

THE WHITE HOUSE

WASHINGTON

July 22, 1970

MEMORANDUM FOR THE WHITE HOUSE STAFF

This is an article which the President and Vice President found particularly interesting.

Herbert G. Klein

Liberal Democrat Refutes Doves

WHY WE CAN'T CUT AND RUN IN INDOCHINA

By W. W. Rostow

Human Events has been sharply critical of many of the positions taken by Walt W. Rostow, who was President Johnson's chief foreign policy adviser within the White House. Aside from disagreeing with his economic views -- which have a Socialistic cast -- Human Events has felt that the controversial Mr. Rostow has too often underestimated the dangers of communism, particularly the Soviet variety. Nevertheless, we feel he has constructed some of the best arguments so far as to why we must not "bugout" of Viet Nam and Southeast Asia; and his arguments, we feel, are all the more persuasive since he has never been considered a militant anti-Communist. Mr. Rostow's reasoning has influenced a number of Senate liberals, including Gale McGee (D-Wyo.), who cast his vote against the Cooper-Church Amendment. We hope that his remarks may change the minds of other liberals and doves who somehow believe that we can run away from the "Southeast Asian problem" without such action bearing terrible consequences.

The heart of the tension in contemporary America over Southeast Asia has been between the choices as seen by the Presidents, on the one hand, those who came to oppose him, on the other. The Presidents have seen the real choice before us as pursuing the engagement there through to stable peace versus a larger war, and quite possibly a nuclear war.

The opponents of their policy in Southeast Asia argue, in effect, that American disengagement from Southeast Asia would lead to peace or to a situation in which the United States would or could passively acquiesce in safety.

There has been -- and there remains -- a dangerous gap between the national interest as our Presidents see it -- and as we have seen it as a nation at times of acute crisis -- and the way many Americans see it when the danger of a major shift in the balance of power in Europe and Asia is not palpable.

What is the basis for this gap?

It arises, I believe, from the nature of democracy -- and, particularly, democracy in the United States.

Alexis de Tocqueville stated the problem vividly 135 years ago. In Democracy in America, he described the overwhelming attractions of civil life for Americans "placed...in the midst of a wilderness where they have, so to speak, no neighbors...." He believed "the excessive love of the whole community for quiet" would lead Americans to ignore military problems until they became acute; and then they would turn to deal with them late but wholeheartedly.

It was an awareness of what we might call Tocqueville behavior by Americans between 1916 and 1947 which led President Truman to face up to Stalin's threat in Europe before it became a purely military threat. Our Presidents have understood how dangerous the Tocqueville oscillation might be in a nuclear highly interdependent world.

And they have understood something else imposed on us by the coming of nuclear weapons. They have been conscious -- in Korea and Southeast Asia, but also in the Middle East and in the Berlin and Cuba missile crisis -- that danger lay not merely in a late reaction but in a wholehearted turning to war, engaging in Tocqueville's phrase, the full "passions" of the people. There is no rational place for total war in a nuclear age.

Contrary to older American instinct, we have been trying to deter threats to the balance of power in Europe and Asia in a forehanded way and, when challenged, to use limited rather than total force.

This has been difficult for Americans, given our history and our national operating style.

It has been made more difficult by two other strands of thought and feeling at work in our domestic life:

First, a feeling that the United States is, in some sense, overcommitted or disproportionately committed on the world scene;

Second, an opinion among some that the fate of Asia does not, in fact, matter all that much to the United States.

I shall say something about each of these factors in turn.

First, the question of American overcommitment.

Taking Stock

After the Cuba missile crisis I took stock with some of my colleagues in the State Department of the forces which gathered strength after that historic event.

One fact was central; the fear of Moscow, rightly or wrongly, was considerably reduced, once the technique of nuclear blackmail was faced down by President Kennedy and, partially in consequence, the Sino-Soviet split became more overt and intense.

In every part of the world this reduction in tension led to an increased desire of nations to take a larger hand in shaping their own destinies. The image of a bipolar world was weakened both by Khrushchev's failure in the Caribbean and by the evident disarray of the Communist camp. There seemed to be more opportunity for old-fashioned nationalism and the nation state.

In the United States there developed a feeling that the Communist threat had been reduced and, somehow, the world ought to be manageable with less American effort, cost and commitment.

Analyzing these trends, I concluded that the problems actually confronted demanded stronger and more effective regional co-operation, if the nations of the world were to forge a destiny

increasingly independent of the major powers. If rich European nations of 50 million could not handle their problems without effective regional co-operation, how could nations of the less-developed regions do so on a nationalist basis?

As for the United States, I concluded that the heart of the problem was not excessive commitment, but a sense of excessive loneliness in bearing the burdens of the world. Our actual outlays for security purposes were declining slightly in the first half of the 1960s as a proportion of Gross National Product; but the American image was one of our carrying an unfair share of the task of maintaining order and progress in the world arena.

What is it, then, that the United States is trying to accomplish?

First, our Presidents have recognized that the American interest in avoiding domination of Europe or Asia (and, indeed Latin America or Africa) by a potentially hostile power is an abiding interest of the United States. It is heightened, not diminished, by the nature of modern weapons and means of communication.

Second, they recognized that this negative interest is fully shared by the smaller nations of these regions. In fact, this convergence between our interest and theirs had been the underlying strength of American postwar diplomacy.

The nations of Europe do not wish to be dominated by Russia or Germany or the United States. The nations of Asia do not wish to be dominated by China or Japan or Russia or the United States. The nations of Africa south of the Sahara wish to forge their destiny without the military presence or political dominance of any major external power.

The wisest leaders of Latin America wish not only to keep extra-continental powers out of security affairs in this hemisphere, but they wish to build societies and a regional structure which would permit them to deal with the colossus of the north from a base of greater strength and dignity. That is the underlying political objective of the movement towards Latin American economic integration.

The United States has been able to throw its weight behind regionalism in all these areas because our interest does not require that we dominate them; and because the stronger the regional organizations -- so long as they are not dominated by a potentially hostile power -- the more likely they are to resolve their own problems and reduce the level of American commitment and concern.

Third, the Presidents have recognized that the pace at which the United States could safely step back had to be delicately adjusted to the rise of strength and cohesiveness in the regions.

They have recognized in Europe, for example, that a premature and excessive pull-out of American forces from NATO could lead not to a new and better-balanced Atlantic equilibrium but to a crisis as dangerous as -- or more dangerous than -- the Berlin crisis of 1948-49 or 1961-62.

The exercise called "Vietnamization" -- if I understand it correctly -- is an even more delicate exercise in shifting the balance of responsibilities in Southeast Asia in ways that would avoid collapse of the region, chaos, and a larger war.

The strategy of our moving back in degree as the strength and cohesiveness of others permit them to take a larger hand in shaping their destinies -- while avoiding a collapse of the balance of power in regions of vital interest to the United States -- is certainly the most subtle and difficult task of foreign policy ever undertaken by the United States.

Historically, America has performed best when it faced a palpable and acute problem -- widely recognized and defined in common terms -- to the solution of which it could address its full energies, talents and resources.

The First World War, once we were in it, was a problem of this kind; the Great Depression after 1933; the Second World War, after Pearl Harbor, Stalin's challenge in western and southern Europe, from 1947; the race to put a man on the moon, after the Soviet launching of the first Sputnik. These slam-bang affairs fitted well the national style.

Now we are trying to do something quite different. After the Second World War we moved into vacuums of power not to build an empire but because the cost of not moving was judged, case by case, more dangerous than the reluctant acceptance of additional responsibility in a war-weakened world.

Now -- a quarter-century later -- we are trying to manage a redistribution of responsibility in which we will do less, others will do more, without inducing major crises or chaos on the world scene. We are trying safely to withdraw -- in degree -- from the preponderant positions we filled.

We are trying to exploit constructively:

the gathering strength of others on the world scene;

their desire increasingly to shape their own destiny, without being dominated by any major power, including the United States;

and the fact that abiding American interests are satisfied by an essentially negative condition -- that no potentially hostile power hold the balance of power in Europe or Asia.

Complex Pattern

This is the complex pattern of policy which our government has been trying to pursue in recent years in order to reconcile abiding American interests and the widespread sense in America that we were, somehow, overcommitted or disproportionately committed in the first postwar generation.

The pursuit of this policy is obviously complicated by many forces in our domestic life:

An economy subject both to rising unemployment and rising prices; an infirm balance-of-payments position; acute racial tension; massive tasks of urban rehabilitation; an ardent margin of the affluent young, affronted by the ugliness of war, racial inequity, and other gaps between American aspiration and performance, who have been led to believe that a quick route to the humane and decent life they seek lies in confrontation, violence and destruction.

I cannot, evidently, deal with all these features of the domestic scene here: The reactions they have set up in our political life; and their playback effects on our ability to conduct the mature and subtle foreign policy which our interests require and to which we have been committed.

But I shall say a few words about one view to which some Americans have come, in part driven by these domestic pressures: The view that the United States can safely abandon its interest in and commitments to Asia and let the forces at work there find their way to chaos or equilibrium, war or peace--without American participation.

Let me quote the words of John Gardner, whom I regard as a good friend, as well as an old and respected colleague. Anguished by the intensity of our domestic debate and the urgency of our unsolved domestic problems, he counsels abandonment of our role in Viet Nam and of our peace-keeping commitments in Asia.

I quote him as an eloquent and sensitive representative of a good many Americans whose views on Viet Nam and Asia have changed. Here is a passage from an interview with Gardner published in the Christian Science Monitor of June 8, 1970:

Q: "What should the President do about Viet Nam?"

A: "I think that if the President would set a date, a terminal date...."

Q: "You're speaking about getting troops entirely out?"

A: "That is right. It would be extremely helpful. I think, if he would finally relinquish the notion that the words 'winning' or 'losing' have any relevance whatever any more with respect to Viet Nam. The whole relevance of those two words is a thing of the past now.

"If he would relinquish what appears to have been his conception in the last press conference that we might conceivably be the peace-keeper in the Asian world, I think we could move expeditiously to get out of Viet Nam and I think it would produce very considerable change in our national mood.

"Then I think moving vigorously on domestic priorities would be the next order of business. And the nation is ready for it. People are hungry for it. Americans are not people who want to turn their backs on their problems."

Elsewhere in this interview Gardner says: "Nothing that we could possibly be accomplishing in Southeast Asia could balance or compensate for what the war is doing to this country."

This is a solemn proposition. It ought to be discussed dispassionately, with care, since we all recognize the burdens thrown upon our national life by the war in Southeast Asia.

The proposition is that the United States should promptly withdraw its forces and commitment from Viet Nam whatever the consequences may be in Asia and on the world scene.

Contrary to every conceivable political and personal interest, three American Presidents decided that the forces set in motion by such a decision risked a larger war in Asia and dangerous instability in other regions of the world.

I believe no citizen taking a contrary view can, in good conscience, ignore the lines of argument that led our Presidents to this conclusion; for the risk of a larger war--quite possibly a nuclear war--should weigh heavily in the scales in assessing how much of a burden we can afford to bear at home.

I would not pretend to reconstruct fully the lines of argument which led the Presidents to this painful judgment; although in two cases I have some knowledge of their thoughts. But I would offer my own brief summary of at least some of the possible or probable costs of unconditional immediate withdrawal from commitment in Viet Nam and Asia.

First, the withdrawal of American commitment from Southeast Asia would change the terms of the debate going forward within mainland China. Powerful forces are at work there to move post-Mao China toward a long-delayed concentration of its energies and talents on the modernization of its life. American withdrawal would, in my view, inevitably lead Peking to exploit its new opportunities to the South.

No one can predict the precise form in which a nuclear China, with huge ground forces, would exercise its power in the vacuum we would create. But I cannot believe that Peking would remain passive. Indeed, it is not passive now: In its influence on Hanoi; its road-building in Laos; and its actions elsewhere.

Second, the nations of Southeast Asia, certainly as far as Singapore--quite possibly as far as Indonesia--would lose their independence or be thrown into a protracted military or quasi-military struggle which would disorient for some of them exceedingly promising paths of economic, social and political progress.

Burma's Role

Third, Burma, in particular, would either fall under Communist domination or become the scene of an Indian-Chinese struggle; for Burma--not Tibet--is the point of critical strategic danger for the Indian subcontinent, a point made in private, with equal lucidity, by high and responsible officials of India and Pakistan.

Fourth, almost certainly Japan and India would quickly acquire nuclear weapons; and, quite possibly, the non-proliferation treaty would die elsewhere in the world as well.

It is, perhaps, not generally understood that the willingness of many nations to forego the production of nuclear weapons is based on a carefully balanced calculation that ties to the United States--explicit or implicit--provide marginally greater security and less risk than going it alone on the basis of national nuclear capabilities. The policy Gardner proposed would shift that marginal calculation.

An America that walked away from a treaty commitment because it could not deal with its domestic problems--after bringing into the field a half-million of its armed forces and encouraging a small ally to fight desperately for its independence--might well not be regarded as a reliable ally on such a mortal issue in Asia--or elsewhere.

Paragraph 1 of Article X of the nonproliferation treaty states: "Each Party shall in exercising its national sovereignty have the right to withdraw from the Treaty if it decides that extraordinary events related to the subject matter of this Treaty, have jeopardized the supreme interests of its country."

I believe an American withdrawal from a treaty commitment in a critical part of the world on the ground that its domestic problems did not permit it to continue to honor that treaty could well be judged an extraordinary event related to the subject matter of the nonproliferation treaty, jeopardizing the supreme interests of nations which now depend upon us. We should be quite clear that, whatever public postures they may strike on one issue or another, India and Japan--as well as many others--count on our nuclear deterrent and the will--as well as the hardware--that give it meaning.

Fifth, I would put a question which every American must answer for himself, out of his knowledge of our country, its history and its character: at home would the United States observe these consequences of its decision passively? Would it turn with energy and pride and unity to clean the air and the water, deal with ghettos and racial inequity as it read of Hue-like slaughter in Viet Nam and elsewhere; of an Asia thrown into chaos or worse; of a world seized of a proliferating nuclear arms race?

And what of the effects of all this in Moscow and Cairo?

I, for one, do not believe we would remain unified and passive. I agree with Gardner that "Americans are not people who want to turn their backs on their problems."

We might repeat what I have called the Tocqueville oscillation, in a peculiarly dangerous way; but I do not believe we Americans, in the end, will turn our backs on Asia and on the world.

For what is Asia?

Asia is the place where about 60 percent of humanity now lives and will continue to live. In the year 2000, which is not so far away, Asia's population will be about 10 times that of the United States--say, 3.7 billion souls.

There are some, I know, who regard Asia as primitive, in no way to be compared to Europe in potential importance to the United States. But as anyone who has recently been to Asia knows, it is a region on the march.

We are all familiar with the extraordinary growth of Japan, now the third industrial power in the world and closing fast on a sluggish Soviet Union. But in South Korea and Taiwan, Thailand and Malaysia and Singapore, and in India, Pakistan and Iran as well, the modernization of these old societies is moving forward swiftly. And Indonesia, too, is coming out of the chaos in which Sukarno left it.

China Stalled

Mainland China has been virtually stalled for a decade, set back first by the failure of the Great Leap Forward and then by the Cultural Revolution. But sometime in the years ahead the great natural gifts of the Chinese on the mainland will come to be focused on the modernization of that society in more or less rational ways.

Round about the year 2000, then, we shall face across the Pacific almost four billion people who, by that time, will have acquired the capacity to use most of the then existing technology. They will have reached -- or be close to reaching -- the stage of growth I have described as technological maturity.

In income per capita they will not be rich: they will average, perhaps, only about \$350 per capita, the average brought down by the low starting point and heavy weight of the Indian subcontinent and mainland China. But they will be a formidable center of power, a major factor in the kind of life Americans -- that is to say our children and grandchildren -- will then lead.

Right now, I believe, the kind of Asia that will exist in the year 2000 is being determined.

It is being determined by the outcome of the debate on the mainland concerning post-Mao Chinese domestic and foreign policy.

It is being determined by the Japanese and Indian decisions on the non-proliferation treaty.

It is being determined, above all, by the growing sense of regional cooperation that has emerged since the United States honored its commitment to South Viet Nam in 1965, at a time of mortal danger to Southeast Asia.

If we patiently, painfully see it through to an honorable and stable peace in Southeast Asia, there is a decent hope that the Asia that emerges will not be dominated by any single power. It could be an Asia in which the inherent weight of mainland China is balanced by the cooperative efforts of those living in the great and vital arc from Seoul and Tokyo to Karachi and Teheran -- an Asia not hostile to China but offering to it no temptation to expand -- an Asia to whose multilateral efforts Japan could make an enormous contribution -- an Asia where nuclear proliferation did not happen, where the guarantee of the United States remained good, but whose inherent strength and cooperation permitted us to fall back on a role of evenhanded partnership across the Pacific.

That outcome is not assured; but it is a decent hope, because it is rooted in a political reality: the political reality that most Asians share with the United States an abiding interest that the region not be dominated by a single power.

If we do not see it through to an honorable and stable peace in Southeast Asia, we could confront a very different and dangerous constellation of power across the Pacific which would alter the whole setting of American society and its inner life and pose dangers greater than those that came upon us at Pearl Harbor.

I disagree, therefore, with John Gardner's dictum that: "Nothing that we could possibly be accomplishing in Southeast Asia could balance or compensate for what the war is doing to this country." The fate of Asia and America's long-run relation to Asia is at stake; and this is a very great matter indeed.

Neither as a former public servant nor as a teacher nor as a social scientist nor as a man am I insensitive to the costs of our commitment in Southeast Asia and the war in which we are still engaged.

Clearly, the war in Viet Nam has contributed substantially to student unrest in the United States; but I do not believe the war is primarily responsible for the restlessness and dissatisfaction of the young; for student unrest is a global phenomenon in the developed world.

Clearly, the war has diverted substantial resources from private and public purposes; but I do not believe it is primarily responsible for the slackening in allocations to the cities for education or for the present state of racial tension.

The net cost of the war in Viet Nam -- what we would actually save by abandoning the effort -- is less than 2 percent of the GNP. The figure is declining, not rising. At a normal 4 percent growth rate it is less than half the annual increment in GNP we would have available to allocate to new private or public purposes.

I regret every nickel of it, as I regret, even more, every casualty of the war. But with a GNP approaching a trillion dollars we obviously command the resources in the United States to do far more in the public sector if we manage the economy well and generate the political will to allocate those resources wisely. And while the war in Viet Nam is not irrelevant to the problem of bringing the Negro to full citizenship in our land, I do not believe for one moment that it is a critical variable.

Deep Roots

The coming of stable peace in Southeast Asia would surely ease some of the strains in our domestic life; but our domestic problems have different and deeper roots and must be dealt with essentially in their own terms.

In considering our domestic life in relation to our foreign policy, I would make one further related point.

Historically, in this century we have had domestic and foreign policy crises in sequence. Wilson had time to launch his New Freedom program before confronting the realities of the First World War. For good or ill -- and probably for ill -- Franklin Roosevelt could launch his New Deal program in an America locked into isolationism; and that program had run its course well before the outbreak of the Second World War.

President Truman could face the Cold War crises of 1945-52 from a base which did not generate acute pressures for domestic innovation: he was, in fact, well out in front of his congressional support in proposing domestic legislation.

But since 1963 -- say, from the civil rights march on Washington of August and the assassination of Diem in November -- our political life has been strained by simultaneous crises of an acute kind, at home and abroad. I can easily understand the instinct of Gardner and others somehow to get "abroad" off our necks so we can turn wholeheartedly to affairs at home. I believe history will record that President Johnson faced and, now, President Nixon faces, challenges of unique severity because of this convergence of domestic and foreign crises.

But history is ruthless with those who build their policies on illusion. And I believe it is an illusion to hold that America, at this time in history, can safely walk away from its commitments and interests in Asia -- or in Europe or the Middle East.

I believe withdrawal to a search for the good life at home in a world of war and chaos and deepening danger is an illusion. And neither we -- nor humanity at large -- can afford another Tocqueville oscillation.

Despite the debate that swirls around us, I believe deep within our nation is the understanding, the strength and the will to do so.

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THE WHITE HOUSE
WASHINGTON

TO: Alex

FROM: JOHN BROWN

FYI _____

COMMENT If we are going
to move the OEP Library--
do you have any thoughts
on what we might use the
space for?

MEMORANDUM

THE WHITE HOUSE

WASHINGTON

July 24, 1970

TO: JOHN BROWN
FROM: BILL HOPKINS 

Tactful inquiry regarding the use of this library elicits the following information:

1. It is used frequently by Mr. Keogh's office -- particularly Miss Bellinger's research activities.
2. It is used by the Record Book Section in connection with any queries of a research nature which come to them and which they can handle through this source rather than the Library of Congress.
3. It is used to some extent by miscellaneous commissions and other groups housed in EOB.
4. It is used to some extent by NSC.
5. The CEA may use it some.

So far as we can ascertain, there is not very much general White House use of the facility.

Since it is an OEP facility, no doubt you will wish to be sure that the matter, if pursued, is discussed with General Lincoln in timely fashion.

Attachment

THE WHITE HOUSE
WASHINGTON

TO: Bill Hopkins
FROM: JOHN BROWN

FYI _____

COMMENT Do white House
Personnel use the
Library very often?

UNITED STATES OF AMERICA
GENERAL SERVICES ADMINISTRATION



Region 3

Washington, D.C. 20407

DATE: July 21, 1970
REPLY TO
ATTN OF: 3PFX
SUBJECT: OEP Library

Honorable John R. Brown, III
Staff Secretary to the President
The White House

In accordance with your request of July 17, 1970, concerning the OEP Library in the Executive Office Building, the following is submitted.

There are 7,095 square feet of space in this library area. It is run by two permanent personnel and two temporary personnel of OEP. The space is assigned to OEP but is used, although very infrequently, by other activities in the building. There was a large library belonging to OEP in the Executive Office Building, which was moved out approximately four years ago and is now in the Winder Building Annex (this is a building in the rear of the Winder Building on Seventeenth Street).

Upon investigation of the possibility of moving it out of EOB, I discovered that there is furniture being stored on the first floor of the Winder Building Annex. There is a possibility that this furniture could be stored elsewhere and the Library in EOB moved to the Winder Building Annex, so that the entire activity would be a complete Library in one building. However, this space move should be discussed with Don Probst as he would have the full scope of the OEP operation. In talking with Don Probst he remarked to me that he thought the White House personnel used the OEP Library. I might suggest that you check this out with Mr. Hopkins. Personally, I see very little activity in this Library at any time. This Library has been in the Executive Office Building for over 25 years.

Please let me know if I can be of further service.


C. F. ROTCHFORD
Manager, White House Area

July 17, 1970

MEMORANDUM FOR CHARLIE ROTCHFORD

I understand that OEP has a library on the fourth floor of the EOB. Maybe this is the one that you took me up to show me several months ago. In any case would you give me a report on how much space it occupies, how long it's been there and also check with Probst on the possibility of moving it from the EOB to the building in which OEP is occupying which I think is 1800 G Street. Please do this on a very quiet basis.

Thank you.

JOHN R. BROWN III

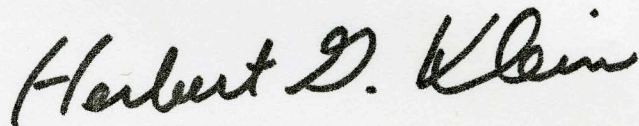
THE WHITE HOUSE
WASHINGTON

July 31, 1970

MEMORANDUM FOR THE WHITE HOUSE STAFF

Attached are excerpts from a memorandum prepared for U. S. Senator Gordon L. Allott by Eberhard Deutsch of New Orleans outlining the legal status of U. S. forces in Southeast Asia and the relative constitutional authority of the President vis-a-vis the Congress, with reference to the deployment of troops in that area.

Attorney Deutsch is one of the foremost authorities in the nation on the constitutional war powers of the President and these excerpts should provide insight into a complex question that is confusing to many Americans.



Herbert G. Klein
Director of Communications
for the Executive Branch

Attachment

In 1954 the Geneva Accords, to effect withdrawal of the French from Indo-China, were executed. The United States was not a party to those Accords, while nevertheless taking official cognizance thereof.

A few weeks after their execution, the Southeast Asia Collective Defense Treaty was signed (September 8, 1954). Parties to it were the United States, Great Britain, Australia, New Zealand, Thailand, Pakistan and the Philippines. The Senate ratified this treaty (SEATO) on 1 February 1955 by a vote of 82 - 1, and it took effect on 19 February 1955. 1/

This was a regional defense treaty under the express terms of, and sanctioned by, the Charter of the United Nations. Without going into details, it simply provides that all parties thereto will defend any one of them or any other nation designated by protocol, in the event of aggression. By protocol on the same day on which the treaty was signed, South Vietnam was expressly made such a "protocol party", entitled to protection by the signatories.

In the meantime, on August 5, 1964, the President, in a message to the Congress, stated that he had "concluded that he should now ask the Congress on its part to join in affirming the national determination ... that the United States will continue in its basic policy of assisting the free nations of the area to defend their freedom"; and he requested Congress to adopt "a resolution expressing the support of the Congress for all necessary action to protect our armed forces ... and to defend freedom and preserve peace in Southeast Asia in accordance with the obligations of the United States under the Southeast Asia Treaty".

On 7 August, the resolution was adopted by votes of 88-2 in the Senate, and 416-0 in the House. 2/

1/ 101 Cong. Rec. 1060.

2/ 110 Cong. Rec. 18470-71; 18555.

The Resolution recites "that the Congress approves and supports the determination of the President, as Commander-in-Chief, to take all necessary measures to repel any armed attack against the forces of the United States and to prevent further aggression"; that "the United States regards as vital to its national interest and to world peace the maintenance of international peace and security in Southeast Asia;" and that "consonant with the Constitution of the United States and the Charter of the United Nations and in accordance with its obligations under the Southeast Asia Collective Defense Treaty, the United States is, therefore, prepared, as the President determines, to take all necessary steps, including the use of armed force, to assist any member or protocol state of the Southeast Asia Collective Defense Treaty requesting assistance in defense of its freedom."

In the course of a colloquy on the floor of the Senate on 6 August 1964, between Senator Cooper and Senator Fulbright who, as Chairman of the Foreign Relations Committee, was manager of the Resolution in the Senate, the following discussion (excerpts) took place:

"SENATOR COOPER: Are we now (by this resolution) giving the President advance authority to take whatever action he may deem necessary respecting South Viet-Nam and its defense, or with respect to the defense of any other country included in the treaty?"

"SENATOR FULBRIGHT: I think that is correct."

"SENATOR COOPER: Then, looking ahead, if the President decided that it was necessary to use such force as could lead us into war, we would give that authority by this resolution?"

"SENATOR FULBRIGHT: That is the way I would interpret it."3/

* * *

On May 4, 1965, President Johnson had requested "the Congress to appropriate, at the earliest possible moment, an additional \$700 million to meet mounting requirements in Vietnam." In his message to the Congress, he explained that "this is not a routine appropriation. For each Member of Congress who supports this request is also voting to persist in our effort to halt this Communist aggression in South Vietnam. Each is saying that

3/ 110 Cong. Rec. 18409.

Congress and the President stand united before the world in joint determination that the independence of South Vietnam shall be preserved, and Communist attack will not succeed".^{9/} The appropriations bill (79 Stat. 109) passed by a vote of 88 to 3 in the Senate, and 408 to 7 in the House.^{10/}

That there has been no change in Congressional approval of the President's conduct of the war in Vietnam is demonstrated very clearly in the very text of the military appropriation bill for fiscal 1967, in which it is stated expressly: "The Congress hereby declares ... its firm intention to provide all necessary support for members of the Armed Forces of the United States fighting in Vietnam ..."^{11/} The vote in favor of this bill in the Senate was 89 to 2, and in the House 363 to 13.^{12/}

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...In 1962, President Kennedy established a blockade of Cuba against the importation and installation of Russian missiles, without Congressional authority; and more recently, both the Korean and Vietnam wars have been conducted without formal declarations.

In Tucker on The Constitution,^{14/} it is stated that "in Greece and Rome, and even in the European countries in the Middle Ages, public declaration of war was uniformly made and was obligatory, but since the middle of the 18th Century formal declarations have not been universal and have fallen into disuse".

In 1800, the Supreme Court had occasion to pass on the question as to whether the United States was actually involved "in war" without a formal declaration thereof. Congress had, by two statutes enacted in 1798 and 1799, respectively, provided salvage allowances for recapture of vessels of the United States which had been taken "from the enemy" (France). All of the Justices

^{9/} H. R. Doc't. No. 157, 89th Cong., 1st Sess. (1965).

^{10/} 111 Cong. Rec. 9210, 9435 (1965).

concurred in the holding by the Court, each in a separate opinion, to the effect that the United States was actually "at war", as recognized by the Congress through the statutes in question, despite the fact that there had been no declaration of war against France.

One of the opinions was written by Mr. Justice Washington (brother of the President). He stated that the question before the Court was whether "there subsisted a state of war between the two nations If it be declared in form it is called solemn ... but hostilities may subsist... limited as to places, persons and things; and this is more properly termed imperfect war Still, however, it is public war, because it is an external contention by force." And Justice Washington concluded his opinion on this point with the statement that "as to America, the degree of hostility meant to be carried on, was sufficiently described without declaring war, or declaring that we were at war.... In fact and in law, we are at war".^{15/}

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In December 1900, while troops of the United States were stationed in China, having been deployed for the protection of American and other interests in the course of the Boxer Uprising there, an American soldier was tried and convicted by court-martial, for the murder of another soldier. The conviction was under an Article of War covering such an offense when committed "in time of war".

It was contended that because the American forces had been deployed to China without a declaration of war, the judgement of the Court-Martial was invalid. The case came before a Circuit Court of the United States in the District of Kansas, which held expressly that formal declaration of war "is unnecessary to constitute a condition of war".

^{14/} Vol. II, p. 576.

^{15/} The Eliza, 4 Dall. 307, 40-41, 42 (1800).

The court pointed out that extensive military forces, both of the United States and of other nations, had been deployed into China, and that "many engagements, resulting in considerable loss of life" had taken place; "military zones were formed"; and "by act of Congress the pay of the officers and men in the military service of this country during the time they were occupied in China was increased to the amount paid in time of actual war ... notwithstanding the further fact that at no time was there any declaration of war on the part of this government against the government of China". The court accordingly concluded that "at the time the homicide in question was committed there prevailed in China a condition of war" 17/

The point here under discussion has been adjudicated directly as to the war in Vietnam, in the case of a man convicted of willful failure to report for induction into the Army. He claimed "that with respect to the war in Viet Nam the Universal Military and Service Training Act is being unconstitutionally applied, because Congress has not declared war; (and) that the Executive, in effect, has declared war ..."

The Court held that "while Congress has not formally declared war with respect to the military action in Vietnam, nor did it in Korea, it has given its wholehearted approval to the action of the President by appropriations and other implementing help. The President, as Commander-in-Chief, has always exercised the power to begin hostilities ... Unquestionably the President can start the guns at home or abroad to meet force with force; he is not only authorized, but bound to do so". 18/

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The next -- and perhaps the more immediate question at issue -- is as to the division of constitutional authority in the matter of the deployment of troops, once a state of war has come into being, as it has in Indo-China.

17/ Hamilton v. McClaughry, 136 F. 445, 447, 450-451 (C. C. Kansas - 1905).

18/ United States v. Mitchell, 246 F. Supp. 874, 897, 898 (1965); aff'd, 369 F.2d 323 (C.A.2 - 1966).

When the Constitution was being framed, there was no objection whatever to the provision that the President, even though he was likely to come, generally, from civilian life, was to be Commander-in-Chief of the Armed Forces.

"This action of the Convention was probably due to some particular consideration, and none seems more reasonable than the fact that during the Revolution Washington experienced great trouble and embarrassment resulting from the failure of Congress to support him with firmness and dispatch. There was a want of directness in the management of affairs during the period which was attributable to the absence of centralized authority or command. The members of the Convention knew this, and probably thought they could prevent its recurrence by making the President Commander-in-Chief of the Army and Navy." 21/

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From all of the foregoing, it should certainly seem abundantly clear that whenever a state of war exists -- whether declared or undeclared -- the President of the United States has, under the Constitution, as Commander-in-Chief, full and plenary power to conduct military operations in prosecution of the war, unhampered by anything in the nature of strategic legislative restrictions.

Any other construction of the Constitution would so hamper the conduct of a war as to portend ultimate military defeat. The Constitution of the United States was never meant to be construed as a suicide pact.

21/ Watson, on The Constitution, Vol. II, 912.

THE WHITE HOUSE

WASHINGTON

August 5, 1970

MEMORANDUM FOR WHITE HOUSE STAFF

Mr. Ehrlichman thought you might be interested in reading Paul McCracken's recent statement before the Joint Economic Committee.


Ken Cole

COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D. C.

FOR RELEASE UPON DELIVERY

Statement of
PAUL W. McCracken, Chairman

of the

COUNCIL OF ECONOMIC ADVISERS

Before the

JOINT ECONOMIC COMMITTEE

July 20, 1970

10:00 a.m.

I appreciate the opportunity to appear again before this Committee for its mid-year review of economic developments and their implications for policy. The past few months since I was last before the Committee have been a period of great uncertainty about where the economy was going and of unusual volatility in sentiment. Recent developments and information, however, have made the main elements in our situation somewhat clearer.

First, the economic decline has not cumulated, but appears to be bottoming out and at worst is unlikely to proceed much further. Its maximum dimension will be far short of the experience in any of the postwar recessions.

Second, signs of the expected slowdown in the rate of inflation are becoming stronger, and there is little doubt that continuation of economic policy on its planned course will reduce the rate of inflation further. The inflation rate has proved to be more stubborn than was commonly expected, but it has not been immune to changing economic policies and conditions.

Third, attention should now focus on the requirements for assuring that the upturn will carry through steadily to full employment but not so rapidly as to cause inflation to speed up once more.

Economic Developments in the First Half of 1970

Let me now turn to economic developments during the first half of 1970, partly against the background of expectations held at the beginning of the year.

The Slowdown of Demand

A major factor in the change that has occurred in the economy in the past year has been the reduction in the rate at which total

expenditures (private and public) for goods and services increased.

Reducing the rate of increase in this money demand for output was

one of the key steps in the policy of reducing the rate of inflation.

It was obvious at the beginning of 1969 that with the economy

crowding capacity and with total output capable of growing by around

4 percent a year, continued increases of expenditure much in excess

of that rate inevitably meant continued rapid inflation. The objective

of fiscal and monetary restraint was to check the growth of total

expenditures for output, but not so sharply as to trip off a down-

ward spiral of incomes and output.

The rate of increase in these total expenditures declined by

almost 50 percent from the three quarters ended in July-September

1969 to the three quarters ended in April-June 1970. The dollar

amounts of these changes in total expenditures and in its main

components are shown in the accompanying table.

Change in the Annual Rate of Total Expenditures (GNP),
by Components

(Seasonally adjusted annual rates in billions)

<u>Component</u>	1968-IV to <u>1969-III</u>	1969-III to <u>1970-II</u>
Total	\$ 51.2	\$ 27.5
Federal purchases	0.6	-2.9
(Defense)	(0.6)	(-2.7)
All other	50.6	30.4
Change in business inventories	2.0	-8.7
Final sales (excl. Federal purchases)	48.6	39.1
Consumption expenditures	31.3	32.1
Nonresidential fixed investment	9.9	1.2
Residential construction	-0.7	-2.5
Net exports	1.2	1.2
State and local purchases	6.9	7.1

Source: Department of Commerce

The complex interaction among components of GNP makes it impossible to say how much of this slowdown in spending was due to policy actions and how much to spontaneous forces, or to isolate the separate effects of different policy measures. Nevertheless, it seems reasonable to conclude, since it conforms to expectations based on past experience, that the reduction in the rate of monetary expansion had a general and pervasive influence. The money supply, which had grown at highly inflationary rates in 1968 and set the stage for further overheating the economy in 1969, increased only moderately in the first

Annual Rate of Increase in the Money Supply
and Time Deposits
(Seasonally adjusted)

<u>Period</u>	<u>Money Supply</u>	<u>Money Supply Plus Time Deposits</u>
December 1967-June 1968	7.3%	6.4%
June 1968-December 1968	7.1	12.5
December 1968-June 1969	4.4	.1
June 1969-December 1969	.6	-.3
December 1969-June 1970	4.2	5.7

Source: Board of Governors of the Federal Reserve System.

half of last year, and in the second half of 1969 there was virtually no expansion. Indeed, the money supply broadly defined to include time deposits actually declined slightly in that half-year period.

The influence of monetary policy was supplemented and to some extent directed into specific channels by the fiscal actions which accompanied it. The shift from increasing to decreasing defense production has clearly exerted an independent influence, and it was on a larger scale than is indicated by defense purchases alone because some part of the reduction in inventory accumulation was also the result of lower defense production. At the same time budgetary actions-- the tax reduction and the social security benefit increase especially -- were helping to sustain the increase of consumption expenditures in the face of a much reduced increase of earned personal income. But

these budgetary actions helped to shift the budget position, as measured in the national income accounts, from a surplus at the annual rate of about \$7 billion in the second half of calendar 1969 to a deficit of about the same size in the first half of calendar 1970. This contributed to the continued tightness of capital markets and to the lag of housing.

Although the increase of total expenditures for output has been markedly less in the past three quarters than earlier, the increase was larger in the second quarter of 1970 than in the previous quarter or in the fourth quarter of 1969. This is part of the evidence of an emergent economic expansion.

That the rate of increase of total spending for output should slow down was, as I have already indicated, both expected and desired, in order to reduce the inflation. The actual increase in the rate of spending from the third quarter of 1969 to the second quarter of 1970 was \$6 billion below the increase expected when we made our projection for the year in January. This difference is largely accounted for by an unexpectedly sharp reduction in the rate of inventory accumulation. Final sales, i. e., total expenditures less additions to inventories, have risen about \$1 billion more than we had projected.

The Decline of Real Output

A slowdown in the rise of real output was an inevitable part of the disinflationary process. The rate of inflation would not respond

immediately to the slower growth of total expenditures, and this lag would adversely affect the rise of real output. Real output would move below its potential, but this would be essential as a part of altering the balance of market pressures against wage and price increases.

It was part of the strategy of policy that a sharp decline of output was to be avoided and that the gap between actual and potential output be kept small. The reason for this was to limit adverse effects on incomes, production, and employment, and to reduce the danger that the slowdown would set off a cumulative downward spiral. It was recognized that caution on that side implied some willingness to accept delay in seeing anti-inflationary results.

In fact, total production, as measured by the gross national product in constant dollars, has declined 0.9 percent from its peak in the third quarter of 1969 to the second quarter of 1970. For perspective, this may be compared with 3.2 percent in the corresponding period after the peak in 1953, 3.4 percent after 1957, and 1.3 percent after 1960.

Industrial production has declined 3.4 percent from its peak in July 1969 to June 1970. Industrial production is typically more variable than total output. The current decline of industrial production

has also been smaller than the decline over an equal interval in postwar recessions.

We consider it important to note that real output showed no sign of a cumulative decline. The largest decline came in the first quarter and, according to preliminary estimates, total output was essentially unchanged in the second quarter. Industrial production continued to fall through June, but the percentage decline in June was less than in May or April.

In our Annual Report at the beginning of the year, we indicated our belief that total real output would be approximately level in the first half of 1970. Instead, the decline in the first quarter and leveling in the second quarter left second quarter output about 0.7 percent below the fourth quarter rate.

Employment and Unemployment

The slowdown in the increases in demand and output have, of course, affected the employment and unemployment picture. By the end of the first half of 1970, total civilian employment, although one-half million greater than a year earlier, was one-half million less than in December 1969. We expected that the demand for labor would be weak in the first half when real output was edging down.

The unemployment rate increased markedly in the first half of 1970, from 3.6 percent in the fourth quarter of 1969 to 4.1 percent

in the first quarter and to 4.8 percent in the second. The increase in unemployment during the first quarter was in part a consequence of an unusually rapid growth in the labor force. On a seasonally adjusted basis, the civilian labor force grew at a 5.9 percent annual rate from December to March, far in excess of its normal rate. However, some correction of this extraordinary growth occurred in the second quarter, when the labor force contracted. By June the labor force was only 2.0 percent above its level a year earlier, a growth rate much more in line with normal expectations.

At the beginning of 1970, we expected some increase in unemployment during the year. The greater than expected increase in unemployment was a result of several factors in addition to the very large increase in the labor force in the first part of the year. Output was more sluggish in the first half than we had expected, and employment growth was consequently weaker. In addition, strikes in the trucking industry, particularly in the Midwest, led to widespread temporary layoffs.

Cutbacks in the defense industry also contributed significantly to job loss, particularly among highly specialized workers in certain parts of the country. The extent of this and its economic implications are inadequately recognized. From the last quarter of 1968 to the second quarter of 1970, the annual rate of defense purchases, of goods and services, declined by about \$13 billion in real terms (at mid-1970 prices). Further significant decline may be expected during the remainder of this year. As I pointed out earlier, the decline in defense production is undoubtedly larger than the decline in defense purchases because as defense orders fall more and more deliveries are made out of inventories rather than out of production. The armed forces have been reduced 423,000 from their peak, and employment in defense product industries has declined 320,000 over the past 2 years.

The unemployment problem normally associated with such a transition from defense to civilian production and employment comes on top of the unemployment problem associated with the ending of an inflation. In other circumstances, a stronger general demand for labor might have existed or been created, which would have speeded up the absorption of former defense workers into other employment.

The number of persons counted as unemployed increased by 1,137,000 from June 1969 to June 1970. The common picture of this as meaning that 1,137,000 persons once permanently employed are now permanently unemployed is, of course, incorrect. In any year large numbers of people experience some unemployment, most of them for very short periods, such as four or five weeks or less. An increase of unemployment is almost always made up of some increase in the number of people experiencing unemployment and of some increase in the average duration of unemployment before a job is resumed. Although figures for 1970 will not be available until next year, both parts of this process are clearly going on now, and a large part of the increase of unemployment is due to a rather moderate increase in the median duration of unemployment, from 4.4 weeks in June 1969 to 5.1 weeks in June 1970. This is not, however, to

belittle the grave problems that these developments have posed for those whose employment has been interrupted. I want to emphasize what I have stated in the past that so long as anyone is unable to find a job, we have unfinished business.

Prices and Wages

At the start of the year we expected that the gap between the economy's actual and potential output would bring about conditions making for a slower price rise. With jobs harder to find, labor would find it more difficult to make the kind of wage bargains it had during periods of low unemployment. Businesses in turn, facing more competitive markets, would be less likely to grant large wage increases if they believed that it would be difficult to recover higher costs in the form of higher prices. Furthermore, business would take more vigorous steps to cut costs by eliminating the inefficiencies that had grown up over the long period of inflation. This change in behavior was not expected to come all at once; we could not expect to root out in a few months problems of an inflation of long standing.

Specific signs of progress in the fight against inflation are not as numerous as we had hoped but they are now emerging. They should increase in number as 1970 progresses because the gap between our actual and potential production will persist.

The most comprehensive measure of price increases, the GNP deflator, showed a clearcut slowdown in the second quarter. The 4.2 percent increase was smaller than in any quarter of 1969 and approximately matched the annual increase from 1967 to 1968. This slowdown is good news for all of us even though the improvement was greatly influenced by changes in the composition of GNP. (Some of the earlier recorded increases in the deflator, of course, also reflected obverse shifts in composition)

We do have final figures on the wholesale price index and here there is unmistakable evidence of a slower rise in prices in the first half of 1970. From December to June, the WPI rose at a seasonally adjusted annual rate of 2.6 percent, which was well below the average quarterly gain of 1969. In the second quarter, the rise came to only 1 percent. All of the improvement this year as compared with 1969 has occurred in prices of farm products and processed foods. On a seasonally adjusted basis, the rise in industrial commodities is about the same as the quarterly average last year. However, the price rise for both producer and consumer (nonfood) finished goods has been smaller from December to June than it was from June to December, 1969.

Two further points should be made here. The decline in food prices is extremely important and should be reflected with the usual lag at the retail level. Second, there is some reason to believe that some price cutting is going on in industrial markets that is not being picked up in the official prices indexes, which tend to reflect list prices only.

Unfortunately, the declines at the wholesale level have yet to be felt at retail. We have no evidence as yet of a slowdown in the consumer price index. However, with more favorable movements in wholesale food prices and with some slowdown in wholesale prices of other consumer finished goods, some response at retail should be forthcoming.

Data for the first half of 1970 indicate that average wage increases for the whole economy have slowed down somewhat during this period. The annual rate of increase in average hourly earnings in all private industries from the fourth quarter of 1969 to the second quarter of 1970 was only 5.2 percent as compared with an increase of 6.3 percent in the corresponding quarters one year earlier. From the first to the second quarters of 1970, average hourly earnings increased at an annual rate of 6.5 percent, while the increase was 6.9 percent for the same period in 1969. The slowdown in the rate of increase appears to be related to the elimination of overtime and changes in industry mix.

Wage increases negotiated under major collective bargaining agreements have not slowed down in the first half of 1970. The highly publicized large collective bargaining settlements, however, can give a distorted view of overall wage developments. Although the calendar for these collective bargaining negotiations is heavy in 1970, only about 6 percent of the total labor force will be covered by settlements reached under major agreements. Furthermore, most of the extremely high settlements have been in construction and trucking, which partially reflect symptoms of continuing

structural problems in these industries. The high settlements in construction, for example, appear to result in part from a combination of the rapid expansion of demand for nonresidential construction in the late 1960's and union limitations on entry to the industry.

The relationship between wages and prices depends heavily on the behavior of productivity, of output per man-hour. It is only when the recent pace of wage increases is combined with the absence of gains in productivity that we can understand the rapid increase of unit labor costs which has contributed to the persistence of inflation. For example, from the fourth quarter of 1968 to the first quarter of 1970, compensation per man-hour in the private nonfarm economy rose at the annual rate of 6.4 percent, but productivity actually declined at the annual rate of 0.8 percent, with the result that labor costs for unit of output rose at an annual rate of 7.2 percent. This, of course, had a great deal to do with the fact that prices of private nonfarm output rose at an annual rate of 4.9 percent in the same period.

Preliminary information for the second quarter of 1970 suggests that productivity began to rise again, and may have increased at the annual rate of as much as 3 percent. This in turn

may be related to early evidence suggesting that profits were somewhat better in the second quarter than many had feared earlier. Whether or not that turns out to have been true, all the conditions seem present for a rise of productivity in the future.

Balance of Payments

Our international transactions during the first half of 1970 have shown both favorable and unfavorable developments. On the favorable side there is a significant improvement in our current transactions. Our merchandise trade surplus, in particular, has shown a fairly steady increase from the low figures of late 1968 and early 1969. In 1968 our merchandise balance had declined to a monthly rate of only \$70 million. In 1969 it was \$105 million. And in the first five months of 1970 it was \$226 million (seasonally adjusted).

Taking goods and services (including factor income) together, our exports for the second quarter of 1970 are provisionally estimated at a seasonally adjusted annual rate of \$62.5 billion, or 23.5 percent above the average rate for 1968, and 12.6 percent above the average for 1969. Our imports of goods and services in the second quarter are tentatively put at \$58.7 billion, or 22.0 percent above 1968 and 9.5 percent above 1969. The surplus on

goods and services of \$3.8 billion, if confirmed by later estimates, would be the largest since the end of 1967. This improvement is due in part to strong demand for our exports and a continued growth in income on investments abroad, and also to some slow-down in the growth of imports.

Developments have been less reassuring in our capital accounts. Second-quarter estimates will not be available for some months, but in the first quarter U.S. private long-term capital flowed out at a record rate. Despite controls on direct investment of U.S. corporations, there was a net outflow at a seasonally adjusted annual rate of \$5.2 billion. Portfolio investment by U.S. residents was also at a high level, while the net inflow of foreign private capital was much less than in the years 1968 and 1969. There was a small reduction in U.S. Government grants and capital, to an annual rate of \$3.3 billion.

The net result of these diverse developments in the current and the capital account was a liquidity deficit at an annual rate of \$6.2 billion, including the first allocation of Special Drawing Rights at an annual rate of \$0.9 billion. This is a large deficit by historical standards, though it was exceeded in the second and third quarter of 1969. The official settlements balance, again

including SDR's, turned from a sizable surplus in 1969 to a large deficit of \$11.4 billion in the first quarter of 1970, reflecting primarily the accumulation of dollars in the hands of foreign official institutions. Tentative indications suggest that the liquidity and official settlements deficits continued into the second quarter but at a significantly lower rate.

Prospects for the Remainder of 1970

We have behind us a moderate decline in the real economy and the first signs of a decline in the rate of inflation.

What lies ahead?

With economic activity bottoming out in the second quarter of 1970, it is reasonable to expect a resumption of growth in real GNP in the second half, accompanied by a better price performance. As we stated in our Economic Report, the existence of slack in the economy means that increases in demand can be translated primarily into output increases rather than price increases. At the same time we are likely to experience a further moderate rise in unemployment rates over the average level that prevailed in the second quarter. The unemployment rate will start to level out and decline only after the recovery is vigorous enough to diminish the gap between actual and potential output.

At the start of 1970 it was recognized that in order for the economy to resume its expansion in the second half, it would be necessary to relax monetary policy at the beginning of the year. A change in monetary policy occurred around mid-winter. Growth of the money supply from December to June averaged 4.2 percent at an annual rate, as compared with 0.6 percent for the preceding half year.

In capital markets, the change in policy first produced easier credit conditions. Short-term interest rates declined sharply. Although U.S. Government and municipal bond yields also receded, corporate yields only leveled off and in May they began to rise again. With pessimism about profits and with a continuing need to refinance short-term indebtedness incurred in earlier months, corporate demand for long-term credit remained intense. Corporate bond issues, which had totaled \$9.3 billion in the first half of 1969 and \$9.1 billion in the second, were \$14.1 billion in the first half of 1970. However, the early weeks of July brought signs that these pressures have abated, and bond yields have backed down from the peaks of June.

At the turn of the year, deposit flows into savings institutions recovered dramatically from the severe decline of 1969. The net change in mortgage holdings of all financial institutions, which had fallen sharply after the middle of 1969, reached a low point in March and showed a definite improvement in April and May.

The increase in the money supply and improvement in credit market conditions should be felt throughout the economy but should be most noticeable in the case of homebuilding and State and local expenditures. There have already been some signs of an imminent upturn in homebuilding; building permits rose in April and May to their best levels in about a year. Housing starts rose sharply in June. A very considerable backlog demand for housing has built up as a result of the low volume of housing starts in the past several years, and the easing of credit ought to find a reasonably prompt response in housing starts.

Fiscal policy also became more expansive in the first half of 1970, and we have by no means felt all of the effects of this stimulus. That is suggested by the unusually high savings rate (7-1/2 percent) in the second quarter, indicating that consumers have not yet fully adjusted outlays to increases in their after-tax incomes. Furthermore, starting in July, there was the complete elimination of the surtax as well as the **increases** in personal exemptions that were part of the Tax Reform and Relief Act of 1969. These provisions will add an estimated \$5 billion to consumer disposable income in the third quarter. Altogether, the elimination of the surtax, the rise in Social Security benefits, the Federal pay raise and the reform and relief provisions of the tax law have added over \$16 billion to consumer disposable income since the final quarter of 1969. We have

already seen some positive results in consumer spending in the first half, and it is reasonable to expect more in the second as consumers adjust more fully to these income changes.

Federal expenditures are not likely to show much change over the current half year. Cutbacks in defense purchases will continue, offset by rising expenditures of other types.

Finally, plant and equipment outlays ought to be a little higher in the second half than in the first. This is not inconsistent with a further scaling back of the plans reported in the June Commerce-SEC survey. Inventory accumulation should also rise after the unusually low figures of the past half-year.

When we put these figures together, they add to increases in real GNP of moderate size in the second half. This assumes no interruptions from major strikes, about which I have no special knowledge. We should also see for the first time a slower price rise at the consumer level. Prospects are particularly favorable for retail food prices to change relatively little in the second half because of larger supplies coming to market.

The Problem of Liquidity

The Chairman of the Committee requested that I comment on the liquidity problem. This is an important matter. It is a factor thought by some to cloud the prospect for economic revival and even to hold potential danger that a decline might resume.

A liquidity problem in the sense of disorganized financial markets clearly does not exist. If there were a generalized scramble for funds, interest rates, particularly short-term rates, would be rising sharply. In fact, they have been declining. Our banks are strong. Consumer credit is not out of line with incomes, and delinquency rates are well within the range of normal expectation.

Certain statistical measures of average liquidity have shown substantial declines. The ratio of quick assets (cash and U. S. Government securities) to current liabilities for nonfinancial corporations declined from 0.33 at the end of 1964 to 0.19 at the end of 1969, and to 0.18 in the first quarter of 1970. For manufacturing corporations in this five-year period, the decline was from 0.43 to 0.23. These declines seemed to come heavily in two spurts, one from 1964 to 1966 and the other from 1968 to date.

These declining measures of liquidity reflect many things. There has been a long-run trend toward holding smaller reserves of cash and marketable securities, as companies have been attracted by the increased profits obtainable from investing such

Liquidity Ratios of U. S. Corporations

Year (end of period)	<u>Nonfinancial Corporations</u> ¹		<u>Manufacturing Corporations</u> ²	
	<u>Current Ratio</u> ²	<u>Quick Ratio</u> ³	<u>Current Ratio</u> ²	<u>Quick Ratio</u> ³
1964	1.84	0.33	2.39	0.43
1965	1.79	0.29	2.27	0.37
1966	1.74	0.25	2.16	0.30
1967	1.75	0.24	2.20	0.29
1968	1.72	0.23	2.14	0.28
1969	1.64	0.19	2.01	0.23
1970 (1st Qtr)	1.63	0.18	1.99	0.21

Sources: F.T.C., S.E.C. Quarterly Financial Reports for Manufacturing Corporations, S.E.C. Statistical Bulletin.

¹ Excludes banks, insurance companies, and savings and loan associations.

² Total current assets divided by current liabilities.

³ Cash plus government securities divided by current liabilities.

funds in inventories and other forms of working assets. Modern techniques of short-term portfolio management have also encouraged this development.

In addition to these long-run trends, two further developments seemed to become more evident in recent years. Both were related to the persisting inflation that began to gather momentum in 1966. As the inflation persisted, and after 1967 accelerated, firms began to shift from cash and financial assets to inventories and physical capital assets. This was presumably a preventive measure reflecting fears about an erosion of the real value of assets from continuing inflation. In their endeavor to minimize this risk, some businesses may have come to give inadequate weight to the normal risks and contingencies for which quick assets and a strong current position are a part of prudent financial management.

Moreover, business capital demands were intense in 1969, as projected increases in outlays for plant and equipment rose to the 12-14 percent range, this in an economy capable of increasing real output by roughly 4 percent per year. There was in many of these capital budgets also a strong component of inflation-mindedness. These developments began to crowd against a flow of internal funds adversely affected by declining profits. Heavy demands were, therefore, thrown into credit markets also under growing pressure from restrictive

monetary policies. Financial markets tightened and interest rates rose sharply. In the face of high bond yields and falling equity prices, many companies borrowed short-term funds last year with the intention of converting to long-term financing at a more opportune time later. This year many firms were faced with converting this short-term indebtedness into longer-term maturities. As a result, the demand for long-term funds continued to be intense this year, and the bond market has been forced to handle a tremendous volume of new issues. In the intense competition for funds, some borrowers have inevitably been squeezed out.

We are now engaged in a more detailed study of the liquidity problems of corporations and hope to be able to submit its results to this Committee soon. However, our study of this problem to date has led us to three main conclusions.

First, the financial institutions of the country are in sound condition and financial markets are working effectively. The ability of the banking system to meet demands upon it has been strengthened by accessibility of the Federal Reserve discount window and by the new ability of banks to attract funds through certificates of deposit.

Second, although the liquidity of non-financial corporations on the average has declined by almost any measure, it is only in quite exceptional cases that serious difficulties exist. These cases

do not constitute a problem for the economy as a whole. At the same time we must be alert to these situations, and have the capability and will to handle them decisively, in order to minimize the danger of adverse secondary effects.

Third, the overall supply of liquidity, as measured by the supply of money and the availability of credit, is on the low side of what is needed, especially for a period which we expect to be the beginning of renewed economic expansion. Assurance of a sustained rise in the economy would be improved by more rapid strengthening of the economy's general liquidity position.

Managing a Noninflationary Expansion

There is strong and increasing basis for confidence that the decline of the economy is about over and that we will soon be seeing the signs of an upturn. While there is, as usual, disagreement about the precise dates and quantities involved, it is timely for us to look beyond the turn as such and explore the problems of managing an orderly recovery to full utilization of our productive capacity.

The word "managing" deserves emphasis. Having come this far along the road of re-establishing the basis for a more stable price level, we must resist the temptations of overly expansionist policies.

There is too much viscosity in our economy for an immediate and dramatic rebound, and in trying to achieve this we would court the risk of reactivating inflationary pressures and inflationary fears.

At the same time we can now begin a more expansionist course for the economy and still continue to make progress against the inflation. Price developments in the period ahead will heavily reflect the emergence of slack in recent quarters. Price-making forces move slowly through the economy. We have already incubated disinflationary pressures whose results on the price level are still largely to come into the picture.

Moreover, even when the economy has turned the corner, we cannot assume an automatic return to full employment. In 1958 the economy began a strong recovery from its low point, but that did not continue long enough to eliminate its slack. The 1960-61 recession was the mildest of postwar history, but four years after its low point the unemployment rate was still 5 percent, and another year was required to achieve 4 percent. Certainly our goal must be to regain full employment more promptly this time.

We must begin now to think in terms of the magnitudes that will be required in the period ahead. They are large. Potential real output rises by at least 4 percent per year as a result of the growing labor force and the various factors that increase productivity. In addition to this we now have some arrearages to make up in a reasonable period. Total

output was probably running about 4 percent below its potential, in the second quarter of 1970, as conventionally defined; that is, it was about 1 percent below the output we would have produced if unemployment had been 4 percent and productivity had been on its long-term trend. And the price level in the period ahead will have some upward drift even though the inflation continues to decelerate. Therefore, the rates of increase of money GNP required for recovery to full employment will be somewhat higher than the needed rates of increase of real output alone. These figures suggest that even for the economy to move along an essentially noninflationary growth path, needed rates of growth in the money demand for output must be large.

Such rates of increase of total output would also involve unusually large increases in productivity -- in output per man hour. The possibility of achieving a large increase of productivity is implicit in the estimate that, while employment in the second quarter of 1970 was roughly 1 percentage point below full employment, real output was 4 percent below potential. A rapid increase of productivity has been our normal experience when the economy was in the early stages of recovery from a slowdown, and there is no reason why it should not occur now.

The rapid rise of productivity would, of course, make a substantial contribution to the reduction of inflation, reversing a factor which has

been making a major contribution to the continuation of inflation. If productivity should now rise for a time at the rate of 4 or even 5 percent, which is not impossible, the rise of unit labor costs would be dramatically reduced, and so would cost pressures on the price level.

In the management of fiscal and monetary policy it will be essential to keep in mind that a rate of expansion which is appropriate if we are moving along the path of reasonably full employment is not adequate when we begin from a position substantially below that path. This is doubly important when we bear in mind that it is also an economy needing some strengthening of its liquidity condition.

The problem of fiscal management in the period ahead is particularly complex. The basic task of fiscal policy is always to assure that we make provision for the most important national needs which should be met through the Federal budget and that resources and finance are left available for those important public and private needs that must be met outside the Federal budget. The overwhelming requirements of this task, and of the political process through which it is performed, leave little room for flexible variation of the budget to meet changing requirements of economic stabilization. In fact, as experience demonstrates, just to keep the budget from being a destabilizing force in the system is difficult.

Probably the basic contribution fiscal policy can make to the orderly and expeditious recovery of the economy is that it should not place upon either monetary policy or on private market forces the need to adapt to sharp changes of conditions. We should achieve at least a balance and hopefully a moderate surplus in the budget when the economy regains full employment, because after this present multifaceted transition the demand for capital to finance housing, State and local investments, and business investment will be high, and a strong budget will help to meet those demands. The transition from today's deficit to the desired full-employment balance or surplus should be made smoothly as the economy rises to its potential. Particularly we should avoid falling off this path into significantly larger deficits. One of the most serious consequences of such a development would be to interrupt the emergent recovery of housing.

The recovery of the economy added to its normal growth will greatly increase the revenue-yielding base. But what is truly amazing is the extent to which this increase is already committed, by tax reductions scheduled under the 1969 Act and by a seemingly irresistible flood of expenditure increases built into existing legislation. The dominant, persistent budgetary problem of our time will be to hold expenditures in line with what the people are willing to pay for. We cannot afford to be diverted from that task.

The Administration relies basically on the combination of fiscal and monetary policy, with the spontaneous adaptive forces of the private economy, to move us along the path to full employment with less inflation. Still we have been anxious, as any Administration would be, to find supplementary measures that would really help to speed the disinflationary process. To this purpose we began considering in March, 1969 a wide range of possible actions falling within the category loosely called price-wage policy or incomes policy. We have not lacked suggestions in this area.

Our objective was to isolate those elements of such possible actions that held promise of success. In this consideration, it was necessary to get behind the labels pinned on policies to discover what they really consisted of and were likely to perform. The conclusion of considerable study and discussion within the Administration was that the following steps would be useful:

1. To mount a major cooperative effort of the private sector and the government to increase productivity.
2. To provide a forum within which leaders of the private sector and of the government can discuss the requirements of a stable and growing economy.
3. To provide the public with more information about the consequences for the course of the inflation of private wage and price decisions.

4. To assure that in the exercise of the Federal Government's procurement and regulatory functions more weight be given to the objective of restraining inflation.

The President announced in his address on June 17 that these steps would be taken. Since then we have been engaged in putting them into effect. A National Commission on Productivity has been established. It will hold its first meeting on August 6. At that time the Council of Economic Advisers will submit to the Commission its first Inflation Alert, outlining the consequences of major price and wage decisions for changes in the price level. A Regulations and Purchasing Review Board has also been established to determine where these Federal activities tend to drive up prices, and this Board is now also functioning.

These measures have been carefully chosen. They are an effort to assure that, within the logic of a free economy, we leave nothing undone to assist the country through the difficult transition we must now make. We will pursue this effort as diligently as possible and are hopeful it will make a contribution.

Cushioning Adjustment Hardships

During this period of transition we need measures to cushion the adverse effects of adjustment. The unemployment insurance system has been a support to hundred of thousands of workers during interruptions of

employment. Last year the Administration proposed legislation that would have extended unemployment insurance coverage to millions of workers now uncovered, and improved the system in other respects. It is to be hoped that this can soon become legislation.

The Administration has also proposed an automatic increase of 10 percent in funds allocated to manpower training programs when the unemployment rate rises above 4.5 percent for 3 consecutive months. Had this legislation been enacted, this increase would already have taken effect. Unemployed workers could take advantage of these increased opportunities for training and upgrading of skill levels during interruptions of employment. Higher skill levels of the work force have been an important source of productivity growth, and the increased training opportunities under the Manpower Training Act would enable these workers to obtain better jobs and lay the basis for future improvements in their earning capacity and in national productivity.

Conclusion

This review of recent economic developments, evidence about our prospects, and the implications of these for the management of economic policies has led me to four major conclusions.

First, the adjustment of the economy to needed measures of disinflation though painful has produced no cumulative decline in business activity. In overall terms it has established itself as discernibly less severe than the 1960-61 decline, which itself was the mildest recession of the postwar period.

Second, an evaluation of basic forces which will be shaping the course of the economy in the period ahead leads to cautious optimism about an improvement in business conditions during the second half of the year.

Third, in our understandable desire to regain full employment promptly, we must not undo the substantial progress that has been made in establishing the basis for a more stable price level.

Fourth, mindful of the need to move in an orderly way, we must now face up to managing the resumption of an expansion that in a reasonable period can bring the economy back to the zone of full employment. The magnitudes are large because the basic capacity of the economy is growing rapidly, we set out on the return to full employment from a position that is below the basic path, and some strengthening of the economy's liquidity resources commends itself now as a prudent consideration of policy.