THE CURRENT NATIONAL ECONOMIC SITUATION

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GENERAL QUILL: Gentlemen: During his 1962 state of the Union address, President Kennedy emphasized the importance of our subject for today. The President devoted considerable attention to the current national economic situation, which is the title of this morning's lecture. He focused his remarks on inflation, unemployment, tax revisions, trade, and legislation designed to prevent a reversal of our rising economy.

Our speaker will present this analysis of the current economic situation in the United States, and a projection of trends for the immediate future. His current position as Vice Chairman of the Manufacturers Hanover Trust Company keeps him in close contact with the economic pulse of our Nation, and his distinguished background in education, government, and industry, bespeaks his qualifications on today's topic.

It is a great pleasure to welcome for his third lecture to the Industrial College, Dr. Gabriel Hauge. Dr. Hauge.

DR. HAUGE: General Quill, Gentlemen: It is a pleasure for me to return to this lectern and to resume a discussion of a subject which, I take it, will be a matter of interest for each class and for each one of us each year. As General Quill has indicated, I am now engaged in the banking business after having had an opportunity to serve here in Washington, and after having spent some years in the academic world. And so, as I look upon this question of developments in our national economy, the likely course of those developments, and how we privately and publicly can influence the course of those developments toward certain agreed ends, I trust that I can bring to this discussion something from each of those different experiences. I hope I shall not be too practical; I hope I shall not be too theoretical; I hope I shall not be too filled with recollections of things that perhaps have not come out quite as I thought they would in the past, and not take too much satisfaction from, perhaps, some expectations about future developments that have been borne out.

As I said, I am in the banking business and you know in the banking business we deal in money. We try to get hold of it and once we get hold of it--by legitimate means, that is--we try to put it out to work. And after we put it out, we hope for two things; one, to get paid back, and two, to get paid something for having put it out. We get paid something called a rate of interest. We pay people for giving us funds unless they are demand deposits, and we get something in return. That something we get in return covers our expenses, and some reward for people who invest in our business.

Some time ago a letter came to our bank from a correspondent banker in Texas. He said he had been trying to get across to people the basic notion of what an interest rate was; what its function was in our kind of market economy, and it was not always easy. Two prices in our economy, he said, seem to evoke all sorts of emotional reactions that made it hard for people to see them steadily and see them whole; one was the price of money and the other was the price of labor, and if we could only look clearly and quietly at those two prices in our economic system, and set them intelligently, we probably would solve all of our other problems. Well, it is an interesting thought. But he went on to say that to illustrate the difficulty of getting the nature of interest rates across to his visitors, he recalled the story of two college graduates who had been roommates and who came back to their 10th reunion. In college one of them had been very bright; he had had a fine academic record, he was excellent in mathematics and finance, personable, and made friends easily, generated confidence and trust in his own judgments and conduct, and for him an excellent career was predicted in business.

His roommate was a big, happy-go-lucky type, rather much of a lazy loafer as far as the academics were concerned. He devoted most of his time to extracurricular activities; could not understand mathematics and finance at all--they were Greek to him--and very little was predicted for him as far as success in business was concerned. But lo and behold, when they came back to the reunion, it was this latter fellow who came in the biggest, blackest Cadillac, wearing the most elegantly tailored clothes and obviously looking very affluent indeed.

The other fellow came back with a bit of a hangdog attitude; his clothes were shiny, rather old; he seemed to have lost a good deal of his old glamour. Well, the successful one was asked, "What in the world have you done to fool us all?" "Well," he said, "it's very simple. I went into the manufacturing business, I make something for the kitchen. The housewives of America love it. I manufacture it for $1, I sell it for $4, and it's wonderful what the 3 percent adds up to."

Gentlemen, I want to talk with you today about the economy, about its present status as I see it, where it might be going, and what we should or could be doing to influence its course constructively. I understand that this subject was introduced to you yesterday and I hope that some of the things that I say will perhaps be relevant to some of the things that were said yesterday.

I want to pull back for a moment and try to set the stage for my discussion in terms of certain basic assumptions. The economy, simply defined, is that organization of our society for getting and spending; for taking resources, combining them, and putting them to use to produce things that we as a people and we as a free world want. As we scan the horizon on the world today we find that people have organized their societies in a variety of ways to achieve the solution to this economic equation.

On the one extreme we have Red China, which, as far as we can tell, has taken most literally the organization of a directed economy, although apparently there has been some relaxation. We come across to Soviet Russia, dedicated to that general idea of organization with a central direction of decision making, though it also apparently has relaxed somewhat from earlier notions. We encounter an economy like that of Yugoslavia which has introduced still more market price relationships into its directed economy. Then we move further through the spectrum, through Scandinavia where we still have avowed Socialist Governments, Labor Governments, which have remained in power since the end of the war but as far as I can see, the reason they have remained in power since the end of the war is that they are not very doctrinaire in their socialism. Then we move through countries like France and Britain which still have some of the aspects of a directed economy. We move, then, to West Germany, the United States, and Canada, which I suppose, represent in our present modern-day world the major countries with so-called market economies where decision making with respect to economic matters is highly decentralized in millions of centers--on farms, in businesses, in professional offices throughout these lands.

Now, in our country we have a mixed economy, obviously, but fundamentally, the decisions to spend, to save, to invest, to direct resources, lie in the hands of individuals. I say this realizing that we have enormous public budgets, but a great deal of those public budgets are devoted to purposes which would not be of interest to the private decision-making process; the whole security operation of the United States, the provision of roads, schools, and of many of the public amenities that we must organize on a common basis. There is an element--a small element--in our budgets, which does represent encroachment, some people would say, upon private decision making, and this is what the debate is about in domestic politics on economic policy.

But fundamentally we approach this matter of economic decision making in these terms. And I think it is important to say this because you cannot run a so-called "free enterprise economy," a so-called "private decision making economy" and not have private decision making really function. The art of government, or the art of influencing a private economy is a very subtle and delicate one indeed.

The tools we have available are oftentimes quite blunt, in terms of government regulation, which often deter rather than stimulate. The genius of government in our kind of society is to find out how this extraordinarily sensitive, highly decentralized decision-making process can be touched in constructive ways to achieve goals that represent a common consensus in our country.

Now, starting with that basic assumption--and this is agreed in America; both political parties, certainly, except for a very, very tiny element in our political groupings, would start from that assumption. So, the debate is about how we do this thing. Now, as I look out around the economic horizon today I must make certain assumptions about the international situation because obviously that is going to color what we can expect in our domestic economics.

As far as the international situation is concerned this is the planning assumption that we in our bank with some $5 billion of other people's money for investment and safekeeping have adopted: that the world situation for this year--and we are talking about this year in the near term--will probably continue, in Lenin's phrase, "Not a war and not peace." We assume a nuclear war possibility, though a very small one, but we do not exclude the possibility of some kind of involvment that could have sharp, shortrun effects upon certain sensitive markets, financial, commodity, and security. As we try to plan for this year, our assumptions run something like this; no war over Berlin, but stepped-up Soviet efforts to destroy NATO and so undermine world confidence in the power and leadership of the United States;

divisive brink-of-war maneuvers by the Soviet to neutralize or absorb all of Germany--and this poses for us the fundamental policy which our Government has promulgated and made very clear, the need to keep Western Germany more tightly than ever, bound to the West.

Next, while we enjoy the reports, we count on no real chance of a breakup of the Moscow-Peking axis. We count on new Red stabs at exposed nations in southeast Asia, Africa, and Latin America, based on a rigid strategy and flexible tactics; action such as in SouthVietnam might be expected to bring a strong reaction from our Government in view of its experience and Cuba and in Laos. A succession of Red nibbling operations could lead gradually to a Korean war-type economy with controls on wages, prices, consumer and other credit, and an excess profits tax. These are possible planning assumptions. The latter one I do not myself consider imminent, as I shall discuss later but it is something we cannot exclude from one of the outer circles of our thinking.

Now, the relevance to the business picture--to the economic picture--of all this, it seems to me about as follows. The impact on the economy--on business, on business turnover--is apt to be one of stimulus rather than one of deterioration as a result of this international situation. I base that on the fact that it has led to rather sharply increased budgets for the security of the United States. It has led to redeployment and increase of our forces outside the United States, with certain financial impacts on our balance of payments. And this planning assumption leads me to the conclusion that we will have from that source a stimulus rather than a deterioration. You could have a deterioration in the short run if there were a very great feeling of caution developing with respect to business planning and business expenditures growing out of this sort of situation. There is some of that and I shall talk about that in a minute. But it comes, I believe, from other reasons.

Secondly, in evaluating the course of the economy we have to make some assumptions about our international financial and trade position--our balance of payments. This matter has come to have a great degree of visibility in informed circles within the United States in the last two or three years. It is a good thing. I remember during my years in Washington, the then Secretary of the Treasury, George M. Humphrey, presented to a Cabinet meeting a report in which he laid out the growing volume of short-term liabilities that we had in terms of dollar claims on us by overseas holders, and the free gold that we had available to meet them. Well, this was about 1955, I think, or 1956, and nobody paid much attention. But I wrote to George Humphrey a few weeks ago and recalled the situation. I reminded him that prophets are seldom heard on their first utterance. But we have felt, now, for three years at least, the pressure from this source upon our economic life.

As far as a planning assumption regarding this matter for 1962, I would say that there is no solution in sight to our balance of payments deficit problem, although its size should be kept below the $3.5 to $4 billion levels of the period 1958, 1959, and 1960. Now, we had a rather discouraging development in the fourth quarter of 1961, as you know, which has lifted the balance of payments deficit for that period up into the range of $2.5 billion from something half a billion dollars less than that, and, of course, much more if we do not count the help from the advanced repayment of certain indebtedness by Germany and others in that period.

I do not, on the other hand, share the view that I hear expressed sometimes in Wall Street, that we may have a gold crisis in the spring. I do not, myself, see any basis for that, nor do I expect any dollar devaluation to be seriously discussed or certainly any action taken in the period that one can see ahead. The fact of the matter is that we need a surplus on trade account of at least $6 billion and perhaps more, to keep our balance of payments in order--$6 to $7 billion perhaps. And by that I mean, as you doubtless know, a surplus of goods and services exported over the volume imported. Now, we have achieved a $6 billion surplus and somewhat better than $6 billion a few times. In the first quarter of 1960 we achieved a trading surplus of $6.3 billion. But it has been declining since that time and is apt to continue under pressure during this year because our economy is in a rising phase; our import appetite is being whetted to service the needs of a growing economy.

The fundamental aspect of solution to the balance of payments problem, of course, as the President announced in his state of the Union message and as was set forth in the report of the Council of Economic Advisers the other day, is to increase this trading surplus; to get up to this $6 billion again, or get it up to $7 billion. Then we can hope to carry the present expenditures for our security objectives overseas as well as to permit investment and our mutual security programs on economic accounts that still involve export dollars to go forward.

Now, there are not very many secrets about this business of increasing the trading surplus. It is all pretty plain, old-fashioned stuff. You develop a trading surplus by having goods and services to sell that people want overseas, to sell them at an attractive price, and to sell them on credit and delivery terms that interest overseas buyers relative to our competitors. There isn't any razzle-dazzle gimmickry that can get around those fundamental matters. I sometimes think that too much of our finest intelligence goes into the set of problems which is pretty simple. It means interesting more businessmen in export markets. It means interesting labor union leaders in the price and cost factors that go into the determination of prices. It means interesting our financial institutions in fully participating in the financing of overseas credit, and where governments overseas intervene with extra financing facilities, then we must competitively do the same as the Export-Import Bank is now in the process of doing under legislation which the Congress enacted, I believe, last year.

This, of course, has led the President to his rather dramatic proposals in the trade field in order that we can cope with the problems of the Common Market and secure to our goods ample access into that tremendously developing area where a consumer goods revolution is going on of extraordinary scope and scale. Beyond that, we, of course, are going to have to cope with this problem of short-term capital movements. That's an elegant phrase. It refers to the fact that people in this day and age of currency convertibility can move their money around freely among the great money centers of the world, and with their sharp pencils seek to get the best rate of return in those various markets. We must have adequate mechanisms and resources to cope with these enormous waves of liquid assets, of money shifting from one international currency into another, so that they do not upset and come to be a threat to the validity of any particular currency rate. I think we have made progress in this field.

The amount of consultation by central banks has been stepped up, and I think it is in the hands of first-class people. Our Federal Reserve System now, is represented at the meetings of the Bank for International Settlements, at Basle, every month. I understand also that a group led by a high-ranking officer of this Government--I believe he is from the Treasury--attends the monthly meetings in Paris, of Working Party Three of the Organization for Economic Cooperation and Development, which is designed to try to exchange information among the countries of the OECD as to their domestic and foreign economic policies.

The prospect of further reducing the balance of payments impact of our aid and military programs, I think is not very great. We have proceeded quite a way along that line already. I understand that "Buy American" now comprehends about two-thirds of our expenditures on such aid procurements. And the economies that can further be effected by our military expenditures overseas, I think, would be very small, except as they can be offset by such things as the procurement of new amounts of military equipment by such countries as the Federal Republic of Germany in this country.

When you talk to Europeans about this problem of ours they give you two general ideas, neither one of which seems to me to be awfully acceptable. One, that we control capital movements--in other words, that we set up, as the British have, a government committee which would have to approve any overseas investment that involved an outflow of dollars from any firm in this country to another country. Or, that we would, in effect, put on some kind of controls with respect to short-term capital movements. I don't think we can do this and have our kind of economy, and foster the forces of adjustment which are the fundamental answer to this question; that is, being competitive in prices and in costs with the other nations.

Another notion that evolved at the Vienna Conference of the World Bank, in the fund, last autumn, was a cut in our foreign aid program. One heard that among Europeans, and it bothered me. I sometimes thought that it was a recommendation to ease their own conscience, since they are not coming forward--at least some of the countries are not coming forward--adequately with what they ought to do in this area. If everybody could be leveled down apparently then nobody would have to be leveled up. This does not seem to be to be a particularly sound solution to the kinds of problems we have. Nothing is more trying, I would suppose, and more difficult for those people working directly with it, than to use effectively the amounts of money that are appropriated by the Congress, for what is called "economic aid." It is a tremendously difficult task. But I see no alternative myself except to help these new nations in the world try to work out their destinies.

I try to put it this way myself. I heard that originally from Sir Leslie Rowan who was then with the British Treasury. He is now managing director of Vickers, one of the really great minds of the United Kingdom. He said, "These nations must not make their choice between freedom and communism in an atmosphere of economic stagnation and hopelessness. They must feel that there is some light at the end of the tunnel, and that by pursuing policies and courses involving freedom, that they can get further down there." Now, we have had some setbacks--Ghana. I don't know; I have met this fellow Nkrumah, but he has certainly gone wrong someplace. There is the Guinea situation and a couple or three other situations. I really do not see any alternative, however, but to try to help these peoples within reason make this choice between freedom and slavery in an atmosphere free of stagnation and economic hopelessness. That is about the best way I can put it. Now, that is strategic; that is not tactical. The tactics are frightfully difficult, I know, but I see no alternative to trying to devise them.

The implication of this brief review of the balance of payments situation for us in 1962, I think, is this. We are going to continue to have to pursue policies in our Federal Government, in our monetary and in our budget policies, keenly attuned to apprehension overseas by holders of $21 or $22 billion of dollar assets who can turn them into other currencies. We are going to have to persuade them that we are dedicated to getting at this balance of payments problem, to keeping our dollar sound so that this will be a currency in which they can repose confidence and leave their assets here earning interest. I think we can count on the fact that these foreign holders of dollars are not anxious to start a run on the dollar either. However, they will if they get scared enough. And I believe that the January documents of the President, while I think his budget estimates are going to require a great deal of boom in the economy to make the revenue estimates come out, reflect a real attempt to face up to this problem. And I have felt from the first, that President Kennedy--whom, I should confess to you, I did not vote for--has, from the first, indicated an understanding of this balance of payments problem as it relates to our standing in the world, to our gold supply, and to our competitive position. I think his problem, as it is the problem of anybody who sits over there in that White House, is to try to persuade other people whose loyalties are to lesser causes and to lesser groups, and to narrower slices of our economy, that they ought to get in line and look at the big picture, but that unfortunately is not what they get paid for.

It is a very, very trying thing for Mr. Number One, to try to hitch all these people with lesser purposes and lesser goals, to see the broad objective. Now, I do not expect a gold crisis this spring. I do not expect interest rates to have to be run up sharply to hold foreign dollar assets in this country. And I am very hopeful that we can continue to make some progress in adult education among various sectors of our economy so that we understand the need to stay competitive in cost and price.

With respect to the budget outlook, this has been very much reviewed in recent days. My own comment is that as far as a planning assumption for 1962 goes, we are going to move from a rather large deficit--much larger than expected--to at best, a balance, probably a deficit of some manageable size, and most probably not a surplus. This in itself will not be catastrophic for the balance of payments or for business, but it bothers me in this sense. This Administration a year ago, as did the preceding Administration, had announced as its budgetary purpose the balance of the budget over the cycle. That is, to let the budget run into deficit when recession contracted revenues, but to budget so that surplus would be available on the up side in order that the debt could be paid down in good times.

If I understand this new budget document, we are not going to balance the budget over the cycle; we are going to balance the budget only in our best year. This represents in a period of 1 year a significant change, it seems to me, and I have been trying to speculate about the implications. Last year we were told that this kind of a budget policy would be helpful because it could permit a less restrictive monetary policy in good times. In other words, if you had a good budget surplus when the economy was booming that would exercise a restrictive force upon the economy by taking out more income than was being put back in, with the difference being used to pay down debt. That circumstance would permit the Central Bank to pursue a less restrictive monetary policy, let interest rates tighten up less, let bank reserves tighten up less.

If we are not to have any budget surplus in our best year what are the implications for monetary policy? Does it mean, then, that monetary policy will have to be tighter than it otherwise would? I do not know. It is something that we will have to wait and see how it develops. The expenditure side of the budget, it seems to me, is rising at a very rapid rate. I do not myself take any comfort from the fact that we have already jumped from $80 billion to $92 billion in a little over a year of the change of the administration, and that we will be at $100 billion very, very soon. I know that there are many billions of defense expenditures in this total and I am sure that those increases have been very carefully worked over, but I take no comfort at all in this very rapid increase in the public sector of spending. I do not take any particular comfort in the fact that percentage relationships with some kind of gross national product is going to be held constant.

That may be all right statistically, but I do not think it impresses the people in our economy who make investment decisions. Once these levels of expenditures rise they never come down. That means we are going to have larger deficits in recessions. It is going to be tougher and tougher to find any surplus out of which to make the revisions in our tax system that are so fundamental to economic growth which all of us in this country want.

Now, having said that, I do, however, want to say that I think the emphasis in the new documents on attempts to spur investment is a constructive move. And I believe that the proposed revisions in schedual F, of depreciation allowances for tax purposes, look constructive to me. I rather regret that during the time I served here in Washington more progress was not made with respect to the impingement of the taxes on investment, because, as far as we understand the matters of growth, this is a key aspect.

The relevance of the budget, then, it seems to me, will generally be--in this year--perhaps a neutral factor, even though there may be something of a surplus or more likely a deficit of some scale. It could have provided a much larger expansionary force in the short run, presumably, had there been a large planned deficit. The President very wisely took into account the adverse effects of that alternative. Here he perhaps had to balance a variety of considerations and it looks to me like he came out well. But I believe he's finding himself now in a situation where he can balance his budget under only the very best circumstances of the economy, that he will not have surpluses, that he will at best have deficits and balances, and this is a new situation from a year ago and we will have to see what the implications are.

As far as monetary policy is concerned I would expect it to continue to be flexible. I would expect the Federal Reserve to continue to provide reserves to the banking system that will expand the money supply somewhat more and generally keep interest rates from rising very much this year. Judging from the experience in our own bank there has been rather little pep in the demand for loans so far in this recovery, now almost a year old. This, of course, is a little bothersome to me as I look at these rather rosy predictions of the economy reaching $570 billion in the second quarter of this year.

The stock market, as you know, has had one of the worst Januarys in many, many years. I was talking yesterday, at our board of directors meeting, to a member of one of the leading Wall Street firms, who is on the floor every day. He said everybody wants to sell and not very many people want to buy. The market is thin and the prices show it. There is a certain kind of caution that is very evident in these centers, even though such overall figures as consumer spending and some other general indicators are still looking very good. I would hope that the demand for loans by business for restocking and for construction money for new plants and equipment would begin to show up in good volume. Then I would begin to feel better about the levels of economic activity that we have been promised for this year.

Now, with respect to the performance of the economy, my own estimate is that the first half of 1962 should see a good advance, perhaps bringing business turnover as a whole to a level of $560, possibly $565 billion. That would be somewhat under the $570 billion which the documents of the early part of January to the Congress have suggested. There was a loss of momentum last autumn, but there has been a recovery from that; a strong period late in the year. The sources have been mainly Government spending, some rebuilding of inventory, and a strong level of consumer income and a good level of consumer spending. Industrial capacity has been moving up as far as its rate of use is concerned, but I do not know of a single important product or important material that is even approaching short supply. There may be specific ones that are not a major item, but as I view it through our loan accounts, through a great variety of businesses, there still is a rather full availability of most kinds of equipment, of most kinds of materials and products.

That brings us, then, to this matter of corporate profits. The budget is projected on the basis of $56.5 billion of corporate profits in calendar year 1962, to yield revenue at 52.5 percent, bringing this budget into a $500 million surplus. I do not see it as of now. There has been a nice improvement from the $39 billion of the first quarter of 1960 and the $45 billion the first quarter of 1961. There has been in the fourth quarter of 1961 a further improvement, perhaps exceeding the previous level of some $51 billion annual rate back in 1959. I would think corporate profits might get up into the range of $54 billion, with a good strong recovery in the first half. This, of course, could be affected one way or the other by a steel strike which the Administration is now in the process of trying to avoid, and goodness knows, we all wish them well in that endeavor, provided it is a settlement that is a viable settlement and one we can live with.

The extent of the business recovery, it seems to me, will be determined, in the final analysis, by whether or not business begins to cut loose on expenditures for plant and equipment. And this is a difficult one to predict because there is in the works a pair of factors that could affect this outcome rather substantially. I am referring again to the Treasury's proposals for an 8 percent investment credit on new equipment expenditures and the liberalization of the depreciation schedules for various categories of heavy goods. Perhaps one of the reasons leading to certain caution currently in expenditures in this field is anticipation of what the tax situation might be later on. If that is the case, of course, we are simply getting a postponement of what will come along in due course.

If these two elements are brought into the picture in 1962, they could have a fairly important stimulus, provided that other factors were not already beginning to look a little bit cloudy as far as the business situation is concerned. My own estimate, therefore, is that second quarter gross national product will be in the vicinity of $560 billion, perhaps--something of that sort--and that for the year, the second half ought to show some improvement over that, bringing the year, perhaps, to $565 billion--$560 to $565 billion--on the basis of what we can now tell. Obviously, this is difficult. But it would leave the budget, on the basis of present projected expenditures, somewhat out of balance inasmuch as corporate profits would perhaps not achieve the levels that they would have to achieve to gain that balance.

In summary, I would say that the prospects for the economy in 1962 are for the best year that we have ever known, but for a year perhaps still somewhat short of the objectives which the documents of January, to the Congress, have set forth. The problem of attaining the economic growth rate of 4.5 percent which the President has set down will remain with us. That is a rather considerable figure, and it is not at all evident to me how the proposals that have so far been set forward could bring us a 50 percent increase in our growth rate.

We know something about what fosters economic growth, but I have the impression it still is shrouded in a good bit of mystery. I am a member of the board of directors of an organization in New York called the National Bureau of Economic Research. One of the major projects of the National Bureau currently is this very subject of economic growth; what is it that produces it. The men in charge of the project are laying out a most comprehensive inquiry in the areas of capital formation, in the areas of health, education, taxation, labor supply, and skills. And just to see the outline of study impresses me with the enormous complexity of understanding what it is. But I suppose we could agree on some things, even though this was not the whole picture. Certainly we could agree on the basis of the role of investment, the role of increase in productivity, the impact of taxes upon that. I think we also, perhaps, have to take a look again at the considerations of equity and economics in our system.

Sir Oliver Franks, the retiring chairman of Lloyds' Bank in his annual report the other day, put down a few sentences which are harsh, but like many harsh sentences have some truth in them. "Speaking of England," he said, "we have forgotten in England that the end goal of our economy is to produce goods and services, and not jobs. And if we make the end goal of our economy to produce jobs and not goods and services efficiently, we are going to get into a very difficult kind of a dilemma in trying to balance these considerations." Now, that is a harsh statement, but I think it leads us to reflect a little bit about the demands of a competitive economy. Competition is not a very lovely thing. It's tough, it's rough, it's demanding. And yet, today, we are up against--in world markets--some very rough and tough competition.

Industrial apparatuses of the most modern sort have been rebuilt throughout devastated countries--Japan, Germany, and even France. I think we are getting over the idea that every good industrial development must, of necessity, originate in the United States. Also there is the labor factor differential which, when you have other factors cancelling out, such as the state of the art of the industry, or fuels, or the availability of good transport, does become important. One of the problems we face, and one of the problems that groups in our society certainly face, is this very harsh thing of how do we, in the world in which we now live, economically face the music? What does it mean for our minimum wage laws? What does it mean for a 4-hour day for electrical workers in my town, in New York? It's perfectly outrageous; a preposterous idea. Only more preposterous is the fact that it is possible to enforce that demand in our kind of society. Maybe it will not always be so.

What does it mean with respect to many managements in our country that have not really been aware of this competitive impact from abroad and have sought Government intervention to blunt that kind of competition in the trade field? The President's trade message was a powerful statement of the implications of the Common

Market for all of us who are engaged in business and finance in the United States, and also for agriculture and labor. It will probably take a while to sink in. There is a sociological lag in facing up to these things and a double one when they are unpleasant. But these are inexorable forces and we can not but do what is indicated to do to face up to them. I think the President's message on the trade matter brought that home very, very clearly.

Also, it means in the area of money and credit, a repudiation of the notion we can have a little deliberate inflation every year as a necessary stimulant to economic growth. Such a notion does not necessarily impress the foreign holders of dollar assets in our country who have a raincheck on our gold supply. And from this balance of payments discipline, external to us because we have such great difficulty bringing ourselves to it, probably will come a better and deeper understanding of the necessity of competition and the benefit of it, and of a tight economy; an economy from which looseness has been competed out and where, quite frankly, there are going to be some changes and some failures on the parts of some that can not quite face this music.

But, having said that, certainly there is no industrial concentration in the world equal to ours in skills, in resources, and in know-how, and in an attitude of mind that is willing to try new things and go ahead.

Therefore, 1962 may, in a special sense, be a year of great decision for us. It is going to be good as far as business is concerned; it is going to be very good. But whether it is going to be as good as we want, as good as it can be, will perhaps be written in the lessons that we learn from the need now to face up to a competitive situation that has not been operating on us so directly before. As I say, I think our Washington officialdom is highly aware of this problem. I think the business community is becoming increasingly aware of this problem. I think the labor community has difficulty, perhaps--some of it--in realizing the full implications for them, because they, like other people, have been living in a rather closed economy concept. The financial world is certainly feeling very strongly the necessity of having to pay higher rates of interest on deposits in order to have rates that will keep foreign money in this country. And, in my own case, this increased interest rate in the savings we pay, will cost many, many millions of dollars which will have to be made up in some other way.

But, this is a part of the way we make progress; this is the way of the law of change; and I think it is perhaps a good thing that we can face up to some of these issues in 1962, when, generally, there ought to be a good solid achievement economically, to provide a favorable atmosphere to do so.

Thank you.

QUESTION: Sir, from time to time I see pieces that stress the long-term importance of the almost complete insolvency of the municipalities in the United States. And I noticed that, although it was not really in the scope of your coverage today, you said nothing about that. Would you care to discuss it?

DR. HAUGE: The reason I did not say anything about it was that I did not believe that during 1962 that that would be a major factor affecting the economic situation. It is a factor to this extent, that government expenditures at all levels in 1962 will probably be about $10 billion above what they were in 1961 and this will be one of the considerable increases in all spending components. Now, this matter of financial insolvency of the municipalities--and I suppose many people include States--this threat of financial insolvency is present all over the place; some people even talk about the Federal Government in the same sweeping statement, which, of course, is not very realistic. The Federal Government can print money, and that is one of the great differences between it and the States and municipalities; whether everyone will accept it or not remains to be seen, but it does have that unique weapon.

Many of our municipalities which rely on tax systems that are outmoded, are in great difficulty. It has also led them to inadequate provision for local needs, and this has led to many of the demands that local problems be dealt with here by the Federal Government in Washington. It is hard to generalize. In my own city--New York--it is fair to say that there are great financial problems. They stem, however, from a great variety of reasons; profligacy in the past; a level of borrowing which has led to a debt service-charge burden that is very considerable; and perhaps a failure to revise the tax system of the city in ways which would produce revenue more in response to current economic, financial, and business developments.

I do not know what I could usefully say about this. I would be reluctant to conclude that the municipalities are permanently broke and therefore we have to shift the responsibility for the financial conduct of their affairs to some higher level, whether the State or the Federal Government. In the State of New York we have a $2 billion budget, and I think 75 percent of it is in grants and aid to lower subdivisions of the State--cities, school districts, and that sort of thing. This is one approach that has been taken to the problem, to try to equalize resources with spending responsibility.

In other States it has not proceeded that far. But I would think that that would be a development that would come before moving local affairs to be financed out of the Federal Government. That is happening anyway. We have enormous grant-in-aid programs to the States, as you know. Now there is a proposal for a Federal department for urban affairs which probably would accelerate that particular process. We have to be careful, it seems to me, that in facing up to financial matters we don't fundamentally change the organization of our society to one of a highly centralized and directable society.

But we probably will see revisions of tax systems within municipalities. Philadelphia, for example, as you know, went to some kind of income tax some years ago. New York has been talking about it. And then, a shifting is taking place to a State level on the basis of an equalization idea among communities or spending areas like school districts. In some specific areas such as school construction, on which, I think, we have had wide agreement for a role of the Federal Government. President Eisenhower, I know, approved a bill for school construction to make up the deficit of school construction. He did not go so far as to include other kinds of school expenditures such as teachers' salaries, because he was apprehensive about the control aspect. But this would be another way in which certain specific types of needs could be dealt with on a national basis.

QUESTION: In your discussion you referred to the need for our American economy to adjust to competition in trade. Yet, we have noted the trend in recent years, of our industry on the light part of our economy, to invest in those areas wherein the competition has become most keen; for example the European Common Market areas, rather than attempt to come down to a competitive level in our own economy. Will you discuss this trend; whether, in the long run, it will be disadvantageous to our economy?

DR. HAUGE: This is a matter which now has come up for a good deal of discussion in connection with a proposal to change taxation of wholly-owned subsidiaries of American companies operating overseas. I believe one of the proposals of the Treasury is that instead of leaving untaxed those earnings overseas, they should be taxed as earned, even before being repatriated by the parent company. I noticed in the paper the other day a press interview by Mr. H. J. Heinz, the head of the Heinz Company--which has very large overseas units--speaking, I think, on behalf of 19 American companies with overseas installations. The burden of his argument was that while there was investment overseas initially, the exports from the United States, of equipment, material, and various kinds of followup, taken together with the repatriation of earnings, showed a net plus for the balance of payments.

He was challenging--I gather from the press report--the idea that investment by American companies overseas was adverse to our balance of payments. Now, with respect to the employment of our labor, this is a matter which has been of much concern to leaders of many of our labor unions. They have seen American companies build plants in Holland, England, France, etc., to get into the Common Market or get into EFTA, and they have thought that had this plant been built in this country it would have provided jobs for American workmen.

Now, I think the point of the Heinz report was that investment overseas in physical facilities does not necessarily displace that amount of American man-hours put into construction or into operation. As I said in my other remarks, it has not been a part of our economy--of our market system--to interpose obstacles to the investment of capital either in this country or outside this country, except where there were security reasons involved, and I think it would be a dangerous thing to interpose such obstacles.

If the President is successful in getting his trade program through the Congress and if, as a result of that, there is a bargaining down of the external tariff wall of the Common Market, then, presumably, some of the incentive to invest there would decline. But by and large, an investment is apt to be made where it is profitable to make it. I have talked to many businessmen who have said, "We have invested in this country or that country because there was a big, growing market there that was not there before, and we can most efficiently produce to meet that growing market right there." Now, it does not mean that you build a plant in Holland to meet needs in Holland. You might produce in Holland to meet needs in other countries with larger markets, but the conditions in Holland with respect to labor, taxes, etc., might be more favorable.

Now, the Treasury has made another point with respect to so-called tax havens. This is different from the point I made about wholly-owned subsidiaries operating in other countries, and is more controversial. But the main point is this: I think we ought to be very careful in beginning to try to direct investment through interventions of the Government. As I say, let us remember the nature of our system. Our system, whether we like it or not, and I think we like it, is built on the simple idea that somebody or somebodies with ideas, who can get together the money behind them, can go and do something where they think they can do the best. And the byproduct is of benefit to the community generally, either through a provision of service or of a commodity at a better price and a better quality than it could be done otherwise. Let us be careful about intervening in that process.

QUESTION: Dr. Hauge, in relation to this gold-flow problem, it is my understanding that the gold reserves of the other nations of the world with whom we trade really cannot be said to be excessive, in view of the current volume of international trade, and that possibly the difficulty here is the fact that with the increasing volume there just is not enough gold to meet the situation. If this is true, why do we retain this 25 percent reserve in this country? Would you comment on that?

DR. HAUGE: Yes. First, with respect to the major premise of your remark, of the inadequacy of gold to meet the needs of our payments situation with an expanding volume of trade, I think that is debatable. As you know, we have been economizing on gold tremendously, as sterling and dollars have been used as substitutes for gold in the foreign exchange holdings of the major countries of the world. And that is why it is so tremendously vital that this matter of a sound dollar and sound sterling be uppermost in our minds. It is not the old fogey notion--I was going to say of old bankers; maybe I should say young bankers--that there is something wonderful about a sound dollar. There is something wonderful about it because it is a reflection of the character of a people to start with. It is not going to be sound unless you can tighten up and do the things that are tough once in awhile.

But more than that, this is the basis of the monetary systems, really, the foreign exchange holdings over a great part of the world. Now, since I would therfore not agree to the major premise, at least without considerable inquiry, which we do not have time for here, I do not find any compelling immediate necessity for removing the 25 percent gold cover. There have been many prominent people who have spoken out for this. I have not, myself, supported this idea, at least at the present time, and I'll tell you why. There are very, very few things left in our system that still operate to force a showdown with some bad habits that we engage in in our national and economic affairs. And when we began to lose gold at a rather considerable rate in the last few years few understood in the vaguest way what in the world the gold was doing out there in Fort Knox. But maybe that is the power of the magic of this idea. You know, we live with some kind of irrational mystique about some things, and it is not always bad.

I may sound irrational now, but I come to feel once in awhile that some unreasonable illogic is our only hope now and then. We began to feel that if we came up against the limit stops on this gold, or as we approached it, something bad was going to happen. Nothing bad would happen, particularly, we would simply relax it or handle the problem otherwise. But I have a feeling that this helped to sober up a lot of people about what in the world was causing this gold to rush out of the country.

Now, you can say that it was not the fact that the gold supply was coming up against the limit stop of 25 percent of X which is the aggregate liabilities of the Federal Reserve banks outstanding on note and deposit accounts. The gold supply was still several billion dollars away from that. But I think the reason that people began to be concerned about it was that it was moving toward a limit stop which we thought would not be approached. If we took that off and put it at zero, maybe we would get the same salutary effect from a $3 billion loss of gold moving toward zero percent as moving toward 25 percent; I do not know. But since I do not see any difficulty, at least for the period as far as I can see ahead, I think I would like to hold onto this thing even though I know I could change it if I had to.

Now, that is not very impressive logic, is it? But that is where I come out. It is a little bit like the debt limit. I remember I had a professor at Harvard who said that was pretty silly because, after all, the executive could not spend what the Congress did not appropriate. The point is, however, that the Congress is not really organized to know what it is appropriating. And it hardly knows until some months after it has adjourned, what the totals are. The Budget Bureau has to put out a midsummer review. And with Congress sitting way up until autumn these days, that review gets out toward Thanksgiving time when the Budget Bureau finally adds up what did happen. Therefore, I say that a debt limit, even though it may be an illogical, unreasonable thing, at least it forces a review of our fiscal situation every time that it has to be raised.

So, we may not have reached the stage yet in our development as members of a great free society where we can individually and collectively and instinctively choose that degree of restraint which will insure health for the body politic, and we may have to put some checkreins on like we do on horses and on machines. Well it is not very impressive logic, but I hold to it.

QUESTION: Dr. Hauge, as I understand it--the recession of 1959 and 1960--one of the major contributing factors was the turnover or sharp change between deficit to surplus in Government expenditures and here we have a recovery associated with the acceleration of Government expenditures. If this is the case why is the businessman so afraid of a Government deficit? Is this another example of this illogic that moves us?

DR. HAUGE: I think there are some fairly simple rules in life. You pay your bills except when there are some good reasons not to. We should not get too sophisticated in explaining to ourselves why we should not pay our bills when times are good. I do not believe that the difference between a high level of economic activity in fiscal or calendar 1963 is going to be determined by whether or not the Federal budget runs a deficit of $1 billion or a surplus of $3 billion. If this is so, then we have here a rather unstable apparatus. I do not happen to believe that the marginal influence of a surplus of $3 or $4 billion at the Federal level, at a gross national product of $560 or $570 billion, is going to exert such a depressing effect that it is going to stunt and abort this great economic engine we have here. So lacking a conviction that that is so, I think we ought to hold to the belief that I thought we had agreed on as a nation, that we balance this thing up over the cycle; that we pay our bills except when there is an obvious reason not to. I do not know of any impressive reason for not doing it.

Now, if people believe that this economy of ours tends to run a chronic slack; that we need a continuous injection of deficits, that is something else. I do not believe that that is accepted by this Administration or anybody else. If it is, then you could have a policy of this sort and you would try to cope with the consequences in some other way. It would probably be difficult but you would at least address yourself to that problem after having identified it.

Now, as far as the business community is concerned, I think the business community perhaps may be preoccupied with paying their bills; you can't get by very long without doing it. There are differences between the budget of a private company and the budget of a nation, obviously. The latter does not have revenue-producing assets; it gets its revenue from other sources; sources that are not related, necessarily, very closely to the expenditure side of the budget. But as I say, I think we have a consensus here in the country about this budget. And it worries me that we are not going to get the acceptance of deficits in recession, which I think is quite accepted now. We are not going to keep that, I believe, if we are going to junk the other part of this thing. And we had better have very good evidence that developing some kind of surplus in our best years is really going to be so abortive to full recovery that we cannot have it. And I would say further, that if that is the case, we had better look to some causes other than the small surplus in the Federal deficit for the reason we do not get a full recovery, such as the fact that costs are too high.

QUESTION: As a followup on the last question, isn't it possible that FY 1963 is not the height of our growth and that 1964 and 1965 will be better and thus we will generate surpluses in those years?

DR. HAUGE: It may be; it may be. I got the impression, though, from the January documents, that a 4 percent unemployment rate by the middle of 1963 was expected, and I believe that that would be accepted as a pretty near full employment situation for our economy at the present time. Also, I think that if the pattern of postwar fluctuation means anything to us, it would be quite unusual to go from January or February 1961 through 1964 and 1965 on a continuously rising curve. It would be an entirely new departure and I do not expect to see it. I think our kind of economy is going to have some of these minor fluctuations, and I think one of our problems in countercycle policy is how much we can effectively do in time, to minimize what was a very minor recession this last time; to do it quickly enough, to do it automatically enough, and to get out at the proper time.

QUESTION: The introduction of data processing in many businesses and industries has enabled them to reduce inventories substantially because of more rapid response in demand, which would conceivably result in a temporary decrease in the requirement for money capital. Do you consider this as significant, and what do you foresee as the source of future demand for money capital?

DR. HAUGE: I think the first part of your statement is certainly true. The better control of inventories has led not only to perhaps an average lower level, but to a much better time pattern of inventory buildup and drawdown. Now, as far as the demand for money capital, I take it you mean both capital in the longer term sense and credit in the shorter term sense, that commercial banks deal in. I think that is a fair and very interesting question. I am looking at the clock, so I am going to have to give you a bobtailed reply.

Bank-earning assets--to take that as an index of the credit side of your question, against the capital side of your question, which would of course, require the inclusion of pension funds, insurance companies, and all that--have been undergoing quite a change. We have had in the commercial banking business, a shift relatively away from this type of credit--the inventory type of credit provision--to term loans for business, which run out for as long as seven years and which are also savings banks and have a greater stability of their deposits. Then there is the growth of consumer credit on a large scale--my bank alone has $200 million in consumer credit. That is a big bank in itself. And these obligations run out past the typical one-year limit of a short-term inventory loan.

One must also mention mortgages, which, of course, in many cases run out 20 to 25 years. So in the loan field you have these developments, plus other specialty developments, and it reflects the fact the short-term type of business credit is a declining aspect of a credit demand.

COLONEL BERGAMYER: Dr. Hauge, I am sorry that we do not have more time, because it is obvious that your interest in this subject has not waned since you were the Special Assistant to the President for Economic Affairs. On behalf of the Commandant, the faculty, and the student body, we would like to thank you very much for your splendid lecture.

(12 July 1962--7,600)H/jc:ijk