Secretaries, Deputy Secretaries, Under Secretaries, General Counsels, Assistant Secretaries, Deputy Under Secretaries, and Treasurers of the United States serving in the Department of the Treasury from January 21, 1973, through June 30, 1975 [1]

Term of service		Officials
From	To	
		Secretaries of the Treasury:
June 12, 1972	May 8, 1974	George P. Shultz, New York.
May 8, 1974	----------	William E. Simon, New Jersey.
		Deputy Secretaries:
Jan. 22, 1973	May 8, 1974	William E. Simon, New Jersey.
July 31, 1974	----------	Stephen S. Gardner, Pennsylvania.
		Under Secretaries for Monetary Affairs:
Jan. 27, 1969	July 8, 1974	Paul A. Volcker, New Jersey.
July 9, 1974	----------	Jack F. Bennett, Connecticut.
		Under Secretaries (Counselors): [2]
June 12, 1972	Mar. 17, 1973	Edwin S. Cohen, Virginia.
Mar. 15, 1974	July 8, 1974	Jack F. Bennett, Connecticut.
July 9, 1974	----------	Edward C. Schmults, New York.
		General Counsels:
July 1, 1970	June 1, 1973	Samuel R. Pierce, Jr., New York.
June 2, 1973	July 8, 1974	Edward C. Schmults, New York.
Aug. 1, 1974	----------	Richard R. Albrecht, Washington.
		Assistant Secretaries:
Apr. 1, 1969	Jan. 21, 1973	Eugene T. Rossides, New York.
Dec. 12, 1971	----------	Edgar R. Fiedler, New York.
Apr. 11, 1972	----------	Warren F. Brecht, Connecticut.
June 12, 1972	July 1, 1974	John M. Hennessy, Massachusetts.
Aug. 1, 1974	----------	Charles A. Cooper, Florida.
Aug. 18, 1972	----------	Frederic W. Hickman, Illinois.
Jan. 22, 1973	Feb. 1, 1974	Edward L. Morgan, Arizona.
May 8, 1974	----------	David R. Macdonald, Illinois.
May 28, 1974	----------	Frederick L. Webber, Virginia.[3]
June 24, 1974	----------	Gerald L. Parsky, Washington, D.C.[3]
		Deputy Under Secretaries:
Aug. 18, 1972	Mar. 14, 1974	Jack F. Bennett, Connecticut.
Aug. 22, 1972	July 4, 1973	James E. Smith, Virginia.
Aug. 3, 1973	Apr. 13, 1974	William L. Gifford, New York.
		Fiscal Assistant Secretary:
June 15, 1962	----------	John K. Carlock, Arizona.
		Treasurers of the United States: [4]
Dec. 17, 1971	Feb. 14, 1974	Romana Acosta Banuelos, California.
June 21, 1974	----------	Francine I. Neff, New Mexico.

[1] For officials from Sept. 11, 1789, to Jan. 20, 1973, see exhibit 81, 1973 Annual Report.
[2] Act of May 18, 1972, which established the Deputy Secretary position, permitted the Under Secretary position to be used as a counselor to the Secretary and so designated by the President as desired.
[3] Act of May 18, 1972, provided for two Deputy Under Secretaries, to be designated Assistant Secretaries by the President as desired.
[4] Treasury Department Order 229, Jan. 14, 1974, raised the position of Treasurer of the United States from the operating level of the Department to the Office of the Secretary.

PRINCIPAL ADMINISTRATIVE AND STAFF OFFICERS OF THE DEPARTMENT OF THE TREASURY AS OF JUNE 30, 1975

Secretary of the Treasury	William E. Simon
Deputy Secretary of the Treasury	Stephen S. Gardner
Under Secretary for Monetary Affairs	Jack F. Bennett
Under Secretary	Edward C. Schmults
General Counsel	Richard R. Albrecht
Office, Secretary of the Treasury:	
Adviser to the Secretary (Counsellor to the Chairman, Economic Policy Board)	Sidney L. Jones
Executive Assistant to the Secretary	John C. Gartland
Director, Executive Secretariat	Margaret Hovell (acting)
Confidential Assistant to the Secretary	Barbara A. Jensen
Senior Consultant	Paul W. McCracken
Office, Deputy Secretary of the Treasury:	
Executive Assistant to the Deputy Secretary	(Vacancy)
Special Assistant to the Deputy Secretary	Alan M. Arsht
Office, Under Secretary for Monetary Affairs:	
Assistant Secretary (International Affairs)	Charles A. Cooper
Deputy Assistant Secretary for International Monetary and Investment Affairs	F. Lisle Widman
Deputy Assistant Secretary for Developing Nations Finance	John A. Bushnell
Deputy Assistant Secretary for Research and Planning	Robert L. Slighton
Deputy to the Assistant Secretary for International Monetary Affairs	George H. Willis
Inspector General for International Finance	Weir M. Brown
Deputy to the Assistant Secretary	Oscar M. Mackour
Assistant Secretary (Trade, Energy, and Financial Resources Policy Coordination)	Gerald L. Parsky
Deputy Assistant Secretary (Trade and Raw Materials Policy)	J. Robert Vastine
Deputy Assistant Secretary for Energy Policy	Edward Symonds
Deputy Assistant Secretary for Financial Resources Policy Coordination	(Vacancy)
Assistant Secretary (Economic Policy)	Edgar R. Fiedler
Deputy to the Assistant Secretary	(Vacancy)
Director, Office of Domestic Gold and Silver Operations	Thomas W. Wolfe
Director, Office of Financial Analysis	John H. Auten
Fiscal Assistant Secretary	John K. Carlock
Deputy Fiscal Assistant Secretary	David Mosso
Assistant Fiscal Assistant Secretary	Sidney Cox
Assistant Fiscal Assistant Secretary	Lester W. Plumly
Treasurer of the United States	Francine I. Neff
Departmental Bicentennial Coordinator	Edward J. Storey, Jr.
Special Assistant to the Secretary (National Security)	William N. Morell
Deputy Special Assistant to the Secretary	Gerald W. Nensel
Special Assistant to the Secretary (Debt Management)	Ralph M. Forbes
Director, Office of Debt Analysis	Edward P. Snyder

Office, Under Secretary:	
Special Assistant to the Under Secretary	Joseph J. Adams
Special Assistant to the Under Secretary for Revenue Sharing and Intergovernmental Relations	Kent A. Peterson
Assistant Secretary (Administration)	Warren F. Brecht
Deputy Assistant Secretary for Administration and Director, Office of Management and Organization	J. Elton Greenlee
Director, Office of Administrative Programs	Robert R. Fredlund
Director, Office of Audit	Wilbur R. DeZerne
Director, Office of Budget and Finance	John Garmat (acting)
Director, Office of Personnel	Arch S. Ramsay
Director, Office of Computer Science	(Vacancy)
Director, Office of Equal Opportunity Program	David A. Sawyer
Assistant Secretary (Legislative Affairs)	Frederick L. Webber
Special Assistant to Assistant Secretary	Jay T. Scheck, Jr.
Special Assistant to Assistant Secretary	Thomas J. McDowell
Special Assistant to Assistant Secretary	Pamela J. Sullivan
Assistant Secretary (Enforcement, Operations, and Tariff Affairs)	David R. Macdonald
Deputy Assistant Secretary	James B. Clawson
Director, Office of Operations	William F. Hausman
Director, Foreign Assets Control	Stanley L. Sommerfield (acting)
Deputy Assistant Secretary for Enforcement	James J. Featherstone
Director, Office of Law Enforcement	(Vacancy)
Chief, Interpol (National Central Bureau)	Louis B. Sims
Deputy Assistant Secretary for Tariff Affairs	Peter O. Suchman
Director, Office of Tariff Affairs	Ben L. Irvin
Special Assistant to the Secretary (Public Affairs)	James N. Sites
Deputy Special Assistant to the Secretary	John O. Mongoven
Director, Office of Revenue Sharing	Graham W. Watt
Office, General Counsel:	
Deputy General Counsel	Donald L. E. Ritger
Assistant General Counsel and Chief Counsel, Internal Revenue Service.	Meade Whitaker
Assistant General Counsel	Wolf Haber
Assistant General Counsel	(Vacancy)
Assistant General Counsel	Hugo A. Ranta
Senior Counselor to the General Counsel	(Vacancy)
Director of Practice	Leslie S. Shapiro
Assistant Secretary (Tax Policy)	Frederic W. Hickman
Deputy Assistant Secretary for Tax Legislation	Ernest S. Christian, Jr.
Deputy Assistant Secretary for Tax Analysis	George S. Tolley
Associate Director, Office of Tax Analysis	Emil M. Sunley, Jr.
Tax Legislative Counsel	Phillip L. Mann
International Tax Counsel	Robert J. Patrick, Jr.
Director, Office of Industrial Economics	Karl Ruhe
Deputy to the Assistant Secretary for Tax Policy (International Tax Policy).	Nathan N. Gordon

BUREAU OF ALCOHOL, TOBACCO AND FIREARMS

Director	Rex D. Davis
Deputy Director	William R. Thompson
Assistant Director (Administration)	William J. Rhodes
Assistant Director (Criminal Enforcement)	John F. Corbin, Jr.

Assistant Director (Inspection)	Jarvis Brewer
Assistant Director (Regulatory Enforcement)	Stephen E. Higgins
Assistant Director (Technical and Scientific Services)	A. Atley Peterson
Chief Counsel	Marvin J. Dessler

BUREAU OF ENGRAVING AND PRINTING

Director	James A. Conlon
Deputy Director	Kenneth A. DeHart

BUREAU OF GOVERNMENT FINANCIAL OPERATIONS

Commissioner	Dario A. Pagliai
Deputy Commissioner	Gerald Murphy
Assistant Commissioner, Administration	George L. McConville
Assistant Commissioner, Banking and Cash Management.	Sebastian Fama
Assistant Commissioner, Comptroller	Steve L. Comings
Assistant Commissioner, Disbursements and Claims	(Vacancy)
Assistant Commissioner, Government-wide Accounting	(Vacancy)

BUREAU OF THE MINT

Director	Mary T. Brooks
Deputy Director	Frank H. MacDonald
Assistant Director for Administrative Support	Chadwick B. Pierce
Assistant Director for Planning, Analysis and Information Systems	Arnold Bresnick
Assistant Director for Public Services	Roy C. Cahoon
Assistant Director for Production	George G. Ambrose
Assistant Director for Technology	Alan J. Goldman

BUREAU OF THE PUBLIC DEBT

Commissioner	H. J. Hintgen
Deputy Commissioner	J. J. Lubeley
Assistant Commissioner (Washington)	William M. Gregg
Assistant Commissioner (Field)	Martin French
Chief Counsel	Calvin Ninomiya

CONSOLIDATED FEDERAL LAW ENFORCEMENT TRAINING CENTER

Director	William B. Butler
Deputy Director	Robert G. Efteland
Assistant Director (Investigator Training)	William H. McClarin
Assistant Director (Police Training)	Alvin C. Turner
Assistant Director (Administration)	David W. McKinley
Assistant Director (Educational Support)	(Vacancy)

INTERNAL REVENUE SERVICE

Commissioner	Donald C. Alexander
Deputy Commissioner	William E. Williams
Assistant Commissioner (Accounts, Collection and Taxpayer Service)	Robert H. Terry
Assistant Commissioner (Administration)	Joseph T. Davis
Assistant Commissioner (Compliance)	Singleton B. Wolfe
Assistant Commissioner (Employee Plans and Exempt Organizations)	Alvin D. Lurie
Assistant Commissioner (Inspection)	Warren A. Bates
Assistant Commissioner (Planning and Research)	Anita F. Alpern
Assistant Commissioner (Technical)	Lawrence B. Gibbs
Chief Counsel	Meade Whitaker

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Comptroller of the Currency	James E. Smith
Executive Assistant	Richard D. Chotard, Jr.
Special Assistant	James T. Keefe
Special Assistant (Strategic Policy Planning)	David H. Jones

Staff Assistant	Palmer Hamilton
First Deputy Comptroller	Justin T. Watson
Deputy Comptroller	Thomas G. DeShazo
Deputy Comptroller	Robert A. Mullin
Deputy Comptroller (Economics)	David C. Motter
Chief National Bank Examiner	Kenneth W. Leaf
Deputy Comptroller (Administration)	W. A. Howland, Jr.
Deputy Comptroller (FDIC Affairs)	Joseph M. Ream
Deputy Comptroller (Mergers and Branches)	Richard J. Blanchard
Deputy Comptroller (Trusts)	Dean E. Miller
Chief Counsel	Robert Bloom
Deputy Chief Counsel	C. Westbrook Murphy
Assistant Chief Counsel (Bank Operations)	Gail W. Pohn
Public Information Officer	William B. Foster
Director, Consumer Affairs	Thomas W. Taylor

UNITED STATES CUSTOMS SERVICE

Commissioner of Customs	Vernon D. Acree
Deputy Commissioner of Customs	G. R. Dickerson
Assistant Commissioner (Operations)	Roland Raymond
Assistant Commissioner (Regulations and Rulings)	Leonard Lehman
Assistant Commissioner (Administration)	John A. Hurley
Assistant Commissioner (Investigations)	George C. Corcoran, Jr.
Assistant Commissioner (Internal Affairs)	William A. Magee, Jr.
Assistant Commissioner (Enforcement Support)	Alfred R. DeAngelus
Chief Counsel	Thaddeus Rojek (acting)

UNITED STATES SAVINGS BONDS DIVISION

National Director	Francine I. Neff
Deputy National Director	Jesse L. Adams, Jr.
Director of Sales	Walter R. Niles
Director of Advertising and Promotion	Louis F. Perrinello

UNITED STATES SECRET SERVICE

Director	H. Stuart Knight
Deputy Director	Lilburn E. Boggs
Assistant Director (Administration)	Francis A. Long
Assistant Director (Inspection)	Myron I. Weinstein
Assistant Director (Investigations)	Burrill A. Peterson
Assistant Director (Protective Forces)	Clinton J. Hill
Assistant Director (Protective Intelligence)	Thomas J. Kelley

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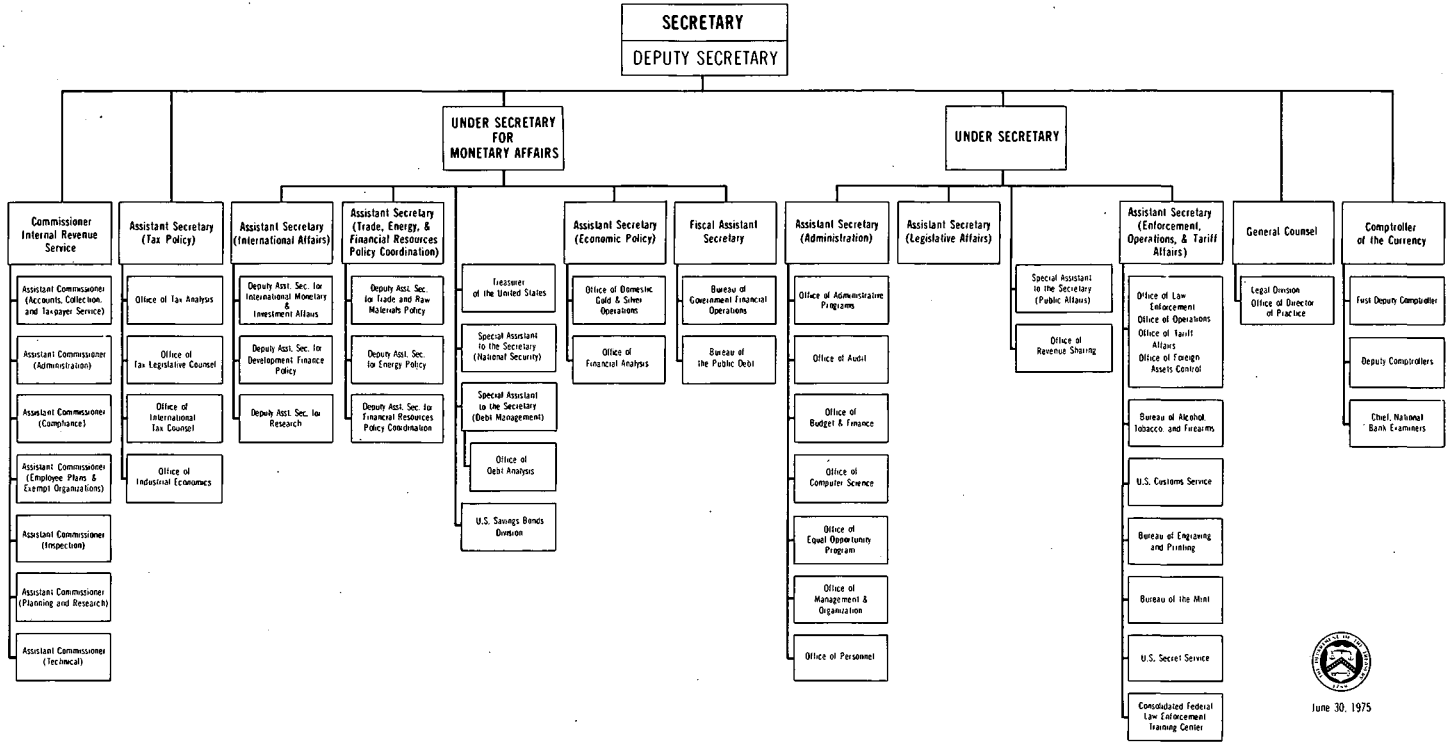
ORGANIZATION OF THE DEPARTMENT OF THE TREASURY



Fiscal Year Ended June 30, 1975

INTRODUCTION

This statement reviews some of the major domestic and international economic developments which affected Treasury areas of interest and responsibility during fiscal 1975. Detailed information on the operating and administrative activities of the Department of the Treasury is provided in the main text of the report and supporting exhibits. Further information is contained in a separate Statistical Appendix.

DOMESTIC DEVELOPMENTS

The Domestic Economy

The U.S. domestic economic situation changed rapidly during the course of fiscal 1975. At the beginning of the fiscal year the domestic economy had apparently stabilized following the sharp decline in economic activity that occurred during the first 3 months of 1974. The gross national product in constant prices did decline during the quarter of July through September, but the domestic economy appeared to be correcting the most severe output distortions even though inflation remained intense and the unemployment rate was beginning to rise.

The consensus among most economic forecasters—both inside and outside of Government—was that nothing worse than a period of slow growth or slight decline seemed to be in prospect. At the time of the Financial Conference on Inflation held in late September, the general view was that economic policies should still be aimed primarily at the containment of inflation. Indeed, the rate of growth in prices, as measured by the GNP implicit price deflator, accelerated to a 12-percent annual rate during the July through September period and to a 14-percent annual rate during the last 3 months of calendar 1974. By the fall it was also apparent that consumer spending had slowed abruptly, that inventories were becoming excessive, and that a full-scale recession adjustment was occurring. During the final 3 months of calendar 1974, the real GNP stated in constant dollars declined sharply at a seasonally adjusted annual rate of 9 percent. Real GNP fell off sharply at a 9-percent annual rate in the fourth quarter.

As the pace of economic activity slowed there was also a sharp decline in consumer confidence which further restricted the strength of personal spending. High rates of inflation and declining consumer real

income and personal financial asset positions appeared to be major factors explaining the decline in consumer confidence. The dropoff in the volume of consumer purchases was especially pronounced during the closing months of calendar 1974. Personal consumption expenditures in 1958 dollars fell from a seasonally adjusted annual rate of $547.2 billion during the July through September period to $528.2 billion in the final 3 months of 1974—an annual rate of decline of about 13 percent. The bulk of this decline was in consumer purchases of durable goods and was exaggerated by some anticipatory buying of automobiles prior to price increases imposed in September at the beginning of the 1975 model year.

The sudden, and largely unexpected, reduction in consumer purchases set in motion a massive inventory adjustment. Business inventories were accumulated at an $18 billion annual rate (current prices) during the last 3 months of 1974, about double the rate of accumulation during the preceding 3 months. Most of this inventory buildup was involuntary and led to a sharp reduction in orders by retailers. Inventory-sales ratios increased, production and employment were cut back, and the classic pattern of inventory cyclical adjustments occurred.

Business inventories declined at about a $19 billion annual rate during the first 3 months of calendar 1975 and at about a $31 billion rate during the second 3-month period. The rapid runoff of inventories resulted in a resumption in new orders for durable goods beginning in April 1975, and retail inventories began to rise again in June 1975. Continued inventory adjustments were still taking place at the manufacturing level throughout the spring and summer of 1975, but the bulk of the inventory adjustment had been completed by the end of fiscal 1975.

From January through March of calendar 1975, real output fell at about an 11½-percent annual rate while inventories were being run off. Nevertheless, there were some clear signs of improvement. Final sales (total GNP less the change in inventories) in constant prices had begun to stabilize in early 1975 and were rising at a relatively strong pace by the summer.

Unfortunately, inflation continued to create problems for the economic recovery even though the rate of price increases did moderate. These inflation problems and resulting financial constraints continued to restrict the strength of residential construction even though some improvement did occur following the low point of new housing starts recorded in April. But even the improved rate of homebuilding after April was still far below the normal historical rate of residential construction activity.

The recent recession turned out to be the most severe decline experienced during the postwar era. However, the threat of a full-scale depression was fortunately averted. Furthermore, a wide range of economic evidence indicates that the direction of the economy turned by April and that the process of recovery was well underway by the end of fiscal 1975. Major factors which clouded the outlook for sustained recovery were the persistence of very high rates of inflation, a fairly pervasive feeling of caution on the part of consumers as a result of recent economic experience, and reduced liquidity and equity ratios on the part of business. In addition, the financial markets had been severely strained by inflation and were having to finance Government deficits that were extremely large by all previous standards.

Unfortunately, the recession caused the rate of unemployment to rise very sharply in late 1974 and early 1975. The peak level of unemployment of 9.2 percent was recorded in April. By June 1975, the total unemployment rate had declined to 8.6 percent. The level of employment did begin to rise in April and the number of hours worked in manufacturing and overtime hours had improved by the end of fiscal 1975. Unemployment assistance—totaling nearly $15 billion during fiscal 1975 and budgeted close to $20 billion in fiscal 1976—tempered the severity of the adjustment. Nevertheless, the recession imposed heavy costs, and very high rates of unemployment among younger people and minority groups were a source of concern.

While the recession conformed in many respects to previous U.S. cyclical experience, there were some important differences. The coexistence of high rates of unemployment and high rates of inflation—sometimes termed "stagflation"—persisted to an unusual degree. Cyclical movements in the United States and major foreign countries were also more closely synchronized. To some extent, this could be related to the international impact of the oil embargo and resulting price rise. More basically, it appeared to reflect a reaction to the prolonged period of world inflation. The U.S. recession was the direct result of the failure to deal effectively with inflation.

Domestic Economic and Energy Policies

As the recession impact became more apparent, domestic economic policy responded to the sharp decline in production and employment. In preparing the Federal budget for fiscal 1976, it was recognized that the underlying economic situation had changed appreciably and that there was a need for antirecession stimulus. The administration proposed a one-time, temporary tax reduction of $16 billion—$12 billion to individual taxpayers and $4 billion to business taxpayers. However, the effort to contain inflation was continued. No new spending initiatives other than those for energy development programs were

proposed in the budget. Limitations were recommended on Federal pay increases and on increases in various benefit programs linked to increases in the cost of living. The intent was to use the budget as an instrument of economic stabilization while continuing to make progress against inflation.

A sweeping program was also outlined in the President's January 15, 1975, state of the Union message to deal with the energy problem but this was designed to be neutral from an overall fiscal point of view. The program included the following major elements: Import fees on crude oil and petroleum products to be imposed in stages by Presidential order and to be replaced by a $2-per-barrel excise tax on domestic crude oil and an import fee on crude oil and petroleum products, an excise tax of comparable magnitude on natural gas, removal of Federal price regulation from new natural gas supplies, removal of price control on domestic crude oil, conversion of powerplants and other major users from oil to coal, and a windfall profits tax on oil companies.

The new energy conservation taxes were estimated to raise $30 billion annually as follows: Oil excise tax, $6 billion; natural gas excise tax, $8.5 billion; import fee increase, $3.5 billion; and windfall profits tax, $12 billion. It was proposed to return that $30 billion to the economy through individual income tax cuts of $16.5 billion (in addition to the one-time $12 billion rebate to individual taxpayers), payments of $2 billion to nontaxpayers, a $0.5 billion tax incentive for energy conservation improvements in homes, a $6 billion corporate tax cut, payments of $2 billion to State and local governments, and $3 billion to offset higher costs of energy purchased directly by the Federal Government for its use.

From the outset there was strong congressional support for antirecession fiscal stimulus, but reaction to the administration's energy program was mixed. The $22.8 billion Tax Reduction Act of 1975 was passed in March which combined key elements of the administration's recommendations along with modifications proposed by the Congress. However, no consensus could be reached between the administration and the Congress during the fiscal year on what legislative steps should be taken to deal with the energy problem. An import fee of $1 per barrel on foreign crude oil was imposed by the President on February 1, and additional fees of $1 per barrel on foreign crude oil and $0.60 on refined products were imposed in late May to become effective on June 1. By the end of the fiscal year, the administration and the Congress had not reached agreement on a comprehensive plan to deal with the energy problem. Much of the disagreement centered upon the way in which the removal of price controls on domestic

crude oil production might be harmonized with other features of a total program.

Inflation Experience

During the last 6 months of 1974, inflation continued at double-digit rates before moderating somewhat during the first half of 1975. That shift contributed to a gradual improvement in consumer attitudes and helped promote the recovery of the economy. Unfortunately, inflation expectations are deeply embedded in the economy. Food and energy prices are still rising more rapidly than wanted and the outlook for rapid progress toward lower rates of inflation is still a matter of great concern. Nevertheless, there has been a substantial improvement in the cost-price situation and the economy responded favorably.

In terms of the broadest measure of price performance—the GNP implicit price deflator—the rate of inflation fell from more than a 13-percent annual rate during the last 6 months of 1974 to less than 7 percent in the first half of 1975. The Consumer Price Index averaged rates of annual increase in the 12- to 13-percent range during the last 6 months of 1974 and then fell to the 5- to 7-percent range in the first 6 months of 1975. The more volatile Wholesale Price Index increased at a 30- to 35-percent annual rate until November of 1974 before moderating sharply and then registered actual monthly declines in February and March 1975 as a result of falling agricultural prices.

By mid-1975, the rate of inflation at both wholesale and consumer levels had turned upward again, primarily because of food and energy price increases. Both consumer and wholesale prices rose by a seasonally adjusted 1.2 percent in the month of July. Large monthly price increases may occur during the coming months, but it is unlikely that double-digit inflation will return in the near future as the economic recovery occurs. However, the continuing strength of price pressures in the early stages of economic recovery indicates that inflationary risks remain.

The continued price increases throughout the severe recession of late 1974 and early 1975 occurred in an underemployed economy. Fortunately, the cost situation improved significantly as fiscal 1975 progressed. Output per man-hour in the private nonfarm economy declined at an average annual rate of roughly 2½ percent from mid-1974 until March 1975 but then rebounded to nearly a 6-percent rate of growth from April through June 1975. Compensation per man-hour grew more steadily throughout the fiscal year at an 8- to 9-percent annual rate. As a consequence, unit labor costs rose at double-digit rates in the first three quarters of the fiscal year but at only a 2-percent rate in the final quarter.

Short-term variations in economywide productivity and costs are

frequently erratic and should not be interpreted as representing long-run significance. However, the improvement toward the end of fiscal 1975 is consistent with the usual cyclical pattern of more rapid productivity gains during the recovery phase. Improving productivity should help hold down inflationary pressures over the coming months despite the persistence of relatively high rates of employee compensation and strong inflationary expectations.

Capital Investment Needs

The major economic problems during fiscal 1975 concerned energy policies, output declines, unemployment, and inflation. However, increased attention was focused on the question of the adequacy of U.S. investment for satisfactory longrun growth, particularly the creation of jobs and moderation of inflation. During the 1960's, the U.S. economy recorded an annual growth rate for real output of approximately 4 percent. That performance was in line with our historical experience but it ranked near the bottom of the rankings for real output gains of the major industrial nations.

There are, of course, some favorable aspects in the U.S. savings-investment record. Capital investment has continued to increase in the United States and the capital-to-labor ratio is still relatively high. However, other nations have allocated a substantially larger share of their resources to new capital formation. Furthermore, the gap between the U.S. level of investment, measured as a share of national output, and the commitment of other leading nations has increased. Total U.S. fixed investment as a share of national output during the time period 1960 through 1973 was 17.5 percent.* The U.S. figure ranked last among a group of 11 major industrial nations for the period in question.

Several factors help to explain the relatively slower rate of capital investment in the United States. First, the size of the U.S. economy and its advanced stage of economic development means that our rate of additional growth might well be somewhat lower than those of other nations without reflecting any serious tendency for the United States to underinvest. Second, the United States has historically placed a high priority on consumption, and the pattern is deeply ingrained in our society. Third, a relatively large share of our total capital outlays are committed to the services category which includes housing, government, and other services. Fourth, a relatively large share of our investment must be used for replacement and modernization of existing

*OECD (Organization for Economic Cooperation and Development) concepts of investment and national product. The OECD concept includes nondefense Government outlays for machinery and equipment in the private investment total which required special adjustment in the U.S. national accounts for comparability. National output is defined in this study as "gross domestic product," rather than the more familiar measure of gross national product, to conform with OECD definitions.

facilities, and increasingly a large share of investment goes to satisfy environmental and other requirements which may raise the quality of life but do little to increase productivity in the usual sense of the term. Fifth, the United States has generally not resorted to capital allocation and special incentive programs that are used intensively by other countries in an effort to encourage additional investment.

Some of the factors explaining slower U.S. capital formation are a matter of deliberate choice. However, there are serious risks in having a slow rate of capital investment for an extended period of time. A number of studies have indicated a close relationship between capital investment and various measures of economic growth and productivity. And, productivity gains in the United States have been disappointingly low, particularly in recent years. From 1948 to 1954, output per man-hour in the private economy rose by 4.0 percent per year, from 1955 to 1964 it rose by 3.1 percent, from 1965 to 1974 it rose by 2.1 percent, and from 1970 to 1974 it rose by only 1.6 percent per year.

In the future, U.S. capital investments will be significantly increased to meet a variety of goals including improvement in the quantity and quality of housing; development of new energy resources, protection of the quality of the environment; rehabilitation of the existing transportation system; continuation of the mechanization of agriculture; construction of new office buildings, communications systems, medical facilities, schools, and other facilities; and to meet the massive needs for new plants and equipment. Although the specific capital needs are difficult to predict, a number of independent studies suggest that total U.S. capital needs over the 1974 to 1985 period could range from $4 to $4½ trillion. By way of contrast, total outlays for capital investment from 1962 through 1973 in a smaller economy were $1½ trillion.

Future capital requirements of $4 to $4½ trillion from 1974 to 1985 imply a need to raise the ratio of gross private domestic investment to gross national product by perhaps 1 percentage point. The ratio has averaged close to 15 percent over the past decade and may need to average closer to 16 percent over the next decade. Such a shift in the composition of national output is certainly feasible, and would apparently be desirable, but may require some fairly extensive changes in public policy. Beginning in May 1975, the Treasury presented testimony to Congress on three separate occasions concerning the need to improve capital formation efforts. In July the Treasury recommended a tax program for increased national savings.

The Budget and Fiscal Developments

Primarily as a result of the recession the Federal budget moved sharply into deficit during fiscal 1975. The initial budget estimates published in February 1974 projected receipts of $295.0 billion, outlays of $304.4 billion, and a deficit of $9.4 billion. By February 1975, receipts were estimated at $278.8 billion, outlays at $313.4 billion, and

the deficit at $34.7 billion. Final figures for receipts were $281.0 billion; outlays, $324.6 billion; and the deficit, $43.6 billion. An even larger budget deficit is in prospect for the 1976 fiscal year.

Large budget deficits were inevitable given the severity of the economic recession. As pointed out in the 1976 Budget of the U.S. Government, aid to the unemployed and the recession-induced shortfall in tax receipts more than accounted for the deficits proposed by the administration for fiscal years 1975 and 1976. However, there were other, more disturbing aspects of the Federal fiscal position. Budget deficits had occurred in 14 of the past 15 years and continued deficits are anticipated in future years. The rapid growth in Federal outlays is also discouraging because the upward momentum of spending erodes our flexibility in responding to changing national priorities and continues to increase the role of Government in the total economy. In fiscal 1975, Federal outlays increased 21 percent over the previous year.

In addition to the rapid growth of expenditures, the problems inherent in the financing of very large Federal deficits were an increasing cause of concern. Although it was generally agreed that the Treasury would be successful in meeting its financial requirements, there was some uncertainty about the prospects for private sector financing even though such demands were expected to be held down by the recession. Nevertheless, there appeared to be a real risk that "crowding out" would occur on an extensive scale if large Federal deficits were to be continued very far into the period of economic recovery. For the first time in the postwar period, there appeared to be a potential financial constraint to recovery resulting from the debt financing requirements of the Federal Government. Therefore, fiscal decisions must be made with increasing regard for their financial consequences.

Domestic Finances

Financial markets in fiscal 1975 reflected the difficult economic situation caused by continued concerns about inflation and the severe recession. The flexibility and resiliency of the financial markets was once again demonstrated as a wide variety of changing credit demands was accommodated and the decline in the demand for funds by the private sector enabled the financial markets to meet the unprecedented demands of the Federal Government.

The changing pattern of credit demands was evidenced by the sectoral demand for funds. Approximately $181 billion of nonfinancial corporate funds were raised, relatively unchanged from fiscal 1974. Funds raised by the public sector, however, increased from $20.5 billion to $67.3 billion with nearly all of the increase represented by Federal sector demands—an increase of $46.6 billion from fiscal 1974.

Short-term interest rates fell almost continuously throughout the fiscal year from the historic highs reported in the summer of 1974. At that time, rates such as the commercial paper rate and the Federal funds rate were between 12 and 14 percent, and Treasury bill rates were in the 8- to 10-percent range. After September, short-term interest rates began to fall and by the summer of 1975 the declines in rates ranged from 4 to as much as 7 full percentage points.

Long- and intermediate-term interest yields also rose to historic highs during the summer of 1974. The Aa corporate new issue rate peaked at over 10 percent, and intermediate-term Treasury securities yielded over 8 percent. New home mortgage rates rose to the 9-percent level. These longer term rates fell somewhat during the fall and winter months but the declines were more gradual and less decisive than for short-term rates. By spring, these declines had generally halted, or reversed somewhat, and by mid-1975 these interest rates had stabilized and some had actually turned upward.

The municipal bond market was under considerable stress during fiscal 1975. Fundamental factors included a lessening of bank demand for new municipal securities due to other offsets to taxable income, development of a general preference for higher quality issues which led to widening rate spreads, and the continuing financial problems of New York City.

The Treasury securities market was dominated by the need to finance the largest Government deficit in the postwar period. The deficit was financed by a $45.5 billion increase in the outstanding privately held markable securities and by an increase of $2.5 billion in nonmarketable issues. The increase in marketable securities was about evenly divided between bills and coupon issues. Bills increased by $23.5 billion, and notes and bonds by $25.5 billion. Savings bonds increased by $3.5 billion.

The Federal Financing Bank completed its first full year of activity. During 1975, the bank made loans totaling $15.8 billion to Federal agencies, making the bank the major instrument through which Federal agencies financed their programs. Bank lending rates were ⅛ of 1 percent above the new issue rate of marketable U.S. Treasury securities with similar maturities.

INTERNATIONAL DEVELOPMENTS

The fiscal year ending on June 30, 1975, was notable internationally for an unprecedented combination of recession and inflation. Among the seven major industrial countries taken together,* industrial pro-

*Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

duction appears to have peaked in the final quarter of 1973, and to have continued near the peak levels until the last quarter of 1974, when a steep decline set in. In April 1975, the level of production was highest in Canada at 119 percent of the 1970 base. Germany, the United Kingdom, and the United States showed the smallest advances over the 1970 level in April, at 102½, 103, and 103, respectively.

In terms of sharpness of the decline from the 1973 peak, the steepest curves were those of Japan, the United States, France, and Italy. The rate of decline was more gentle for the United Kingdom, Canada, and Germany. Japan and the United States appear to have shown the earliest tendencies for industrial production to level out or to rise in 1975.

According to the International Monetary Fund's tabulation of the annual rate of change in consumer prices during the preceding 12 months, the worldwide inflation rate began to rise in 1973 and reached a peak of about 16 percent at an annual rate in November 1974. It had subsided to an annual rate of about 14 percent by March 1975. For the developed areas of the world, this measure of inflation had declined to an annual rate of about 11 percent by June 1975, down nearly 3 percentage points from November 1974. In the less developed areas, the timing was somewhat different. The average rate of inflation rose rapidly in 1972 and 1973, from a little less than 10 percent in 1971 to over 20 percent in 1973. It reached an annual rate peak of 30.5 percent in September 1974, receding to about 26 percent in March 1975.

The growth of real GNP did not fall off so rapidly in the smaller industrial countries as in the seven largest economies, and this was also true for the primary producing countries as a group, even excluding the oil producers. Thus for a time their continued growth has helped to sustain total world output and incomes. However, the appearance of recession before inflation really subsided, and the continuing threat of a revival of an inflationary cost-price spiral, presented new and difficult problems.

In some industrial countries inflationary pressures were made more severe by a tendency for wage increases to advance even more rapidly than prices, and to lead rather than follow the rising curve of prices. More broadly, aggressive use of bargaining power by wider segments of the public appears to have accelerated inflation pressures, concentrating even more severe pressure on the narrowing segment of groups with the weakest bargaining power. Thus recovery has tended to be impeded more than in the past by rapid and competitive rises in the money incomes of particular bargaining groups. Moreover, the

severity of repeated shocks to some extent temporarily weakened the confidence of consumers, which sustained the world economy so well during the postwar years.

Despite these problems, the decline has been arrested and recovery has begun in Japan and the United States. As the cumulative forces of recovery appear in other countries, world output and income will recover at a moderate but persistent pace, thus reducing the danger of renewed inflation.

Financing of Current Account Surpluses and Deficits

In international payments, changes were dominated by the higher cost of petroleum. The current account surplus of the Organization of Petroleum Exporting Countries (OPEC) has been estimated at $67 billion in 1974 and $47 billion in 1975, as compared with $3 billion in 1963 by the Organization for Economic Cooperation and Development (OECD). In 1974, the current account position of OECD countries shifted from a small $2 billion surplus the preceding year to a deficit of $34 billion. In 1975, the continued deficit of the OECD countries as a group is estimated at only about one-third of the smaller OPEC surplus. Moreover, within the OECD the current account deficits of the seven leading industrial countries may be rather small. Thus the general picture at midyear 1975 was one in which the deficits that offset the OPEC surpluses were shifting toward the smaller industrial countries and the developing world. This may prove to be a passing phenomenon, to be partly reversed as the industrial countries recover further. It does, however, imply that for calendar 1975 a current deficit of about $45 billion for the smaller industrial countries and the developing world may need to be financed, compared with a total need of about $35 billion in 1974.

Thus the financial markets continue to be faced with substantial movements of funds through direct or indirect channels from the surplus oil producers to the deficit countries. To date, most of this financing has been carried out through private financial channels, with the IMF and other official lending institutions providing perhaps something like one-tenth of the total financing of the OPEC current account surplus. The initial fears of difficulty in financing these huge amounts have not been realized. However, there are signs that some of the developing countries may be cutting back on their other imports and slowing down their rates of growth to reduce their financing problems.

World Trade

While the dollar value of world trade is estimated to have increased by nearly one-half in 1974 over 1973, most of this was due to higher

prices of internationally traded goods, particularly for energy. The physical volume of trade is estimated to have expanded by only about 5 percent, compared with an average annual rate of growth of 8½ percent during the 1960's. Incomplete data indicate that even weaker volume figures can be anticipated for the first half of 1975. The only part of world trade that was expanding early in 1975 was the movement of imports into the oil-exporting countries.

Exchange Market Developments

Since March 1973, the world has operated under what may be broadly described as a tripartite system of exchange policies. By June 30, 1975, about 40 percent of world trade was accounted for by 16 countries whose currencies were independently floating, with discretionary intervention. About 30 percent of global trade was recorded by seven continental European countries (including France after July 10, 1975) that adhered to a "common margins" agreement among themselves, with their currencies as a group floating against outside currencies. The remaining roughly 30 percent of total international trade was reported by countries that were under some form of loose or tight pegging of currencies to the dollar, to the pound sterling, to the French franc, to the special drawing right (SDR), or to some other composite unit in which several currencies were combined.

This tripartite system has worked well in helping the world to make adjustments to unprecedented peacetime shifts in international payments balances. Exchange crises have been avoided and no dramatic closings of official exchange markets such as occurred in earlier years have taken place. The very steep rise in the foreign exchange reserves of industrial countries, that was associated with those currency crises, pushed the total holdings from $12 billion in 1965 to $70 billion in early 1973. Since exchange rates for the dollar were permitted to float, the rise in foreign exchange reserves has leveled off. In fact, for a number of such countries, effective net reserves have been reduced by official borrowing abroad, though the gross reserves have held at about $70 billion. The substantial accumulations of dollars and other reserves since March 1973 have been concentrated in the holdings of the oil-producing countries. These holdings are in the nature of investments, rather than the byproduct of disruptive flows across the exchange markets.

During fiscal 1975, the composite exchange rate for the dollar, weighted by bilateral trade figures with about 50 countries, showed an appreciation of 3.8 percentage points, from a depreciation against the May 1970 rates of 10.6 percent at the end of June 1974, to a depreciation of 6.8 percent at the end of June 1975. Calculated on a narrower trade-weighted geographical base, the dollar also showed a slight rise

of 0.5 percentage points vis-a-vis the OECD currencies as a group, ending the year at a 16-percent depreciation from May 1970. In terms of SDR's, however, which give a smaller weight to the Canadian dollar than the trade-weighted averages, the dollar depreciated about 2½ percent during the fiscal year.

The currencies of the European common margins group (commonly called the "snake") did, however, appreciate against the dollar rather steadily from about August 1974 to March 1975, and then depreciated moderately through June 1975. The French franc, before rejoining the snake at its original relationship in July, rose from March to June. At the end of June, the dollar prices of some European currencies had reached their earlier 1973 peaks and, in the case of the Swiss franc, had moved considerably above those levels. After the end of the fiscal year, however, there was a sharp reversal in the exchange rates, with the European currencies falling steeply in terms of the dollar. The pound sterling, reflecting very high rates of inflation in Great Britain, moved steadily downward in the second quarter of 1975. The Italian lira and the Japanese yen ended the year without much change, with the authorities giving considerable guidance and support to the exchange market in both cases.

Money Markets and Interest Rates

Short-term market interest rates in monetary terms were generally at unusually high levels of 10 to 14 percent, or even higher, in a number of industrial countries in the summer of 1974. They receded from these levels in most countries during the final 6 months of 1974, particularly in the United States, and then began to level off or rise moderately again during the April–June 1975 time period. Long-term interest rates changed more slowly, but were moderately higher than the 1973 average in most industrial countries in the first half of 1975.

International Monetary and Financial Negotiations

The Committee of the Board of Governors of the International Monetary Fund on Reform of the International Monetary System and Related Issues, at its final meeting on June 13, 1974, agreed on a program of immediate action, as well as transmitting to the Governors for publication its final report on the longer range approach to international monetary reform. The elements in this action program have provided the principal agenda items for international discussions during the year. Among other provisions, they included: (a) Establishment of an advisory Interim Committee of the Board of Governors, pending amendment of the Articles of Agreement of the IMF to confer decisionmaking powers on a permanent and representative Council, (b) establishment of guidelines for the management of floating

rates, (c) establishment of a facility in the IMF to assist members in meeting the initial impact of higher oil prices, (d) further study of reform of gold arrangements, (e) valuation of the SDR in terms of a "basket" of currencies, (f) preparation of draft amendments to the Articles of Agreement, and (g) establishment of a Joint Ministerial Committee of the Boards of Governors of the IMF and World Bank to carry forward the study of the broad question of the transfer of real resources to developing countries and to recommend measures to implement its conclusions.

The Interim Committee of the Board of Governors of the International Monetary Fund on the International Monetary System held its inaugural meeting in Washington on October 3, 1974, and selected Finance Minister Turner of Canada as Chairman for 2 years. It called upon the IMF to examine the adequacy of private and official arrangements for financing oil-related payments deficits. The Committee decided to give priority to the issues of the adjustment process, quotas in the IMF, and amendments of the IMF Articles, including amendments on gold and on the link between development assistance and SDR allocations. The Joint Ministerial Committee of the Boards of Governors of the World Bank and the International Monetary Fund on the Transfer of Real Resources to Developing Countries was organized on October 2, 1974.

In November 1974, the United States proposed a "three-track" approach to multilateral financial arrangements designed to supplement private financing channels. This called for use of IMF regular resources as the first recourse, augmented by a quota increase, and by more effective policies for use of members' subscriptions to the Fund. This would be supplemented by a new Financial Support Fund designed to help industrial countries that could not arrange sufficient financing on reasonable terms from private sources and the Fund making them less vulnerable to financial pressures. The third proposal involved the creation of a temporary trust fund in the IMF, in the amount of $1.5–$2 billion, to be financed by sale in the market of some of the IMF's gold, and by contributions from member countries. This trust fund would be designed to provide concessional financing to the developing countries most seriously affected by the high cost of petroleum.

After several months of negotiations, the Financial Support Fund Agreement among participating members of the OECD was signed on April 9, 1975, on behalf of the United States, subject to the necessary legislative action. The quotas of participants in the Financial Support Fund total SDR 20 billion (about $25 billion), with the U.S. share amounting to 27.8 percent of the total, or about $7 billion.

The quotas of members determine voting rights, shares in financing the Financial Support Fund, and borrowing rights, as well as establishing a maximum limit on the risk of loss shared by a member in its operations. The United States intends to meet its share of any financing required by the Financial Support Fund principally through the issuance of guarantees providing a basis for market borrowing by the Fund. Legislation authorizing U.S. participation in the new facility had been introduced and was under consideration in the Congress at the end of the fiscal year.

Enlargement of the quota contributions to the International Monetary Fund was also discussed extensively during the past year. The United States has argued that consideration of such an increase in quotas should occur only in the context of a broader package agreement covering arrangements for gradually phasing gold out of the monetary system and amendments to the Articles of Agreement providing for floating exchange rates as a permitted option for member nations of the IMF. In this context, the Interim Committee in January 1975 approved an increase in IMF quotas to SDR 39 billion (about $47 billion), an increase of about one-third in Fund resources. This increase would double the quota shares of the major oil exporters, while maintaining the collective shares of all other developing countries. The Committee also agreed to review the quotas again in 3 years, instead of waiting the normal 5-year period. Since January, further discussions have been held on the distribution of quotas among individual members, and some problems remain to be resolved. Despite the economic justification for a larger quota, the United States in these discussions agreed to accept some decrease in its quota share, thus reducing its voting share fractionally, on condition that the Articles be amended to increase from 80 percent to 85 percent the vote required to approve amendment of the Articles and certain other basic decisions.

Considerable progress has been made toward agreement on phasing gold out of its monetary role over time. The Interim Committee has agreed on some principles such as abolition of the official gold price in the IMF and elimination of the obligation to use gold in payments between the IMF and its members. The Committee also agreed that a portion of the IMF's gold should be used for the benefit of the developing countries, particularly the low-income developing countries. There remain, however, several issues, including the question of transitional arrangements outside the IMF designed to avoid reappearance of a de facto official price of gold and to limit a rise in aggregate official holdings.

More difficulty has been encountered in reaching accord on amendments to the Articles of Agreement concerning exchange rate policies.

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The United States believes that the IMF Articles should offer nations wide latitude for choice among exchange rate systems, including full acceptance of floating rates as an option, and should impose neither a moral nor a legal obligation to establish par values, now or in the future. While there is wide support for this objective, some countries would like to see all nations accept an obligation to return to par values. The United States has indicated that it will not agree to this.

International Investment and Capital Flows

The accumulation of financial assets by oil-producing countries, amounting to about $60 billion in calendar year 1974 and about $25 billion in the first half of 1975, aroused public interest in foreign investment in the United States. Under the Foreign Investment Study Act of October 1974, the Treasury is carrying out a special study to improve data on foreign portfolio investment in the United States. The Commerce Department is examining data on foreign direct investment in this country. The Treasury study will also analyze the methods and determinants of foreign investment here and the purposes and effects of U.S. laws and regulations bearing on such investment.

Following a report to the Economic Policy Board and the National Security Council by an interagency committee chaired by the Under Secretary of the Treasury for Monetary Affairs, several decisions were taken regarding inflows of foreign investment. It was decided that the United States should maintain its traditional open economy and investment policies and that no new legislation was needed to supplement existing safeguards. A high-level Committee on Foreign Investment in the United States was established to monitor the impact of foreign investment by Executive Order 11858 in May 1975. The Under Secretary for Monetary Affairs was designated as Chairman of that Committee.

During fiscal 1975, Congress appropriated $619.1 million for the operations of various international development banks. Although the United States is the largest single contributor, other donor countries together contribute more than twice as much as the United States. Total lending from the international development banks was equal to more than 40 percent of total new commitments of official development assistance from OECD countries in calendar 1974.

The World Bank group committed over $6 billion for development projects in fiscal 1975, an increase of 35 percent over fiscal 1974, and 72 percent higher than the lending level in fiscal 1973. The Inter-American Development Bank committed $1.1 billion and the Asian Development Bank $570 million. In the Inter-American Development Bank, an important event was the progress made toward broadening the base of the Bank to bring in 12 nonregional members: Austria,

Belgium, Denmark, Germany, Israel, Italy, Japan, the Netherlands, Spain, Switzerland, the United Kingdom, and Yugoslavia. These new members will bring additional resources, both in capital subscriptions and in contributions to the Fund for Special Operations, which supplies financing on concessional terms.

At the annual meeting of the World Bank, the U.S. Governor stressed the need for effective utilization both of the private capital and of the modern technology available on a commercial basis. He pointed out that within the World Bank group the International Finance Corporation has a particularly important role in stimulating investment, and the Secretary of the Treasury emphasized the vital importance to developing countries of effective mobilization and use of domestic resources. The scarce resources of the international lending agencies should be concentrated on the countries with the greatest need and on high-priority projects such as promotion of food production.

Unfortunately, the increase in oil prices has fundamentally changed the growth outlook for the developing countries. In the 1960's and early 1970's, growth was proceeding at a considerably faster rate in those countries than in the industrialized nations. The impact of higher oil prices placed an immediate burden on the balance of payments of developing countries and also contributed to the subsequent recession which so adversely affected the exports of the developing countries. The economic growth rate of the most seriously affected countries has fallen below their rate of population growth. In the middle- and high-income developing countries, the problem of financing current account deficits has led to very heavy borrowing demands on the world's capital markets, and a slowing down of growth to avoid too rapid a rise in external debt.

To alleviate these undesirable pressures, the United States has proposed that a temporary trust fund be created under the management of the IMF to help meet the balance of payments needs of the poorest countries. The amount suggested is $1.5–$2 billion, to be financed by contributions derived from the sale of a portion of the IMF's gold reserves, as well as by contributions from oil producers and other countries. Resources provided by the trust fund would be on concessional terms.

The Development Committee has urged the Executive Directors to consider all aspects of such a trust fund, including possible sources of financing. It has also agreed to establish a working group to review regulatory and other constraints affecting access to capital markets and to study further proposals to support access, including the possible use of multilateral guarantees. The Committee also supported a 1-year

intermediate lending facility in the World Bank (known as the "third window") to lend on terms intermediate between those of the International Development Association and the World Bank. The interest rate on such loans is to be subsidized with contributions from member countries. Pledged contributions will permit about $500 million in third window lending during fiscal 1976 with criteria for these limited funds favoring countries with an annual per capita income below $375.

On other matters concerning relations with developing countries, the Treasury submitted papers to the Economic Policy Board and the Council on International Economic Policy outlining measures to broaden and strengthen U.S. policy on expropriation. The Overseas Private Investment Corporation, which insures investments against the political risks of expropriation, inconvertibility, and war, revolution, and insurrection, issued $1,211.9 million in investment insurance in fiscal 1975, up over 20 percent from the amount issued in fiscal 1974.

In February 1975, the Secretary submitted the first comprehensive annual report on debt relief granted by the United States to developing countries, as required by legislation approved in 1974. Discussions on debt relief were held with Pakistan and Bangladesh to conclude bilateral debt rescheduling agreements, and a bilateral agreement was signed with India covering service due during the Indian fiscal year ending March 31, 1975. A multilateral understanding was reached with Chile under which debt due from the Government of Chile in 1975 would be rescheduled.

The Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries (Development Committee) was established in October 1974, during the IMF–IBRD annual meetings. The U.S. member is the Secretary of the Treasury.

CONCLUSION

An unprecedented combination of recession and inflation developed, both domestically and internationally, during the course of fiscal 1975. By the close of the fiscal year, the U.S. economy was in the early stages of an economic recovery. Unemployment was high but falling, and the rate of inflation had been reduced significantly during the year. An unprecedented amount of Federal financing was accomplished during the year while private credit demands were relatively slack, but interest rates remained high by historical standards and there was some difficulty in obtaining access to funds for some private borrowers. Despite considerable effort to devise programs to deal with the energy problem and to encourage a higher rate of capital formation, much remains to be done in each of these areas.

On the international side, significant progress occurred during the fiscal year in restoring the strength of the international economy although the rate of recovery in many nations is still slow and much remains to be accomplished. Inflation remains a major problem in many nations.

The international monetary system continued to evolve along three lines, comprising individually floating rates for the dollar and some other major trading currencies, a group of European currencies floating together against the dollar with limited intervention, and a number of other currencies pegged to the dollar or to some other currency or basket of currencies. During the year, progress was made toward international agreement on phasing down the international monetary role of gold, enlarging resources of the International Monetary Fund, and liberalizing access by developing countries to financing from both the Fund and the World Bank group. The massive accumulations of liquid international resources by oil-producing countries slowed down, but continued to contribute heavily to the worldwide situation of recession combined with receding, though still abnormally high, rates of inflation.

INTRODUCTION

This statement reviews some of the major domestic and international developments which affected areas of Treasury interest and responsibility during fiscal 1976 and the transition quarter. Detailed information on the operating and administrative activities of the Department of the Treasury is provided in the main text of the report and supporting exhibits. Further information is contained in a separate Statistical Appendix.

DOMESTIC DEVELOPMENTS

The Domestic Economic Recovery

The U.S. domestic economic situation improved substantially. At the beginning of fiscal 1976 an economic recovery was just getting underway after the severe recession downturn. The economy bottomed out early in 1975 and once again began to expand. During the ensuing 18 months of economic expansion which includes the period under review, real GNP rose at a 6 1/4-percent annual rate. In the first 12 months of the expansion, real output rose at over a 7 1/4-percent annual rate before slowing to a 4 1/4-percent rate of advance in the next 6 months. This was an impressive turnaround when compared with the negative growth registered during the severe recession of 1974 and early 1975—the deepest recession since the 1930's. While recovery is far from complete, the U.S. economy is back on a path of economic expansion and making good progress.

Significant improvements also occurred in U.S. employment conditions although the unemployment rate remained disturbingly high. Civilian employment rose by 3 1/2 million persons—a strong recovery by past cyclical standards. The labor force also rose by about 3 million persons and the number of persons unemployed was reduced only slightly from over 8 million to the 7 1/2 million level. The total unemployment rate during the transition quarter was 7.8 percent, down from a peak quarterly rate of 8.7 percent at the end of fiscal 1975.

Specific structural employment problems persist in the forms of very high rates of unemployment among minority groups, certain geographical pockets of high unemployment, and serious difficulties in particular industries. Various government programs continue to try to alleviate these specific unemployment problems. In round numbers, recent annual expenditure levels have been close to $20 billion in unemployment assistance, about $2.5 billion in public employment programs, and another $6 billion or so in manpower training programs. These are substantial levels of expenditure, but even higher levels of Federal expenditures in

these and other areas have been urged by some in order to reduce the rate of unemployment. In general, the current administration has believed that a sustainable economic expansion would do more to reduce unemployment than anything else and that excessive government stimulus would only create additional problems.

Personal consumption has been a major source of strength in the recovery and it will necessarily continue to be an important element. Personal consumption increased at about a 10 1/2-percent annual rate leading to a renewal of economic activity throughout the economy. With price inflation removed, the real growth of personal consumption was 5 percent. During the latter months of fiscal 1976, gains in real consumption slowed down and a minor inventory reaction resulted, particularly for some nondurable industries. Consumers remained cautious during the transition quarter and spending was proceeding about in line with fairly modest income gains. After correction for inflation, retail sales had been virtually flat during the latter months of fiscal 1976 and the transition quarter. Continuation of this sluggishness for much longer would raise questions as to the strength of the economic expansion. Evidence of strengthening began to emerge at the turn of the transition quarter and the early months of the new fiscal year.

A crucial element in the current economic outlook is an expected acceleration of capital investment. Spending for capital equipment bottomed out early in fiscal 1976 and modest improvement had been registered by the end of the transition quarter with larger increases expected in 1977. Improving corporate profits, the prospect of emerging capacity constraints in some industries, and the overall improvement in business demand are basic reasons for expecting increased capital spending.

Business spending for inventories swung from massive liquidation during the last half of fiscal 1975 to accumulation during the 15-month period under review. This contributed to very rapid growth in GNP. By the close of the transition quarter, the rate of increase in inventory was leveling off and apparently contained a certain amount of involuntary accumulation. However, the bulk of inventory investment was still voluntary and appeared to be justified by the fundamentals of the economic situation. Nonetheless, sluggishness in retail sales was beginning to cause some concern by the end of the transition quarter and inventory-sales ratios, while low by historical standards, were rising.

The other major investment sector—housing—has been slow to regain satisfactory levels of operation although a cyclical recovery is now apparently underway. Total private housing starts were averaging about a 1 1/4 million-unit annual rate in the early months of fiscal 1976 and moved up to about a 1 1/2 million rate by the fiscal yearend. A sharp monthly increase to a 1.8 million rate occurred at the close of the transition quarter, but the significance of such monthly changes is difficult to judge.

In any event, residential construction activity is expected to continue to show gradual improvement. A large and continuing flow of savings into thrift institutions provides mortgage financing, and new building permits also point to increased activity.

On balance, the economic expansion was proceeding fairly satisfactorily as the transition quarter came to a close. Real growth had slowed to the 4-percent range but a similar slowing had occurred in the second year of previous postwar expansions. In the present case, it seemed to reflect the cessation of rapid rebuilding of inventories rather than any serious imbalances or lack of forward momentum in the economy. However, there was room for difference of opinion as to whether or not a satisfactory pace of expansion would continue spontaneously, or whether some moderate increase in economic stimulus might be required.

Slower Rates of Inflation

One of the more encouraging features of the economic expansion was the progress made in controlling inflation. While real output increased rapidly, the double-digit inflation that crested in 1974 steadily moderated. Consumer prices rose at slightly less than a 6-percent annual rate in contrast to a gain of 9.3 percent in fiscal 1975. Wholesale prices rose 5.0 percent in contrast to an 11.6-percent rise in fiscal 1975. Some of the improvement was due to special factors in the food and fuel area, and it was disturbing that the wholesale prices of industrial commodities rose at a 6.5-percent annual rate during the 15-month period, particularly since even somewhat higher annual rates of increase were being registered by the end of the period. On balance, however, considerable improvement had occurred in the inflation area.

The improvement was reflected in a better balance between wage costs and productivity increases. Output per man-hour in the private business sector rose at a 4.1-percent annual rate, well above the meager 1.7-percent rise during fiscal 1975. Compensation per man-hour, on the other hand, rose less rapidly, at a 7.8-percent annual rate in contrast to a 10.6-percent rate in fiscal 1975. As a result, cost-push pressures eased substantially. Labor costs per unit of output, which had risen at an 8.7-percent annual rate during fiscal 1975, increased at a 3.5-percent annual rate during fiscal 1976 and the transition quarter.

After sorting through the detailed statistics, it appears that three things could be said about the inflation problem. First, considerable progress has been made in moderating inflation pressures, and the economic recovery that has occurred is directly related to the improvement. Second, despite this progress, the current 5- to 6-percent rate of inflation is still far too high and will continue to distort the economy and its financial markets until the rate of inflation can be returned to the 2- to 3-percent range. Third, and more broadly, inflation remains the greatest single threat to both the

sustainability of the current economic expansion and the longer term stability of the U.S. economy.

The Budget and Fiscal Developments

Recent budgetary experience has been dominated by two major developments: The strong upward momentum of Federal spending and large budget deficits because of economic recession. In fiscal 1966, Federal outlays totaled some $135 billion. By fiscal 1974 spending had increased to $268 billion. After this doubling in a period of 8 years, Federal spending then jumped 36 percent in just 2 fiscal years—1974 to 1976. While some of this sharp increase in the last 2 fiscal years was recession induced, expenditure increases were spread widely throughout all the major categories. The rapid momentum of rising Federal spending has increasingly restricted rational economic choice because the bulk of the Federal budget, an estimated 75 percent, is considered to be uncontrollable in the technical budgetary sense of the term.

For fiscal 1976 the President initially proposed budget outlays of $349.4 billion. In January 1976 this estimate was raised to $373.5 billion. Continued efforts were made by the administration during fiscal 1976 to hold down the growth of Federal spending including the frequent use of the Presidential veto power. These efforts and other developments held the fiscal 1976 outlay figure to $365.6 billion—about $8 billion below the January estimate. Spending in the transition quarter totaled $94.5 billion. This was $3.5 billion below the January estimate and $7.6 below a mid-session review estimate prepared in July 1976. An assumed shift in spending into the transition quarter did not occur.

Receipts were held down by the recession, and large budget deficits resulted. Final budget results show a $65.6 billion deficit in 1976 and a $12.7 billion deficit in the transition quarter. Future budgetary prospects were clouded by the forward momentum of Federal spending, but the recovery of the economy was contributing to strong growth in receipts.

Taxation Developments

Tax policy developments reflected the urgent need for both substantial income tax reduction coupled with spending control and comprehensive tax reform to promote efficiency and equity and to provide tax simplification.

Temporary tax cuts had been enacted in March 1975 in the Tax Reduction Act of 1975 and would have expired at the end of calendar 1975. The President proposed in October 1975 a permanent $28 billion income tax cut for fiscal 1977 tied to equivalent Federal spending cuts. The program included $20.7 billion in personal income tax reductions concentrated at low- and middle-income levels and $7 billion of business tax cuts to encourage investment in productive facilities. But Congress passed a temporary tax cut in December 1975 of $8.4 billion to expire in

6 months. The President vetoed the bill because in his view it was inadequate and provided no spending limitation. Congress sustained the veto. A short-term compromise was immediately enacted in the Revenue Adjustment Act of 1975 which provided temporary tax reduction and a spending limitation commitment. The act extended with some modification the 1975 tax cuts and withholding rates for the first 6 months of 1976. In his 1976 state of the Union address, the President renewed his request for a permanent income tax cut. His fiscal 1977 budget assumed congressional approval of his tax cut recommendation of $28.1 billion coupled with $0.8 billion of reduced revenue from other income tax proposals, $3.3 billion of increased revenues from a proposed social security tax rate increase, and $2.1 billion of increased revenues from proposed higher unemployment taxes. The net effect on fiscal 1977 receipts of all tax changes in the budget was estimated to be a net reduction of $23.4 billion.

Three short-term tax cut extensions were enacted after mid-1976 as Congress continued to debate the omnibus tax reduction and reform bill, H.R. 10612. Finally, a $16.8 billion tax cut extension for fiscal 1977 was enacted in the Tax Reform Act of 1976.

The administration continued to recommend and urge enactment of numerous tax reform proposals in fiscal 1976. Proposals were directed at substantially reducing the number of individuals with high economic incomes who pay little or no tax, encouraging economic growth through more capital formation, encouraging job creation, making estate and gift taxation more equitable, and helping State and local governments borrow needed funds. Comprehensive tax reform resulting in a net revenue gain of $1.5 billion in fiscal 1977 was enacted in the Tax Reform Act of 1976 encompassing many of the administration's recommendations with congressional modifications.

Overall, the impact on fiscal 1977 budget receipts of tax cut extensions and reform measures in the 1976 Tax Reform Act was reduced revenues of $15.3 billion.

Domestic Finances

The financial markets during the 15 months absorbed record amounts of funds at generally declining interest rates. Occasional tightening actions by the Federal Reserve in response to flareups in the rates of growth of the monetary aggregates were followed by periods of more ready credit accommodation during which interest rates fell to successively lower levels. By late September 1976, money market rates were fluctuating around 5 1/4 percent, about 3/8 percent below the level of June 1975. In the bond markets, the decline in yields on Treasurys was somewhat less than 3/8 percent, while the decline in yields on corporates and municipals was considerably greater—nearly 1 percentage point. Nonetheless, by historical standards, these rates were still very high.

The large volume of financing was marked by divergent trends. Strengthened demands for long-term funds, not only on the part of the Treasury but also for corporate securities and mortgages, were moderated by continuing weak demand for short-term credit, especially on the part of the business sector.

Nonfinancial corporations continued the restructuring of their balance sheets and improved their liquidity through the funding of short-term debt. Bank loans to nonfinancial corporations declined by about $9 billion, and although other types of corporate short-term nonfinancial borrowings (notably, commercial paper and finance company loans to business) expanded modestly, nonfinancial corporations reduced their short-term borrowings significantly. At the same time, there were $39.5 billion in net new issues of corporate and foreign bonds—only slightly below the record rate reached in fiscal 1975—and net new stock issues expanded to $21 billion.

During fiscal 1976, the reduction in business borrowings from commercial banks, coupled with the slow pace of other bank lending, enabled the commercial banks to place substantial funds in Treasury securities. Although the pace of expansion of total bank credit, at about 4 1/2 percent for the fiscal year, was relatively slow, commercial bank net purchases of Treasury securities accounted for about 32 percent of the net volume of Treasury securities issued to the public.

In all, Treasury securities in the hands of the public (that is, excluding holdings by trust funds, other Government accounts, and the Federal Reserve) increased by $73 billion during fiscal 1976. These net issues served to help finance off-budget agency borrowing for Federal credit programs as well as the Treasury deficit. The Federal Financing Bank accounted for the bulk of such financing, increasing its loans by $9.1 billion.

Not only commercial banks but also nonfinancial corporations, savings institutions, and State and local governments, in the course of rebuilding their liquidity positions, added unusually large amounts to their holdings of Treasury securities, absorbing in combination about 44 percent of the net issues to the public. Some Treasury issues attracted widespread purchases by individuals, bringing net purchases by individuals to about 18 percent of the total. Net purchases of Treasury securities by foreign investors were relatively small.

The Treasury tailored its security offerings to meet investor preferences and also with a view toward lengthening the average maturity of the marketable debt. Notes and bonds totaling $44.3 billion comprised 55 percent of the net offerings other than special issues to Government accounts. In May, the first offering was made of a 10-year note under newly granted authority. In addition, savings bonds increased by $4.2 billion. Although the percentage of debt issued to the public in the form of Treasury bills was considerably lower than in other recent years, the

required huge financing operation resulted in a net increase in Treasury bills outstanding of $32.6 billion.

The municipal bond market was able to absorb a record volume of bond issues in fiscal 1976, despite a degree of temporary unsettlement precipitated in part by the New York City crisis. Municipal bond yields, as measured by the Bond Buyer index, reached a peak of 7.67 percent in October 1975 but had receded to about 6 3/4 percent by mid-1976. During the transition quarter, municipal bond offerings remained strong, but yields continued to decline in line with market trends, reaching 6 1/2 percent in late September 1976.

The pattern of financing in fiscal 1976 was carried over into the transition quarter. Short-term credit demands rose at a moderately faster pace even though bank loans to business continued to decline. A curtailment in corporate security offerings was about offset by stronger mortgage demands. While Treasury's net borrowings from the public subsided noticeably from the fiscal 1976 rate, the overall volume of financing consummated during the transition quarter was at a record rate.

The placement of these heavy financing demands during the 15 months was facilitated by the surge of funds to savings institutions. Notwithstanding some hesitation early in fiscal 1976, new records were set for inflow of funds to savings and loan associations, mutual savings banks, credit unions, insurance companies, and corporate and State and local government pension funds, which altogether totaled $143 billion. In addition, nonfinancial businesses put some of the proceeds of their security offerings and of their heavy internal flows into credit market instruments. Foreign investors also supplied some $15 billion in funds to the credit markets, a rate somewhat below that of several recent years and considerably below the $21 billion in fiscal 1971. Although the provision of funds by the banking system remained on the low side ($42 billion), the heavier inflow of funds to savings institutions was sufficient to provide a ready market for the enlarged demands for credit without much growth in purchases by individuals.

INTERNATIONAL DEVELOPMENTS

The world economy underwent substantial changes during the period under review. At the beginning of July 1975, only the U.S. and Japanese economies had begun to pull out of their respective recessions. For the industrial economies as a whole, negative real growth of some 4 percent had been experienced in the preceding half year but during the last half of 1975 recovery spread as confidence was rebuilt—in large part due to the strength of the U.S. performance. By the end of the first half of 1976 the major economies were growing at annual rates in excess of 7 percent while the industrial world in total expanded in real terms around 6 percent.

As often happens during periods of expansion, "pauses" in the recovery process follow high and unsustainable rates of growth. The late summer months reflected such periods of pause in most of the major economies, but by the end of September some indications of renewed progress on the growth front were appearing.

Economic recovery was reflected in a resumption in the growth in both the nominal and real value of world exports and imports, which turned upward again in the first and second quarters of 1976, after allowance for seasonal factors. Trade volumes rose an estimated 13–14 percent after experiencing declines in the half year leading into the fiscal year.

Equally significant to progress in the recovery of real growth was the reduction in worldwide inflation rates that took place in the 15-month period. The global annual rate of inflation, which had already receded from the peak level reached in November 1974, showed some further improvement. By May 1976, however, it was still extremely high at 11 percent, as measured by the IMF calculation of 12 months' changes in consumer prices.

Industrial countries as a group brought down the 12 months' increase in consumer prices from over 11 percent in the second quarter of 1975, to about 7 percent in August 1976, though in individual countries there were wide differences, ranging from 1 1/2 percent in Switzerland to 17 percent in Italy. The U.S. figure was 5.6 percent in August.

Progress was also made in slowing down price advances in the oil-exporting countries, and in Australia and South Africa. Slow progress was made in less industrialized European countries where the rate of price advance averaged 16 percent in June 1976, and inflation actually became worse in the oil-importing developing countries as a group, rising to 33 percent in July 1976 (74 percent in the Western Hemisphere in that month). Although these latter high average rates of inflation were influenced by hyperinflation in a few countries, there were also mixed results among countries with less extreme rates of price increases.

Economic recovery also was accompanied by some important shifts in the pattern of world payments. After allowing for official transfers in the form of grants, there remained in calendar 1976 about $41 billion of the current account surpluses of the oil-exporting group which had to be reflected in the corresponding current deficits of other countries and financed (as compared with about $40 billion in calendar 1975). However, it is estimated that OECD (Organization for Economic Cooperation and Development) countries will account for about $23 billion in 1976, as against about $6 billion in 1975, and that the net current deficits for the rest of the world, including the state trading countries, will accordingly be reduced to about $18 billion, as against about $34 billion in 1975. Among individual countries, the current account positions of the United States, France, Italy, and the Nordic group appear to have softened, while those of Japan, Benelux, and Switzerland were expected to harden, between the 2 years.

Financing of the unusually large current account deficits resulting from the oil price increase has meant that foreign debts to private international lenders have been increasing much more rapidly than in the years before 1974. Consequently, a number of countries are seeking to reduce their rates of borrowing by restraining domestic demand, curbing inflation, and strengthening their current account positions. In doing so, they presumably shift part of their deficits to other oil importers which continue to attract private capital, given that the OPEC (Organization of Petroleum Exporting Countries) surplus which must be offset is essentially set by governments of producer countries rather than by economic factors.

The current impact of these large payments imbalances on the world economy and the global financial system to some extent has become less severe as the value of world trade has increased, but each year of large OPEC surpluses adds to their cumulative effect. In 1974, the ratio to world imports (cost, insurance, and freight) of the gross current account imbalances appears to have been in the range of about 10 percent, as against less than 4 percent in 1973, because of the increase in oil prices. In 1975, this ratio fell to about 7 1/2 percent and in 1976 might be in the neighborhood of 6 percent, which is still well above the 1973 figure.

International Monetary Developments

Negotiations on reform of the international monetary system succeeded in reaching agreement on future provisions in the IMF Articles of Agreement relating to exchange arrangements, and on measures to further move gold from the center of the monetary system. The first major revision of the Articles of Agreement of the International Monetary Fund since its inception in 1945 was completed by the Governors of the Fund, with the Secretary acting for the United States. It was then transmitted to member governments for their formal approval. The revised Articles were accompanied by a proposed increase in IMF quotas of about one-third, to SDR 39 billion (about $45 billion), after the Interim Committee of the Board of Governors (in which the United States is represented by the Secretary of the Treasury) resolved the difficult questions of allocating new quotas among individual countries. This involved a doubling of the quota shares of the oil-producing countries and a corresponding reduction of the shares of the developed countries, leaving the oil-importing developing countries with an unchanged share of the quotas in the Fund. The U.S. share in quotas was reduced, but changes in certain requisite qualified majorities mean that future proposals to amend the Articles, or to increase quotas, cannot become effective without U.S. approval.

The amended IMF Articles will give countries latitude to apply exchange arrangements of their choosing. However, this freedom of national choice as to exchange regimes will be subject to general obligations applicable to all countries to pursue policies that are necessary to achieve underlying economic stability, which is recognized to be a

prerequisite for exchange stability. Member countries also undertake, under the amended Articles, to avoid manipulation of the exchange rate or, more generally, of the international monetary system in order to prevent the effective adjustment of payments imbalances or to gain unfair advantage over other members. The Fund is given responsibility for overseeing the international monetary system in order to ensure its effective operation. Moreover, the Fund is directed to exercise "firm surveillance" over the exchange rate policies of members, and to adopt specific principles for the guidance of all members with respect to these policies.

The principal features of the understandings reached on gold were: (1) The official price of gold in the IMF Articles will be eliminated, with the special drawing right (SDR) taking the place of gold as the unit of account for the IMF; (2) all requirements to use gold in transactions with the IMF will be eliminated, and the IMF will be prohibited from accepting gold in any transaction unless there is an 85-percent majority vote to the contrary; (3) one-sixth of the Fund's gold (25 million ounces) will be sold over a 4-year period, with the excess of sales receipts over the present official gold price being channeled to a trust fund for the benefit of developing countries; also, one-sixth of the Fund's gold will be restituted (i.e., sold to members in proportion to their quotas in the IMF in exchange for currency at the present official gold price) over the same 4-year period.

Supplementing this agreement, the members of the Group of Ten industrial countries undertook to observe certain transitional arrangements with respect to their treatment of gold. They agreed not to peg the price of gold or to increase the aggregate quantity of gold held by the Fund and the monetary authorities of the Group of Ten, and to respect any further conditions that were agreed upon by their central banks at regular meetings. These arrangements will be reviewed in 2 years.

The major decisions on all these matters were reached through an intensive series of informal and formal international negotiations during the year in which the Secretary of the Treasury and the Under Secretary for Monetary Affairs took leading roles. Basic understandings on exchange rate arrangements under the amended IMF Articles were reached in bilateral discussions with the Government of France and endorsed by the heads of state participating in the summit meetings in Rambouillet in November 1975. These understandings formed the basis for agreement by the IMF Interim Committee in Jamaica in January 1976. Agreements on gold and the distribution of quotas were reached at the meeting of the Interim Committee in August 1975, in Washington.

Legislation authorizing U.S. acceptance of the proposed amendments to the Articles of Agreement of the Fund and consent to the proposed increase in the U.S. quota in the IMF was approved by the Congress and signed by the President in October 1976. The amendment of the Fund's Articles of Agreement and the proposed increase in IMF quotas will

become effective, however, only after acceptance of the amendments by 60 percent of the member countries having 80 percent of the voting power.

During 1975–76, access to Fund resources was liberalized in several ways. Each regular credit tranche was temporarily enlarged by 45 percent, effective during the interim period preceding the coming into effect of the proposed amendment to the IMF Articles. The IMF's compensatory financing facility was substantially liberalized in December 1975. And, as noted above, a trust fund has been established (separate from the IMF but managed by it as trustee) for the benefit of developing countries.

The special IMF oil facility, under which the Fund borrowed about $8.2 billion for lending to countries in need in 1974–76, was terminated in the spring of 1976. This action was related to the realization that, while deficit countries had been given a breathing space by this facility, to meet the initial impact of higher oil prices, the Fund should now return to its normal policies of fostering payments adjustment while providing assistance through its regular procedures, thus helping countries to adjust their deficits and avoid excessive borrowing to finance payments deficits that would otherwise continue to pile up too much foreign debt.

The net use of Fund credit rose from about SDR 5 billion ($6.2 billion) at the end of June 1975 to SDR 12 billion ($13.9 billion) at the end of August 1976.

National Economic Policies and the Renewed Threat of Inflation

As the world recovery gained momentum in the summer of 1976, it became clear that inflationary pressures were reviving quickly even though unemployment in industrial countries was receding slowly. The Secretary of the Treasury joined with other Finance Ministers and monetary authorities in endorsing a strategy for sustainable economic expansion, pointing to the need for caution in the pursuit of expansionary policies. Such new spending might produce a renewed round of excessive inflation and a resulting loss of confidence of businessmen and consumers, thus failing to achieve the desired lasting expansion. This theme was strongly supported by the Secretary both in Paris at the OECD Ministerial meeting in June 1976 and by President Ford at the Puerto Rico summit meeting in June 1976. It received wide acceptance at the annual meeting of the IMF and World Bank in Manila in October 1976.

Exchange Rate Relationships and World Reserves

During this recovery period the currencies of the advanced countries continued to be permitted to move against the dollar, either individually, or jointly, as through the European common margins agreement (the "snake"). The latter required intervention, often on a substantial scale, to maintain the basically fixed rates among the participating countries. Also, a number of countries borrowed abroad on official account or with official guarantees. In these countries, part of the dollar exchange available to the

market was provided by feeding these governmental receipts into the market. Increasingly, however, countries began to carry out the broad objective under the Rambouillet and Jamaica agreements, allowing exchange rates to reflect underlying conditions in the national economies rather than intervening officially to resist market forces tending to produce changes in the exchange rates.

In 1975–76, the Canadian dollar, the German mark, the Swiss franc, and the Japanese yen tended to appreciate in dollar terms while several currencies, including the French franc, the pound sterling, and the Italian lira, decreased in dollar value, reflecting relatively high rates of inflation and large payments deficits. The dollar value of the SDR depreciated from $1.236 at the end of June 1975 to $1.146 at the end of June 1976. At the end of the transition quarter the dollar value of the SDR stood at $1.154.

Gross official reserves of all reporting countries rose from SDR 186 billion in June 1975 to SDR 207 billion ($237 billion) in June 1976, for an annual rate of increase of 11 percent. About one-third of this accrued to the oil-exporting countries, and the remainder was divided among the industrial countries and the developing countries. Thus, less than a fifth of the current surplus of the oil-exporting countries was financed by reported reserve accumulation in these countries as a group, a much smaller portion than in 1974–75.

International Trade and Raw Materials Policies

As trade and raw materials policies have grown in international importance in recent years, Treasury's role in both national and international policy formulation has become progressively more active. The need for coordinated domestic and international policy goals has produced an increasing emphasis on trade and raw material policy formulation. U.S. positions on a more open and market-oriented world trading order were important elements in the Rambouillet and San Juan economic summit meetings. The United States actively participated in negotiations leading to a consensus among major trading nations to avoid artificial stimulus of exports through use of official export credits. As a member of the interagency Task Force on the Law of the Sea, the Department proposed a weighted voting system for the International Seabed Authority and helped develop a financing program for the operating arm of the Authority.

The East-West Foreign Trade Board, chaired by the Secretary of the Treasury, continued to monitor trade with the nonmarket economies to ensure that it remained consistent with U.S. national interests. The Board has kept a close watch on Soviet grain purchases and the negotiation of the U.S.-U.S.S.R. Long-term Grain Sales Agreement. In addition, Secretary Simon visited Poland, Yugoslavia, and Romania in June 1976 to explore ways of strengthening economic, trade, and financial relations with those states.

The Treasury played an active role in formulation of U.S. commodity policies, providing staff support and policy input to the Commodities Policy Coordinating Committee, which it cochairs with the State Department, and participating in the interagency Commodities Policy Task Force.

The multilateral trade negotiations (MTN) underway in Geneva are the principal means for pursuing the U.S. goal of a more free and open market-oriented system. Positions adopted by the United States in the MTN with respect to tariffs, subsidies and countervailing duties, safeguards, customs matters, and special treatment for developing countries have benefited from active Treasury participation. The Department also helped in preparation of the U.S. generalized system of preferences for developing countries' exports.

North-South Relations

The UNCTAD IV meeting in Nairobi was of symbolic importance in the North-South dialog. The United States made a series of concrete proposals in Nairobi and agreed to participate over the next 2 years in a series of undertakings to come to grips with key economic issues such as commodity policy, trade, debt, transfer of technology, and special measures to assist the poorest nations. While political considerations sometimes overrode substance at the conference, confrontation was avoided and agreement was reached on a work program which should allow developed and developing nations to bring technical expertise to bear on critical economic issues.

International Investment

During 1975 and 1976, the United States continued its efforts to maintain a free and open climate for international investment. As a result of U.S. initiatives, and with active participation by the Treasury, the member governments of the OECD adopted, in June of 1976, a declaration on international investment and multinational enterprises with the objective of promoting a stable and open environment for international investment. In addition and again at a U.S. initiative, the OECD began discussions aimed at removal of existing impediments to the flow of international portfolio capital. During 1976, the U.N. Commission on Transnational Corporations undertook a comprehensive program designed to lead to the formulation of a U.N.-wide code of conduct for multinational enterprises.

In March of 1976 President Ford established a Cabinet-level Task Force on Questionable Corporate Payments Abroad to review the problem of bribery. As a result of the task force work, in June 1976 the President announced that he intended to propose legislation to the Congress requiring reporting and disclosure of certain payments by U.S. businesses to foreign government officials. In addition, the United States proposed to

the United Nations in August 1976 that action be taken toward a comprehensive international agreement to curb corrupt practices in international commerce. As a result, an intergovernmental working group of the Economic and Social Council charged with developing an international agreement on illicit payments, is expected to report to the Council in the summer of 1977.

In the spring of 1976, the Treasury completed its benchmark survey of foreign portfolio investment in the United States, as a part of an overall administration survey of foreign investment in the United States, required by the Foreign Investment Study Act of 1974. Also, Congress passed legislation in September 1976 to create the necessary legal authority to maintain a regular information collection program with respect to foreign investment in the United States and U.S. investment abroad.

The Committee on Foreign Investment in the United States, an interagency group chaired by Treasury officials, was established by President Ford in the spring of 1975 to coordinate overall policy towards inward investment. It considered certain proposed investments by foreign governments in the United States—including an investment by Romania in the Island Creek Coal Co. and a proposed Iranian investment in Occidental Petroleum.

International Energy Developments

The most significant international energy developments have been the increasing solidarity and cooperation among consuming nations, the initiation of a producer/consumer dialog on energy matters in the Energy Commission of the Conference on International Economic Cooperation (CIEC), and the continued dominance by OPEC of the world oil market.

As a result of the 1973 oil embargo, 19 industrialized oil-consuming countries established the International Energy Agency (IEA) to help coordinate their international energy policies. The IEA has succeeded in (1) developing an international oil allocation system to ensure adequate distribution of oil supplies among member countries in the event of another embargo, and (2) adopting a long-term cooperative program to promote increased energy production in member countries.

The CIEC was formally inaugurated by a Ministerial meeting in December 1975. It was agreed that discussion of international economic issues would take place among delegates from 19 countries representing the OPEC and nonoil developing countries and 8 representatives of the developed nations beginning in February of 1976 with the objective of meeting periodically leading up to a Ministerial conference scheduled for December 1976.

Discussion of energy issues in CIEC concentrated on the effects of higher oil prices on world economic progress and the problems of effecting a smooth transition from a world economy based on hydrocarbon energy sources to one based increasingly on alternative energy sources. This

commission is the only international forum where oil producers and oil-consuming nations are engaged in a dialog on important energy issues, and its deliberations are breaking new ground in international economic relations.

Developing Nations Finance

The Secretary has frequently expressed the U.S. philosophy surrounding our contribution to the financing of developing-country needs: Development assistance should be thought of not as an international welfare program to redistribute the world's wealth but as an important element of an international investment program to increase the rate of economic growth in developing nations and to provide higher living standards for the people of every nation.

The United States provides financial assistance to developing nations both through multilateral channels such as the World Bank group, the regional development banks, and the IMF, and through bilateral channels such as the Agency for International Development and Public Law 480.

Multilateral assistance has been accelerated: Congress appropriated $745.5 million for U.S. contributions to the international development banks for fiscal 1977, compared with $695.6 million for fiscal 1976. The World Bank group committed $6.9 billion for development projects in fiscal 1976, an increase of 13 percent over 1975. Commitment levels of the Inter-American Development Bank (IDB) rose to $1.2 billion, a 16-percent increase, and those of the Asian Development Bank increased to $880 million, a sizable increment. These increases in the commitments of the international financial institutions can be expected to continue in the near future.

Repeatedly, the Secretary has stressed the importance of sound financial policies for the development banks. A step in this direction was taken when the World Bank adopted a lending rate formula which covers the cost of funds to the Bank plus its operating costs. Similarly, the IDB adopted an automatic lending rate formula, and one is under consideration as well in the Asian Development Bank. These actions will enable the development banks to continue to have access to capital markets at favorable interest rate terms. Thus, the banks will be better able to finance their expanded levels of development lending.

In addition to long-term development financing needs, developing nations have requirements for short-term balance of payments financing. Large current account deficits have been encountered by non-oil-exporting developing countries in recent years due to the twin shocks, in 1974 and 1975, of higher oil prices and recession in the industrialized countries. The international community has responded to the situation in various ways. With a doubling of net official flows, and an even larger increase in private flows, the current account deficits of developing

countries have been financed, providing these countries time to undertake necessary economic adjustments.

In the bilateral sphere, the United States has pursued a number of programs for financing developing-country needs. The Agency for International Development committed $2.3 billion in loans and grants and supporting assistance in fiscal 1976, $200 million less than in 1975. Under Public Law 480, during fiscal 1976 and the transition quarter, Title I sales agreements for $914 million were signed, while Title II donations totaled $247 million. Programs of the Overseas Private Investment Corporation and the Council on International Economic Policy contributed to the security of private investment flows to developing countries.

The growing foreign indebtedness of developing countries is a matter of particular concern to the Treasury. On January 30, 1976, the Secretary submitted to Congress the administration's second annual report on the external debt of developing countries. The vast majority of loans by the United States to developing countries are repaid on schedule. However, some countries have fallen into arrears on their repayments to the United States, and the Treasury has taken vigorous action to encourage these countries to become current on their payments.

Although the Treasury does not believe that generalized debt rescheduling should be employed as a form of foreign assistance, it recognizes that in a few exceptional cases the official debts of a developing country must be rescheduled for the economy of that country to remain viable. The United States signed rescheduling agreements in March 1976 with Pakistan and with Bangladesh. In June 1976, the United States entered into a multilateral understanding with other creditor countries pursuant to which each country agreed to enter into a bilateral agreement with Zaire to reschedule certain outstanding indebtedness of Zaire.

Finally, to strengthen U.S. economic and financial relationships with the countries of the Middle East, the Secretary visited Saudi Arabia, Egypt, Israel, Syria, and the United Arab Emirates. The Secretary also traveled to three Latin American nations—Chile, Brazil, and Mexico. The visit to Brazil settled several bilateral trade disputes, and in Chile the Secretary warned officials that U.S. support for their economic programs depends on the Chilean Government's commitment to the protection of human rights.

Financial Support Fund

The Secretary testified before both House and Senate committees advocating approval of the Support Fund of approximately $24 billion negotiated in April 1975 as a temporary safety net, or insurance mechanism, to strengthen international cooperation in the energy and economic policies of participating OECD members. It would be used to supplement other sources of financing if it developed that these countries could not obtain elsewhere on reasonable terms the financing they need

to avoid introducing restrictive trade policies, capital controls, or unduly severe deflation. The Agreement establishing the Support Fund had been ratified by 15 OECD member countries, including Germany and Japan, by the end of fiscal 1976 and 3 other countries have completed domestic procedures prerequisite to ratification. The Congress did not act on the bill before adjournment, however.

CONCLUSION

The U.S. domestic economic situation improved substantially during fiscal 1976 and the transition quarter. Strong gains in production, employment, and real income were achieved during this period of cyclical recovery although the unemployment rate remained disturbingly high. Real growth had fallen slightly below a 4-percent annual rate by the end of the period, but this seemed to reflect the cessation of rapid rebuilding of inventories rather than any serious imbalances or lack of forward momentum in the economy.

One of the more encouraging features of the economic expansion was the progress made in controlling inflation. While real output increased rapidly, the double-digit inflation that crested in 1974 moderated to the 5- to 6-percent range. However, this rate was still far too high and inflation remained the greatest single threat to both the sustainability of the current economic expansion and the longer term stability of the U.S. economy.

In other industrial countries, a period of rapid real growth in fiscal 1976 was succeeded by a pause in the past few months. World trade expanded vigorously after declining during the recession. Some further progress was made in reducing excessive rates of inflation in some industrial countries, but in the rest of the world abnormally high rates persisted. In calendar 1976, OECD countries anticipated current payments deficits totaling about $23 billion, while the oil-importing developing countries and the state trading countries together may record about $18 billion in deficits. A current account surplus of about $41 billion for the group of oil-exporting countries was anticipated.

Negotiations on reform of the international monetary system, which began in 1972, were completed, resulting in the first major revision of the Articles of Agreement of the International Monetary Fund since its inception in 1945. The United States adhered to the revised Articles and agreed to an increase in the resources of the IMF of about one-third, to a total of $45 billion.

The U.S. emphasis on moderate but sustainable economic progress, and on the avoidance of overstimulatory policies that could re-ignite inflation, received wide international acceptance. Exploratory discussions on a wide front were also undertaken in the fields of energy, commodity policies, international investment, and other matters of concern to developing countries. The United States maintained the basic posture that commodity

problems and international debt resettlement problems should be examined on a case-by-case basis.

The United States continued to provide financial assistance to developing nations through both multilateral and bilateral channels, based on the philosophy that development assistance should be considered as an important element of an international investment program to increase the rate of economic growth and provide higher living standards for the people of every nation, and not as an international welfare program to redistribute the world's wealth.

INTRODUCTION

This introduction reviews major domestic and international developments which affected areas of Treasury interest and responsibility during fiscal 1977. Detailed information on the operating and administrative activities of the Department is provided in the text of the report and supporting exhibits. Statistical information may be found in the separate Statistical Appendix.

DOMESTIC DEVELOPMENTS

Domestic Economic Recovery

The domestic economic situation continued to improve in fiscal 1977, but the pace was uneven during the year as a minor inventory adjustment ran its course. Real economic growth, which was at a 3.9-percent annual rate of increase during the transition quarter (the third quarter of calendar 1976), slowed to only 1.2 percent during the final quarter of calendar 1976, when growth in GNP was held down by a substantial fall in the rate of inventory accumulation. During the early part of calendar 1977, real growth was checked temporarily by severe winter weather but rebounded vigorously when the weather warmed up. As a result, real GNP rose at nearly a 7-percent annual rate during the first half of calendar 1977. By the third quarter of the calendar year—2 1/2 years after the recovery began—growth eased back to just over 5 percent, still somewhat above the longrun rate of growth in potential output. By the end of the fiscal year, the economy had grown by 15.2 percent from the recession low, and 5.0 percentage points, or about one-third of that growth had occurred during the fiscal year under review.

Employment registered strong gains during the year in conjunction with unusually large increases in the labor force. Total employment increased by 3.3 million persons (3.8 percent) from September to September, somewhat more than the increase of 2.6 million persons (2.8 percent) in the labor force. As a result, the unemployment rate dropped from the 7.8-percent level prevailing at the beginning of the period to 6.9 percent. Most of the improvement in the unemployment rate occurred over a relatively short interval. The rate dropped five-tenths of a percentage point from 7.8 percent in December to 7.3 percent in January and continued to fall to 7 percent by April. After April the rate seesawed back and forth between 7.1 percent and 6.9 percent, indicating a temporary plateau had been reached at a still unacceptably high rate of unemployment.

The improvements in the unemployment picture did not affect all labor force groups equally, however. Because the labor force growth for adult males was generally more modest than that of adult women or teenagers, this group enjoyed the largest improvement in the unemployment rate—a decline from 6.1

percent in September 1976 to 4.9 percent in September 1977. Adult women, whose increased labor force participation accounted for about two-thirds of the total labor force growth over the period, experienced only half as much decline in the unemployment rate, from 7.6 percent to 7 percent. The situation for teenage workers was still less favorable. For this group, the growth in the labor force and employment were approximately equal, with the number of unemployed teenagers remaining virtually unchanged at around 1,670,000 persons and with little improvement in the unemployment rate which fell from 18.8 percent to 18.1 percent. The structural character of the unemployment problem thus became clearer during fiscal 1977, and by the end of the period new policy initiatives dealing with the unemployment of youth were being investigated.

Personal consumption was a major source of economic strength early in the recovery and it continued to be one in fiscal 1977 though some weakness was becoming evident toward the end of the period. After a relatively lackluster performance in the third quarter of calendar 1976, retail sales increased strongly as the holiday season approached, and that strength continued throughout the first quarter of 1977, except for the decline due to the cold weather during January. In mid-1977, the pace of personal consumption again turned weak, and the quarter-to-quarter rates of increase were disappointingly small in the second and third calendar quarters of 1977, although some strength was evident in the monthly data in the third quarter.

Investment continued to play a pivotal role in economic developments during fiscal 1977 and occupies a critical position with respect to the outlook for 1978. Nonresidential fixed investment began the year on a rather poor note, increasing at only a 1.8-percent annual rate as a consequence of weakness in investment spending for both structures and equipment. In the second quarter, however, settlement of a major strike in the motor vehicle industry boosted total spending on equipment by near-record rates. In the subsequent quarters, investment for structures began to exhibit some strength, though the final quarter of the fiscal year once again saw diminishing performances for both categories of nonresidential investment. Residential investment, on the other hand, grew at a rapid 49-percent annual rate in the first quarter, followed by a much smaller gain in the next quarter due to the cold weather, and another gain in excess of a 40-percent annual rate in the third quarter. Having thus reached a high plateau, activity in the final quarter edged off slightly for this sector.

The major developments in business inventories over the course of the fiscal year consisted primarily of a significant inventory retrenchment at the beginning and much smaller adjustments during the final quarters. Overall, relatively tight inventory control appeared to be the order of the day. The events of 1976 and 1977 suggest that businesses are no longer inclined to accumulate inventory stocks significantly in excess of sales growth, and whenever they find this happening, adjustments—occasionally involving production cutbacks—almost surely follow.

On balance, the economic expansion proceeded at a fairly satisfactory pace during fiscal 1977 though the rate of progress was not smooth. For the year as

a whole, growth amounted to 5.0 percent in real terms with the individual quarterly rates varying from 1.2 percent to 7.5 percent. The easing which became evident as the year wore on was a function of decreasing gains in personal consumption as well as the absence of further large jumps in inventory accumulation.

Inflation

Substantial progress was made in controlling inflation early in the economic recovery, but in the course of fiscal 1977 very little further moderation was achieved. At the beginning of the period, consumer prices were increasing at an annual rate of about 4 1/2 percent—a rate not greatly different from that which prevailed by the final quarter. In between, however, the pace was driven to almost double the beginning and ending rates of advance as a consequence of sharply higher prices for food and, to a lesser extent, for energy and services. Wholesale prices showed a roughly similar pattern during the period except that absolute declines in food prices during the summer led to small absolute decreases in the total index and generally moderate rates of advance as the year came to a close. For the Wholesale Price Index, as was the case with the Consumer Price Index, the volatility of food prices played a major role in quarter-to-quarter variations.

Early in the fiscal year, food prices jumped as a consequence of the exceedingly cold and dry weather in Florida and California, respectively, and concern about the lack of snow cover over much of the Great Plains. When the effects of these special influences proved to be less severe than expected and favorable harvests became assured, equally strong declines in food prices occurred which served to dampen the pace of the major price indexes.

The recent behavior and outlook for industrial prices is not as favorable, but even here there are few signs that a major resurgence of inflation is imminent. The pace of industrial price increases accelerated somewhat at the very end of the fiscal year, but substantial improvements in the price behavior of crude materials suggest the deterioration may well prove to be transitory.

Productivity growth in the private business sector slowed slightly to a 2.3-percent rate of increase during the fiscal year. Within the year, the quarterly pattern was erratic. Compensation per man-hour continued to increase at relatively rapid rates and rose 8.7 percent during the fiscal year. The net result was that unit labor costs continued to rise fairly strongly, with the increase for the fiscal year slightly in excess of 6 percent, as had been the case in the previous year.

Thus, inflation continues to be a major problem. Further moderation is proving progressively more difficult to achieve, yet the current rates remain far too high and cannot be tolerated indefinitely without running the risk of progressively more serious distortions. Such distortions—in consumption, saving, and investment patterns—would eventually pose a significant threat to the current economic expansion and the longer term stability of the U.S. economy.

The Budget and Fiscal Developments

The budget estimates for fiscal 1977 presented in January 1977 by the outgoing administration called for outlays of $411.2 billion and revenues of $354 billion, leaving a deficit of $57.2 billion. In the early months of the new administration (i.e., during the second quarter of fiscal 1977) budget revisions were submitted to Congress which would have increased outlays to $417.4 billion and reduced revenues to $349.4 billion. As a result, the deficit for the year would have been increased by approximately $10.8 billion, to $68 billion. Before congressional action on the revisions took place, however, the emergence of greater than expected economic strength led to the administration's cancellation of its proposal for a tax rebate, the major item in the 1977 revisions.

Actual outlays totaled $401.9 billion and receipts amounted to $356.9 billion, for a deficit of $45 billion. The major reason for the difference between the expected and realized budgetary outlays was the continued occurrence in fiscal 1977 of outlay underruns. The underruns had first attained noticeable dimensions during fiscal 1976 and the transition quarter, and at that time it was expected that once the fiscal year had been shifted to its new terminal date the phenomenon would largely disappear. The underruns continued throughout fiscal 1977, however, and no single cause could be identified.

Off-budget net outlays for fiscal 1977 were also somewhat lower than had been anticipated. In the revised budget such outlays were expected to amount to $10.8 billion and the midsession review issued on July 1 had lowered that estimate to $10.3 billion. Off-budget net outlays actually amounted to $8.7 billion for the year.

Domestic Finances

The financing of the record volume of funds raised in the financial markets in fiscal 1977 was facilitated by substantial inflows of funds to savings institutions and by a buildup of liquidity by other investors. Money market rates generally declined in the first half of the year and rose in the second as the Federal Reserve tightened credit policy in response to accelerating growth rates of the monetary aggregates. By late September 1977, short-term interest rates were around 6 3/8 percent, about 1 percentage point higher than 12 months earlier. In the bond markets, yields on Government and corporate issues remained remarkably stable through this period, but municipal bond yields fell by 1 percentage point. Even so, long-term interest rates were still high by historical standards.

The volume of financing was large in both the capital and money markets. Strong demands for long-term funds, particularly for mortgage loans and by State and local governments, were accompanied by greater demand for short-term business loans and consumer credit. Nonfinancial corporate businesses continued to restructure their balance sheets, and corporate liquidity stabilized in fiscal 1977. Bank loans to nonfinancial corporations climbed by an estimated $17 billion, and other kinds of short-term borrowings by nonfinancial corporations (namely, commercial paper and finance company loans to business) rose

by another $12 billion. At the same time, net new issues of corporate and foreign bonds (including bonds issued by financial companies) amounted to about $34 billion, down from $36 billion the year before, and net new stock issues $10 billion, down from $12 billion.

During fiscal 1977, the rather strong demand by business for bank loans, coupled with rapid expansion in bank real estate and consumer loans, held down bank purchases of Treasury securities. Although total bank credit expanded at a rapid 11 percent during the year, net purchases of Treasury securities by commercial banks accounted for only 12 percent of the net volume of Treasury securities issued to the public.

Public debt securities held by investors other than U.S. Government accounts and Federal Reserve banks rose $46.4 billion in fiscal 1977. Foreign investors were the largest purchasers of Treasury securities followed by State and local governments. The combined net purchases of the two absorbed 77 percent of the net issues of Treasury securities to the public. Individuals increased their purchases of savings bonds but reduced their holdings of marketable securities, as did corporations.

A large segment of the Treasury's security offerings consisted of additional amounts of regular bills and notes with maturities up to 5 years. Also, the Treasury issued longer notes and bonds with a view toward lengthening the average maturity of the marketable debt. In fiscal 1977, notes and bonds increased by $41.3 billion, while Treasury bills decreased by $5.4 billion. Issues to State and local governments (for advance refunding) rose by $8.6 billion and savings bonds by $4.7 billion.

Despite the issuance of a record volume of municipal bonds in fiscal 1977, bond prices rose sharply. The Bond Buyer's index of yields on municipal bonds averaged 6.51 percent in September 1976, but dropped to 5.50 percent in September 1977, a low for the past 3 1/2 years.

Record inflows of funds were set in fiscal 1977 not only by savings institutions but also by credit unions, insurance companies, and private pension funds. In addition, nonfinancial businesses placed some of the proceeds of their security offerings and of their heavy internal flows into credit market instruments. Foreign investment in the U.S. credit markets rose by a record $28 billion.

Taxation Developments

Tax policy developments reflected the need for economic stimulus coupled with tax simplification and permanent tax reductions.

In February 1977, President Carter proposed a $26.4 billion tax package for fiscal 1977 and 1978 which included an $18.5 billion economic stimulus program and a $7.8 billion tax cut in fiscal 1978 through a permanent extension of the temporary tax cuts enacted in the 1976 Tax Reform Act.

The $18.5 billion tax cuts to stimulate the economy consisted of $15.4 billion of personal tax reductions, including $8.2 billion for a per capita tax rebate, and $3.1 billion of business tax cuts to encourage investment in productive facilities.

Taxes would have been reduced by $10.6 billion in fiscal 1977 and $7.9 billion in fiscal 1978 under this proposal.

Extension of the temporary tax cuts provided under the 1976 Tax Reform Act would have lowered individual taxes by $6.8 billion and corporate taxes by $1 billion in fiscal 1978.

Acting on the President's proposals, Congress passed and the President signed on May 23, 1977, a $20.4 billion tax reduction program for fiscal 1977 and 1978 in the Tax Reduction and Simplification Act of 1977. The permanent extension of the temporary tax cuts was enacted with some modification providing $7.9 billion of tax reduction, of which $6.9 billion went to individuals and $1 billion went to business. The basic tax reduction and simplification in the act (excluding the extension provisions) amounted to an aggregate $12.5 billion in fiscal 1977 and 1978, of which $10.5 billion went to individuals and $2 billion went to business.

The act omitted the per capita rebate proposal, which was withdrawn by the President in the light of the performance of the economy, accepted a slightly modified version of the President's standard deduction proposal, and added a new jobs credit. The net reduction in fiscal 1977 and 1978 receipts from all tax changes in the Tax Reduction and Simplification Act of 1977 is $2.6 billion and $17.8 billion, respectively.

The President proposed an energy program containing, in part, tax proposals which would first take effect in fiscal 1978. The objective of the energy program is to conserve energy use and to reduce the annual energy growth to less than 2 percent a year by 1985. At the close of the fiscal year, congressional consideration of alternative approaches was proceeding with the nature of the eventual legislative outcome in doubt.

The President took action to resolve both short- and long-term problems in the social security system. High unemployment in recent years curtailed revenues while benefits rose with inflation. Since 1975, outlays have exceeded income and existing reserves are being seriously depleted. In addition, the current system will have an estimated deficit of 8.2 percent of taxable payroll over the next 75 years. This is attributable in part to a projected higher proportion of elderly persons in the population as life expectancy increases and birth rates drop. It is also attributable in part to a technical flaw in the automatic cost-of-living formula applicable to benefits.

To bring financial stability back into the system, the President proposed that general revenues be used in countercyclical fashion to replace payroll tax receipts lost during recessions. He also proposed increased payroll tax revenues by removing in one action the taxable payroll ceiling for the employer tax and moderately increasing, in several changes by 1985, the ceiling for the employee tax. In addition, the tax rate for self-employed would be increased so that it equaled 1 1/2 times the rate for employees. The 75-year deficit would be reduced to a manageable 1.9 percent under the President's proposals. At the fiscal yearend, social security changes were under consideration by the Congress.

Work continued on the development of tax reform proposals. Final decisions had not been reached by the end of the fiscal year on the exact nature of the legislative package which the President would submit to the Congress.

INTERNATIONAL DEVELOPMENTS

The World Economy

During the past fiscal year, the pace of real growth in world economic output was somewhat slower than in the first year of cyclical recovery, 1975-76, and was stronger outside Western Europe than in that region. Most of the progress made in 1975-76 in restraining global inflation was retained, but the wide differences in national rates of inflation persisted. In many countries, inflation still continued at an unacceptably fast pace, unemployment remained appreciably higher than in the sixties, and global payments deficits continued to require financing on the much higher plateau that has prevailed since the abrupt increase in oil prices in 1973-74.

In May 1977, the Secretary participated in the summit meeting in London, where leaders of seven large industrial democracies committed themselves "to stated economic growth targets or to stabilization policies which, taken as a whole, should provide a basis for sustained non-inflationary growth, in our own countries and world-wide and for reduction of imbalances in international payments."

The seven major industrial economies experienced real growth rates of roughly 4 1/2 percent in the first half of calendar 1977, following 3.2 percent in the last half of 1976. This average rate is somewhat misleading as the economies of Japan and the United States—which account for about 60 percent of the group's GNP—expanded at 7.7 and 5.5 percent rates, respectively, while those of the other five averaged 2.3 percent. Again this year, as in 1976, the summer months produced a "pause" in the expansion. Real growth in the seven industrial countries as a group in calendar 1977 now seems likely to fall significantly short of the 5.2-percent rate posted in 1976.

The smaller industrialized countries, largely as a result of stabilization policies in some countries, are now expected to post gains averaging about 2 1/2 percent per annum in calendar 1977, down slightly from the corresponding rate of about 3 percent in 1976.

As for the oil-importing developing countries, real growth rates for the full year 1977 seem likely to average close to the 5-percent level estimated for 1976.

In 14 industrial countries, the average annual rise in consumer prices at the end of September 1977 was 7.8 percent (latest 12-month period), as compared with 7.3 percent at the end of September 1976. During the final quarter of the fiscal year, the rate of price increases in several countries was perceptibly slower than earlier in the year. At the end of September 1977, the possibility of future improvement depended particularly upon the course of basic commodity prices and future wage settlements.

Within the less developed countries (LDC's), consumer prices in the oil-exporting countries continued to rise at an average rate of about 15 percent per annum. Although some slowdown of extremely rapid price changes was achieved in a few oil-importing developing countries, the average rate of inflation in this large and diverse group of countries continued to hover around 30 percent a year, with a wide range from 9 percent in Asia to 50 percent in the Western Hemisphere.

In most industrial countries other than the United States, rates of unemployment were higher in mid-1977 than in 1976 or 1975, though in Germany and Japan they were about the same as in 1976, and in Switzerland remained very low.

Aggregate payments imbalances, as measured by current account deficits (goods and services, plus those official and private transfers of funds that are not considered capital transfers), appeared to be holding at about the 1976 level of $70 billion in dollar terms. Although they were somewhat reduced in real terms, these imbalances remained nearly twice as high, relative to the aggregate exports of the deficit countries, as in the years 1971-73.

Financing for about three-quarters of the total deficit of about $225 billion in 1974 through 1976 was provided by private market-oriented financing, something less than 20 percent by official development financing, and about 7 percent by the International Monetary Fund.

There were marked changes in the distribution of payments deficits and surpluses. During the first half of 1977, the current account position of the United States moved to a deficit at an annual rate of $17 1/2 billion, seasonally adjusted, as against $1.3 billion in the full calendar year 1976. By contrast, the Japanese and German current account surpluses together were running at an annual rate of $15 billion, up from about $7 billion for the full year 1976. The combined deficit of the United Kingdom, Italy, France, and Canada was down about $2 billion on the same comparison, at the annual rate of $13 1/2 billion. Thus the rest of the world had improved its aggregate position, at midyear, by something like an annual rate of $10 billion.

As of September, it was clear that severe and complex problems remained, but it was also evident that there were important signs of encouraging progress. Stabilization programs in Italy, the United Kingdom, France, Brazil, Mexico, and some other countries had helped to slow the pace of inflation, check the deterioration of payments positions, and restore financial confidence. There continued to be very wide differences, among both industrial and developing countries, in inflationary pressures and in payments positions. Nevertheless, foreign industrial countries, as a group, succeeded in arresting further deterioration and made some progress in coping with inflationary pressures and improving their payments positions. The payments position of non-OPEC developing countries as a group also appears to have strengthened during the fiscal year. During the period October 1976-March 1977, the rise in the dollar value of imports (c.i.f.) over the previous 6 months was only 75 percent of the growth in exports (f.o.b.) during the same period.

International Monetary Cooperation

At the annual meeting of the International Monetary Fund in October 1976, Ministers were concerned primarily with the persistence of high rates of inflation and high levels of unemployment. There was also a general consensus that, nearly 3 years after the abrupt increase in oil prices, it was time to place more emphasis on adjustment of payments imbalances, and thus slow down the rapid growth of debt by some deficit countries. To attack these problems simultaneously and symmetrically, the Interim Committee of IMF Governors agreed on a basic four-point strategy:

- Deficit countries should arrange their domestic policies so as to restrain domestic demand and to permit the shift of resources to the external sector, to the extent necessary to bring the deficit on current account in line with a sustainable flow of capital imports and aid.
- Industrial countries in strong payments positions should ensure continued adequate expansion in domestic demand, within the limits set by effective anti-inflationary policies.
- Exchange rates should be allowed to play their proper role in the adjustment process.
- In the context of the use of the Fund's resources, adjustment by deficit countries can be promoted by a larger use of the credit tranches and the Extended Fund Facility.

Late in 1976, the International Monetary Fund arranged to borrow about $3.3 billion from a number of Group of Ten countries and Switzerland, including a commitment of $1.1 billion from the U.S. Treasury, under the General Arrangements to Borrow. These funds were used to provide a standby commitment to the United Kingdom of about $3.9 billion, associated with the adoption of a stabilization program. Additional support to the United Kingdom was provided in February 1977 by a number of monetary authorities under the aegis of the Bank for International Settlements, in an amount up to $3 billion, related to potential drawdowns of official sterling balances. The U.S. commitment, provided by the Federal Reserve and the Exchange Stabilization Fund of the Treasury, amounted to $1 billion, but had not been drawn upon as of September 30, 1977.

In April, supplementary financing (about $390 million) was committed to the International Monetary Fund under the General Arrangements to Borrow to facilitate a standby arrangement for about $520 million with the Italian Government, in connection with the Italian stabilization program.

At their meeting in April 1977, the Interim Committee of Fund Governors encouraged the Managing Director of the Fund to proceed with a plan for a Supplementary Financing Facility, designed to provide needed additional resources to the Fund, to help promote orderly adjustment and to provide confidence to private markets that adequate official financing was available. The Managing Director's negotiations resulted in an undertaking by seven industrial countries and seven oil-exporting countries to establish credit lines to the Fund,

aggregating slightly over $10 billion. The U.S. share was $1.7 billion. Legislation to authorize U.S. participation was pending before the Congress as of September 30, 1977.

At their meeting in September 1977, the Interim Committee, concerned with the weakness of domestic demand in several foreign countries in relatively strong overall positions, urged such countries to make every effort to ensure adequate growth of domestic demand compatible with containing inflation. In this connection, they welcomed recent announcements of expansionary programs by Germany and Japan. The Committee also noted the importance of structural problems in these and other countries, and the need to develop appropriate energy policies. They expressed the belief that, as the results of adjustment actions became more evident, other countries would become strong enough to contribute to the growth of the world economy; but they also cautioned that policies should at a minimum be directed at avoiding a resurgence of inflation.

The second amendment to the Articles of Agreement of the International Monetary Fund, which would formally establish the reform of the Bretton Woods international monetary system, and the one-third increase in Fund quotas agreed last year have not yet become effective. As of September 30, 1977, the amendment had been accepted by 56 nations with 58.14 percent of the voting power. The amendment will become effective when three-fifths of the members (79 at present) having at least four-fifths of the voting power have formally accepted it. The increase in quotas enters into force when the amendment is effective and members with 75 percent of quotas have consented to their increased quotas. By the end of the fiscal year, members with 52.43 percent of quotas had given their consent. The United States accepted the amendment and the quota increase pursuant to Public Law 94-564, effective October 19, 1976.

In many foreign exchange markets, official intervention, official borrowing, and other actions by national authorities have exerted strong influence on dollar and other exchange rates. Nevertheless, the substantial number of exchange rate changes in the past 2 years in major countries attest to the fact that countries have become more flexible in their attitudes toward such rate movements. Currencies of countries in relatively strong payments positions have appreciated, while currencies of countries in relatively weak positions have depreciated by varying amounts. On a trade-weighted basis, against a basket of Organization for Economic Cooperation and Development (OECD) currencies, the U.S. dollar appreciated by about 2.4 percent during the year ending September 30, 1977. During this period, the Swiss franc, deutsche mark, yen, and pound sterling rose in terms of the U.S. dollar, while the values of the Canadian dollar, the Australian dollar, and the Italian lira fell.

The Treasury and the Federal Reserve continued to maintain very close contact with major foreign monetary authorities in order to discuss current market conditions and official exchange market operations. These consultations have been of great value in avoiding misunderstandings on policies and in ensuring that markets function effectively. From time to time there have been periods of nervous markets in some foreign currencies, often associated with

market expectations as to possible changes in official policies and attitudes affecting exchange rates.

The U.S. exchange rate policy is based on the view that the value of the dollar in the exchange markets will tend to reflect the underlying performance of the domestic economy—success in dealing with inflation, ability to expand the economy and to maintain an open, efficient, and attractive capital market. The United States has intervened to counter disorderly conditions in the exchange market. This policy has not, however, merited regular or massive participation in the market.

Financial Relations with Non-OPEC Developing Countries

The aggregate current account deficit of this group of countries is estimated to have improved markedly in calendar 1976, falling from about $37 billion in 1975 to about $26 billion in 1976 (excluding official transfers). The net flow of official financing (including transfers) reached about $22 billion in 1976 and the private money and capital markets and direct investment provided something like $15 billion. As the combined flows exceeded the current account deficit, the international reserves of the group rose by 37 percent in 1976 (to $41 billion at yearend), and another 10 percent in the first half of 1977. In analyzing financial flows to these countries, it is useful to distinguish between those that obtain the bulk of their external capital from private capital markets and those that rely primarily on official flows. In 1974 and 1975, the privately financed group (Brazil, Mexico, Korea, etc.) experienced relatively larger increases in their current account deficits than the officially financed group (Bolivia, India, Zaire, etc.). In 1976 and 1977, the first group accounted for most of the reduction in the aggregate deficit of the nonoil LDC's. As for the officially financed group, their deficits are constrained by the amount of financing available, and in 1977 are on an increasing trend as official flows increase.

The improved payments position since 1975 has resulted from buoyant exports to the industrial countries at improved terms of trade, while imports grew more slowly. This change reflected the higher growth rates in the United States and some other countries, as well as some especially sharp price rises in coffee and cocoa. Moreover, in some major countries exchange rates were permitted to depreciate and domestic stabilization programs were undertaken to slow down the pace of inflation. In one case, that of Mexico, temporary financing was provided by the Treasury's Exchange Stabilization Fund, to meet short-term pressure on the peso during an interval preceding an arrangement with the International Monetary Fund to support the Mexican stabilization program. Thus domestic policy changes as well as external influences contributed to the improved payments position.

The rate of increase in debt of the non-OPEC LDC's has been slowing down, and the size of their aggregate external public debt, relative to their recurring external receipts and level of output, appears to be moving back toward historical levels. This change has been brought about mainly by a reduction of

deficits in the dozen or so larger and more advanced countries that have relied primarily on borrowing from private money and capital markets. At the same time, average rates of real growth in the oil-importing developing countries recovered from about 3 percent a year in 1975 to about 5 percent in 1976, a rate likely to be sustained in 1977. Brazil and Mexico instituted major adjustment policies and are likely to record somewhat lower growth rates in 1977. Other countries that adopted stabilization programs earlier are likely to have somewhat higher growth rates in calendar 1977 than in 1976.

During 1977, U.S. policy placed an increasing emphasis on the role of the multilateral development lending institutions, especially the World Bank and the regional development banks, in providing financing for sound projects and programs in developing countries. On a net flow basis financing by multilateral development institutions provided about 15 percent of total private and official capital flows to the nonoil developing countries in 1976. The soft-loan windows of the development banks presently supply about two-thirds of the official capital flows to the poorest countries.

The United States is committed to encouraging growth with equity in the developing world. For this reason, the United States favors increased priority for lending by the development banks for agriculture, nutrition, health, and education to meet the basic human needs of the world's poorest people. Protection of human rights is also an important element of U.S. policy. The United States believes that these rights should be advanced through the multilateral development agencies.

During the year, Congress appropriated $1.9 billion as the U.S. fiscal 1978 contribution to the resources of the international development banks. Of this figure, $800 million represented an appropriation for the full amount of the first installment of the U.S. contribution to the fifth replenishment of the International Development Association. For fiscal 1977, the United States had contributed $1.1 billion to the resources of these institutions. During the year under review, Congress also approved authorizing legislation totaling $5.1 billion for U.S. contributions to the World Bank group, the Asian Development Bank, and the African Development Fund.

During consideration of the appropriations legislation, the House of Representatives proposed certain restrictive amendments barring the use of U.S. funds for loans by the international development banks to certain countries and for certain commodities. A compromise was ultimately worked out under which the restrictive amendments were not enacted, and the President agreed to instruct the U.S. representatives at the respective institutions to oppose and vote against such loans.

Reflecting the importance of the development banks in U.S. relations with developing countries, the Department of the Treasury under the new administration has undertaken a review of the effectiveness of these institutions in achieving U.S. objectives and of how U.S. objectives can best be pursued in them. The study is expected to be completed early in 1978.

The Development Committee brings together a group of Governors of the World Bank and the IMF several times a year. During this year, the Committee endorsed recommendations by a working group aimed at improving developing country access to private capital markets, and it created a second working group to examine certain aspects of official development finance and policy. At its September 1977 meeting, the Committee adopted an ambitious work program including the subjects of coordination among the multilateral development institutions, the stabilization of export earnings, private direct investment, the role of borrowing in development, and a World Bank study of development issues.

The Treasury continued to take part in interagency coordination of the U.S. bilateral financing and aid programs through the National Advisory Council on International Monetary and Financial Policies, the Development Coordination Committee, and the Development Loan Committee of the Agency for International Development.

Treasury also continued to follow developments in international indebtedness. In January 1977, the Treasury submitted to Congress the third annual report on the external debt of developing countries and debt relief provided by the United States. During the fiscal year, the United States participated in only one multilateral rescheduling of official debts, in response to the inability of the Government of Zaire to meet its debt obligations.

New Initiatives in Commodity Policy and Energy

The administration undertook a fourfold approach to international commodity problems in 1977. First, it adopted a positive and open attitude toward the negotiation of individual commodity agreements to stabilize prices around market trends. Second, the U.S. representatives agreed at the North-South conference in May 1977, along with other developed and developing countries, to support the establishment of a common fund, in order to facilitate the financing of buffer stock arrangements. Third, the United States undertook a policy of promoting increased investment in the production of key raw materials through encouraging increased involvement in such activities by the World Bank group, the regional development banks, and the U.S. Overseas Private Investment Corporation. Finally, it was decided to continue to review the adequacy of existing mechanisms to assure adequate support for the stabilization of export earnings of developing countries, although it was concluded that the IMF compensatory financing facility, following its extensive liberalization in 1975, was functioning well and was capable of meeting export earnings stabilization needs, as and when they arose, for the foreseeable future.

Much of the attention of the administration in the commodities area focused on the type of buffer stock arrangement which would be most economically rational and in the U.S. interest as a major producer and consumer of a number of important raw materials. It was concluded, for example, that the United States should seek to provide sufficient financial resources to agreements it

joined and to accumulate buffer stocks large enough to be effective in protecting against price surges as well as price declines. It was also decided to limit the use of export quotas in support of buffer stocks to extreme situations, and to oppose production controls in any buffer stock arrangement.

Where international buffer stock agreements were not feasible, but greater price stabilization appeared desirable, the United States could consider export quota arrangements which would promote national stocking to protect against high prices and encourage investment through a flexible quota reallocation system. It was also decided that the United States could consider internationally coordinated national stocks in cases where international buffer stocks were not feasible.

When a sufficient number of commodity agreements with operating buffer stocks had been negotiated, the funds allocated for such agreements could be pooled in a common fund in order to facilitate the financing of buffer stocks. This purpose would be achieved by making unused funds from some agreements available to others which were in a buying phase and by providing such agreements with supplementary financing through common fund borrowings on commercial markets.

A new commodity agreement for sugar, requiring stockholding, seemed certain to enter into force. Negotiations for a new International Sugar Agreement were successfully concluded and the agreement was scheduled to become effective on January 1, 1978. The new agreement, through the combined use of stock and quota mechanisms, was designed to stabilize prices within a 10-cent-per-pound price band (11-21 cents). Market forces would be allowed to operate freely over a substantial segment at the center of this band. The United States actively participated in negotiating the new agreement because it believed the pact would serve the interests of the United States as both a major sugar-producing nation and as the world's leading sugar importer.

In the energy area, the key issues revolved around price, supply, and technical and financial cooperation. There was also the question of establishing an appropriate means to continue an energy dialog, following the conclusion of the Conference on International Economic Cooperation. The key demands of developing countries included indexation of oil export revenues and increased resource transfers to the oil-importing developing countries, particularly those deficient in energy resources, to help in meeting their oil bills and to assist in developing any existing indigenous energy resources. Increased financial, scientific, and technological cooperation in conventional and nonconventional energy areas continued to receive considerable attention.

The United States called for international cooperation to effectuate an orderly and smooth transition to the period of global energy use when there would be increased reliance on sources other than oil and gas. The industrialized nations indicated they recognized the importance of oil prices to all nations and continued to seek to achieve energy prices that were fair to both producers and

consumers. The OPEC countries continued to seek to maintain the purchasing power of their oil export earnings, calling for indexation of oil prices, transfers of real resources to LDC's, and substantial revisions of pricing policies.

The developed nations proposed specific initiatives to intensify cooperation in energy research and development programs with special attention given to technologies appropriate for developing nations. The United States developed an energy investment proposal which recognized the importance of capital in energy development in the oil-importing developing countries, the role of the private sector, and the need to improve access to capital markets. It also considered a possible increase in the role of international financial institutions in fostering energy development. The United States fully recognized the importance of such financial and investment issues to the oil-importing developing countries.

International Trade Policy

The key emphasis of our trade policy remained our commitment to maintaining and improving an open international trading environment in the face of increasing protectionist pressures. The May 1977 summit conference in London and the renewal of the OECD trade pledge provided vital opportunities for the United States and its major trading partners to reconfirm their commitment to avoid protective trade measures. During the year, the United States also participated actively in efforts to achieve a broadened and strengthened international consensus on export credits to avoid destructive competition in this area.

At the same time, the administration responded to serious problems of import competition in domestic television and shoe sectors through mutual agreements which facilitate domestic adjustment, by slowing the pace of imports from the one or two countries responsible for the rapid surge in U.S. imports. The President asked Treasury Under Secretary for Monetary Affairs Solomon to chair an interagency task force to look into the problems of the steel industry and propose a comprehensive policy program for that industry early in fiscal 1978.

The United States and the European Community succeeded in achieving a major breakthrough in the stalemate which had deadlocked the multilateral trade negotiations and established a timetable for the submission of requests, offers, and draft codes. Treasury remained actively involved in the preparation of subsidy/countervailing duty and safeguard codes in particular.

The East-West Foreign Trade Board, chaired by the Secretary of the Treasury, continued to monitor trade with the nonmarket economies to ensure that it remained consistent with U.S. national interests. Secretary Blumenthal was cohost of the Sixth Session of the Joint U.S.-U.S.S.R. Commercial Commission on June 9-10, 1977, in Washington, D.C. [He also served as cochairman of the U.S.-U.S.S.R. Trade and Economic Council meeting in Los Angeles on November 14, 1977.]

International Investment

The administration established a policy on direct international investment that is based on four basic premises:

- First, international investment will generally result in the most efficient allocation of economic resources if it is allowed to flow according to market forces.
- Second, there is no basis for concluding that a general policy of actively promoting or discouraging international investment would further the U.S. national interest.
- Third, unilateral U.S. Government intervention in the international investment process could prompt counteractions by other governments with adverse effects on the U.S. economy and U.S. foreign policy.
- Fourth, the United States has an important interest in seeking to assure that established investors receive equitable and nondiscriminatory treatment from host governments.

In accordance with these premises, it was determined that U.S. policy should be neither to promote nor discourage inward or outward investment flows or activities. From this it followed that the U.S. Government should not give any special incentives or disincentives to international investment or intervene in the activities of individual companies regarding international investment.

On the basis of this policy, a task force identified several objectives that the U.S. Government should seek. They include strengthening international restraint over government interventions in the investment process which adversely affect other countries, obtaining equitable treatment for investors based on national treatment and the principles of international law, and fostering international cooperation in this area.

INTRODUCTION

This introduction reviews developments which affected areas of Treasury interest and responsibility during fiscal 1978. Only major domestic and international developments are covered since detailed information on the operating and administrative activities of the Department is provided in the body of the report. Statistical information is presented in the separate Statistical Appendix.

DOMESTIC DEVELOPMENTS

The Economic Expansion

The economic upswing which began at the end of the first quarter of 1975 continued through fiscal 1978. The pace of growth moderated somewhat during the course of the year, and the expansion remained remarkably well balanced although inflationary pressures did intensify. The level of economic activity (measured in terms of real GNP) at the close of fiscal 1978 was up 3.5 percent from a year earlier. A 5.3-percent increase had been recorded during fiscal 1977. During 1978, the pace of growth was interrupted in the first quarter of calendar 1978 by severe winter weather and a lengthy coal strike, but the economy rebounded during the following quarter. In the final quarter of the fiscal year real GNP registered an annual growth rate of 2.6 percent, somewhat below the average growth rate for the year but definitely not a cause for concern. The Department of Commerce estimated that if the strike and weather effects are set aside, real GNP probably would have increased at about a 3½-percent annual rate in each of the three quarters of calendar 1978. This was a remarkably steady and satisfactory pace for such an advanced stage of the economic expansion.

During the course of the fiscal year, economic policy began to shift from the promotion of rapid rates of real growth toward the control of inflation. This resulted in large part from two developments. First, the decline in the rate of unemployment was much more rapid than expected during the first half of the fiscal year and this was combined with a very slow rate of advance in productivity which, in turn, added to cost pressures. Second, the economy began to move into a zone of high utilization within which demand pressures were more easily translated into rising prices. The result was a relatively unsatisfactory price performance which acted adversely on the value of the dollar abroad. By the close of the fiscal year, control of inflation became the primary economic policy objective of the administration in recognition of the fact that accelerating rates of inflation would imperil the continuation of the expansion itself and would further undermine the foreign exchange value of the dollar.

Employment continued to register strong gains during the year which even outpaced the exceptionally large increases in the labor force. Total

employment increased by 3.8 million persons (4.2 percent) from September to September, significantly faster than the increase of 3.2 million persons (3.2 percent) in the labor force. The consequence of this rapid rate was a drop in the unemployment rate from 6.8 percent at the beginning of the fiscal year to 5.9 percent at the end. Most of the improvement in the unemployment rate occurred during the first half of the fiscal year. After April of 1978, the overall rate generally remained in the vicinity of 6.0 percent but did go as low as 5.8 percent for one month (June).

The improvements in the unemployment picture affected all labor force groups more or less equally in fiscal 1978, somewhat in contrast with the previous year. For adult men, the unemployment rate dropped from 4.7 percent to 4.1 percent from September 1977 to September 1978, while the corresponding figure for adult women was a drop from 6.9 to 5.9 percent and for teenagers a drop from 18.3 to 16.3 percent. In the previous fiscal year, adult women had experienced a decline in the unemployment rate only half as large as that for adult males. While the rate for teenagers declined somewhat in fiscal 1978, the absolute number of unemployed teenagers remained relatively constant.

Personal consumption spending was a key element in the economic developments of fiscal 1978. In a pattern reminiscent of the cold-weather-related stop-and-go movements of a year earlier, retail sales sagged during the first quarter of calendar 1978, recovered briskly, and then entered a period of relatively slow growth which continued until fall. The weakness in retail sales at the end of the fiscal year occurred in conjunction with a relatively low personal saving rate (5.2 percent) and some tightening in credit conditions, as reflected primarily in rising interest rates. The latter development was potentially important since it appeared that some consumption spending during the year had been financed by converting equity in existing homes into cash and this source of funds was presumably being made less attractive by rising interest rates. However, there was very little direct evidence that any seriously restraining effect on consumption spending was being exerted through this or other avenues. The ratio of consumer debt repayments to disposable income moved up during the fiscal year, but demographic and other factors have probably been raising the level of what constitutes an acceptable debt ratio for consumers. Therefore, the fiscal year closed without any obvious signs of weakness in the consumer spending picture.

Investment also played a key role in the economic developments which occurred during fiscal 1978. Nonresidential fixed investment in real terms increased at about a 4-percent annual rate in three out of the four quarters of the fiscal year. The second quarter of 1978 was the exception, however, and it witnessed a sharp jump in investment spending, particularly for nonresidential structures. The second quarter 1978 increase contributed substantially to the increase of 8.3 percent recorded for the fiscal year as a whole. Residential investment, on the other hand, stabilized at a

high level but did not provide much further net contribution to real growth, rising by only 1.5 percent for the year as a whole and posting small declines in the first and third quarters of calendar 1978.

The important fact was that the high levels of activity in the homebuilding industry which had been reached by the end of fiscal 1977 were essentially maintained in fiscal 1978, despite rising interest rates. This was accomplished, in large part, by the regulatory authorities allowing thrift institutions to issue money market certificates with yields geared to the 6-month Treasury bill rate. Inflows into thrift institutions were well maintained and mortgage lending continued at high levels. This was in marked contrast to earlier postwar experience when monetary restraint and high interest rates led to sharp contractions in mortgage lending and residential construction activity.

Business inventories were relatively stable over the course of the fiscal year and reflected the somewhat cautious behavior evident in this area after the inventory corrections of the beginning of fiscal 1977. In manufacturing, inventories came under increasingly tight control as evidenced by the steadily declining inventory-sales ratios for most industries. At the retail level, the only significant aberration was in the early cold-weather-related months and the inventory-sales ratio was little different from a year earlier as fiscal 1978 drew to a close. Wholesale inventories were only slightly tighter at the end of the fiscal year than they were at the beginning and also showed unusual stability during the period. Inventory-sales ratios in some general merchandising levels were relatively high by historical standards at the close of the fiscal year, but this was the exception, with most industries holding very low inventories relative to sales. The absence of inventory imbalance was a favorable development, suggesting that the expansion might well continue, rather than move into a recessionary phase. Indeed, by the close of the fiscal year, there were few signs that the expansion was running into its late stages. Growth had moderated but few of the traditional signs of cyclical imbalance had emerged. The main flaw in economic performance was an excessively high rate of inflation.

Inflation

The need to control inflation became an increasingly urgent task during fiscal 1978. At the beginning of the fiscal year, the Consumer Price Index for all urban workers was increasing at an annual rate slightly under 5 percent, a rate which represented substantial improvement from only 6 months earlier.

Following the fiscal 1977 pattern, however, prices again accelerated until mid-1978, when once again a moderating phase set in. Before the moderation occurred, however, the inflation rate had accelerated to a double-digit pace, reaching 11.4 percent (annual rate) for the 3 months ending in June. In the final quarter of the fiscal year the rate eased to 7.8 percent.

Also in a replay of 1977, the driving forces of the monthly price movements were concentrated in the behavior of food prices, and to a lesser extent in energy and services. Producer prices tended to exhibit somewhat the same pattern for the year except that both the acceleration and deceleration turning points in the index tended to occur a few months in advance of the equivalent movements in the Consumer Price Index. At the producer level, food prices were again the major contributor to the volatility of the quarter-to-quarter changes.

The behavior of industrial prices at the close of the fiscal year suggested that the recently observed moderation in price performance might prove to be short lived. Crude materials prices declined for 2 of the 3 months of the final quarter of fiscal 1978, but the final month recorded a 1.6-percent monthly rate of increase. The disturbing element here was that the earlier declines were largely due to decreasing prices of foodstuffs and feeds while the prices of other crude items continued showing a definite tendency to accelerate, a tendency which had been evident for several months.

Productivity in the private business sector was virtually unchanged in the final quarter of fiscal 1978 from the level which had prevailed a year earlier. Within the year the quarterly pattern was quite erratic, reflecting the influence of severe weather and the coal strike on the economy during the first half of calendar 1978. Increases in compensation per man-hour accelerated from the already rapid pace of fiscal 1977, going up at an annual rate of 9.3 percent for fiscal 1978. The net result of the productivity and compensation movements was a rapid acceleration in unit labor costs, which went up at a worrisome 9.1 percent for the year. Thus inflation which had been a major problem in fiscal 1977 became the most critical economic issue as fiscal 1978 drew to a close. Significant improvement on the price front was imperative to prevent distortions in consumption, saving, and investment patterns. Furthermore, the absence of progress in controlling inflation at home was beginning to undercut the dollar abroad.

The Budget and Fiscal Developments

The budget estimates for fiscal 1978 presented in January 1978 called for outlays of $462.2 billion and revenues of $400.4 billion, leaving a deficit of $61.8 billion. Outlays for the fiscal year actually turned out to be $450.8 billion and receipts $402 billion, producing a deficit of $48.8 billion. The major reason for the difference between the expected and realized budgetary outlays was the continued occurrence of outlay underruns. Much of the shortfall which occurred in the actual outlays figure was evident by the middle of calendar 1978. By that time it was becoming increasingly clear that as a result of accelerating inflationary pressures a shift in fiscal stance was in order and steps were not taken to combat or offset these shortfalls.

The slight addition to budgeted revenues in fiscal 1978 reflected legislative changes and higher receipts under existing tax statutes. Congressional action brought about slightly higher individual and corporate income taxes which were only partly offset by lower excise taxes. These changes accounted for about half of the gain in receipts compared with the January estimates, while higher receipts under existing legislation accounted for the other half.

Off-budget net outlays for fiscal 1978 were also somewhat lower than had been anticipated. In the January budget submission such outlays were expected to amount to $11.5 billion, including an offset of net revenues amounting to $78 million from the Exchange Stabilization Fund which, beginning in July, became a budget item (meaning, for comparison purposes, the January off-budget estimate should have been considered to be $11.6 billion). In the midsession review issued on July 1, off-budget outlays were estimated to amount to $11 billion. At the conclusion of fiscal 1978, total off-budget outlays were reported to have been $10.3 billion, with most of the decline from expectations attributable to a shift by the Postal Service from an expected deficit in excess of $800 million to a net revenue position just slightly below $500 million.

Domestic Finances

The financing of the record volume of funds raised in the financial markets in fiscal 1978 was facilitated by substantial inflows of funds to depository institutions, assisted by the introduction of the new money market certificates on June 1, 1978. These permitted savings and loan associations, mutual savings banks, and commercial banks to offer higher yields on 6-month certificates based on the yield on 6-month Treasury bills. Some $37 billion of these certificates were outstanding at the close of the fiscal year. The successful introduction of these certificates helped maintain the flow of funds into mortgage markets and supported a high level of residential construction activity.

Total funds raised aggregated some $453 billion during the fiscal year, up about 19 percent from $380 billion in fiscal 1977. Business—nonfinancial and financial institutions—moved into first place as the largest borrowing sector. Its borrowings increased by 32 percent, rising from $129 billion in fiscal 1977 to $170 billion in fiscal 1978, with the increase accounting for about 56 percent of the higher total borrowings. The nonfinancial corporate portion of the business sector raised about $91 billion, up from $71 billion in fiscal 1977, as the margin between corporate capital expenditures and internally generated funds widened. The greater share of the increase in corporate debt—about 57 percent—was funded at long term. Households, which had been the largest borrowing sector in fiscal 1977, raised $151 billion during fiscal 1978, for an increase of 13½ percent. Home mortgages accounted for nearly two-thirds of household borrowing and consumer credit for nearly one-third, with other borrowings

relatively small. Federal Government (Treasury) borrowings accounted for a slightly smaller percentage (13 percent) than in the year before, but a substantial rise in Federal agency borrowings resulted in a slight increase in the share of the Federal sector (including Federal agencies) in total borrowings. State and local government net borrowing, on the other hand, virtually leveled off, at about $25 billion.

The large volume of funds was raised in an environment of rising interest rates and some shift toward monetary restraint. Credit became more expensive during the course of the fiscal year but remained readily available. As is typical of periods of strong credit demand, the potential gap between funds raised and supplied was bridged by an increase in direct household purchases of market securities induced by rising interest rates. Thus, even though the ratio of financial intermediation to total funds raised declined from the levels of the previous 2 years, the credit markets functioned smoothly.

Short-term money market rates increased over the 12-month period, with most of the rise occurring in the second half of the year. By late September 1978, private short-term interest rates had climbed by 2 to 2½ percentage points to levels of 8½ to 8¾ percent, not seen in nearly 4 years. The prime lending rate to corporate borrowers at commercial banks rose from 7½ percent to 9¾ percent during the fiscal year. In the capital markets, yields on Treasury coupon issues and on corporate bonds climbed over most of the fiscal year, but dipped slightly towards the end. Intermediate-term issues rose about 1½ points over the fiscal year as a whole, while longer term Treasury and corporate bonds rose about 1 point. Municipal bond yields, on the other hand, advanced only about one-half of a percentage point. Even so, by the end of the fiscal year, all long-term yields were generally high by historical standards.

Federal Reserve policy moved in a restraining direction during fiscal 1978. The discount rate was raised in six steps from 5¾ percent to 8 percent by the end of the fiscal year. Federal funds, which had been trading close to 6 percent at the end of fiscal 1977, rose to the 8⅝ range by the end of fiscal 1978. Restraint was not as clearly reflected in the behavior of the monetary aggregates. The money supply on a narrow definition, consisting of currency and demand deposits (M−1), rose by 8.4 percent during the fiscal year, up slightly from 8.2 percent in fiscal 1977. On a slightly broader definition, including time deposits at commercial banks other than large certificates of deposit (M−2), the rise was 8.5 percent, down from nearly 11 percent in fiscal 1977.

Federal financing proceeded smoothly during the course of the fiscal year. Treasury net cash borrowing (excluding Government account transactions) totaled $60.2 billion, up from $54.8 billion in fiscal 1977. The bulk of Treasury financing was done in the intermediate area, with only a slight expansion over the period in Treasury bills outstanding in the market, following a net paydown of bills in fiscal 1977. A high priority continued to

be placed upon the issuance of longer term notes and bonds. As a result, the average length of the privately held marketable debt was increased from 2 years 11 months at the beginning of the fiscal year to 3 years 3 months at the end.

Of the $60 billion increase in public debt securities held by the public during the fiscal year, the Federal Reserve banks absorbed $11.6 billion. (Publicly held securities include nonmarketable issues as well as the market financing discussed above.) Commercial banks reduced their holdings by about $2.8 billion in the face of strong loan demand—a usual adjustment during a cyclical expansion. Household net purchases equaled $15.6 billion, of which savings bonds held by individuals accounted for $4½ billion. State and local holdings rose about $15 billion, in large part reflecting special nonmarketable issues, and foreign and international issues rose $26.3 billion. Corporations reduced their holdings by $6.7 billion, and nonbank financial and other investors increased theirs by $1 billion.

Taxation Developments

Tax policy developments reflected tax proposals to reduce tax burdens and provide economic stimulus coupled with tax reform to make the tax system fairer. Social security, energy, and urban matters were also reflected in tax policy.

In January 1978, President Carter proposed a $25 billion net tax reduction program for fiscal 1979. It provided for a gross reduction of $30.4 billion in fiscal 1979 offset, in part, by tax reform that would have increased tax liabilities by $5.4 billion.

The proposal also included: (1) Net cut, in individual income tax liabilities of $18.3 billion, comprising gross cuts of $22.6 billion and tax-raising reforms of $4.3 billion; (2) net business income tax cuts of $5.1 billion, reflecting gross tax cuts of $6.3 billion combined with $1.2 billion of reform; and (3) cuts in excise taxes and payroll taxes of $1.6 billion in fiscal 1979.

In May 1978, the administration trimmed the proposed tax cut from $25 billion in fiscal 1979 to $14.3 billion. The administration recognized that economic conditions had changed substantially since January 1978 and there was a need to get a better balance between monetary and fiscal policy. Inflationary pressures were mounting; employment was increasing, the unemployment rate was falling. Under these circumstances, a smaller budget deficit in fiscal 1979 was appropriate.

Congress gave immediate consideration to the President's proposals but had not enacted a tax program by the close of the fiscal year.

In March 1978, the administration proposed several tax incentives related to urban policy: An employment tax credit for the hiring of young and handicapped persons to replace the existing "new jobs" credit and an additional investment credit for certain investments made in distressed areas. "Small issue" industrial development bonds were to be limited to

distressed areas but the dollar limit on an issue increased. No final congressional action had been taken by the end of the fiscal year.

Acting on the President's proposals of May 1977 to resolve both short- and long-term financing problems in the social security system, Congress passed and the President signed on December 20, 1977, the Social Security Amendments of 1977. The amendments included the President's recommendation to correct a serious inflation-indexing flaw and to change the relationship of the self-employment tax rate to the employee rate.

Subsequent to the approval of the 1977 amendments and during congressional consideration of the President's 1978 tax program, various legislative efforts were made to modify or reduce the social security tax increases in the 1977 act. These actions were opposed by the administration, and the Congress did not approve any change.

The Congress continued to consider President Carter's comprehensive long-term national energy program proposed in April 1977 which included a number of tax penalty and tax incentive recommendations. At the close of the fiscal year, congressional consideration of these proposals and alternatives was proceeding with the nature of the eventual legislative outcome in doubt.

INTERNATIONAL DEVELOPMENTS

International Cooperation on Payments Problems

The central feature in the international monetary and payments sphere was the recurrent periods of pressure on dollar exchange rates that were associated with the continuing imbalances in international payments. Overall payments surpluses were especially prominent in Japan, Germany, and Switzerland, while the United States, Canada, and a number of other countries were in deficit. The recurrent periods of strain in the exchange market led to appreciation of the currencies of surplus countries in terms of the dollar. At times the exchange markets became nervous, uncertain, and disorderly, leading to substantial purchases of dollars by foreign central banks.

In the month of October 1978, in particular, very heavy sales of dollars took place, leading to rapid declines in dollar exchange rates against major currencies that were exaggerated by a seriously deteriorating market psychology. This situation was met by an important series of actions culminating in the announcements made by the President, the Treasury, and the Federal Reserve System on November 1, 1978. U.S. monetary policy was tightened, and major foreign exchange resources were arranged to finance participation by U.S. authorities in internationally coordinated market intervention. These announcements were followed by a rise in dollar exchange rates and by more balanced and orderly exchange market conditions.

Faced with the problems presented by these imbalances of payments, the United States and the major industrial nations took action during the year along three broad and interrelated lines of approach.

The first of these three aspects was a series of policy measures of fundamental importance taken by the United States to deal with underlying economic factors that exerted a powerful influence on both the external and internal value of the dollar. In the sphere of energy, the Congress, after long and arduous deliberations, enacted an energy bill, designed to reduce dependence on imports of oil by an amount estimated at up to 500,000 barrels per day from the level otherwise expected, as early as 1979, with further import reductions in later years. These reductions would decrease the anticipated deficit in the current accounts and thus contribute to correcting the imbalance in world payments.

As the year progressed, and output and employment continued to advance closer to the economy's potential, prices began to move upward in the United States, with consumer prices rising at an annual rate of 8.0 percent in July–September 1978, as against 6.7 percent a year earlier. By contrast, in Germany and Japan, consumer prices were rising only about 2½ and 4 percent, respectively, in the third quarter of 1978, and the rate of growth had been declining during the year. Slower growth relative to potential in those countries was considered to be one factor in their divergence from U.S. price behavior, which contributed to the strength of their currencies vis-a-vis the dollar in the exchange market.

To cope with the resurgent inflationary pressures, fiscal policy in the United States was modified during the year, resulting in a budget deficit estimated at $33.2 billion for fiscal 1979, as compared with $48.8 billion in fiscal 1978. For fiscal 1980, the President has proposed that the deficit be reduced to $29 billion. This is roughly 1 percent of gross national product, and it compares with a deficit of $66 billion in fiscal 1976, which was about 4 percent of gross national product.

Monetary policy also became progressively more restrictive during the year, with the average Federal funds rate rising from 5.82 percent in the third quarter of 1977 to 8.45 percent in September 1978 and later to 9¾ percent or more after the Federal Reserve's discount rate was raised from 8½ to 9½ percent on November 1, 1978. Some reserve requirements were also tightened at that time. The uncovered margin between short-term dollar rates and German and Japanese rates widened markedly, providing an interest incentive to international investors.

In October 1978, the President announced a broad, tough, and determined anti-inflation program designed to slow down the rate of change in wages and prices.

To promote exports, the President also announced on September 26, 1978, a series of measures committing the administration to placing a higher priority on exports. Congress will be asked to increase the loan authorization of the Export-Import Bank; intensified efforts were an-

nounced to reduce domestic governmental barriers to U.S. sales abroad; and the Treasury was directed to negotiate more effective international arrangements to restrain excessive subsidies through export credit procedures.

The second of the three broad approaches to the problem of international imbalance was encouragement of policy measures that would stimulate domestic-led economic growth in the major surplus countries. Responding to international consultations, including meetings of Ministers and heads of government, Germany and Japan adopted programs designed to maintain or expand rates of growth, and thus to reduce their excessively large trade and current account surpluses. Comparing the third quarter of 1978 with the third quarter of 1977, the German rate of real growth had risen from about 2 percent per annum to 4 percent, but the Japanese rate had advanced only from about 5½ percent to nearly 6 percent.

The appreciation of the currencies of these countries, together with their increased growth rates, began to have an impact on physical volumes of exports and imports of Germany, Japan, and Switzerland in 1978. However, dollar prices of exports rose more rapidly than dollar prices for imports, including oil, and this caused the combined current account surpluses of these three countries, in dollar terms, to rise from about $18 billion in calendar 1977 to an estimated $30 billion in calendar 1978.

From a longer term perspective, compound annual rates of real economic growth in the decade 1962–72 were substantially higher in other industrial countries than the figure of 3.9 percent for the United States. Corresponding figures were 10.3 percent in Japan, 5.5 percent in Canada, and 4.5 percent in industrial European countries. In 1977, by contrast, foreign growth rates on average were well below the U.S. figure of 4.9 percent. Corresponding figures were 5.3 percent in Japan, 2.7 percent in Canada, and 2.1 percent in European industrial countries in that year. This sizable shift in relative economic progress had affected the U.S. trade position adversely in 1977. The movement towards a narrower divergence in real growth rates that has occurred in 1978, and that is expected to continue in 1979, should over time have a favorable impact on the trade and current account positions.

In the nonoil developing countries, the growth in output was relatively well sustained at about 5 percent in both 1976–77 and 1977–78, a level somewhat higher than in the major industrial countries.

The third major line of approach to international cooperation in correcting imbalances was the response to disturbed and increasingly disorderly market conditions through evolving intervention policies. During the year, U.S. intervention became more forceful as market conditions changed.

At the beginning of the fiscal year, the dollar encountered generalized and continuing selling pressure in increasingly unsettled foreign exchange market conditions. These conditions reflected, in particular, the sharply rising U.S. trade deficit, the delays in completion of U.S. energy legislation, and concerns that growth rates among major industrialized nations

would not soon converge. In January 1978, the Treasury began to use the Exchange Stabilization Fund actively, along with the resources of the Federal Reserve System, in foreign exchange market operations. Treasury operations were financed by drawings of German marks against a swap agreement concluded with the Bundesbank on January 4, 1978.

In March, Secretary Blumenthal and the German Finance Minister reaffirmed that forceful action would be continued to counter disorderly market conditions. In this connection, in order to provide further foreign currency resources if needed, the Treasury announced that arrangements had been made for the sale of SDR 600 million to purchase German marks, that the United States was prepared to draw against its reserve position in the International Monetary Fund, and that the Federal Reserve and Bundesbank had agreed to double the amount of their swap arrangement from $2 billion to $4 billion.

In early April, selling pressure on the dollar intensified following the release of U.S. trade figures showing a record $4.5 billion deficit in February. Later in April the Treasury announced that a series of monthly public auctions of gold would be initiated in May, amounting to 300,000 ounces at each of the first six auctions, which would reduce net imports of gold.

In August, the Treasury announced that the amount of gold offered would be increased to 750,000 ounces beginning with the November auction. At that time, a congressional compromise on the natural gas bill was achieved, paving the way for passage of energy legislation. The Federal Reserve moved to increase U.S. interest rates further and reduced reserve requirements on Eurodollar borrowings by U.S. banks.

Swap indebtedness to the Bundesbank, incurred by the Treasury and Federal Reserve to finance foreign exchange market operations in German marks, reached a peak in early April 1978 of $2,284 million. However, by the end of the fiscal year, this indebtedness had been reduced to $1,031 million.

During October, it became evident that the severe and persistent disorder and excessive decline in the dollar were undermining U.S. efforts to control inflation and adversely affecting the climate for continued investment and growth in the United States. The market did not respond favorably to the President's comprehensive anti-inflation program and was failing to take account of the improvements that were being made in the underlying conditions that determine the dollar's value.

Accordingly, on November 1, 1978, the President, the Secretary of the Treasury, and the Chairman of the Board of Governors of the Federal Reserve System announced a series of major corrective actions. The Federal Reserve raised the discount rate from 8½ to 9½ percent and imposed a supplementary reserve requirement on large time deposits. The U.S. authorities joined Germany, Switzerland, and Japan in closely coordinated exchange market intervention. To finance the U.S. participation in the

coordinated market intervention, the United States announced that it would mobilize up to $30 billion in the currencies of those three countries. These resources were to be obtained by drawings on the IMF, sales of special drawing rights (SDR's) to foreign monetary authorities, increases in Federal Reserve swap lines, and by the issuance abroad by the Treasury of up to $10 billion in securities denominated in foreign currencies. The Treasury also increased its monthly sales of gold to at least 1½ million ounces per month, starting with the December auction.

The market responded favorably to these measures, dollar exchange rates rose from the October lows, and more orderly conditions resulted.

Changes in Dollar Exchange Rates, Gold Market Prices, and Global Reserves

Persistent large current account surpluses of Japan, Germany, and Switzerland reached a combined total of nearly $30 billion during the 12 months ending September 30, 1978. These surpluses were not fully offset by outward nonofficial capital movements. The currencies of those countries appreciated by 40, 19, and 50 percent, respectively, in terms of the U.S. dollar, from September 30, 1977, to the end of September 1978. There were also substantial accumulations of reserves by the three countries, amounting to about $20 billion during fiscal 1978, which absorbed a substantial amount of market pressure on their currencies.

Overall, during the fiscal year, the dollar depreciated by 12.5 percent on a trade-weighted basis, as against the other Organization for Economic Cooperation and Development (OECD) currencies, and by 9.2 percent in terms of the SDR.

Gold market prices rose from about $155 per ounce at the beginning of the fiscal year to about $188 per ounce in March 1978. After declining to about $168 per ounce in the latter part of April, the gold price resumed rising in May. The price was about $218 per ounce at the end of the fiscal year, representing an increase of about 40 percent during the fiscal year. Under the Treasury's monthly program, sales of gold to the public were conducted by the General Services Administration on a competitive bid basis. Through September 30, 1978, proceeds of the sales totaled nearly $300 million.

The oil-exporting group of countries, for the first time in several years, reported to the IMF a decline of about SDR 15 billion (nearly $19 billion) in reserves during the fiscal year, though part of this appears to be accounted for by reclassification of some assets into a nonreserve and unreported category. Other developing countries continued to build up their aggregate reserves at a somewhat faster rate than the industrial country group. For the world as a whole, reported reserves increased to SDR 264 billion ($338 billion) at the end of September 1978, as compared with SDR 249 billion ($290 billion) a year earlier, an increase of about 6 percent in SDR terms, and 17 percent measured in dollars.

The International Monetary System and the International Monetary Fund

The entry into force of the second amendment of the IMF Articles of Agreement, on April 1, 1978, represents the most fundamental change in the international monetary order since the Bretton Woods system was established in 1944. The United States had earlier accepted the amendment pursuant to Public Law 94–564, effective October 19, 1976.

The central features of the new international monetary system, as embodied in the amended IMF Articles, are:

- Members are given wide latitude in the choice of exchange rate practices, subject to specific undertakings regarding promotion of orderly underlying economic and financial conditions and avoidance of unfair exchange rate practices. The IMF is given expanded authority for surveillance over exchange rate policies to ensure that members comply with their obligations;
- Concrete steps to reduce the monetary role of gold, including the abolition of the official price of gold, the elimination of gold's function as the "numeraire" of the system and as an important instrument in IMF transactions, and provision for continued disposal of the IMF's gold holdings;
- Changes in the characteristics and expansion of the uses of the SDR, designed to enhance its role in the system;
- Changes in the IMF's operation and organization to modify obsolete provisions, simplify operations, and adopt structural changes.

The increase in IMF quotas agreed in 1976 also became effective on April 1, 1978. Total Fund quotas were raised from SDR 29.2 billion to SDR 39 billion (about $50 billion). The U.S. quota was increased from SDR 6,700 million to SDR 8,405 million, pursuant to Public Law 94–564.

Legislation required for U.S. participation in the Supplementary Financing Facility was passed by Congress and signed by the President. The facility will temporarily supplement the IMF's resources by credit lines from members of approximately $11 billion, and should enable it to provide more financing to members experiencing particularly difficult payments problems. The U.S. share in the facility is approximately $1.8 billion, 17 percent of the total.

At the September 1978 meeting of the IMF's Interim Committee, a consensus was reached in support of two major additional measures to strengthen the International Monetary Fund and the monetary system: A 50-percent increase in IMF quotas and new allocations of SDR's totaling approximately SDR 12 billion, to be issued over 3 years.

The continued uncertainties in the world economy—and the associated wide range of world payments patterns which could develop—argued for a substantial increase in Fund quotas. The 50-percent increase was the result of the seventh periodic review of quotas, and is intended to cover the next 5 years. It is mainly equiproportional; i.e., equal percentage in-

creases for most countries, with only 11 developing countries receiving selective quota increases.

The consensus on SDR allocations reflects the view that SDR allocations should provide a part of the growth of reserves as international transactions continue to expand in value, and that such allocations will help to assure the viability and credibility of the SDR as a reserve asset and will assist the SDR in fulfilling its longrun potential in the international monetary system.

Financial Relations with Non-OPEC Developing Countries

The overall economic situation of the non-OPEC developing countries in 1977–78 was mixed with significant improvments being made in some indicators and less progress in others. Current account deficits for the group, which declined significantly to $26 billion (excluding official transfers of funds) in calendar 1976 and fell further to $22 billion in calendar 1977, have been projected to rise in calendar 1978 to about $28 billion.* This nominal increase is not significantly different from historical averages when world inflation and economic growth are factored in, and it should not pose financing difficulties for the group as a whole.

Total official and private flows to non-OPEC developing countries have been more than adequate to cover the aggregate current account deficits. Official development assistance (grants and loans) from Development Assistance Committee countries and multilateral institutions to less developed countries (LDC's) as a group increased in 1977 to about $15 billion; concessional and nonconcessional flows from OPEC countries to non-OPEC LDC's were about $5 billion. Gross foreign exchange reserves of the non-OPEC LDC's increased 29 percent to about $53 billion by the end of calendar 1977. Data for December 1978 showed slower growth in aggregate reserves although it is estimated that import coverage did not decline.

During 1978, the United States continued its policy of placing increased emphasis on the role of the multilateral development banks in providing financing for sound projects and programs in developing countries. These institutions, including the World Bank group, the Inter-American Development Bank, the Asian Development Bank, and the African Development Fund, provided almost $12 billion in loans during the year, of which nearly $4 billion was on concessional terms for the poorest countries.

A paramount objective of U.S. policy in the banks has been to encourage projects which reach poor people in recipient countries and which help meet the basic human needs of these people. For this reason, the United States has favored greater priority in bank lending for the agricultural sector and for those projects which improve health, education, and nutrition. In working toward this objective, the United States has also

*Including official transfers of funds (grants only) to these countries, their deficits were approximately $17 billion in 1976, $12 billion in 1977, and are projected at about $16 billion for 1978.

proposed the channeling of more assistance to small-scale enterprises and the development and use of labor-intensive and capital-saving technologies. During 1978, significant progress was made in reaching the poor through changes in the sectoral composition of lending to meet basic human needs, modifications in the design of projects to pass greater benefit to poorer people, and increased use of aid leverage to encourage policy changes in developing countries.

Improvement of human rights conditions in recipient countries has also been an important policy objective of the United States. Accordingly, during 1978, the United States used its voice and vote on a number of occasions in the multilateral development banks to advance these rights. Other issues within the banks on which substantial progress was made in 1978 included greater availability of information concerning the operations of the banks, improved audit procedures, and reduction of administrative costs including travel and compensation.

The Congress appropriated $2,514 million for U.S. subscriptions and contributions to the multilateral development banks for fiscal 1979, up from $1,925.5 million in fiscal 1978. Of this amount, $1,258 million represented contributions to the International Development Association, including $800 million for the second installment of the fifth replenishment of resources and $458 million for the fourth replenishment of resources. Under the same appropriation, $265 million was made available to the Asian Development Bank; $763 million to the Inter-American Development Bank; $163 million to the International Bank for Reconstruction and Development; $40 million to the International Finance Corporation; and $25 million to the African Development Fund.

The appropriations legislation enacted by the Congress also included the following provisions: That the U.S. Governors of the banks propose and seek the adoption of amendments to the Articles of Agreement to establish human rights standards to be considered in connection with each application for assistance; that international consultations be initiated to develop a viable standard for allocation of development assistance for production and export of commodities; and that the United States oppose loan proposals for the production for export of surplus commodities which would cause substantial injury to U.S. suppliers of similar or competing commodities.

The IMF/IBRD Development Committee, which was established in 1974 to maintain an overview of the development process especially regarding the transfer of resources to developing countries, continued to provide a forum for discussion of important issues. The United States is represented on the Committee by the Secretary of the Treasury.

The Department of the Treasury participated actively in the formulation of U.S. development assistance policy through its membership in the National Advisory Council on International Monetary and Financial Policies, in the Development Coordination Committee (DCC), and in various other

interagency committees designed to coordinate economic assistance programs. Under the reorganization of the DCC, four new subcommittees were established to treat issues in the specific areas of multilateral assistance, bilateral assistance, food aid, and international organizations. Treasury assumed responsibility for chairing the Subcommittee on Multilateral Assistance.

Treasury continued to follow developments in international indebtedness. In January 1978, Treasury submitted to Congress the administration's fourth annual report on developing countries' external debt and debt relief provided by the United States. The report is comprehensive, containing detailed information on the debt situation of major debtor countries and the means by which the United States and other creditor countries have dealt with debt service programs. During fiscal 1978, the United States participated in multilateral debt reschedulings for Zaire and Turkey.

Trade

Treasury activities in the trade area during the fiscal year centered on continuing efforts to secure significant trade liberalization and reform of the international trading system, as well as on specific trade problems and new efforts to reduce our record trade deficit.

Treasury continued to participate actively in drafting proposals for a subsidy/countervailing duty code within the multilateral trade negotiations in Geneva, as a prerequisite for U.S. adherence to the final package of agreements. The Department also participated actively in the adoption of positions with respect to tariffs, safeguards, customs matters, and special treatment to developing countries. In July 1978, the major trading nations agreed upon a basic "framework of understanding" for these negotiations, which the Bonn economic summit agreed should be completed by December 15.

A number of special import problems also developed during the year, the most important relating to steel imports allegedly dumped in the U.S. market. To assure prompt investigation of potential dumping in the future, an interagency steel task force chaired by Under Secretary Solomon proposed, and the administration adopted, a trigger price mechanism (TPM) for steel imports. The TPM is part of a comprehensive steel program to modernize and improve the competitive position of the U.S. steel industry.

A new International Arrangement on Export Credits was negotiated. This constituted a useful, if limited, instrument of international discipline in the provision of officially supported export credits. The clear need for substantive improvements in the Arrangement caused the Secretary to undertake renewed consultations with major trading nations in the fall of 1978 to strengthen and broaden the Arrangement.

In September 1978, the United States adopted a new national export policy to encourage U.S. exports, as one means of helping to reduce the record U.S. trade deficit. The new program includes efforts to assure fully competitive financing through the Export-Import Bank and to minimize Government disincentives to exports. Export expansion should also assist our broader efforts to maintain confidence in the dollar and stimulate continued domestic economic growth.

The East-West Foreign Trade Board, chaired by the Secretary of the Treasury, continued to monitor trade with the nonmarket economy countries to insure that it remained consistent with the national interests of the United States. Secretary Blumenthal participated in the meeting of the U.S.-U.S.S.R. Trade and Economic Council in Los Angeles on November 14, 1977. In December 1978, Secretary Blumenthal served as Cochairman of the Joint U.S.-U.S.S.R. Commercial Commission during its Seventh Session at Moscow. He also conferred with Chairman Brezhnev and other Soviet leaders, and addressed a meeting of the U.S.-U.S.S.R. Trade and Economic Council. He subsequently visited Bucharest, where he met with President Ceausescu and other Romanian officials.

Investment

In the international investment area the U.S. Government placed special emphasis during the past fiscal year on the problems associated with governments' use of (1) subsidies to induce investors to locate in their territories and (2) other measures to tilt the benefits of such investments their way. Several initiatives, which the Treasury played a key part in developing, were taken in international organizations and on a bilateral basis. In the OECD the Committee on International Investment and Multinational Enterprises (CIME) has agreed, at the suggestion of the United States, to undertake a comprehensive examination of the effects of investment incentives, performance requirements, and other measures on international economic relations. This work will begin after the CIME's review of the 1976 OECD Investment Declaration, a part of which covers investment incentives and disincentives. Bilateral consultations between the U.S. and Canadian Governments were also begun, and will continue in fiscal 1979, on governments' use of investment incentives. These consultations were initiated after the Canadian Government gave a subsidy to an American automobile manufacturer to induce it to locate a new plant in the Province of Ontario.

The incentives issue was also among those relating to the role of foreign investment in development that were pursued in a working group of the IMF/IBRD Development Committee. The group completed its work in December 1978, with the preparation of a report to the Development Committee regarding appropriate policies for developed and developing countries. Discussions are now underway to establish a small task force

consisting of policy-level officials from a few countries to continue and give added emphasis to this work.

Regarding inward investment, the Committee on Foreign Investment in the United States, an interagency group chaired by Treasury, met during the fiscal year to review current trends in and coordinate U.S. policy on such investment. One of the Committee's major concerns was foreign investment in U.S. farmland. It served as a forum for coordinating the positions taken by executive branch agencies in congressional discussions of the issues and legislative proposals relating to it.

The House and Senate committees with legislative responsibility approved plans submitted by Treasury for a survey of foreign residents' portfolio investment in the United States and authorized the funds required to initiate this project. The last such survey conducted by Treasury was in 1974. Questionnaires were to be mailed in November, the reporting or "as of" date being December 31, 1978, and respondents are being requested to file their reports by the end of March 1979. Up to a year will be required to tabulate and check the roughly 10,000 expected responses. Treasury plans to file a report with the Congress by the end of 1980. In addition, the feasibility of surveying U.S. residents' portfolio investment abroad is being studied. If such an outward survey is conducted, its outcome will be reported in 1981.

Energy

In the energy area, the key issues continued to be price, supply, and development of indigenous energy resources in the United States itself and also in the oil importing developing countries. The Bonn economic summit gave major attention to these issues, as well as to the growing dependence of the United States on imported oil. In this regard, President Carter committed the United States to adoption of a comprehensive energy program by the end of the year that would result in oil import savings of 2.5 million barrels per day by 1985.

During the year, the U.S. current account deficit, the national energy program, and oil prices became intimately linked. Our deficit was increasingly a result of excessive oil imports, while the depreciation of the dollar led to renewed pressure within OPEC for an oil price increase.

In their relations with the developing countries, the developed countries took steps to intensify cooperation in energy research and development, with special attention to renewable energy resources and technologies. The United States continued to stress the importance of adequate investment in indigenous energy resources and the role of the multilateral development banks and the private sector in fostering energy development.

The World Bank adopted new policies in July of 1977 which significantly enlarged its participation in the development of energy resources of the developing nations. A Petroleum Projects Division was established to

coordinate this. In 1978, missions were sent to a dozen developing countries to identify and prepare projects aimed at oil and gas production.

Loans have been approved by the World Bank group to India ($150 million), to Zaire ($4.1 million), Turkey ($2.5 million), and Pakistan ($30 million) for training of technicians and for petroleum development.

In response to the Bonn summit request, the World Bank sent a report to the Board in November of 1978 on the first year of this program, together with proposals to extend the group's activities into energy exploration in the oil-importing LDC's.

Commodity Policy

During fiscal 1978, the United States continued to develop and refine its basic initiatives in commodity policy. In these discussions, the United States has advocated commodity proposals that would work to the mutual benefit of producers and consumers.

Foremost among commodity problems is the sharp fluctuation of prices which is detrimental to stable economic growth in both developed and developing countries, by giving rise to near-term inflationary pressures and by discouraging investment in commodity industries. To remedy the situation in the most volatile markets, the United States has supported, where feasible, the negotiation of international commodity agreements. These agreements, operating to the maximum possible extent through buffer stocks, are aimed at stabilizing prices within a broad range around their long-term trends while at the same time allowing for the play of market forces to promote an efficient allocation of resources. Currently, international commodity agreements are in effect for tin, coffee, and cocoa (though the United States is not a member of the latter); a sugar agreement was negotiated in fiscal 1978, but has not as yet been acted upon by Congress. Discussions which may eventually lead to agreements have been undertaken for wheat, natural rubber, and copper. Proposed negotiation of a tungsten agreement was rejected as technically infeasible by the United States and other industrial countries.

To assist in financing buffer stock activities designed to reduce instability in commodity prices, the United States actively participated in the November 1977 negotiating conference on a common fund. The industrial countries presented a proposal at that session for the consolidation of individual international commodity agreement financial resources in a common fund that would lower the paid-in financial requirements for each agreement. To provide for more equitable sharing of financial responsibility for the agreements, the proposal implicitly assumes participation of consuming and producing countries in their financing. The developing countries presented their own proposal for a common fund which would be financed by mandatory direct government contributions and which would contain a second window to finance non-buffer-stocking measures for commodities and a voting structure which would give developing countries a controlling voice in decisions.

The differences between the two approaches prevented agreement in the November 1977 session. Subsequent informal discussions took place in Geneva in an attempt to narrow the differences. These discussions led to a resumption of the negotiations in November 1978. The resumed negotiations saw some convergence of views, with the developed countries indicating a willingness to accept an element of direct contributions in the financial structure of the fund and some possible activities which the second window might finance. However, developing countries insisted on a larger role for direct government contributions in the financial structure of the fund, and a broader scope for the second window, than developed countries could accept. These differences between the developed and developing countries reflected different conceptions of the nature and role of the fund, and the negotiating session concluded without reaching agreement. Another conference is scheduled for early 1979.

The administration undertook a commitment to contribute tin to the International Tin Agreement buffer stock. Although considerable support for it developed in Congress, legislation faltered late in the session because of Congress's inability to settle policy with respect to disposals from the U.S. strategic stockpiles.

The United States participated in the Third United Nations Conference on the Law of the Sea which met twice in 1978 and will reconvene in the spring of 1979. Much of the discussion at these two sessions centered on the deep seabed mining regime, as serious differences persist between the industrialized and the developing countries on the scope, nature, and organization of this regime.

The Congress considered seabed mining legislation in 1978 which would have authorized the licensing of private firms to begin mining the seabeds. The legislation passed the House of Representatives, but was not acted on by the full Senate. It is expected that such legislation will again be considered at the next session of Congress.

The staffs of the International Monetary Fund and World Bank undertook an examination of the provisions of and possible changes in the compensatory financing facility of the International Monetary Fund. Their analysis showed heavy use of the facility in 1975–76 and indicated the effects of possible changes. Action on the need for any changes will await the results of the full-scale review now scheduled for the spring of 1979.

Major International Meetings and Consultations

During the spring and summer of 1978, the Secretary took part in the meeting of the Interim Committee of Governors of the International Monetary Fund in Mexico at the end of April, the OECD Ministerial meeting in Paris in mid-June, and the Bonn meeting of heads of government of seven industrial countries in July. Through these meetings a consensus was reached on the major policy adaptations needed for achieving further progress toward better balanced growth among major industrial countries.

A meeting of the IMF/IBRD Development Committee in September 1978 was held at the time of the annual meeting of the Boards of Governors of the two institutions. The Committee commented favorably on the Bank's World Development Report, reviewed the Committee's work program, and agreed to establish a Task Force on Foreign Direct Investment.

Secretary Blumenthal visited the Middle East twice over the past 2 years to discuss U.S. economic and financial concerns with the leaders of important countries in that area. In October 1977, he visited Egypt, Israel, Kuwait, Iran, and Saudi Arabia. In November 1978, he met with the leaders of Saudi Arabia, the United Arab Emirates, Iran, and Kuwait.

United States/Saudi Arabian Joint Commission

While in Saudi Arabia, Secretary Blumenthal headed the U.S. delegation and served as Cochairman of the Fourth Session of the Commission, held in Riyadh November 18–19, 1978. Three new technical cooperation agreements were signed, in the areas of transportation, agricultural bank operations, and executive management development.

The Joint Commission now is implementing 20 major projects, with a total ultimate value of over $850 million.

Funding of the International Affairs Function of Treasury

The Congress, in early October 1978, terminated the financing of administrative expenses by the Exchange Stabilization Fund, to become effective when appropriations become available.

INTRODUCTION

This section reviews developments which affected areas of Treasury interest and responsibility during fiscal 1979. Only major domestic and international developments are covered since detailed information on the operating and administrative activities of the Department is provided in the body of the report. Statistical information is presented in the separate Statistical Appendix.

DOMESTIC DEVELOPMENTS

The Economic Expansion

The economic upswing which began at the end of the first quarter of 1975 faltered somewhat during fiscal 1979. The first quarter of the fiscal year registered relatively strong growth, and the final quarter was unexpectedly buoyant. Real GNP at the close of fiscal 1979 was 1.8 percent higher than a year earlier. Fiscal 1978 saw a 3.9-percent increase. The most disturbing domestic economic development in fiscal 1979 was a resurgence of inflation averaging about 9½ percent as measured by the fixed weight GNP deflator.

As in 1978, the economic growth during 1979 was interrupted by severe winter weather. Unlike 1978, however, a rebound did not follow in the second quarter of the calendar year. Instead, real GNP declined that quarter at a 2.3-percent annual rate. In retrospect, it is clear that special factors were a major influence in the decline in economic activity in the second quarter. The Teamsters strike disrupted production patterns early in the quarter, while reduced and uncertain availability of gasoline cut into consumer demand late in the quarter. At the time, the decline led many observers to believe the recession expected in the latter half of calendar 1979 had begun. But the resumption of growth—at a 3.1-percent annual rate—in the final quarter of fiscal 1979 clouded the picture and made assessment of the economy's momentum less certain.

During the course of the fiscal year, economic policy shifted increasingly toward controlling inflation. The unemployment rate remained low despite slower economic growth while the inflation rate, particularly as reflected in the Consumer Price Index, accelerated and proved resistant to measures aimed at bringing it down. Domestic costs and prices received a further upward jolt in the early summer when the Organization of Petroleum Exporting Countries imposed an additional price increase of some 60 percent on imported crude oil.

Personal consumption spending was a key element in shaping the pattern of economic developments during fiscal 1979, rose by about 2.3 percent in real terms, down significantly from a 4.8-percent increase in the previous fiscal year, but about in line with the 2.2-percent rise in real final sales during the fiscal year. However, the quarterly pattern of consumption expenditures was extremely uneven.

After a brisk start during the first quarter of the fiscal year, consumer spending sagged during the next two quarters before showing surprising strength again in the final fiscal quarter. The weakness in the second quarter probably reflected adverse weather conditions, but the failure of the economy to rebound in the succeeding quarter requires other explanations. Possible alternatives are that the weakness represented a real retrenchment by consumers, that it was a reflection of the acceleration of price increases, or that recovery was forestalled by short gasoline supplies. The rebound in real consumer outlays in the final quarter of the fiscal year when supplies of gasoline were more readily available underscores the third explanation as the probable cause of the slowdown.

Previously, spending had been growing at a rate in excess of income growth and had depressed the personal saving rate to 4.7 percent, the lowest rate since the early 1960's—except for the first quarter of 1977. In the two weak quarters the personal saving rate moved up to 5.0 percent, then 5.4 percent. In the final quarter of fiscal 1979, however, it decreased to 4.3 percent.

Inflation also accelerated markedly in the second quarter. As measured by the implicit price deflator for personal consumption expenditures, inflation accelerated from a 6.9-percent annual rate in the first quarter to 10.8 percent in the second. The pace eased to around 9½ percent during the latter half of the year. Rising prices kept nominal retail sales climbing all during the period of weakness in real retail sales, thus adding some support to the inflation explanation of consumer behavior. However, the resurgence of retail sales in the final quarter of the fiscal year in the face of high rates of inflation was difficult to explain, as was the apparent upturn in some of the major indexes of consumer confidence. At the end of the fiscal year, neither basic consumer attitudes on the likely course of economic activity nor their reactions to inflation were very clear.

Investment spending exhibited noticeable gyrations during fiscal 1979. Real gross private domestic investment (which includes fixed residential and nonresidential investment, as well as inventory investment) dipped lower in the second quarter, contributing to the lackluster growth of that period. It expanded at an 8.5-percent annual rate during the third quarter (when real GNP declined) and was down a sharp 12.8-percent annual rate in the last quarter (when real GNP growth resumed). Swings in inventory investment were the main factors in that jagged pattern. After three consecutive quarters of steady increases at about a $12 billion annual rate, inventory additions suddenly jumped by about 50 percent in the third quarter of the fiscal year (to an $18.1 billion annual rate), then dropped back to $7.1 billion in the final

quarter when consumer spending accelerated, partly under the stimulus of sales incentive contests and rebates in the auto industry.

Business inventory-sales ratios (in real terms) drifted higher as the year progressed. Most of that increase reflected a rise at the manufacturing level. Wholesale inventory-sales ratios were virtually unchanged from the previous year, while the slight drift upward in retail inventories of autos was offset elsewhere in that sector, thus keeping the retail inventory-sales ratios (in real terms) at the end of the fiscal year 1979 equal to that of a year earlier.

The pattern of fixed investment during the course of the year paralleled that of the overall economy. Nonresidential fixed investment started and ended the fiscal year strongly, with annual rates of growth around 11 percent in real terms. Second-quarter growth was substantially weaker and was followed by an 0.8-percent annual rate decline in the third quarter. A second-quarter drop in investment in structures, and then a large falloff in investment in producers' durable equipment, led to midyear weakness.

Residential fixed investment in real terms declined by 6.1 percent during the fiscal year, with each quarter registering a real decline from the quarter before. An especially sharp 14.3-percent annual rate decline was recorded during the second quarter of the year, but real spending continued to slide through the remainder of the year as construction activity was affected by tighter financial conditions and a more cloudy economic outlook.

Employment growth in fiscal 1979 was only about two-thirds as large as in 1978. It did, however, about match the growth in the labor force, leaving the total number of persons unemployed at yearend virtually unchanged from the year-earlier figure. Total employment increased by 2.5 million persons (2.6 percent). The unemployment rate stood at 5.9 percent in September 1978 and 5.8 percent in September 1979, reflecting the approximately equal growth in the labor force and in employment. During the year, the unemployment rate as a whole remained quite stable with a low of 5.6 percent (June) and a high of 6.0 percent (August).

The marginal improvement in the unemployment rate during the year solely reflected improved job opportunities for adult females. Their unemployment rate declined moderately over the year, from 5.9 percent to 5.5 percent. The unemployment rate of adult males remained essentially unchanged, moving up only 0.1 percent to 4.2 percent in September 1979. The high teenage unemployment rate also remained basically the same, 16.4 percent, as employment declined slightly more than this component of the labor force.

Inflation

The need to control inflation increased in fiscal 1979. At the beginning of the fiscal year, the Consumer Price Index for all urban workers was increasing at an annual rate of over 10 percent. Some improvement was recorded over the first quarter, but prices rose rapidly across the board in January. Food, energy, medical care, and homeownership prices all accelerated, with food and energy both moving up at annual rates in excess of 18 percent. The rise in food prices

moderated substantially in the third and fourth quarters, but energy prices continued to surge throughout the year and increased at an annual rate of over 60 percent during the final quarter of fiscal 1979.

Industrial prices in all three major categories—crude materials, intermediate materials, and finished goods—rose at annual rates in excess of 15 percent during the final quarter.

Productivity in the nonfarm business sector of the economy in the final quarter of fiscal 1979 was 1.8 percent below the year-earlier figure. During the year, only the first quarter recorded a gain from the prior quarter (0.8 percent, annual rate), while declines were registered in each of the next three quarters (3.2 percent in the second, 4.1 percent in the third, and 0.8 percent in the fourth). Increases in compensation per hour were relatively steady at annual rates of around 9 percent. The combination of declining productivity and relatively constant rises in compensation per hour produced a rapid acceleration in unit labor costs. At the end of the fiscal year, unit labor costs were 10.9 percent higher than the previous year. The corresponding increase over the course of fiscal 1978 was 8.1 percent.

The Budget and Fiscal Developments

The budget estimates for fiscal 1979 presented in January 1979 called for outlays of $493.4 billion and revenues of $456 billion, leaving a deficit of $37.4 billion. Final figures for the year revealed outlays to have been $493.2 billion and revenues of $465.9 billion, producing a deficit of $27.3 billion. The major reason for the difference was higher than expected receipts, as employment and personal income performances exceeded the projections made at the time the budget was submitted in January.

Budget outlays for 1979 were very close to the January estimate, but only as a consequence of offsetting changes. The largest increases were for military procurement ($2.9 billion) and the Farmers Home Administration ($1.4 billion). The largest decreases were for the Commodity Credit Corporation ($1.5 billion) and military assistance programs ($1.4 billion).

Off-budget net outlays for fiscal 1979 were slightly larger than anticipated. In the January budget submission, such outlays were expected to amount to $12 billion. The actual figure was $12.4 billion, with an increase in outlays by the Federal Financing Bank from $11.5 to $13.3 billion being partially offset by a swing in the Postal Service from an expected deficit of $0.3 billion to a surplus of $0.9 billion.

Domestic Finance

The volume of funds raised by non-Federal borrowers in domestic financial markets continued to rise in 1979, especially in the short-term sector of the market, although at a slower pace than the increase in nominal GNP. With a smaller budget deficit, Federal demands for credit declined from the 1978 level. Aggregate nonfinancial credit flows were little changed from the 1978

levels. At the same time, the atmosphere in money and credit markets was one of considerable uncertainty about the likely pace of economic activity, about the intensity of inflationary pressures, and about the course of fiscal and monetary policy in response to these economic problems.

The onset of what appeared to be a recessionary downturn in the spring of the year led many to suppose that some easing of monetary and fiscal policy could develop before the end of the year. Consequently, interest rates declined and demands on credit markets slackened in anticipation of more favorable borrowing costs in the future. In the event, the closing months of the fiscal year brought a renewed uncertainty as to whether the spring's events had been illusory. With inflationary pressures intensifying, demands for credit rose sharply, especially in the area of short-term bank lending.

Money supply growth over the year followed the quarterly pattern that has been characteristic of recent years: slow growth in the fourth and first calendar quarters and quite rapid advances in the remainder of the year. The final calendar quarter of 1978 witnessed only a small net growth in the basic money supply, in part because of shifts of funds from demand deposits to ATS and NOW accounts, which are not part of the traditional money supply data. M1 growth slowed even more in the early part of the new year and for the first quarter as a whole declined at a 2.1-percent annual rate. Unfortunately from a monetary policy standpoint, the second calendar quarter once again experienced a sharp acceleration in money growth. This more rapid pace of money growth continued throughout the summer. After the end of the fiscal year several monetary policy actions were taken, including (1) an increase in the discount rate from 11 to 12 percent, (2) the imposition of an 8-percent marginal reserve requirement on certain managed liabilities, and (3) a sharp redirection of Federal Reserve policy emphasis from a focus on money market conditions to one based on reserve availability.

With the money supply growing only modestly in the first two quarters of fiscal 1979, and with some evidence that a peak in the current cycle of economic activity was near, the monetary authorities made little effort to push interest rates to higher levels in the winter months. As a consequence, interest rates in the first half of the fiscal year fluctuated within a relatively narrow band, with the 13-week Treasury bill rate at about $9^3/_4$ percent, and the 90-day commercial paper and Federal funds rates around the 10-percent level. In light of the failure of the economy to weaken further after the slowdown in the spring, however, both market demands for credit and monetary policy actions in the final months of the fiscal year pushed rate levels in the short-term sector of the market sharply higher, and by the end of the fiscal year the 3-month bill rate had climbed to $10^1/_4$ percent and commercial paper to an $11^3/_4$-percent level.

In terms of credit demands by particular sectors, Treasury borrowing from the public totaled $33.6 billion in the fiscal year, compared with $59.1 billion in the fiscal year 1978. Of the $21.5 billion increase in interest-bearing marketable public debt over the fiscal year, a relatively small $442 million

increase was in the Treasury bill sector. Marketable Treasury notes accounted for $6.4 billion of the total increase, while Treasury bonds, largely in the 20- to 30-year maturity category, increased by $14.7 billion in reflection of the Treasury's continuing efforts to lessen the burden of refinancing the public debt on the market through the extension of the maturity of its obligations into long-term securities.

Foreign official investment in marketable Treasury debt decreased $3.1 billion to $95.3 billion despite $3.6 billion in foreign "add-ons," i.e., augmented amounts to regular offerings of marketable issues. In addition, the Treasury sold just over $4 billion of nonmarketable foreign-currency-denominated securities, about equally divided between German marks and Swiss francs, in order to finance official activities in foreign exchange markets. In contrast to foreign currency borrowings in earlier years, these latter securities were issued not to official buyers, but to foreign private investors under registration arrangements that would preclude purchases by U.S. investors.

Business demands for credit in the fiscal year totaled $132 billion, $97 billion of which represented demands for short-term credit, of which $68 billion took the form of bank lending. Corporate bond offerings totaled $29.5 billion, while equity issued accounted for $5.75 billion. In terms of the sources of these funds, the greatest increase over previous years represented flows from Treasury-bill-rate-based market certificates issued by banks and thrift institutions or flows from money market mutual funds. Money market certificates issued by banks and thrift institutions increased by $169 billion over the fiscal year to an estimated $204 billion; funds raised by money market mutual funds totaled $35 billion, of which $9 billion represented funds received in the final quarter of the fiscal year.

State and local borrowing in the year rose less dramatically than other demands for credit, partly in reflection of a decline in the issuance of advance refunding bonds. In total, long-term State and local borrowing totaled $42.5 billion in the fiscal year, compared with the previous year's total of $48 billion.

The final major category of credit demands, consumer borrowing, either short-term or in the form of mortgage finance, was heavily influenced by economic developments over the course of the year. On the one hand, the intensification of the inflation pressures apparently led to anticipatory buying of both consumer durables and nondurables, sparking a $40.5 billion record rise in consumer credit in the year. For the same inflation-based reasons, housing and real property demands soared in the year, with the result that mortgage credit rose by $162 billion over fiscal 1978 to a level of $1.3 trillion despite an increase in the level of mortgage rates from about 9.60 percent at the beginning of the year to 10.49 percent in early summer and 10.72 percent at the end of the fiscal year.

Taxation Developments

Tax policy developments reflected the need for permanent tax reduction to reduce individual and business tax burdens; and to encourage economic

stimulus, spending control, energy research and development, and tax simplification.

The Revenue Act of 1978 (Public Law 95–600), proposed January 21, 1978, was enacted November 6, 1978 (effective January 1, 1979). President Carter originally proposed a $25 billion net tax reduction program for fiscal 1979. The administration later recognized the need to get a better balance between monetary and fiscal policy; therefore, this proposal was trimmed to a total tax cut of $14.3 billion in fiscal 1979.

The final version of the Revenue Act of 1978 gave a reduction much higher than the original proposal. It provided new tax cuts of $21.3 billion in calendar 1979 and an extension of previously expiring cuts and added a reduction of $13.5 billion; therefore, the act provided tax cuts of $34.8 billion for calendar 1979.

Individuals received tax cuts equal to 40 percent of the entire Revenue Act. Capital gains taxes were reduced significantly and taxpayers aged 55 and older received a once-in-a-lifetime exclusion on gains of up to $100,000, realized on the sale of their principal residence.

Tax liability increased by $1.4 billion in calendar year 1979 by repeal of the itemized deduction for State and local gasoline taxes; and by taxation of unemployment compensation benefits paid to taxpayers with adjusted gross income (including benefits) above $20,000 for singles and $25,000 for joint returns.

To encourage formation and expansion of small business and increase investment generally, business tax reductions of about $5 billion were enacted in 1979. These cuts were established by reducing the top corporate tax rate from 48 percent to 46 percent and by creating a system of graduated tax rates for smaller corporations. Also, the investment tax credit was made permanent at a 10-percent rate.

On November 8, 1978, the Foreign Earned Income Act of 1978 was enacted. A U.S. citizen, living in a foreign country for 3 years or more, can use an exclusion based on excess cost of living (other than housing and education) due to living abroad.

The Energy Tax Act of 1978 was enacted on November 9, 1978, to reduce U.S. reliance on uncertain foreign energy supplies. This act imposed energy-related taxes and credits, resulting in a reduction in tax liability of $0.2 billion in fiscal 1979.

Real wage insurance, proposed in October 1978 and considered throughout 1979, was intended to encourage compliance with wage standards set by the President's Council on Wage and Price Stability. The credit rate was to be equal to the difference between the percentage increase in the Consumer Price Index and 7 percent (for fiscal 1979) with a maximum credit of 3 percentage points on wages up to $20,000.

After the April 1979 announcement that the administration was phasing out petroleum price controls between June 1, 1979, and October 1, 1981, oil companies were expected to reap billions of dollars of windfall profits due to

the rising prices. The administration proposed a 50-percent windfall profits tax to be effective January 1, 1980. The windfall profits tax, estimated at $2.9 billion for fiscal 1980 and $9.3 billion for fiscal 1981, would be assigned to energy-related uses through an energy security trust fund. The House of Representatives passed H.R. 3919 (the Crude Oil Windfall Profits Tax Act of 1979) and it was still under Senate Finance Committee consideration at the close of fiscal 1979.

The administration proposed cash management measures that were not considered in fiscal 1979; however, Treasury will continue to support the issue. At the close of fiscal 1979, Congress had not completed action on proposed airport and airway trust fund taxes.

In fiscal 1979, the administration proposed legislation to distinguish between employees and independent contractors. Now, independent contractors receive more favorable withholding and social security tax treatment and there exists no clear method to show a distinction between the two groups. Congress did not act on this proposal.

INTERNATIONAL AFFAIRS

Background Survey of World Finance

Uncertainties over the availability of oil and the upward trend in oil prices dominated developments in the world economic situation in fiscal 1979. Revolution and continued political instability in Iran led to a sharp reduction in that country's output which had in fiscal 1978 provided more than 16 percent of the oil moving in international trade. The average price of internationally traded crude oil rose roughly 73 percent in the course of U.S. fiscal 1979. By the end of December 1979, the average price of internationally traded oil from all sources (including spot markets) was over $27 a barrel, about 108 percent above the level of December 1978.

Nevertheless, world economic growth was somewhat higher than had been anticipated at the beginning of the fiscal year. In part, this higher growth rate appears to have reflected expectation of higher rates of inflation. Rates of saving generally declined. Strong expansion of the German and Japanese domestic economies helped to maintain the average rate of growth in industrial countries other than the United States at about 4 percent. In the non-oil-exporting less developed countries (LDC's), the average rate of real economic growth continued in the 5-percent-a-year range.

In fiscal 1979 the industrial countries generally recognized that inflation was the most serious problem they faced. Increases in the cost of living in the developed countries accelerated sharply during the second half of the fiscal year, spurred by energy price increases and by spreading public expectations of higher wages and prices. Consumers and investors throughout the world demonstrated less confidence in the basic ability of governments to control inflation.

Rates of inflation advanced sharply in all major industrial countries except Japan. In Germany and Switzerland, the rise in consumer prices from September 1978 to September 1979 reached about 5 percent, as compared with 1 to 2½ percent between September 1977 and September 1978. The dampening of inflation by exchange rate appreciation, which had held down the German and Swiss inflation rates during fiscal 1978, was not present in fiscal 1979. In addition, the cost of imported oil rose more sharply. Even with higher inflation rates in Germany and Switzerland, there remained important divergences in the inflation rates among the major industrial countries. In September 1979, consumer price indices showed advances of 3 to 5 percent over September 1978 in Japan, Germany, and Switzerland, while the corresponding figures for France, Italy, and the United Kingdom ranged from 11 to 16½ percent. In the United States the advance was about 12 percent, as compared with 8.3 percent a year earlier. In Canada the corresponding figures were about 9½ percent in both 1978 and 1979.

In fiscal 1979 the President and the Secretary of the Treasury made clear that the overriding objective of the U.S. economic policy would be to reduce inflation. The administration and the Federal Reserve System pursued an integrated set of policies aimed at the fundamental causes of inflation. Fiscal restraint was applied, reducing the Federal deficit from about 4 percent of the gross national product in fiscal 1976 to about 1 percent in 1979. In the monetary sphere, credit was tightened. As a result, short-term interest rates moved upward sharply during the fiscal year with 3-month Treasury bill issues yielding an average of 10.18 percent in September 1979, as against 7.84 percent in September 1978.

The growth in monetary aggregates slowed down markedly in January–June 1979, but turned upward again in the July–September period. This reversal led the Federal Reserve, in the week following the close of the fiscal year, to take new actions designed to assure "better control over the expansion of money and bank credit, help curb speculative excesses in financial, foreign exchange, and commodity markets and thereby serve to dampen inflationary forces." Greater emphasis was placed on the objective of containing the growth of the monetary aggregates within the desired ranges and with less emphasis on confining short-term fluctuations in the Federal funds rate. These measures, which included a further rise in the discount rate to 12 percent and some special reserve requirements, were well received in the international money and exchange markets as indicators of a firm resolve to apply strong credit restraint to reduce inflationary expectations.

A voluntary program to moderate pay and price increases was introduced in October 1978 which helped to gain time for other policies to take hold. Intensified attention was devoted to the costs of unnecessary Federal regulation of business activity. The series of measures taken on November 1, 1978, to stop a decline in the exchange rate for the dollar removed inflationary influences on the domestic economy which were being exerted by dollar depreciation.

The administration gave high priority to the development of a national energy program to reduce our dependence on imported oil. Major measures adopted during the fiscal year included the President's decisions to begin progressive decontrol of crude oil prices, to limit U.S. oil imports to an amount below 1977 levels, and enactment of the five-part National Energy Act to increase energy supplies and reduce demand through measures which included gradual decontrol of natural gas prices. Other measures under consideration in Congress at the end of the fiscal year were a windfall profits tax, the Energy Security Corporation, and the Energy Mobilization Board. Specific programs called for fuel conversion by utilities from oil to coal, energy conservation incentives for families and businesses, improvement of the Nation's mass transportation system, and increased automobile fleet fuel efficiency.

Oil consumption in the United States declined progressively during fiscal 1979 resulting in fourth-quarter consumption more than 4 percent lower than during the corresponding period in fiscal 1978.

The oil price increases that took place in 1979, most of which occurred during the first half of the calendar year, have had a strong effect on international payments patterns. Estimates are not available for the U.S. fiscal year, but the members of the Organization of Petroleum Exporting Countries (OPEC) collectively are estimated to have had a current account surplus of more than $65 billion in calendar 1979 as compared with near balance in 1978. Most of this change affected the member countries of the Organization for Economic Cooperation and Development (OECD) whose balances shifted by an estimated $40 billion from an aggregate current account surplus of about $10 billion in calendar 1978 to a deficit of about $30 billion in 1979. The deterioration in the position of non-OPEC developing countries was probably more than $10 billion, leading to an aggregate deficit of about $35 billion (about $50 billion before taking account of official grants). The bulk of this deficit was experienced by the more advanced developing countries which were able to obtain financing from foreign private capital markets.

Although most of the deterioration in the position of the non-oil-exporting developing countries was accounted for by a few relatively advanced developing countries, the fact that all of the developing countries have been and will be paying higher prices for oil is likely to affect their ability to purchase other consumer goods and to finance development without adversely affecting their future debt service capacity.

The impact of this severe and abrupt deterioration in the current account position of oil-importing countries as a group was, however, mitigated by the fact that the pattern of individual current account positions among the major industrial countries became much better balanced. Despite an increase of $17 billion in oil imports, the U.S. current account was in approximate balance in calendar 1979 following a $131/2 billion deficit in calendar 1978. Japan's 1978 surplus of $16 billion was replaced by a deficit of nearly $9 billion in 1979. Germany had a current account deficit of about $4 billion in calendar 1979 in contrast to a surplus of about $8 billion in 1978. This more balanced position

among the major countries was a significant factor in the maintenance of better exchange market stability.

Foreign Exchange and Gold Market Developments

Exchange market conditions reflected the contrasting developments in the world economy. The narrowing divergence in real growth rates and current account imbalances, coupled with the actions taken by the U.S. authorities in November 1978, were successful in bringing a halt to the exchange market disorders in the first quarter of fiscal 1979. The Federal Reserve further tightened monetary policy; the Treasury and the Federal Reserve announced their intent to mobilize up to $30 billion of foreign currencies to finance U.S. participation in coordinated market intervention with other major countries; and the Treasury increased its monthly sales of gold. These developments and policy measures provided a basis for more stable conditions and for a considerable appreciation of the dollar into the January–March quarter. However, the shift in market attention to the performance of the major countries in their efforts to reduce inflationary pressures began to be reflected in renewed tensions, first in the commodity markets and later in the foreign exchange markets. The prices of gold and other commodities began to rise steeply in the January–March quarter and continued to accelerate into the summer. The sharp increases in oil prices added to these tensions, generating further upward pressures on commodity prices and contributing to further strains in the exchange markets.

In September 1979, the European Monetary System underwent a realignment of rates, selling pressure on the dollar mounted, and the Japanese yen depreciated sharply in terms of all currencies. Credit conditions in all countries tightened quickly to address the resurgence in price pressures. Shortly after the end of the fiscal year on October 6, the United States announced: (1) A further 1-percentage-point increase in the discount rate to 12 percent, as compared with 8 percent at the beginning of the fiscal year, and (2) a shift in credit policy designed to restrict more effectively the rate of growth in the money supply. These actions, as well as similar moves in other countries, were effective in restoring more orderly conditions in the markets.

Overall, greater stability prevailed in exchange market conditions over the course of the fiscal year than in the previous fiscal year. On an average trade-weighted basis in terms of OECD currencies, the dollar experienced a negligible depreciation over the 12 months ending September 30, 1979, as compared with a 9.1-percent depreciation in the preceding 12-month period. The German mark appreciated 3.3 percent on a trade-weighted basis vis-a-vis other OECD currencies during the first quarter of the fiscal year. Further changes were minor. The greatest change, on this average basis, was seen in the Japanese yen, which depreciated by 18.1 percent over fiscal 1979 following a 31.6-percent appreciation in the previous fiscal year.

The greater stability in the value of the dollar and major European currencies was accompanied by a continuing rise in the aggregate reserves of

foreign exchange reported by countries to the International Monetary Fund from $260 billion in September 1978 to $315 billion at the end of September 1979. This 20-percent growth was about the same rate of growth as in the previous fiscal year. The additions to reserves resulted in large part from official intervention and from official borrowing to add to reserves. Both industrial and developing countries increased their reserves. Those of the oil-exporting countries rose only by about 10 percent during this period.

The Treasury gold sales program was continued in fiscal 1979 with the basic purpose of strengthening the U.S. balance of payments position and, thus, contributing to stability in the foreign exchange market. At the same time, these sales furthered progress towards gradual reduction in the monetary role of gold. Monthly sales were increased from 300,000 ounces to 750,000 ounces in November 1978 and to 1,500,000 ounces in December, before being reduced to 750,000 ounces per month in May 1979. During the fiscal year, the Treasury sold 21.3 million ounces, improving the U.S. trade position by approximately $4 billion and providing $3.5 billion in financing of the Federal budget deficit.

The gold price advanced from $217 per ounce to nearly $400 per ounce during fiscal 1979. This speculative increase in the gold price was a disturbing sign both of heightened inflation and inflationary expectations affecting currencies generally as well as a reflection of growing political uncertainties in the Middle East. These disturbances contributed to instability in other commodity markets and in the foreign exchange markets and added to inflationary pressures. Shortly after the close of the fiscal year, the Treasury announced a more flexible approach to conducting gold sales in order to help deter the disruptive speculation that has characterized the gold market. In contrast to the regular monthly sales that had been held until that time, future sales were to be subject to variations in the amounts and dates of offerings.

The International Monetary System and the International Monetary Fund (IMF)

A number of steps were taken during the year to (a) strengthen the international monetary system and the role of the special drawing right (SDR) over the longer term and (b) enhance the IMF's ability to meet members' temporary balance of payments financing needs and to promote payments adjustment.

The IMF Articles of Agreement established the objective of making the SDR the principal reserve asset in the international monetary system. In December 1978 the IMF Board of Governors adopted a resolution providing for new allocations of SDR 12 billion over the 3-year period 1979–81. The initial distribution of SDR 4 billion was completed in January 1979 and represented the first allocation of SDR's since the 1970–72 distribution of SDR 9.3 billion. The United States received SDR 874 million, bringing total U.S. allocations to SDR 3,168 million.

The IMF also acted to improve the financial characteristics and usability of the SDR. The SDR interest rate has been brought more in line with market

rates in order to make the SDR more competitive with other reserve assets. The minimum level to which SDR holdings may fall (on a 5-year average basis) was reduced from 30 percent to 15 percent of net cumulative allocations. The types of SDR transactions authorized have been expanded to include settlement of financial obligations not involving currencies, as well as loans of SDR's and use of SDR's as collateral.

The IMF also began consideration of the establishment of a substitution account that would accept deposits of dollars (and perhaps of other currencies) in exchange for SDR-denominated claims under prescribed rules and conditions. As the fiscal year ended, the IMF Interim Committee of Governors concluded that a properly designed account could contribute to an improvement of the international monetary system and could constitute a step toward making the SDR the principal reserve asset in the system. The Committee noted a number of desirable features for such an account and requested that the Executive Board give priority attention to designing an account. The Board is to report progress to the next meeting of the Interim Committee in April 1980.

The Board of Governors concluded the seventh review of quotas in December 1978 and recommended a 50-percent increase in quotas. The new quotas are to come into effect by November 1980 provided members with 75 percent of the total voting power consent to the increases in their quotas by that time. Legislation authorizing an increase in the U.S. quota, pursuant to the general increase in quotas, will be submitted to Congress during fiscal 1980.

The IMF remained in a position to meet temporary official financing needs throughout the fiscal year although private sources provided the major part of the needed financing during this period. Drawings from the IMF during the fiscal year exceeded $5 billion, of which nearly $3 billion was drawn by the United States. Repayments totaled over $6.5 billion.

In February 1979 the Supplementary Financing Facility entered into operation, providing $10.1 billion in additional resources to the IMF to cover the period before the quota increase becomes effective and to provide supplementary resources for lending to those countries experiencing most severe financing needs. The compensatory financing facility was also liberalized in August 1979, enabling the IMF to provide increased financing for payments difficulties arising from export earnings shortfalls. The IMF's policies on conditionality were modified in March 1979 in order to reflect changes in the global economy and to provide greater encouragement to members to seek IMF asistance at an early date before financial problems become severe.

The Eurocurrency Market, Private Sector Lending, and OPEC Investment

Against a background of substantial increases in the flow of international credit through private banks, major countries, with strong U.S. support, agreed to undertake through central bank channels a review of issues relating

to the volume of such lending, in particular the portion taking place through the Eurocurrency market.

"Recycling" of oil exporters' surpluses was not a central feature of international credit flows during fiscal 1979; indeed, the OPEC area was a net borrower during much of the year. However, toward the end of this period the large oil price increases restored the OPEC countries to their previous status as large net suppliers of funds to international banks.

Financial Relations With Non-OPEC Less Developed Countries

Despite the increase in the aggregate current account deficit of the non-OPEC LDC's during calendar 1979 by nearly 50 percent to approximately $35 billion (after counting official unrequited transfers), total official and private financial flows to non-OPEC LDC's continued in calendar 1979 to exceed the aggregate current account deficits. Thus preliminary estimates suggest a further $8 billion increase in the aggregate reserves of these countries in calendar 1979 to a level of $74 billion following an increase of almost 30 percent in calendar 1978.

In 1979 the multilateral development banks (MDB's) were at the forefront of the international development effort. The World Bank group and the regional development banks made loan commitments of more than $13 billion to recipient countries in fiscal 1979. Disbursements of World Bank loans now constitute a very large percentage of official development assistance.

Although other countries contribute 75 percent of MDB resources, the United States has an influential role in determining the policies and practices of the MDB's. The United States, working through both the Secretary of the Treasury, who serves as U.S. Governor, and the U.S. Executive Director, who obtains his advice from the Treasury, has used this influence to increase the effectiveness of MDB lending. The United States, for example, played a leading role in supporting and encouraging adjustments in MDB lending policies which would ensure a greater participation of the poor in the benefits of growth. All of the banks in the last few years have changed the sectoral composition of their lending to favor projects which directly meet the needs of the poor. The United States has also encouraged the MDB's to adapt their lending policies to reflect both the growing diversity among recipient countries and changing world economic circumstances. In this context, the United States took the lead in encouraging the World Bank to help to expand and diversify sources of energy in the non-oil-exporting LDC's and to increase its role as a financial catalyst through cofinancing and guarantees.

The U.S. position on human rights in the MDB's is part of its overall policy to enhance the observance of human rights. Consistent both with existing legislation and administration policy, the U.S. Executive Directors to the MDB's are required to register opposition to projects for countries which are serious human rights violators unless such assistance serves the basic human needs of the citizens of the country.

The United States recognizes the importance of assuring that the MDB's have the financial resources adequate to continue and, where possible, expand their vital role in the development process. During fiscal 1979 the United States participated in negotiations leading to agreements on replenishment of the resources of the Inter-American Development Bank, the African Development Fund, and the Asian Development Fund. It also participated in negotiations, not completed until the end of the calendar year, for the sixth replenishment for the World Bank group's concessional loan institution, the International Development Association. The United States also supported a proposal for a general capital increase for the World Bank group's nonconcessional loan institution, the International Bank for Reconstruction and Development.

In fiscal 1979, legislation was introduced in Congress to authorize U.S. participation in replenishments and increases in resources for the Inter-American Development Bank, the Asian Development Fund, and the African Development Fund. The total amount being requested for these three regional institutions was $4,019 million and covered U.S. subscriptions and contributions to be made over a 3- to 4- year period beginning in fiscal 1980. At the end of fiscal 1979, legislation to appropriate fiscal 1980 funding for U.S. participation in the MDB's was also awaiting final congressional approval.

The Treasury continues active participation in interagency formulation of U.S. development assistance policy through its chairmanship of the National Advisory Council on International Monetary and Financial Policies and its membership in the Development Coordination Committee and in various other interagency committees designed to coordinate economic assistance programs.

Treasury also continued to monitor closely developments regarding international indebtedness. During fiscal 1979, the U.S. Government participated in multilateral debt-rescheduling arrangements for Peru, Togo, and Turkey. Similar arrangements involving the United States were negotiated with Sudan in November 1979 and with Zaire in December 1979.

Trade and Investment

Fiscal 1979 saw the conclusion of the multilateral trade negotiations, normalization of economic relations with the People's Republic of China, more competitive financing of U.S. exports by the Export-Import Bank, and efforts to develop international understandings regarding investment policies. Treasury participated in the development of U.S. policy and in negotiations in each of these areas.

The successful conclusion of the multilateral trade negotiations, initiated in Tokyo in 1973, assures not only a substantial reduction in industrial tariffs, but also new codes governing the use of government subsidies, standards, procurement, licensing, and customs valuation which should significantly reduce these nontariff barriers to trade. The Trade Agreements Act of 1979,

signed by President Carter in July 1979, makes the obligations contained in the MTN codes part of U.S. domestic law.

Of special interest to Treasury is the new code on subsidies and countervailing measures which will bring much-needed discipline to one of the most contentious areas of government intervention in trade. The code provides for explicit prohibitions on subsidies affecting industrial trade, for improved discipline over the use of agricultural export subsidies, and for more rapid dispute resolution procedures.

Following the establishment of diplomatic ties with the People's Republic of China in January 1979, Secretary Blumenthal was charged with the task of coordinating the normalization of U.S.-China economic relations. The Secretary led an official delegation to China in February which successfully negotiated a claims/assets agreement, established the U.S.-China Joint Economic Committee, and initiated discussions on a trade agreement and banking and finance matters. Treasury has actively participated in the subsequent negotiation of a trade agreement and in the formulation of U.S. Government policy on other bilateral economic issues, including maritime, civil aviation, and textile matters and the extension of Overseas Private Investment Corporation and Export-Import Bank programs for China. Secretary Miller succeeded Mr. Blumenthal as Co-chairman of the U.S.-China Joint Economic Committee, which will continue to address a wide range of bilateral trade, technological, investment, and financial matters.

Early in fiscal 1979, the Secretary and other Treasury officials sought to negotiate improvements which would strengthen the International Arrangement on Export Credits. It was not possible to achieve common agreement on these objectives among participants in the Arrangement. The U.S. Government therefore reexamined and modified its own policies to assure that the United States would remain competitive in the export credit area. The Export-Import Bank has become more aggressive in providing official support for U.S. exports by increasing its participation in project financing, providing competitive interest rates, and matching on a selective basis the mixed credits and local cost financing offered by other industrial exporting countries. The United States continues to adhere to the International Arrangement as a useful, though limited, first step toward international discipline in this area.

Treasury played a key part in formulating and developing U.S. initiatives to promote both international discussions on the use of governmental investment incentives and performance requirements as well as possible agreements to deal with them. At the suggestion of the United States, the OECD Committee on International Investment and Multinational Enterprises agreed to undertake a comprehensive examination of the effects of investment incentives and disincentives on international economic relations.

The IMF/IBRD Development Committee, formed in 1974 to maintain an overview of the development process especially regarding the transfer of resources to developing countries, established a Task Force on Private Foreign Investment chaired by the U.S. Assistant Secretary of the Treasury for

International Affairs. The task force is examining home and host country policies affecting international investment, including incentives and performance requirements, and will make recommendations to the Committee.

Treasury also chaired the Committee on Foreign Investment in the United States, an interagency group which reviewed and coordinated general U.S. policy on foreign investment in this country. During the year, this Committee also dealt with the issues of purchases by foreigners of U.S. farmland, Renault's plans to invest in American Motors Corp., and other issues.

Commodities and Natural Resources

There is a general agreement among both producing and consuming countries that the most effective instruments for achieving greater commodity market stability are international commodity agreements (ICA's) utilizing buffer stock mechanisms, wherever feasible, as the vehicle for stabilizing price fluctuations. During fiscal 1979 the United States participated in the negotiation of rubber and cocoa agreements, and in October 1979 an accord was reached on an agreement for buffer stocking natural rubber. Operation of this agreement is expected to begin before the end of calendar 1980. Serious differences between exporters and importers on the price range caused a temporary recess in the cocoa discussions. International discussions on several other commodities—copper, cotton, jute, tea, tungsten—continued, but none of these has yet advanced to the stage of formal negotiation of agreements.

In addition, the framework for the negotiation of the final text of an agreement establishing a common fund to provide adequate financing of ICA's was achieved in March 1979. By pooling the financial resources of ICA's, the common fund can facilitate more efficient financing of individual commodity agreements and, thereby, lessen the budgetary outlays of member countries for these agreements.

The Conference on Law of the Sea made some progress in defining the international deep seabed mining arrangement although serious differences remained between industrialized and developing countries on the structure and functions of the arrangement's institutions. At issue are the terms and conditions under which individual private companies or national governments would be permitted to engage in mining activities in the international seabeds.

United States-Saudi Arabian Joint Commission on Economic Cooperation

Two developments in the energy field were of particular significance in the operation of the United States-Saudi Arabian Joint Commission during fiscal 1979. The first was the completion of a comprehensive 25-year electrification plan for Saudi Arabia. The second was identification of the site, within Saudi Arabia, for the world's largest solar-powered electrical generating station. The initial phase of the power station is scheduled to be in operation by mid-1980. The $15 million solar village project is the first in a series of projects to be implemented under a 5-year, $100 million joint United States-Saudi solar program. During the fiscal year, 19 projects in various fields were underway.