CHAPTER 1

Performance and Policy to Mid-August

ON AUGUST 15, 1971, the President announced a far-reaching New Economic Policy designed to check the rise in prices and wages, strengthen the Nation's external economic position and stimulate economic activity at home. To curb the rate of inflation, prices, wages, and rents were subjected to a 90-day freeze, which was followed by a comprehensive but more flexible system of mandatory controls. To improve the Nation's balance of payments, the President suspended the convertibility of the dollar into gold and other reserve assets and imposed a temporary 10-percent surcharge on imports. And to strengthen the domestic economy, the President proposed, in addition to these measures, a fiscal package whose stimulus came from a set of tax cuts, which were passed by the Congress in December in somewhat altered form.

Results of the new program were visible in varying degrees by the end of the year. They were most apparent in the slowdown of price and wage increases during the freeze. On the international front the major industrial countries agreed to a realignment of currencies more favorable to the U.S. competitive position and to prompt discussions concerning trade barriers and long-term monetary reform. The strong upsurge in purchases of automobiles from mid-August through November was partly a result of the proposed removal of the Federal excise tax, but much of it was apparently an attempt by consumers to buy automobiles before prices were increased in the post-freeze period. Perhaps the most significant effect of the combined package was the impact on public confidence. From mid-August to the end of the year, there was slow but steady improvement in confidence that the rate of inflation was subsiding and the pace of the economic recovery was gathering strength.

The decision to embark on the New Economic Policy (NEP) came from an increasing awareness in the Administration that the ambitious goals it had set at the beginning of the year were not being met. Progress in the fight against inflation was proceeding too slowly, and its future success was uncertain. At the same time, the recovery was also progressing, but not fast enough to cut the rate of unemployment. More crucial than either of these for the timing of the decisions was the serious weakening of the dollar in international markets. As the summer wore on, there were no signs of a resolution of the financial crisis that in May caused the Swiss franc and the

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Austrian schilling to be revalued and the German mark and the Netherlands guilder to be set free to float in value. In the second quarter, the U.S. balance of payments on the official reserve transactions basis had recorded a deficit of $23 billion at a seasonally adjusted annual rate, and in July and August pressure against the dollar reached enormous proportions. Funds totaling about $3.7 billion moved into foreign official reserve accounts in the week ended August 15. The time had come to deal decisively with the international financial problem that had persisted for at least a dozen years despite the efforts of four successive Administrations.

The domestic aspects of the New Economic Policy are discussed at the end of this chapter and in Chapter 2 and the international aspects in Chapter 5. The rest of this chapter deals with events and policies in 1971, generally up to the midsummer shift in policy.

DEMAND, OUTPUT, AND THE LABOR MARKET

The year 1971 was one of limited recovery in demand and production. During 1969 the Administration had actively sought to slow down the economy in order to control inflation. Those efforts had their major impact at the end of 1969 and early 1970, when the rise in demand slowed considerably and output dipped, after which policy shifted in the direction of expansion. A fragile recovery was reversed toward the end of 1970 by the lengthy and severe strike at General Motors. The underlying course of the economy was upward throughout 1971 and its pace was moderate for most of the year, but the actual course of events was irregular because of strikes and their aftermaths (Chart 1, p. 23).

Changes in demand and output as measured by GNP through the third quarter of 1971 are reviewed in the following pages. Although the NEP was announced in mid-August, it would be difficult to measure changes through the middle of the third quarter. In any case, the measured demand conditions of the third quarter are probably generally representative of the demand conditions at the time the August 15 decisions were made, although the increase of GNP in the quarter has turned out to have been lower than was expected at that time.

DEMAND PATTERNS

From the third quarter of 1970 to the third quarter of 1971, total GNP rose 7.1 percent or by $70 billion (Table 1). This was considerably more than the $43 billion rise over the preceding 4 quarters. The rise was dominated by increases in residential construction and State and local government purchases, both of which were especially responsive to the improvement in credit conditions. Consumption expenditures showed an above-average gain, while Federal purchases and business fixed investment were weak. The overall increase was held down by a reduction in business investment in inventories and by unexpectedly severe weakness in net exports. Indeed, if our economic performance were measured by domestic

TABLE 1.—*Changes in gross national product in current and constant dollars, 1968 III to 1971 III*

[Billions of dollars]

Component	Change in seasonally adjusted annual rates				
	1968 III to 1969 III	1969 III to 1970 III	1970 III to 1971 III	1970 III to 1971 I	1971 I to 1971 III
Current dollars:					
Total GNP	65.0	43.3	69.9	37 3.	32.6
Personal consumption expenditures	40.1	36.8	47.9	24.0	23.9
Business fixed investment	11.9	4.1	4.5	−.1	4.6
Residential structures	1.0	−2.0	14.0	6.7	7.3
Change in business inventories	2.7	−5.3	−6.3	−2.0	−4.3
Net exports of goods and services	−.6	1.2	−4.0	.7	−4.7
Federal Government purchases	.5	−4.2	1.5	.3	1.2
State and local government purchases	9.4	12.8	12.2	7.6	4.6
Gross auto product	1.7	−4.0	8.0	8.0	.0
All other product	63.3	47.3	61.9	29.3	32.6
Constant (1958) dollars:					
Total GNP	15.5	−4.5	17.4	6.4	11.0
Personal consumption expenditures	12.2	8.0	16.4	6.9	9.5
Business fixed investment	5.8	−1.0	−1.2	−2.4	1.2
Residential structures	−.5	−2.1	8.3	4.1	4.2
Change in business inventories	2.2	−5.3	−4.4	−1.4	−3.0
Net exports of goods and services	−1.0	2.6	−3.1	−.2	−2.9
Federal Government purchases	−5.2	−9.4	−1.1	−2.5	1.4
State and local government purchases	1.9	2.7	2.5	2.0	.5
Gross auto product	.9	−4.7	5.9	5.2	.7
All other product	14.6	.2	11.5	1.2	10.3

Note.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

final sales, that is, by GNP excluding inventory investment and net exports, the rise over the period would have been about a full percentage point greater.

[Percentage change]

	1968 III to 1969 III	1969 III to 1970 III	1970 III to 1971 III
GNP	7.4	4.6	7.1
Domestic final sales	7.3	5.1	8.2

The 7.1-percent increase in GNP reflected a 4.6-percent rise in prices and a 2.4-percent increase in physical volume. Although this increase in volume was an improvement over the decrease of 1970 and the 2.2-percent gain of 1969, it fell short of the rate required to keep unemployment from rising. Unemployment reached a peak around the beginning of 1971 and thereafter remained essentially on a plateau.

Consumer Income and Spending

Fiscal policy helped to buttress consumer income last year, as it had in 1970. Because the demand for labor was weak, the expansion in payrolls was

TABLE 2.—*Changes in personal income, taxes, and disposable income, 1967 III to 1971 III*

[Billions of dollars]

Item	Change in seasonally adjusted annual rates			
	1967 III to 1968 III	1968 III to 1969 III	1969 III to 1970 III	1970 III to 1971 III
Wage and salary disbursements	44.7	45.8	28.7	31.7
Other earned income	12.4	13.4	8.6	10.4
Transfer payments	8.4	5.8	14.9	15.7
Less: Personal contributions for social insurance	2.4	3.5	1.7	3.0
Equals: Personal income	63.1	61.5	50.5	54.8
Less: Personal tax and nontax payments	18.7	13.4	−2.6	2.5
Equals: Disposable personal income	44.5	48.0	53.0	52.3

Note.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

limited. Indeed, personal income excluding transfer payments rose only 5.4 percent from the third quarter of 1970 to the third quarter of 1971 (Table 2). However, transfer payments rose almost 20 percent, mainly because in the second quarter of 1971 Social Security benefits were increased, the change being retroactive to the beginning of 1971. Altogether the rise in total personal income during this period came to 6.8 percent. Because of the tax reductions under the Tax Reform Act of 1969 that became effective at the start of 1971, personal taxes declined relative to income. The 7.5-percent increase in disposable (after-tax) income was somewhat more than the average annual gain for the past decade in current dollars but not in real terms.

Personal consumption expenditures rose 7.7 percent from the third quarter of 1970 to the third quarter of 1971, or 3.4 percent in real terms. Spending on durable goods, which had changed little over the preceding year, rose much more than average even when allowance is made for the sharp increase in automobile purchases after August 15. What was noteworthy about consumer behavior during this period was the persistence of a very high rate of personal saving. The 8.3-percent rate from the third quarter of 1970 through the second quarter of 1971 was higher than any 4-quarter average since 1946. The rate peaked in the second quarter, coincident with the large payment of Social Security benefits, and edged down thereafter.

Business Investment

Despite the improvement in profits and cash flow and the greater availability of credit in 1971, business fixed investment in real terms changed little during 1971; the 4-percent rise in outlays from the third quarter of 1970 to the third quarter of 1971 was slightly less than the rise in prices. Excess plant capacity was the main factor discouraging investment.

Investment was not uniformly weak last year. The sluggishness centered in manufacturing and railroads, both of which showed typical cyclical responses, and in airlines. With their output decreasing from 1970 to 1971 to a level far below capacity, manufacturers cut back their investment by 5½ percent from 1970 to 1971 after holding it even from 1969 to 1970. Increases were large for electric utilities, whose investment rose 20 percent over the year.

Although real investment declined during 1970, gauged by recessions in the postwar years the decrease was very mild—if allowance is made for the GM strike. As a share of real GNP, business fixed investment has remained high. The 10.6-percent share for 1971, although below the high average of 10.9 percent from 1965 through 1970, was above the average of 10.1 percent for the 20 years from 1951 through 1970.

At the start of 1971 the Administration announced that depreciation rules would be liberalized to stimulate fixed investment. The main features of this liberalization were a shortening of permissible useful lives of equipment and a change in the regulations affecting the calculation of depreciation in the year of acquisition. The Treasury Department estimated that in the first full year following these changes depreciation would be raised by $6½ billion and taxes on business income reduced by $2.8 billion. The liberalization, with first-year benefits considerably reduced, later became part of the Revenue Act of 1971. The new regulations were not expected to exert a large influence in 1971—the main benefits were expected to be achieved subsequently—but they may have played a role in the step up of appropriations and new orders for capital goods after the middle of the year.

The mildness of the recovery and uncertainty about the outlook caused businessmen to pursue cautious inventory policies during most of 1971. The $2 billion added to stocks during the year was even less than the small addition in 1970. Last year, special factors associated with strikes had the effect of stimulating inventory investment at first and depressing it subsequently. Automobile stocks were built up in the first half following the pronounced liquidation of stocks caused by the General Motors strike in late 1970. Prospects of a possible steel strike after July 31, the expiration date of the labor contract, caused steel consumers to build up stocks in the first 7 months of 1971, after which these inventories were liquidated.

The pattern of GNP change is altered if the change in investment in auto and steel stocks is excluded from the total, as is done below. On this basis the rise in GNP strengthened rather than weakened from the first to the third quarter as compared to the rise over the preceding 2 quarters.

[Billions of dollars; seasonally adjusted annual rates]

	1970 III to 1971 I	1971 I to 1971 III
Change in GNP	37.3	32.6
Less: Change in investment in auto and steel stocks	3.9	−6.6
Equals: Adjusted change in GNP	33.4	39.2

Residential Construction

Housing was the strongest sector of the economy in 1971. Private housing starts totaled more than 2 million units, the largest number recorded for any year. Residential construction outlays rose almost 50 percent, or $14 billion, from the third quarter of 1970 to the third quarter of 1971. This was one-fifth of the rise in total GNP.

The rise in housing was an extension of the recovery in starts that began in the spring of 1970 and reflected exceptionally strong demand in a setting of easing credit. Government subsidy programs and Government assistance in mortgage markets also contributed to the housing expansion. Demand for new homes had been partially frustrated during the second half of the 1960's, largely because of competing demands for credit by business and government in an environment of restrictive monetary policy in 1966 and in 1969. Traditional mortgage lending institutions, which were inhibited in their ability to attract savings deposits, reduced mortgage credit sharply. Mortgage interest rates rose to unusually high levels in 1969 and early 1970. From a peak in the first quarter of 1969 to a trough in the first quarter of 1970 private starts declined 24 percent. The decreases in private starts of 2.7 percent in 1969 and 2.3 percent in 1970 occurred at a time when increases in family formation and replacement demand suggested the production of more rather than fewer homes. Consequently, a backlog of housing demand, evidenced by extremely low vacancy rates, was carried into 1971.

The shift to an easier monetary policy in 1970 was the decisive factor in the turnaround in housing. This change, along with growing support from a number of Government-related housing institutions and a flood of savings deposits into mortgage lending institutions, greatly increased the availability of mortgage credit and brought the secondary market yield on FHA mortgages down slowly from the 9.29-percent peak that had been reached in March 1970.

The strength of demand showed up in several different ways. Sales of new one-family homes from January through October were 40 percent greater than the corresponding 1970 total. The ratio between the inventory of unsold homes and homes sold was lower than in any earlier year, at least since 1963, when numbers of this sort were first collected. Vacancy rates were low for both rental and homeowner units. Homeowner vacancy rates through the third quarter remained at their lowest levels in over a decade; and although the rental vacancy rate rose from 4.9 percent in the second quarter to 5.3 percent in the third, it remained low by the standards of the 1960's.

Other Demand

Purchases by State and local governments rose about as much during 1971 as during the preceding year. Improving credit conditions facilitated financing by State and local governments. There was no evidence of any slowdown in the growth of payrolls, which make up close to three-fifths of State and local purchases; however, the rise in employment continued to slow down, while wage increases accelerated.

The deterioration in the Nation's trade balance is discussed in Chapter 5. Here it need only be noted that the deterioration had a significant effect on the change in GNP. In the third quarter of 1970, for example, net exports were at the comparatively high rate of $4.0 billion. In the third quarter of 1971, the balance had fallen to zero, with imports rising much more rapidly than exports. As a result, U.S. output of goods and services rose less than the domestic U.S. demand, because more of that demand was met from imports.

LABOR MARKET

Although growth of the labor force slowed down and civilian employment expanded somewhat before the start of the NEP, the unemployment rate remained near 6 percent through August and indeed through all of 1971 (Chart 1, p. 23). The stickiness of the jobless rate reflected primarily the slowness of the cyclical recovery of private demand, the continuing downward adjustments occurring in the defense sector, and the strong cost-cutting efforts in all sectors of the economy that resulted in greater output per hour of work.

Labor Force

The total labor force increased by about 1.1 million from the third quarter of 1970 to the third quarter of 1971, or by nearly one-third less than would normally be expected from population growth and long-run trends in labor force participation. Because of reductions in the Armed Forces, the civilian labor force expanded more than the total labor force, rising by about 1.5 million. For men aged 20 to 24, increases in the civilian labor force were particularly large again in 1971, reflecting the return of ex-servicemen to civilian activity (Table 3 and Chart 2).

TABLE 3.—*Changes in the working-age population, Armed Forces, and labor force, 1962 to 1971 III*

Group	Change (millions of persons, 16 years and over)				
	1962 to 1965 average	1965 to 1968 average	1968 to 1969	1969 to 1970	1970 III to 1971 III
Noninstitutional population	2.1	2.1	2.3	2.3	2.4
Total labor force	1.2	1.7	2.0	1.7	1.1
Armed Forces	(1)	.3	(1)	−.3	−.4
Civilian labor force	1.3	1.4	2.0	2.0	1.5
Men 20 to 24 years	.2	.1	.2	.4	.5
Men 25 years and over	.1	.3	.3	.4	.3
Women 20 years and over	.6	.9	1.1	.9	.5
Both sexes 16 to 19 years	.3	.2	.4	.3	.3

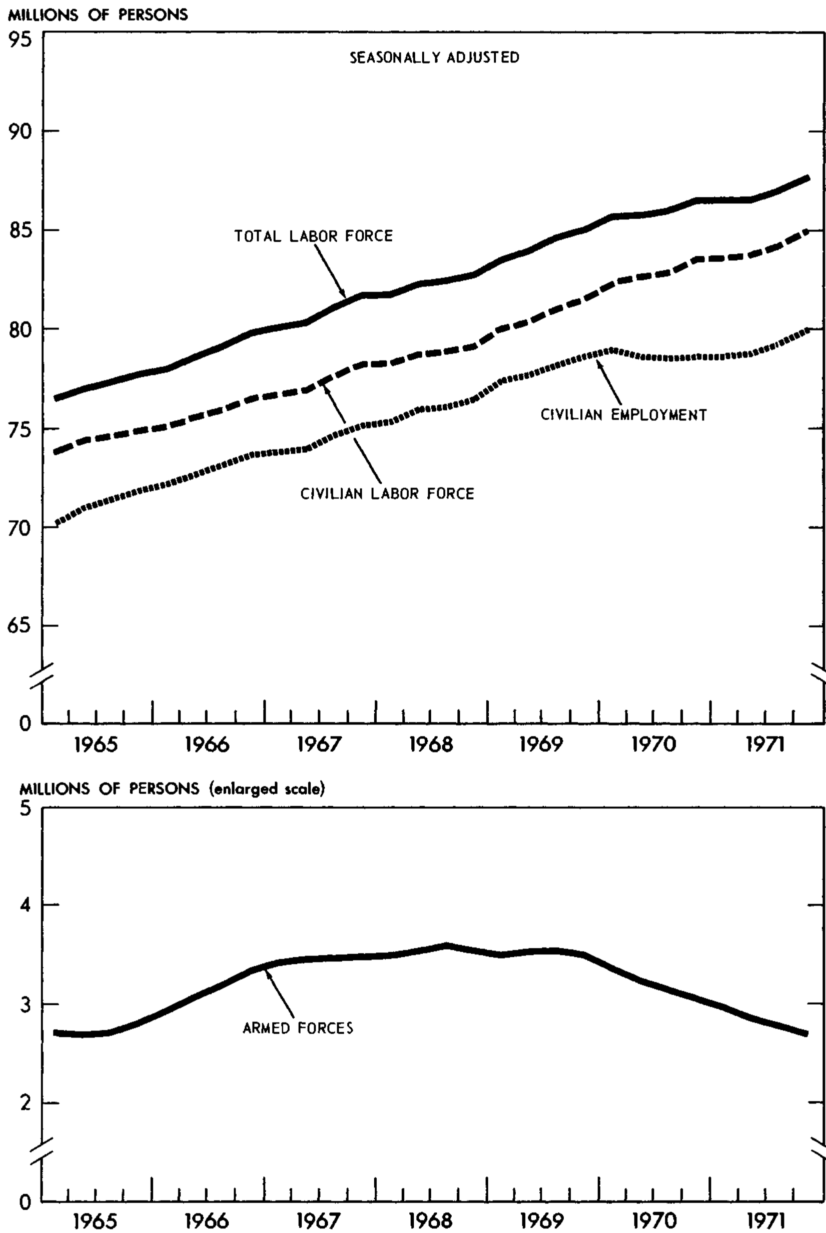
[1] Decrease of less than 50,000.

Note.—Detail will not necessarily add to totals because of rounding.

Source: Department of Labor.

Chart 2

Labor Force, Employment, and Armed Forces



SOURCE: DEPARTMENT OF LABOR.

Long-run increases in the size of the Nation's labor force are governed primarily by the growth of the working-age population (persons 16 years of age and older). Over shorter periods, labor force changes are affected by cyclical changes in economic activity. On balance, when labor demand is strong, additional workers enter the labor force, attracted by plentiful job opportunities, and when labor demand is not strong there is often a net decline in participation. This responsiveness to changing demand conditions cannot be measured with great precision; but during the period of very tight labor markets in the late 1960's, when unemployment was low, overall labor force participation rose sharply. From early 1970 to about mid-1971, participation rates declined.

Employment

Reflecting the relatively mild expansion of aggregate demand and employers' efforts to raise productivity, total civilian employment rose only 700,000 over the year ending in the third quarter. A large share of the employment increase occurred in State and local governments. In the private nonfarm sector, continued growth of employment in service-producing industries was largely offset by further small declines in the goods-producing industries.

This pattern of employment changes was similar to patterns after earlier recessions with one major exception: There was no rebound in manufacturing employment. Within manufacturing, reductions by producers of defense goods and their suppliers continued to be large; from December to August, employment in three industries primarily engaged in the production of military hardware—ordnance, aircraft and parts, and communications equipment—declined at an annual rate of 212,000 jobs. By August, after the sharp layoffs in the steel industry, manufacturing employment had fallen below 18.5 million, its lowest point since December 1965. Total man-hours worked in factories in the third quarter of 1971 were down nearly 10 percent from the peak reached in late 1969.

Defense Adjustment

The progressive winding down of the U.S. military involvement in Vietnam and a general realignment of defense spending have sharply reduced manpower utilization in defense activities. Although the largest cuts caused by this realignment are now behind us, imbalances and distortions arising from the transition are still an important factor in the labor market.

In all, there has been a net reduction of about 2.0 million persons in defense during the past 3 years (Table 4). The steady flow of young veterans out of the Armed Forces, which was more than twice as large as the net reduction in the Armed Forces in 1970 and 1971, created a special unemployment problem, because most young men leaving the service require somewhat longer than the average period to find work in local job markets. Unemployment among former defense industry workers also tends to last longer than the average because of their relatively specialized skills and

TABLE 4.—*Employment attributable to defense expenditures and personnel requirements, 1965 and 1968–71* [1]

[Millions of persons]

Type of employment	1965	1968	1969	1970	1971 [2]
Defense-generated employment	6.2	8.0	7.5	6.7	6.0
Public employment	3.7	4.6	4.6	4.2	3.8
Federal military	2.7	3.5	3.5	3.2	2.8
Federal civilian	1.0	1.1	1.1	1.0	1.0
Private employment	2.5	3.4	2.9	2.5	2.2

[1] Estimates primarily based on national income and product accounts, which include atomic energy programs.
[2] Preliminary estimates.

Note.—Data are calendar year averages.
Detail will not necessarily add to totals because of rounding.

Source: Department of Labor.

their residence in communities where large defense contractors are the major employers. Persons and communities affected by defense cuts have been beneficiaries of a variety of Government programs which are tailored to their particular problems (see Chapter 3, pp. 109–10).

Unemployment

After rising steeply to approximately 6 percent of the work force at the end of 1970, unemployment leveled off in 1971. Jobless rates for most groups were unusually steady from late 1970 to late 1971 (Table 5).

TABLE 5.—*Selected unemployment rates, 1969 IV–1971 IV*

[Percent, seasonally adjusted [1]]

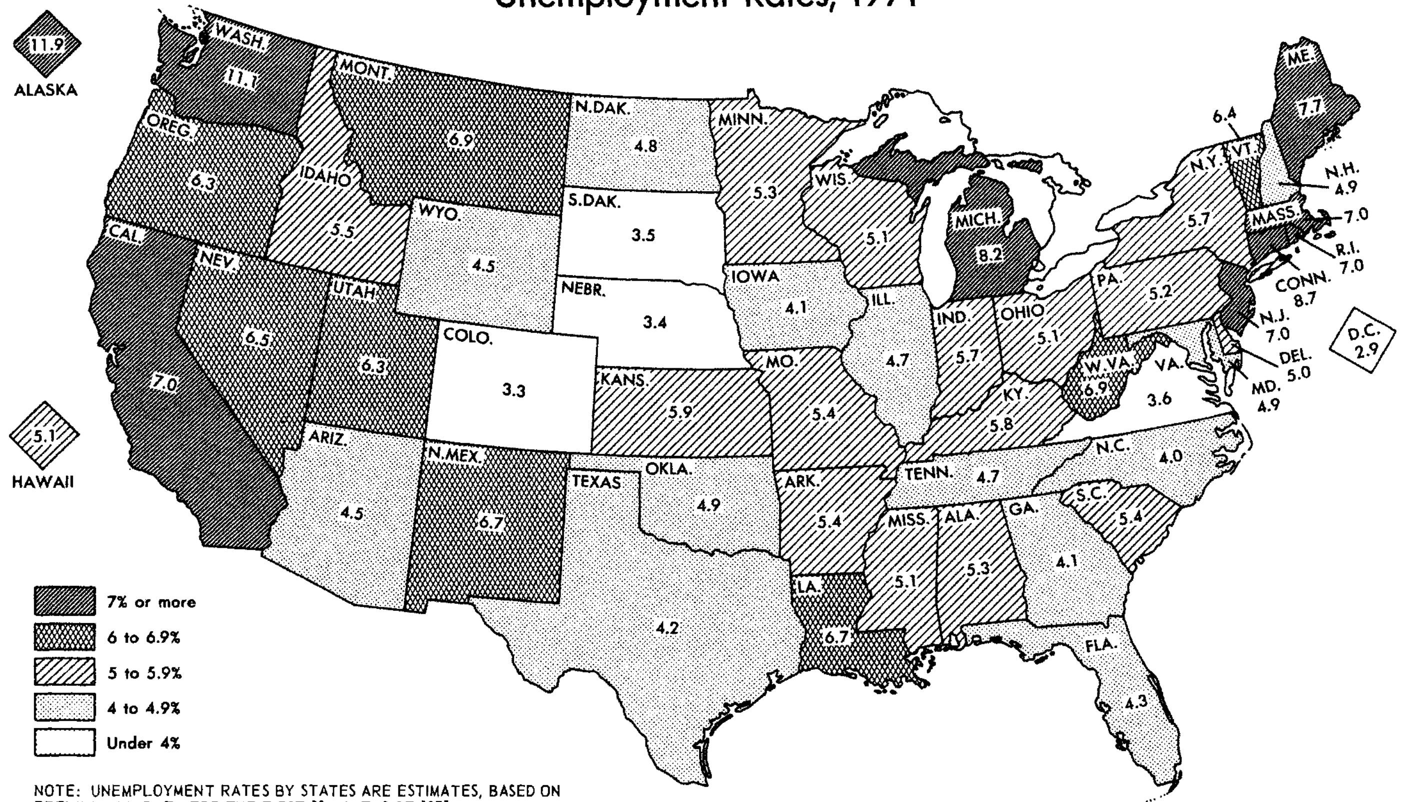
Selected groups of workers	1969 IV	1970 IV	1971 I	1971 II	1971 III	1971 IV
All workers [2]	3.6	5.8	5.9	6.0	6.0	5.9
Sex and age:						
Men 20–24 years	5.7	10.7	10.0	10.3	10.4	10.5
Men 25 years and over	1.8	3.4	3.5	3.5	3.5	3.5
Women 20 years and over [2]	3.7	5.5	5.7	5.8	5.7	5.7
Both sexes 16–19 years [2]	12.2	17.2	17.2	16.9	16.8	16.9
Race:						
White	3.3	5.4	5.5	5.5	5.5	5.5
Negro and other races	6.3	9.2	9.5	9.9	10.1	10.1
Occupation:						
White-collar workers	2.2	3.5	3.6	3.5	3.5	3.5
Blue-collar workers	4.3	7.5	7.5	7.3	7.6	7.4
Service workers	4.0	6.0	6.1	6.3	6.6	6.4
Other categories:						
State insured workers	2.4	4.4	3.8	4.2	4.2	4.3
Married men	1.6	3.2	3.2	3.2	3.2	3.2
Full-time workers	3.2	5.5	5.5	5.5	5.5	5.7
Part-time workers	6.4	8.4	8.9	8.7	8.7	8.5

[1] Unemployment as a percent of civilian labor force in group specified.
[2] Reflects revisions for 1970–71. See note, Appendix Tables B–22–24.

Source: Department of Labor.

Chart 3

Unemployment Rates, 1971



NOTE: UNEMPLOYMENT RATES BY STATES ARE ESTIMATES, BASED ON PRELIMINARY DATA FOR THE FIRST 11 MONTHS OF 1971.
SOURCE: DEPARTMENT OF LABOR.

The average duration of unemployment continued to rise in 1971, moving up from about 9 weeks in 1970 to nearly 12 weeks in 1971. Toward the year's end, about 560,000 persons had been jobless for at least 6 months—the maximum period for unemployment insurance payments under regular programs. Many of the long-term unemployed were former aerospace and defense workers living in Washington, California, Massachusetts, and a number of other States that were heavily affected by reduced defense purchasing (Chart 3). Some additional income protection was provided to many of these workers under the provisions to extend unemployment benefits contained in the Employment Security Amendments of 1970. This Act, signed into law by the President on August 10, 1970, established a Federal-State program to provide up to 13 additional weeks of unemployment compensation when local or national unemployment became high. In all, 22 States established eligibility under the individual State program at some time during 1971. About 340,000 workers were drawing extended benefits at the peak. The extended benefits program became effective throughout the Nation in January 1972 because the national insured unemployment rate had been above 4.5 percent for 3 successive months.

Regular unemployment insurance programs continued to provide shorter-term income protection to experienced unemployed workers who had been jobless for shorter periods. An average of 2.1 million workers, the largest share of whom are men in the prime working age groups, drew weekly unemployment benefits averaging $54.50 under regular State unemployment insurance programs during 1971.

PRICES AND COSTS

At the start of 1971 there were signs that the fight against inflation was yielding tangible results, and there were expectations that it would continue to do so in the coming year. During 1970 both the wholesale price index and the consumer price index rose less than they had in 1969. Less pronounced than the moderation in the rise of all wholesale prices, but really more significant, was the slowdown in the rise of wholesale industrial prices. There was considerable slack in the economy. With activity recovering, prospects were good that there would be an improvement in productivity, the growth of which had lagged seriously in the 2 preceding years. Indeed, the rise in unit labor costs had already slowed significantly during 1970.

To be sure, the then current evidence and the prospects were by no means uniformly reassuring. The rise in the comprehensive GNP deflator increased sharply in the fourth quarter of 1970, after declining from a peak in mid-1969. And a slower rise in wage rates was yet to be seen. The automobile industry had just concluded a costly wage settlement that was followed by a sizable increase in prices, and the 3-year contracts in the can, aluminum, and steel industries were due to expire at varying times by the end of July.

Still the evidence at the beginning of 1971, viewed in the light of past experience, gave support to the conclusion that the disinflationary policies were bearing fruit.

PRICES

The behavior of prices from the end of 1970 to mid-August and especially after April heightened concern about inflation. Although the rise in consumer prices continued to decelerate for several months early in the year, it quickened in the spring, as did the rise in wholesale industrial prices (Charts 4 and 5). The evidence provided by the more comprehensive measures of price change, the GNP deflators, also suggested at least a partial setback to earlier progress.

No single price index can tell the whole story of price behavior. For this reason special indexes are reviewed below and after this a summary statement is given.

Consumer Prices

The consumer price index (CPI), which had increased at rates of 6.1 percent during 1969 and 5.5 percent during 1970, rose at a seasonally adjusted annual rate of 2.8 percent in the first quarter of 1971 (Chart 4). The 1970 improvement had been due mainly to a slower rise in food prices. The further slowdown in early 1971, however, reflected a much reduced rate of increase for nonfood commodity prices, which in the past had displayed a cyclical behavior but during 1970 had failed to decelerate. Lower interest rates on mortgages were also important in the first-quarter slowdown.

The improvement proved to be short-lived as the second quarter brought a rise of 5.3 percent (annual rate) in the CPI. Not only was there some stepup in the rise of food prices, but nonfood commodities also rose more rapidly, at about their 1970 rate, while mortgage interest rates leveled out. Prices in July and August rose less rapidly than in the second quarter; the slowdown was especially pronounced for food, but it was also evident for nonfood commodities.

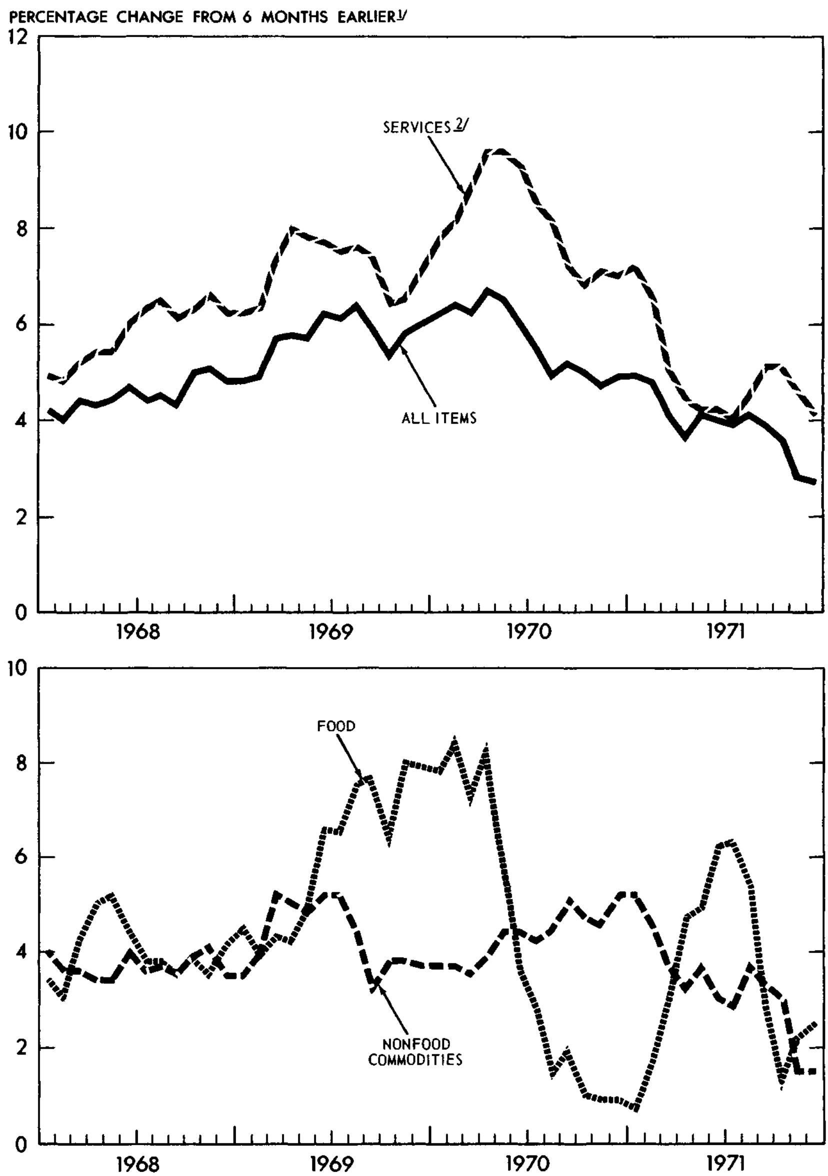
The behavior of the CPI, excluding mortgage interest and food, has a special interest because the short-term movements of food prices are exceptionally sensitive to changes in supply as well as demand and because mortgage interest costs are governed by factors rather different from those influencing most other prices. This calculation also shows a slower rise in the first quarter of 1971 as compared to 1970, a setback in the second quarter and a slowdown from June to August (Table 6).

Wholesale Prices

Mainly because of pronounced declines in farm prices, the rise in the wholesale price index (WPI) slowed considerably from 1969 to 1970—from 4.8 percent during 1969 to 2.2 percent during 1970. Conversely, in the first half of 1971, a strong recovery in farm prices was mainly responsible for the acceleration to a 5.0-percent rate of increase.

Chart 4

Changes in Consumer Prices



1/SEASONALLY ADJUSTED ANNUAL RATES.
2/CHANGES BASED ON UNADJUSTED INDEXES SINCE THESE PRICES HAVE LITTLE SEASONAL MOVEMENT.
SOURCE: DEPARTMENT OF LABOR.

The industrial component of wholesale prices, representing nearly three-fourths of the weight of the WPI, is more significant as an index of the

TABLE 6.—*Changes in consumer prices for all items and all items less food and mortgage interest, December 1968 to August 1971*

Period	Percentage change	
	All items	All items less food and mortgage interest costs
December 1968 to December 1969	6.1	5.2
December 1969 to December 1970	5.5	5.9
	Seasonally adjusted annual rates	
December 1970 to March 1971	2.8	3.8
March 1971 to June 1971	5.3	6.2
June 1971 to August 1971	3.3	2.5

Source: Department of Labor.

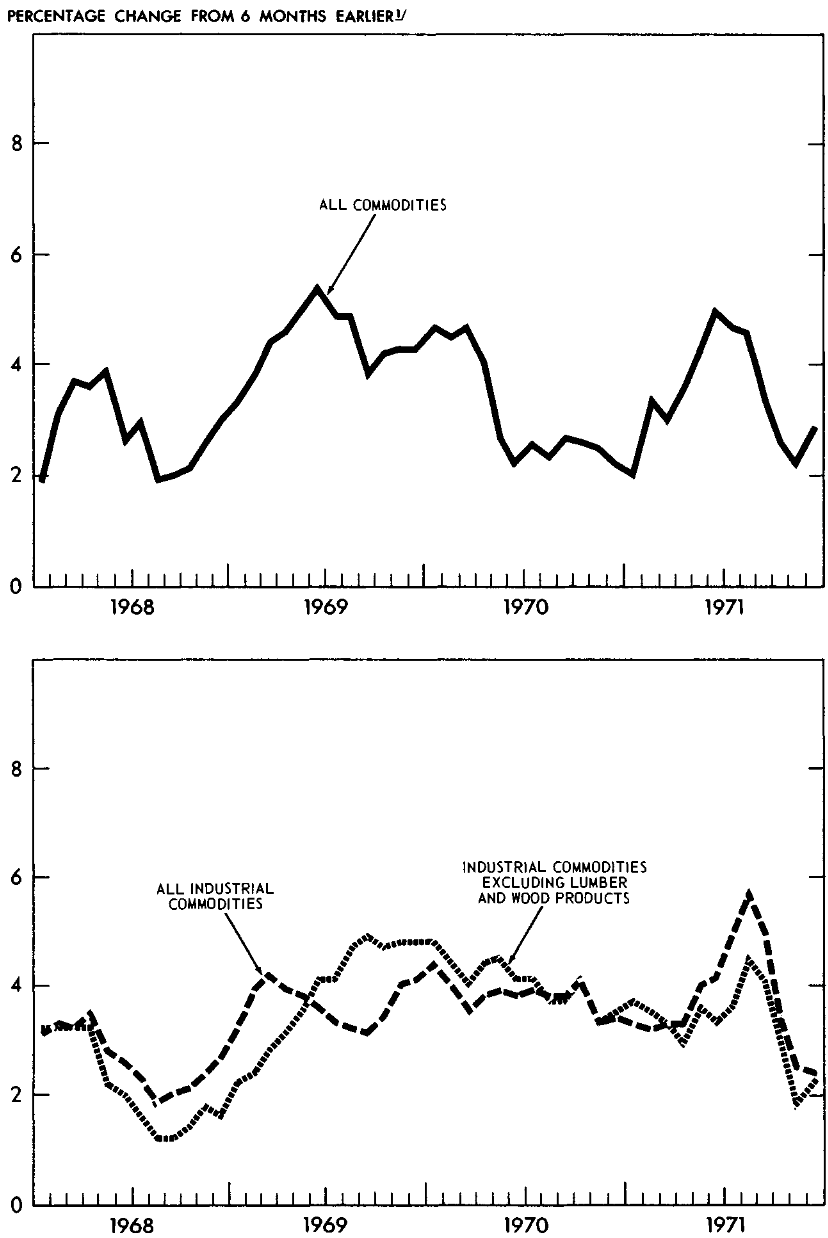
underlying inflationary trend because it is little influenced by short-run supply fluctuations. There had been some progress in restraining industrial prices. After rising 3.9 percent during 1969, they rose 3.6 percent during 1970, and in the first quarter of 1971 a further deceleration was apparent. However, this improvement was reversed in the second quarter. Industrial prices rose at a seasonally adjusted annual rate of 5.3 percent and then at a much faster rate in July and August. In general, the quarterly pattern of price change by major industry groups was very diverse and one cannot easily categorize the industries showing the largest increases (Chart 5).

GNP Deflators

The broadest measure of price change is the implicit GNP deflator, which is obtained as a by-product of the calculation of real output. A related measure is the deflator for gross private product; this excludes the pay of government workers and thus their pay raises, which have often distorted the interpretation of the behavior of overall prices because the raises have come at irregular intervals, and because no allowance is made in the accounting for increased productivity of government workers. Unlike commonly used indexes such as the CPI and the WPI, whose movements reflect price changes of fixed bundles of goods and services, movements in the implicit deflators reflect not only price changes but also shifts in the composition of output, which are sometimes very pronounced. To abstract from the effect of changes in the composition of output the Commerce Department has calculated alternative deflators; some use fixed 1967 weights, and others are chain indexes utilizing weights of the preceding quarter. Some of these measures appear in Table 7. All show some progress toward lower rates of inflation around the second or third quarters of 1970, some setback

Chart 5

Changes in Wholesale Prices



[1] SEASONALLY ADJUSTED ANNUAL RATES.
SOURCE: DEPARTMENT OF LABOR.

TABLE 7.—*Alternative measures of price changes for gross national product and gross private product, 1968 I to 1971 IV*

[Percentage change from preceding quarter; seasonally adjusted annual rates]

Quarter	Gross national product			Gross private product		
	Implicit deflator	1967 weights	Chain[1]	Implicit deflator	1967 weights	Chain[1]
1968: I	3.6	3.9	3.9	3.3	3.6	3.6
II	3.9	4.5	4.5	3.7	4.3	4.3
III	4.3	4.7	4.7	3.6	4.0	4.0
IV	4.6	4.6	4.6	4.4	4.4	4.3
1969: I	4.5	4.7	4.7	4.6	4.7	4.7
II	5.3	5.1	5.0	5.4	5.1	5.1
III	6.1	6.6	6.5	4.8	5.4	5.4
IV	4.8	4.8	4.7	4.5	4.6	4.5
1970: I	6.6	5.9	5.7	5.4	4.6	4.5
II	4.6	5.1	5.0	4.1	4.7	4.6
III	5.0	4.8	4.7	4.9	4.7	4.5
IV	6.3	5.3	5.5	6.2	5.2	5.4
1971: I	5.4	6.8	6.4	4.5	5.8	5.5
II	4.2	4.9	4.8	4.3	5.0	4.8
III	2.5	3.4	3.3	2.5	3.6	3.4
IV[2]	1.5	2.2	2.0	1.1	1.5	1.5

[1] Weighted by quarter preceding quarter shown.
[2] Preliminary.

Source: Department of Commerce.

in late 1970 and early 1971, and varying degrees of improvement from the setbacks in the second quarter of 1971.

Summary of Price Behavior

Chart 6 summarizes the behavior of several price measures in order to describe the progress against inflation prior to the freeze. Six measures have been selected, all but one of which—the GNP price deflator for personal consumption expenditures—have already been discussed. These indexes have all been computed quarterly, and in all cases the measure used is a base-weighted index. The charts illustrate calendar quarter-to-quarter changes, calculated at seasonally adjusted annual rates.

An examination of Chart 6 indicates the following: (1) Most of the indexes show a peak rate of increase at some time in 1969; (2) most of the indexes show a trough at some time in 1970; (3) in the second quarter of 1971, the last full quarter before the freeze, we find that the rate of increase is above the trough in all instances but below the peak in all but one instance—wholesale industrial prices. That, of course, is a serious exception. Although it does not negate the improvement shown in the other indexes, the exception was important enough and the other improvements small enough to leave uncertainty about the future decline of inflation.

COMPENSATION AND WAGES

Increases in average hourly compensation in the private nonfarm sector accelerated sharply from late 1965 until 1968, then leveled off at an average annual rate of increase of about 7 percent until the freeze was instituted in August 1971. A careful examination of these data on a quar-

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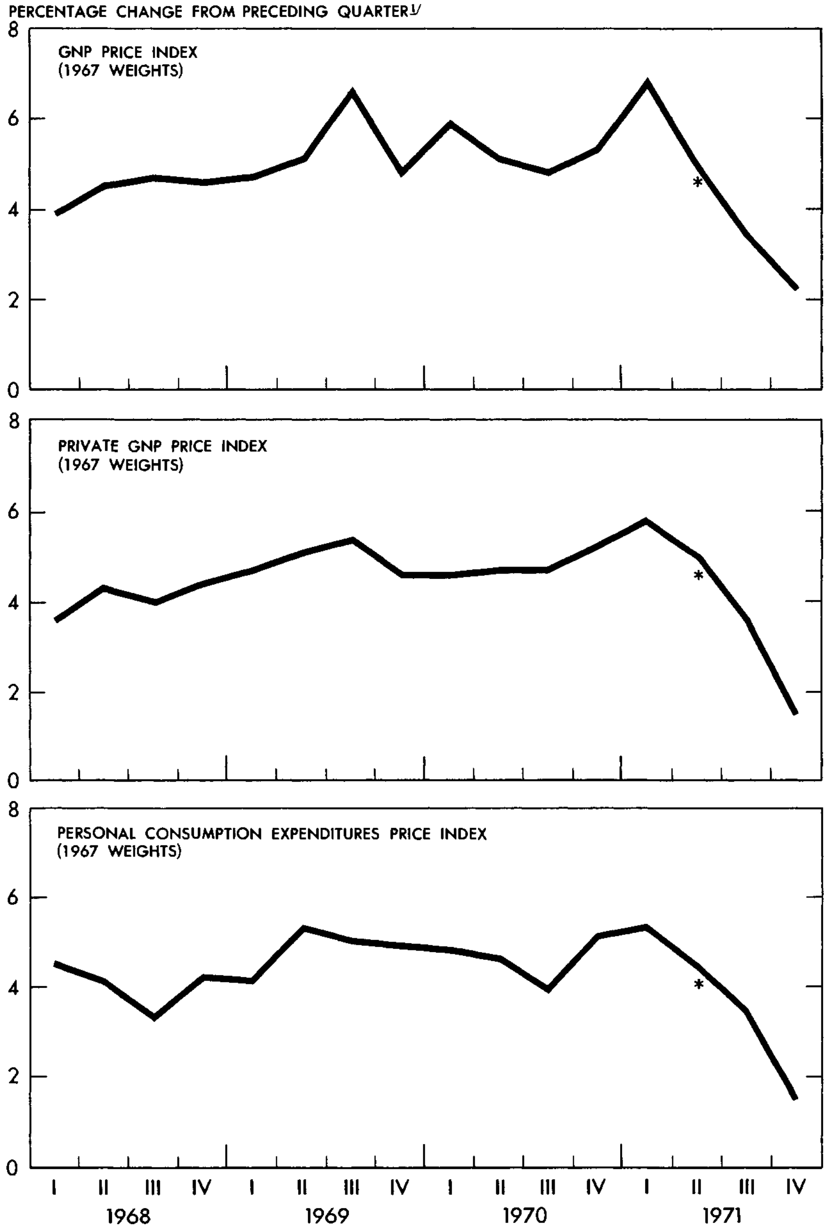
Chart 6

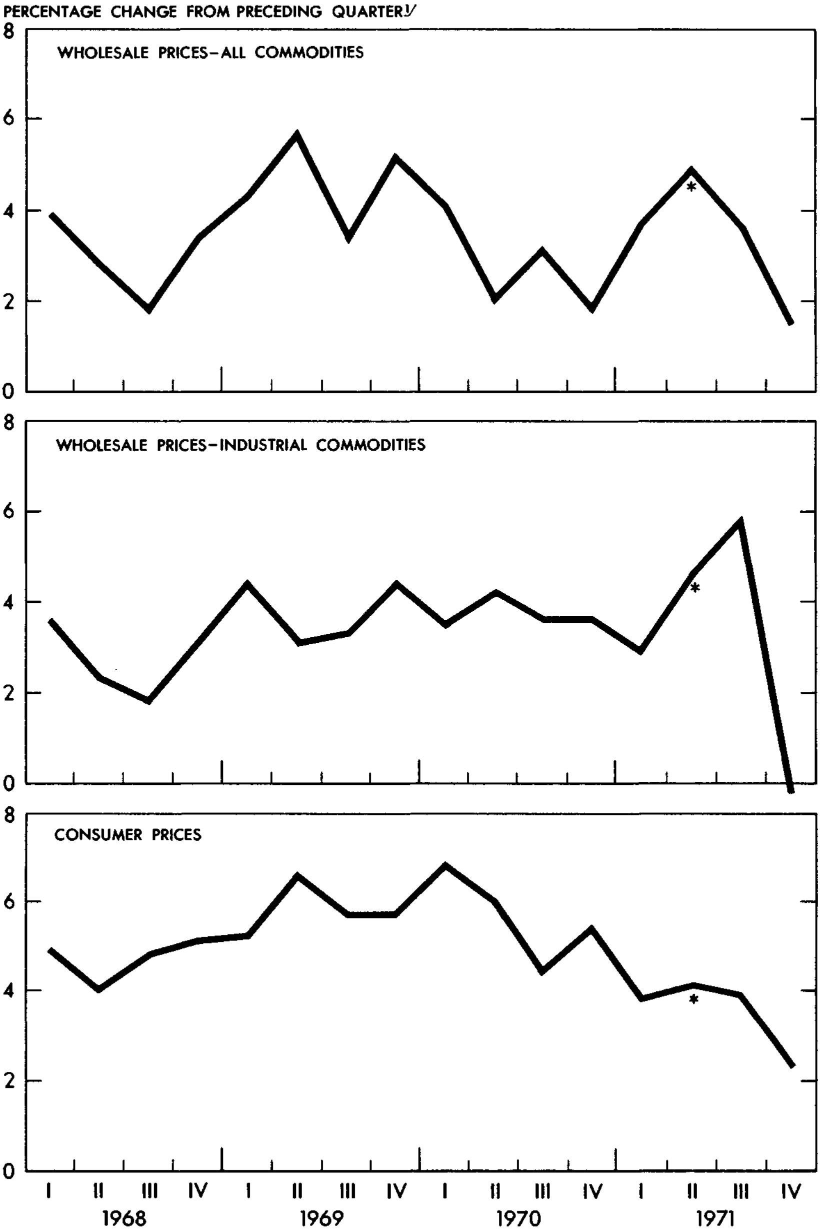
Changes in Selected Price Measures



1/SEASONALLY ADJUSTED ANNUAL RATES.
*LAST QUARTER BEFORE NEW ECONOMIC POLICY.
SOURCE: DEPARTMENT OF COMMERCE.

Chart 6

Changes in Selected Price Measures



1/SEASONALLY ADJUSTED ANNUAL RATES.
*LAST QUARTER BEFORE NEW ECONOMIC POLICY.
SOURCE: DEPARTMENT OF LABOR.

terly basis does not reveal any clear sign of a slowdown in compensation growth. To have halted the acceleration in the rise of hourly compensation was an accomplishment, but as long as increases of 7 percent persisted, there would be a continuation of considerable price inflation.

Historically, increases in hourly compensation have slowed significantly during periods of slack economic activity (Table 8), mainly but not exclusively as a result of cyclical reductions of overtime and a shift in the mix of employment away from high-wage industries. Such a respite was anticipated for 1970 but did not materialize either then or in 1971. As is indicated further on, the underlying causes of this continued rapid rate of increase are not clear. A technical factor that has hindered an understanding of wage developments has been the lack of comprehensive time series data on wage and salary rates. However, the information that is available suggests that average increases in wage and salary rates remained high for most occupation groups in most industries until mid-August.

TABLE 8.—*Rates of increase of hourly compensation during expansions and recessions, 1947 IV to 1970 IV* [1]

[Percentage change; seasonally adjusted annual rates]

Cyclical turning points [2]		Private nonfarm economy		Manufacturing	
Peak	Trough	Year before peak to peak	Peak to trough	Year before peak to peak	Peak to trough
1948: IV	1949: IV	8.0	0.4	11.4	0.9
1953: II	1954: III	6.0	3.3	5.7	4.2
1957: III	1958: II	5.4	3.3	5.6	3.6
1960: II	1961: I	4.3	1.7	4.5	1.9
1969: IV	1970: IV	6.5	7.0	6.1	6.9

[1] Hourly compensation estimates include salaries, wages, and supplemental benefits, for all workers, including the self-employed.

[2] Quarter designated as cyclical turning point by National Bureau of Economic Research.

Source: Department of Labor (except as noted).

Figures on average hourly earnings are available for production and nonsupervisory workers in private nonfarm industries, a group that accounts for over four-fifths of all employees in the private sector. These data can be adjusted so that they more nearly approximate average wage rates by eliminating both the effects of employment shifts between high- and low-wage industries and the effects of overtime changes (the latter adjustment is carried out only for manufacturing). The adjusted earnings increased nearly 7 percent during the year ending in the third quarter, about the same rate as in the 2 preceding years (Table 9). Although different patterns were evident among the individual industries, rates of increase in adjusted hourly earnings for all these broad industry groups were above 6 percent, an indication of the pervasiveness of the wage spiral. In the trade, finance, and services industries, where wage rates have ordinarily been more

TABLE 9.—*Changes in adjusted average hourly earnings of private nonfarm production or nonsupervisory workers, 1968 III to 1971 III* [1]

Industry	Percentage change		
	1968 III to 1969 III	1969 III to 1970 III	1970 III to 1971 III
Private nonfarm industries	6.6	6.9	6.8
Mining	7.9	5.8	6.4
Construction	9.2	9.9	8.4
Manufacturing	6.2	6.6	6.4
Transportation and public utilities	6.2	6.2	9.1
Wholesale and retail trade	6.4	6.1	6.1
Finance, insurance, and real estate	5.4	6.3	6.9
Services	6.6	7.6	6.3

[1] Adjusted for interindustry shifts, and for manufacturing for overtime also.

Source: Department of Labor.

sensitive to the business cycle, hourly earnings continued to advance rapidly, despite ample supplies of labor and the relatively mild expansion of demand.

Statistics on negotiated wage rate changes are available for workers covered by large collective bargaining agreements. Wage increases negotiated in major collective bargaining agreements in the first 3 quarters of 1971 averaged a bit less than in 1970 (Table 10). However, these average changes are significantly affected by the mix of industries and by the unions involved in bargaining. Moreover, they exclude the potential effects of wage increase

TABLE 10.—*Wage rate increases in major collective bargaining agreements, 1969–71*

Item	Mean percentage increase		
	1969	1970	1971 first 3 quarters
Negotiated annual wage rate increases averaged over life of contract:			
All industries	7.6	8.9	8.0
Manufacturing	6.0	6.0	7.1
Nonmanufacturing	9.3	11.5	9.0
Construction	13.1	14.9	11.7
Other	7.4	10.2	8.5
Negotiated first-year wage-rate increases:			
All industries	9.2	11.9	11.8
Manufacturing	7.9	8.1	10.7
Nonmanufacturing	10.8	15.2	13.0
Construction	13.1	17.6	13.5
Other	9.6	14.2	12.9
General wage increases in manufacturing: [1]			
Union establishments	7.4	7.7	9.6
Nonunion establishments	6.1	6.0	5.4

[1] Data relate only to establishments in which a decision was made to increase wages.

Note.—Data relate to contracts covering 1,000 workers or more and exclude possible increases in wages from cost-of-living escalator clauses except where guaranteed.

Source: Department of Labor.

agreements with open-ended cost-of-living escalator clauses. In 1971, there was a large increase in the number of workers covered by such cost-of-living escalator clauses, although the total number so covered remains a small proportion of the work force. Much of the slowing in the rate of increase for negotiated wage rates in 1971 occurred in the construction industry, apparently as a consequence of actions of the Construction Industry Stabilization Committee (see Chapter 2).

Collective bargaining agreements in manufacturing provided larger wage increases in 1971 than in 1970, with average first-year wage increases accelerating from 8.1 percent in 1970 to 10.7 percent in the first 9 months of 1971. Since 1965, average wage increases have been larger in nonmanufacturing industries than in manufacturing. Efforts of manufacturing workers to reverse this pattern, to regain old wage differentials, and to obtain gains more nearly like those in the transportation and construction industries were partly responsible for the acceleration in manufacturing.

Data for manufacturing point to differences in wage behavior between nonunion and union firms. Among nonunion establishments that made decisions to raise wages in the first 3 quarters of 1971, the increases were a little less than in 1970. Union establishments, however, granted much larger increases than those of the year before. Nonunion wage rates appeared to be responding more promptly to the weakness in labor demand, just as they had responded more promptly to the inflation that gained headway after 1965. At that time nonunion wage rates rose more sharply than union wages.

Some statistics are also available on changes in salary rates in quite narrowly classified white-collar occupation groups. To judge from these data, the rise in salary rates accelerated further in 1971, even though unemployment in most of these occupations had risen in 1970 and remained high in 1971 (Table 11).

Thus, although our statistics on wage and salary rates and changes are imperfect, it appeared in the summer of 1971 that the expected slowdown in wage and salary increases had not materialized. On the contrary, increases were persisting at an inflationary pace.

TABLE 11.—*Rise of white-collar salaries, selected occupations in private industry, 1961 to 1971*

Occupation	Percentage increase					
	1961 to 1966 average	1966 to 1967	1967 to 1968	1968 to 1969	1969 to 1970	1970 to 1971
White-collar workers	3.1	4.5	5.4	5.7	6.2	6.6
Professional, administrative, and technical	3.4	4.2	5.5	5.8	6.2	6.7
Clerical	2.7	4.8	5.3	5.5	6.2	6.5

Note.—Changes are based on data for June of each year and relate to weighted averages of a cross section of representative occupations (subdivided into levels of responsibility) designed to compare Federal pay with private pay.

Source: Department of Labor.

PRODUCTIVITY AND LABOR COSTS

The rise in output from the third quarter of 1970 to the third quarter of 1971 was accompanied by a slight decline in man-hours of work. The resulting rise in productivity—output per man-hour—was an extension of an upturn that began after the first quarter of 1970, and followed 2 years in which output per man-hour was essentially unchanged (Chart 7). From then until the third quarter of 1971, output per man-hour in the private nonfarm economy increased at an annual rate of 2.5 percent. This did not make up the earlier shortfall from trend.

The pattern of productivity change described above was broadly consistent with patterns during previous business cycles, although there were some significant differences. First, the period of no appreciable increase in average output per man-hour was unusually long—nearly 2 years. In the first part of this period, from roughly mid-1968 to the summer of 1969, employers increased their employment rolls rapidly even though the rise in output was slowing down. That period was one of low unemployment and high labor turnover, one also in which employers seemed to be engaged in labor hoarding because of their expectations of rising demand and difficulties in hiring experienced help. An extended interval of insignificant productivity growth while output is still rising is not a characteristic of cyclical experience. In the second part of the period, output declined while work forces continued to expand until early 1970, and then were maintained or cut very little. Developments of this kind have been observed in other mild recessions.

Second, after 3 quarters of output growth total man-hours remained about unchanged instead of rising, as in previous recoveries. The failure of man-hours to rise probably reflected a heightened emphasis on cost control resulting from the continuing profit squeeze and the mild recovery of output.

With the rise in hourly rates of compensation holding steady, the upturn in productivity growth moderated the rise in unit labor costs. After having risen at an annual rate of 6.5 percent during the 2 previous years, unit labor costs rose at a rate of 3.9 percent from the third quarter of 1970 to the third quarter of 1971 (Table 12).

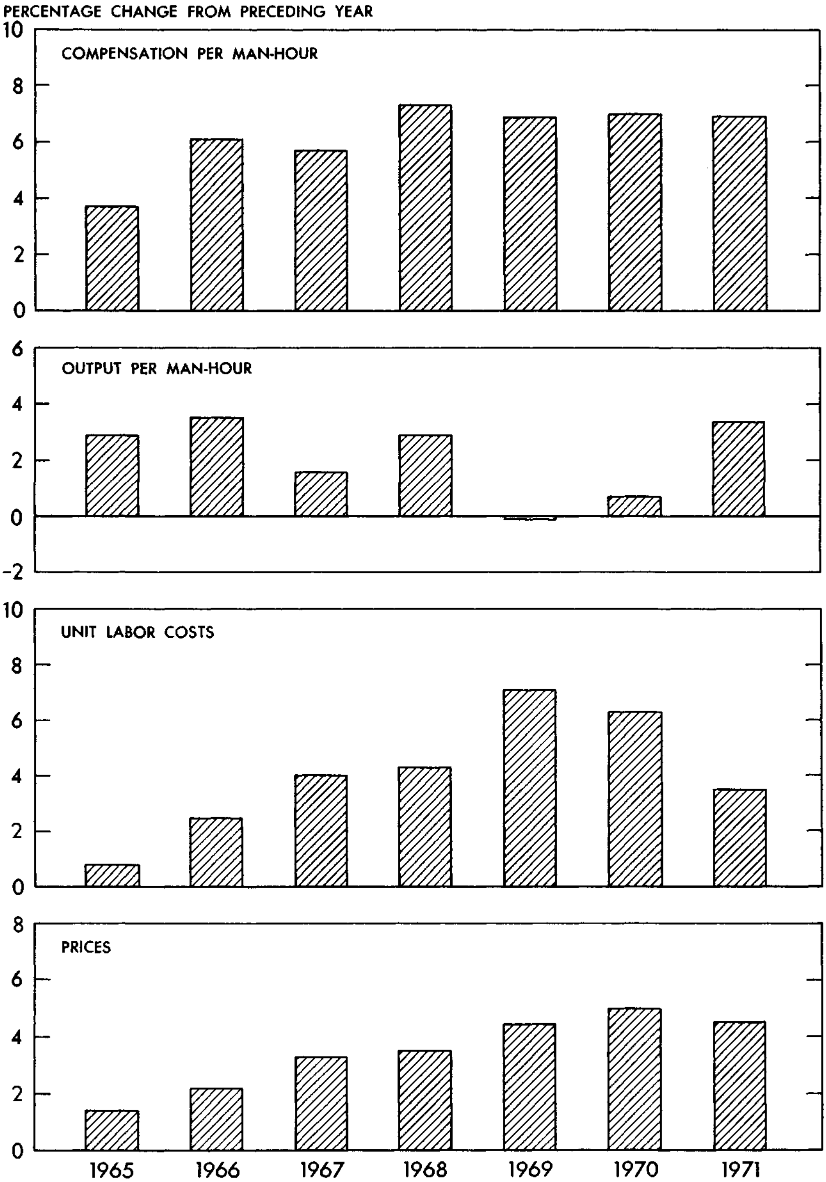
CORPORATE COSTS AND PRICES

The labor costs discussed above are not the full story of cost inflation. Data pertaining to nonfinancial corporations provide a useful framework for breaking down the price of output into labor costs, nonlabor costs (depreciation, indirect business taxes, and net interest), and profits. This particular sector of the economy accounts for a large proportion of the Nation's output, constituting 60 percent of private GNP in 1971. A special advantage of analyzing corporate data is that the line between wages and salaries on the one hand and profits on the other is fairly distinct, whereas in the noncorporate sector the income earned by a partner or sole proprietor is a mixture of labor and property income.

Chart 7

Changes in Compensation, Productivity, Labor Costs, and Prices

Private Nonfarm Sector



NOTE: DATA RELATE TO ALL PERSONS.
SOURCE: DEPARTMENT OF LABOR.

TABLE 12.—*Changes in compensation, productivity, and labor costs in the private nonfarm economy, 1962 to 1971 III*

[Seasonally adjusted annual rates]

Item	Percentage change				
	1962 to 1964	1964 to 1966	1966 to 1968	1968 III to 1970 III	1970 III to 1971 III
Compensation per man-hour	4.2	4.9	6.5	7.2	6.5
Output per man-hour	3.4	3.2	2.2	.7	2.5
Unit labor costs	.8	1.6	4.1	6.5	3.9
Implicit price deflator	1.2	1.8	3.4	4.8	4.6
Real compensation per man-hour [1]	2.9	2.5	2.8	1.4	2.1

[1] Compensation per man-hour adjusted for changes in the consumer price index.

Note.—Data relate to all persons.

Source: Department of Labor.

In the short run prices are viewed as being responsive to total costs as well as to demand, but a rise in a particular component of cost does not necessarily mean a rise in price. For example, a rise in depreciation costs may reflect a substitution of capital for labor which has the net result of leaving total costs unchanged.

From the third quarter of 1970 to the third quarter of 1971, the price of corporate output rose 4.2 percent, a little more than in 1970 and considerably more than in any one of the 3 years preceding 1970. The rise in total costs slowed, and profits before taxes per unit of output rose 8.6 percent, or 10.2 percent if allowance is made for the liberalization in depreciation. Despite the increase, unit profits were extremely low by post-war standards.

Unit costs of all types rose less rapidly during 1971 than the year before, but the slowdown in nonlabor costs was less than that of labor costs (Table 13). The rise in capital consumption allowances per unit during the past year was partly influenced by the more liberal depreciation permitted by the Treasury in 1971. Because of changing regulations affecting depreciation, and the use of historical costs in calculating depreciation, changes in this component of costs are difficult to interpret. One cannot infer that a rise in measured depreciation costs means a more rapid using up of the stock of physical capital held by nonfinancial corporations.

When corporate output fell in 1970, indirect business taxes accounted for a rising share of total price. To some extent this was a cyclical response, since some of these taxes are relatively fixed and their share increases as volume declines. The increase in output in 1971 was too small to keep these costs from rising still more, despite the decline in taxes due to the elimination of the excise tax on motor vehicles.

Interest costs per unit rose less rapidly last year, partly because the decline in interest rates slowed the rise in the effective interest charge paid on all nonfinancial corporate indebtedness.

TABLE 13.—*Changes in prices, costs, and profits per unit of output for nonfinancial corporations, 1966 III to 1971 III*

Item	1966 III to 1967 III	1967 III to 1968 III	1968 III to 1969 III	1969 III to 1970 III	1970 III to 1971 III
Dollar change per unit of output:					
Price	0.031	0.029	0.036	0.048	0.051
Total costs	.044	.028	.061	.062	.041
Employee compensation	.028	.020	.044	.038	.021
Other costs	.016	.008	.017	.024	.020
Capital consumption allowances	.008	.001	.007	.012	.010
Indirect business taxes [1]	.005	.005	.004	.008	.007
Interest	.003	.002	.006	.004	.003
Profits [2]	−.014	.002	−.026	−.013	.011
Percentage change per unit of output:					
Price	2.9	2.6	3.2	4.1	4.2
Total costs	4.9	3.0	6.3	6.0	3.8
Employee compensation	4.1	2.8	6.0	4.9	2.6
Other costs	7.4	3.4	7.1	9.3	7.1
Capital consumption allowances	8.0	.9	6.4	10.3	7.8
Indirect business taxes [1]	5.2	5.0	3.8	7.3	5.9
Interest	15.0	8.7	24.0	12.9	8.6
Profits [2]	−7.8	1.2	−15.6	−9.2	8.6
Output	1.0	7.0	3.3	−1.2	2.1

[1] Also includes business transfer payments less subsidies.
[2] Before taxes and including inventory valuation adjustment.

Note.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

Cost and Profit Shares

Table 14 shows the distribution of gross product originating in nonfinancial corporations. The profit share in 1971 (before taxes and including the inventory valuation adjustment) was 11.0 percent, up from the very low 10.3 percent for 1970, but well below the 15.1-percent average from 1960 to 1969. Without the new 1971 depreciation regulations, the profit share would have been only slightly higher at 11.2 percent.

The profit share is sensitive to the stage of the business cycle, and one reason for the present low share is that the economy is operating considerably below capacity. As noted above, changing depreciation regulations also affect the profit share, but this can be remedied if depreciation is calculated on a uniform basis. The Commerce Department has done this in special calculations, shown below on line 2 for selected high-employment years and the more recent period. On this basis the decline in the profit share from 1948 is less than the decline in the reported share, but the decline since 1956 is the same on the two bases.

A comprehensive analysis of property income requires consideration of interest charges, which have become substantially more important in postwar years. When the interest share is combined with the adjusted profit

TABLE 14.—*Distribution of gross product originating in nonfinancial corporations, 1947–71*

[Percent]

Year	Total	Compensation of employees	All other costs: Total	All other costs: Capital consumption allowances	All other costs: Indirect business taxes [1]	All other costs: Net interest	Profits [2]
1947	100.0	65.9	14.8	4.8	9.3	0.7	19.4
1948	100.0	63.9	14.5	5.0	8.8	.7	21.6
1949	100.0	63.8	16.1	5.9	9.5	.8	20.1
1950	100.0	62.4	15.5	5.7	9.2	.6	22.1
1951	100.0	63.1	15.1	5.8	8.7	.6	21.7
1952	100.0	64.8	16.1	6.2	9.2	.7	19.1
1953	100.0	65.9	16.6	6.6	9.3	.7	17.4
1954	100.0	65.9	17.6	7.7	9.1	.8	16.6
1955	100.0	63.9	17.5	7.9	8.9	.7	18.6
1956	100.0	65.3	17.7	8.0	9.0	.7	16.9
1957	100.0	65.6	18.6	8.4	9.3	.9	15.8
1958	100.0	65.9	19.9	9.1	9.7	1.1	14.2
1959	100.0	64.7	19.1	8.7	9.3	1.0	16.2
1960	100.0	65.5	19.7	8.9	9.7	1.1	14.8
1961	100.0	65.1	20.4	9.2	9.9	1.3	14.5
1962	100.0	64.3	20.8	9.7	9.8	1.4	14.9
1963	100 0	63.9	20.9	9.7	9.8	1.4	15 2
1964	100.0	63.3	20.8	9.5	9.8	1.5	16.0
1965	100.0	62.6	20.4	9.4	9.5	1.6	17.0
1966	100.0	63.2	20.0	9.3	8.9	1.8	16.8
1967	100.0	64.0	20.9	9.7	9.1	2.1	15.1
1968	100.0	64.2	21.2	9.7	9.3	2.2	14.7
1969	100.0	65.8	21.8	9.9	9.4	2.6	12.4
1970	100.0	66.7	23.0	10.5	9.7	2.9	10.3
1971 [3]	100.0	65.5	23.5	10.7	9.8	2.9	11.0

[1] Also includes business transfer payments less subsidies.
[2] Before taxes and including inventory valuation adjustment.
[3] Preliminary.

Note.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

share, the total property share appears to have declined from earlier years, but less than the share of reported profits alone.

[Percent of gross product of nonfinancial corporations]

	1948	1956	1965	1968	1969	1970
(1) Reported profits	21.6	16.9	17.0	14.7	12.4	10.3
(2) Adjusted profits	21.7	18.2	18.4	16.0	13.7	11.7
(3) Net interest	.7	.7	1.6	2.2	2.6	2.9
Total (2+3)	22.4	18.9	20.0	18.2	16.3	14.6

INCOMES IN AGRICULTURE

Agricultural incomes often fluctuate widely from year to year for reasons only partially related to output and price developments in the general economy. The demand for farm products is relatively insensitive to changes in overall output and prices. Farm prices, therefore, fluctuate primarily in response to supply conditions for agricultural products. On the other hand, since many farm inputs are purchased from the nonfarm sector, price increases in the nonfarm economy have a direct impact on farm production costs.

In the past 3 years, farm production expenses have been increasing at a slightly faster pace than the general rate of inflation, reflecting primarily higher input prices but also some increases in quantities of inputs purchased. During this period, the value of farm sales increased 9.1 percent in 1969, only 2.3 percent in 1970 and 4.9 percent in 1971. Net income of farm operators increased sharply in 1969—to the highest levels in over 20 years—and then declined in 1970. According to preliminary estimates net income (including increases in the value of yearend inventories) recovered slightly in 1971. The pattern of the 1970 decline and 1971 recovery has also been significant. Income of farm operators declined in each consecutive quarter through 1970 and improved in each quarter of 1971. The improvement was particularly strong in the second half of last year.

Aggregate measures do not give a complete picture of recent changes in the income situation of farm families. Because of the continuing secular decline in farm numbers, average net income per farm declined only slightly in 1970 and the 1971 recovery returned it to the record level of 1969. This indicator is also imperfect because the current census definition of a farm includes many places only nominally engaged in farming. Many people who are counted as living on farms are primarily dependent on nonfarm earnings; others supplement their farm income with nonfarm work. Earnings from nonfarm sources by the farm population have been increasing regularly for many years and in 1971 they constituted over 48 percent of the farm population's total personal income. Because the growth in nonfarm jobs has been limited, income from this source has expanded at a slower rate the last 2 years than in earlier years.

FINANCIAL POLICY AND FINANCIAL MARKETS

The economic goals of 1971 required considerable aid from monetary policy. In the first half of the year monetary growth proceeded at very high rates, but expansive effects upon the economy normally associated with such rapid growth in money were not forthcoming. This shortfall from expectations came about because a large part of the increase in the money stock went to satisfy an increased desire by the public for money balances. The year 1971 saw generally lower interest rates than 1970, and sectors sensitive to the costs of credit, particularly housing, enjoyed a considerable expansion.

MONETARY POLICY

The Federal Reserve's stated goals of monetary policy in 1971 were "the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments." After August 15 the success of the New Economic Policy became one more goal of monetary policy. Throughout the year the Federal Reserve sought monetary growth rates that would best bring about attainment of these goals.

At the beginning of 1971 there was concern that monetary growth in the last quarter of 1970 had been less than desirable. The growth rate for the money supply (currency and demand deposits) or M_1 during that quarter appeared at that time to have been about 3½ percent at a seasonally adjusted annual rate (measured from the final month of the third quarter to the final month of the fourth quarter), and it was decided that a rate of growth of about 7½ percent in the first quarter of 1971 would compensate for this shortfall. Policy in January was thus directed at attaining "some moderate easing of money market conditions." Accordingly, open market operations were aimed at lowering market interest rates. As the quarter progressed, preliminary reports showed that the money stock was not growing as rapidly as the Federal Reserve's analysis had predicted it would under the attained money market conditions, and greater ease was sought.

In the second quarter revised data showed that the money stock had in fact grown faster than had been anticipated. Because this was faster than desired, policy was then directed at slowing the monetary growth rate. To this end temporary "minor firming of money market conditions" was sought, and market interest rates increased. Nevertheless the rate of monetary growth in the second quarter exceeded the rate in the first quarter, despite an increase in interest rates. For the 2 quarters combined, monetary growth was very high, even after allowance for the shortfall in the fourth quarter of 1970. From December 1970 to June 1971, the money stock rose at a seasonally adjusted annual rate of 10.2 percent, and the broadly defined money stock that includes all time deposits at commercial banks except large certificates of deposit (M_2) climbed at a seasonally adjusted annual rate of 16.1 percent. These were high, not only compared to 1970 but compared to the preceding decade. During 1970, M_1 had risen at a 5.4-percent rate, M_2 at an 8.1-percent rate. In the 7 years ending December 1970, the average annual rates of growth were 4.9 and 7.2 percent, respectively.

In June, the Federal Reserve showed less explicit concern with money market conditions and continued its effort to moderate monetary growth rates. Although in July the money stock continued to grow rapidly despite a considerable rise in interest rates, in August the rates of expansion for both M_1 and M_2 fell sharply and the rate for M_1 turned negative in September. The rise in M_1 came to 3.8 percent for the third quarter as a whole. In contrast to the first half of the year, the Federal Reserve at this time overestimated the monetary expansion resulting from the money market conditions that had been produced.

Despite the stated policy to place emphasis on the monetary growth rate in 1971, actual operations were designed to influence interest rates and conditions in short-term money markets, with the intention of thereby achieving the desired monetary growth rate. In practice the Federal Reserve operated most directly on the interest rate on loans among banks, called the Federal funds rate, relying on its appraisal of how monetary growth rates would respond to various levels of the interest rate. If the money stock responded to the Federal funds rate in a way that differed from the expected response, the monetary growth rate would differ from that desired.

In the first half of 1971, the public apparently wanted to hold more money balances at the prevailing level of interest rates and income than past relations among income, interest rates, and money balances suggested. The bulk of the increases in money holdings appeared in individuals' accounts, and the pattern was part of a larger shift in the public's desire for additional financial liquidity in the first half of 1971. Table 15 shows that in

TABLE 15.—*Amount and composition of individuals' saving, 1968–1971 III*

[Billions of dollars]

Type of saving	1968	1969	1970	1971 I	1971 II	1971 III
				Seasonally adjusted annual rates		
Total saving by individuals	63.5	56.1	71.4	87.7	99.6	82.8
Increase in financial assets	69.6	60.9	74.6	90.4	114.4	97.3
Currency and demand deposits	11.3	6.0	4.8	10.9	15.7	4.6
Savings accounts	28.6	13.3	32.2	97.9	67.8	57.6
Securities	4.0	16.2	8.4	−53.1	−1.3	1.1
U.S. savings bonds	.4	−.4	.3	1.9	2.7	2.4
Other U.S. Treasury and agency securities	4.9	13.6	.0	−51.8	−7.2	−10.9
State and local obligations	.9	1.5	−1.5	.0	−1.4	8.4
Corporate and foreign bonds	5.4	5.4	12.2	9.5	7.8	6.1
Investment company and other corporate shares	−7.5	−3.8	−2.6	−12.8	−3.2	−5.1
Insurance and pension reserves	25.7	25.3	29.2	34.7	32.2	34.1
Net investment in tangible assets	37.2	36.4	25.8	39.7	42.8	49.7
Less: Increase in debt	43.3	41.1	29.0	42.5	57.6	64.2
Mortgage debt on nonfarm houses	14.9	16.2	12.5	13.1	22.7	27.1
Noncorporate business mortgage debt	6.6	6.9	8.0	9.9	10.0	13.3
Consumer credit	11.1	9.3	4.3	4.0	9.0	12.6
Other debt	10.8	8.6	4.1	15.3	15.8	11.2

Note.—Detail will not necessarily add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

the first half of 1971 unusually large increases occurred in individuals' holdings of money, savings accounts, and U.S. savings bonds, while decreases or smaller than usual increases were recorded in their holdings of other U.S. Treasury and U.S. Government agency securities, corporate bonds, and corporate stock. This shift in the composition of assets was also influenced by the substantial decline in interest rates after mid-1970, especially in the rates on short-term securities.

The shift in assets by individuals in favor of more liquidity was accompanied by particularly large increases in debt incurred by the public, notably in the form of mortgage and other personal debt. There were also important changes in the structure of business borrowing. As Table 16 shows, in the past year and a half corporations have shifted their financing toward equities and long-term bonds and away from bank loans and

TABLE 16.—*Sources and uses of funds, nonfarm nonfinancial corporate business, 1968–1971 III*

[Billions of dollars]

Source or use of funds	1968	1969	1970	1971 I	1971 II	1971 III
				Seasonally adjusted annual rates		
Sources, total	108.0	118.1	105.5	118.0	123.7	124.3
Internal sources	61.7	59.5	61.5	68.3	71.8	71.6
External sources	46.3	58.6	44.0	49.7	51.9	52.7
Stocks	−.8	4.3	6.8	9.0	16.4	12.1
Bonds	12.9	12.1	20.3	23.8	22.1	16.2
Mortgages	5.8	4.8	5.3	8.8	12.3	11.8
Bank loans	8.8	11.0	1.2	−.1	2.5	16.2
Trade debt	10.1	19.7	5.5	.3	−6.3	−8.5
Other loans and liabilites	9.5	6.8	5.0	7.9	4.9	4.8
Uses, total	101.7	112.7	103.7	109.6	111.5	111.8
Purchases of physical assets	76.1	84.9	84.2	83.8	91.7	87.4
Increase in financial assets	25.6	27.8	19.5	25.8	19.8	24.4
Liquid assets	8.6	1.3	8.9	3.0	7.2	8.0
Currency and demand deposits	1.6	−.9	−1.0	.3	4.7	.8
Time deposits	1.9	−9.8	12.8	3.0	−1.5	1.0
U.S. Government securities	1.7	−1.7	−3.2	.8	6.0	3.5
Open-market paper	4.4	8.6	−1.1	−7.3	−5.5	2.1
State and local obligations	−1.1	5.1	1.4	6.1	3.4	.6
Consumer credit	1.7	1.3	1.4	1.7	1.8	2.0
Trade credit	13.9	17.3	6.2	11.6	.0	3.5
Other financial assets	1.4	8.0	3.0	9.6	10.8	11.0
Discrepancy (uses less sources)	−6.3	−5.4	−1.8	−8.3	−12.1	−12.5

Note.—Detail will not necessarily add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

short-term open market instruments. The shift of both individuals and corporations toward longer-term debt and shorter-term assets reflects in part a reaction to the period of restrictive credit conditions in 1969. In that year, business and individual borrowers had considerable difficulty obtaining funds at rates they deemed reasonable. As a result, they began insulating themselves from the pressures of credit markets when conditions eased in 1970 and 1971 by refunding short-term debt with long-term and rebuilding their holdings of liquid assets.

INTEREST RATES

With monetary policy more expansive and with growing sentiment that progress was being made against inflation, market interest rates early in 1971 continued their downward trends of the second half of 1970, reaching levels that turned out to be the lowest of the year (Table 17 and Chart 8). Fluctuations in long-term rates are typically smaller than in short-term, but the differential movement last spring also reflected in part the continued shift from short- to long-term financing by business borrowers, who were attempting to insulate their liquidity position.

TABLE 17.—*Interest rates, 1970–71*

[Percent per annum]

Type	1970		1971		
	High	End of year	Low	High	Aug. 13[1]
3-month Treasury bill rate (new issues)	7.96 Jan. 5	4.83	3.31 Mar. 15	5.55 July 26	5.37
4–6 month prime commercial paper rate	9.13 Jan. 8	5.75	4.00 Mar. 24	5.88 Aug. 18	5.88
Long-term taxable Treasury bond yield	7.15 June 12	6.16	5.40 Nov. 3	6.13 Jan. 6	5.82
Corporate Aaa bond yield	8.60 July 2	7.48	7.05 Feb. 16	7.69 June 2	7.71
New Aaa corporate offering rate (weekly average)	9.30 June 19	7.68	6.76 Jan. 29	8.07 July 30	7.97
High-grade municipal bond yield (weekly)	7.14 May 29	5.81	5.14 Nov. 5	6.39 July 2	6.17
FHA new home mortgage yield	9.29 Mar.	8.90	7.32 Apr.	8.40 Jan.	7.97

[1] Rates for Aug. 13 or nearest date for which data are reported.

Sources: Board of Governors of the Federal Reserve System, Moody's Investors Service, Standard & Poor's Corporation, and Department of Housing and Urban Development.

After March, interest rates began rising as a result of the reversal of inflationary expectations and attempts by the Federal Reserve to curtail the monetary growth rate in the face of a shift in the demand for liquidity. By July many market rates had risen to roughly the levels prevailing in November and December 1970, but all remained below the 1970 peak levels.

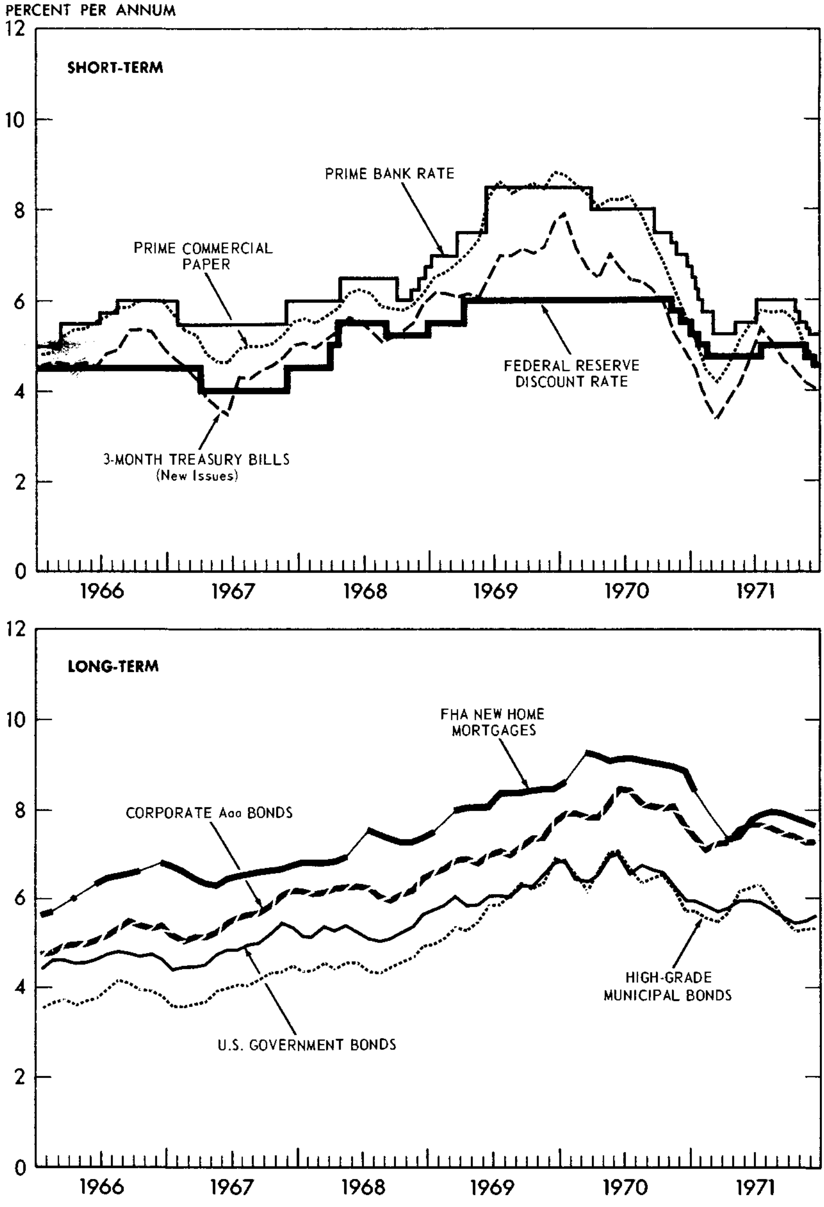
Reintermediation

The year 1971 saw a continuation of the process of "reintermediation," which had started in 1970 as a correction of the preceding year's "disintermediation."

Most thrift institutions are constrained in their ability to retain deposits during periods of rising interest rates. Because the yields on their assets, which are generally long term, change very slowly, it is difficult for them to change rates paid on their liabilities, which are generally short term. Partly in recognition of this problem, most of these institutions have regulatory ceilings on the rates they can pay on deposits. Under conditions of rising market interest rates, earnings on long-term assets would generally not rise quickly enough to enable institutions to pay rates on their deposits that would be competitive with unconstrained money market instruments. The rate ceilings also curtail the ability of institutions to retain funds. As a result, when interest rates rise very sharply, as they did in 1966 and 1969, financial intermediates both lose funds and acquire fewer new funds, more of which are invested directly in primary assets, such as Treasury bills and bonds or municipal and corporate bonds. This process has been termed "disintermediation" and, as Table 18 shows, it occurred in 1969. In that year banks

Chart 8

Interest Rates



SOURCES: DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, TREASURY DEPARTMENT, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE, AND STANDARD & POOR'S CORPORATION.

and other savings institutions experienced a $1.6 billion net decrease in total time and savings deposits, compared to a $33.4 billion rise in 1968.

Since short-term rates in the second half of 1970 and all of 1971 were generally below the high levels of 1969, this process of disintermediation was reversed. Table 18 shows that the net increase in the flow of total time

TABLE 18.—*Flows of savings deposits through savings institutions, 1968–71 III*

[Billions of dollars]

Institution	1968	1969	1970	1971 I	1971 II	1971 III[1]
				Seasonally adjusted annual rates		
Total net increase	33.4	−1.6	53.9	112.9	73.3	68.5
Savings deposits at commercial banks	20.6	−9.7	36.7	60.6	30.0	33.7
Large certificates of deposit	3.1	−12.6	15.2	5.8	4.0	18.0
Other time deposits	17.4	2.9	21.6	54.8	26.0	15.7
Savings at savings and loan associations	7.5	4.1	11.1	36.8	28.6	25.2
Savings at mutual savings banks	4.2	2.6	4.4	12.4	11.6	6.6
Savings at credit unions	1.1	1.4	1.7	3.1	3.1	3.0

[1] Preliminary.

Note.—Detail will not necessarily add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

and savings deposits through commercial banks and thrift institutions in 1970 exceeded the 1968 levels by 61 percent. The increase for the first 3 quarters of 1971 expressed at an annual rate was 58 percent above 1970.

Mortgage Interest Rates

Mortgage interest rates responded sharply to the general movements in market rates and to the reintermediation process. In March 1970, reduced deposit inflows and restrictive monetary policy had helped push secondary market yields on mortgages to a postwar peak of 9.29 percent from a 7.13-percent average in 1968. As market rates rose, the maximum rates permitted on FHA-insured and VA-guaranteed mortgages were raised from 6.75 percent in 1968 to 8.5 percent in January 1970. Subsequently, as open market rates declined and reintermediation occurred, the ceiling rate was reduced to 8 percent in December 1970, and down to 7 percent in February 1971.

In the early months of 1971 mortgage rates fell much more sharply than other long-term rates. The secondary market yield on FHA new-home mortgages fell 1.58 percentage points from December to April, reaching the year's low of 7.32 percent. Mortgage yields last spring were about equal to those paid on new long-term debt issues of the highest rated corporate borrowers. This drop in mortgage rates made an important contribution to the record demand for housing in 1971.

In early summer, mortgage rates began rising somewhat faster than other long-term rates as the housing expansion gained momentum. As the summer wore on, discounts on insured mortgages rose to as much as 9 or 10 points to equate the 7-percent maximum permissible rate with the higher yields (7.97 percent as of early August) demanded by permanent mortgage investors. At the time, the ceiling rates on FHA and VA mortgages were not raised, in order to avoid adversely affecting inflationary sentiment. As an alternative to raising this mortgage rate ceiling, several Government agencies and Government-sponsored private institutions supported the market by mortgage purchases, thus reducing the number of discount points (lowering the yield) on these mortgages. Partly as a result of these actions, yields on insured mortgages began a downward trend in early August.

Assistance to Mortgage Markets

Because reintermediation in the first half of 1971 produced a large volume of private funds for investment in mortgages, the housing boom proceeded with little assistance from Federal programs. However, when the general rise in interest rates in the spring threatened the expansion in housing, Federal mortgage market assistance programs assumed much greater prominence. In June the Federal National Mortgage Association (FNMA), a privately owned Government-sponsored institution, sharply increased its purchases of insured mortgages. FNMA's net acquisitions of mortgages totaled $2.4 billion in 1971 as compared to $4.5 billion in 1970 and $3.8 billion in 1969. But the bulk of the 1971 purchases came after May, with approximately $1.4 billion of the year's purchases in Government-subsidized loans. The Federal Home Loan Mortgage Corporation also made purchases of $217 million of participations in conventional (uninsured) mortgages and $562 million of FHA-insured mortgages during 1971.

In the third quarter, the Federal Home Loan Bank System took several steps to aid the mortgage market. It liberalized terms on mortgage loans by allowing 95 percent conventional loans. In August, shortly after the NEP was announced, the FHLB Board reduced the liquidity requirements of member savings and loan associations from 7.5 percent to 7.0 percent to free more liquid assets for lending. Simultaneously, the Federal Home Loan Mortgage Corporation raised the price at which it purchased FHA-insured mortgages from 91 to 94 percent of par and reduced from 7⅞ percent to 7⅝ percent the yields it required on participations in conventional mortgages. These moves closely followed a new program, in which the Government National Mortgage Association (GNMA) used a $2 billion authorization to purchase unsubsidized FHA-insured and VA-guaranteed mortgages in cooperation with FNMA and other purchasers.

This plan subsidizes FHA and VA mortgage rates when rate ceilings produce high discounts. GNMA purchases these mortgages at 95 or 96 percent of par and sells them to any authorized purchaser at lower prices that reflect market interest rates. GNMA absorbs the difference between the support price and the market price, enabling home buyers to obtain mortgage financing at lower rates.

FISCAL POLICY TO AUGUST 15

The Administration's fiscal policy as reflected in the budget submitted in January 1971 was in general to keep expenditures from exceeding the revenues that would be yielded by the existing tax system under conditions of full employment. There were two reasons for the Administration's adoption of this principle. First, the conventional notion of balancing the actual budget more or less all the time had proved to be unworkable because either tax increases or expenditure cuts would be required whenever revenue was depressed by an economic slowdown, and this would be precisely the wrong time for a restrictive fiscal policy. In fact, this standard of fiscal policy had not been followed by an Administration for almost 40 years. Second, some rule of policy that would confine expenditures within the limits of what the Government was willing to raise in taxes was necessary to enforce economy in Government. The principle that expenditures should not exceed full-employment revenues has the advantage that fiscal action likely to intensify the slowdown would be avoided while the discipline of the basic relationship between revenues and expenditures would be retained.

In conformity with this principle, the Administration's January 1971 budget called for the following relationship between expenditures and the revenues that would be collected at full employment:

[Billions of dollars]

	Outlays	Revenues at full employment	Excess of revenues
Fiscal 1971	212.8	214.2	1.4
Fiscal 1972	229.2	229.3	.1

The outcome for fiscal 1971 was close to these plans. Estimated full-employment revenues after the end of the fiscal year were only $0.1 billion below the January 1 estimates. Outlays were $1.4 billion, or about one-half of 1 percent, under the estimate. Instead of an excess of full-employment revenues of $1.4 billion there was an excess of $2.7 billion as then defined (see footnote, p. 65).

Developments in the first 6 months of 1971 more significantly changed the estimates of the full-employment budget for fiscal 1972. On the revenue side the postponement, from 1971 to 1972, of the increase in the base for Social Security contributions reduced estimated fiscal 1972 receipts by $2.6 billion. This was expected to be offset in part by an increase in the Social Security contribution rate to take effect January 1, 1972. The net effect of these and other smaller changes was to reduce the estimated full-employment receipts by $1.9 billion. Estimated expenditures were raised by $4.7 billion. The largest item in this total was an increase of $1.4 billion of Social Security benefits above the budget. Other major items were an increase of $1 billion in the estimated payments for unemployment compensation because of the continued high rate of unemployment, and a possible increase of $0.8 billion in military pay as a result of congressional action.

Thus there was in prospect an excess of expenditures over full-employment revenues of $6.5 billion in fiscal 1972, compared to an excess of revenues of $2.7 billion in fiscal 1971.* On the national income accounts basis the surplus would show a decline of about $3.5 billion between the 2 fiscal years.

This estimate for fiscal 1972 as it appeared in July depended heavily on action still to be taken by Congress. Although the estimate made some allowance for probable delays in the enactment of expenditure programs that had been proposed by the Administration, even longer delays were possible. And although the estimate also made some allowance for pending congressional proposals above the budget, not all of those possibilities were expected to materialize. Despite these uncertainties, it seemed highly probable in the summer of 1971 that there would be a significant shift from a full-employment surplus in fiscal 1971 to a full-employment deficit in fiscal 1972. The Administration considered this development appropriate in view of the sluggishness of the economy. At the same time the Administration was averse to making decisions that would add substantially to expenditure commitments for the future. Even within the limits of fiscal 1972, while more fiscal stimulus was desired, there was danger of excessive expansion in the prevailing inflationary atmosphere.

THE NEW ECONOMIC POLICY

WHERE WE STOOD ON AUGUST 15

As the summer of 1971 progressed, these facts became increasingly clear:

1. The economy was rising, and a continued rise could be expected; but the rise was not as fast as was desirable, especially from the standpoint of reducing unemployment.

2. Although the rate of inflation had stopped rising and might have declined, the decline was not clear cut, and there was some danger that the rate might rise again.

3. The U.S. international balance-of-payments position was deteriorating sharply, and willingness abroad to hold dollars was ebbing.

While these facts were clear, their reasons and their implications were unclear. The rate of economic expansion in the first half of the year was not less than many forecasters had predicted, but two aspects of the limited expansion were puzzling. As noted earlier, the rate of expansion of the money supply had been extraordinarily large, much larger than had been commonly

*In this calculation, expenditures for unemployment compensation payments are not standardized for the unemployment rate that would prevail at full employment. It should be noted, however, that the estimates for fiscal 1972 made in July 1971 assumed about the same average rate of unemployment for the fiscal year as was actually experienced in fiscal 1971. This procedure has been changed for the fiscal 1973 budget, which standardizes for the unemployment rate.

expected at the beginning of the year. Even when allowance was made for some lag between the increase in the stock of money and any consequent increase in economic activity, the response of the economy to the monetary expansion was less than many studies had found in previous experience.

One possible explanation was that recollection of the liquidity squeeze of 1970 left individuals and businesses with an extraordinary desire to rebuild their money balances when interest rates declined, as happened in early 1971. This attitude might have been reinforced by the belief that rapid monetary expansion presaged a future rise in interest rates. In any case the rapid growth of money in the first half of 1971 seemed to have resulted from a rapid growth in the demand for money and did not imply a growth of money relative to desired cash balances, which in time would have stimulated more economic expansion.

The other unusual feature of the limited expansion was the exceptionally high saving rate of 1971. Personal saving for the first 3 quarters of the year represented 8.3 percent of disposable personal income, as compared to an average of 6.3 percent in the preceding 10 years. The high rates of unemployment and inflation in 1970 and 1971 may have contributed to the high saving rate, as households tried to protect themselves against those hazards. Whether there was another independent factor, "lack of confidence," as commonly claimed is difficult to say. The measurements we have of this factor are weak and their historical connection with savings is loose. Even in retrospect, the reasons for the exceptionally high saving rate of 1971 are not entirely known.

Why the slowdown in the inflation was so halting and uncertain is another question which has not been clearly answered. Although this phenomenon is often ascribed to "structural" changes in the economy, these structural changes are not unmistakably evident. And although the delay in the disinflationary process was undoubtedly connected with the strength and duration of the inflation in the preceding years, one could not be sure that this explanation alone was sufficient.

The third part of the picture, the great enlargement in 1971 of the balance-of-payments deficit, also had its share of unanswered questions. On the basis of past experience, the sharp swing in the trade deficit was somewhat more than one might have expected from the rise in domestic demand and the slower expansion of foreign economies. Nor was it clear why the trade balance turned to deficit at a time when the rate of inflation in the United States was less than in most other industrial countries.

Policy in the summer of 1971 had to address the uncertainties as well as the obvious facts of these three interlocking problems. The relations among the problems greatly complicated the choice that had to be made.

The Administration's economic targets and projections at the beginning of the year were predicated on the idea that if the economy failed to rise at the desired rate, steps could be taken to make it rise more rapidly. This option was open in the middle of 1971. In fact, the planned fiscal policy for fiscal 1972 had already been made more expansive than had been contemplated in the January budget, and further moves in this direction were possible. Also, the rate of increase of the money supply had been larger than had been expected at the beginning of the year, and actions already taken by the Federal Reserve to slow this expansion could have been modified or reversed.

However, consideration of these expansive moves in the summer of 1971 ran first into the fact that the rate of inflation was still high, and then into the danger that it might rise again. It could have been argued that a more rapid rate of economic expansion would help to slow down the inflation because it would speed up the growth of productivity and cut the rise in unit labor costs. Although this argument was quite plausible early in 1971, a half year later it seemed less convincing in the existing psychological atmosphere, where any action that looked inflationary tended to increase the expectations of inflation, even though the indication was superficial. In fact, some were concerned at the time that action intended to be expansive might really be restrictive because the expansive measures might intensify fears of inflation, raise interest rates, weaken confidence, and thereby depress consumer and business spending. Moreover, there was a related danger that fiscal and monetary expansion might make America's international financial problem more difficult by increasing the supply of funds available for investment abroad and by arousing fears that American inflation would speed up again.

At the same time, the continued high rate of unemployment ruled out the restrictive approach to the problems of the rate of inflation and the balance of payments. Moreover, the Administration was determined not to try to solve the balance-of-payments problems solely by tightening up controls on international transactions. This had been tried repeatedly in the preceding decade without yielding a satisfactory long-term solution.

THE AUGUST 15 DECISIONS

The key to unraveling this knot of difficulties was the necessity for dealing with the international financial problem promptly and the Administration's determination to deal with it in a bold and lasting way. The decision initiated two policy actions in the international economy. First, the United States suspended the convertibility of dollars into gold or other international reserve assets, in order to protect the U.S. reserve position from further drain and to signal to other countries our determination to achieve meaningful improvement in our own position as well as needed reform of the international trade and payments system. Second, the United States imposed a temporary surcharge on imports, generally at the rate of 10 percent, to help protect the U.S. payments position until other more satisfactory actions could be taken that would assure a stronger balance-of-payments position for this country.

These international decisions tipped the scales on an issue that had been the subject of intense consideration in the Administration for many months, and indeed since January 1969. This was the question whether the Administration should intervene directly in holding down wages and prices—adopting what had come to be called an "incomes policy"—and, if so, on what scale and in what way.

There were two fundamental objections to adopting such a policy:

1. Experience with such policy as it had been practiced abroad suggested that it would not work—or at least not with much effect or very long—for the natural reason that success would require that powerful groups suspend the effort to reap the full advantage of their power.

2. Such a policy, at least if continued for very long, would interfere with the efficiency of the economic system and might create an undesirable increase in the power of the government over its citizens.

On the other hand, a number of considerations argued for some direct intervention:

1. Progress against inflation was disappointingly slow, and despite the unspectacular record of incomes policies elsewhere the possibility of some assistance from that source, even if temporary, could not be ruled out or discounted.

2. There seemed to be a large and growing sentiment in the country for some kind of incomes policy, and steps in that direction might relieve anxiety, strengthen confidence, and improve the economy. This sentiment also increased the chance of getting the kind of voluntary self-restraint required for success.

3. The Administration's acute consciousness of the pitfalls encountered in previous attempts might enable it to avoid, on the one hand, premature collapse of the control system and, on the other hand, its unnecessary prolongation.

The Administration took limited steps to influence wage and price behavior directly in 1969 and 1970. These included actions with respect to lumber, and the construction industry generally, as well as the institution of the National Commission on Productivity, the Regulation and Purchasing Review Board, and the *Inflation Alerts,* as described in the 1971 *Economic Report of the President.* Early in 1971 the Administration took a much stronger step, establishing a system of wage controls in the construction industry, with parallel actions intended to affect other cost elements in the industry (see Chapter 2, where the construction program is described). This action was the first use of the mandatory control power given to the President by the Congress through the Economic Stabilization Act of 1970.

The steps decided upon for dealing with the international situation introduced a potent new argument into the Administration's consideration of the merits of a comprehensive system of controls. Improvement of our international position would require effective and convincing action on domestic inflation, in addition to the action the United States was seeking in the international sphere. Such action on the domestic front would assure our trading partners of our intentions and provide the framework for a cooperative approach to the solution of international payments problems.

These considerations, combined with others already present, led to the decision to institute a powerful, but temporary, price-wage control system. Once this decision had been made it altered the balance of considerations with respect to a more expansive fiscal policy. Action to make fiscal policy more expansive had been limited by the need to avoid intensifying any inflationary expectations and stepping-up the inflation. The establishment of the direct wage-price controls created room for some more expansive measures, because it provided a certain degree of protection against both the fact and the expectation of inflation. This situation had to be approached with caution, because excessive expansion could make the price-wage control system unworkable. Still there could be no doubt that the tolerable rate of expansion had been increased.

Thus, the decisions of August 15 consisted of a three-part, integrated package: (a) International measures aimed at the balance of payments; (b) controls aimed at checking inflation; and (c) fiscal measures aimed, in combination with the international measures and controls, at speeding up economic expansion and reducing unemployment.

The international measures taken on August 15 and their sequels are described in Chapter 5. The controls are discussed in Chapter 2. Here we take up the fiscal measures and the expected effect of the total program.

FISCAL ELEMENTS IN THE NEW ECONOMIC POLICY

The fiscal package proposed by the Administration on August 15 (as described in detail by the Secretary of the Treasury to the House Ways and Means Committee on September 8, 1971) was primarily motivated by the desire to stimulate at once a more rapid expansion of the economy. The composition of the package reflected a number of other objectives: To improve the balance of trade, to accelerate productivity growth by raising investment, to minimize the loss of long-term revenue-raising capacity, and to hold down the deficit in the budget for fiscal 1972, while recognizing realistically the likely outcome for the budget.

The package included the following items whose effects on the 1972 budget are shown in the table:

1. *A job development credit.* This would provide businesses with a tax credit of 10 percent for new investment in the first year of the program and 5 percent for investment thereafter. The two-tier form of credit would create a strong incentive to push investment forward into the first year of the program and would also hold down the revenue loss in subsequent years.

2. *Repeal of the 7-percent excise tax on automobiles.* This change was expected to have a stronger immediate effect on spending, production, and employment than a reduction in, say, the corporate or individual income

tax with an equivalent revenue loss. Repeal of the tax would also reduce the price level a little.

3. *Two steps changing the timing of tax cuts that had been previously legislated.* One change would raise the individual exemption to $750 on January 1, 1972, instead of to $700 on that date and $750 on January 1, 1973. The other would increase the standard deduction on January 1, 1972, to 15 percent with a $2,000 maximum. Both of these moves would increase the after-tax incomes of individuals, and both were expected to increase consumer spending in 1972 without reducing the revenues after 1973.

4. *A temporary surcharge on dutiable imports, generally at the rate of 10 percent.* (When all exceptions to the 10-percent rule were taken into account, the effective rate of surcharge came down to 4.8 percent.) The surcharge was not imposed to raise revenue but to provide the U.S. external position with some temporary protection. The surcharge would raise revenues; but unlike the conventional revenue-increasing measure it would stimulate rather than restrain the economy.

5. *Provision for the Domestic International Sales Corporation (DISC).* Through this new type of organization, U.S. exporters would be able to obtain a deferral of income tax on their earnings from qualified export sales. The purpose was to eliminate the previous bias that had worked against exporting and in favor of manufacturing abroad, and thus to stimulate exports.

6. *Recognition that certain proposed expenditure programs had been delayed in the legislative process and thus required a reduction of estimated fiscal 1972 outlays.* The main items involved were general and special revenue sharing and welfare reform.

7. *Deferral for 6 months of the Federal pay increase scheduled to take effect on January 1, 1972.* This was the Federal counterpart of the wage freeze being put into effect on August 15.

8. *A 5-percent reduction in Federal employment.* Such a reduction would be the most effective way to reduce Federal outlays with minimum short-range loss of service to the citizens.

9. *Miscellaneous small reductions in expenditures.* These included a 10-percent cut in foreign aid.

As Table 19 shows, the effect of this package was to reduce estimated expenditures for fiscal 1972 by about $1.1 billion more than the reduction in estimated receipts. At the same time, the program was intended and expected to be expansionary. The primary reason, as already noted, was that the surcharge, while revenue-yielding, was foreseen as having an expansive effect on domestic production, and the two-tier investment credit as exerting an unusually powerful effect on investment in the next year relative to the revenue loss in that year.

In addition, a common view was that both business spending and consumer spending had been held down in the early part of the year by anxiety over the inflation. One motive for the freeze on prices, wages, and rents, was the

TABLE 19.—*Effect on fiscal year 1972 Budget of tax and expenditure changes in New Economic Policy*

Type of change	Billions of dollars
Revenue reductions	5.8
Job development credit	2.7
Accelerated increase of personal exemptions	.9
Elimination of auto excises	2.2
Revenue increase	2.0
Import surcharge [1]	2.0
Revenue reductions, net	3.8
Expenditure reductions	4.9
Freeze of Federal pay increase	1.3
Deferral of general revenue sharing	1.1
Reduction of Federal employment	.8
Deferrals of some special revenue sharing	.5
Deferral of welfare reform	.6
Other	.6
Excess of expenditure reductions over net revenue reductions	1.1

[1] It was arbitrarily assumed that the surcharge would continue until June 30, 1972.

Source: Treasury Department.

hope of relieving this anxiety and encouraging more spending. If these ends were accomplished there could be a major expansive effect without any prior change in the budget.

Many aspects of the full package—that is, the freeze, the international measures, and the fiscal steps—were unprecedented, and therefore any reliable calculation of the size of their effects was exceedingly difficult. The Council of Economic Advisers estimated at the end of August that the Administration's package would make real 1972 GNP in 1972 prices about $15 billion greater than it would have been without the new program, but this figure was recognized as subject to a wide range of uncertainty.

The legislative outcome followed the general outline of the Administration's proposal but differed in several respects. Congress did not enact the 10-percent–5-percent job development credit, but instead passed a permanent 7-percent credit. Congress disapproved the revision in the treatment of first-year depreciation which the Treasury had made administratively. Congress also cut back the Administration's proposal, which had already been passed by the House in 1970, to defer taxes on profits from exports. On the other hand, Congress not only raised the personal exemption to $750 for calendar year 1972 but also raised the 1971 exemption to $675. Congress went beyond the Administration's proposals in several other respects: It raised the "low income allowance," or minimum standard deduction, to $1,300 from $1,000 for 1972 and repealed the 10-percent excise tax on light trucks. Other legislation made the Federal pay increase effective on January 1, 1972, contrary to the Administration's proposal. A new deduction for child care and household help was also introduced.

The effect of the congressional action was to reduce the net revenue loss for calendar 1972 about $1.2 billion below the cost of the Administration's proposal. Possibly more significant was the failure to adopt the job development credit in its original form, which provided a strong incentive for investment in 1972. Nevertheless, the enactment of the tax bill contributed to the expectation that a strong economic advance lay ahead, an expectation which was becoming general as 1971 ended.