in stability of our economy--strengthening of the unemployment insurance system, standby authority to initiate a temporary expansion of public works, and standby authority to cut personal tax rates for recession periods. We do not expect a recession in the period covered by this budget that would call for the use of these weapons. But as the President stated, "the time to repair the roof is when the sun is

shining." I hope this Committee will give its wholehearted support in setting up this new policy machinery.

The new budget document

We have received and are studying with interest the very recent staff report of this Committee on the Federal budget as an economic document. It is an excellent report on the data economists need to analyze issues of public finance, and should prove helpful to us in making future improvements in the budget document. Some of its recommendations follow similar ideas of our own that are already incorporated in the new document for 1963.

This administration is certainly sympathetic to the general philosophy underlying your staff report, that the budget process must be useful for purposes of economic analysis, as well as for budgeting in the traditional and most important sense of assessing the proper level of Federal expenditures to meet defense, international, and other national needs, and of calculating revenue requirements and availability. There is increasing recognition of what economists have long held--that the Federal budget can and should be used for economic stabilization, and to promote economic growth, equilibrium in our balance of international payments, and efficient allocation of resources. The budget document should be a vehicle for promoting intelligent public discussion of these and other economic questions.

In the new budget document for fiscal 1963, we have taken a number of steps along these lines. For one thing, the budget contains a more

comprehensive and explicit discussion of the economic assumptions underlying the revenue estimates. Second, we have included in the budget document a translation of Federal fiscal activities into the national income terms more familiar to economists--an alternative presentation of the budget totals more indicative of the direct impact of Federal activity on current incomes and output in the national economy. The very recent statement of the Committee for Economic Development, "Fiscal and Monetary Policy for High Employment," has, in fact, recommended the national income basis as the most useful single way to express budget totals for the purpose of evaluating fiscal policy. Third, we have incorporated in the document new tables, including summaries of obligations incurred, of Federal civilian employment, and the investment character of Federal budget expenditures. Fourth, we have put back into the document itself certain special analyses that are particularly useful for analyzing the economic character of the budget, such as those on public works, Federal credit programs, research and development programs, and Federal aid to State and local governments. Finally, the new format (and I might add, the lower price) of the budget should promote wider public use and understanding.

In considering further improvements in the budget document, we will of course continue to welcome suggestions. However, I believe we must agree that much more than a modification of the budget is involved in improving the flow of data on the economic aspects of Federal activities. Reports and documents prepared by various Federal agencies,

including those directly involved in carrying out important Federal programs, must also share this responsibility. Moreover, a large part of the economic analysis of individual Federal programs must continue to be a part of the budget review process within the executive branch and in testimony of responsible agency officials before the Committees of the Congress.

TABLE 2. TRUST FUND SUMMARY
(Fiscal years. In billions of dollars)

Description	1961 actual	1962 estimate	1963 estimate
Trust fund receipts:			
Federal old-age and survivors insurance trust fund.....	11.9	12.3	14.2
Federal disability insurance trust fund.....	1.1	1.1	1.2
Unemployment trust fund.....	3.8	3.6	4.2
Railroad retirement account.....	1.1	1.1	1.2
Federal employees' retirement funds.....	2.0	2.1	2.1
Highway trust fund.....	2.9	3.1	3.4
Veterans life insurance funds.....	.7	.7	.7
Other trust funds.....	.8	1.0	1.0
Subtotal.....	24.3	25.0	28.0
Deduct interfund transactions.....	.5	.5	.5
Total, trust fund receipts.....	23.8	24.5	27.5
Trust fund expenditures:			
Federal old-age and survivors insurance trust fund.....	11.8	13.3	14.3
Federal disability insurance trust fund.....	.8	1.1	1.2
Unemployment trust fund.....	4.7	3.8	3.9
Railroad retirement account.....	1.1	1.1	1.1
Federal employees' retirement funds.....	.9	1.0	1.1
Highway trust fund.....	2.7	3.2	3.4
Veterans life insurance funds.....	.8	.7	.7
Federal National Mortgage Association trust fund, net.....	-.1	.9	.5
Deposit funds and all other trust funds.....	1.0	.9	1.0
Subtotal.....	23.8	26.0	27.1
Deduct interfund transactions.....	.5	.5	.5
Total, trust fund expenditures.....	23.2	25.6	26.6
Net accumulation.....	.6	-1.0	.9

January 26, 1962

TABLE 3. RECEIPTS FROM AND PAYMENTS TO THE PUBLIC

(Fiscal years. In billions of dollars)

Description	1961 actual	1962 estimate	1963 estimate
<u>Receipts from the public:</u>			
Budget receipts.....	77.7	82.1	93.0
Trust fund receipts.....	23.8	24.5	27.5
Less:			
Intragovernmental transactions.....	4.2	4.0	3.9
Receipts from the exercise of monetary authority.....	.1	.1	*
Total receipts from the public.....	<u>97.2</u>	<u>102.6</u>	<u>116.6</u>
<u>Payments to the public:</u>			
Budget expenditures.....	81.5	89.1	92.5
Trust fund expenditures.....	23.2	25.6	26.6
Government-sponsored enterprise expenditures (net).....	-.2	.5	.3
Less:			
Intragovernmental transactions.....	4.2	4.0	3.9
Accrued interest and other noncash adjustments (net).....	.8	.1	.8
Total payments to the public.....	<u>99.5</u>	<u>111.1</u>	<u>114.8</u>
Excess of receipts (+) or payments (-).....	-2.3	-8.5	+1.8

* Less than \$50 million.

January 26, 1962

TABLE 4. FEDERAL RECEIPTS AND EXPENDITURES IN THE NATIONAL INCOME ACCOUNTS

(In billions of dollars)

Fiscal year	Expenditures			Receipts	Surplus (+) or deficit (-)
	Purchases of goods and services	Other	Total		
1953.....	56.8	19.6	76.2	69.9	-6.3
1954.....	53.9	20.6	74.5	65.9	-8.6
1955.....	45.0	23.0	68.1	67.0	-1.1
1956.....	45.2	24.3	69.5	76.3	+6.8
1957.....	48.3	28.3	76.5	80.9	+4.4
1958.....	50.5	32.2	82.8	77.8	-4.9
1959.....	53.8	36.5	90.2	85.4	-4.8
1960.....	52.9	39.0	91.9	94.1	+2.2
1961.....	54.6	42.3	97.0	94.8	-2.2
1962 estimate.....	60.2	45.9	106.1	105.6	-.5
1963 estimate.....	64.2	47.7	111.9	116.3	+4.4

January 26, 1962

TABLE 5. RELATION OF PURCHASES OF GOODS AND SERVICES
TO TOTAL FEDERAL EXPENDITURES

(National income accounts basis)

<u>Fiscal year</u>	<u>Purchases of goods and services as % of total</u>
1953.....	74.5%
1954.....	72.3
1955.....	66.1
1956.....	65.0
1957.....	63.1
1958.....	61.0
1959.....	59.6
1960.....	57.6
1961.....	56.3
1962 estimate.....	56.7
1963 estimate.....	57.4

January 26, 1962

Office Correspondence

Date December 18, 1961

To Mr. Martin

Subject: Statement for Joint Economic

From Chas. Molony

Committee

Although your 1962 appearance before the Joint Economic Committee is nearly 1 1/2 months away, preliminary preparations for your statement and testimony ought to begin now, with an alert to key staffers on the material you'll want to have in hand -- by the end of the first week in January, if possible .

Bearing in mind that your statement must serve as (1) the really timely review and annual report of the Board, (2) the position setter not only for Federal Reserve operations over the last year but those in prospect, and (3) the base for your subsequent testimony in response to questions, it seems to me the following materials will be essential:

1. From Mr. Noyes ✓ - A review of overall developments in 1961, stressing the financial over the economic. Preferably this would be an analysis of the flow-of-funds over the period, such as you used to background your statement covering 1959. This review should be the opening part of your statement, and be the backdrop for your subsequent remarks.
2. From Mr. Thomas ✓ - A review and analysis of open market operations in 1961. This should be the core part of the entire statement. As there were no discount or reserve requirement actions in 1961, here you will have the best -- and most timely -- opportunity in years to give a really good, undistracted account of the Federal Reserve's use of its most important instrument. Because the subject is so big and so crucial at this time, perhaps the best thing to do is to tell Mr. Thomas the importance you attach to developing everything of significance (certainly including the scale of Federal Reserve operations outside of short-terms, and perhaps Treasury operations as well, if the combined figures add light to the story), and then give him full scope to develop it.
3. From Mr. Young ✓ - The international financial story, not only for balance of payments and international flows but also for the international "cooperation" arrangements -- a situation that's sure to draw some questions, and therefore one that had better be told at least in essential outline so as to facilitate the handling of questions. Since you may be setting a position here with future bearings, perhaps here, too, the best thing is to give Mr. Young the dimensions of the job and whatever scope he needs for developing the significant.

4. From Mr. Wernick (or through Mr. Noyes) -- Significant employment-unemployment developments and prospects, with attention to anything (cyclical-structural unemployment included) that the Joint Economic Committee shows an interest in during the hearings it opened on this subject today (December 18). At an absolute minimum, you'll need to show an awareness of and an interest in what's happening in the employment-unemployment field.

5. In addition, the change in Regulation Q will need some coverage in the statement to give some necessary perspective before the questions start on this subject. We're already in shape to cover what the Board had in mind in making the changes in Regulation Q, but could Research, Bank Examinations or the Reserve Banks furnish material on what the member banks have been doing in follow-up to the permissive action? You're sure to be asked about that, and we'll look bad if we don't show we've been interested enough to follow-through on what the banks did in consequence.

There may be other matters needed in the statement, but I'd think the above would cover the really essential, pertinent matter -- and I'd think it best not to clutter up with anything not essential, even though it may be a topic for questioning -- as, for example, tax questions (depreciation allowances, taxation of overseas firms, of savings and loan associations, etc.).

Also, I'd think it well to leave out reference to the report and recommendations of the Commission on Money and Credit, even though questions on this subject undoubtedly will be asked of you. If you do want to say anything in the statement about Federal Reserve structural matters, I'd think you'd want to weave it in with the open market operations, where it might stand as indirect comment unconnected with the Commission's report.

1. Pick to bill Ted Sorensen

2. Pres Ec. Message

A. Acceptable

B. Need of Study

C. unacceptable

3. Administration Bill

U. Corps

Flexible tax credit

Debt limit

4 yr co terminous term

Study groups

Deerson

head

subsidies

December 19, 1961.

The Honorable Wright Patman,
Chairman,
Joint Economic Committee,
Congress of the United States,
Washington 25, D.C.

Dear Mr. Chairman:

Thank you for your letter of December 14,
and the afternoon of Tuesday, January 30, is
agreeable to me for the hearings before your
Committee on the President's Economic Report.

May I take this opportunity to wish you
a Very Merry Christmas and a Happy New Year.

Sincerely yours,

Wm. McC. Martin, Jr.

cc: Mr. Shay
Miss Muehlhaus ✓

WMM:mmm

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Congress of the United States

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DIRECTOR AND CLERK

December 14, 1961

Mr. Tolson

EW

Mr. William McChesney Martin, Jr.
Chairman of the Federal Reserve System
Washington, D. C.

Dear Mr. Martin:

We expect to receive the President's Economic Report next year on or about January 20 and the Committee would like very much if you would be one of the earlier witnesses.

Accordingly, we would like to schedule your appearance for the afternoon of Tuesday, January 30.

Please let me know whether or not this meets with your convenience.

Sincerely,

Wright Patman
Wright Patman
Chairman