Introduction

In 1971 monetary policy encouraged further substantial growth in bank reserves, money, and bank credit in helping to stimulate economic recovery from the mild recession of 1969–70. Monetary aggregates in general expanded somewhat more rapidly than they had the year before. Interest rates fluctuated widely—reflecting, among other things, shifts in inflationary expectations and large flows of funds between the United States and foreign countries. After the President's mid-August announcement of new economic policies, which included a program of wage and price restraint and far-reaching international measures to combat inflation and the deterioration in the balance of payments, interests rates showed a declining trend, and at the end of the year they were down somewhat, on the average, from their beginning-of-1971 levels.

For 1971 as a whole the real gross national product rose only 2.7 per cent from the year before. Greatly increased spending for residential construction and larger expenditures by State and local governments helped to sustain economic activity. But economic recovery was hampered by domestic and international economic uncertainties and generally cautious attitudes on the part of both businesses and consumers. Unemployment remained at about 6 per cent of the labor force throughout the year. And prices, as measured by average prices of the goods and services that make up the GNP, rose about as much in the first half of the year, prior to the new economic program, as they had in 1970.

During the first half of the year, surveys of consumer attitudes suggested that concern about rising prices, as well as fear of unemployment, was causing consumers to hold back on spending. Consumer outlays for goods and services did rise rather substantially, but the increase reflected in large measure the first-quarter bulge in disposable personal income and auto sales following settlement of the late-1970 auto strike, a Federal pay raise, and retroactive increases in social security benefits. The personal saving rate remained exceptionally high.

With the strength of consumer spending uncertain, businessmen pursued conservative inventory policies, although there was some

strike-related inventory-building during the first half of the year. In addition, outlays for new plant and equipment were held down by the sizable amount of excess manufacturing capacity already in place and by the sluggishness of new orders for the output of these plants. Defense and nondefense orders from the Federal Government remained at a reduced pace. The cumulative effect of rising costs and prices limited the ability of U.S. industries to compete in foreign markets, and in many cases to compete in domestic markets with goods produced abroad.

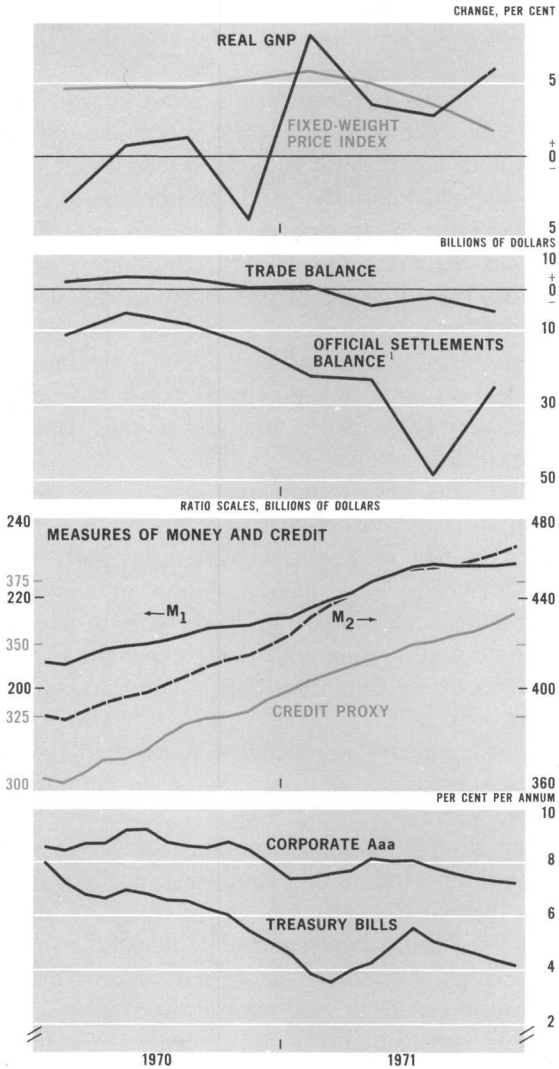
During 1971 the U.S. balance of payments worsened dramatically. The trade balance was only marginally in surplus in the early months of the year; then it slipped into monthly deficits, making increasingly evident the extent to which the competitive position of the United States had eroded.

The worsening of the over-all balance of payments reflected also the very large outflows of capital from the United States to foreign countries that occurred in response to interest rate incentives and expectations of changes in currency values. In the early part of the year U.S. interest rates declined much faster than those in leading financial centers abroad, and U.S. banks continued to repay Eurodollar borrowings. Foreign official reserves were swollen by these and other recorded and unrecorded flows of capital. German reserve gains were especially large until the German mark was permitted to float upward in May. As evidence of deepening difficulties for the U.S. balance of payments mounted, international traders and investors shifted out of dollar assets into other currencies on a large scale.

From the end of 1970 to the end of July 1971, U.S. liabilities to foreign official accounts increased by $12.5 billion to a level of $37 billion, while U.S. reserve assets fell by a little more than $1 billion to $13.3 billion. In the first 2 weeks of August reserve liabilities grew by a further $4.5 billion, while reserve assets dropped by another $1 billion.

The worsening in the balance of payments situation heightened public concern about the effectiveness of policies being pursued to contain inflation—a concern that was related to the continuation of large wage settlements and to the lack of evidence that price increases were abating to any significant extent. Interest rates—which had declined further in the very early months of the year—began to

1. SELECTED ECONOMIC DEVELOPMENTS



[1] Excludes SDR allocations.

NOTE.—GNP and price data are based on seasonally adjusted annual rates data from Bureau of Economic Analysis, Dept. of Commerce; changes from preceding quarter at compounded annual rates; fixed-weight price index is for gross private product. For definitions of measures of money and credit, see Chart 12, p. 34; for Treasury bills and Aaa bonds, see Chart 11, p. 32.

rise. Long-term rates in particular were affected by renewed resistance to fixed-income securities on the part of investors who feared that the value of such securities would be eroded over time through inflation.

The decline in short- and long-term market interest rates early in the year had been accompanied by three successive reductions of ¼ percentage point in the Federal Reserve discount rate, to a level of 4¾ per cent by mid-February. And the monetary aggregates expanded at rapid rates in the first quarter, with growth in M_1 (currency and private demand deposits) reflecting increased transactions demands and the lagged effects of previous declines in interest rates. Expansion in the broader monetary aggregates was even more rapid as low levels of market interest rates relative to offering rates on time and savings accounts, together with the high rate of personal saving, led to a very large rise in time and savings deposits at banks and nonbank thrift institutions.

These inflows, and the accompanying easing of over-all credit conditions, supported a substantial rise in private housing starts and in expenditures for new residential construction; starts rose from 1.4 million units in 1970 to more than 2 million units in 1971 and exceeded a 2.2-million-unit annual rate in the fourth quarter. Residential construction outlays, along with rising expenditures by State and local governments, were important forces contributing to economic recovery during the year.

Growth in the monetary aggregates continued to be rapid in the second quarter; growth in M_1 accelerated to an annual rate of around 10.5 per cent from its 9 per cent first-quarter pace. This, together with the disappointing performance of prices, was causing some concern at home and abroad about the adequacy of public economic policies then in effect to contain inflation. At the same time, the slack in the domestic economy made it clear that monetary policy needed to remain expansive. Under the circumstances, the Federal Reserve continued to provide reserves at a substantial rate, but in the spring and early summer it did so less readily than earlier in the year. This policy contributed to the rise in short-term rates that developed during the second quarter. To bring the discount rate into better alignment with market rates, the rate was raised by ¼ of a percentage point in mid-July to 5 per cent.

In an effort to maintain accommodative capital market conditions, in view of the comparatively weak expansion of the economy, the Federal Reserve stepped up its purchases of longer-term Treasury securities during the first quarter. Later in the year, it extended its outright purchases of securities in the open market to include Federal agency issues. These operations were adopted within the over-all objectives of System open market operations, and they did not contribute, net, to faster growth in the System's total portfolio of securities or to expansion in bank reserves.

Developments over the first 7 months of the year brought increasingly into question whether conventional monetary and fiscal policies alone were adequate to combat the cost-push inflation and the deterioration in the U.S. balance of payments, while at the same time continuing to promote more vigorous recovery in the domestic economy. The new economic policies initiated in mid-August broadened the mix of public policy measures with a view to dealing more effectively with the Nation's diverse and, in the short run, partly conflicting objectives.

The basic elements of the new program were a temporary 90-day freeze on wages and prices, to be followed by a more flexible system of restraints in the second phase; suspension of the convertibility of the dollar into gold or other reserve assets; imposition of a temporary surtax of up to 10 per cent on dutiable imports; and certain fiscal measures designed to stimulate spending, including proposed elimination of the excise tax on autos and an investment tax credit to encourage business capital outlays. The program of tax incentives, with some modifications, was enacted by Congress late in the year, as was legislation authorizing the continuation of a program of restraint on wages, prices, rents, dividends, and interest. The 10 per cent surtax was rescinded following the international monetary agreement reached on December 18 in Washington.

The new economic program recognized the need for a sizable and broadly based revaluation of foreign currencies vis-a-vis the dollar to help restore the international competitiveness of U.S.-produced goods. But in addition the new program was intended to encourage improvements in the Bretton Woods Agreements and to eliminate at least some of the major foreign trade practices injurious to U.S. exports. After August 15 all major countries allowed their currencies

to rise somewhat in price relative to the dollar, although foreign official institutions added substantially more to their holdings of dollars.

The monetary agreement signed in Washington in mid-December allayed international uncertainties that had threatened to impede the flow of trade and to hinder U.S. economic recovery. Major foreign countries agreed to an adjustment of exchange rates, the over-all effect of which was to produce a substantial appreciation, on the average, of foreign currencies in relation to the dollar. The settlement also included a widening of intervention bands to 2¼ per cent on either side of the new exchange rates (or parities) as well as an increase of 8.57 per cent—from $35 to $38 per ounce—in the dollar price of gold to be requested from Congress.

The new domestic and international economic program was immediately reflected in renewed confidence in credit markets. After mid-August, interest rates declined as inflationary expectations abated and as fears eased that the worsensing balance of payments might lead to tighter financial conditions in the United States.

The new wage-price program effectively constrained wage and price increases during the freeze period. After the freeze ended in mid-November, some catch-up of wage and price increases developed. The Phase II program of wage and price restraint is being administered by a Pay Board and a Price Commission. The activities of these two bodies, composed of private citizens, are coordinated by the governmental Cost of Living Council. The objective of the Phase II program is to hold average price increases to no more than 2.5 per cent per year, in conformity with the Council's goal of reducing the rate of inflation to a range of 2 to 3 per cent by the end of 1972. Such an achievement would halve the rate of inflation that had prevailed in 1970 and the first half of 1971. A Committee on Interest and Dividends was also formed as part of the Phase II program to see that the behavior of dividends and interest rates—particularly those that affect the American family, such as on mortgages and consumer loans—is consistent with the program of wage and price restraint.

The initial effects of the new economic program appear to have been stimulative. Immediately after announcement of the price freeze, there was a surge in purchases of new domestically produced

autos, and consumer purchases of other goods and services, in real terms, also quickened. Employment gains accelerated as did the over-all rate of economic activity. In the final quarter of the year, real GNP rose at an annual rate of around 6 per cent, notably faster than in the second and third quarters and the highest rate of gain, except for the strike-recovery period in the first quarter of 1971, since the first half of 1968.

Monetary developments in the latter part of 1971 were highlighted by moderation in the growth rates of the monetary aggregates. In particular, the level of the narrowly defined money stock (M_1) showed only a very minor increase from August to December. Following the sharp build-up earlier in the year, when economic uncertainties were pervasive, the public's demand for cash balances leveled off, reflecting in part reductions in precautionary demands for liquidity as confidence increased. The broader measures of money continued to expand at substantial rates in the latter part of the year, although in these too the rate of growth moderated somewhat from the rapid rates that had occurred in the first half.

At the same time sufficient bank reserves were being provided to encourage the interest rate declines initially set in motion by the wage-price freeze. By the year-end longer-term interest rates were about 1 percentage point below their mid-August levels, and short-term rates were down by about 1.5 percentage points over the same period. And in mid-December the discount rate was reduced to 4½ per cent in recognition of the lower levels of market interest rates and to assist in encouraging a more rapid economic expansion.

Developments in 1971 laid the basis for an accelerated rate of economic recovery in 1972 and for further moderation of wage and price pressures. To be sure, effective administration of the Phase II wage and price program will be critical in maintaining public confidence in the containment of inflation. But this result should be encouraged also by basic economic forces, including continuation of an ample supply of labor and materials, the absence of demand-induced inflation generally, and the prospect that faster growth in productivity is likely to accompany more vigorous expansion in over-all economic activity.

The outlook for a strengthening in demands for goods and services appears highly favorable. Plant and equipment surveys suggest

greater capital outlays by business in 1972 than in 1971. Moreover, the realignment of exchange rates should make domestically produced goods more competitive, thus enhancing the potential for exports by U.S. firms and perhaps shifting investment plans toward the United States. And corporations are now in good financial positions to expand operations—having worked over the past 2 years to restructure their debt and to improve their liquidity positions.

Residential construction outlays should increase somewhat further in 1972, given the rising rate of housing starts in the latter part of 1971. The currently ample liquidity of banks and other financial institutions and the continuation of large net inflows of time deposits suggest that credit will be available to finance construction activity —even if there is a pick-up in business loan demands at banks. State and local governments are also likely to increase their spending for construction; these governments issued very sizable amounts of securities in 1971, and according to preliminary indications their demands for funds will continue to be large in early 1972. Furthermore, the Federal budget indicates a stimulative fiscal policy during 1972.

An acceleration of economic recovery will depend importantly on a strengthening in consumer demands. The saving rate declined somewhat in the latter part of 1971, suggesting an increased consumer propensity to spend and greater confidence in the longer-run economic outlook. Increases in consumption together with increases in construction, investment, and net exports would be likely to stimulate increased holdings of inventories since businesses have followed comparatively conservative policies in this type of investment over the past 2 years. Such a pick-up in inventory accumulation has been a major feature of past cyclical recoveries, when it has played a significant role in inducing gains both in employment and in consumption expenditures.

Other sections of this report analyze developments in certain key areas of the economy in 1971. A digest of the principal Federal Reserve policy actions in 1971 appears on pages I–VII following page 24. □

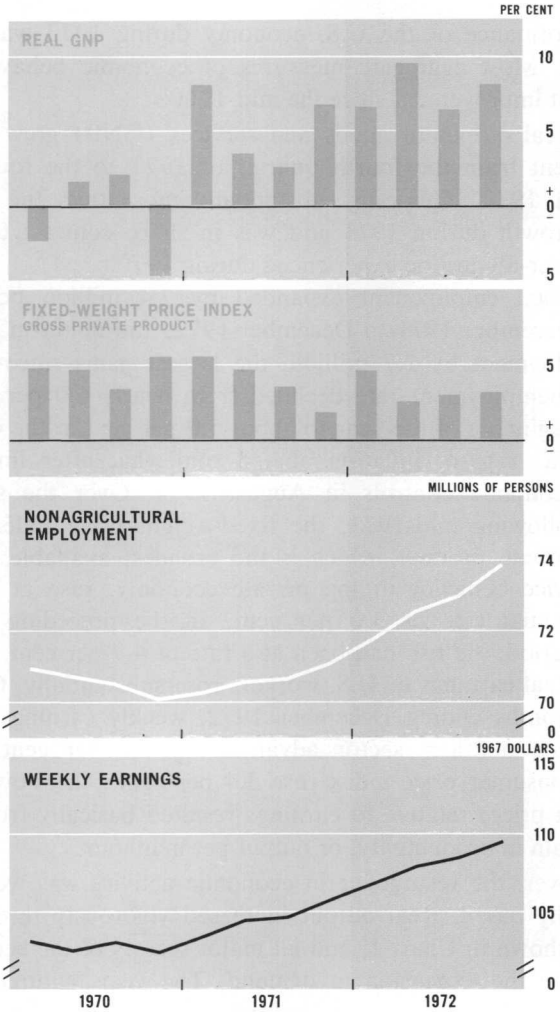
Introduction

The performance of the U.S. economy during 1972 was unusually favorable. Most aggregate measures of economic behavior showed the largest improvement since the mid-1960's.

- Real output of goods and services (GNP) grew by 7.6 per cent from the fourth quarter of 1971 to the fourth quarter of 1972. This was substantially more than the 5 per cent growth during 1971 and was in sharp contrast to the small over-all decline experienced during 1970.
- Total employment expanded by 2.4 million persons from December 1971 to December 1972, and nonfarm payroll employment by 2.7 million, the largest gains since 1966. The unemployment rate declined from nearly 6.0 per cent at the beginning of the year to about 5.0 per cent at the close.
- The rate of inflation abated somewhat after imposition of economic controls in August 1971. Over the six quarters following mid-1971, the fixed-weight price index for gross private product, which is the broadest available measure of price behavior in the private economy, rose at an average annual rate of 3.0 per cent. In the preceding six-quarter period, the rise had been at a rate of 4.7 per cent.
- Real earnings of U.S. workers rose substantially. Over the 12 months ending December 1972, weekly earnings in the private nonfarm sector advanced by 6.2 per cent, while the consumer price index rose 3.4 per cent. The slower advance in prices relative to earnings resulted basically from a strong gain in productivity, or output per manhour.

Moreover, the resurgence in economic activity was well balanced and solidly based. Real output increased vigorously throughout the year, as shown in Chart 1, and all major sectors of the economy contributed to the expansion in demand. The year featured large and steady gains in consumption, a further substantial increase in residential building, and a sizable expansion in business fixed investment. Government purchases rose 7.5 per cent from the fourth quarter of 1971 to the fourth quarter of 1972. State and local government units

1. INDICATORS OF ECONOMIC PERFORMANCE



NOTE.—Gross national product (GNP) and price index: Changes from preceding quarter compounded at annual rates, based on seasonally adjusted data from the Dept. of Commerce, Bureau of Economic Analysis. Change in real GNP is based on 1958 dollars.

Other series: Dept. of Labor, Bureau of Labor Statistics. Employment data are seasonally adjusted. Earnings are averages for private nonfarm production workers.

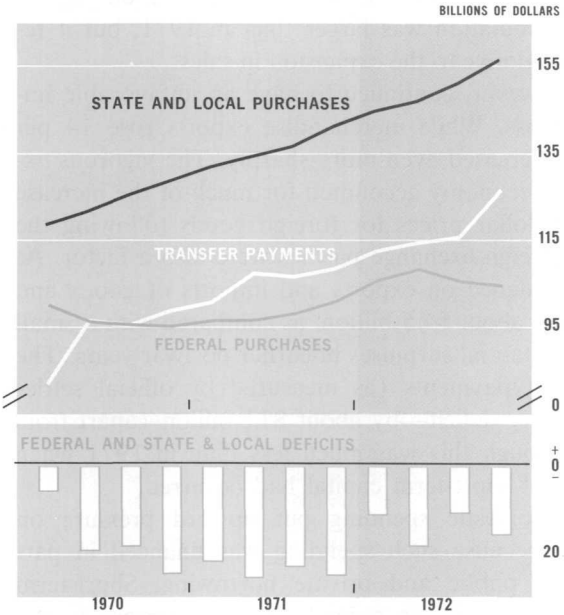
accounted for most of the increase—as shown in Chart 2 on page 6. Business inventory accumulation was larger than in 1971, but it remained quite moderate relative to the expansion in sales.

Net foreign trade, however, continued to have an unfavorable impact on domestic business. While merchandise exports rose 14 per cent in 1972, imports increased even more sharply. The vigorous expansion of the domestic economy accounted for much of the increase in imports, but higher dollar prices for foreign goods following the late 1971 changes in foreign exchange parities were also a factor. As a result, the net U.S. balance on exports and imports of goods and services was in deficit by about $4.5 billion, as compared with a small surplus in 1971 and substantial surpluses in earlier postwar years. The over-all U.S. balance of payments (as measured by official settlements) remained in heavy deficit—by about $11 billion (apart from SDR allocations)—although this was much less than in 1971 when extraordinary outflows of short-term capital had occurred.

The sharp rise in domestic spending put upward pressure on interest rates in 1972 because such spending was financed in part by very high levels of public and private borrowing. Short-term interest rates rose considerably, as reflected by an increase in the rate on 3-month Treasury bills from a low of 3.20 per cent early in the year to an average of more than 5.00 per cent in December. Long-term rates, however, changed relatively little over the course of the year. Yields on new corporate bond issues and on municipal securities declined moderately, on balance, while yields on longer-term Treasury bonds rose under pressure of increased supplies. Mortgage rates were generally stable, as both the volume of savings flowing into mortgage lending institutions and mortgage credit expansion continued at record levels.

Some narrowing in the yield spread between long- and short-term securities is typical during periods of cyclical expansion in business. But the markedly different behavior of rates in these two types of markets in 1972 was attributable in part to special factors. First, Treasury borrowing requirements, while somewhat smaller than in 1971, did put greater pressure on domestic short-term credit markets. Although foreign central banks continued to invest much

2. GOVERNMENT OUTLAYS

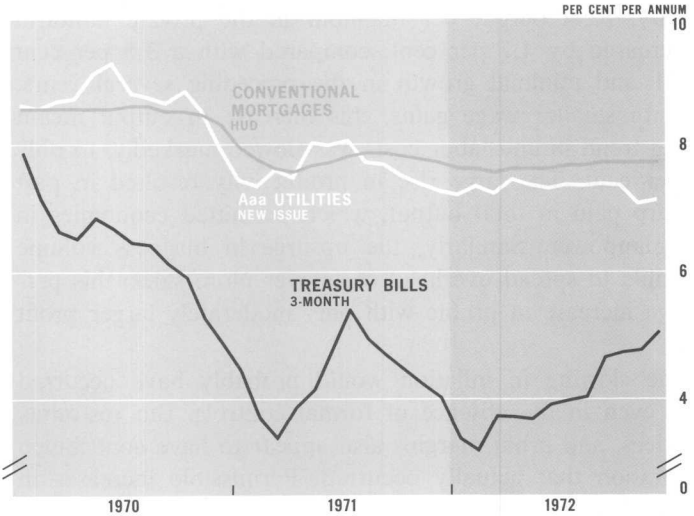


NOTE.—National Income Accounts (NIA) data at seasonally adjusted rates, from Dept. of Commerce, BEA. Transfer payments include net interest payments, subsidies, and net deficits of government enterprises. Combined deficits throughout (Q4 '72 estimated) exclude surpluses of State and local government retirement funds, which amounted to $7.4 billion (annual rate) in the final quarter of 1972.

of the expansion in their dollar reserves in U.S. Treasury debt, the over-all total of such placements was far below that of 1971. Moreover, these banks put three-quarters of the total into higher-yielding coupon issues, in contrast to their 1971 emphasis on Treasury bills. Second, the volume of private long-term security issues declined appreciably, as the flow of internal funds available to corporations from depreciation allowances and retained profits improved sharply. Finally, efforts under Phase II of the economic stabilization program to moderate the increase in wages and prices—along with the slowing in inflation that actually took place—may well have induced some decline in the inflation premium required by investors for long-term commitments of funds.

The behavior of wages and prices during 1972 was significantly more favorable, on balance, than in other recent years. There was a

3. SELECTED INTEREST RATES



For notes, see Chart 16, p. 42.

temporary bulge in the first few months following termination of the wage–price freeze in November 1971, but after that the increase in both wages and prices moderated on balance. For example, the index of average hourly earnings in the private nonfarm economy, adjusted for overtime premiums in manufacturing and for interindustry shifts in employment, rose at an annual rate of 5.9 per cent from January 1972 to January 1973. This compared with a 7.0 per cent rate of increase before the freeze in 1971.

Consumer prices of nonfood commodities rose 2.5 per cent during 1972, compared with 4 per cent in the 12 months before the freeze; increases in prices of services also slowed appreciably. Consumer food prices, however, rose nearly 5 per cent during 1972, reflecting the larger consumer demands associated with rising personal incomes and the shortages in supplies of meats and some other foodstuffs in the market. It should be noted that prices of raw agricultural products were exempted from the controls because of the serious problems inherent in balancing supply and demand at non-market-determined prices in the absence of rationing.

A major factor contributing to moderation in the inflation of

nonfood commodity prices during 1972 was the stepped-up growth in productivity. Real output per manhour in the private nonfarm economy increased by 4.7 per cent, compared with a 3.5 per cent gain in 1971 and minimal growth in the preceding several years. Combined with smaller wage gains, this increase in output meant that the rising trend in unit labor costs was slowed markedly, to only about 1.5 per cent. The large rise in productivity resulted in part from the sharp gain in total output, which permitted economies in the use of manpower. Similarly, the upsurge in business volume made it possible to spread overhead costs over more sales; this permitted a large increase in profits with only moderately larger profit margins.

Thus, some slowing in inflation would probably have occurred during 1972 even in the absence of formal controls. But restraints on wages, prices, and profit margins also appear to have contributed to the moderation that actually occurred. Permissible increases in most wages and prices were limited by the program, and in some instances there were enforced rollbacks of increases that had been put into effect. Moreover, the existence of the program tended to discourage inflationary behavior in the policies and plans of business firms and the public generally.

Phase III, announced in January 1973, introduced additional flexibility into the program. But the intent remains one of strong resistance to inflationary behavior, both on a broad scale and in individual cases, and the goal is to reduce further the over-all rate of inflation.

During 1972 both fiscal policy and monetary policy were directed toward encouraging more vigorous expansion in economic activity and achieving a higher level of utilization of the Nation's labor and other economic resources. As a part of the new economic program announced in August 1971, tax policy was liberalized in several respects to stimulate demands by the private sector of the economy and to provide additional spending incentives. The Federal excise tax on automobiles was repealed, the investment tax credit was reinstated at 7 per cent, and certain tax reductions that had been scheduled for later were advanced to January 1, 1972. In addition, programmed Federal expenditures were boosted, largely

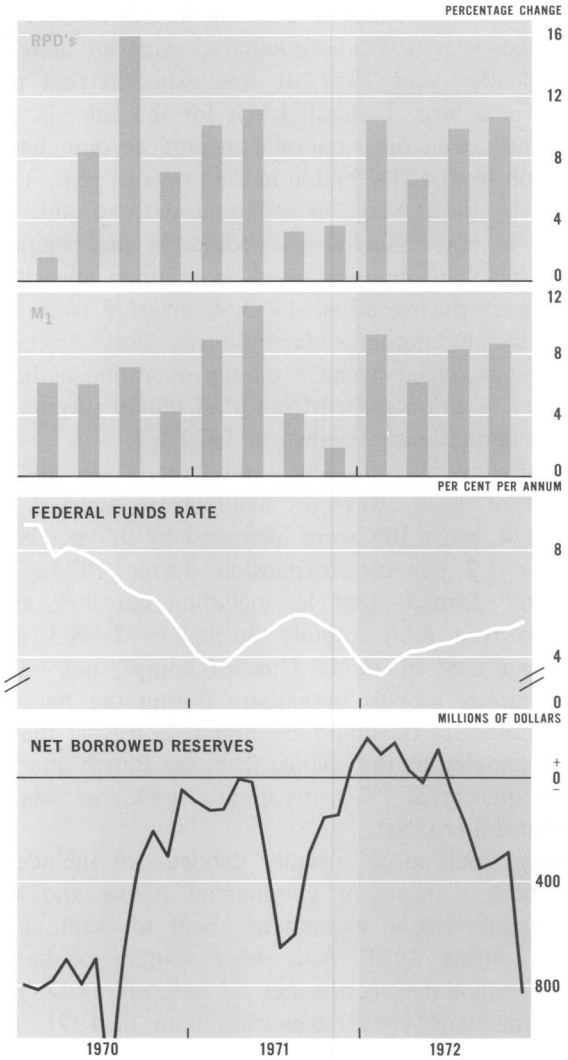
with respect to transfer payments and grants to State and local governments.

As a result of these changes, Federal outlays rose by $26 billion in the calendar year 1972 as compared with an increase of $16 billion in calendar year 1971. It was expected that the changes would result in a large Federal deficit for the calendar year 1972. But in fact the deficit on a national income account basis declined to $18.5 billion from $21.7 billion in the previous year. Tax revenues were buoyed by the upsurge in economic activity and, in addition, by a change in tax-withholding schedules at the beginning of the year, which resulted in substantial, continuing overpayments on individuals' taxes during all of 1972. Converted to a full-employment basis, which compares expenditures with the tax revenues that would be produced by an economy operating at high employment, the fiscal position shifted from a $4 billion surplus in calendar year 1971 to approximate balance in 1972.

Monetary policy also was in a moderately stimulative posture through most of 1972. Reserves available to support private deposits (Chart 4, page 10) were increased by 9.7 per cent as compared with a 7.2 per cent expansion during 1971. The money stock narrowly defined—that is, including currency and demand deposits—also rose more rapidly during 1972—8.3 per cent as against 6.6 per cent in 1971. This, of course, not only reflected the more vigorous growth in activity during the period but also helped to finance it. It should be noted, however, that when the increase is calculated as the change from the fourth quarter of 1971 to the fourth quarter of 1972, the money stock rose less than either real or current-dollar GNP.

The money stock more broadly defined—to include also consumer-type time deposits at commercial banks and other thrift institutions—continued to expand at about the same high 13 per cent rate as during 1971. And other sources of bank funds—mainly large negotiable certificates of deposit (CD's)—provided more funds for bank credit expansion than in 1971. Credit thus was readily available from banks and other institutional lenders to finance private and public spending. Expansion in credit and money was not large enough to satisfy all demands, however, so short-term interest rates rose considerably over the course of the year whereas

4. SELECTED MONETARY INDICATORS



NOTE.—RPD's and M_1 are quarterly changes at annual rates, based on seasonally adjusted data. RPD's are reserves to support private nonbank deposits. M_1 is currency held outside the Treasury, F. R. Banks, and the vaults of all commercial banks, plus demand deposits other than interbank and U.S. Government.

Federal funds rate and net borrowed reserves are monthly averages of daily figures.

interest rates on most long-term securities showed relatively little net change.

Upward pressure on short-term interest rates continued into early 1973, and the Federal Reserve discount rate was raised in two steps of ½ percentage point each to 5½ per cent. The discount rate had not been changed in 1972 as short-term market rates fluctuated around it, first falling below and then in the latter part of the year rising above it.

Economic activity rose especially sharply in the closing months of the year, with production, sales, and employment all expanding vigorously. Real GNP increased at an 8.0 per cent annual rate in the fourth quarter, and the unemployment rate moved significantly lower. By the year-end, the prospects seemed clearly to point in the direction of a continued substantial upward momentum in 1973.

Indications early in 1973 are that business outlays on new plant and equipment will be rising rapidly and that inventory investment may accelerate in line with the rising trend of business sales. Consumer spending, which was exceptionally strong in the fourth quarter of 1972, will very likely be buoyed in coming months by sizable refunds of Federal taxes overwithheld during 1972, as well as by continuing gains in employment and income. State and local government expenditures are to receive substantial financial assistance from the general revenue-sharing payments of the Federal Government, which commenced—with a retroactive disbursement—only very late in 1972.

Only residential construction seems likely to be moving down following 2 years of record-high activity. But both building permits and housing starts, which lead construction outlays, remained extremely strong through the end of 1972, so any appreciable decline in such outlays is likely to be deferred until the latter part of 1973.

The foreign trade outlook also appears more favorable than in 1972. Exports should be stimulated by the high and rising levels of economic activity prevailing in most major countries and by the further improvement in competitive position likely to stem from the 10 per cent devaluation of the dollar announced by the President on February 12, 1973. Domestic production that competes with imports will also be stimulated as a result of the increase in dollar

prices of imported goods. Thus, the physical volume of imports will tend to be limited, although—as in early 1972—the total dollar value of imports may be inflated by these higher prices. Past experience, both here and abroad, indicates that progress toward a better balance of payments position will be slow and gradual, but the further change in dollar parity in February should make an additional contribution toward that end.

Summarizing, there is good reason to believe that the U.S. economy will continue to expand at a relatively rapid rate in the period ahead. And as the economy approaches maximum levels of practicable resource utilization, the nature of the demand–management problem facing governmental policy will be in process of change. Rather than the stimulus that was needed to encourage rapid economic recovery, the need increasingly may be to restrain the expansion in economic activity to insure that future growth will moderate to a rate consistent with the Nation's longer-run potential.

The administration's new budget plans for the remainder of the fiscal year 1973 and for fiscal 1974 recognize this need. If the spending totals proposed are not exceeded, the rise in Federal outlays during calendar year 1973 will be substantially smaller than during calendar year 1972. Tax refunds will keep the deficit large in the first half of 1973, but thereafter revenues will be expanding in line with growth in the economy. Under these conditions, the slower rise planned in Federal expenditures would imply appreciably less fiscal stimulus by the second half of 1973 and on into 1974.

Monetary policy too must be responsive to the financial requirements imposed by the needed moderation in economic growth to a more sustainable, noninflationary pace. Although expansion in the monetary aggregates continued comparatively rapid in the latter part of 1972 as demands for funds intensified, reserves to support this expansion were being provided more reluctantly, and efforts by banks to adjust their positions by other means put upward pressure on short-term interest rates. Less of the recent rise in bank reserves has stemmed from open market operations, and more from further increases in the average level of temporary bank accommodation at Federal Reserve Bank discount windows.

If the past is any guide, the firming in monetary conditions over

recent months should soon result in moderation in the rate of monetary expansion. Developing monetary restraint affects monetary growth and economic activity with some lag, since it takes time for borrowers, lenders, and investors to adjust to changed financial conditions. Thus, the cumulative effects of monetary actions in 1972—particularly those initiated in the latter part of the year—will be working for some time toward restraint of monetary expansion and of aggregate demand in the future.

In any event, prospects at the beginning of the year make it unlikely that the needs of the economy in 1973 will or should call for the degree of monetary stimulus provided in 1972. Monetary policy is a flexible instrument for influencing the economic environment, however, and it will be in a position to respond to changing needs as economic developments unfold during the year.

Introduction

In 1973 the U.S. economy was plagued by its worst inflation since the end of World War II. Wholesale prices rose by 18 per cent during the year and consumer prices by nearly 9 per cent. At the end of the year inflation was still running strong, led by sharply higher prices for foreign crude oil and petroleum products in U.S. markets. The economic expansion, under way since 1971, slowed markedly over the course of 1973 in response to more restrictive national economic policies and the adverse effects of the rapid advance in prices on consumer buying power. Activity was also dampened in the latter part of the year by the energy shortage, which generated widespread buyer uncertainty and seriously disrupted longstanding patterns of demand for autos and other goods and services.

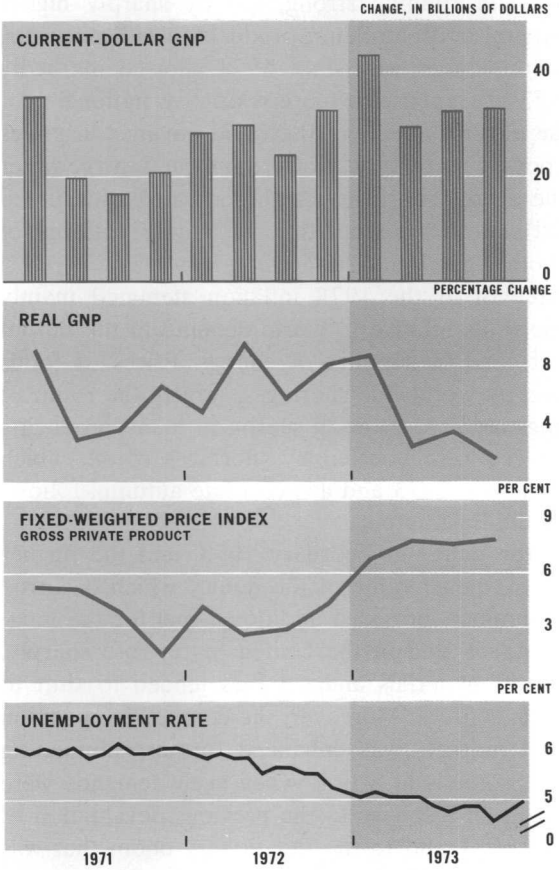
The exceptional strength of the 1973 inflation stemmed mainly from extraordinary shortfalls relative to world demand in the output of agricultural products and in supplies of energy. Prices of foods and fibers were affected by worldwide shortages, largely the result of poor crop yields during the 1972 growing season in many producing countries. And fuel prices were boosted by shortages of oil, which were serious at times early in 1973 and acute in late autumn, following the cutbacks in Middle East output.

The devaluation of the dollar in February 1973, and the further decline in the foreign exchange value of the dollar, which occurred during the spring and summer, provided additional fuel for the inflation. Prices of foreign goods sold in the United States rose sharply, and business demands for materials and supplies tended to shift to this country from foreign sources. Moreover, the competitive position of U.S. goods in world markets was enhanced further, stimulating foreign demands for U.S. goods at a time when such demands were already growing markedly in response to the previous devaluation of the dollar in December 1971 and to the inflationary boom that was under way in the economies of most industrial countries of the world.

The economic situation that was developing in this country also contributed to the inflation. The U.S. economy had expanded at a

very rapid rate in late 1972 and early 1973 as demands for goods and services strengthened substantially further, partly in reaction to public policies instituted to encourage greater utilization of the Nation's productive resources. And consumption demands were also

INDICATORS OF ECONOMIC PERFORMANCE



NOTE.—Changes for current-dollar GNP are from preceding quarter and are based on quarterly data at seasonally adjusted annual rates. Changes for real GNP (based on data expressed in 1958 dollars) are at annual rates. Data are from Dept. of Commerce.

Fixed-weighted price index: Change from preceding quarter compounded at annual rates based on seasonally adjusted data from Dept. of Commerce.

Unemployment rate: Monthly data, seasonally adjusted, from Dept. of Labor.

buoyed in the first half of the year when households received unexpectedly large refunds of Federal income taxes.

The strong final demands in the United States and abroad bolstered the needs of manufacturers for a wide array of raw materials, and even though production of such materials increased sharply, demands often exceeded the available supplies. Thus, many producers of basic materials reached practicable capacity limits well before the over-all output potential of the U.S. economy came under strain. Inflationary conditions may have been heightened also by public response to the liberalization of the wage-price controls program early in the year. In retrospect, it appears that the move to Phase III of the program, though intended to provide needed flexibility to changing economic conditions, was widely viewed as a virtual ending of controls, and this attitude contributed to the bulge in prices that ensued.

Domestic economic stabilization policy could not have been expected to check fully these extraordinary forces of inflation. To have halted the acceleration in the over-all price rise—influenced so importantly, as it was, by sharply higher prices for food, fuel, and internationally traded industrial commodities—would have required exceptionally stringent measures, with potentially disastrous consequences for employment and economic activity. Public policies did move, however, to restrain the cumulative upward momentum in domestic economic activity—which had gained great force during the previous fall and winter—and to dampen inflationary forces stemming from the overheating.

Monetary policy, which had begun to tighten in late 1972, became progressively more restrictive through the summer of 1973. Thereafter, some actions were taken to moderate the intensity of monetary restraint. Fiscal policy also turned somewhat more restrictive in 1973, as the rise in public expenditures was curbed and the volume of tax receipts, produced by higher incomes and higher profits, grew more rapidly than outgo. And wage-price controls, reintroduced on a strict mandatory basis following the temporary price freeze in the summer, were directed toward developing and making more diffuse the price advances necessitated by continuing rapid increases in production costs.

In the effort to avoid excessive monetary expansion during 1973 the Federal Reserve made use of all its instruments of monetary policy. Through much of the year open market operations were directed toward achieving adequate restraint on the growth in bank reserves and in the monetary aggregates. In the process the Federal funds rate moved from around 5.5 per cent at the beginning of the year to a high of nearly 11 per cent in September. In the late spring marginal reserve requirements were imposed on any expansion in certificates of deposits (CD's) and other money market sources of funds at large banks beyond the amounts outstanding as of mid-May, and such requirements were increased further in September. In early July reserve requirements were raised by ½ percentage point against the demand deposits (above a $2 million base) of all member banks. The Federal Reserve discount rate was raised, in successive steps, from 4½ per cent at the beginning of the year to 7½ per cent from August on, to keep the cost of borrowing more in line with market rates. And margin requirements on stock market credit, which had been increased to 65 per cent late in 1972, were kept at that level throughout 1973, despite a steady downward trend in the use of such credit.

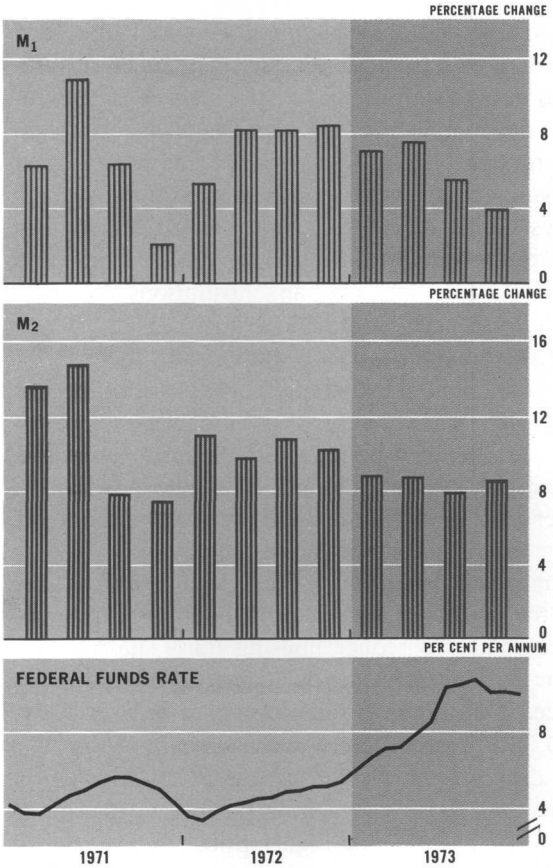
As a result of these efforts, the growth in money and credit slowed markedly relative to the continuing expansion in domestic spending. The narrowly defined money stock (M_1),[1] even after revision in early 1974 to reflect unexpectedly large growth in deposits at nonmember banks, increased 6.1 per cent from the fourth quarter of 1972 to the fourth quarter of 1973. If measures of money are expanded to include consumer-type time and savings deposits at banks (M_2) and at other depositary institutions (M_3), the resulting growth rates are 8.8 per cent and 8.9 per cent, respectively. In each case these increases were well below the 11 per cent growth in the gross national product (and total domestic expenditures) over the same period, and also appreciably smaller than those recorded in 1972.

With significantly slower growth in money and continued rapid growth in total spending, interest rates were subject to marked up-

[1] Currency held outside the Treasury, F.R. Banks, and the vaults of all commercial banks, plus demand deposits other than interbank and U.S. Government.

ward pressure over the first 9 months of the year. Short-term market rates, as represented by 3-month Treasury bills, rose by nearly 400 basis points from the 1972 year-end level, peaking out at just above 9 per cent in August. The interest rate charged by banks on their prime loans—those to large business customers with the highest credit rating—increased by a similar amount, from 5¾ per cent to

MONEY STOCK AND THE FEDERAL FUNDS RATE



NOTE.—Money stock, annual rates of growth calculated from daily-average figures for all 3 months of the quarter. Federal funds rate, monthly averages of daily figures. For definitions of M_1 and M_2, see notes to chart on p. 42.

10 per cent. Long-term bond yields rose less dramatically but still substantially, by around 100 basis points. And yields on FHA and VA mortgages sold in the secondary market increased by about 150 basis points—to more than 9 per cent—before declining moderately in the closing months of the year.

Because of the sharp rise in market yields, savings flows began to shift increasingly into market instruments and away from the depositary institutions (where the interest rates that can be paid are constrained by regulatory ceilings). Accordingly, in early July the Board and other Federal regulatory agencies, after consultation, raised rate ceilings applicable to commercial banks, mutual savings banks, and savings and loan associations. In addition, these financial institutions were permitted to issue ceiling-free, 4-year time deposit instruments, so that they could compete actively for funds against high-yielding market instruments. This ceiling-free authority was withdrawn later, following congressional action that required the imposition of ceiling rates on all deposits of less than $100,000. But the array of rate ceilings applicable to the various types of time and savings deposits issued by banks and nonbank institutions remained significantly higher than it had been before midyear.

Partly as a result of these increases in maximum rates, deposit inflows to the institutions—though substantially slowed—dropped less drastically than during tight money periods in the 1960's. Nevertheless, and despite a liberal lending policy by the Federal home loan banks and support from the Federal National Mortgage Association and other Federal agencies, a marked contraction developed in the availability of mortgage credit and its cost rose sharply.

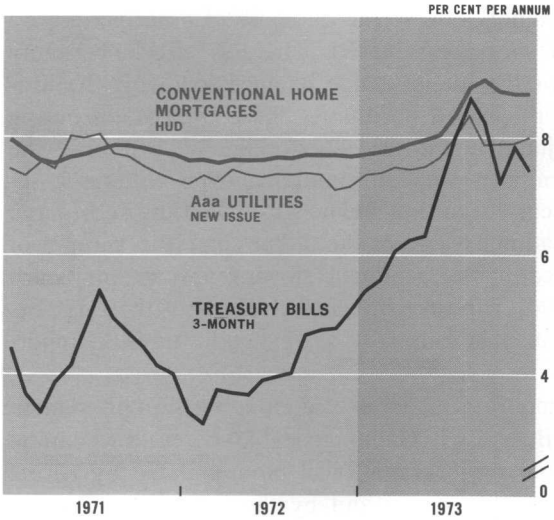
The tightening in mortgage credit, together with much higher prices for houses and the sustained high level of building during the two preceding years, combined to reduce housing starts sharply over the course of the year. Declining residential construction, however, was not the only source of weakness in the economic situation. New-car sales had begun to fall off even before the news of a prospective oil shortage, and they dropped sharply further thereafter. Growth in consumer spending for other goods declined on balance in real terms after the first quarter of 1973, reflecting higher prices and a gradual reduction in real take-home pay of the average worker. In the autumn the developing energy shortage, resulting from the embargo on

direct and indirect shipments of oil from the Middle East to the United States, created new uncertainties and new fears about continued economic stability both at home and abroad.

The result was a marked slowing in over-all economic growth as the year progressed. Expansion in real GNP moderated from an unsustainably high 8.7 per cent annual rate in the opening months of the year to an annual rate of about 3 per cent in the second and third quarters combined. This reflected not only the leveling off in consumer demands but also shortages in supplies of foodstuffs and raw materials and the limitations of capacity in some critical industrial sectors. In the fourth quarter real growth slowed further, to only about 1.5 per cent (annual rate). Growth in employment also slowed toward the end of the year, and the unemployment rate—which had declined through most of the year—began to rise.

In view of these developments monetary policy in the autumn began to back away from its earlier posture of substantial restraint. Open market operations became a little less restrictive, and interest

SELECTED INTEREST RATES



NOTE.—For notes see chart on p. 37.

rates edged down in both long- and short-term markets. Savings flows to the depositary institutions improved as interest rates on market instruments were reduced, and the mortgage market eased in terms of both interest rates and the availability of funds. In December the Board reduced the marginal reserve requirement on CD's and other money market funds at large banks from 6 to 3 per cent, and in early January 1974 it cut margin requirements on stock market credit from 65 per cent to 50 per cent. The interest rate on Federal funds declined from its September high of nearly 11 per cent to about 9 per cent by February of 1974.

The move to a moderately less restrictive monetary policy was warranted by the leveling-off in the economic expansion and by the evidence of developing weakness in the economy caused by the oil shortage and other factors. But the continuation of rapid inflation and the persistence of serious supply shortages, not only in oil but also in many other product lines, counseled against any aggressive easing in policy.

In early 1974, weakness in economic activity appeared to be growing, dominated by a slowing in consumer expenditures for the goods and services most closely associated with the use of gasoline and oil products. This situation may worsen for a time; or the problem may wane, if consumers shift to the purchase of other goods and services, or if the oil shortage is eased. There is also uncertainty about the prospects for the foreign trade balance following the dramatic improvement in the export position of the United States during 1973. The quantum jump in the price of foreign oil will raise the Nation's bill for oil imports very substantially, even without a resumption of oil shipments from the Middle East. And the substantial recovery in the international value of the dollar since the autumn of 1973, along with indications of economic slowing abroad, may curb foreign demands for U.S. exports, though the effects of these factors on the trade balance may be offset by a weakening in U.S. import demands.

At the same time important sources of continuing support remain in the U.S. economy. Business is planning sizable increases in capital spending, and additional projects may well be stimulated by efforts to economize on the use of energy and by the evident need for a major effort to expand domestic capacity in the energy field and in

other basic materials industries. Businesses generally have followed conservative inventory policies, and with many commodities still in very short supply, the ratio of stocks to sales remains close to its lowest level in many years. Residential building activity is likely to show some recovery later in the year from its present depressed state, as there is further improvement in the availability of mortgage money, materials, and labor.

The inflationary problems of the U.S. economy remain severe, however. Prices of materials—not only of oil but also of many other commodities—have continued to rise at a rapid pace. And many shortages remain that are capable of disrupting production schedules and deliveries. Moreover, the rise in unit labor costs has accelerated in recent quarters as increases in wage rates have been substantial and gains in productivity have come to a halt.

The outlook for inflation is not entirely bleak, however. Adjustments in relative prices of the dimensions witnessed over the past year should not be expected to continue indefinitely, since the effect of the higher prices is to induce larger output and constrain demand. In the case of oil and other fuels, the price response to shortage conditions may still have some distance to go. In other areas, however, the outlook seems more promising. Agricultural output has been rising, and crop yields around the world generally appear to have been much more favorable in 1973. The upsurge in international demand for industrial raw materials shows clear signs of moderating, and the dollar has strengthened again in foreign exchange markets. In any event, lasting improvement in supply conditions for foods and other raw materials will be dependent on long-run structural processes that encourage increases in investment, output, and efficiency in these sectors and economy in the use of their product.

The job for monetary policy—and for economic stabilization policy generally—therefore, is to steer a course that will not exacerbate present and prospective inflationary forces, but at the same time will avoid an unacceptably severe or extended weakening in economic activity that might develop from the energy crisis. Given the many uncertainties that confront the economy, this is not likely to be an easy task. Monetary policy, however, is by its nature a flexible and adaptive instrument that can be shaped promptly to the Nation's emerging economic needs.

Introduction

The performance of the U.S. economy during 1974 proved extremely disappointing. The persisting problem of inflation that had plagued the Nation since 1965 worsened appreciably; the general price level—as measured by the implicit deflator for gross national product —rose by more than 10 per cent, the largest increase since 1947. Equally disconcerting, if not more so, were the substantial declines that occurred in real output, in productivity, and late in the year in employment. By year-end the rate of unemployment had risen to more than 7 per cent of the civilian labor force, and the economy was in the midst of a general cyclical downturn in business activity.

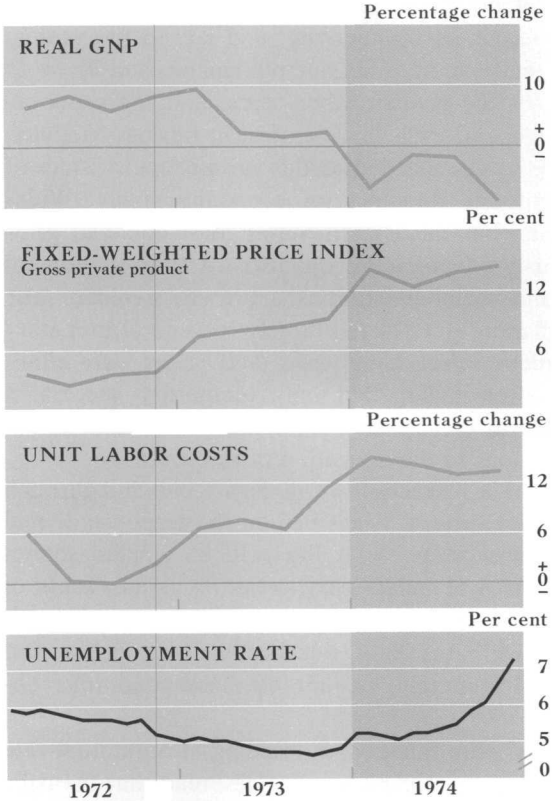
The character of the forces that led to this unsatisfactory state of affairs presented a profound dilemma for economic policy. Widespread agreement exists that the United States must come to grips with inflation if seriously adverse consequences for the structure of financial, economic, and social institutions are to be avoided. The task of moderating inflation in 1974 fell largely to general monetary and fiscal policies; direct controls over wages and prices were eliminated in the spring, after having had only temporary success in moderating the increase in the average price level—and that at the cost of increasing distortions in the allocation of resources.

The effect on prices of a restriction of aggregate demand through monetary and fiscal policy generally lags behind the response of real output. However, the price response is likely to be elicited sooner when the proximate source of inflationary pressures is an excess of aggregate demand relative to aggregate supply and when expectations of further price increases have not become entrenched and pervasive. In 1974, unfortunately, neither of these conditions obtained.

The year 1974 opened with inflation proceeding at an annual rate of about 8 to 9 per cent. Expectations were widespread that the pace of price advance would continue unabated, or worsen. Real GNP had begun to decline in the first quarter—reflecting largely the effects of the oil embargo—and the gap between actual and potential real output widened over the course of the year. The rate of increase in

the general price level, meanwhile, rose to the 12 to 14 per cent range in the first quarter and remained there through most of the year. Signs of moderation in the pace of inflation did not begin to appear until the closing months of 1974, after steep declines in real activity had occurred both here and abroad.

INDICATORS OF ECONOMIC PERFORMANCE



NOTE.—Changes for real GNP (based on data expressed in 1958 dollars) are at annual rates. Dept. of Commerce data.

Fixed-weighted price index: Change from preceding quarter compounded at annual rates based on seasonally adjusted data from Dept. of Commerce.

Unit labor costs are for all persons in the private nonfarm economy; percentage change from previous quarter compounded at annual rates.

Unemployment rate: Monthly data, seasonally adjusted, from Dept. of Labor.

What accounted for this stepped-up rate of inflation in the face of a growing gap between real aggregate demand and the productive capacity of the economy? Three factors deserve particular attention.

First, rising costs of petroleum and other energy products had a substantial influence on the over-all level of prices. At the retail level, prices of gasoline and motor oil in December 1974 were about 20 per cent higher than a year earlier, while costs of fuel oil and coal were 32 per cent higher. At wholesale, prices of fuel, power, and related products rose approximately 50 per cent in the 12 months ended in December 1974. Moreover, rising prices of energy and petrochemical products used as inputs in industry were an important factor driving up the costs of producing other manufactured goods. For example, prices of chemicals and allied products rose about 50 per cent at wholesale in the year ended in December 1974, and rubber and plastic products were up about 28 per cent over the same period.

Second, relaxation and ultimate termination of wage and price controls in April 1974 led to a bulge in prices of the sort that has occurred in other countries when direct controls have been removed. As noted earlier, controls had had only temporary success in moderating the pace of inflation; in early 1974, and indeed throughout 1973, the influence of the controls program had been waning. Nonetheless, some 2½ years of controls had given rise to serious distortions in relative prices and had also compressed profit margins in some industries. For many individual products, therefore, a substantial adjustment in prices was to be expected. The adjustments were particularly noticeable for finished goods—perhaps because price controls had been more effective in holding down the prices of those commodities. For example, wholesale prices of producers' finished goods had risen at an annual rate of around 5 per cent during the latter half of 1973; in 1974, however, the annual rate of increase jumped to 13 per cent in the first quarter, to 27 per cent in the second, and to 32 per cent in the third.

Third, shortages of many industrial materials, component parts, machinery, industrial equipment, and other commodities continued to plague the business community through the summer of 1974, despite the slowdown in general business activity. Excess demand in particular markets is not an uncommon condition, even when some

slack exists in product markets generally. Nevertheless, the acute severity of shortages in 1974 was quite unusual in view of the sluggishness of consumer spending and the decline in residential construction that had been in process since early 1973.

The reasons for these shortages cannot be dealt with at any length here. Growth in export demands—reflecting the worldwide boom in economic activity during 1972 and 1973 and the devaluation of the dollar in international markets—was certainly a factor; so also was the relatively slow expansion earlier of productive capacity in major materials industries. But expectations of price increases and fears of continuing shortages were themselves a part of the problem, because they led to speculative buying of inventories to "jump the gun" on price increases, to hoarding of critical materials and supplies, and to ordering from several sources in the expectation that deliveries would be long delayed, if made at all.

While these three factors help to account for the step-up in the rate of price advance in 1974, they alone do not explain fully the severity of the inflation during the year. Underlying these special factors was an inflationary process that had begun much earlier and had become deeply embedded in the structure of wages, costs, and prices. The rate of increase in compensation per manhour, for example, had risen to around 8 per cent by the end of 1973, some 5 or more percentage points above the long-term rate of improvement in productivity. By the end of 1973, therefore, unit labor costs were already rising very rapidly and were putting substantial upward pressure on prices. Moreover, the rate of advance in unit costs accelerated in 1974—as productivity declined sharply and the rate of increase in compensation per manhour rose still further.

Unwinding from an inflation as pervasive as that which gripped the economy in 1974 takes time. Economic policy in 1974 did not endeavor to end the inflation at once, but it did seek to create conditions in which the process of unwinding would begin. To appreciate the accomplishments of fiscal and monetary policies in this regard, account must be taken of the significance of inflation for the movements of fiscal and monetary variables.

For example, total Federal expenditures as measured in the national income accounts (NIA) rose about 16 per cent from the latter half of 1973 to the latter half of 1974. This is a relatively large

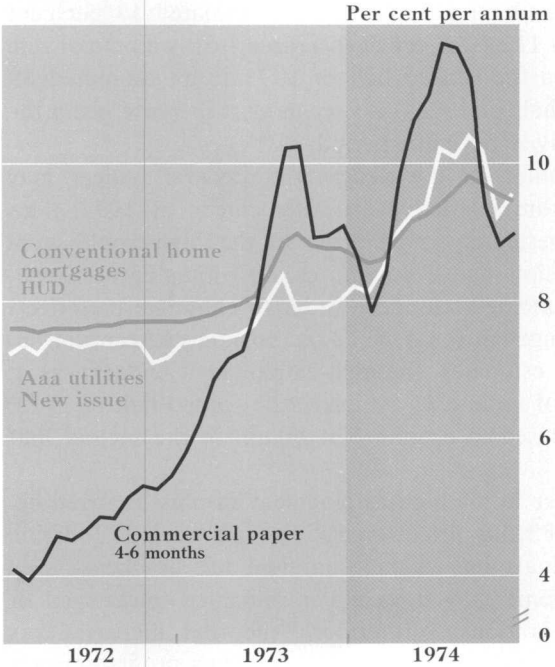
percentage increase by historical standards, but in large part it reflected rising prices. Federal receipts rose an estimated 13 per cent over the same period. The NIA deficit increased from an annual rate of about $2 billion in the second half of 1973 to an estimated $9 billion in the second half of 1974—a very modest increase given the steady slowing of activity over this period.

Despite this deepening of the deficit, the Federal budget may well have become more restrictive over the course of 1974. This interpretation is suggested by movements in the high-employment budget, in which receipts and expenditures are estimated as if economic activity had remained strong, in order to eliminate the effects on the budget of changes in the pace of the economy. According to Federal Reserve staff estimates, the high-employment budget was in surplus to the extent of around $5 billion in the second half of 1973, and the surplus increased to around $24 billion in the second half of 1974.

Most of this increase in the high-employment surplus occurred because of the effects of rising prices on Federal tax receipts. Inflation pushed many individuals into higher marginal tax brackets—even though their real income may have either remained unchanged or declined. Many corporations, furthermore, incurred increased tax liabilities in 1974 on what were in a sense fictitious profits—profits derived from the first-in, first-out method of inventory accounting, which fails to make allowance for replacement at higher prices of goods sold or used up in production. Thus, the inflation, by raising effective tax rates, significantly reduced the increase in disposable incomes of individuals and after-tax profits of businesses, and thereby contributed to a slowing of aggregate demand.

Monetary policy also contributed importantly to the moderation of aggregate demand in 1974. Federal Reserve policy had begun to move toward restraint in late 1972 and early 1973, but some relaxation of policy was needed during the winter of 1973–74, in an effort to compensate for some of the adverse effects of the oil embargo on economic activity. As a result of the reduction in private credit demands and the relaxation of monetary policy, interest rate levels by February of 1974 had fallen considerably below their pre-oil-embargo peaks, and growth rates of the principal monetary aggregates were appreciably above their lows of 1973.

SELECTED INTEREST RATES



NOTE.—Monthly averages except for conventional mortgages (based on quotations for one day each month). Yields: prime commercial paper, dealer offering rates; conventional mortgages, rates on first mortgages in primary markets, unweighted and rounded to nearest 5 basis points, from Dept. of Housing and Urban Development; Aaa utility bonds, weighted averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis.

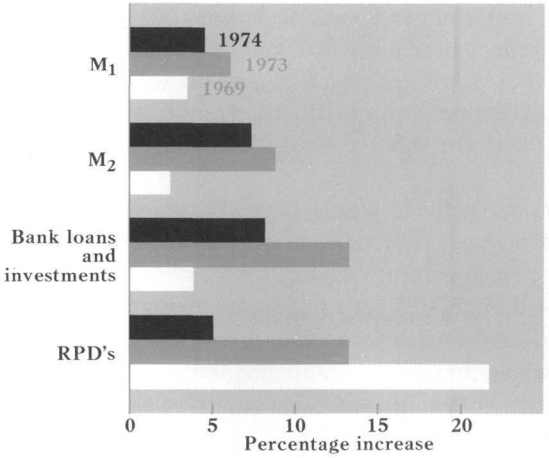
When the threat to the economy from the oil embargo had passed, the Federal Reserve began again to exert pressure on bank reserves—chiefly through open market operations—to slow the rapid rate of expansion in money and bank credit. The Federal Reserve persisted in applying monetary restraint until late in the summer of 1974. At that time growth rates of the money stock and of bank credit were relatively sluggish, and signs of an impending cyclical downturn were multiplying. Monetary policy, therefore, began to move toward ease over the closing months of the year.

The amounts by which growth rates of the major monetary aggregates were reduced in 1974 were not unusually large. For example,

total member bank reserves rose nearly as much in 1974 (7.1 per cent) as they had in 1973 (7.8 per cent). The narrowly defined money stock—M_1, which consists of currency and demand deposits—increased by 4.7 per cent in 1974, compared with 6.1 per cent in 1973. The growth rate of M_2, which includes also consumer-type time and savings deposits at commercial banks, declined from 8.8 per cent in 1973 to 7.4 per cent in 1974. The increase in total loans and investments of commercial banks did show a more appreciable moderation—from 13.5 per cent in 1973 to around 8.3 per cent in 1974. Nevertheless, as the following chart shows, the growth rates for the monetary aggregates in 1974 were well above those recorded in 1969, a prior year in which monetary policy had been quite restrictive.

In interpreting changes in these monetary variables, however, account must be taken of the effects of inflation on demands for money and credit. In 1969 the general price level was rising at a rate of around 5 per cent; in 1974, the figure was more than twice that amount. Thus, growth rates of the major monetary and credit

CHANGES IN MONETARY AGGREGATES



NOTE.—M_1 is currency plus private demand deposits. M_2 is M_1 plus commercial bank time and savings deposits other than large-denomination certificates of deposit (CD's). Loans and investments are adjusted to exclude domestic commercial interbank loans. RPD's are reserves available to support private nonbank deposits. Changes are calculated from December to December.

aggregates were actually very low in 1974 relative to demands for money and credit. In these circumstances the usual signs of severe financial restraint began to develop: Interest rates rose to unprecedented levels; stock prices plummeted; the mortgage market came under severe pressure; and the availability of loanable funds to other borrowers was curtailed.

Monetary and fiscal restraints worked jointly to moderate aggregate demand in 1974, but the volume of spending in the private sector was curbed also by several other factors. Prominent among these was the sharp rise in the price of imported oil, which transferred a substantial amount of purchasing power from U.S. consumers and businesses to the oil-exporting nations. Rising prices also resulted in transfers of real income among various economic sectors within the United States—although the effects of such transfers on aggregate expenditures are problematical—and they led to a sharp decline in the real value of financial asset holdings, which must have exerted a substantial, depressing effect on current spending and on spending plans.

All of these dampening effects on aggregate demand in 1974, moreover, occurred at a time when the economic expansion was losing momentum, and when imbalances were beginning to develop between inventories and sales and between production of capital goods and production of consumer goods. Such imbalances are often the precursors of a cyclical downturn in economic activity, as they were in 1974. When that downturn began to cumulate in the fourth quarter of the year, the decline in production and employment proved to be about as steep as at any other time in the period since World War II.

Weakness in economic activity seems likely to persist well into 1975—judging by the adverse tendencies evident in recent economic data. However, corrective forces are under way: Excess inventories in the auto industry—though still very high—are being worked off; businesses are making strenuous efforts to cut costs; residential building permits have shown some signs of stabilizing; conditions in financial markets have eased significantly since last summer; and the freeze in the mortgage market has begun to thaw. Fiscal actions to bolster purchasing power are under active consideration, and they are likely to be stimulating consumer and business spending before too long.

The tasks for economic stabilization policy in 1975 are indeed formidable. Clearly, a prime requisite is to cushion the forces of recession and to enhance the chances for an early and vigorous recovery in real economic activity. But great care must be taken to avoid releasing a new wave of inflationary forces.

These two objectives are not necessarily inconsistent. The special factors giving rise to a stepped-up pace of inflation in 1974 are now largely behind us, and the rate of increase in prices has begun to moderate in recent months in response to growing slack in labor and product markets. In this environment, temporary fiscal and monetary stimulants could be expected to have their principal effects in 1975 on real output and employment, and not on prices. But fiscal and monetary policies must not be permitted to depart too much, or too long, from the posture needed over the longer term to ensure an eventual return to price stability. □