THE ANNUAL REPORT
OF THE
COUNCIL OF ECONOMIC ADVISERS

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LETTER OF TRANSMITTAL

COUNCIL OF ECONOMIC ADVISERS,
Washington, D.C., January 14, 1963.

THE PRESIDENT:

SIR: The Council of Economic Advisers herewith submits its Annual Report, January 1963, in accordance with Section 4(c)(2) of the Employment Act of 1946.

Respectfully,

WALTER W. HELLER,
Chairman.

GARDNER ACKLEY

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Chapter 1

The Economic Record and Its Challenge

THE UNITED STATES is currently in the midst of its fourth postwar recovery—a recovery which began in February 1961 and has now run for almost 2 years. This recovery is notable in that for the first time since the war we have made important progress toward all of our major economic goals: we have made significant advances toward the goals of fuller employment and faster growth at the same time that we have avoided inflation and achieved substantial improvement in our balance of payments position. And these gains have been accompanied by the continued strengthening of free competitive markets and continued progress toward greater equality of economic opportunity.

But in the present expansion, the economy has faced the problem of recovering from not one but two recessions—for the recession of 1960 followed an incomplete recovery from the 1957–58 recession. Despite the gains of the past 2 years, the economy has not yet regained full use of its labor and capital resources. Moreover, the progress made during the current recovery was most rapid in 1961; although advances continued throughout 1962, the rate of expansion was markedly slower. The forces responsible for slowing the expansion in 1962 threaten to prolong the period of economic slack. As 1963 begins, too many workers remain without jobs; too many machines continue idle; too much output goes unrealized as our economy runs below its potential.

The challenge and the opportunity for the American economy are to move from this situation of continuing slack to one which calls forth the full participation of a rapidly growing labor force and the introduction of fruitful technological developments. It is in this setting of promising change that we must consider our commitment to the goals of the Employment Act.

In this chapter we first review the record of 1962 and of the 1961–62 expansion. Then, to draw from the experience of a longer period, we look at the record of the past 5 years, and finally we appraise the outlook for 1963.

COMPARISON OF 1962 WITH 1961

Significant gains were registered in all major categories of economic activity between 1961 and 1962. For the year 1962 as a whole, gross national product (GNP) rose 7 percent over its 1961 level—from $519 billion to $554 billion. Industrial production showed an 8 percent rise. Demands for automobiles and housing were particularly strong: sales of domestic automobiles increased by more than 20 percent—from 5.6 million units in 1961 to 6.8 million units in 1962—making 1962 the second biggest automobile year in history; private nonfarm housing starts rose by 11 percent, with an exceptionally strong advance in apartment construction. Business spending on plant and equipment rose by 9 percent, and the rate of business inventory accumulation increased from $2.1 billion to $3.1 billion.

Disposable personal income increased by $19 billion, or 5 percent. Consumer spending kept pace and, apart from autos, most major components of consumption rose by 4 or 5 percent. Corporate profits (adjusted for inventory valuation, and before taxes) for the year rose by an estimated $5½ billion, to $51 billion.

The gains in output and incomes achieved in 1962 were accompanied by relative stability in prices. The average price of output increased by less than 1½ percent as measured by the comprehensive GNP deflator. Wholesale prices remained virtually stable at 100.6 percent of their 1957–59 average. And consumer prices rose by only 1.2 percent.

The unemployment rate, which averaged 6.7 percent in 1961, fell to an average of 5.6 percent in 1962—the result of an increase of 1.2 million in employment accompanied by an increase of 400,000 in the civilian labor force. The number of involuntary part-time workers declined from 2.8 million to 2.3 million. The fraction of labor-force time lost through unemployment and part-time work dropped from 8.0 to 6.7 percent. The higher levels of employment resulted in a substantial reduction in the number of depressed areas. During 1961, an average of 81 of the 150 major labor market areas in the United States were classified as areas of substantial unemployment. The monthly average for 1962 was 52 areas. Some areas benefited dramatically from the expansion in economic activity: for instance, in Detroit, Michigan, the unemployment rate fell from 10.9 percent in 1961 to 6.8 percent in 1962. Even an area like Wheeling, West Virginia, which still had an intolerable unemployment rate in 1962 (12.2 percent), showed improvement from its 15.2 percent rate of the year before.

Progress was also made by the Nation's agricultural population. Farm income per capita from all sources rose from $1,373 in 1961 to $1,430 in 1962. This is nearly 60 percent of the nonfarm per capita income of $2,445. By comparison, per capita income of the farm population aver-

aged approximately 50 percent of per capita income in the nonfarm sector during the mid-1950's and less than 40 percent just prior to World War II.

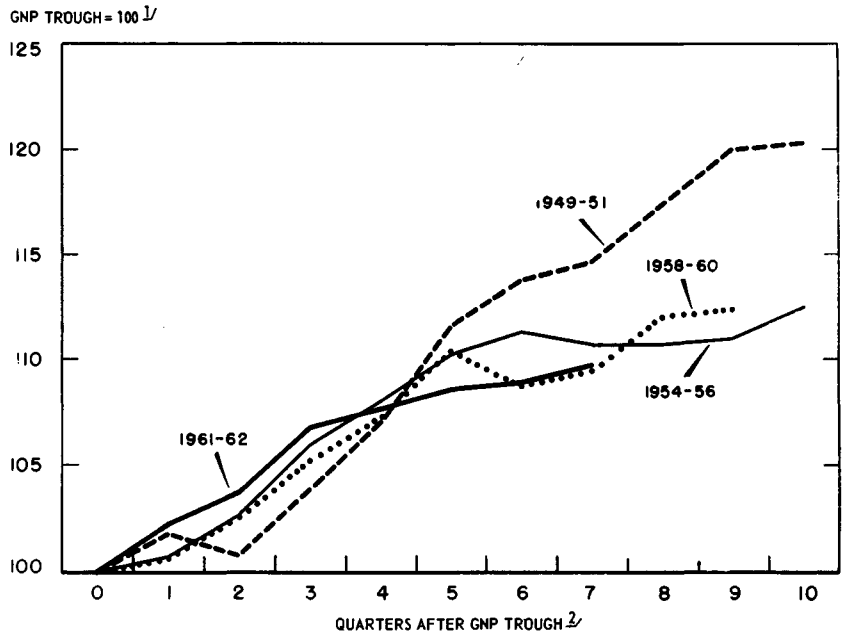
Recovery in domestic output, incomes, and employment was accompanied by improvement in the balance of payments. The over-all balance of payments deficit, which fell from $3.9 billion in 1960 to $2.5 billion in 1961, declined further, to about $2 billion, in 1962. Although exports did not increase as rapidly as the rise in merchandise imports induced by domestic expansion, improvement in the over-all balance was registered because of increased earnings on U.S. investment abroad, and substantial declines in short-term private capital outflows and net government expenditures overseas.

THE RECORD OF THE EXPANSION

The pattern of activity since the 1960 recession is not adequately revealed by the annual figures just cited. The last quarter of 1962 was the seventh quarter of the present expansion and December the 22nd month of sustained recovery from the low point of February 1961. GNP rose to an annual rate of $562 billion in the last quarter of 1962, $61 billion, or

CHART 1

Real Gross National Product in Four Postwar Expansions

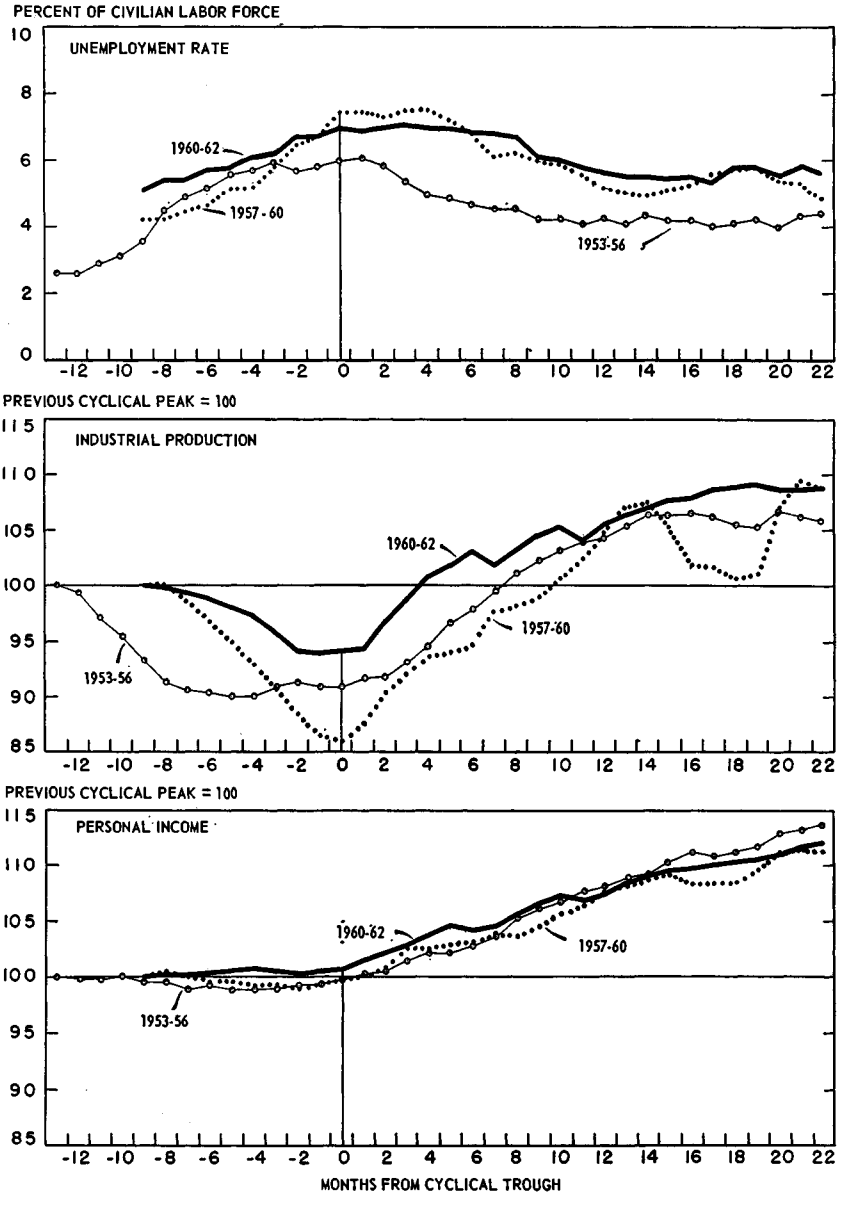


1/ BASED ON SEASONALLY ADJUSTED DATA.
2/ TROUGH QUARTERS FOR GNP WERE 1949 II, 1954 II, 1958 I, AND 1961 I.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

CHART 2

Unemployment, Production, and Income in Three Business Cycles



NOTE: RATE AND INDEXES BASED ON SEASONALLY ADJUSTED DATA. EACH SERIES STARTS AT ITS PREVIOUS CYCLICAL PEAK AND ENDS 22 MONTHS AFTER THE CYCLICAL TROUGH, WHICH CORRESPONDS WITH THE MOST RECENT MONTH OF THE PRESENT EXPANSION.

SOURCES: DEPARTMENT OF LABOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, AND DEPARTMENT OF COMMERCE.

12 percent, above its recession low. In constant prices, this rate was 10 percent above the recession low and 8 percent above the previous peak in the second quarter of 1960.

Despite these gains, the present expansion, along with its immediate predecessor, has not matched the increases in GNP attained at the comparable periods of the two earlier postwar recoveries in 1949–51 and 1954–56, as shown in Chart 1. Chart 2 compares the last three postwar recessions and recoveries in terms of other measures of activity. The comparisons in this chart start with activity at the previous cyclical peaks, not troughs, and thus reflect the record of each cycle over a variable period spanning recession and the first 22 months of expansion. So viewed, the gains in income and production from May 1960 to date approximately match the average of the previous two cycles. But, as already noted, the May 1960 peak itself represented an incomplete recovery.

Slowdown in expansion

As Chart 1 shows, throughout 1961 the current recovery was relatively brisk. However, during 1962, quarterly GNP increases fell to about half their 1961 pace, from an average annual rate of $12½ billion to $6 billion. The slower pace of the expansion is evident in the performance of other major indicators of economic activity during the last 3 quarters of 1961 as opposed to the 4 quarters of 1962 (Table 1). Reflecting the slowdown, the unemployment rate in December 1962 was only 0.4 percentage points below its level a year earlier.

In retrospect, it is clear that the slowdown which was to mark the entire year began in the first quarter. Despite large inventory building, especially of steel, GNP in that quarter rose by only $6.4 billion, after a rise of $16.3 billion in the fourth quarter of 1961.

The second quarter found total activity still expanding moderately. It was marked by the stock market decline that culminated in the historic price break of May 28. The fall in the market contributed uncertainty to the investment outlook later in the year. But the timing indicates strongly that the market break was not a major causal influence on the economic shape of the year as a whole.

By midyear, the uncertainties posed by mixed signs in current economic developments, accompanied by the break in stock prices, led to widespread concern about the possibility of an imminent recession. However, the economy weathered the developments of the spring without a downturn in activity. Stock prices recovered half of their losses by the end of 1962. And business spending on plant and equipment was stronger in the second half than the surveys in February and May had anticipated.

In the third quarter, GNP rose by only $3.3 billion, to $555.3 billion, as net exports declined by $1.2 billion and the rate of inventory accumulation,

TABLE 1.—*Changes in output, income, and employment in 1961 and 1962*

[Seasonally adjusted]

Item	1961 I	1961 IV	1962 IV[1]	Average quarterly change	
				1961 I to 1961 IV	1961 IV to 1962 IV[1]
	Billions of dollars, annual rates				
Output (current prices):					
Gross national product	500.8	538.6	562.0	12.6	5.8
Personal consumption expenditures	330.5	346.1	363.5	5.2	4.4
Gross private domestic investment	60.1	76.6	75.0	5.5	−.4
Fixed investment	63.7	70.6	74.5	2.3	1.0
Residential nonfarm construction	19.0	22.8	23.7	1.3	.2
Other construction	20.3	20.4	21.3	[2]	.2
Producers' durable equipment	24.4	27.4	29.6	1.0	.6
Change in business inventories	−3.6	6.0	.5	3.2	−1.4
Net exports of goods and services	5.3	3.8	2.5	−.5	−.3
Government purchases of goods and services	104.8	112.1	121.0	2.4	2.2
Federal	55.4	59.5	63.7	1.4	1.0
State and local	49.4	52.6	57.3	1.1	1.2
Income:					
Disposable personal income	354.3	372.6	389.3	6.1	4.2
Corporate profits after taxes	20.3	26.3	[3] 26.1	2.0	[3]−.1
	Millions of persons				
Employment:					
Total civilian employment	66.8	67.0	68.1	0.1	0.3
Employment in nonagricultural establishments	53.5	54.5	55.6	.3	.3
Private	44.9	45.5	46.2	.2	.2

[1] Preliminary estimates by Council of Economic Advisers.
[2] Less than $50 million.
[3] Data for 1962 III and change from 1961 IV to 1962 III.

NOTE.—Detail will not necessarily add to totals because of rounding.
See Tables C-1, C-15, C-19, C-25, and C-64.

Sources: Department of Commerce and Department of Labor (except as noted).

under pressure from steel liquidation, declined by $3.0 billion from the second quarter level. But by the fourth quarter, exceptionally large early sales of 1963 automobile models helped bring GNP to $562.0 billion.

Role of investment

A year ago the Economic Report and the Budget Message projected a GNP of $570 billion for 1962. After allowance for intervening revisions in the national accounts, this called for a 9 percent rise compared with the 7 percent rise that was achieved. While this was toward the upper end of the range of forecasts then being made, the Administration believed it to be realistic. Now, in restrospect, it can be seen that the predictions of government purchases of goods and services, private nonfarm residential construction, consumer purchases of durables, and net exports were essentially correct.

Consumer purchases of nondurables and services in 1962 fell short of the year-ago forecast by about $6 billion. Changes in such expenditures are largely responsive to changes in disposable personal income which in turn are related to changes in total spending. The percentage of disposable incomes spent by consumers actually rose in 1962. It was therefore the failure of expenditures other than consumption to rise as far as had been expected that held down the rise in incomes and in turn consumers' expenditures.

The error, then, was in the area of business investment, which fell about $8 billion short of the level that had been expected for the year 1962. Indeed from the fourth quarter of 1961 to the fourth quarter of 1962, total business investment actually declined. Expenditures for new plant and equipment rose by $3.1 billion, but this advance was more than offset by a drop of $5.5 billion in the rate of inventory investment. As Chart 3 shows, this decline of investment, which was unuusal for the current stage of expansion, followed 3 quarters of brisk increases in investment spending during 1961.

Half of the shortfall from the prediction of business investment occurred in inventory accumulation. During the current expansion, the ratio of inventory accumulation to the increase in final sales of goods (Table 2) has been only 0.25, compared with ratios of 0.46 and 0.50 in the two preceding expansions. However, the growth of manufacturers' new orders has been slow enough so that unfilled order backlogs have declined and the ratio of inventories to order backlogs has edged upward.

TABLE 2.—*Changes in final sales of goods and inventory accumulation in three expansions*

[Billions of dollars, 1954 prices, seasonally adjusted]

Period [1]	Change in final sales of goods [2]	Inventory accumulation [3]
1954 III to 1956 II	19.1	8.8
1958 II to 1960 I	17.4	8.7
1961 I to 1962 IV [4]	22.1	5.5

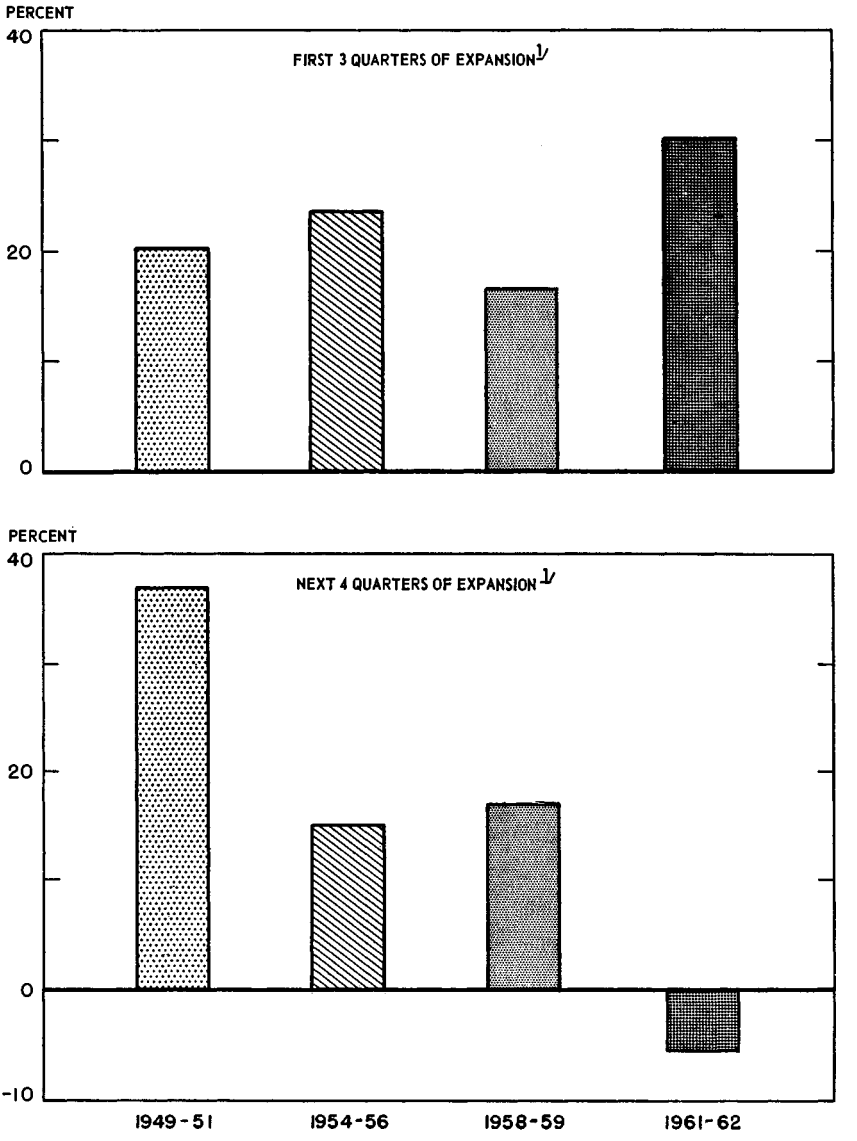
[1] Specific trough for final sales to 7 quarters after trough.
[2] Total change in annual rate of sales.
[3] Total accumulation during period.
[4] Preliminary estimates by Council of Economic Advisers.

Source: Department of Commerce (except as noted).

With easy supply conditions and their own markets growing less than buoyantly, many businesses evidently chose in 1962 to pursue cautious stocking policies and to speed their introduction of new inventory-conserving managerial techniques. Despite the unfavorable effect upon 1962 output and income, inventories, as a result, are less an area of potential weakness in 1963 than might otherwise have been the case.

CHART 3

Change in Total Business Investment in Four Postwar Expansions



1/ BASED ON SEASONALLY ADJUSTED DATA IN CONSTANT PRICES. INVESTMENT CONSISTS OF NONRESIDENTIAL CONSTRUCTION, PRODUCERS' DURABLE EQUIPMENT, AND CHANGE IN INVENTORIES. RECOVERY MEASURED FROM TROUGH QUARTERS FOR GNP: 1949 II, 1954 II, 1958 I, AND 1961 I.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

The other half of the shortfall in 1962 business investment below year-ago expectations was in fixed investment. Although this did rise by 9 percent, 1962 over 1961, it did not exhibit the stronger surge that had been anticipated. A number of conditions that had been expected to facilitate a rapid expansion in plant and equipment spending did in fact materialize. External finance was comparatively cheap and plentiful. Internal finance was relatively abundant; indeed, by the end of the year gross corporate saving exceeded gross investment expenditures by $3 billion. And by summer, as noted in the section that follows, businesses received the combined impetus of liberalized depreciation schedules and an investment tax credit.

To all appearances, the stimulus to invest in new products and in cost-reducing changes of equipment and process remained strong during the year. And the stimulus arising from the current degree of capacity utilization could reasonably have been expected to be stronger than during the preceding expansion. For the index of capacity utilization compiled at the Federal Reserve Board, which rose from 78 percent in the first quarter of 1961 to 85 percent in the fourth quarter of that year, had consistently remained 3 to 5 percentage points above corresponding quarters in the 1958–59 recovery. A similar difference in utilization rates between the end of 1961 and the end of 1958 has also beeen reported in a survey by a private organization.

Rather than in any of these factors, the restraint upon fixed investment in 1962 lay in another circumstance that became increasingly apparent as the year progressed. This was the cumulative effect upon business expectations of 5 years of persisting slack in the economy. By 1962, this prolonged period of underproduction and underemployment had dampened business' willingness to invest. It left businessmen with a long record of consistently, not merely temporarily, redundant capacity. Excess capacity meant lower average profit margins. Further, it meant that new investment was more likely to be risky and less likely to be profitable.

With respect to both fixed investment and inventory investment, in short, the disappointing 1962 performance was a reflection of inadequate demand—not only of a current inadequacy but of one that had been accumulating for half a decade. By the end of 1962, it was plain that businessmen had become conditioned to appraise future expansion cautiously and were slow to extend their commitments beyond near-term needs. Business investment had taken on a character that was likely—in the absence of strong expansionary forces elsewhere in the economy—to cause the economy to stabilize at less-than-full employment levels more or less indefinitely. Plainly, a decisive upward adjustment in the economy's underlying expan-

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sionary forces was needed, and it is this the President's 1963 tax program is designed to supply.

FISCAL POLICY

As remarked already, the President's budget for the fiscal year 1963 expected continuation of the strong tide of recovery that had marked the last 3 quarters of 1961. Fiscal policy was designed to support but not to spur the economy's expansion. The Administration was resolved to avoid repeating the premature and abrupt swing of 1959 toward restrictive budgetary policy. At that time, the budget on a national accounts basis moved from a deficit of $11 billion (annual rate) in the third quarter of 1958 to a surplus of $8 billion 6 quarters later. Federal outlays rose only $1 billion while revenues rose $20 billion, reflecting improved corporate profits, the continuing growth of personal incomes, and higher tax rates for social insurance. Between the calendar years 1959 and 1960, the estimated budget surplus that would occur at 4 percent unemployment rose from $6 billion to over $13 billion. During 1961, the first year of this Administration, this implicit surplus was reduced to about $8 billion. The budget presented last January envisioned little further change in this surplus.

Actual revenues were expected to increase rapidly as profits and employment improved in 1962, and Federal receipts and expenditures in the administrative budget were expected to be almost exactly balanced in fiscal 1963. The fiscal 1963 Budget Message noted explicitly that a deficit would appropriately occur if the expansion fell below expectations. When this happened, the automatic shortfall in revenues helped to cushion the burden of taxes on private demand.

Two important changes in taxation were initiated in 1962 to help to stimulate the investment needed for sustained expansion and longer-run growth. On July 11, the Treasury Department issued revised guidelines for determining depreciation schedules for tax purposes. Their effect was to increase, in some cases substantially, the rate at which business firms can write off plant and equipment, thus reducing corporate profits tax liabilities. In addition, the new procedures permit management greater flexibility in determining depreciation charges and allow more fully for prospective obsolescence. As a further encouragement to investment, Congress in October enacted an investment tax credit as part of the Administration-supported Revenue Act of 1962. This credit permits corporations to deduct from their tax liabilities a part of the cost of newly acquired equipment. Taken together, these two changes increase the flow of internal funds by over $2 billion a year and strengthen incentives to invest by an estimated 20 percent increase in the profitability of eligible new investment in plant and equipment. These two measures are described in more detail in Appendix A.

The Public Works Acceleration Act of 1962, passed by the Congress in September, authorized the President to inaugurate public works programs in areas of persistent and substantial unemployment and underemployment. The Administration moved rapidly to carry out this program, which permits acceleration of work on Federal projects, as well as grants for State and local projects. (See Appendix A.)

During the late spring and summer as the slowdown generated concern about impending recession, the Administration considered carefully the need for stronger fiscal measures. By the middle of August, the evidence pointed to continued expansion through 1962. In his August 13 address, the President reviewed the economic situation and discussed his decision to ask the Congress to enact comprehensive tax reduction and reform legislation in 1963 to meet our basic longer-term needs but not to ask for tax reduction in 1962 on an emergency basis.

MONETARY AND DEBT MANAGEMENT POLICIES

Monetary policy has remained favorable to economic expansion. During 1962, most interest rates on long-term financing fell below their levels at the trough of the recession in February 1961 (Chart 4). While this was partly a passive result of economic slack and stability in the price level, it also reflected deliberate effort on the part of the monetary authorities to maintain adequate liquidity and favorable credit conditions.

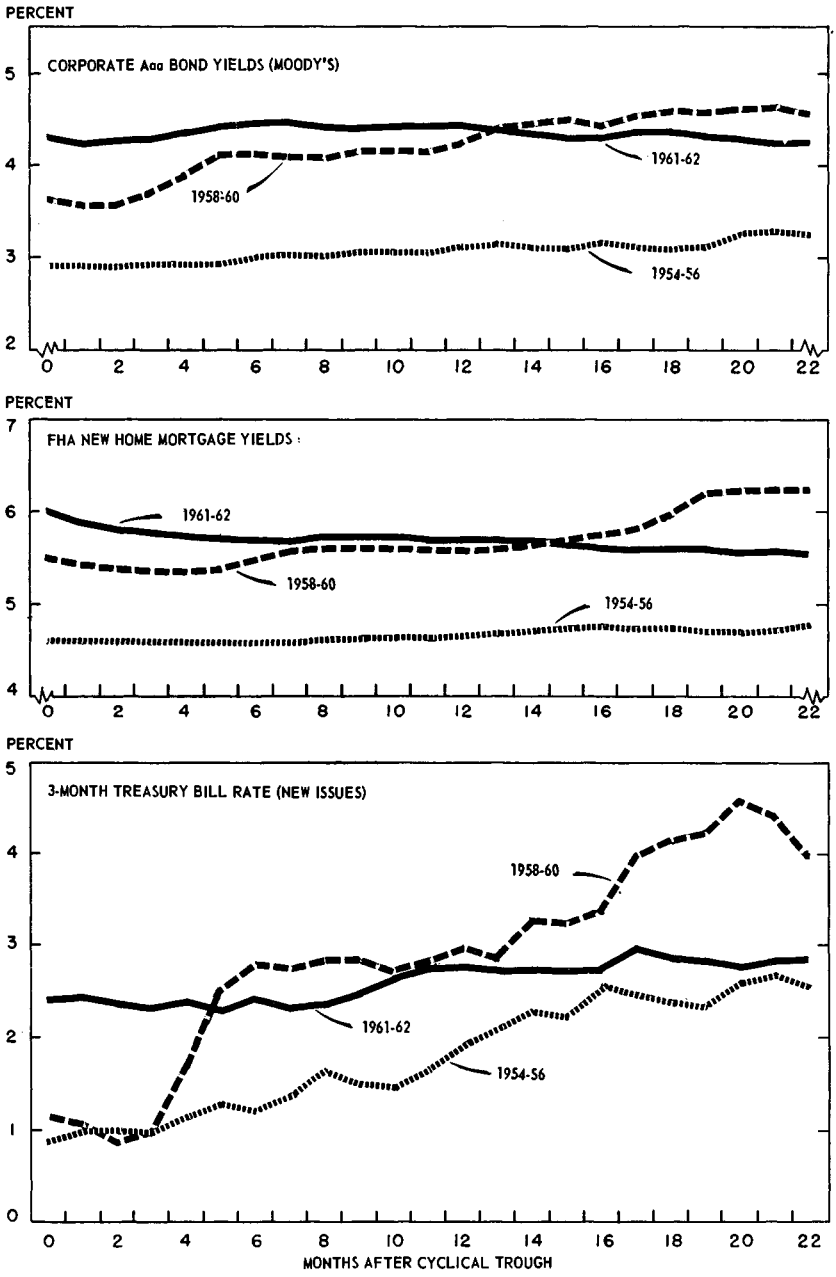
Monetary and debt management authorities faced a continuous challenge in maintaining such credit conditions without encouraging short-term capital movements that would hinder improvement in the U.S. balance of payments. Since mid-1960, monetary and debt management authorities have worked together to keep short-term interest rates from falling out of line with rates abroad.

Federal Reserve open market operations were geared to two objectives. First, they provided the basis for deposit expansion as well as restoring to the banking system reserves absorbed by the decline in the gold stock and the rise in currency in circulation. Since the Federal Reserve also reduced cash reserve requirements against savings and time deposits from 5 to 4 percent, the result was an effective net increase in reserves of more than $1 billion during the year.

Second, purchases and sales of U.S. Government securities were designed to minimize the downward pressures on short-term interest rates resulting from monetary expansion, while encouraging the flow of long-term funds and keeping downward pressures on long-term rates needed for domestic recovery and growth. The Federal Reserve System continued the policy, begun in February 1961, of purchasing longer-term securities, although on a more moderate scale in 1962 than in 1961. Most purchases, on balance, were concentrated in the 1–5 year range. There were negligible net purchases of securities with maturities of under 1 year.

CHART 4

Interest Rates in Three Postwar Expansions



SOURCES: MOODY'S INVESTORS SERVICE, FEDERAL HOUSING ADMINISTRATION (FHA), AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

TABLE 3.—*Net funds raised by nonfinancial borrowers, 1957–62*

[Billions of dollars]

Borrower	1957	1958	1959	1960	1961	1962 [1]
Total	32.5	42.8	52.7	36.2	46.3	58.3
Federal Government [2]	−1.3	8.6	8.7	−2.2	7.4	7.4
Foreign borrowers	1.4	2.3	.8	2.0	2.7	1.5
Private domestic nonfinancial sectors	32.4	31.9	43.1	36.3	36.2	49.4
Loans	6.8	3.1	14.1	11.0	5.8	14.6
Consumer credit	2.6	.1	6.1	4.4	1.4	5.5
Bank loans [3]	2.3	1.8	5.6	2.9	2.3	4.8
Other loans	1.9	1.1	2.4	3.7	2.2	4.3
Securities and mortgages	25.6	28.8	29.1	25.3	30.4	34.8
State and local obligations	4.6	5.5	4.7	3.7	5.1	5.4
Corporate securities	8.8	8.0	5.4	5.4	7.0	5.2
1-to-4 family mortgages	8.6	10.1	13.2	10.4	12.1	15.2
Other mortgages	3.5	5.2	5.8	5.8	6.1	9.0

[1] Preliminary estimates by Council of Economic Advisers.
[2] Includes CCC-guaranteed loans.
[3] Bank loans not elsewhere classified.

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

Source: Board of Governors of the Federal Reserve System (except as noted).

Meanwhile, the Treasury expanded its cash offerings of securities of under 1-year maturity. As a result of this and other factors, $1 billion was added to the public's holdings of short-term securities. At the same time, as explained in Chapter 2, the Treasury lengthened the average maturity of the publicly held debt by 5 months, largely through advance refunding operations.

Growth in private demand deposits and currency was $2.3 billion, or only 1½ percent. But the increase in maximum rates payable on commercial bank savings and time deposits under Regulation Q led to a $15 billion rise in these deposits. The money supply—currency and demand deposits—plus savings and time deposits rose by about 7½ percent, somewhat faster than in 1961.

The pattern of commercial bank credit expansion was different from that of 1961 because of three related factors which affected credit: private loan demand grew moderately as economic activity expanded; expectations for stable long-term interest rates formed; and the inflow of savings and time deposits accelerated.

As a result, business lending was the highest in 3 years, and banks were a major factor in the capital markets. Banks added record amounts—over $9 billion—to their holdings both of State and local government securities and of mortgages, but they did not add to their holdings of U.S. Government securities, as they had in 1961. The postwar cyclical pattern of interest rates had led the financial community to expect rising long-term interest rates once recovery began in February 1961. This expectation helped to prevent long-term interest rates from moving downward in the early months of expansion. But as monetary ease persisted, and inflationary psychology

waned, this pattern of expectations broke down, and lenders entered longer-term capital markets more aggressively. The abundant flow of funds through institutions that lend in the long-term capital markets, and the substantial operations of commercial banks, helped support a new record volume of mortgage financing, while State and local governmental securities flotations increased somewhat (Table 3).

New issues of corporate securities fell off substantially in the face of modest capital expenditures relative to the large internal cash flow.

THE FIVE-YEAR RECORD

The slowdown of 1962 was rooted in the prolonged sag of demand below capacity that has continued since 1957. The forces that have kept us below full employment in the past several years persist. Our challenge now is to overcome them.

The 1957–62 period matches neither our own record of performance between 1947 and 1957, nor the gains achieved by other free nations (see Chapter 4). The annual growth rates of output, income, and productivity have all run about 1 percentage point lower in the most recent period than in the previous decade, as Table 4 shows.

TABLE 4.—*Changes in output, income, and employment in two postwar periods*

[Percentage change per year]

Item	1947–57	1957–62 [1]
Gross national product (GNP), constant prices	3.9	3.0
Private GNP, constant prices [2]	3.9	3.0
Industrial production	4.4	3.3
Disposable personal income, constant prices	3.9	3.1
Labor force [3]	1.4	1.1
Employment [3]	1.3	.9
GNP per capita, constant prices	2.1	1.2
Private GNP per man-hour, constant prices	3.7	2.7
Disposable personal income per capita, constant prices	2.1	1.3

[1] Based on preliminary estimates for 1962 by Council of Economic Advisers.
[2] Total gross national product less compensation of general government employees.
[3] Includes armed forces; data for 1962 adjusted by Council of Economic Advisers for comparability with data for preceding years.

Sources: Department of Commerce, Board of Governors of the Federal Reserve System, and Department of Labor (except as noted).

In the past 5 years, the economy has been consistently out of balance—with too little demand to match our supply capabilities. In the first postwar decade, when demands were considerably stronger, the balance was frequently tipped in the other direction. There are several reasons why total private demand—and especially investment demand—was particularly strong in the 1947–57 period and less buoyant in the recent period. We began the postwar era with an abundance of liquid assets and a dearth of physical assets—plant and equipment, inventories, housing, and con-

sumer durables. As a result, firms and households were eager spenders for goods in the late 1940's. Then the expansionary fiscal actions required by the Korean conflict helped to underwrite full utilization in the early 1950's. Aided by a tax reduction in 1954, the Nation subsequently adjusted readily to a peacetime, high-defense environment. Demand for capital goods and automobiles sparked a brisk advance toward full employment during 1955. Prices rose considerably in 1956–57, and monetary and fiscal policies were tightened.

When prices stabilized and output began to fall short of full utilization, fiscal and monetary policy continued to treat excess demand as the principal threat to our economic performance. Tax reduction was widely discussed in 1958 but was rejected as unnecessary for reversing recession—a correct judgment in view of the April upturn—and as overly expansionary for the longer run—a judgment that now appears incorrect. In 1959–60 fiscal and monetary policies were tightened sharply in response to what was considered a lingering inflationary threat, contributing to the brief duration and weakness of the 1958–60 expansion. In the immediate postwar years, it took time for policy to be adjusted to the strength of the expansionary forces; later, it again took time to recognize that these forces had largely expended themselves. In the current expansion, no backlogs of private demand, no sums of excess liquidity, no unusual body of deferred technical changes have been present to push the economy toward full employment. And once unemployment of manpower and machines had persisted for nearly 5 years, expectations in 1962 were colored by the suspicion that underutilization was to be the normal state of the American economy. As a result, inadequate demand remains the clear and present danger to an improved economic performance. The manifestations and costs of this imbalance are evident in a review of unemployment and production in the 1957–62 period.

RECORD OF UNEMPLOYMENT

Unemployment has been consistently and significantly higher since 1957 than it was in earlier postwar years. The unemployment rate averaged 4.3 percent of the civilian labor force during the decade which ended in 1957, and exceeded 4 percent significantly only during recessions and early phases of recovery. Since then, unemployment has averaged 6.0 percent and has been below 5 percent for only 1 month in the past 5 years. Both the average number of persons unemployed and the average length of each spell of unemployment have risen. From 1948 to 1957, the average duration of unemployment was 10.3 weeks; since then it has been 14.3 weeks. The comparability of the unemployment data for the years of the postwar era has recently been reaffirmed by the President's Committee to Appraise Employment and Unemployment Statistics.

TABLE 5.—*Unemployment rates for experienced wage and salary workers, by industry, 1957, 1961, and 1962*

[Percent [1]]

Industry	1957	1961	1962
Total experienced wage and salary workers	4.5	6.8	5.5
Nonagricultural industries	4.5	6.7	5.5
Mining, forestry, fisheries	6.3	11.6	8.6
Construction	9.8	14.1	12.0
Manufacturing	5.0	7.7	5.8
Durable goods	4.9	8.4	5.7
Nondurable goods	5.3	6.7	5.9
Transportation and public utilities	3.1	5.1	3.9
Wholesale and retail trade	4.5	7.2	6.3
Finance, insurance, and real estate	1.8	3.3	3.1
Service industries	3.4	4.9	4.3
Public administration	2.0	2.7	2.2

[1] Percent of civilian labor force in each group who were unemployed.

Source: Department of Labor.

As shown in Table 5, unemployment has risen since 1957 among workers attached to services, finance, and trade—industries where employment is at or near record levels—as well as among workers attached to manufacturing, mining, construction, and transportation and public utilities—industries where employment remains below earlier highs. Similarly, as shown in table 6, no major occupational group has been spared higher

TABLE 6.—*Unemployment rates by occupation, 1957, 1961, and 1962*

[Percent [1]]

Occupation	1957 [2]	1961	1962
Total unemployed	4.3	6.7	5.6
Experienced workers	3.9	5.9	4.9
Professional, technical, and kindred workers	1.2	2.0	1.7
Medical and other health workers	1.4	1.4	1.4
Teachers, except college	.7	1.3	1.3
Other professional, technical, and kindred workers	1.3	2.5	2.0
Farmers and farm managers	.3	.4	.3
Managers, officials, and proprietors, except farm	1.0	1.8	1.5
Clerical and kindred workers	2.8	4.6	3.9
Stenographers, typists, and secretaries	2.3	3.7	3.4
Sales workers	2.6	4.7	4.1
Craftsmen, foremen, and kindred workers	3.8	6.3	5.1
Carpenters	8.1	12.3	9.4
Construction craftsmen, except carpenters	6.4	10.7	8.8
Mechanics and repairmen	2.8	4.7	3.6
Metal craftsmen, except mechanics	2.6	6.2	3.4
Other craftsmen and kindred workers	2.4	3.4	3.4
Foremen, not elsewhere classified	1.7	2.6	2.6
Operatives and kindred workers	6.3	9.6	7.5
Private household workers	3.7	5.9	4.9
Service workers, except private household	5.1	7.4	6.4
Farm laborers and foremen	3.7	5.7	4.3
Laborers, except farm and mine	9.4	14.5	12.4

[1] Percent of civilian labor force in each category who were unemployed.
[2] Average of January, April, July, and October estimates.

Source: Department of Labor.

unemployment rates since 1957. The rise has affected professional and technical workers, craftsmen, clerks and sales workers, as well as unskilled and semiskilled workers. Higher unemployment exists even among skill categories in which labor is still assumed to be in short supply. For instance, unemployment rates have risen among mechanics and repairmen, stenographers, clerks and typists, and teachers.

The statistics given above indicate that today jobs are more scarce than skills. But the skills of the labor force must continually adjust to changes in demand and technology, and these adjustments are neither easy nor automatic.

The incidence of high unemployment has fallen most sharply on young persons newly entering the labor market. The inadequate rate of growth in job opportunities has resulted in new entrants encountering special difficulty in finding jobs despite their better educational qualifications. Though lacking in experience and specific skills, young entrants to the labor force are better educated than the average worker and significantly better educated than older workers retiring from the labor market. This has resulted in an increasing proportion of younger persons entering the white collar and more highly skilled occupations, but has not prevented a dramatic rise in the unemployment rate for the group as a whole.

Even during highly prosperous years, there is an imperfect matching of unfilled jobs with unemployed labor. Technological changes, shifting patterns of demand, and the relocation of industry are continuously displacing workers. New skill requirements arise, and old ones become redundant. As a result, there are always unmanned jobs and jobless men. But it is reasonably certain that the number of unfilled job vacancies has not risen along with unemployment these past 5 years. The United States unfortunately does not have a comprehensive statistical series on job vacancies—although work leading to the eventual institution of such a series is being recommended in this year's budget. However, the index of help-wanted advertisements compiled by the National Industrial Conference Board—a partial measure of job vacancies—indicates a substantially smaller volume of such advertisements in 1962 than in 1957 after adjustment is made for growth of the labor force. Higher unemployment is explained by the shortage of new job opportunities; the matching of unfilled jobs and unemployed workers has not become any less efficient in recent years, though current efforts to make it more efficient were long overdue.

The problems of structural unemployment—of imperfect adaptation of jobs and workers—are persistent and serious, and they are thrown into bold relief by the prolonged lack of sufficient job opportunities over the past 5 years. But these problems of adaptation have not constituted a greater cause of unemployment in recent years than in earlier periods. The source of the high unemployment rates in recent years, even in periods of cyclical expansion, lies not in labor market imbalance, but in the markets for goods and services.

While aggregate output rose by 3 percent a year from 1957 to 1962, the productive capacity of the economy rose even faster. A gap between potential and actual output began to emerge in the late stages of the 1954–57 expansion and has persisted ever since. From 1958 through 1962, actual fell short of potential by more than 6 percent on the average.

The difference between unemployment rates of 5.6 percent and 4 percent understates the loss of output that occurred in 1962. Higher employment in a slack economy brings with it higher man-hour productivity through more efficient use of manpower and machinery. In addition, as production moves at a faster pace the total number of hours worked increases faster than employment itself; fully-employed workers find themselves on overtime, and the substantial number of involuntary part-time workers—more than 2 million in 1962—is reduced. Finally, the availability of jobs encourages entry into the labor force of many who had not actively sought work in the knowledge that there was none to be had. The 1962 Report of the Council discussed these aspects of the unemployment-output relationship in more detail.

No precise and unvarying connection exists between higher output and reduced unemployment. The relationship depends on the industry and region producing the added output, the capital available for expanded production, the existing amount of on-the-job underemployment, and the skills of available workers. But our postwar experience indicates that a reduction of 1 percentage point in the global unemployment rate at any moment of time is associated, on the average, with an increase in real GNP of slightly more than 3 percent. Put the other way around, if GNP were 3 percent higher than it is now, the unemployment rate would be approximately 1 percentage point lower.

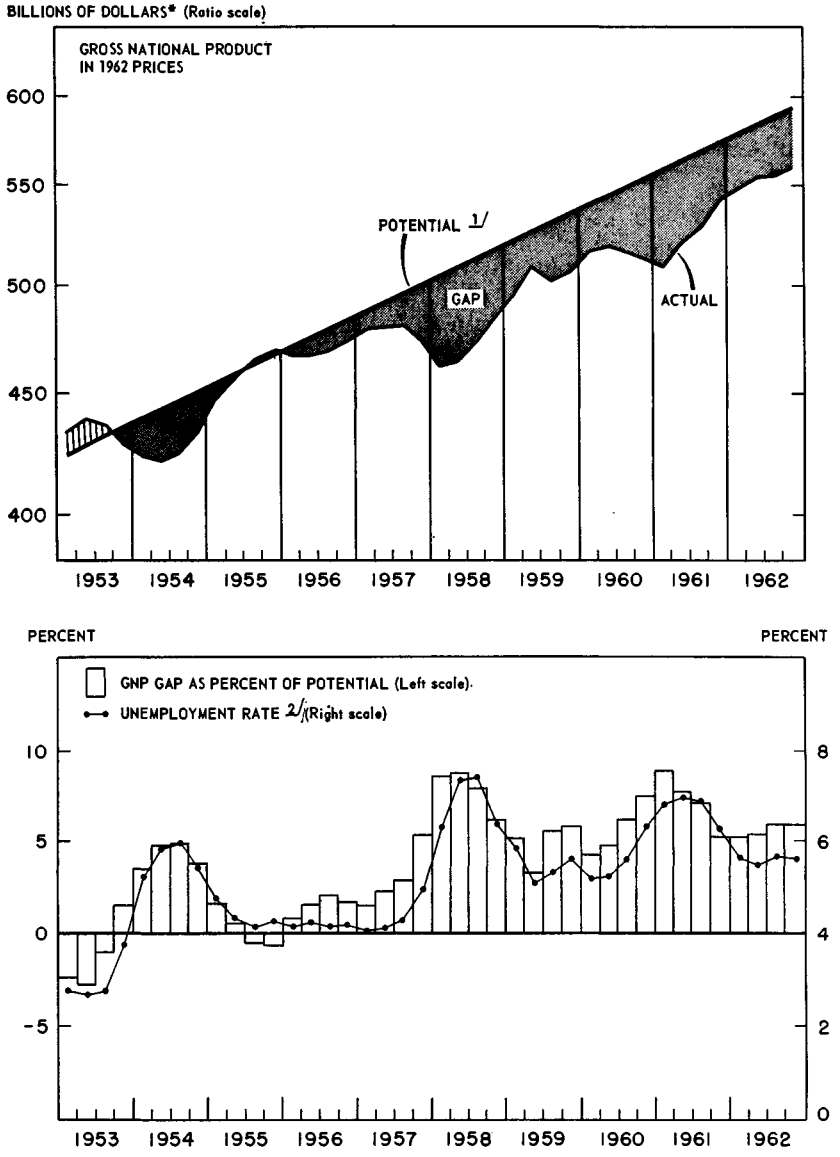
With the passage of time, the unemployment rate will remain constant only if output rises. Because the labor force grows over time, constancy in the unemployment rate means a rise in the number of employed workers and thus requires an increase in total output. And because output per worker also tends to rise—with advances in technology, improvements in skills, and additions of new capital equipment—production must increase faster than employment.

In the post-Korean period, the aggregate output associated with a constant unemployment rate has grown at about 3½ percent a year. For example, in 1954, 1960, and again in 1962, unemployment averaged 5.6 percent of the labor force. From 1954 to 1960, the annual growth rate of output was 3.2 percent; from 1960 to 1962, it was 3.6 percent.

Chart 5 shows the Council's estimate of potential output for the years 1953–62. The path of potential is represented by a 3½ percent trend line through actual output in mid-1955, which is taken as a period of approximately full use of resources. This smooth curve is a consistent approxima-

CHART 5

Gross National Product, Actual and Potential, and Unemployment Rate



* SEASONALLY ADJUSTED ANNUAL RATES.
1/ 3½% TREND LINE THROUGH MIDDLE OF 1955.
2/ UNEMPLOYMENT AS PERCENT OF CIVILIAN LABOR FORCE; SEASONALLY ADJUSTED.
SOURCES: DEPARTMENT OF COMMERCE, DEPARTMENT OF LABOR, AND COUNCIL OF ECONOMIC ADVISERS.

tion to the more irregular path traced out by the alternative calculation using unemployment rates. (This is suggested by the lower panel of the chart, which compares changes in the gap between actual and potential GNP with fluctuations in the unemployment rate.)

The chart also shows actual GNP and the discrepancy between actual and potential output. The cumulative excess of potential over actual output in the period 1958 to 1962 totals $170 billion (1962 prices) or nearly $1,000 a person. The gap was dramatically reduced during early stages of the two expansions of 1958–59 and 1961. But the subsequent stages of each expansion failed to bring actual GNP up to potential.

The estimate of the gap shown in the chart is consistent also with the evidence on the utilization of industrial capacity. There are statistical difficulties in any attempt to measure capacity and utilization rates, and the available material is relatively narrow in coverage. Nevertheless, it provides a partial check on calculations based primarily on unemployment rates. Since 1957, the average of a quarterly index of manufacturing capacity utilization compiled at the Federal Reserve Board has been 5 percent below the average for 1947–57. In the past 5 years, the index has not exceeded its 1947–57 average. As in all recent years, the 1962 operating rate left room for considerable expansion of output and employment without strain on existing manufacturing capacity.

The thrust of recovery during the past 2 years has narrowed the gap of unrealized potential and excess industrial capacity. The problem remaining is to create an economic environment in which the expansionary powers of the private economy can reinforce each other in a movement toward full utilization. Once we have brought our actual performance up to our potential, we can look toward a more rapid growth of our potential as well. From 1947 to 1955, GNP in constant prices, matching the growth of potential GNP, rose at an average annual rate of 4.3 percent. The lower 3½ percent growth rate of potential in recent years is attributable to our failure to use existing capacity fully, thereby blunting the incentives for investment and innovations.

THE LEVEL AND PATTERN OF DEMAND

Higher rates of unemployment, slower advances in output, excess industrial capacity, reduced growth of incomes—these features of our economy in the past several years are not separate phenomena. They are all part of the syndrome of persistently sluggish demand. Total expenditures for goods and services have been insufficient to take full advantage of our capacity to produce, to keep our manpower and machines fully employed, and to support the rapid growth of incomes of which the economy is capable.

The relative strength or weakness of the major categories of demand has varied during the period. Thus Federal purchases of goods and services in constant (1962) prices declined by $4.6 billion between the end of 1958

and the end of 1960. As a fraction of disposable income, consumption ranged from a low of 92 percent in 1958 to a high of 94 percent in 1960. Expenditures on new housing showed strength in 1958–59 and 1961–62. Business investment in fixed assets and inventories fluctuated cyclically around a relatively low average. However, the variations from component to component and from year to year are less significant than the consistent insufficiency of total expenditures. The weakness of total demand held down capacity utilization and retarded the incentives for investment. Weak investment in turn slowed the growth of incomes and demand.

Investment

Throughout the 1957–62 period, weakness in the demand for investment goods was both cause and effect of the weakness of total demand. Unlike other major components of GNP, gross private domestic investment in 1962 prices has shown no upward trend since the mid-1950's. After a brisk rise of about 50 percent from 1947, it reached a peak of $75 billion in 1955, then fell, and did not return to the 1955 level until 1962, when real GNP was 16 percent larger.

Business fixed investment was high in the early postwar years, averaging about 12 percent of total output (1962 prices) in 1947–48. Demand for plant and equipment was especially strong after nearly 2 decades of low growth in capacity associated with the depression of the 1930's and the war. From 1949 through 1957, business fixed investment remained within a range of 10 to 11 percent of real GNP. In sharp contrast, during the past 5 years the proportion of output devoted to business fixed investment has averaged only 9 percent. This trend is shown in Chart 7 in Chapter 2.

The relative weakness in plant and equipment outlays in recent years is reflected in the apparently slow growth of business fixed capital. The amount of business fixed capital in useful existence can only be inferred. But using average service lives based on actual business practice, the Department of Commerce estimates that the existing stock of business structures and equipment has increased by only 2 percent per year over the past 5 years, compared with 4 percent a year in the period 1947–57 (Table 7).

TABLE 7.—*Growth of gross stocks of fixed business capital in two postwar periods* [1]

[Percentage change per year]

Type of stock	1947–57	1957–62 [2]
Total nonfarm	3.9	1.7
Structures	1.7	2.7
Equipment	6.9	.6
Manufacturing	4.3	1.2
Structures	1.7	.4
Equipment	6.5	1.6

[1] Based on stocks, in 1954 prices, at end of year; lives 20 percent shorter than in Internal Revenue Service Bulletin F (1942 edition).
[2] Based on preliminary estimates for 1962 by Council of Economic Advisers.

Sources: Department of Commerce and Council of Economic Advisers.

Changing incentives to invest are reflected in the relationship between corporate saving and investment. Profitable and expanding markets lead businessmen to invest more than their gross retained earnings. Through their participation in debt and equity markets, business firms then channel personal savings into new capital goods and inventories. Chart 6 shows that, from 1947 to 1957, nonfinancial corporations generally invested more than their own gross saving. The only exceptions in that period occurred in the recession years of 1949 and 1954. But, since 1957, the relationship has been reversed: investment by corporations in plant, equipment and additions to inventories has not kept pace with gross retained earnings. Corporate investment fell considerably short of corporate saving in 1958 and 1961, and exceeded saving by a bare margin in 1959 and 1960. The past year, 1962, was the first in the postwar era when corporate investment fell short of corporate saving in a year untinged by recession. While the slow pace of advance in the economy since 1957 has held down the supply of internal funds to nonfinancial corporations, their incentives to invest have not even kept pace with the over-all availability of internal funds.

Residential construction expenditures are so volatile from year to year that a clear trend is hard to discern. The record does suggest that the rise in construction activity slowed after the first postwar decade. Housing activity in 1961–62 surpassed the 1955–57 average by less than 15 percent, while construction in 1955–57 represented a 55 percent gain over 1947–49. Expenditures on residential construction remained the same percentage of personal disposable income (in 1962 prices), 6.0 percent, during 1958–62 as in the previous decade. In view of the large backlog of housing demand in the earlier period, housing activity has held up well.

Consumption

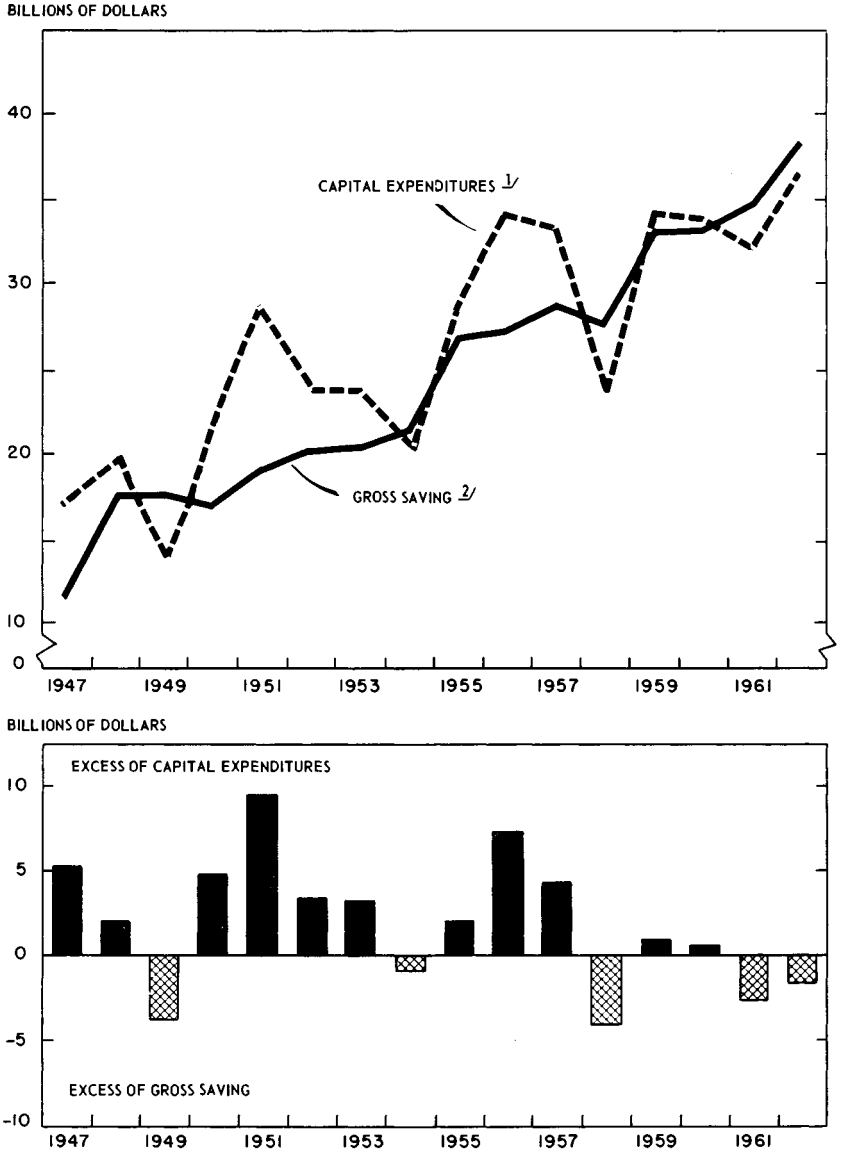
In 1947–49, consumer outlays clearly exerted an important expansionary force on the economy, averaging more than 95 percent of disposable income over the 3-year interval. Since 1950, however, the fraction of disposable personal income spent on consumers goods and services has remained between 92 and 94 percent each year. The fraction has varied in this range from year to year, but it has shown no clear trend. Consumers expenditures have not been constrained in recent years by any unwillingness of consumers to spend out of their disposable incomes.

But the growth of consumption has slowed, constrained both by a smaller rise in personal income and by the high and increasing bite of personal taxes. As a result of a rising ratio of personal tax collections—both Federal and State and local—to personal income, disposable personal income as a fraction of personal income has declined from 87.9 percent in 1957 to 86.9 percent in 1962.

Since 1951, the proportion of disposable income (1962 prices) spent on durable goods has shown no trend, although it ranged from a high of 13.6 percent in 1955 to a low of 11.3 percent in 1958. It averaged 12.1

CHART 6

Gross Saving and Capital Expenditures of Corporate Nonfinancial Business



1/ CONSTRUCTION, EQUIPMENT, AND CHANGE IN INVENTORIES.
2/ PROFITS AFTER TAX ACCRUALS AND DIVIDENDS PLUS CAPITAL CONSUMPTION ALLOWANCES.
SOURCES: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND COUNCIL OF ECONOMIC ADVISERS.

percent from 1958 to 1962. This stable proportion gives strong evidence of the continuing demand for durables. Automobile sales have been supported by increasing replacement demand and the growing tendency of families to own more than one car. Expenditures on other durables have grown proportionally with incomes. Since 1957, an increased—but still small—fraction of households have acquired such items as air conditioners, dishwashers, dryers, and freezers.

The most notable change in the composition of consumption in the postwar period has been the shift away from nondurable goods and toward services. From 1951 to 1962, the proportion of disposable income (1962 prices) spent on nondurables fell from 45.8 to 42.3 percent, while the fraction spent on services rose from 34.9 to 38.5 percent.

Conclusion

Total demand depends on the strength of expenditures in the several sectors of the economy. But it is not a simple sum of the parts. Exceptional strength in any component of expenditure will raise employment and capacity utilization, household incomes and business profits, consumption and investment, spreading its expansionary influence throughout the economy. These forces can sometimes be too strong, and they then need to be restrained by fiscal and monetary policies.

At other times, there may be no exceptional upward drive in the economy. In this type of situation, weakness in any sector is diffused throughout the economy unless it is offset by a sufficiently expansionary fiscal or monetary policy. In the past 5 years, total demands have not been adequate to promote rapid growth of incomes. Consumption has not generated the profitable markets needed to stimulate investment; and investment spending has not generated the incomes needed to promote strong gains in consumption. Even though the capital stock has grown slowly, so has total demand; thus the economy has not been able to grow into its unused capacity. And as sluggishness has persisted, unfavorable experiences have generated unfavorable expectations and cautious planning, reinforcing the inadequacy of demand.

Taking the past 2 years by themselves, gains in employment, incomes, and output have been substantial. Fiscal and monetary policies have supported recovery from the recession. However, despite this encouraging progress it is now apparent that demands originating in the private economy are insufficient by themselves to carry us to full employment. Nowhere are there visible spontaneous forces of sufficient strength to put an end to the period of slow growth. But there is a way: through tax reductions and reforms, the Federal Government can relax its restraints on the expansionary power of the private economy.

The Employment Act of 1946 requires estimates of "current and foreseeable trends in the levels of employment, production, and purchasing power." This is a wise and constructive mandate. The plans and policies of both Government and business are forward-looking: they influence the future; they must rest—however uneasily—on expectations about the future.

For some purposes, the forecasts upon which public policies are based need not be numerically precise. As a justification for an expansionary tax reduction in 1963, for example, it is enough to know that, lacking such a cut, the prospect for 1963 and beyond is for substantial shortfalls of demand below capacity. On the other hand, the need, for budgetary purposes, to make fairly exact projections of Federal revenues requires the relatively precise kind of forecast—namely, that GNP will amount to $578 billion, plus or minus $5 billion—contained in this year's Budget Message. This estimate implies moderate gains in employment, production, and purchasing power throughout 1963, with expansion beginning to accelerate later in the year in response to the President's tax program. The average quarterly gain in GNP during the course of the year would be about the same as in 1962—nearly $6 billion.

The projection for 1963 emerges from a survey of prospects for the major categories of public and private spending.

GOVERNMENT PURCHASES OF GOODS AND SERVICES

The budget estimates for the fiscal years 1963 and 1964 indicate that Federal purchases, reflecting increases in defense and space activities, should continue to rise, reaching in the calendar year 1963 an average $4 billion higher than in calendar 1962. State and local purchases are expected to continue rising at the same pace as in recent years, adding another $4 billion increase in total spending.

RESIDENTIAL CONSTRUCTION

Although down a bit from the preceding quarter, activity in housing remained strong at the year-end; November starts and permits were above the 1962 average. Basic demand, supply, and financial conditions should be as favorable in 1963 as they were in 1962. In the past, housing has usually declined considerably before a downturn in over-all activity, at least partly in response to monetary tightness. Ease in mortgage markets is expected to continue in 1963, reinforcing the prospects for sustained strength in residential construction. The best estimate is that nonfarm housing starts and residential construction expenditures will hold at about their 1962 levels.

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BUSINESS FIXED INVESTMENT

Business investment in plant and equipment during 1963 is expected to show modest gains above 1962 levels. Its progress is estimated in the light of the following factors:

1. Over-all rates of capacity utilization improved markedly in 1961, but they leveled off well short of full utilization during 1962. There is little prospect of an improvement in operating rates in the near future.
2. The ready availability of funds will continue to favor investment in 1963. In both 1961 and 1962, gross corporate saving exceeded corporate investment. Recent tax adjustments are adding further to business liquidity. And the improved state of equity markets and the continued ease of bond markets will facilitate external financing.
3. New orders for machinery and equipment improved moderately in the second half of 1962. As the year ended, new orders continued to point upward.
4. The November Commerce-SEC survey of investment plans for the first quarter of 1963 gave puzzling results. Estimated expenditures for the last half of 1962 were revised upward by businessmen; yet their plans pointed to a decline in outlays in the first quarter of 1963. Typically, upward revisions of plans are accompanied by continued gains in succeeding quarters, not the reverse. Privately conducted surveys for the year 1963 as a whole report investment plans exceeding 1962 levels by a small margin.
5. Evidence is accumulating that the new depreciation guidelines and the investment tax credit will have a significant influence on investment decisions. According to industry sources, the planned investment of the steel industry has been substantially increased under the stimulus of these measures, and now shows a marked rise over 1962.

Taken together, these considerations support the estimate of a small year-to-year increase in capital outlays.

CHANGE IN BUSINESS INVENTORIES

Businessmen are likely to add to their stocks in 1963, largely in response to moderate increases in final sales of goods. But the expected growth of sales is unlikely to push rates of inventory accumulation above the $3 billion average for 1962. Inventory-sales ratios have, on the whole, remained at conservative levels. The stability of these ratios suggests that businessmen view their current stock-sales relationships as appropriate and are not likely

to alter them significantly in either direction in the months ahead. But any sharp departure from expected patterns of final sales would be magnified in this highly volatile component of GNP.

PERSONAL CONSUMPTION EXPENDITURES

Consumer outlays are expected to continue to absorb about 93 percent of disposable personal income in 1963. Services are likely to claim a slightly increased fraction of incomes, with the share devoted to goods declining a bit. Early sales of 1963-model automobiles point to another good year for car sales, but increases in the sales rate achieved in the last quarter of 1962 are unlikely.

Disposable income is expected to grow at a slightly faster rate than GNP in 1963. While the increase in payroll taxes effective January 1, 1963, will retard the rise in disposable income, the prospects for consumer purchasing power are much improved by the President's recommendation for a midyear drop in the withholding rate for individual income taxes.

SUMMARY

In pointing to the likelihood of continued expansion, this review of the major sectors of demand is gratifying; in pointing to continued underutilization, it is challenging.

Continued expansion in 1963 would reverse the apparent postwar trend toward shorter expansions and more frequent recessions. By March 1963, the current expansion will have matched the 1958–60 upswing in duration. If it continues throughout 1963, the present recovery will have lasted 34 months, nearly equaling the 35-month duration of the 1954–57 expansion. The likelihood of such sustained expansion will be increased by prompt enactment of the President's recommendation for tax reduction in 1963.

The estimated GNP for 1963 is 4½ percent above the level of 1962 in current prices. With an increase of this magnitude, real GNP would not change significantly relative to the economy's potential. Neither the average unemployment rate nor excess industrial capacity in 1963 could be expected to decline appreciably. Apart from the effects of reduced taxes, real disposable income per capita and corporate profits could grow slowly at best. The prospects for 1963 reflect the same insufficiency of demand that has slowed our growth in the past several years. New investment will still be inhibited by underutilization of existing capital. Consumer spending will still be held down—until the tax reductions take effect—by a burdensome tax system. With that drain of purchasing power, the achievement of full employment would require a level of private investment that experience suggests will not be forthcoming.

Thus, the prospects for the future join with the facts of the present and the record of the past 5 years in posing a challenge for economic policy. But the same record—past, present, and prospective—furnishes valuable

guidance on how to respond to the challenge. It suggests that investment will be brisk when consumer spending provides the stimulus of profitable markets; that consumers' living standards can advance rapidly when business firms have strong incentives to expand employment; that capacity will grow rapidly when existing capacity is put to full and productive use; that a business firm can gear its plans to sustained prosperity when it enjoys buoyant markets; that there is latent strength of private demand which can be activated when tax reduction relaxes the restraints of fiscal policy. The President's proposals for tax legislation in 1963 are fashioned to respond to the realities of the economic record. They are designed to write a far brighter record in the years ahead. As the proposed tax changes take effect and release the force of stronger private demands, we can expect our gains to accelerate markedly. The moderate advance projected for 1963 should be the forerunner of sharply faster advances thereafter. Under the stimulus of tax reduction and reform, the years ahead promise to write a new chapter of full prosperity and rapid growth in our economic history.

Chapter 2

Domestic Economic Policy for the Mid-1960's

THE PROGRESS of the American economy in 1961 and 1962, and the further advance expected in 1963, have been discussed in Chapter 1. The record is one of steady gains in output, progress toward balance in our international accounts, maintenance of reasonable price stability, and a steady rise in incomes which—although moderate in money terms—translates almost entirely into higher living standards. These are achievements which we all welcome.

But this record is not good enough. Since 1957, progress in creating new jobs, absorbing idle capacity, and achieving a satisfactory rate of growth has not measured up to our earlier postwar performance; neither has our competitive position in the world improved sufficiently to solve our balance of payments problem. Our economy has not met the standards rightly expected of it by the American people. Given effective public and private action to make full use of our human and physical resources, our economy could readily be producing at a rate $30–40 billion higher than it is. Given effective policies, as discussed in Chapter 4, our balance of payments problem can be solved.

Our review shows that progress is not likely to be interrupted in the near future by a recession of the type experienced in 1949, 1953, 1957, and 1960. Thus we do not now face a cyclical emergency compelling immediate action. But the record does disclose that, for more than 5 years, the U.S. economy has lacked the buoyancy and vigor which spell full employment and rapid growth. The unemployment rate since mid-1957 has averaged 6 percent. Excess manufacturing capacity has averaged 5 percentage points higher than in the preceding decade. The result has been smaller advances in total payrolls and profits, and lower levels of investment and consumption, than we are willing to, or need to, accept.

Unemployment and excess capacity also take their toll by slowing down our long-run growth. They weaken the vital incentive to expand capacity and to innovate. They hold many of our resources—especially our human resources—in inferior uses. And they often generate resistance to mechanization and superior technology.

The need for early action lies, then, not in imminent recession but in continued waste of manpower and machines, and in thwarted opportunities for more rapid growth. Any program adequate to the task will take time

to enact and to become fully effective. Two recessions and two incomplete recoveries in the past five years bear witness that there is ample cause for action and no cause for delay.

FISCAL POLICY FOR FULL EMPLOYMENT AND GROWTH

The pace of expansion foreseen in business, consumer, and government expectations promises no easy resolution of our problem. Indeed, the prospective pace of expansion in 1963 promises little if any reduction of unemployment, little if any narrowing of the gap between actual and potential output. Positive action to invigorate the economy is required to reverse the record of the past 5 years and bring output, employment, and income up to their potential.

Accordingly, the President is recommending a major program of tax reduction and tax reform to expand private purchasing power and to strengthen private incentives—a program which will thus attack the problem of idle men and machines at its source and provide new vigor to the forces for expansion of the U.S. economy. It is the key instrument of policy for meeting our responsibilities for high employment and faster economic growth in the mid-1960's.

By reducing taxes, stimulating cost-cutting investment, strengthening incentives, and promoting a more efficient allocation of productive resources, a balanced tax program serves to lower unit costs. It thereby lays a firmer foundation for continued price stability and an improved U.S. competitive situation in world markets.

This chapter will examine the employment and growth objectives which confront tax and other economic policy this year, summarize the major elements of the proposals for tax reduction, examine the process by which tax revision generates higher levels of economic activity, consider monetary and debt management policies appropriate for complementing the tax changes while aiming at international equilibrium, and review briefly other policies for economic expansion.

GOALS OF HIGH EMPLOYMENT AND FASTER GROWTH

Need for more jobs

Today's unemployment, excessive as it is, provides only a partial measure of the employment problem confronting us—the problem that gives us the most dramatic single index of the need for tax action. The measure of the problem can be illustrated by the number of new jobs that would be needed to reduce unemployment to 4 percent by the end of 1963. This number can be divided into four parts:

1. The jobs needed to reduce unemployment among the present labor force from 5.6 percent even to 4.0 percent: 1.1 million.

2. The jobs needed to employ the added workers who would be drawn into—or drawn back into—the labor market by strong employment opportunities: perhaps 800,000 within a year (a larger number as unemployment remained at 4 percent.)
3. The jobs needed to employ the normal annual increase in the labor force: in 1963, an estimated 1.2 million.
4. The jobs needed to absorb the workers released from their present employment by mechanization, by technological advance, by improved organization and management, in a word, by rising productivity—jobs required merely to "hold our own" rather than to absorb today's unemployed or tomorrow's new entrants into the labor force.

The fourth category represents the replacement jobs needed, the other three, totaling 3.1 million, the extra jobs needed, to achieve the 4 percent unemployment level by the end of 1963. Raising the total number of jobs by 3.1 million would represent an increase in employment of 4.7 percent from December 1962 to December 1963, exceeding the rate of increase for any postwar year except the boom year 1955. And to supply, net, 3.1 million *additional* jobs, would require creating an even larger number of *new* jobs in 1963.

Costs of unemployment

Unemployment is an important index of economic slack and lost output, but it is much more than that. For the unemployed person, it is often a damaging affront to human dignity and sometimes a catastrophic blow to family life. Nor is this cost distributed in proportion to ability to bear it. It falls most heavily on the young, the semiskilled and unskilled, the Negro, the older worker, and the underemployed person in a low income rural area who is denied the option of securing more rewarding urban employment. Especially serious is the discouragement, disillusion, and bitterness generated among young people, entering the labor market for the first time, when the economy leaves them without opportunities of finding employment.

The concentrated incidence of unemployment among specific groups in the population means far greater costs to society than can be measured simply in hours of involuntary idleness or dollars of income lost. The extra costs include disruption of the careers of young people, increased juvenile delinquency, and perpetuation of conditions which breed racial discrimination in employment and otherwise deny equality of opportunity.

There is another and more subtle cost. The social and economic strains of prolonged underutilization create strong pressures for cost-increasing solutions. The longer the economic slack continues, the more difficult it is to resist the efforts of its victims to claim, often quite plausibly, prosperity incomes out of undercapacity output. On the side of labor, prolonged high unemployment leads to "share-the-work" pressures for

shorter hours, intensifies resistance to technological change and to rationalization of work rules, and, in general, increases incentives for restrictive and inefficient measures to protect existing jobs. On the side of business, the weakness of markets leads to attempts to raise prices to cover high average overhead costs and to pressures for protection against foreign and domestic competition. On the side of agriculture, higher prices are necessary to achieve income objectives when urban and industrial demand for foods and fibers is depressed and lack of opportunities for jobs and higher incomes in industry keep people on the farm. In all these cases, the problems are real and the claims understandable. But the solutions suggested raise costs and promote inefficiency. By no means the least of the advantages of full utilization will be a diminution of these pressures. They will be weaker, and they can be more firmly resisted in good conscience, when markets are generally strong and job opportunities are plentiful.

Demand and employment

The demand for labor is derived from the demand for the goods and services which labor participates in producing. Thus, unemployment will be reduced to 4 percent of the labor force only when the demand for the myriad of goods and services—automobiles, clothing, food, haircuts, electric generators, highways, and so on—is sufficiently great in total to require the productive efforts of 96 percent of the civilian labor force.

Although many goods are initially produced as materials or components to meet demands related to the further production of other goods, all goods (and services) are ultimately destined to satisfy demands that can, for convenience, be classified into four categories: consumer demand, business demand for new plants and machinery and for additions to inventories, net export demand of foreign buyers, and demand of government units, Federal, State, and local. Thus gross national product (GNP), our total output, is the sum of four major components of expenditure; personal consumption expenditures, gross private domestic investment, net exports, and government purchases of goods and services.

The primary line of attack on the problem of unemployment must be through measures which will expand one or more of these components of demand. As will be explained more fully below, the tax reduction program being proposed for enactment in 1963 will reduce unemployment by increasing the consumption and investment components of demand, thus raising production and creating new jobs.

Full employment, however defined, is a moving target. The GNP needed to achieve full employment is also a moving target; indeed, it moves faster than the employment target. The GNP target rises from year to year not only because the labor force increases but also because output per worker grows each year, as new technology is introduced, as workers are better educated and trained, and because capital investment provides each worker with more as well as better tools and machinery with which to work.

As an illustration of these relationships, based on average experience in the past, GNP in 1962 prices must grow by about 3½ percent a year, or nearly $20 billion in 1963, merely to keep the average unemployment rate at the 1962 level. To have the unemployment rate fall by 1 percentage point in the course of a year, GNP in constant prices would have to grow by an additional 3 percent, or a total of about 6½ percent. For the unemployment rate to be reduced from 5.6 percent to 4 percent within one year would require an 8 to 9 percent increase in GNP at constant prices.

Once a satisfactory level of employment has been achieved in a growing economy, economic stability requires the maintenance of a continuing balance between growing productive capacity and growing demand. Action to expand demand is called for not only when demand actually declines and a recession appears but even when the rate of growth of demand falls short of the rate of growth of capacity.

Structural aspects of unemployment

Although increased demand must be the major line of attack on unemployment, other measures are needed as well. Some workers are unemployed because they are not properly trained. Some are unemployed because they are geographically separated from the places where jobs are opening up and they are unaware of the existence of such opportunities. As a result of insufficient geographic and occupational mobility, bottlenecks and shortages of particular types of labor may occur as job opportunities expand at a time when there are still many unemployed workers.

A high percentage of the currently unemployed are unskilled and teenagers. But past periods of expansion have demonstrated industry's capacity for employing and training large numbers of persons who were considered unemployable in times of slack. If the total demand for labor expands, hiring specifications may be made less rigid, jobs redesigned, and on-the-job training programs expanded. But past experience also makes it clear that to facilitate the reduction of unemployment to minimum levels without undue upward pressure on wages and prices calls for vigorous government measures to improve the mobility and skill structure of the labor force.

Such measures as the Manpower Development and Training Act of 1962 and the "adjustment" provisions of the Trade Expansion Act of 1962 (both of which are outlined in Appendix A) will help to bring employee skills into better balance with employers' job requirements and to improve the geographic balance of labor supply and demand. These measures are an integral part of a program to reduce unemployment to a minimum. The policy circle will be closed only when markets for goods and services are strong enough to create new jobs for the retrained and relocated workers. The problems of structural unemployment and the key role of labor mar-

ket policy will be further developed in the first annual Manpower Report of the President, to be issued early this year.

It would be wrong to think of the problem of structural adaptation of our manpower supply only in terms of re-adapting present members of the labor force to new jobs. Much of the matching of supplies of skills with demand for them must take the form of appropriate education and training of new entrants into the labor force. The importance of this factor becomes readily apparent when we consider that nearly one-third of all workers in our labor force in 1970 will have entered it during the 1960's. By correctly anticipating the economy's needs for upgraded knowledge and skills, and aiming our education and training efforts to meet them, we can steadily improve the fit of available manpower to available jobs.

Success in a combined policy of strengthening demand and adapting manpower supplies to evolving needs would enable us to achieve an interim objective of 4 percent unemployment and permit us to push beyond it in a setting of reasonable price stability. Bottlenecks in skilled labor, middle-level manpower, and professional personnel tend to become acute as unemployment approaches 4 percent. The result is to retard growth and generate wage-price pressures at particular points in the economy. As we widen or break these bottlenecks by intensified and flexible educational, training, and retraining efforts, our employment sights will steadily rise.

But reaching an interim goal, a way-station, of 4 percent would be no small achievement in itself. The benefits would be felt by all, but particularly by those who bear the brunt of today's unemployment—the one in eight teenagers, the one in eight unskilled workers, the one in nine Negroes. However, an unemployment rate of 4 percent is an unacceptable target. Therefore, we must expand the various programs that would assist us in pushing below it.

The growth objective

Economic policies for 1963 couple pursuit of employment objectives with stimulation of more rapid economic growth. U.S. growth has been lagging. From 1955 to 1962, the economy's potential grew at an estimated annual rate of 3½ percent, nearly a percentage point lower than its growth rate from 1947 to 1955. Actual output grew even more slowly, averaging 2.7 percent a year in the 1955–62 period. This performance falls short of our aspirations, both as stated by the President and as translated into our share of the Organization for Economic Cooperation and Development commitment to a 50-percent growth target for the 1960's (for the 20 member nations as a group). These aspirations can be realized only by stepping up our growth rate to 4 percent and beyond as we move through the decade.

Our commitment for the pursuit of policies for faster growth is not only to our allies in the Atlantic community; it is first of all to ourselves. More rapid economic growth raises living standards, enhances job oppor-

tunities, and permits satisfaction of many needs now beyond our reach—in short, it improves the quality of our lives. But it does more. It builds a broader base for free world leadership, not only in easing the burdens of defense and foreign aid but, more important, in demonstrating the continued capacity of a free market economy to expand production, improve distribution, and increase well-being.

Fuller utilization of existing resources provides the primary spur to growth; indeed, it is a virtual prerequisite to speedier growth. A tax program aimed at high employment simultaneously stimulates growth by (1) pushing production increasingly toward higher use of plant capacity and thereby stimulating new investment to expand that capacity, (2) drawing more workers into the labor force and upgrading others from inferior to superior uses, (3) decreasing the resistance of labor and management to the risks of technological change, and correspondingly relaxing the grip of restrictive practices, (4) providing a business climate which tests ingenuity and invigorates a spirit of boldness and innovation, and (5) increasing the profitability of business investment, and generating an enlarged flow of funds to finance such investment.

More directly, as discussed below, the 1963 tax program will provide business with greater incentives and financial ability to invest in new capacity and new products. Incentives to risk-taking and to human effort will be strengthened by rising markets for goods and services, which increase the flow of profits, and by lower tax rates, which increase business profitability and personal disposable income. A lowering and restructuring of income tax rates will be the major stimulus to growth. But the 1963 tax program will also contribute significantly to the growth objective by removing or reducing tax distortions which interfere with the optimal use of resources. Tax reforms to promote a more even-handed treatment of income from different sources will contribute to a more efficient allocation of investment and manpower, i.e., to greater output per unit of input.

While the proposed 1963 tax actions are central to a program for faster growth, a rounded policy embraces many other measures. A later section of this chapter deals with selected additional aspects of the growth program.

A TAX PROGRAM FOR THE MID-1960'S

The Administration's 1963 tax program will be presented in a forthcoming Presidential message. Its major outlines are sketched here to serve as the basis for a review of its impact on total demand and thus on production, income, and employment.

In the first stage, beginning on July 1, 1963, the rate reductions will cut individual liabilities by a total of $6 billion at annual rate. For wage-earners, most of this cut will be translated immediately into greater take-home pay, through a reduction in the withholding rate; other taxpayers will realize the benefit of this reduction in rates by adjusting their quarterly tax payments; some will receive refunds during the first half of 1964 for

overpayment of 1963 tax liabilities. Further reductions will occur in the rates applicable to 1964 and 1965 incomes, and these will be offset only partially by enlargements of the tax base.

The proposed gross annual reduction in individual and corporate income tax liabilities, ocurring in three stages, is estimated at $13½ billion, based on current levels of income. Most of this gross reduction—$11 billion—is in individual income tax liabilities. The proposed final rate structure will range from 14 to 65 percent, contrasted with the present range of 20 to 91 percent. The largest part of the total reduction will be received by the lower and middle income groups of taxpayers.

The corporate profits tax rate will be reduced in stages from the current 52 percent to 47 percent. This represents a reduction in corporate tax liabilities of about $2½ billion annually at current levels of profits. Payment of corporate income taxes will, however, be placed on a more nearly current basis, adding about $1½ billion annually to administrative budget revenues for the next several years.

In addition to the tax rate reductions described above, the program incorporates structural changes—offsetting about $3½ billion of the rate reduction—designed to improve the equity of the tax system and to encourage greater efficiency in the use of resources. The present income tax system contains numerous provisions that allow special treatment for income derived from particular sources, for expenses incurred in certain ways, for capital gains that are sometimes thinly disguised transformations of current income. Such exceptions have a number of consequences: (1) they provide a strong element of "horizontal" inequity, taxing differently persons in essentially similar income positions; (2) they complicate enormously the task—for the taxpayer and the Government—of ascertaining any individual's liability, and they divert energies from productive activities to tax avoidance and enforcement; (3) because some forms of production receive preferential tax treatment, resources are allocated to the production of certain goods at the expense of others whose value to the economy is greater; and (4) because they reduce the tax base, the exceptions compel higher rates on incomes that remain subject to tax, compounding the inequity and resulting in rates that may interfere with incentives to work, to assume risks, and to invest.

To eliminate in a single step all forms of unjustifiable special treatment is not feasible. But the President's program will make decisive progress in this direction.

Much, though not by any means all, of the income that currently escapes full taxation is received by persons who are, or would be, in the higher income tax brackets, paying rates on marginal income ranging up to 91 percent. The very height of these rates is, of course, partly the reason

for the exceptions: taxpayers looking for ways to escape rates which seem oppressive have sought special treatment, and have often obtained sympathetic response. Those high rates, where paid, undoubtedly have a dampening effect on incentives to invest and take risks; and they impair the ability to accumulate investment funds. Since a higher rate of investment of risk capital is essential to a higher rate of growth, it is appropriate to reduce significantly the highest income tax rates at the same time that a more comprehensive tax base is provided. For these reasons, the President is recommending a top marginal rate of 65 percent on taxable income, together with measures to deal with tax preferences that pull resources away from their most efficient uses.

TAX REVISION: IMPACT ON OUTPUT AND EMPLOYMENT

Tax reduction will directly increase the disposable income and purchasing power of consumers and business, strengthen incentives and expectations, and raise the net returns on new capital investment. This will lead to initial increases in private consumption and investment expenditures. These increases in spending will set off a cumulative expansion, generating further increases in consumption and investment spending and a general rise in production, income, and employment. This process is discussed in some detail in this section. Tax reduction may also have financial effects associated with the increased budget deficit that it will initially produce. Since these effects—in the first instance, at least—depend on the methods used to finance the deficit, they are left for discussion in a later section dealing with monetary and debt management policy.

Initial effects: consumption

Effects on disposable income. The proposed reduction in personal income tax rates will directly add to the disposable income of households. In addition, the reduction in corporate tax rates will increase the after-tax profits of corporations as a result of which corporations may be expected to increase their dividend payments. The initial direct effect on the disposable income of households resulting from the entire program of tax reductions should be approximately $8½ billion, at current levels of income.

Consumer response to increase in disposable income. The ratio of total consumption expenditures to total personal disposable income has in each recent calendar year fallen within the range of 92 to 94 percent. Although there are lags and irregularities from quarter to quarter or even year to year, the change in personal consumption expenditures has in the past, after a few quarters, averaged roughly 93 percent of any change in personal disposable income. On this basis, the initial addition to consumer expenditures associated with tax reductions would be on the order of $8 billion, although all would not be spent at once.

Additions to after-tax incomes resulting from tax reduction are likely to be spent in the same way as other additions to income. The largest

part of the proposed tax reduction will be reflected in reduced withholding of taxes from wages and salaries, and therefore in larger wage and salary checks; thus, it will be indistinguishable from additional income arising from wage or salary increases, greater employment, or longer hours of work. Similarly, part of the reduced corporate taxes will be passed along to stockholders in increased dividend checks. Stockholders will not be able to identify the source of their additional dividends. Tax reduction dollars carry no identifying label, and there is no reason to expect recipients to treat them differently from other dollars.

Recent experience with tax reduction demonstrates clearly that additions to disposable income from this source are spent as completely as any other additions. Taxes were reduced by about $4.7 billion on May 1, 1948, retroactive to January 1, with resulting large refunds in mid-1949. Again taxes were cut, net, by about $6 billion, effective January 1, 1954, with further cuts later that year. Table 8 shows that the percentage of disposable income spent by consumers remained within the normal range of quarterly fluctuation during the periods following the enactment of each of these tax reductions.

TABLE 8.—*Personal consumption expenditures as percent of disposable personal income during two postwar periods of tax reduction*

1948–49		1953–55	
Quarter	Percent	Quarter	Percent
1948: I	97.3	1953: IV	91.5
II	94.0	1954: I	91.8
III	92.6	II	92.8
IV	93.2	III	93.0
1949: I	93.9	IV	93.2
II	95.2	1955: I	94.5
III	95.7	II	93.5

Note.—Based on seasonally adjusted data.

Source: Department of Commerce.

It is sometimes suggested that tax reductions which add only a few dollars to the weekly pay check of the typical worker would do little good even if the money was spent, since the amounts involved would not be large enough to permit major expenditures—say on washing machines or automobiles. Instead, the money would be "frittered away" on minor expenditures and would do little good for the economy. But all purchases lead to production which generates income and provides employment. Therefore, the purpose of tax reduction is achieved when the proceeds are spent on any kind of goods or services.

Actually, of course, tax reduction which expands take-home pay even by a relatively small amount each week or month may induce recipients to purchase durable goods or houses of higher quality, since the increased income would permit them to handle larger monthly installment payments. It may even induce a rearrangement of expenditure patterns and thus bring about purchases of durable goods that would not otherwise be made.

Initial effects: investment

Investment is a more volatile element than consumption in national expenditure. The timing and magnitude of its response to tax changes is less predictable. But a cut in tax rates on business income will stimulate spending on new plants and new machinery in two ways. First, it will strengthen investment incentives by increasing the after-tax profits that businessmen can expect to earn on new productive facilities. Second, it will add to the supply of internal funds, a large part of which is normally reinvested in the business (though part of this effect may initially be offset by the proposed acceleration of corporate tax payments).

Since the largest part of business investment is made by corporations, the proposed cuts in the corporate income tax are especially significant. But investments of unincorporated businesses will also be encouraged by cuts in personal income tax rates, especially in the upper brackets.

Two important reforms affecting the taxation of business income designed to stimulate investment in plant and equipment were put into effect during 1962: the new depreciation guidelines and the investment tax credit. (For details of these changes, see Appendix A.)

Evidence to date clearly indicates that these measures are already stimulating some capital spending that would not otherwise have taken place. The impact of the 1962 actions and the 1963 proposals to reduce taxes on business will, of course, differ from company to company and industry to industry, depending in part on the adequacy of their internal funds and their levels of capacity utilization. Though the speed of response may vary, industry after industry will begin to feel pressure on its capital facilities and funds as markets for its products are expanded by the 1963 tax program.

Furthermore, there are many individual companies for which the supply of internal funds is a constraint on investment, and many others that do not have excess capacity. Moreover, it is estimated that some 70 percent of the investment in plant and equipment is for modernization and replacement rather than expansion, that is, it is designed to produce new or better products, or to reduce production costs rather than primarily to expand productive capacity. For this large segment of capital spending, the stronger inducement to invest provided by the business tax changes already adopted and those now proposed will translate much more readily into actual purchases of plant and equipment.

As production expands and existing capacity is more fully utilized, the depreciation guidelines and the investment tax credit and the new business tax reductions will provide an even stronger stimulus to investment.

Cumulative expansion: the consumption multiplier

Tax reduction will start a process of cumulative expansion throughout the economy. If the economy is already undergoing slow expansion, this cumulative process will be superimposed upon it. The initial increases in spending will stimulate production and employment, generating additional

incomes. The details and timing of this process will vary from industry to industry. The first impact may be to draw down inventories rather than to expand production. But as inventories are depleted, retailers will quickly expand orders. As manufacturers' sales rise in response and their own inventories of finished goods decline, they will activate idle production lines, hire additional workers, place orders for materials and components. Thus the expansion will spread to other industries, leading to further expansion of production, employment, and orders.

Expanded sales mean increased profits. Increased employment means greater wage and salary income. Each additional dollar's worth of gross production necessarily generates a dollar of additional gross income.

But expansion does not proceed without limit. A considerable fraction of the value of gross production is shared with governments or becomes part of corporate retained earnings and does not become part of consumers' after-tax income. Some of the increase goes to pay additional excise and other indirect business taxes. Typically, when GNP is rising toward potential, corporate profits increase by about one-fourth of the rise in GNP. But a substantial part of this increase in profits is absorbed by Federal and State corporate income taxes, and another part is ordinarily retained by the corporations. Only the remainder is passed on to the households in dividend payments. Part of the additional wage and salary incomes associated with added production is absorbed by higher social security contributions. At the same time, increased employment means a drop in payments for unemployment insurance benefits.

When all of these "leakages" are taken into account, a little less than two-thirds of an additional dollar of GNP finds its way into the before-tax incomes of consumers in the form of wages, dividends, and other incomes. Part is absorbed by personal taxes, Federal, State, and local. The increase in personal disposable income is 50 to 55 percent. Of this amount a small fraction—about 7 percent—is set aside in personal saving, and the remainder—about 93 percent—is spent on consumption, as indicated earlier. Thus, out of each additional dollar of GNP, initially generated by the tax cut, roughly half ends up as added consumption expenditure. But the process does not stop here.

The additional expenditure on consumption that is brought about by the rise in GNP generates, in its turn, further production, which generates additional incomes and consumption, and so on, in a continuous sequence of expansion which economists call the "multiplier process." The "multiplier" applicable to the initial increase in spending resulting from tax reduction, with account taken of the various leakages discussed above, works out to roughly 2. If we apply this multiplier only to the initial increase in consumption (about $8 billion), the total ultimate effect will be an increase in annual consumption—and in production (and GNP)—of roughly $16 billion. Lags in the process of expansion will spread this increase in GNP over time, but studies of the relationships between changes in disposable income,

consumption, and production of consumer goods suggest that at least half of the total stimulus of an initial increase in disposable income is realized within 6 months of that increase.

Cumulative expansion: the investment response

Tax reduction will also have important cumulative indirect effects on investment in inventories and in fixed productive facilities. These effects are much more difficult to predict than the induced effects on consumption.

Inventory investment. The stocks of goods that businessmen wish to hold depend upon current and expected rates of sales and production and the volume of new and unfilled orders, as well as on price expectations and other factors. An expansion of aggregate demand can be expected to raise business inventory targets. Production for inventory will generate further increases in demand and income over and above the multiplier effects discussed above, and will in turn induce further increases in consumption spending.

Inventory investment is volatile, and induced inventory accumulation can add significantly to the expansionary effects of tax reduction within a few months. At the same time, it should be recognized that inventory investment is exceedingly difficult to forecast. As the increase in production and sales tapers off, stocks and the rate of inventory investment will be correspondingly adjusted.

Business investment in plant and equipment. A tax reduction large enough to move the economy toward full employment will also stimulate business investment in plant and equipment. General economic expansion will reinforce the initial stimulus to investment of cuts in business taxes. In the first place, narrowing the gap between actual and potential output—now estimated at $30–40 billion—will increase the utilization of existing plant and equipment. As excess capacity declines, more and more businesses will feel increasing pressure to expand capacity. At the same time, increases in the volume of sales and in productivity will raise corporate profits—in absolute terms, relative to GNP, and as a rate of return on investment. Internal funds available for investment will rise, while at the same time higher rates of return on existing capital will cause businessmen to raise their estimates of returns on new investment. When investment incentives are strengthened by rising demand, internal funds are more consistently translated into increased investment than when markets are slack.

Residential construction. The demand for housing depends on growth in the number of families, on the existing stock of houses, and on the cost and availability of mortgage credit. But housing demand also responds, to some extent, to changes in disposable income. Thus, tax reduction will have some direct effect on residential construction. And as production, employment, and income generally expand, the demand for new homes can be expected to increase further. This increase will, in turn, reinforce the other expansionary effects of tax reduction.

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State and local government expenditures

State and local government units have found it difficult to finance the needed expansion of their activities. Given the present importance of income and sales taxes in State and local tax systems, government revenues at the State and local level expand automatically as GNP rises. The additional State-local revenues generated by economic expansion will assist these governments to meet their pressing needs. Moreover, since Federal tax liabilities are deductible under many State income tax laws, reduction in Federal tax rates will automatically generate some further addition to State-local tax revenues. Finally, a reduction in Federal taxes will enlarge the tax base available to State and local government units and may make it easier for them to raise rates or impose new taxes.

Undoubtedly, some of the added State-local tax revenues will be used either to retire existing debt or to reduce current borrowing rather than to increase expenditures. Whether the net result will be expansionary will depend upon whether the proportion of additional tax revenues spent on goods and services by State and local government units is greater or smaller than the proportion which would have been spent by the taxpayers from whom they collect the additional taxes. But whether or not the response of State and local government units is such as to strengthen the aggregate impact of Federal tax reduction on income and employment, the Federal tax program will ease, to some extent, the problems of these units in obtaining revenues needed to finance urgent public activities, such as education, transportation facilities, and urban development.

Summary of effects on GNP

Tax reductions for consumers will have initial direct effects on the demand for goods and services, as consumers raise their spending level to reflect their higher after-tax incomes. Corporate tax reductions and the lower tax rates applicable to the highest personal income brackets will stimulate investment directly, through raising the rate of return on new investments and providing additional funds for their financing. Some of the tax reforms will also have a directly stimulating effect on productive investment.

These direct or initial effects on spending would occur even if total output, employment, and incomes remained unchanged. But the increased spending cannot fail to increase total output, employment, and incomes. And as activity responds to the initially increased level of spending, cumulative impacts begin to develop in which the several elements interact to carry the expansion far beyond its initial point.

The higher incomes which consumers receive from the added production of both consumer and capital goods will lead to a further step-up in the rate of spending, creating further increases in incomes and spending. The same expansion process raises rates of capacity utilization, thereby interacting with the initial impact of tax reduction on business incomes to make investment both for modernization and expansion more profitable.

This in turn generates higher consumer incomes and more spending, helping to provide the added demand which justifies the higher investment.

If there were no investment stimulus—either initially, or as a result of the cumulative process of expansion—we could expect that GNP would ultimately expand by about $16 billion. If the result were no more than this, the tax reduction would still be abundantly rewarding in terms of greater production, employment, purchasing power, and profits. What will really be given up to produce added output will be only unwanted idleness of workers (whose families have reduced neither their needs nor aspirations) and incomplete utilization of plant and machinery (which have continued to depreciate).

But the pay-off is much more than this purely consumption impact. There is also an investment impact, and each extra dollar of investment that is stimulated should bring roughly another dollar of added consumption and encourage still further investment.

A strong expansion can alter profoundly the whole climate within which investment decisions are made. If not at once, then somewhat later, subtle but significant changes in business attitudes occur in response to the trend in the economic outcome. We have referred earlier to the cautious investment attitudes that more than 5 years of slack markets have generated. This caution did not arise at once in mid-1957, when output first began to fall away from the track of potential expansion. It developed gradually, fed on itself, and in part helped to justify itself. The reverse can and will happen.

No one can pretend to estimate with precision the ultimate impact of a program so far-reaching as that which the President will propose: it would come into operation in stages extending from July 1, 1963 to January 1, 1965, and its effects would cumulate and spread into 1966 and beyond.

Our study of the program, and our tentative projections based upon it do, however, convince us that the program measures up to the challenge that the 1960's present to our economy: that it will surely set us on a path toward our interim employment target; and that it will lay the foundation for more rapid long-run growth.

TAX REVISION: IMPACT ON THE BUDGET

When the Congress legislates changes in income taxes, it defines or redefines the income subject to taxation—by setting the exclusions, exemptions, and deductions allowable for various reasons—and sets the new tax rates that are applicable to various fractions of that income. Given the levels and structure of current incomes, these new definitions and rates can be translated into fairly precise estimates of the new tax yield in billions of dollars. This can be compared with the actual yield at the old rates and definitions. The difference is the gross cost of (or gain from) tax revision, and it also measures the initial change in deficit or surplus.

This would be the whole story if the tax revision had no effect on incomes. But a prime purpose of tax revision is precisely to affect production, employment, and incomes. The President's tax program for 1963 is designed to end 5 years of undercapacity production, excessive unemployment, and unnecessarily depressed incomes.

Tax revenues do not depend on tax rates alone, but on the tax base as well. The tax base is determined by the level of income. Because tax revision will raise incomes, it will also raise tax revenues, through a "feedback" out of the expanding tax base. Greater prosperity will also reduce some important types of Federal expenditures, such as unemployment insurance, area redevelopment assistance, and public works acceleration. For these reasons, the net cost of tax revision will be less—substantially less—than the gross cost.

FINANCING ECONOMIC EXPANSION IN 1963

In 1963, the financial policies of the Government, like the fiscal policies, will place high priority on expansion of the demand for goods and services to reduce excess capacity and unemployment while maintaining general price stability. Monetary and debt management policies will continue to play a significant role in facilitating balanced economic expansion and in fostering longer-run economic growth. At the same time, these policies continue to bear special responsibilities to sustain our progress toward balance of payments equilibrium. And since they are the most flexible instruments of general economic policy available to the Government, they can and should be used flexibly. If, contrary to present expectations, aggregate demand should expand too fast and too far, seriously jeopardizing stability of prices and the balance of payments, monetary and debt management policies are the first line of defense.

In what follows, these policies will first be discussed in terms of domestic objectives; then in terms of balance of payments objectives. This order indicates nothing as to relative importance. Monetary policy must reconcile, as best it can, both objectives.

FISCAL POLICY, MONETARY POLICY, AND DEBT MANAGEMENT POLICY

As explained earlier in this chapter, the President's program of tax revision will, by increasing the disposable incomes of consumers and business and by strengthening incentives to invest, cause an expansion in private spending, which will, in due course, increase production and employment by a multiple of the original tax cut. Initially, however, the tax cut will increase the budget deficit, and the increased deficit will have to be financed—that is, the money to cover the excess of expenditures over taxes will have to be raised by the Treasury. The financing of the deficit will have effects on private spending in addition to those produced by the tax cut itself. Depending on the methods employed, the financing may either add

to the expansionary effects of the tax cut or cancel out a portion of these effects.

Fiscal policy—mainly past fiscal policy—determines the size of the Federal debt. From the financing of past Federal deficits less surpluses the public has accumulated a certain total net claim upon the Government. Only time and future fiscal policy—deficits and surpluses—can change this total. But monetary control and debt management can change its composition, and changes in composition can affect aggregate demand through affecting the level and maturity-structure of interest rates and the availability of credit at various maturities.

The Treasury influences the composition of the interest-bearing Federal debt by deciding what types and maturities of securities to issue to finance current deficits or to replace maturing issues. Part of the interest-bearing Federal debt is owned by the Federal Reserve Banks. When the Federal Reserve purchases Treasury securities in the market, whether from banks or from other private holders, the reserve balances of commercial banks on deposit at the Federal Reserve increase. In this way, Federal Reserve open market purchases reduce the interest-bearing government debt held by the public, and increase bank reserves by an equal amount. An increase in bank reserves permits in turn a multiple expansion of bank deposits and bank credit. Similarly, Federal Reserve open market sales replace bank reserves with additional public holdings of interest-bearing government securities, requiring a multiple contraction of bank deposits and credit.

Thus, in effect the Treasury and the Federal Reserve together determine the composition of the Federal debt held by the public—the Treasury deciding the composition of its interest-bearing debt, and the Federal Reserve the division of public claims on the Government as between interest-bearing securities and bank reserves and currency. By its choices of which kind of government securities to buy or sell, the Federal Reserve also affects, in some degree, the composition of the interest-bearing debt in the hands of the public. The net result of the transactions of these agencies with the public, therefore, determines how the Government borrows from the public to finance a new deficit.

But their powers are not confined to transactions in new debt. These agencies can also—in refunding maturing debt, or in transactions with the public in existing securities—change the composition of old debt. In all these transactions, the government agencies must act within the framework of investors' preferences; they can sell securities of different types and maturities only on terms consistent with these preferences.

FINANCING BUDGET DEFICITS

How can the Federal Government raise the money to finance a budget deficit?

At one logical extreme—which of course no one seriously contemplates—the Federal Reserve could buy Treasury securities and increase the quantity of bank reserves in an amount equal to the deficit. In this way, the reserve base of the banking system would be increased by virtually the entire amount of the deficit, paving the way for a multiple expansion of bank deposits and bank credit. This is the most liquid and most expansionary way of increasing the debt of the Federal Government.

At the other extreme, the Government might finance a deficit while the Federal Reserve permitted no increase in bank reserves. This means that the Treasury would not be able to sell any of its securities, directly or indirectly, to the Federal Reserve Banks. The Treasury would have to sell them either to the public or to the commercial banks; and the banks would be able to buy them only to the extent that they in turn sold other securities to the public or denied loan accommodation to private borrowers. The effects of this policy would depend to some degree on the type and maturity of the new Treasury obligations. Short-term securities, such as Treasury bills, are highly liquid; they satisfy the needs of banks for second-line reserves and are fairly close substitutes for cash in the working balances of other financial institutions and business firms. Long-term bonds are less liquid. Selling only long-term bonds to the public would be the most illiquid and most restrictive way to finance a deficit.

Sometimes the sale of government bonds to commercial banks is considered *per se* expansionary, while the sale of bonds directly to the public is considered neutral. But this distinction is not a reliable guide. When commercial banks increase their government bond holdings, it is one thing if bank reserves and deposits rise correspondingly and quite another if the banks have to unload other securities on the public to make room for the new securities. The important things are *how much* and *what kind* of new indebtedness the Government (together with the Federal Reserve) incurs to the banks and other public creditors rather than *to whom* the indebtedness is incurred.

Ordinarily, neither of the extreme methods of financing deficits mentioned above is appropriate monetary and debt management policy. There are, of course, many gradations between them. The considerations which determine how new debt should be financed are the same as those which guide the monetary authorities and debt managers in their daily decisions on the composition of old debt. These considerations are well known.

A more expansionary method of financing is needed when unemployment is substantial and considerable excess capacity is available than under conditions when the economy is closer to its potential. Thus, the "proper" way of financing a deficit is that which contributes to the goals of increased output, growth, price stability and payments balance. It cannot be determined by preconceived rules.

In 1961 and 1962, budget deficits which increased the Federal debt by $13.3 billion were successfully financed during a period of economic expansion without causing inflation or aggravating balance of payments difficulties. In current circumstances, monetary policy and debt management have to reconcile carefully the needs of domestic economic expansion and those of the U.S. international payments position. But prospective budget deficits do not, in themselves, warrant any shift in the way this reconciliation should be sought. More forceful use of tax policy in support of economic expansion, however, gives greater freedom to monetary policy to maintain conditions in our money and capital markets which are favorable to our balance of payments position.

Monetary policy as well as debt policy must be coordinated with fiscal policy to secure the objectives of higher employment and growth without inflation. We are now, and for some time still will be, in a situation of substantial slack in labor force and capital resources, a situation in which expansionary policies are required. Even after the proposed tax revision begins to release consumer demand and spur investment, other phases of public policy, including monetary and debt policy, can serve to support the absorption of unused resources. When the economy approaches higher levels of capacity utilization and employment, labor as well as capital markets will tend to tighten, and the policy mix will need to be adjusted to changing circumstances. Public policy thus involves a continuous process of adjustment, and no validity attaches to general rules of "tight" or of "easy" money meant to be valid under all conditions. What matters most at this time is that financial policy should be designed to facilitate rather than retard the expansionary process which the tax program is designed to launch.

The ease or tightness of monetary and credit conditions depends only in part on the supplies of bank reserves and liquid government obligations. It also depends on the balance between these supplies and the economy's demands for money, liquid assets, and credit accommodation. Economic expansion increases these demands. As private income and wealth increase, so do the public's needs for money and liquid assets. Normally, the public will wish to place part of its new saving every year in additional holdings of checking accounts, thrift deposits, and other liquid assets. Likewise, business requirements for loans to finance inventories and trade credit expand. When unused productive resources are available, it is not inflationary to permit a parallel expansion in the supplies of money and liquid assets and in the availability of bank credit.

On the other hand, it would clearly be a restrictive monetary policy to hold bank reserves constant while the monetary and credit needs of the economy increase. Interest rates would tend to rise, and private borrowers would find it both more expensive and more difficult to obtain bank loans or to float securities in the capital markets.

Immediately following World War II, the economy was oversupplied with liquid assets accumulated during the war; liquidity requirements were low relative to demands for producers' and consumers' durable goods and were further reduced by the spread of inflationary expectations. But in the 1950's the economy grew up to its supply of liquidity; demands for durable goods became less urgent; and price stability in recent years has dissipated inflationary psychology. Therefore, resumption of growth in liquidity parallel to the growth of the economy's potential has been appropriate.

Over the past year, one measure of liquid assets—including the money supply, savings and time deposits and shares, U.S. Government savings bonds, and short-term marketable U.S. Government securities—grew by about 8 percent, in contrast to an average annual growth of slightly over 4 percent in the period since the war. The growth in liquid assets in 1962 was desirable for the domestic economy. In fact, since economic activity also rose, the ratio of liquid assets to GNP is still only moderately above its postwar low. The stock of liquid assets in the United States does not pose inflationary dangers at this time. These data are summarized in Table 9.

TABLE 9.—*Selected liquid assets held by the public, 1946, 1957, and 1960–62*

Liquid assets	1946	1957	1960	1961	1962 [1]
	Billions of dollars [2]				
Total selected liquid assets [3]	239.1	356.0	399.2	424.6	458.7
Money supply [4 5]	108.5	133.5	138.4	142.6	144.8
Money supply and time deposits at commercial banks [5]	142.4	191.0	211.5	225.1	242.2
	Percent of GNP				
Total selected liquid assets [3]	113	80	79	82	83
Money supply [4 5]	51	30	27	27	26
Money supply and time deposits at commercial banks [5]	68	43	42	43	44

[1] Preliminary estimates by Council of Economic Advisers.
[2] Seasonally adjusted, end of year.
[3] Money supply, time deposits at commercial banks and mutual savings banks, Postal Savings System, savings and loan shares, U.S. Government savings bonds, and U.S. Government and Federal agency securities maturing within one year.
[4] Demand deposits and currency; data are for last Wednesday.
[5] Agrees in concept with data in Table C-45 except for deductions to avoid duplication of items in liquid assets series.

Source: Board of Governors of the Federal Reserve System (except as noted).

Sometimes concern about monetary aspects of government deficits focuses on the risks of inflationary consequences in the long run. The stimulus to private spending associated with increased liquid claims against the Government may be appropriate and welcome at the time the claims are created. But at some future time, when the economy is tight and prices are under upward pressure, this stimulus may be an embarrassment. More-

over, at such a time the public's desire for liquid assets may sharply decline; as they try to unload liquid claims, they add fuel to inflationary flames.

This possibility is not a reason for avoiding deficits, or for avoiding expansionary monetary policy, when the economy needs stimulus; the dangers of high blood pressure are no reason to permit a patient to suffer chronically from low blood pressure. It is, however, a reason for not flooding the economy with liquidity even at times like the present when the economic malady is quite the opposite of inflation. It is, above all, a reason for flexibility in monetary policy and, indeed, in fiscal policy as well. Government authorities need not stand by helplessly in times of inflationary peril; the same mechanisms which supply the economy with liquidity can be reversed—and very quickly—to restrict liquidity and credit.

The tremendous growth of the public debt resulting from wartime Federal budget deficits did, to be sure, interfere with the effectiveness of the Federal Reserve in opposing inflation after the war. In order to facilitate the sale of government securities at low interest rates during the war, the Federal Reserve committed itself to "peg" the prices of these securities. To prevent a fall in these prices—a rise in interest rates—after the war, this "pegging" policy was continued with the result that the Federal Reserve had to buy from the public and the banks all the securities they wished to sell. This meant that it was virtually powerless to prevent large quantities of government debt inherited from the war from being converted into member bank reserves with consequent multiple expansion of the money and credit supply. This policy was ended in 1951 by the Treasury-Federal Reserve accord, which restored effective monetary powers to the Federal Reserve. At present, the authorities are not hamstrung by any "pegging" commitment. They are free to manage the debt flexibly in the light of current domestic and international needs of the economy.

In a situation where there existed a perfect mix between fiscal and monetary policy—a situation where both together gave the precisely right degree of stimulus to the economy—adoption of a more expansionary fiscal policy would have to be matched by a more restrictive monetary policy to avoid inflation. But this is not our present situation. A substantial degree of net expansion is clearly required. Since the budget and tax program is a gradual and conservative one, it is not likely to overshoot the mark; and the objective of orderly growth would seem to be best served by a monetary policy which supports economic expansion. As the program succeeds and a widespread tightening of markets develops, changes in the policy will be needed.

MONETARY POLICY AND THE BALANCE OF PAYMENTS

The needs of the domestic economy are clearly for expansionary monetary policy. But monetary and debt management policies are formulated in the context of an open economy, and must continue to aim at external balance as well as domestic expansion. The monetary authorities, in facilitat-

ing domestic expansion, must also consider the U.S. international payments position.

First of all, of course, the authorities can continue to adapt their techniques of monetary control and debt management so as to reconcile to the maximum degree possible their domestic and external aims. One method open to the Federal Reserve and the Treasury is to adjust outstanding supplies of government securities of various maturities so as to keep upward pressure on short-term rates, most important in international competition for funds, and downward pressure on long-term rates, important for domestic expansion. In the past 2 years, the Federal Reserve and the Treasury have consistently sought to supply bank reserves and provide for needed increases in currency in ways which would not reduce short-term interest rates and drive mobile funds to foreign financial centers. The Federal Reserve discount rate, the central pivot of the interest rate structure, has remained constant at 3 percent since August 1960. The differential between rates on 3-month Treasury bills and on long-term government obligations narrowed from 1.6 percent in January 1961 to 1 percent in December 1962. In 1962, the Federal Reserve, in purchasing, net, $1.9 billion of U.S. Government securities bought, net, $1.8 billion of securities of over 1-year maturity, mainly in the 1- to 5-year range, and only, net, $100 million of securities of under 1-year maturity. In 1961, the Federal Reserve, in purchasing, net, $1.5 billion of U.S. Government securities, had acquired $2.6 billion of securities of maturity of over 1 year, offsetting this by sales of $1.1 billion of under 1-year securities.

Treasury debt management operations in 1962 were even more important than Federal Reserve operations in affecting the maturity structure of publicly held U.S. Government securities. The Treasury expanded its cash offering of securities of maturity of under 1 year. Advance refunding operations moved some securities out of the "under 1-year maturity" category, but the net increase in such securities held publicly (i.e., outside of the Federal Reserve and U.S. Government investment accounts) amounted to about $1 billion in 1962. The increase in outstanding regular Treasury bills, meanwhile, was considerably larger, about $7 billion. Such increases offset downward pressures on short-term rates resulting from monetary expansion, and they are consistent with present needs for increased liquidity in the economy. In addition, the Treasury, in administering the portfolios of government investment and trust accounts, continued to buy longer-term rather than short-term securities. At the same time, through advance refunding operations, the Treasury offered existing holders of some government securities an opportunity to exchange them for other securities of longer term. This lengthened the debt structure with a minimum impact on other investment flows. The average maturity of the publicly held marketable debt thus actually rose by 5 months.

Other monetary techniques can also help to meet the needs of both payments balance and domestic expansion. At the beginning of 1962, ceiling rates on time and savings deposits in commercial banks, under Regulation Q, were increased. This was an important and successful measure. On the one hand, it enabled U.S. banks to compete more effectively for funds that otherwise would be deposited abroad. (Subsequently, the possibility of attracting into time deposits the balances held as monetary reserves by foreign governments and central banks was further enlarged by enactment of legislation exempting such deposits from all interest rate ceilings.) On the other hand, it increased the flow of funds through the savings departments of commercial banks into mortgages and other longer-term assets, and actually helped to reduce rates charged domestic borrowers. In late 1962, the Federal Reserve released reserves to the banking system by lowering the reserve requirement on time and savings accounts from 5 to 4 percent. This action made it unnecessary for the Federal Reserve to supply these reserves by purchasing short-term government securities in the open market.

While a balance must be continuously struck between credit and interest rate policies in support of domestic economic expansion and policies to protect or improve the balance of payments, any conflict is more a short-run than a long-run one. In the long run, the U.S. balance of payments probably has much to gain from a fully operating, rapidly gaining domestic economy. Only this will create profit opportunities that would keep more American corporate and equity funds at home and attract more long-term foreign capital. Only this will induce the productivity-increasing investments and innovations necessary to improve America's competitive position and increase the export surplus. Only this can create the basic confidence in the U.S. economic future on which confidence in the dollar depends. Without the dynamic of an expanding economy operating at full steam, monetary measures could scarcely be of more than transient help to the balance of payments. No country can permanently balance its international accounts by interest rates so high that its productive potential is kept underutilized and its labor force underemployed. Nevertheless, defense of the currency may require vigorous use of monetary instruments, and there can be no doubt that the U.S. authorities are prepared to take whatever steps are necessary to defend the dollar. An expansionary fiscal policy will give them greater freedom to do what has to be done.

International capital flows are, of course, not a U.S. problem alone. They concern all the major monetary countries, those with payments surpluses as well as those with payments deficits. When interest rates and credit conditions are out of line among major countries, it cannot always be taken for granted that the lower rates should rise. If international borrowing is centered too much on the United States, one clear implication is that other countries should improve their capital markets and relax or dismantle the

remaining restrictions on borrowing in their markets. Finally, shifting attitudes toward currency exchange parities may well be at least as important as interest differentials in inducing movements of liquid funds between countries. International arrangements to offset speculative flows are both more effective and more desirable than unilateral action to compensate fears and expectations of currency devaluation with high interest rates. In recent years, remarkable progress has been made in international consultation and coordination, both with respect to national policies affecting the payments balances of the major countries and with respect to concerted measures to defend the international monetary system against speculative attacks. These are discussed in Chapter 4.

ECONOMIC GROWTH

In the Council's Annual Report in 1962, a chapter was devoted to the analysis of economic growth and to a full discussion of its significance. It is unnecessary to repeat that detailed discussion again at this time. We have found no reason to revise that statement of the importance of this goal and the feasibility of achieving it.

DETERMINANTS OF GROWTH

Starting from our present position of underutilization, it has been estimated that we can achieve an increase of about six-tenths of a percentage point in our average annual growth rate for the 1960's by reducing our unemployment rate to 4 percent with the concomitant increase in utilization of capital facilities. This rise in the growth rate comes as a bonus to successful employment policy. Once underutilization of productive capacity has been eliminated, our rate of growth will depend upon the pace at which productive capacity itself expands. Growth of productive capacity in turn is the sum of (a) the percentage rate of growth of the labor force adjusted for changes in the average workweek, and (b) the percentage rate of increase in productivity per man-hour. Public policy can accelerate growth of productivity mainly by stepping up the pace of our efforts to:

—improve the education, health, occupational skills, motivations, and attitudes of the labor force;

—build up the stock of private producers' plant and equipment, and improve its composition by age, type, and location;

—increase the stock of public physical capital, including roads, water systems, school buildings, and hospitals;

—improve the terms on which the economy has access to natural resources, whether through domestic production or imports;

—advance the level of technology, covering the range from managerial and organizational competence to scientific and engineering understanding;

—raise the efficiency with which capital, resources, technology, and labor are used;

—improve communications systems so as to accelerate the dissemination of information on technological, commercial, and employment opportunities.

CABINET COMMITTEE ON ECONOMIC GROWTH

In order to emphasize the high priority of economic growth in the formulation of Federal policies and programs, the President, in August 1962, established a Cabinet Committee on Economic Growth. (For a description of the Committee, see Appendix B.) The first task of this Committee was to identify key measures for the achievement of more rapid growth. The President has directed the Committee to continue to serve as a focal point for concentrating the Government's interests and activities on the growth objective. The Committee has emphasized the importance of achieving and maintaining full employment as a prerequisite to an effective growth policy. In addition, it has made a number of initial recommendations for longer-range programs to stimulate more rapid growth.

The Committee in its work thus far has focused on a number of Federal programs which make or could make important contributions to economic growth. These include public investment in natural resources and agricultural development, in transportation, in urban and rural development; they emphasize investment in human resources—education and health—and in advancing knowledge. Where existing programs are involved, the recommendations of the Cabinet Committee have pointed up the growth-stimulating features of the programs and, in some cases, have urged increased budget support. These recommendations are reflected in the President's budget for fiscal 1964 and do not require repetition here. Education is one of these program areas. The contributions that education has made and must continue to make to economic growth and other national objectives are so important that the proposed new program will be presented in a special Presidential message.

The Administration is proposing programs which are especially relevant to two of the key determinants of economic growth—private investment and civilian technology.

PRIVATE INVESTMENT

The Cabinet Committee has emphasized the importance of private investment as a source of economic growth. The analysis in this chapter has shown how the proposed tax program, together with the tax revisions of last year—the investment tax credit and depreciation reform—will stimulate a higher level of private investment.

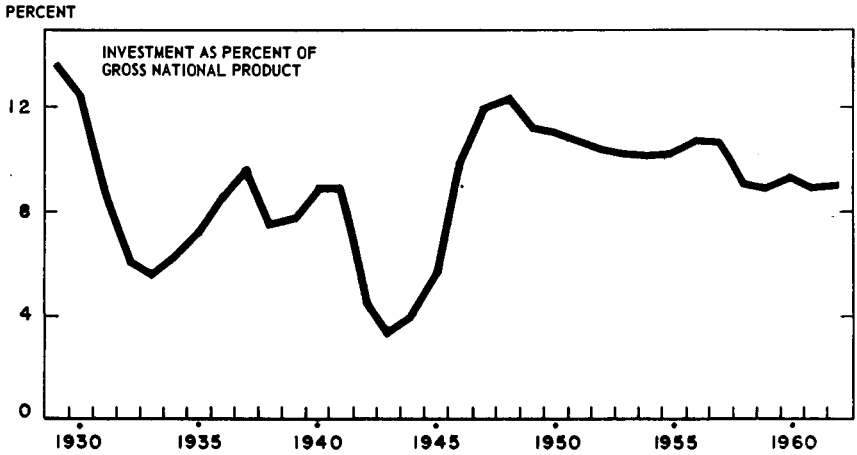
Investment in private plant and equipment is a principal source of long-run gains in productivity. Both in this country and in others, periods of

rapid growth have been associated with high rates of investment. In the United States since 1947, the stock of privately owned plant and equipment per worker has increased by nearly 50 percent. During this period the rate of growth of output per worker has been nearly twice its rate during the 1929–47 period when capital growth only barely kept pace with the growth of employment.

The rate of growth of the capital stock is determined, in part, by the share of GNP allocated to investment in new plant and equipment. Chart 7 shows the fluctuation in the share of output devoted to private investment

CHART 7

Business Fixed Investment in Relation to Total Output



NOTE: PERCENT IS BASED ON DATA IN 1962 PRICES. INVESTMENT CONSISTS OF PRODUCERS' DURABLE EQUIPMENT AND NONRESIDENTIAL CONSTRUCTION.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

since 1929. Many factors determine the amount of investment that is needed to achieve a given rate of growth of potential GNP. However, given the expected rate of growth of the labor force during the 1960's—an annual rate of 1.6 percent—and assuming technological progress at roughly the rate experienced during the 1950's, the Council's calculations suggest that to achieve a growth of potential output of 4.0 percent a year will require private investment to be between 10 percent and 11 percent of GNP. As the chart indicates, this is above the proportion achieved during the past 5 years; but we did even better during the early postwar years. We do not need to settle for less in the years ahead; indeed, our aim is to regain and exceed the earlier pace of growth.

A high rate of investment is needed to equip our growing labor force with better and more modern equipment. Without new equipment, the new

inventions and designs which flow from research and development lie fallow; with it, they can contribute fully to economic growth. Some estimates suggest that during the past few years almost 70 percent of investment has been for modernization and replacement, rather than to increase capacity. The stimulation of capacity increases will provide further impetus to modernization, since the two go hand in hand. When the capacity of an industry is expanded rapidly by new investment, the proportion of new equipment tends to increase, the average age of capital tends to decline, and the average quality of capital in place improves substantially.

The investment needed to gain our growth objectives will be achieved only if we eliminate economic slack—only if we strengthen demand and broaden incentives to take risks. The tax program is designed to help us reach this objective.

CIVILIAN TECHNOLOGY

The Cabinet Committee on Economic Growth as well as the White House Panel on Civilian Technology and officials of the Department of Commerce have identified an urgent need to stimulate more rapid development and fuller use of technology in those sectors of the civilian economy which, despite high potential returns to the Nation, have not been able, or have not been motivated, to seize the opportunity without assistance.

In recent years, there has been a dramatic increase in total expenditures on research and development and in the number of scientists and engineers engaged in these activities. However, defense and space efforts have accounted for nearly three-fourths of the increase. The research laboratories of industry and the universities have been important sources of new products and processes for the civilian economy, but most private research and development is still concentrated in a relatively few industries and is carried on by a few large firms. With the exception of a few hundred manufacturing firms, most enterprises neither undertake much research and development nor have sufficient trained technical manpower to take advantage of the research and development done by others. Our economy would be strengthened significantly over the long run if our civilian research and development resources were expanded to meet better the wide range of private and public needs.

The private business firm, stimulated to meet the needs of the economy by the opportunity for profit and the spur of competition, is generally the most effective organization to conduct and support research and development for the advance of civilian technology. But private business firms are not always in a position to undertake research, especially where one company takes the risks and covers the costs but many companies share widely in the benefits. Research on process improvements not subject to patenting—a major source of productivity growth—and analysis of materials and methods are important cases in point. Experimental work which

explores advanced concepts and designs is also likely to provide interesting and useful information without leading directly to a patentable product that can be marketed by the firm sponsoring the research. Unless cooperative arrangements are made, these types of research will not receive enough support.

There are also some serious problems with respect to the dissemination of technical information. Many business firms are not fully aware of the technological possibilities open to them; without a strong technical staff they are often unable to follow and understand the new developments published in the technical literature and communicated informally among technicians.

Government has a responsibility for maintaining a suitable environment for private research activity and for supporting programs which are in the public interest but which are not adequately stimulated by private market opportunities alone. Agriculture provides an outstanding example of the successful role Government can play by supporting and sponsoring research in cooperation with State institutions and private organizations. The fruits of this cooperative research effort, initiated in the last century, are seen in the spectacular increases in American agricultural output and productivity through the improvement in techniques and products.

The details of the programs for Federal support of civilian technology are included in the Administration's 1964 budget proposals. The efforts in the first year will necessarily be modest in budgetary terms and exploratory in nature, but over the long run the program promises great returns.

It is proposed that the Department of Commerce sponsor a pilot program for an industry-university engineering extension service. This program will include identification of technical problems, technical advice, in-plant demonstrations of new technologies, and short courses and conferences. The objective is to strengthen the scientific and technical competence of management and supervisory personnel, to develop the facilities of universities to meet local and regional technological needs, and to reduce the gap between the technologies of leading and lagging industries and firms.

A selective program of research and development support is recommended, designed to take advantage of promising technical possibilities now being ignored. Industries would be selected where there is promise of significant returns from research and development applied to their technology, but where there is little prospect that the firms in the industry, acting alone, will do the job that is needed. The development and improvement of technical information services would also be supported. Grants would be made to industry research associations or industrially oriented development institutions, to encourage technical work which is not called forth in adequate quantity by the prospect of private profit because the results must be shared with firms not supporting the research, and to provide research

facilities for small firms which do not have a broad enough spectrum of products to support a research and development effort.

Of particular promise is an experimental program designed to develop new means of translating results of government-financed research and development into a form usable by private industry oriented to civilian markets. The possibilities of adapting to civilian industry the techniques developed in advanced space and defense activities would receive special attention.

To increase the supply of scientists and engineers with appropriate training and interest in industrial research and development, it is planned that support be provided for university research on problems of civilian technologies.

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Chapter 3

Fiscal Policy In Perspective

TAX REVISION is the principal instrument of U.S. economic policy to achieve prosperity and more rapid economic growth in the mid-1960's. The nature of that revision and the means by which it will accomplish its objectives have been described in the preceding chapter.

The aim and expectation of this program is to restore full prosperity, which, in the last analysis, is the only sure path to budgetary balance. Since this will, at least temporarily, involve large budgetary deficits, it is important also to examine what deficits mean in modern economic society. Government deficits are not a new fiscal experience for Americans. The first part of this chapter reviews several relevant aspects of that experience, and in particular distinguishes two kinds of deficits and their economic effects—deficits that grow passively out of economic recession or inadequate growth, and deficits that grow out of positive fiscal action, such as tax reduction, to invigorate the economy. The perspective is further widened by placing the Federal deficit or surplus in the context of balancing and offsetting deficits and surpluses in the other major sectors of the national economy.

Since deficits increase the national debt, it is important also to appraise that debt in relation to the Nation's wealth and the Nation's income. The national balance sheet allows us to view the Federal debt as one of a set of interrelated assets and liabilities.

Expansionary tax policy must be considered also in terms of the possible effects it may have on the stability of our price level. Not only is inflation unjust and disruptive, but it would interfere with our progress toward achieving balance in our international financial accounts.

These are some of the problems discussed in this chapter. They are problems which have been considered at length in the technical literature of finance and economics. But they become problems for all Americans to consider as the Nation prepares to take bold steps to invigorate its economy—steps involving large interim Federal deficits. Both experience and analysis confirm that this positive use of fiscal policy in 1963 will make a significant contribution to the achievement of our employment and growth goals and incur minimum risks of interfering with continued price stability and progress toward balance of payments equilibrium.

PASSIVE FISCAL POLICY AND AUTOMATIC STABILIZATION

Any weakening in private spending will reduce incomes, causing tax revenues to fall and transfer payments to rise. Thus disposable incomes will decline less than pre-tax incomes, and will be partly cushioned against the decline in private demand. In effect, the impact of the decline in private income is shared with the Federal Government, which does not shrink its purchases when its income falls. The greater the extent to which a fall in government revenues cushions the decline in private incomes, the less the flow of spending for output will be curtailed.

Automatic stabilization operates in reverse when private demand increases. Additional income is generated, but part of it is siphoned out of the spending stream in higher tax payments and lower transfers. Disposable incomes therefore rise less than incomes before taxes, and the spending and re-spending is limited and damped.

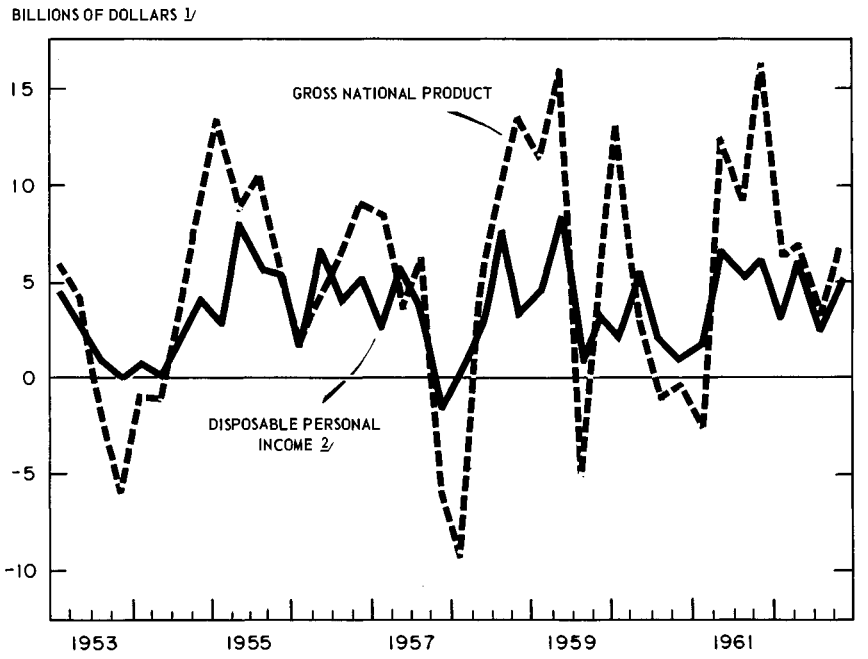
Thus the tax-and-transfer response narrows fluctuations in income caused by irregularities in the strength of demand. The sharper the response of tax collections to changes in GNP, the stronger the stabilization effect. Although the tax-and-transfer response cannot prevent or reverse a movement in GNP, it can and does limit the extent of cumulative expansions and contractions. At least with respect to contractions, this is clearly an important service to the economy.

Automatic fiscal stabilizers have made a major contribution in limiting the length and severity of postwar recessions. Each of the four postwar recessions—1948–49, 1953–54, 1957–58, and 1960–61—has been both short and mild. The decline in real GNP from its peak to its trough has ranged from a high of 4.4 percent in 1957–58 to a low of 2.1 percent in 1960–61, and the duration of the recessions has varied from 9 to 13 months. Chart 8 demonstrates that changes in disposable personal income from quarter to quarter have been much smaller than changes in GNP. Although GNP changes were frequently negative (in each of the postwar recessions), disposable income fell in only one quarter in the entire postwar period. This relative stability of personal disposable income has been mainly due to the automatic fiscal stabilizers, together with the tendency of corporations to maintain their dividends at the expense of retained earnings during recessions. The maintenance of disposable incomes has prevented sharp declines in consumer expenditures. The resulting stability in markets for consumer goods, which constitute by far the largest component of final demand, has prevented any drastic collapse in business investment in fixed capital.

Automatic fiscal stabilizers increase the stability of the economy. Stability is a desirable thing for an economy that is balanced where it wants to be. Thus, an economy operating, on the average, at high levels of output

CHART 8

Quarterly Changes in Gross National Product and Disposable Personal Income



1/ SEASONALLY ADJUSTED ANNUAL RATES.
2/ PERSONAL INCOME LESS PERSONAL TAXES.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

and employment benefits from a tax-and-transfer system highly responsive to changes in output and income, as a cushion against sharp movements of aggregate demand either toward inflation or toward recession.

However, in the present situation—with the American economy laboring for over five years well below its potential rate of output—automatic stabilization becomes an ambiguous blessing. The protection it gives against cumulative downward movements of output and employment is all the more welcome. But its symmetrical "protection" against upward movements becomes an obstacle on the path to full employment, throttling expansion well before full employment is reached.

Under such conditions, high employment can be restored—as is being proposed under the 1963 tax program—by a reduction in taxes. When this is done the need is not primarily to lessen the responsiveness of tax receipts to changes in GNP. Rather the whole schedule of taxes should be lowered—so that, at any given GNP, taxes siphon off less private purchasing power—while leaving the response of tax receipts to *changes* in GNP about as great as before. To be sure, it is almost impossible to lower taxes without lessening to some degree their sensitivity to changes in GNP. But the

purpose of such a change should be to lower the level of taxes—and hence their persistent drag on purchasing power—rather than to reduce their automatic countercyclical response.

TAX CUTS TO AID RECOVERY

Just as we have had postwar experience with automatic stabilization, we have had experience with active tax cuts which served positively to increase demand. These experiences are of interest in the present context.

In two of the postwar recessions—1948–49 and 1953–54—tax cuts helped to check the decline and to spur the ensuing recovery. Neither of the tax cuts is an example of deliberate countercyclical fiscal action, but both had important expansionary effects which came when they were needed.

Under the Revenue Act of 1948, which was passed by the Congress in April, taxes were reduced by $4.7 billion. While at the time, the tax cut appeared inappropriately timed—few observers were predicting recession—when the recession of 1949 in fact occurred, it turned out to be fortunate that the tax cut had been legislated. The cut was retroactive to January 1, 1948, and as a result refunds were exceptionally large in mid-1949. The upturn began in October 1949. In addition to the tax cut, there was a significant increase in Federal expenditures in late 1948 associated with the introduction of the Marshall Plan. This also helped to mitigate the recession. The economy was further stimulated in the expansion phase by the heavy increases in placement of military orders associated with the Korean War, which began in June 1950. As a result of the tax cut and the increased expenditures, together with the effects of the automatic stabilizers, the recession was short and mild, and the ensuing expansion was strong. By the first quarter of 1951, unemployment had been reduced to 3.5 percent of the labor force.

As a result of the rapid expansion, by the second quarter of 1950, Federal tax liabilities as shown in the national income accounts had risen substantially above the levels that prevailed at the time taxes were cut in the second quarter of 1948.

Taxes also were cut during the recession of 1953–54. Effective January 1, 1954, the excess profits tax was repealed, and personal income tax rates were reduced. Excise taxes were reduced on April 1, and further tax reductions for both individuals and corporations were embodied in the Internal Revenue Code of 1954. These measures are estimated to have reduced Federal revenues by about $6.1 billion (seasonally adjusted annual rate) in the first half of 1954. Further cuts which went into effect later brought the revenue loss on a full-year basis to about $7.4 billion. These cuts in personal and corporate income and excise taxes were partially offset, however, by an increase of about $1.4 billion (annual rate) in OASI contributions, which became effective on January 1, 1954. For the most part,

the tax reductions in 1954 were part of a program of tax reform and were not viewed primarily as fiscal policy measures aimed at countering the recession. Yet as a result of the tax cuts that became effective at the beginning of 1954, disposable personal income and personal consumption expenditures turned up in the first quarter, while personal income and GNP were still declining. It is generally agreed that the recession ended in August. Tax reduction, together with an easy monetary policy which made a plentiful supply of funds available to finance a strong expansion of housing and automobile demand, helped to shorten the recession and to invigorate the ensuing expansion which brought unemployment down to 4.2 percent of the labor force by the third quarter of 1955.

As a result of the expansion, by the first quarter of 1955 total Federal tax liabilities, as shown in the national income accounts, had risen significantly above the level that prevailed in the fourth quarter of 1953 before the tax cuts were put into effect.

While the tax cuts of 1954 helped considerably in rescuing the economy from the recession, it should be recognized that had they gone into effect earlier, the recession of 1953–54 might have been completely avoided. Government expenditures (principally defense spending) were cut by nearly $11 billion between mid-1953 and mid-1954. The tax cuts took effect 6 months after expenditures began to fall. As it was, fiscal policy, taken as a whole, was contractionary in this period and was a major cause of the recession. The Federal deficit as shown in the national income and product accounts was $7.0 billion (seasonally adjusted annual rate) in the second quarter of 1953 when the recession began. By the fourth quarter the operation of the automatic stabilizers associated with the decline in economic activity had increased the deficit to $11.8 billion despite significant cuts in expenditures. The deficit dropped to $10.6 billion in the first quarter of 1954, and as a result of sharp cuts in expenditures, to $5.4 billion in the second quarter despite the tax reductions that went into effect in the first half of 1954.

Private scholars who have studied the period have estimated that if the economy had continued to operate at the same rate of unemployment that prevailed in the second quarter of 1953, the budget deficit would have dropped from $7.0 billion in that quarter to $3.8 billion in the fourth quarter of 1953 and would have shifted to a surplus of $3.0 billion by the second quarter of 1954. This represents a shift of $10 billion between the peak of the previous recovery and the trough of the recession. It is an approximate measure of the net contractive effect of active fiscal policy during this period.

FISCAL POLICY IN THE 1930'S

During the 1930's, America had its longest uninterrupted experience with budget deficits. Their persistence, their relatively large size in comparison with GNP, and their association with an unprecedented unemployment

rate (averaging 18.2 percent from 1930–39) have sometimes been interpreted as demonstrating the futility of expansionary fiscal policy.

The 1930's were a tragic period in the Nation's history. The "Great Depression," the causes of which are still not fully diagnosed, produced a tremendous "gap" between actual and potential output—not the 6 percent average of recent years but about 40 percent during much of the period. In such an abnormal situation, it is perhaps too much to expect that fiscal policy alone could have fully offset a prolonged failure of the private economy to generate strong expansionary forces.

But in fact, active fiscal policy was not employed vigorously, consistently, or with proper timing. And whatever constructive impact fiscal policy may have had was largely offset by restrictive monetary policies and by institutional failures—failures that could never again occur because of fundamental changes made during and since the 1930's.

Briefly summarized, the facts are these:

(1) Fiscal policy was moderately expansionary for the decade as a whole. Federal expenditures increased substantially, adding to total demand. But most of the effect of this expenditure growth was offset by a series of very heavy tax rate increases, especially in the Revenue Acts of 1932 and 1936. Federal revenues increased by 77 percent over the decade even with a terribly depressed tax base. If the unemployment rate had stayed at the 1929 level, revenues would have more than doubled. The Federal budget changed from a surplus of slightly over $1 billion in 1929 to deficits that would have averaged less than $1 billion over the decade had unemployment been at the same level as in 1929. Of course, because of the collapse of the revenue base, actual deficits were much larger; but these were partly the passive product of depression and partly the reflection of an actively expansionary policy.

(2) At two crucial periods, fiscal policy shifted sharply in a contractionary direction: in 1932–33, and again in 1937–38. In the first period the contractionary policy coincided with and intensified the monetary collapse, and in the second choked off the 1937 recovery.

(3) State and local government budgets were then much larger than the Federal budget, and they were changed in a highly restrictive manner, shifting from a deficit in 1929 to surpluses after 1934.

(4) Unemployment melted away very rapidly when military needs began in 1941 to lead to large budget deficits. Of course, as these expenditures and deficits grew during the war, they not only restored full employment but became a serious inflationary danger. But this wartime overdose of expansionary fiscal medicine should not obscure the fact that more moderate dosages in the early stages quickly solved an unemployment problem which had seemed

insoluble for 10 years. This was not because the expenditures happened to be military in nature—any expenditures, private or public, on the same scale would have expanded demand and put men back to work.

SOME CONCLUSIONS FROM PAST EXPERIENCE

Several conclusions emerge from the preceding review.

The automatic stabilization which our present fiscal system provides is a powerful weapon to damp cyclical movements of output and employment. It is one of the factors that has kept the U.S. economy free from major depressions in the postwar period.

The postwar record shows that deliberate tax cuts can have a countercyclical impact, encouraging recovery by stimulating private demand. The experience reviewed above shows how in two cases tax reduction contributed in this manner to recovery from recession. The fact that these tax changes came at times when they helped to check recession and encourage recovery was, however, largely accidental.

The 1948 tax reduction was intended as a permanent one, reflecting the postwar decline of military expenditures. The 1954 tax cuts were also intended as a permanent adjustment to the sharp reductions in government expenditures at the end of the Korean emergency. But a recession will not always coincide with the need for permanent tax reduction. The temporary fluctuations in private demand that are commonly responsible for cyclical movements in business activity thus may call for temporary adjustments in fiscal policy that can be reversed as the need for them recedes.

Last year the President proposed two measures for greater fiscal flexibility to meet recessions. These were (a) a proposal that the Congress grant to the President limited authority to initiate temporary reductions in personal income tax rates, subject to Congressional approval; and (b) a proposal that the Congress give the President stand-by authority to accelerate and

TABLE 10.—*Federal Government surplus or deficit: Comparison of estimate and actual, fiscal years 1958–63*

[Millions of dollars]

Fiscal year	Date of estimate [1]	Administrative budget surplus or deficit (−)	
		Estimate [1]	Actual [2]
1958–63 average		1,411	−5,511
1958	1957	1,813	−2,819
1959	1958	466	−12,427
1960	1959	70	1,224
1961	1960	4,184	−3,856
1962	1961	1,468	−6,378
1963	1962	463	[3] −8,811

[1] Estimate in Budget document issued in January of year indicated.
[2] Actual, except for 1963.
[3] Estimate, January 1963.

Source: Bureau of the Budget.

initiate appropriately timed public capital improvements in times of serious unemployment. In his Economic Report the President has reaffirmed his support of the principle underlying these two proposals.

A weak private economy can generate very large deficits without receiving a positively stimulating effect from those deficits. The large passive deficits of the 1930's provide examples. More recent examples appear in the experience of the past 5 years. Although the administrative budgets presented for the fiscal years 1958–63 foresaw a surplus in every year, averaging $1.4 billion, the actual outcome has been a deficit in all but one of these years, averaging $5.5 billion. This record is summarized in Table 10. The discrepancy between the Administration's proposed budget and the actual fiscal outcome is, of course, accounted for by two factors: variance between actual and anticipated GNP, and Congressional action modifying both expenditures and taxes. But the major factor explaining these discrepancies was the failure of the economy to attain the GNP that had been anticipated.

Passive deficits are largest when the economy experiences recession. A recession which would reduce the expected GNP gains in fiscal year 1964 by even $15 billion below what they would otherwise be would add almost $5 billion to the deficit.

The experience of the last few years should make it clear that merely to incur deficits is not an appropriate objective of policy. For it is not the deficits as such that provide stimulus. Only reductions in tax rates or increases in expenditures have an actively stimulating role. The passive deficits which are the product of recession or slack, however, have a valuable cushioning function. Nevertheless, it is an appropriate objective of policy to eliminate the deficits that are the product of a recession or a sluggish economy—because of the human and economic waste that is involved in recessions and slack. The proper objectives of policy are full employment and growth, and recessions and slack are the opposites of these.

It is clear that the deficit which a slack economy or recession produces cannot realistically be eliminated by raising tax rates or by reducing government expenditures. Its source is not excessive spending or tax rates that are too low. The attempt to eliminate a deficit by these means would be largely self-defeating. Such a policy would be disastrous for employment, incomes, profits; the deficit would remain; and the role of the dollar as an international currency would be undermined.

Expenditures that are wasteful or represent improper fields for government action (something which only the public, acting through elected representatives, can determine) should surely be eliminated. But unless taxes were simultaneously reduced by more than expenditures decline, the effect would be contractionary on the economy. The beneficial effect on incentives through lower tax rates might be more than offset by a net loss in demand. A cut in expenditures reduces market demand directly by the full amount of the cut, while an equal reduction in taxes expands market de-

mand by a smaller amount, because a part of the reduction will be added to personal and business saving.

Deficits that result from recession or slack can be eliminated only by restoring and maintaining a vigorous, rapidly growing economy. If the tax system imposes an excessive drag on the economy—through its effects on purchasing power and on incentives—tax rates may be too high relative to expenditures, even though the budget is in deficit. Thus, tax revision, involving both reduction and reform, can not only provide stimulus for growth and prosperity, but can even, as a result, balance the budget or produce surpluses. Recession and slack generate deficits; prosperity and growth balance budgets.

The reciprocal relationships among surpluses and deficits in the Federal budget and the strength of the private economy can be clarified by examining the counterparts of the Federal budget for the other sectors of the economy.

DEFICITS AND SURPLUSES—PRIVATE AND PUBLIC

For the economy as a whole, expenditures on final output in any past period must necessarily add up to the value of total gross product or income. Therefore, if any one sector in the economy has incurred a deficit by spending more than it has received in income, some other sector must have incurred a surplus by spending less than it has received. Putting it differently, the sum of all sectoral deficits must be identical with the sum of all surpluses. The problem is to maintain a relationship between the deficits and surpluses of the various sectors that will permit this balance to be reached at a satisfactory level of economic activity—and without a prolonged succession of government deficits. The interrelationship between the levels of surplus and deficit of various sectors in the economy has been tabulated in the President's Economic Report each year since 1947. It gives an interesting insight into the cyclical behavior of the economy and places fluctuations in the Federal deficit or surplus in better perspective.

A Federal deficit on national income account means that the Government's injections into the stream of income and expenditures through purchases of goods and services and transfer payments exceed its withdrawals through taxes and social insurance contributions. Conversely, a surplus means that its withdrawals exceed its injections. (The way in which the Government uses its surplus or finances its deficit may have an important bearing on the level of business or even consumer expenditure. These transactions on asset account are not explicitly treated in the present analysis, but these vital considerations of financial policy are dealt with elsewhere in this Report.)

For consumers, receipts of disposable income are withdrawals, and outlays for consumption represent injections. Expenditures on residential construction, though usually treated in the national income accounts as

business investment, are here assigned to the consumer sector, and depreciation charges on residential property are treated accordingly as gross consumer saving.

State and local governments, as the Federal Government, withdraw purchasing power from the income stream through taxes, and inject it by purchases of goods and services and by transfer payments. The concept of surplus and deficit is the same as for the Federal Government. In the case of the foreign sector, imports of goods and services drain purchasing power away to other countries, while exports of goods and services for which payments must be made to the United States constitute injections.

For business firms, retained earnings and depreciation allowances (gross saving) are withdrawals from the gross income stream, while expenditures for fixed and inventory investment are injections. A "deficit," in these terms, exists if investment exceeds gross saving. Thus defined, a "deficit" on capital account does not mean that business is unprofitable—quite the contrary. Borrowing to finance investment in productive plant and equipment that yields a return over time lies at the heart of the growth process of the economy. In years of prosperity, when unemployment is low and capacity is fully utilized, business profits are high and the saving from retained earnings and depreciation allowances is relatively large. But in these years, the inducement to invest in new productive facilities is so strong that it substantially outruns even the large supply of internal saving.

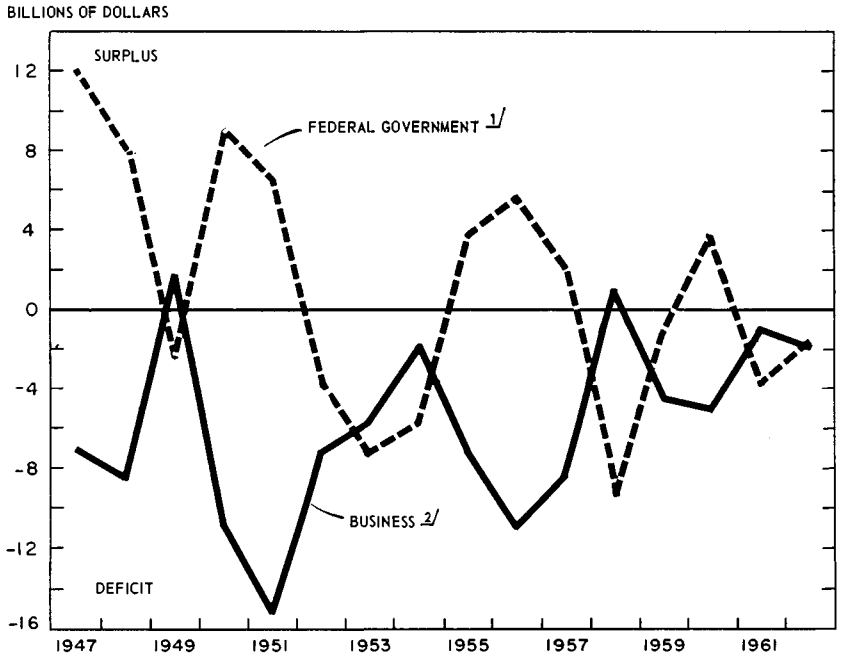
The "budget" of the consumer sector characteristically shows a surplus—an excess of disposable income plus depreciation of houses, over the combined total of personal consumption expenditures and residential construction. Indeed, during the period 1947–62, the consumer sector was in surplus in every year except 1947. The average surplus in that period was about $6.5 billion.

State and local governments have had deficits in 8 out of the last 9 years and in 11 of the entire 16 years under review. Their deficits have been relatively small, averaging a little less than a billion dollars in the last few years. The foreign sector has had an excess of current purchases from the United States over sales to the United States in 9 of the 16 years, and for the whole period the excess of purchases averaged a little less than a billion dollars a year. This excess of purchases is a deficit for purposes of the U.S. national income accounts.

Characteristically, the business and Federal Government sectors combined show a deficit, which offsets a consolidated surplus in the remaining sectors. However, the only two sectors whose deficits and surpluses exhibit fluctuations clearly related to changes in the general level of business activity are the business sector and the Federal Government. Chart 9 shows the deficit or surplus in the Federal national income accounts budget and the deficit or surplus of the business sector on capital account for each year from 1947 to 1962. The chart shows clearly that movements in the deficits and sur-

CHART 9

Federal Budget and Business Capital Account: Surpluses or Deficits



1/ SURPLUS OR DEFICIT (–) ON NATIONAL INCOME ACCOUNTS BASIS.
2/ EXCESS OF GROSS RETAINED EARNINGS (EXCLUDING DEPRECIATION ON NONFARM RESIDENTIAL PROPERTY) OVER GROSS PRIVATE DOMESTIC INVESTMENT (EXCLUDING RESIDENTIAL CONSTRUCTION), OR EXCESS OF GROSS PRIVATE DOMESTIC INVESTMENT OVER GROSS RETAINED EARNINGS (–). SEE TABLE C–7 FOR DATA AND DEFINITIONS OF EARNINGS AND INVESTMENT.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

pluses of these two sectors bear a marked inverse relationship. The year-to-year movements of the deficits or surpluses were in opposite direction for these two sectors in 12 of the 15 cases shown.

The budget of the business sector exhibits surpluses or small deficits in years of recession and slack, moves toward deficit as the economy expands, and commonly achieves a substantial deficit in years of prosperity and low unemployment. Consequently, it is in prosperous years, such as 1947, 1948, 1950, 1951, 1952, 1955, 1956, and 1957, that the business sector has had large deficits on capital account. It is in those years that business raises large amounts of funds on the capital market and uses the surpluses of other sectors. On the other hand, when there is substantial unemployment and unutilized capacity, as in the recession years 1949 and 1954 and the years 1958–62, the inducement to invest tends to be so weak that investment

spending falls, even relative to the reduced levels of gross retained earnings, and the business sector budget shows only a small deficit or even a surplus.

The Federal budget shows a reverse pattern. It consistently moves toward a surplus as the economy expands and toward a deficit as it contracts. These movements are mainly a passive result of the operation of the automatic fiscal stabilizers, though they reflect also active measures of fiscal policy aimed at minimizing economic fluctuations. As a general rule, the Federal Government has had budget surpluses in years when the unemployment rate has averaged less than 5½ percent of the labor force and budget deficits in years when the rate has exceeded that figure. The only exceptions to this rule between 1947 and 1962 were the years 1952 and 1953 when the requirements of the Korean war forced very high military expenditures in a time of prosperity and low unemployment, and the year 1960 when a deliberate contraction of Federal expenditures cut short recovery from the 1957–58 recession while unemployment was still high. On the other hand, in years when unemployment has exceeded 5½ percent, the business sector has had an average deficit of less than $2 billion, whereas in years in which unemployment has been less than 5½ percent the business sector deficit has averaged $9 billion.

It is evident that the deficit or surplus in the business sector is related to the surplus or deficit in the Federal Government sector. More important, it is a major determinant of the total level of expenditures and hence of economic activity. When capital spending is sluggish, the over-all level of expenditure, and hence income, is likely to be unsatisfactory. A passive deficit in the Federal sector will occur. But this, in itself, cannot provide the new inducement to investment that will restore full employment and in the process permit the Federal Government a surplus in its own accounts.

The business sector cannot, of course, be expected to run large deficits merely in order to maintain high levels of economic activity. General economic stabilization is a responsibility of the Federal Government, not of private business organizations. Unavoidable fluctuations in private demand make it almost certain that the Federal budget will show deficits in some years. But the way to avoid chronic Federal deficits and achieve surpluses with reasonable frequency is to pursue active Federal policies—including budget and tax policies—designed to keep the economy operating continuously at high levels of employment and capacity utilization.

PROSPECTS FOR THE FUTURE

There are many reasons for confidence that, once full employment is restored by fiscal action, the private sectors will once again find it to their advantage to increase investment and incur deficits sufficient to generate a balance in the Federal account—that the private economy will find new buoyancy which will make surpluses possible and appropriate.

The weakness of fixed business investment in recent years has reflected—and in turn reinforced—the slow and uncertain growth of aggregate demand. Greater utilization of existing capacity may not immediately yield a burst of investment activity. Businesses which expanded capacity in 1955–57 in the expectation of expanding markets and reaped only a harvest of higher overhead costs may be hesitant to bet again on sustained prosperity. But as strong markets are restored and maintained, business confidence can and will revive. Private investment will then be once again the primary force for economic growth. Structural factors will favor this development. For example, beginning in the second half of the 1960's demographic conditions will be ripe for one of the strongest and most prolonged booms in residential construction this country has ever known. The vast research and development effort of American industry will yield new techniques and new products which will be profitable to install in steadily expanding markets.

The historical record of the American economy—like that of every industrialized country—exhibits an irregular sequence of periods of strong and buoyant demand, alternating with intervals of weakness and slack. The reasons for this irregularity are many: massive innovations like the automobile or electrification, the opening or closing of new territories, bursts of population growth, the temporary drying-up of profitable investment opportunities. History teaches that all such periods end. The natural tendency to extrapolate the recent past ought not to blind us to the likelihood that the weakness of the past few years will sooner or later be transformed into strength. But if we fail to do what is needed now, the transformation may be long delayed.

TAX REDUCTION AND THE NATIONAL DEBT

Tax reduction in 1963 will, as indicated previously, lead to a transitional increase in the budget deficit. As a result, the total Federal debt will rise by an estimated $5.4 billion in the fiscal year 1963, from $298.6 billion in June 1962 to $304 billion in June 1963.

The significance of the public debt—and its increase in 1963—can be best understood by putting the debt in the context of the over-all economy and taking into account the development over time of both the debt and the economy.

World War II led to a $211.9 billion increase in total Federal debt outstanding—from $47.6 billion in December 1939 to $259.5 billion in December 1946, as shown in Table 11. By December 1962, the debt had risen by a further $44.5 billion. Since the war, its size relative to the total economy has declined by more than one-half: the ratio of the debt to GNP was 123 percent at the close of 1946, and at the close of 1962 it was 55 percent. The decline has been fairly steady and has continued in each of the last 2 years. While the absolute size of the debt will again increase during the

TABLE 11.—*Federal debt and interest payments on the debt, selected calendar years, 1939–62*

Item	1939	1946	1950	1955	1960	1962 [1]
	Billions of dollars					
Federal debt: [2]						
Total [3]	47.6	259.5	256.7	280.8	290.4	304.0
Held by the public [4]	38.6	205.3	196.7	204.3	207.9	217.6
Interest payments on debt:						
Total debt	1.0	5.0	5.6	6.5	9.3	9.6
Debt held by the public	.8	4.2	4.3	4.8	6.7	6.9
	Percent					
Debt as percent of gross national product:						
Total debt	52.3	123.2	90.2	70.6	57.7	54.9
Debt held by the public	42.4	97.4	69.1	51.4	41.3	39.3
Interest payments on debt as percent of national income:						
Total debt	1.4	2.8	2.3	2.0	2.2	2.1
Debt held by the public	1.1	2.3	1.8	1.5	1.6	1.5

[1] Preliminary estimates by Council of Economic Advisers.
[2] Amount outstanding, end of calendar year.
[3] Gross public debt and guaranteed issues held outside the Treasury.
[4] Total less amounts held by U.S. Government investment accounts and by Federal Reserve Banks.

Sources: Treasury Department, Department of Commerce, and Council of Economic Advisers.

fiscal year 1963, it will continue to decline relative to GNP: the growth of 1.8 percent in the debt will be less than the expected rise of 4.3 percent in GNP.

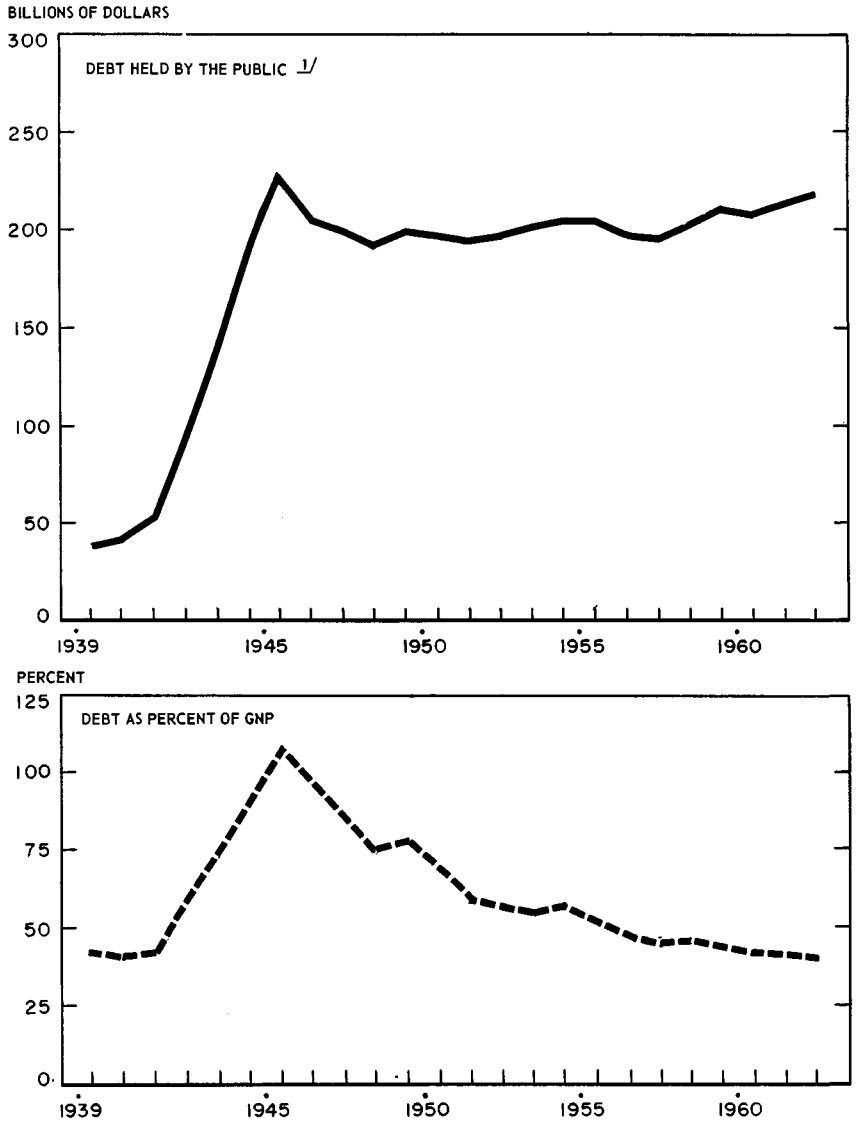
The absolute amount of interest payments shown in the administrative budget has risen from $5 billion in the calendar year 1946 to over $9 billion in the calendar year 1962, primarily because of the necessity of refinancing at higher current interest rates debt incurred during World War II. Such payments, however, have declined as a percentage of national income and as a percentage of total Federal expenditures during the postwar period.

Even in the perspective of the GNP, figures for *total* outstanding Federal debt and gross interest payments overstate the debt "problem." The total outstanding debt includes Federal securities held by the U.S. Government investment accounts—such as the social security trust funds—and by the Federal Reserve System. Interest payments on these components of the debt are, in effect, internal transfers of funds within the Federal Government itself and do not involve payments to the public. Moreover, debt held by the government investment accounts and the Federal Reserve does not pose a significant problem of debt management. The economically significant concepts are, accordingly, the publicly held debt, which excludes these components, and Federal interest payments to the public, which excludes interest transfers within the Government.

The publicly held Federal debt was $217.6 billion in December 1962, compared with total outstanding Federal debt of $304.0 billion. In the calendar year 1962, net Federal interest payments to the public were $6.9 billion, compared with the $9.6 billion of interest shown in the administra-

CHART 10

Federal Debt Held by the Public and its Relation to Gross National Product



1/ TOTAL GROSS PUBLIC DEBT AND GUARANTEED ISSUES LESS AMOUNTS HELD BY U. S. GOVERNMENT INVESTMENT ACCOUNTS AND BY FEDERAL RESERVE BANKS; END OF CALENDAR YEAR.

SOURCES: TREASURY DEPARTMENT, DEPARTMENT OF COMMERCE, AND COUNCIL OF ECONOMIC ADVISERS.

tive budget. From 1946 to 1962, the net increase in the publicly held debt was $12.3 billion, compared with the increase of $44.5 billion in the total outstanding Federal debt. (See Table 11 and Chart 10.) Net publicly held debt per capita fell from $1,450 in 1946 to $1,170 in 1962.

Since 1946, State and local governments in the United States have increased their net indebtedness fivefold—from $13.6 billion to $72 billion, or from $96 to $390 per capita. During this same period, total net private debt increased from $154 billion to an estimated $672 billion. Net corporate debt, accounting for one-half of this total, tripled its 1946 level, while individuals and noncorporate business increased their net indebtedness by over fivefold during this period. (See Appendix C, Table 51.)

Whether the increases in indebtedness in these sectors were wise or foolish depends not on the mere fact of an increase in their debt, but on the purposes achieved and on the future prospects of the individuals or organizations assuming the debt obligations. For the Federal Government, these same guides underlie our judgment as we decide whether an increase in the debt is appropriate. Federal expenditure programs must be rigorously judged on their merits. The decision as to the appropriate method of financing them, however, should be based on the Nation's economic condition, not on the object of the expenditure. In this respect the public debt is unique.

FEDERAL DEBT AND NATIONAL WEALTH

Our national wealth consists of real objects which yield direct services to us (such as the family automobile) or enable us to produce more or better goods and services (the machines in a factory). It also includes the amount by which Americans' claims on foreigners exceed foreigners' claims against Americans.

The measured national wealth, together with the skills and efforts of our labor force, constitutes the productive capacity of the American economy, the source of each year's output. In turn, the portion of annual output devoted to net investment equals the yearly addition to our national wealth—in the form of productive equipment, plants, houses, schools, post offices, and so on. The national wealth grows rapidly in prosperous years when investment is high and slowly in years of recession and slack. Thus, Table 12 shows that during the depressed 1930's national wealth actually declined; during both the prosperous 1920's and 1950's it increased substantially.

If our public debt were owned by foreigners, it would be a deduction from our national wealth and would place a direct burden on our economy by requiring us to export part of our total output to cover interest and amortization. But our public debt is nearly 95 percent internally held. Public debt held by Americans neither directly increases nor directly reduces national wealth. Also, it is not directly related to the asset holdings of

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TABLE 12.—*Civilian national wealth, selected years, 1900–58*

[Billions of dollars, 1947–49 prices]

End of year	National wealth [1]			Net foreign assets
	Total	Privately owned	Publicly owned	
1900	314.6	292.0	22.6	−6.9
1912	464.7	423.5	41.2	−4.8
1922	588.2	532.5	55.7	12.0
1929	778.0	700.2	77.8	18.2
1933	742.2	644.7	97.5	15.8
1939	748.4	623.2	125.2	3.1
1945 [2]	763.7	628.5	135.2	1.2
1945 [2]	788.4	647.1	141.3	−2.7
1946	812.9	671.7	141.2	3.0
1950	949.1	790.6	158.5	12.0
1954	1,086.3	907.8	178.5	12.8
1958	[3] 1,244.5	1,041.7	202.8	18.9

[1] Includes net tangible wealth and net foreign assets; excludes military assets.
[2] Two estimates for 1945: the first comparable with data for earlier years and the second comparable with data for later years.
[3] Total in 1958 prices is $1,702.8 billion.

Source: Raymond W. Goldsmith, *The National Wealth of the United States in the Postwar Period.*

the Government—although it may be noted that a recent report of the House Government Operations Committee estimates that the total wealth, including military assets, owned by the U.S. Government, exceeds its debt.

The tax program that is being proposed for enactment this year will bring about an increase in investment, both by raising demand and reducing excess capacity and by increasing incentives and the availability of funds. Thus, it will increase the accumulation of real capital and add to our national wealth.

Under other circumstances, of course, a fiscal policy which involved an increase in the public debt might operate to reduce real investment and retard the growth of national wealth. For example, when employment is high and demand is pressing against capacity, deficit financing of public noninvestment expenditures may contribute to inflation or raise interest rates and thereby depress private capital formation. Changes in national debt, therefore, bear no simple relation to changes in national wealth. An increase in national debt may indirectly spur the growth of wealth under some conditions and stifle it under other conditions.

THE BURDEN OF THE PUBLIC DEBT

An understanding of the relation between national debt and national wealth helps to place the problem of debt burden in further perspective. In what respects can it be said that public debt imposes a burden on either present or future generations?

1. As indicated above, the kind of fiscal policies we follow can either increase or decrease the living standards of future generations by affecting the stock of wealth we bequeath to them. But, clearly, the tax program being proposed for enactment in 1963, which

encourages both high employment and high capital formation for economic growth, will benefit future generations as well as our own. It will do so even though it results in some increase in the public debt.

2. At full employment, an increase in interest payments on the publicly held Federal debt will ordinarily require higher personal income and corporate profits taxes than would otherwise be necessary in order to prevent inflation. The resulting transfer from taxpayers to interest recipients does not constitute a direct draft on the real resources available to the American people as a whole, but it may impose a burden of a more subtle kind. By dampening incentives, the higher tax rates may reduce total output. How serious such a burden will be depends on the level of tax rates that is needed. In recent years, interest payments to the public by the Federal Government have amounted to less than 2 percent of the national income, as shown on Table 13. Moreover, the ratio of interest payments to national income has declined, and it is this ratio that matters in setting the required level of tax rates. Given the magnitudes of debt change involved in a fiscal policy for high employment, and relating them to the expected growth of our economy, it is likely that the debt burden will continue to decline.
3. A further potential disadvantage of debt service may result from its effects on income distribution. If all the debt were held by one group of investors while taxes were paid by a quite different group, undesirable distributional consequences might result. This, however, is not the case in the United States where debt-holding is fairly widely dispersed and our tax structure partially offsets the distributional effects of interest transfers.

Today's economic problem is slack, not inflation. Thus, under the present circumstances there is no reason to fear such increases in the public debt as tax reduction may entail. The ratio of interest payments on the debt to national income is small and is likely to fall, not rise. Nor is there any danger that the increase in the Federal debt will be a burden on future generations. Tax reduction will increase investment, and hence the wealth we will bequeath, not decrease it. The danger is the opposite one. By failing to take expansionary fiscal action, we will keep both consumption and investment depressed, thus hurting not only ourselves, but future generations as well.

PRICES, WAGES, AND THE BALANCE OF PAYMENTS

The primary purpose of the President's tax program is to strengthen greatly the forces of economic expansion, within an environment of contin-

ued price stability and improvement in our balance-of-payments position. The prospects are good that this can be accomplished by a proper combination of fiscal and monetary policies, continued adherence to sound wage and price policies, and even more intensive application of the measures already taken to improve our balance of payments position—particularly export expansion.

PRICES AND WAGES

Prices rise when demand exceeds supply. The most widely experienced form of inflation occurs when the demand for most or all commodities exceeds or is expected soon to exceed productive capacity. Inflationary pressures cannot directly result from passive deficits associated with economic slack and sluggish growth. The deficits of the past 5 years have occurred in a period of almost unprecedented stability of wholesale prices. Much larger deficits, as a proportion of GNP, were experienced during the 1930's, in a period of falling prices.

Active deficits, on the other hand, arise from policies designed to expand demand. An expansion of demand sufficient to achieve high employment tends to put pressure on prices and wages. But expansions which originate from tax reductions and which are associated with government deficits impose neither more nor less inflationary pressure than expansions originating in any other source. It is not the source of the increased demand, but the extent to which increased demand can be met without increases in costs, and the extent to which competition keeps prices in line with costs, that determine the effect of the expansion on prices and wages.

Effects of expansion on prices and wages

At present, considerable latitude exists in the American economy to increase output by bringing unemployed labor and unused capital back to work; this is a principal reason why a tax reduction is needed. While the record of the postwar years indicates that wages tend to rise more rapidly in years when unemployment is low, given the present high unemployment rate demand for labor can expand substantially without resulting in much additional pressure on labor markets.

In addition, competition is keen. Employers, labor, and the public all are aware of the dangers of cost inflation. The potential mobility of labor is high, and there are reasons to believe it will increase. In the years ahead a larger proportion of the total labor force will be new entrants, and their average educational level will be higher than ever before. New Federal programs of retraining, and other measures to increase the adaptability of the labor force have been introduced. These measures will be further strengthened in 1963 and the years ahead. These improvements in the adaptability of the labor force to changing demand conditions should permit relatively low levels of unemployment to be achieved before bottlenecks become serious.

Although wage pressures undoubtedly would be somewhat stronger at lower rates of unemployment, unit labor costs need not be higher because a considerable improvement in productivity would be the direct consequence of return to higher rates of capacity utilization. An underutilized economy incurs high costs relative to its output—the overhead costs of usable but unused plant and equipment, the cost of maintaining underutilized clerical and administrative staff, etc. All these costs are incurred whether production is low or high. Raising demand for goods and services will permit more efficient use of existing capacity and reduce underemployment of workers still on the payroll—in short, will increase the productivity both of labor and of capital. While higher demand will certainly pull some prices up and lengthen some delivery periods, reduced costs resulting from higher utilization of capacity in many industries will be a force on the side of stability. And in the longer run, the return to full employment, by stimulating investment in new plant and equipment, and the technical improvements it makes possible, will help to speed up the long-run advance in productivity and thus help stabilize or reduce unit costs.

Moreover, the world supply situation for primary products suggests stability in the prices of internationally traded raw materials. Thus substantial expansion of production in the United States can take place without upward pressure on costs from that source.

The extra gain in productivity associated with higher utilization will permit increased profit margins without price increases, provided wage rate increases do not outrun gains in productivity. Total profits will increase even more as sales rise. It is important that the push from the side of profits, like the push from the side of wages, be restrained within limits consistent with over-all stability. Stiff competition from abroad has already disciplined the price policies of a number of American industries and will continue to do so. In addition, a resolute policy of maintaining competition and encouraging the mobility of capital and enterprise as well as labor can make an important contribution in containing inflationary pressures.

A return to low unemployment after the recent period of price stability is unlikely to be encumbered by the same degree of inflationary psychology as earlier postwar periods of low unemployment.

Wage and price "guideposts"

To aid public understanding, the 1962 Economic Report concluded (pp. 185–90) with a set of "guideposts for noninflationary wage and price behavior." These guideposts were designed to provide standards for evaluating those price and wage decisions where the public has an interest in their content and consequences. They cannot, and should not, replace the normal processes of free private decisions and negotiations.

As the margin of unemployed labor and idle capital narrows, and as markets for goods and services become tighter, the guideposts will gain

in importance. They are restated here in the belief that an enlightened public understanding of the nature and causes of inflation would be an additional force minimizing any inflationary threats in the years ahead.

The guideposts themselves involve *general* guides for noninflationary wage and price behavior, subject, in each case, to a number of important and specific *qualifications* required by the objectives of equity and efficiency.

The general guide for wages is that "the rate of increase in wage rates (including fringe benefits) in each industry be equal to the trend rate of over-all productivity increase." Under these conditions the gain from increases in productivity throughout the economy would be shared between wage and nonwage incomes by allowing each to grow at the same percentage rate. Each sector of economic life would share in the gains of advancing productivity. The qualifications call for faster increases in wage rates in an industry that (a) would otherwise be unable to attract sufficient labor to meet demands for its products, or (b) currently pays wage rates exceptionally low compared with those earned elsewhere by labor of similar ability. Symmetrically, increases in wage rates would fall short of the general guide rate in an industry that (a) could not provide employment for its entire labor force even in generally prosperous times; or (b) currently pays wage rates exceptionally high compared with those earned elsewhere by labor of similar ability.

The general guide for prices is that prices should fall in an industry whose rate of productivity increase exceeds the over-all rate, rise in the opposite case, and remain stable if the two rates of productivity increase are equal. The qualifications call for a faster price increase or slower price decrease in an industry in which (a) the level of profits is insufficient to attract the capital required to meet expansion of demand, or (b) costs other than labor costs have risen. On the other hand, increases in price would be slower or decreases faster than indicated by the general guide in an industry in which (a) productive capacity exceeding full-employment demand shows an outflow of capital to be desirable, or (b) costs other than labor costs have fallen, or (c) excessive market power has resulted in rates of profit substantially higher than those earned elsewhere on investments of comparable risk.

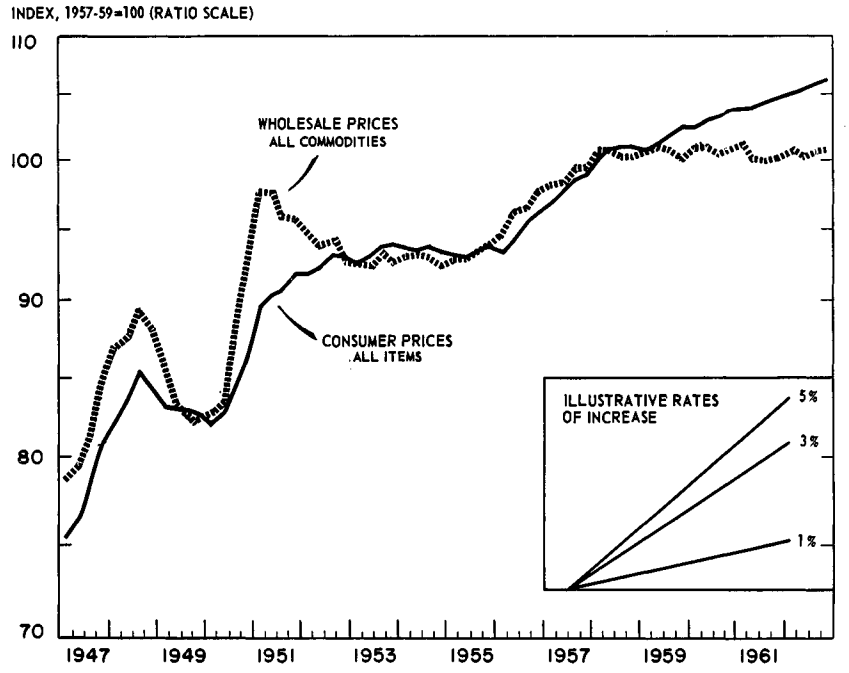
The recent record

Inflationary pressures in the American economy have receded since 1957. Between the first quarter of 1947 and the first quarter of 1958, wholesale prices increased at an annual rate of 2.2 percent, and consumer prices at 2.6 percent. Between the first quarter of 1958 and the last quarter of 1962, however, these annual rates of increase had fallen to 0.1 percent and 1.2 percent, respectively (Chart 11).

Between 1958 and 1959 a decline in wholesale prices of farm products and processed foods offset a slight increase in the average of all other wholesale prices. Since 1959, wholesale prices of all groups have been

CHART 11

Price Developments in the Postwar Period



SOURCE: DEPARTMENT OF LABOR.

essentially unchanged. Within the total of consumer prices, service prices continued to rise more rapidly than the average, but there has also been some slowing in the rate of increase of service prices. When it is recognized that improvements in the quality of goods and services are only imperfectly allowed for, the 5-year record of the consumer price index, and its several components, is cause for satisfaction.

The principal threat to the continuation of price stability in 1962 occurred in April when a general increase in steel prices was announced by a number of the major producers. This increase followed the agreement in March on a wage contract generally regarded as noninflationary. Had this increase stood, it would have caused and invited other price increases throughout the economy; it would have led organized labor to adopt a new militancy in its wage demands; and it would have seriously weakened the forces working toward the restoration of our international competitive position. Fortunately, the price increase was rescinded after the President expressed the country's concern over the serious threat to price stability and our balance of payments.

TABLE 13.—*Changes in hourly earnings in manufacturing industries, 1947–62*

Period	Percentage change per year [1]
1947 I to 1962 IV [2]	4.7
1947 I to 1958 I	5.5
1947 I to 1949 III	8.0
1949 III to 1954 III	4.9
1954 III to 1958 I	4.3
1958 I to 1962 IV [2]	2.9
1958 I to 1961 I	3.4
1961 I to 1962 IV [2]	2.2

[1] Change in average hourly earnings of production workers, adjusted to exclude overtime and inte industry shifts. Quarterly data not available prior to 1959; first month in quarter used.
[2] Preliminary estimates by Council of Economic Advisers.

Source: Department of Labor (except as noted).

The rate of annual increases in average hourly earnings in all manufacturing, adjusted to exclude overtime and interindustry shifts, has declined steadily throughout the postwar period, and the rate of increase has been considerably reduced in the past 5 years.

As is shown in Table 13, average hourly earnings rose 5.5 percent a year between 1947 and 1958, and only 2.9 percent a year between 1958 and 1962. This pattern needs, of course, to be interpreted in the context of the concurrent slowdown in the rate of increase of consumer prices. Labor costs per unit of output in all manufacturing have been stable or declining since 1958, whereas in the earlier period they had advanced.

The fact that these developments have occurred under the cloud of a 5-year underutilization of resources warns against overconfidence in their continuation. But sober confidence that expansionary policies can proceed without fear of premature revival of inflationary pressure is justified by the fact that price stability has been maintained through the second year of cyclical expansion.

BALANCE OF PAYMENTS

Chapter 4 discusses the impact of economic expansion on the balance of payments. The main point to be made here is that the immediate effects on the balance of payments of an expansion of domestic economic activity brought about by fiscal measures are no different from those produced by an expansion finding its origin in a spontaneous increase of private demand. However, the 1963 tax program, in addition to expanding total demand, will strengthen incentives, thereby increasing investment, decreasing unit costs, and helping our international competitive position.

Stability of prices is particularly important for the balance of payments. It should be emphasized, however, that what is significant for America's competitive position in international trade is not the absolute change in the level of U.S. prices, but rather the change relative to prices abroad. In the

past several years, prices in the principal industrial nations of the world have risen relative to ours and indications are that this tendency will continue.

Perhaps the most important impact of economic expansion on the balance of payments will be through increased confidence around the world in the strength of the U.S. economy and thus in the strength of the dollar. Such confidence cannot be bred by the perpetuation of a sluggishly growing U.S. economy, subject to frequent recessions and incomplete recoveries.

Until recently there was widespread belief that foreign businessmen and private and central bankers would be frightened by expansionary fiscal policies and budget deficits in the United States. Fears of inflation and intensified balance of payments difficulties, it was said, would drive short-term capital funds from the United States and lead central banks to convert more and more of their increasing dollar holdings into gold. But in part through the joint studies and activities of the United States and its partners in the Organization for Economic Cooperation and Development (OECD) a better understanding now exists abroad of American prospects and policies. While there is an alert concern that inflation might again develop, important segments of European opinion now realize the urgency of expansionary U.S. fiscal policy—not only to strengthen the U.S. economy but to support the world economy and the international payments system based on the dollar.

In recent months, the OECD has recommended vigorous fiscal action to revive a strong and growing U.S. economy. For example, the annual OECD Economic Survey of the United States (issued December 13, 1962) concluded its review as follows:

> At the risk of over-simplification, the conclusions of this survey may be summarized as follows:
>
> i) The United States needs to raise its growth rate substantially above that experienced since the middle of the 1950's * * *
>
> ii) The major problem underlying the unsatisfactory experience of recent years has been the persistent weakness of demand * * *
>
> iii) It seems unlikely that demand from the private sector will, by itself, prove sufficiently buoyant to put the economy back on to a more appropriate long-term growth trend * * *
>
> iv) Under these circumstances, a greater stimulus from the Federal budget would seem necessary to offset the weakness of private demand, a stimulus that could be provided by tax reductions, by higher Federal expenditure, or by a combination of the two. This may well entail some temporary resort to deficit budget financing; but the quicker the economy regains the full-employment level the shorter will be the period during which deficits are incurred. It is greatly to be hoped that the fiscal changes to be proposed to Congress in 1963 * * * will be adequate in scope and timing to permit the early absorption of the present slack in the economy.
>
> v) In the short run stronger expansion involving increased imports will tend somewhat to decrease the balance of payments surplus on current account. But the government's efforts to promote exports and increase invisible earnings should counteract this tendency, given the cooperation of other Member countries. Rising activity at home should somewhat reduce the outflow on capital account, increasing the attractiveness of investment at home relative to investment abroad. Confidence in the dollar depends in good part on a strong domestic economy; it is unlikely to be fostered for any length of time by policies which keep the level of activity low.

As is clear from the final paragraph, our European and Canadian partners in the OECD recognize that stronger expansion might tend to intensify balance of payments problems in the short-run, and they are concerned that U.S. monetary and debt management policies should take appropriate account of these problems—as indeed they have in the past and will in the future. But our foreign friends also recognize—as most segments of domestic opinion now agree—that the problems prosperity will bring are far less serious than the problems it will solve.

The United States can stand prosperity.

Chapter 4

The United States and the International Economy

THE INTERNATIONAL ECONOMY has undergone a remarkable transformation in the past decade. For many years after World War II, import quotas, discriminatory trade practices, and exchange restrictions on all forms of international payments characterized the bulk of international transactions. Though further progress needs to be made, much of this restrictive legacy has now been swept away. This transformation culminated in the formal acceptance by the major European countries in early 1961 of the currency convertibility requirements of the International Monetary Fund. It is a notable achievement and has far-reaching implications for the U.S. economy and U.S. economic policy.

Among the factors facilitating this development has been a massive redistribution of the world's gold and foreign exchange reserves. At the end of 1948, the United States held 71 percent of the free world's monetary gold stock; by June 1962, the U.S. share had fallen to 40 percent. During the same period, Western Europe's share grew from 15 percent to 44 percent. In addition, foreign official holdings of liquid dollar assets rose by nearly $9 billion. This redistribution ended the excessive concentration of reserves which had been brought about by the political upheavals in Europe in the 1930's, World War II, and the requirements of postwar reconstruction. In achieving balance of payments surpluses which rebuilt reserves, continental European countries gained greater freedom of action to promote economic expansion and to reduce restrictions on international transactions.

The redistribution of reserves was brought about partly through deficits in the international payments of the United States, which led to large transfers of gold and liquid dollar assets to Europe. These U.S. payments deficits have persisted beyond the point where they improve the distribution of the world's monetary reserves. Indeed, continuing large payments deficits by the United States could create doubts about the stability of the dollar and threaten the efficient operation of the international payments system. As a result, the U.S. Government has had to pay close and constant attention to the net financial outcome of its transactions, and those of its citizens, with the rest of the world. Important measures have been taken to improve the payments position of the United States, and domestic economic policy has been framed with attention to the balance of payments

and the position of the dollar. International transactions of the United States are discussed in the first section of this chapter.

The relaxation of many restrictions on trade and payments and the redistribution of world reserves have not been the only factors transforming the world economy. The progress of the European Economic Community (EEC) toward a rapidly growing, unified, tariff-free market encompassing six European countries—and possibly more in the future—has already profoundly altered world economic relationships. The EEC offers a domestic market broadly comparable to the United States and an import market even larger. Liberal access to this market will be vital to future foreign trade; exclusion by restrictive import tariffs or other barriers could seriously affect the trade and economic development of many countries of the free world. The emerging EEC and the relationship of the United States to it are discussed in the second section of this chapter.

It is now generally acknowledged that the responsibility of the industrial nations for providing capital and technical knowledge to other countries for economic development requires more than the occasional and sporadic efforts made before the mid-1950's. Systematic economic development of the low-income parts of the free world—within a span of time that is very short by historical standards—has become a major objective of western foreign policy. Carrying out this gigantic task will require considerable transfers of capital and technical skill. It will result in large shifts in the structure of world production and trade, and will require substantial adjustments in both advanced and developing countries. Some of these problems are discussed in the third section of this chapter.

These developments have one common characteristic: they bring countries economically closer together. They tend to integrate the free world economy. Markets will become more unified, competition will be keener, and differences among nations in techniques of production will diminish. Substantial progress toward our foreign economic objectives will be made, but new challenges for economic policy, national and international, will arise. Some of these problems and recent efforts to find solutions are discussed in the final section of this chapter.

U.S. INTERNATIONAL TRANSACTIONS

THE UNITED STATES AS WORLD TRADER, INVESTOR, AND BANKER

The United States is by far the largest producing nation in the world, accounting for more than 40 percent of total industrial production of the free world. Its 188 million inhabitants place it fourth among nations in population, and its unequalled level of per capita income makes it the world's largest domestic market and largest source of savings.

As trader

The basic purpose of our foreign trade is to exchange goods produced efficiently in the United States for goods which we can produce relatively

less efficiently or not at all. International trade lowers costs and raises standards of living both at home and abroad. Foreign trade accounts for a much larger part of transactions of the U.S. economy than is generally appreciated. Even though our merchandise exports are only about 4 percent of total gross national product (GNP), they amount to nearly 9 percent of our total production of movable goods. For some products, overseas demand is exceptionally important; it provides over half the market for such diverse U.S. products as rice, DDT, and tracklaying tractors. Imports by the United States provide materials essential for production and also permit Americans variety and diversity in their consumption. Crucial products like nickel and cobalt come almost entirely from foreign sources.

U.S. exports and imports are a major part of world trade. In the first three quarters of 1962, U.S. merchandise imports were nearly 14 percent of total world imports. For some countries and some commodities, of course, the U.S. market is far more important than this average share implies. For example, U.S. coffee imports are usually over half of total world imports of coffee.

U.S. citizens pay large sums for services provided by foreigners—transportation of goods and persons, food and lodging for American tourists and businessmen traveling abroad, interest, dividends, and profits on the funds of foreigners invested in American enterprise or securities. In addition, the United States spends overseas nearly $3 billion (gross) a year for its own military defense and, indeed, for the defense of the entire free world. This expenditure is made in part directly by the U.S. Government and in part by more than one million U.S. servicemen and their dependents stationed abroad.

The United States is also a major supplier of goods and services, accounting in 1961 for nearly 18 percent of total world exports of merchandise, for nearly one-fourth of world exports of manufactures, and for nearly one-third of world exports of capital goods. It is a principal exporter of many agricultural goods, especially cotton, wheat, tobacco, soybeans, and poultry, and it exports large amounts of military equipment to its allies—some on a grant basis, some for cash payment.

The very size of the United States in the world economy lends to its economic activity and its economic policies special importance and interest abroad. Its rate of unemployment, economic growth, and commercial and financial policies are closely charted and carefully watched throughout the world.

As saver and investor

A nation as large and wealthy as the United States is naturally an important source of savings for the entire world, and national savings move abroad both as private investment and as official foreign aid. Its advanced technology invites emulation abroad, and the profitability of duplicating

American technology draws American savers and investors beyond domestic borders. Its need for foreign resources to supply American production attracts private U.S. development capital. In addition, the United States has accepted heavy responsibility for the economic development of emerging nations, which require public as well as private capital.

Private long-term investment abroad by U.S. residents has risen markedly in the past decade, from an annual average of $0.9 billion in 1952–55 to $2.5 billion in 1958–61. Much of this increase has gone to Europe.

The U.S. Government provided $3.2 billion to foreign countries and international lending institutions in the first three quarters of 1962—in the form of development loans, Export-Import Bank export credits, sales for local currencies, commodity and cash grants, technical assistance, and contributions to international institutions. This was 12 percent more than in the corresponding period in 1961. U.S. foreign aid to the developing nations has risen markedly since 1954, and under new programs, notably the Alliance for Progress in Latin America, U.S. economic assistance is expected to continue to be high. Total aid expenditures are, however, still below those reached in the late 1940's under the Marshall Plan to assist European recovery.

Both private investment outflows and government aid are appropriate for a high-output, high-saving country such as the United States, and both are expected to yield considerable economic and political returns in the long run. Government and private lending and equity investment add substantial amounts each year to the net foreign assets of the United States, which have risen steadily in the past decade. Their contribution to the growth of U.S. national wealth is shown in Table 12, Chapter 3. But in the short run, both also aggravate the U.S. balance of payments deficit. To reduce the impact of the foreign aid program on the balance of payments, a large part of foreign aid expenditure has been tied to the purchase of goods and services in the United States. In the first three quarters of 1962, 76 percent of government grants and capital outflows resulted in no direct dollar outflow, compared with 64 percent two years earlier. Recent changes in the tax treatment of earnings on foreign investments (described in Appendix A) were designed to achieve more equitable tax treatment between U.S. investment at home and abroad. They should reduce the outflow of investment funds to the extent that these funds were attracted by various tax privileges available in several other countries, and should also increase the repatriation of foreign earnings. Thus these changes should improve the U.S. payments position, at least in the short run when improvement is crucially needed.

Though foreign aid and investment absorb only a small part of U.S. savings, the United States is providing a substantial part of the total flow of savings across national boundaries, especially of the flow to the developing nations. The Development Assistance Committee (DAC) of the 20-nation

Organization for Economic Cooperation and Development (OECD) estimates that the United States in 1961 supplied 57 percent of official foreign aid and 44 percent of private long-term investment flow from DAC members to the less developed countries.

As banker

Since the end of World War I, and especially in the past 15 years, the U.S. dollar has emerged as the principal supplement to gold as an international store of value and medium of exchange. The important position of the United States as a market for goods and as a source of goods and savings, its well-developed, extensive, and efficient financial markets, and its long-standing policy of buying gold from, and selling it to, foreign monetary authorities at a fixed price have all made the U.S. dollar an attractive form in which to hold international reserves. Foreign monetary authorities hold more than $12 billion—over one-quarter of their total gold and foreign exchange reserves—in liquid dollar assets, mostly in the form of U.S. Treasury bills and deposits in American banks. In addition, foreign private parties hold $8 billion in dollar assets, and international institutions nearly $6 billion.

These large outstanding claims on the United States indicate the importance attached by the rest of the world to the dollar as an international currency, and the significance of the United States as an international banking center. For a number of years, the deficit in the U.S. balance of payments was financed to a large extent by increases in foreign dollar holdings which enabled foreign governments and nationals to acquire earning assets and at the same time add to their liquid resources. In recent years, about one-fourth to one-half of our over-all deficit has been settled in gold, but the growth in dollar holdings abroad has continued on a significant scale. The rise in dollar holdings has been an important element in the growth of international liquidity.

But these large balances also make the dollar peculiarly vulnerable. A decline of confidence in the dollar, resulting in widespread conversion of dollars into gold, would create a serious problem for the international payments system and for the economic progress of the free world. Therefore, satisfactory progress in reducing the U.S. payments deficit is essential at this time.

The United States still holds large gold and foreign exchange reserves. Last summer the President reaffirmed U.S. determination to defend the existing parity of the dollar and indicated the country's willingness to use its entire gold stock, if necessary, to do so. In addition to the $16 billion in gold and convertible currencies held by the United States, stand-by arrangements have been entered into with a number of individual countries, and the United States has extensive drawing rights on the International Monetary Fund. The Fund itself was strengthened in October when a special bor-

rowing arrangement, supplementing the Fund's resources by as much as $6 billion, came into force. The final section of this chapter will describe how international cooperation in the past few years has developed new and more effective techniques to protect the dollar and the international payments system against speculative attack.

The balance of payments in 1962

A record of the international transactions of the United States is presented in the balance of payments accounts, compiled by the Department of Commerce (Table 14). For the year 1962 as a whole, the over-all payments

TABLE 14.—*United States balance of international payments, 1951–62*

[Billions of dollars]

Type of transaction	1951–55 average	1956–60 average	1958	1959	1960	1961	1962 [1]
Current account and unilateral transfers	−0.6	0.8	−0.1	−2.3	1.3	2.4	2.1
Merchandise trade balance	2.4	3.9	3.3	1.0	4.7	5.4	4.7
Exports	13.4	17.8	16.3	16.3	19.5	19.9	20.8
Imports	−11.0	−13.8	−13.0	−15.3	−14.7	−14.5	−16.1
Military expenditures	−2.3	−3.2	−3.4	−3.1	−3.0	−2.9	−3.0
Income on foreign investments, net [2]	1.6	2.2	2.2	2.2	2.3	2.8	3.1
Other services, net [3]	.3	.2	.2	.1	−.1	−.1	.1
Government nonmilitary grants	−2.1	−1.7	−1.6	−1.6	−1.7	−1.9	−1.9
Pensions and remittances	−.6	−.7	−.7	−.8	−.8	−.9	−.9
Long-term capital account	−.9	−3.0	−3.5	−1.9	−3.2	−2.9	−2.7
U.S. direct investment [4]	−.7	−1.7	−1.2	−1.4	−1.7	−1.5	−1.2
Other private U.S. investment	−.2	−.9	−1.4	−.9	−.8	−1.0	−1.1
Government loans (less repayments) [5]	−.2	−.8	−1.0	−.4	−1.1	−.9	−1.1
Foreign long-term capital [6]	.3	.4	.1	.7	.4	.5	[7] .7
Balance on entries above ("basic" accounts)	−1.5	−2.3	−3.7	−4.2	−1.9	−.5	−.6
U.S. private short-term assets and nonliquid liabilities	−.2	−.5	−.4	.1	−1.4	−1.3	−.6
Errors and omissions	.4	.4	.5	.4	−.6	−.6	−.7
Over-all balance [deficit (−)]	−1.2	−2.3	−3.5	−3.7	−3.9	−2.5	−1.9
Sales (−) of gold and convertible currencies	−.2	−.7	−2.3	−.7	−1.7	−.7	[8] −.7
Increase (−) in liquid liabilities to foreigners	−1.0	−1.6	−1.3	−3.0	−2.2	−1.7	[8] −1.3

[1] First 3 quarters, seasonally adjusted annual rate (except as noted).
[2] Excludes subsidiary earnings not repatriated.
[3] Includes foreign military purchases in the United States.
[4] Excludes reinvested subsidiary earnings, amounting to $1.0 billion in 1961.
[5] Includes changes in holdings of nonconvertible foreign currencies.
[6] Excludes reinvested subsidiary earnings, amounting to $0.2 billion in 1961.
[7] Includes certain increases in nonliquid U.S. Government liabilities to foreigners.
[8] Unadjusted annual rate.

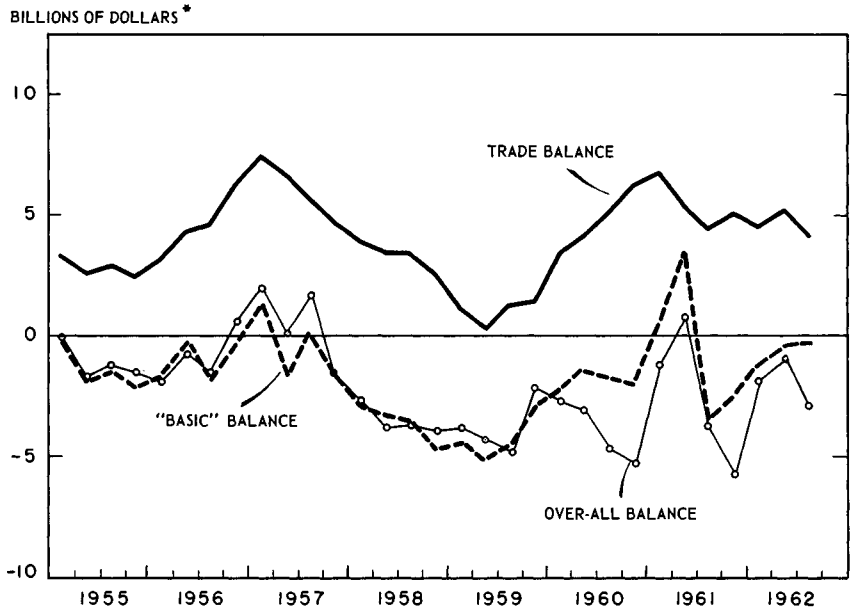
NOTE.—Minus signs indicate payments to foreigners.
Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Council of Economic Advisers.

deficit of the United States was around $2 billion—a decline from $2.5 billion in 1961 and $3.9 billion in 1960 (Chart 12). Although U.S. imports have risen substantially above their 1961 recession low, rising commercial exports have offset a part of the increase. Earnings from American investments abroad continued their upward trend of the past few years. Net mili-

CHART 12

Balance of Trade and Payments



* SEASONALLY ADJUSTED ANNUAL RATES.
NOTE: FOR DEFINITIONS OF DIFFERENT BALANCES SEE TABLE 14.
SOURCE: DEPARTMENT OF COMMERCE.

tary expenditures abroad were offset substantially by accelerated payments by Germany against current and future delivery of materials for national defense. The German Government has agreed to offset fully U.S. defense expenditures in Germany by military purchases in the United States, thus both bolstering the German defense contribution and reducing the net impact of our military spending abroad. More recently the Italian Government has also agreed to substantial military purchases in the United States.

U.S. foreign aid expenditures rose further in the first three quarters of 1962, but since they were increasingly tied to purchases of U.S. goods and services, the direct outflow of dollars actually fell slightly below that in the corresponding period of 1961. Private long-term investment abroad continued at a rate of about $2.5 billion a year. In the first three quarters of 1962 the deficit on goods and services, Government assistance, and long-term capital—the so-called basic accounts—was slightly larger (at an annual rate) than in 1961. The net recorded outflow of short-term capital declined sharply, reflecting in part a reduction in the flow of bank credit to Japan as its payments position improved.

U.S. balance of payments developments during the course of 1962 reflected the Canadian exchange crisis of May and June. Payments to Canada

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dropped sharply during the first half of the year, but rose again in early summer when an extensive stabilization program brought to a halt speculation against the Canadian dollar, for which a new par value equal to 92½ U.S. cents had been established in May.

A substantial contribution to U.S. receipts was made by advance repayments totaling over $660 million by France, Italy, and Sweden of postwar debt to the U.S. Government. In addition, late in 1962 the U.S. Treasury sold 15- and 16-month, nonmarketable securities denominated in foreign currency to Italy and Switzerland, totaling the equivalent of $250 million. Debt prepayments of over $660 million had also been received in 1961.

Without these special receipts, the U.S. payments deficit in 1962 would have been $900 million higher. This underlines the importance of policies to correct the balance of payments. The U.S. Government is continuing to carry out and develop programs affecting a wide variety of transactions, ranging from exports to the outflow of funds attracted by higher interest yields abroad. New measures adopted in 1962 are described in Appendix A. Particular attention is being given to the share and terms of development assistance extended by other industrial nations and to their share of the common costs of defending the free world. Greater effort on their part would not only increase free world security; at the present time it would also contribute to better balance in international payments. Countries in which U.S. military forces make large expenditures are being urged to offset these expenditures, for example by purchasing military equipment in the United States.

EXTERNAL IMPACT OF U.S. ECONOMIC EXPANSION

Structure of the world economy

Virtually no economic event can occur anywhere without affecting trade flows and capital movements throughout the world economy. These repercussions can rarely be traced completely or precisely, but they are nonetheless real and important and cannot be ignored in the formulation of economic policies. The prominence of the U.S. payments deficit since 1958 has focused attention on those economic factors, at home and abroad, which most influence the international transactions of the United States. Because of their size and variability, U.S. exports warrant special attention.

About two-thirds of U.S. exports go to countries outside Europe. Typically, the ability of these countries to import depends directly on their foreign exchange receipts from their own exports, from capital inflow, and from foreign aid. Without such receipts, most non-European countries are unable to allow their citizens to import. As their receipts fluctuate, so do their purchases from the United States. The share of their markets captured by American goods depends upon a variety of factors—historical business relationships, the availability and terms of financing, and the competitiveness of American products.

Most countries in Europe are in a quite different position. Their large and growing gold and foreign exchange reserves indicate that they need not gear their imports and other foreign expenditures so closely to their receipts. On the contrary, their reserves provide an ample cushion for considerable deviation between foreign exchange receipts and expenditures. European imports are therefore, at least in the short run, more closely related to their domestic economic activity and to competitive conditions than to actual or prospective foreign exchange earnings.

The United States is an important supplier both of foodstuffs and of industrial materials to Europe (Table 15). These exports are closely

TABLE 15.—*Commodity composition and destination of United States exports, first 3 quarters of 1962*

[Millions of dollars]

Commodity group	Total exports	Destination				
		European Economic Community	Other Western Europe	Canada	Japan	Rest of world
Total exports	14,571	2,712	2,054	2,868	1,059	5,878
Food and beverages	2,747	566	572	305	204	1,100
Industrial supplies and materials	5,250	1,170	739	951	538	1,852
Agricultural	887	226	180	55	131	295
Capital equipment	4,862	751	561	1,154	267	2,129
Machinery	3,693	621	460	846	242	1,524
Transportation equipment	1,168	131	100	308	26	603
Consumer goods, nonfood	1,026	117	126	279	19	485
All other	687	108	56	178	31	314

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

Source: Department of Commerce.

related to the level of European economic activity and of consumption. The United States is also an important exporter of capital goods to Europe, and U.S. sales of such goods have been growing rapidly in recent years. Because the demand for capital goods reflects the prospects for growing markets, not simply large markets, continuing economic growth in Europe is of great importance for an early solution to the U.S. balance of payments problem.

The close dependence of other countries of the free world, and particularly of the less developed countries, on large and steady foreign exchange earnings to finance needed imports gives them, as well as the United States, a special interest in economic developments in Europe. The heavy dependence of many countries on exports of primary products for exchange earnings with which to purchase needed imports makes their development programs especially vulnerable to fluctuations in import demand either in Europe or in the United States. A recession or slowdown in economic activity in either of these major industrial regions reduces the export earn-

ings of the other countries of the free world both by lowering the sales of their goods and by weakening the prices they receive. The network of world trade by major trading areas in 1961 is shown in Table 16.

TABLE 16.—*Origin and destination of free world exports, 1961*

[Billions of dollars]

Exports from ↓ / Exports to→	Total exports [1]	United States	Canada	Japan	European Economic Community	Other Western Europe	Rest of world [2]
Total exports [1]	110.4	14.3	5.3	4.6	29.1	25.4	31.6
United States [3]	18.7	-------	3.6	1.7	3.5	2.7	7.2
Canada	5.6	3.2	-------	.2	.5	1.1	.9
Japan	4.0	1.1	.1	-------	.2	.3	2.3
European Economic Community	30.9	2.2	.3	.3	11.9	8.9	7.3
Other Western Europe	21.2	1.7	.7	.2	5.8	6.3	6.5
Rest of world [2]	29.9	6.1	.6	2.2	7.2	6.1	7.7

[1] Excludes some trade which could not be allocated by destination.
[2] Excludes Soviet bloc.
[3] Excludes "special category" exports of $1.8 billion.

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

Source: United Nations.

These complex world-wide relationships must be taken into account in assessing the ultimate impact of changes in U.S. domestic economic activity on the U.S. balance of payments. Economic expansion in the United States, reducing and eventually closing the gap between actual and potential output, would have important repercussions throughout the world economy and significant "feedback" effects on the U.S. balance of payments. Because of the sheer size of the United States in the world economy, changes in its trade and investment outflows affect significantly its own international transactions receipts. The complexity of the feedbacks makes it impossible to trace with great precision the impact of higher economic activity on the U.S. payments position. But there is good reason to believe that the adverse impact, even in the short run, would be far less than is frequently assumed. Furthermore, vigorous prosecution of programs aimed specifically at improving the balance of payments and maintaining price stability should enable the United States not only to avoid an adverse over-all effect but to strengthen its payments position.

Effects of domestic expansion on foreign trade

The most obvious effect of a more rapid rise in GNP would be a more rapid rise in imports. Over the years, total U.S. imports have maintained a reasonably stable relationship to total domestic demand. Some imports complement U.S. production, providing both raw materials for expanding industrial production and foreign products to satisfy diversified consumer demand. Other imports compete with domestic products; and as U.S. demand increases, imports can sometimes respond more quickly than domestic output.

However, the net balance of payments impact depends also on the feedback effects. Higher U.S. imports provide additional dollars to foreigners. As already noted, many countries are so hungry for foreign goods that additional foreign exchange earnings are promptly re-channeled into additional expenditures abroad. Additional imports by the United States will increase substantially the foreign exchange earnings of these countries, and the United States will in turn receive a large part of their additional export orders. For example, over one-fifth of U.S. imports come from Latin American countries, and these countries together buy nearly half their imports from the United States. Over two-thirds of Canadian imports normally come from the United States. Whether the United States maintains these shares of Latin American and Canadian markets depends, of course, on the competitiveness of U.S. products and the salesmanship of U.S. firms.

An expanding U.S. economy may also be expected to strengthen some of the primary product markets which have deteriorated in recent years. This too would add to the export earnings of countries relying heavily on sales of primary products, and would maintain their demand for industrial imports while lessening their dependence on U.S. economic assistance. However, even in the best of cases, some primary product markets may remain weak.

Rising domestic demand, by reducing unemployment and excess capacity, may after a time create upward pressure on domestic prices too. Price increases in export industries, or in industries competing with imports, would tend to weaken the U.S. trade position. But for reasons discussed in Chapter 3, raising demand for goods and services will permit more efficient use of existing plant capacity and of underemployed workers still on payrolls—in short, will increase the productivity both of capital and of labor. These factors work counter to the tendency of rising demand to pull costs and prices up. Higher demand will also reduce pressures—by labor, by business, by agriculture—for cost-increasing or protectionist solutions to social and economic strains created by prolonged underutilization of domestic resources.

Effects of domestic expansion on U.S. investment abroad

The outflow of private investment funds is influenced by many economic factors, especially the profitability of investment abroad. But it is also influenced by economic activity in the United States. When U.S. capacity is fully utilized, and when capital for domestic investment is in large demand, high profitability will tend to keep capital at home provided that bank credit expansion is not excessive. When capacity is underutilized, unemployment widespread, and the domestic investment outlook discouraging, capital will seek higher profits and interest yields abroad.

Full utilization of capacity will also increase savings in the United States, both corporate and individual. In its impact on the balance of payments,

this increase in total savings works counter to the improvement in profitability of domestic investment, since some of the new savings may be sent abroad. But in present circumstances, investment abroad is probably not limited by the supply of savings. Corporations now have a larger cash flow than they are investing both at home and abroad, and both corporations and individuals have had ample opportunity to invest abroad from existing wealth, i.e., from past savings. For these reasons, we can expect the improvement in profitability which full utilization will bring—reinforced by recent and proposed tax measures to improve incentives for domestic investment—to be a major influence in reducing the outflows of U.S. investment funds.

In recent years, Americans have made very large direct and portfolio investments in Europe, especially in the EEC. These investments have reflected in part the weakness of markets and profit prospects in the United States; this can be remedied only by higher utilization of domestic capacity.

They have also responded to important attractions to investment in Europe, but the resulting outflows can be expected to diminish in size.

1. The vigorous growth of European economies has been accompanied by high profit rates, and the steps to create a large internal common market have reinforced expectations of substantial profits. There are now signs, however, that profitability is declining in Europe; some of the most obvious investment opportunities have already been exploited, and increasing manpower shortages are leading to increases in labor costs which squeeze profit margins. Furthermore, sharp declines in European stock prices—generally much larger than the U.S. decline earlier in 1962—have demonstrated to some American investors the thinness of European stock markets.

2. Many American businessmen have built facilities in Europe for fear of being excluded from the EEC by preferential commercial policies. The resulting surge of capital flows to Europe can be expected to taper off. Moreover, successful tariff negotiations under the Trade Expansion Act of 1962 would reduce the tariff discrimination against outside producers inherent in the Common Market.

3. Europe has achieved political, economic, and monetary stability in the past decade, and full currency convertibility only in the last five years. Moreover, in an age of missiles, Europe is no more vulnerable than North America to military attack. These developments have removed certain extra-economic factors which concentrated capital, both American and foreign, in the United States in the 1930's and 1940's. Accordingly, American individuals, business firms, and investing institutions have recently had special reasons to reconsider investment opportunities in Europe, and to diversify their investments to include European assets. This, again, is mainly a once-for-all development, which will spend its force in time.

4. European and U.S. tax laws have, in many instances, favored investment in Europe over comparable opportunities in the United States.

Recent legislation should increase the relative attractiveness of investment in the United States. The investment tax credit and changes in tax regulations governing depreciation should increase the profitability of U.S. domestic investment, while changes in the tax treatment of earnings on foreign investments should reduce the attraction of so-called foreign tax-havens. These measures are described more fully in Appendix A. The tax bill to be recommended to the Congress this year should also encourage investment at home.

Summary of the impact of expansion on the balance of payments

Fuller use of domestic resources can, therefore, improve the balance of payments in a number of ways. Against these improvements must be counted several negative effects: the prompt and regular response of imports of goods and services to increases in domestic activity and income; any tendency of economic expansion to pull prices up or to encourage faster increases in wage rates and profit margins; the increase in total saving. Moreover, the favorable effects will not occur all at once; they may be slower than the unfavorable effects of expansion. Considerable time will be needed, for example, for cost-reducing investments to yield higher export orders. Capital flows should adjust more quickly to domestic profitability, but many months may be required before higher utilization is visibly reflected in higher yields, higher profits, and higher profit expectations.

No one can be certain whether the positive or negative effects of domestic economic expansion on the balance of payments will predominate in the long run. It may be that sustained underutilization and deflation could restrict imports and, in time, encourage exports sufficiently to correct a balance of payments deficit. But neither our domestic aspirations nor our world responsibilities permit us to follow such a course. And recent experience here and abroad suggests strongly that, ultimately, the key to a sustained balance in international payments is a dynamic, growing, fully operating economy. That kind of economy has produced payments surpluses in Europe, while 5 years of economic slack have not eliminated the U.S. payments deficit.

Any doubts on this score should be resolved by a consideration which far transcends mechanical estimates of balance of payments effects. Long-run confidence in the dollar as an international currency, and therefore in the international payments system in which the dollar plays a central role, depends on underlying confidence in the American economy—on its ability to produce efficiently, to use its vast resources fully, and to grow without inflation.

The American economy is still the ultimate example—the showcase—of free enterprise in action. A sluggish American economy will raise doubts everywhere, and especially in the newly developing nations, about the

ability of a free enterprise economy to perform efficiently and to grow continuously. Full utilization and economic growth in the United States are of critical importance to the less developed countries in one further respect. These countries cannot develop without an increasing demand from abroad for their products. They cannot diversify their economies without export markets for their new products—especially light manufactures. Full utilization and full employment in the United States will not only raise U.S. demand for these imports, but will also—by permitting labor, capital, and enterprise to adjust more readily to changing patterns of supply and demand—make it easier to accept imports of light manufactures even when they compete with domestic production.

COMPETITIVENESS OF U.S. PRODUCTS

If full employment and rapid growth are to improve the balance of payments, there is one crucial requirement. The competitiveness of U.S. products must continue to improve. Export competitiveness has many dimensions, including price, credit availability, product design, timing of delivery, sales and distribution outlets, and servicing facilities. Strengthening the U.S. export position therefore requires a broadly gauged program.

In the past two years, the Department of Commerce has launched an export drive to inform potential U.S. exporters about sources of foreign demand and to acquaint U.S. manufacturers with foreign requirements. Details of the National Export Expansion program are given in Appendix A. In July 1962, a National Export Expansion Coordinator was appointed by the President to oversee and coordinate the many aspects of the export promotion program. The Department of Agriculture, in cooperation with private trade groups, has under way an extensive export promotion program directed at expanding foreign dollar markets for U.S. food and agricultural products. More than 40 agriculture and trade groups cooperate with the Foreign Agricultural Service in carrying out this program. In addition, as described in Appendix A, the Export-Import Bank has greatly improved its export credit programs and has instituted a new credit insurance program to bring the credit facilities available to U.S. exporters closer into line with those available to European exporters. While these export credits defer receipts from foreign importers to a later date, the enlarged exports serve to interest foreigners in American products and Americans in foreign markets.

A key element in competitiveness is price. If we want to sell more abroad, we cannot allow our prices—and particularly the prices of our exports—to rise relative to those of our major foreign competitors.

Reversing the trend of the mid-1950's, prices on the whole have tended to move in favor of the United States in the last three years. Wholesale U.S. prices during the past 23 months of economic recovery have been stable. Meanwhile, high demand and growing supply shortages, especially

of labor, have tended to raise costs and prices in many other industrial countries (Table 17).

TABLE 17.—*International comparison of changes in prices and wages, 1953–62*

[Percentage change]

Country	Consumer price index		Wholesale price index		Hourly earnings in manufacturing	
	1953–59	1959–62 [1]	1953–59	1959–62 [1]	1953–59	1959–62 [1]
United States	9	4	8	0	26	9
Belgium	10	3	1	2	33	14
Canada	10	[2] −7	4	[2] −7	26	[2] −2
France	[2] −8	12	[2] −10	7	[2] [3] 13	[3] 23
Germany (Federal Republic)	10	[2] 13	2	[2] 9	46	[2] 38
Italy	13	9	−2	4	31	23
Japan	10	16	−1	6	[4] 36	[4] 28
Netherlands	18	[2] 12	6	[2] 3	[3] 46	[2] [3] 29
Sweden	20	11	7	7	40	24
United Kingdom	20	9	12	6	[3] 33	[3] 14

[1] Based on incomplete data for 1962.
[2] Adjusted for changes in exchange rates.
[3] Hourly wage rates.
[4] Monthly earnings.

Sources: Organization for Economic Cooperation and Development, United Nations, and Council of Economic Advisers.

Industries which figure importantly in U.S. exports, such as metals, machinery, and transport equipment, played a leading role in the U.S. price inflation of 1955–58; and prices in these industries rose considerably more than prices of similar foreign products. The relative increase in U.S. prices probably contributed to the decline in the American share of world exports of manufactures. Lately, these prices have not risen significantly, and some have even fallen. Avoiding increases in these prices is particularly important for success in expanding U.S. exports.

Prices reflect costs and profit margins. Wage increases in the United States, particularly in recent years, have been modest compared with increases in most other major industrial countries. Even where productivity has been growing rapidly, as in France and Germany, wages have been rising even faster, raising unit labor costs. In the United States, by contrast, unit labor costs have actually declined since 1959. The period of modest wage and price increases in the United States has also been one of high unemployment. We cannot tell how large these increases would have been in the last 5 years if unemployment and excess capacity had been substantially lower. If expansionary economic policy is not to be severely constrained by an adverse external balance, wages must not rise faster than productivity for the economy as a whole, even when higher employment tips the bargaining scales more in labor's favor. Other income claimants must respect similar limits. Noninflationary wage and price behavior and its relation to productivity are described in Chapter 3. Both labor and management stand to gain by obtaining higher incomes from higher output rather than by seeking full capacity incomes from undercapacity operations.

THE UNITED STATES AND THE EMERGENCE OF A UNIFIED EUROPE

In the early postwar years, the United States necessarily played the leading role in an international economy disorganized by the depression of the 1930's and World War II. As a market for other nations' goods, as a source of needed materials and capital funds, and as a center of finance, the United States had no peer. But reconstruction, prosperity, and growth have restored Europe's historic position in the world economy. And now the movement toward European unity is leading to a major restructuring of international economic relations.

European prosperity and growth and increasing European economic unity have not developed independently of each other. The progress toward greater economic unity might have come much more slowly in an atmosphere of economic slack and uncertainty. The reduction of national economic barriers in Europe in turn has fostered economic growth by stimulating investment and by improving efficiency.

POSTWAR EUROPEAN PROSPERITY AND GROWTH

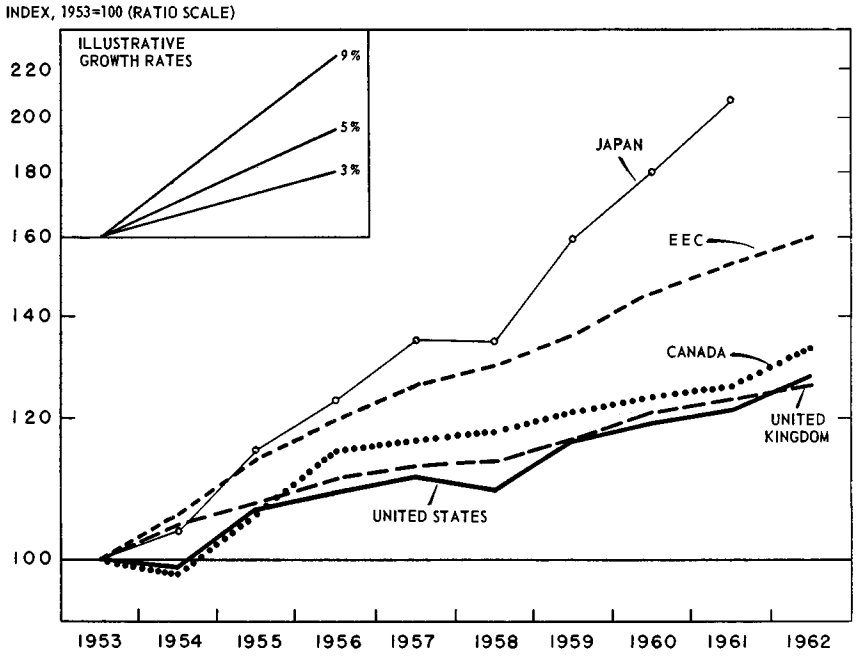
The postwar economic growth rates of various industrial nations are compared in Chart 13. Members of the EEC have experienced rapid growth in total output and in output per man-year of employment. Canada, the United Kingdom, and the United States have advanced more slowly. While European growth was fastest in the early 1950's, it has continued at a rapid pace even in recent years. Clearly, Europe's progress no longer can be attributed to the impetus of recovery and reconstruction. The contrast with U.S. growth over the past 5 years is particularly striking.

European growth has been steady and stable. Whereas the United States has had four recessions since the war, there have been only two periods of economic slack in Europe—in 1952 and 1958—and these were marked more by temporary slowdowns in the rate of expansion than by actual downturns in activity. While in the United States and Canada unemployment has fluctuated around a rising trend, in Western Europe it held at compartively low rates throughout the 1950's or else contracted sharply as in Germany and Italy.

The pace of European growth recently has been somewhat more moderate than in earlier postwar years, but the reason has not been a general deficiency of demand; rather it has been pressure on supply. Such convenient sources of growth as technological "catching-up," the elimination of traditional inefficiencies, and the availability of large inflows of immigrants are beginning to dry up. Unemployment is low and new entrants to the labor force are relatively few. But continued technological progress and the increased efficiency provided by the reduction of internal trade barriers within Europe are still expanding Europe's economic potential. And

CHART 13

Growth in Real Gross National Product, Selected Countries



SOURCES: ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, JAPANESE ECONOMIC PLANNING AGENCY, AND COUNCIL OF ECONOMIC ADVISERS.

European economic performance gives every indication of continuing to match this potential.

PROGRESS TOWARD EUROPEAN UNITY

Substantial progress has been made since World War II toward the attainment of the centuries-old ideal of European unity. The most far-reaching step taken in this direction since the war is the formation of the European Economic Community, with its goal of full economic union and increased political unity among its member states.

The Community was established by the Treaty of Rome, which was signed on March 25, 1957 by representatives of Belgium, France, Germany, Italy, Luxembourg, and the Netherlands. Article 2 of this Treaty states:

> It shall be the aim of the Community, by establishing a Common Market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, increased stability, an accelerated raising of the standard of living and closer relations between its Member States.

The Rome Treaty is an ambitious document; it is also proving to be a workable and flexible charter. The decision of the United Kingdom and three other European nations (Denmark, Norway, and Ireland) to seek admission to the Community testifies to the success and promise of the EEC.

The establishment of the EEC has created a powerful new trading unit in the international economy. The magnitude of the EEC, both as it is and as it will become if the present applicants are admitted, is indicated by Table 18. Even as presently constituted, it is a vast and productive economic unit. Its population is only slightly less than that of the United States. Its total output is more than one-third that of the United States; and after adjustment for differences in price structure, EEC output has been estimated at approximately half U.S. output.

TABLE 18.—*Comparison of United States and European Economic Community (EEC), selected data, 1961*

Item	Unit	United States	EEC [1]	EEC plus current applicants for membership [2]
Population	Millions of persons	183.7	170.7	234.7
Civilian labor force [3]	do	70.6	72.8	101.7
Gross output: [4]				
Total	Billions of dollars	475.4	[5] 173.7	[5] 251.7
Per capita	Dollars	2,588	1,018	1,073
Exports [6]	Billions of dollars	20.6	20.5	26.2
Imports [6]	do	16.1	20.6	29.4
Exports share of gross national product	Percent	4.3	11.8	10.4

[1] Includes Belgium, France, Federal Republic of Germany, Luxembourg, Netherlands, and Italy.
[2] Current applicants for membership are Denmark, Ireland, Norway, and United Kingdom.
[3] Data for 1960.
[4] At factor cost; adjusted to comparable definitions.
[5] Valued at official exchange rates. No allowance has been made for differences in price structure.
[6] Excludes intra-trade; imports valued c.i.f., exports valued f.o.b.

Sources: Organization for Economic Cooperation and Development, International Monetary Fund, and Council of Economic Advisers.

The EEC has extensive trade and financial ties with the rest of the world. Its imports and exports together (not including intra-Community trade) account for 18 percent of total free world trade, compared with 17 percent for the United States. The EEC as a unit comprises the world's largest importer of agricultural products and raw materials—accounting for more than 25 percent of world imports of those commodities in 1960—and, as an agricultural exporter, it is second only to the United States. Exports account for 12 percent of its total output, compared with only 4 percent for the United States. EEC countries hold a large and growing share of the world's gold and foreign exchange—27 percent in September 1962.

Membership by the present four applicants not only would increase the size of the Community; it also would have an important qualitative impact. The United Kingdom imports more temperate-zone agricultural products than any other nation. Moreover, it is a major importer of manufactures

from nonindustrial countries. These products comprise a significantly larger part of U.K. imports than of EEC imports.

The best known aspect of the EEC is the customs union for which the Treaty provisions are most explicit and toward which progress has been rapid. To achieve a customs union, barriers among its member states must be eliminated and a common external tariff established. The common external tariff contemplated in the Treaty is the unweighted average of the national tariffs in force as of January 1, 1957, with the exception of certain German and Italian tariff reductions made prior to that date which were not included in the base used for calculation. Certain commodities were specifically exempted from this formula and tariffs on them were to be negotiated separately. The Treaty also provided detailed timetables for removal of barriers to intra-EEC trade and for alignment of national tariffs to the common external tariffs. These adjustments were to be completed by 1970, but the timetables have since been accelerated.

All quantitative restrictions on industrial goods in intra-Community trade were eliminated on December 31, 1961. Tariffs on internal trade in industrial products have been reduced by 50 percent. On December 30, 1960—1 year ahead of schedule—an initial 30 percent adjustment of national tariffs to the new common external tariff took place and a second such step is planned for July 1963. In its suggested action program, the EEC Commission has proposed the elimination of all internal duties and the full attainment of the common external tariff no later than the end of 1966. During the negotiations in the General Agreement on Tariffs and Trade (GATT) that ended in March 1962, the EEC agreed, in exchange for U.S. tariff concessions, to reduce its common tariff by 20 percent on many industrial items for which the United States is the Community's principal supplier. Comparable progress has not been made toward liberalizing trade in agricultural products—either intra-Community or with third countries—but agreement was reached early in 1962 on the broad outlines of a Common Agricultural Policy.

The EEC, by moving toward the elimination of internal trade barriers and a common external tariff, is giving its member states increasingly preferential access to a vast and growing market. This discrimination against the outside world is inherent in the formation of any customs union. Such discrimination diverts trade from nonmembers toward the member states. However, the reduction of internal barriers to trade broadens the scope for efficient allocation of resources within a union; it is also likely to provide an important stimulus to investment and growth. Whether the net result is beneficial to the rest of the world depends upon the particular conditions of the case in point. One thing is clear: the lower the external tariff of a customs union, the smaller is the burden of discrimination on other nations.

A full EEC customs union will be a creation of far-ranging significance. But the Rome Treaty itself, the history of the EEC, and the views of its leaders indicate that the EEC is more than that. The drafters of the Treaty sought to lay the basis for a fully integrated economic union within which goods, capital, and people will move freely across national boundaries—a union with common or harmonized policies in such diverse matters as taxes, social insurance, money and credit, and market organization. Even beyond this, the drafters looked upon the EEC as establishing "the foundation of an ever closer union among the European peoples."

The success of the EEC in promoting economic integration seems assured. Its role in the world is more uncertain; here the plans and goals of the Community are much less clear and definite. Where differences of opinion and interest among the members threaten to block progress toward the Community's European goals, there are of course strong temptations to resolve them by seeking to throw the burdens of adjustment onto the rest of the world. How well these temptations are resisted in the difficult decisions that confront the Community over the next few years will determine whether the EEC is to be inward looking or outward looking.

EUROPE AND WORLD TRADE

European prosperity and emerging European unity have had a direct influence on European trade. From 1953 to 1961, for example, the share of EEC exports in total free world exports (excluding intra-EEC trade) increased from 15 percent to 20 percent. But parallel with this development was an even sharper increase in intra-EEC trade. Exports from the EEC to the rest of the world increased by 97 percent over the 1953–61 period, while intra-EEC exports increased by 197 percent. In 1953, 26 percent of total EEC imports came from within the Community; by 1961, the percentage was 36 (Table 19). This development stems in part from rapid European growth, but it also reflects the reduction, actual and anticipated, of internal European barriers to trade.

There has been little change in the share of imports of manufactures from the United States in total imports of manufactures of the EEC nations. However, total U.S. exports of manufactures to the EEC in the 4 years following 1957, the year before the Rome Treaty went into effect, increased by 70 percent—from $1.1 billion to $1.8 billion—whereas U.S. exports of manufactures to the rest of the world declined by 6 percent.

Nevertheless, this experience does not indicate that growth in European demand induced by the EEC will automatically offset increased trade discrimination by the EEC. The EEC is only one of the factors that have fostered recent European growth, which was proceeding rapidly even before the Treaty of Rome. Also, the virtual elimination of quotas on manufactures since 1957 was a special factor favoring U.S. exports. Whatever

TABLE 19.—*European Economic Community (EEC) imports by selected commodity category and source of supply, 1953 and 1958–61*

Commodity category and source of supply	Billions of dollars					Percent distribution [1]				
	1953	1958	1959	1960	1961	1953	1958	1959	1960	1961
Total imports	15.1	22.9	24.3	29.6	32.2	100	100	100	100	100
Intra-EEC	4.0	6.8	8.1	10.1	11.5	26	30	33	34	36
From United States	1.6	2.8	2.7	3.8	3.9	10	12	11	13	12
Manufactures [2]	4.8	8.9	10.3	13.6	15.2	100	100	100	100	100
Intra-EEC	2.3	4.5	5.4	6.9	8.1	47	50	52	51	53
From United States	.6	1.1	1.3	2.0	2.0	13	13	12	15	13
Agricultural products [3]	3.8	5.3	5.5	6.0	6.1	100	100	100	100	100
Intra-EEC	.6	.9	1.2	1.4	1.5	16	18	21	23	24
From United States	.4	.5	.6	.6	.7	11	9	11	11	12

[1] Percents based on imports in millions of dollars.
[2] Standard International Trade Classification sections 5, 6, 7, and 8.
[3] Standard International Trade Classification sections 0, 1, and 4.

Sources: United Nations and Organization for Economic Cooperation and Development.

happens to European growth in the future, the commercial policy of the EEC is a matter of great concern to the whole world.

The emergence of liberal trade policies in the EEC is of major importance for our industrial exports; it is even more important for the continuation of high agricultural exports. U.S. agriculture is more dependent than U.S. industry on Europe as an export market; nearly 50 percent of U.S. dollar sales of agricultural exports goes to EEC members or prospective member countries. While these agricultural exports have been increasing in recent years, decisions now being taken by the EEC concerning its Common Agricultural Policy will have a profound effect on the future course of world trade in agricultural products.

EEC agricultural policy

The EEC members reached agreement in January 1962 on the major features of a Common Agricultural Policy to replace the different national systems of agricultural support in the member states. This agreement calls for a uniform agricultural policy, based largely on a system of target prices and variable levies, to be established by 1970. The agreement also provides for a transitional adjustment period permitting price differences among the members of the EEC until 1970. Many details of the Common Agricultural Policy have not yet been settled. It could provide the basis for a more rational use of world agricultural resources; or it could severely restrict world trade in agricultural products.

On July 30, 1962, national restrictions on imports of grain (excluding rice) were replaced by variable levies calculated to offset the differences in market prices (after adjustment for transportation costs) between the EEC importing country and foreign suppliers. The levies on imports from other EEC countries are to be eliminated by 1970, when a single price system will

come into effect throughout the Community. During the transition period, national support prices will be fixed within the limits set by the high and low national prices prevailing currently in the Community.

New import regulations related to differences in feed grain prices inside and outside the Community were also instituted for poultry, eggs, and pork. Minimum prices have been established for these products within the Community, and imports at lower prices are barred. Agreement was also reached in principle on the establishment of similar arrangements for certain other agricultural products, including rice and dairy products. Protective and support arrangements not involving variable levies have been established for other commodities, such as fruit. The action program of the EEC Commission proposes as a goal that 90 percent of EEC agricultural production be covered by common policy regulations of some kind.

The January 1962 agreement also provides for subsidies on exports to other member countries; these are designed to enable any member country with an agricultural surplus to meet the import needs of other member countries where the price of the commodity is lower. These subsidies are scheduled to disappear by 1970, along with price differences among members. However, the agreement also envisages export subsidies for sales outside the Community if the Community as a whole should develop an exportable surplus.

Under the system of variable levies, the full amount of national production forthcoming at domestic support prices is marketed in each country. Only after these supplies are exhausted are foreign suppliers likely to be able to enter the market. In the transition period, EEC suppliers are afforded priority access to markets of other member countries since outside suppliers must pay an additional fee beyond the variable levy.

In the short run, high market prices may not stimulate a substantial expansion of EEC supplies. Over several years, however, high market prices without production controls for domestic producers can be expected to increase production within the Community significantly. Moreover, once the transitional period ends and a single EEC price system is established, production anywhere within the EEC will have unlimited access to the entire EEC market at the prevailing market price.

In the next several months, the EEC will face difficult decisions concerning the development and application of its Common Agricultural Policy. While agreement was reached on establishing a single Community target price for grains by 1970, both the target price and the mechanism for reaching it were left undecided. A decision is scheduled to be made this spring, possibly on a provisional basis, on the common grain prices to come into effect in 1970. It is possible that this decision will be delayed. High grain prices would encourage expansion of production within the Community and seriously curtail its imports, while relatively low grain

prices would encourage international specialization and trade. The establishment of these prices will be an important factor in determining whether EEC agricultural policies develop along trade-restrictive lines or along lines that will permit efficient agricultural exporters, such as the United States, to continue to sell in the EEC market.

How the Community implements its Common Agricultural Policy will determine, more than anything else, how the nations of the free world develop their agricultural policies—whether these policies are internationally or nationally oriented, whether they promote efficient production and competitive trade or lead to protected national and regional markets in which resources are used inefficiently. The Community's agricultural policy will also affect the entire course of free world commercial policy. Industrial and agricultural trade are closely interrelated and it would be difficult and shortsighted to try to maintain highly protective barriers in one and free competition in the other.

The Trade Expansion Act

The whole free world can benefit from removal of age-old national barriers to the full utilization of Europe's productive strength. But the nations of the free world, both within and outside the EEC, must assure that the EEC uses its new power, not as a lever to secure gains for its members at the expense of nonmembers or for some of its producers at the expense of others, but as an engine to promote economic progress and cooperation throughout the world.

The Trade Expansion Act of 1962, signed by President Kennedy in October, is designed to meet this challenge by enabling the United States to bargain more effectively and comprehensively. The tariff reducing authority provided by the Act (outlined in Appendix A) greatly increases U.S. flexibility in tariff negotiations, particularly in negotiations with the EEC. If the United Kingdom becomes a member of the Community, the special authority to negotiate tariff reductions greater than 50 percent with the expanded EEC on goods for which the United States and the EEC together furnish 80 percent or more of world exports would apply to a wide variety of products, including coal, organic chemicals, transportation equipment, most kinds of machinery, photographic supplies, paints, cosmetics, and miscellaneous chemical products. In 1960, free world exports of those goods to which the special authority would apply amounted to some $22.5 billion; of this total, exports from the United States were $8.8 billion. Those from EEC countries plus present applicants were $10.4 billion. The United States and the EEC as presently constituted accounted in 1960 for 80 percent of world exports in only two commodity groups: aircraft, and margarine and shortenings.

It will not be easy for the United States and the EEC to reach a tariff agreement of the comprehensive scope that is essential. But both sides realize the importance of providing a liberal framework for world trade.

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Since any tariff reductions negotiated by the United States, the EEC, and other participants will be extended to other free world nations on a most-favored-nation basis, these trade negotiations will contribute to a general expansion of free world trade. This extension of tariff reductions to other countries gives them a direct interest in the success of trade negotiations under the Trade Expansion Act. General tariff reductions should benefit all nations, including those exporting products in competition with the exports of former African colonies which now have preferred access to the EEC market. Negotiations under the special authority will also benefit major industrial nations such as Canada and Japan—the two largest trading partners of the United States. To achieve maximum success in tariff reduction, full participation of all major trading nations in the forthcoming negotiations will be essential.

Since trade in many important agricultural products is restricted not only by tariffs but also by quotas and other barriers, negotiations concerning agricultural trade are likely to prove especially complicated and difficult. Both the EEC and the United States may have to make concessions that will be painful to some producers in each area. With the help of the bargaining authority given by the Trade Expansion Act of 1962, the United States hopes to obtain substantial liberalization of trade in agricultural products and to avoid, in the long run, any unfavorable net impact of EEC agricultural policies on U.S. agricultural exports. Some short-run U.S.-EEC understandings along these lines have already been reached. In particular, the EEC has agreed that, if the common policy for grains should result in a reduction in trade in higher quality wheat, corrective action will be taken to restore historical relationships. Also, during the last GATT round of tariff reductions, the United States received important concessions on several agricultural commodities, including cotton and soybeans. The EEC has agreed to negotiate further on trade access for ordinary wheat, corn, grain sorghum, rice, and poultry, and to reconsider during the next general round of negotiations the high external tariffs for tobacco and vegetable oils.

These understandings, stemming from the tariff negotiations concluded in early 1962, are limited and do not themselves assure access for U.S. exports that compete with domestic EEC production. However, they point toward rather than away from liberalization. In contrast, the early actions implementing the Common Agricultural Policy indicate a trend toward increased protection. It would be unfortunate if this trend were not reversed. The reversal will be painful to some EEC producers who have envisaged the Community as an assured market for their products, but will be in the general interest of EEC consumers.

In return for assurances that the EEC will set prices at levels which will allow efficient exporters continued access to their markets, the United States may have to limit its own export subsidy program and subject its own

domestic price policies to international review. U.S. agricultural policies and programs, like those of other agricultural exporting countries, will be subject to close examination and our waiver in the GATT, permitting us to restrict agricultural imports under certain specific conditions, is likely to come under increasing criticism.

Quantitative restrictions, prohibitive import duties, and subsidies are out of place in the world which both the United States and other industrial nations are trying to build. They do not meet the long-run needs of producers and consumers in these developed countries; they restrict mutally advantageous trade; and they are unfair handicaps to the developing countries in other continents.

EUROPE AND THE FLOW OF WORLD CAPITAL

Although the countries of continental Europe, and particularly the EEC member countries, have grown in financial and economic strength since the war, they have not assumed international investment and banking responsibilities commensurate with their importance in world trade. Capital markets in several major European countries remain relatively undeveloped by American standards. They are not effective in channeling savings into long-term debt instruments or equity capital. These markets do not meet adequately the growing domestic requirements for long-term capital, let alone foreign demands. Moreover, most European countries maintain official controls which deter foreign issues in their markets. Many of the European issues which are floated in New York appear to be attracted not so much by differences in lenders' interest rates as by other advantages in cost and service.

Progress toward more efficient capital and money markets can be expected under the EEC. The Treaty of Rome envisages reductions of barriers to the free flow of capital within the Community. Some progress in this direction is already being made. Several individual countries are also trying to improve the adequacy of their domestic capital markets through institutional and governmental reforms. They feel a pressing need to do so because businesses are now less able than in the early postwar years to finance investment out of retained earnings and must inevitably tap the rising volume of personal savings. Finally, the emergence and rapid development in the past 3 years of the Euro-dollar market, in which European banks accept and re-lend short-term deposits denominated in U.S. dollars, represent progress toward an efficient and competitive short-term capital market for Europe, and indeed for the whole world.

The inadequacies of European capital markets, in addition to causing European borrowers to turn to the U.S. market for funds, have limited net outflows of private capital from Europe to developing nations in the postwar period. In recent years, the total outflow of private long-term capital from the European members of the Development Assistance Committee

(DAC) to the developing nations has amounted to only a little more than $1½ billion a year. Outflows of government funds have partially made up the deficiencies of private capital markets in this respect. DAC data show that official capital flows, including all export credits of more than 1 year, from its European members rose from $1.1 billion in 1956 to $2.2 billion in 1961 and that there has been some tendency toward easier terms.

THE UNITED STATES AND THE LESS DEVELOPED COUNTRIES

A basic objective of U.S. foreign economic policy is an economic environment in which the people of all nations can steadily raise their standards of living. Economic growth in the industrial countries should support, and be supported by, progress and development in the less developed countries. The transfer of capital and skills from the industrial nations to the developing countries is increasingly important, and is now widely recognized as essential for speeding their development. But foreign assistance will not be sufficient; the developing countries must also find markets for their rising output. International commerce must distribute equitably and efficiently the fruits of productive specialization and economic growth.

ECONOMIC ASSISTANCE FOR INTERNATIONAL DEVELOPMENT

Through the foreign economic programs of the Agency for International Development, the United States committed $2.5 billion to the less developed countries and international lending institutions in the fiscal year 1962, a sharp rise over previous years (Table 20). There has also been a

TABLE 20.—*Agency for International Development: Regional allocations of economic assistance, fiscal years 1958, 1960, and 1962*

Region	Millions of dollars			Percent of total		
	1958	1960	1962	1958	1960	1962
Total new commitments [1]	1,502	1,714	2,300	100	100	100
Far East	675	595	367	45	35	16
Near East and South Asia	547	749	1,124	36	44	49
Latin America	88	105	478	6	6	21
Africa	82	170	315	5	10	14
Europe	109	95	16	7	6	1

[1] Excludes contributions to international organizations and nonregional funds.

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

Source: Agency for International Development.

marked shift in emphasis during the past 5 years, especially toward Latin America. In March 1961, the President proposed a ten-year program for the social and economic development of the Americas. The Alliance for Progress, stemming from the proposals in his address and from the Act of Bogota of September 1960, has been gathering strength and taking concrete form in national development programs during the past year.

Multilateral development financing must supplement U.S. foreign assistance. U.S. participation in multilateral financing institutions—the World Bank and its affiliates, and the Inter-American Development Bank—is an important aspect of promoting economic development. The World Bank made loan commitments of almost $900 million in its latest fiscal year, with subscribed funds and funds raised in U.S. and other capital markets. The International Development Association (IDA), an affiliate of the World Bank set up in 1960 to make credits available on liberal terms, will commit about $400 million of such credits in the present fiscal year. The demand for IDA financing has necessitated an early replenishment of its resources, and negotiations are now being carried on among IDA's members for substantial new contributions. Authority for the United States to contribute will be sought at this session of Congress. A second affiliate of the World Bank, the International Finance Corporation, was esablished to assist private enterprise in developing countries.

The Inter-American Development Bank (IDB) is playing an increasingly important role in the Alliance for Progress. It lends its subscribed resources and borrowed funds, and administers the Social Progress Trust Fund, which is financed by the U.S. Government. Increases in the available resources of the IDB and the Social Progress Trust Fund will also be sought from the Congress this year.

U.S. economic assistance, even when joined with that of other nations and international agencies, can provide only a small part of the total capital and technical resources needed. In the 14 countries receiving over two-thirds of U.S. development aid, 1962 per capita income averaged about $130 and domestic per capita saving available for development averaged $18. U.S. assistance furnished over $2 per capita to these countries. The small extra amounts provided by this assistance permit an inflow of machinery and equipment, spare parts, essential commodities, and technical skills to the aided economies that makes it possible for them to marshal internal resources far more effectively. The United States tries to design the amounts, timing, content, and conditions of its assistance in order to encourage recipient countries to strengthen their own development efforts. The willingness of countries to adopt self-help measures increasingly influences the allocation of U.S. aid. The type of assistance extended to any foreign country is influenced by the nature of our objectives, the nature of our relations with the government, the country's political situation, and the capacity and potential of the local economy.

In many developing countries, foreign assistance is indispensable for the economic development required to preserve stable, nonauthoritarian political institutions. But this economic development should become self-generating. It must not only expand the flows of skilled manpower, savings, and other domestic inputs required for self-sustaining growth; it must also generate the foreign exchange earnings which will enable the developing

nations eventually to become independent of foreign assistance. The imports needed to promote economic growth and to meet rising consumption standards can be obtained only by substantial expansion of exports. In the years ahead, the pace at which economic development will proceed and the rate at which the developing nations reduce their dependence on foreign assistance will depend very heavily upon the pace at which they can increase their export markets.

TRADE AS AN "ENGINE OF GROWTH"

Foreign trade has historically been of major importance in stimulating and facilitating economic development. But the relationship between trade and development has varied with national circumstances.

The United States, richly endowed with natural resources, was able to develop and export resource-using products needed in Europe. During the 19th century, when the United States was in transition from a predominantly agricultural and raw material producing economy to a major industrial power, exports of agricultural products and raw materials furnished a major share of U.S. earnings of foreign exchange. In 1870, primary products accounted for 81 percent of the total value of U.S. exports. Even as late as 1900, their share was approximately 65 percent.

Japanese growth followed a different pattern. Lacking abundant natural resources, Japan concentrated on the development of its human resources and on the export of labor-using agricultural and manufactured products. Foreign exchange earnings from these exports financed imports of raw materials and capital equipment necessary for industrialization.

No single trade and development strategy is appropriate for all economies. The appropriate policy for a country depends on its particular resource endowment, its people, its location, and many other factors; a careful assessment of these factors is a first step in the design of development programs.

Trade problems

Developing economies, whatever strategies for development and trade they choose, today face certain disadvantages that impinged less heavily on the developing economies of the late 19th and early 20th centuries. Simultaneous efforts by many countries to increase foreign exchange earnings to finance development place downward pressure on the prices of the goods they export. And competition from new substitute products in the industrial countries—the widespread replacement of silk by nylon is a classic example—constantly threatens the markets of countries with less abundant capital and less advanced technology. Against this sharp competition for markets must be placed the advantage of deliberate development assistance from the more developed nations and unparalled possibilities for the rapid transfer of advanced technology.

Despite dramatic fluctuations in the prices of foodstuffs, agricultural raw materials, and minerals since the 1920's, the prices of these products in the mid-1950's bore essentially the same relationship to prices of products produced in the industrial countries as they did 30 years earlier. Since the mid-1950's, however, the prices of primary products have declined sharply relative to the prices of finished products (Table 21). This decline has not

TABLE 21.—*Price indexes of selected commodity groups entering international trade, 1956–62*

[1956=100]

Period	Primary products			Manufactures
	Food	Agricultural nonfood	Minerals	
1956	100	100	100	100
1957	102	99	104	103
1958	99	88	101	103
1959	92	92	95	102
1960	90	94	94	104
1961	89	90	93	106
1962: I	89	88	93	106
II	90	87	93	106
III	89	85	93	106

Source: United Nations.

affected all commodities uniformly. Some foodstuffs have declined more than fibers and metals. And prices of a few commodities, such as silver, tin, and, more recently, sugar, have risen.

Many less-developed countries have turned to labor-intensive light manufacturing in an attempt to compensate for the decline in prices of primary products by developing new export products and replacing needed imports with domestic production. India, Pakistan, Spain, and Yugoslavia, among others, are attempting to supplement earnings from the export of industrial materials by exporting textiles and other light manufactures. This trend can be expected to weaken markets for such products both in the advanced countries and in developing countries. Japan, which pioneered the development route of light industry, is beginning to feel competitive pressure from other areas and is shifting more and more to heavy industry. India expects to be a substantial exporter of steel to other Asian nations in the near future. Such shifts in the composition of the exports of the less developed countries are necessary if these countries are to become self-supporting and achieve the higher levels of income they seek.

Adjustments will be required by the less developed countries if they are to take effective advantage of the freer trade opportunities offered by the industrial nations. Their commodity policies must avoid the mistake of stimulating surplus production. Countries producing commodities in long-run oversupply, such as coffee, must be encouraged to shift into other products. Efficient specialization in raw material production among countries must be encouraged, but countries which are overly dependent on the

output of primary products must endeavor to diversify and industrialize their economies.

Cooperation for widening markets

The ability of the less developed countries to increase earnings depends both upon growing world demand and upon the commercial policies followed by the industrial countries.

Economic growth in the advanced economies will greatly facilitate worldwide economic development. Rapid economic expansion leads to increased world demand for the industrial materials and light manufactures produced in the less developed countries. Sluggish economic performance in the advanced economies, on the other hand, places increasing pressure on the prices of exports of developing countries, and also hardens resistance within the advanced countries to the domestic adjustments called for by increased imports from developing areas.

The industrial nations can make an essential contribution to worldwide economic development by accepting, and indeed encouraging, the expansion of imports from the newly developing countries. Free access to the markets of the industrial nations is of major importance in providing developing nations with the foreign exchange needed to purchase the imports essential for their own economic development. In terms of the total output of the advanced economies, increasing imports from developing areas can be easily absorbed; but there are generally some domestic producers who will be affected by increased competition from imports. The advanced countries must find ways to ease their problems of adjustment which do not interfere with trade. The Trade Expansion Act contains important new adjustment provisions, described in Appendix A, to ease the hardships of transition and help firms and workers affected by foreign competition shift to new lines of work.

The benefits of increased exports from the developing nations accrue not to these nations alone, but to the industrial nations as well. Given the assurance of open markets for their exports, the developing nations are capable of providing cheaply and efficiently to the advanced economies large and growing supplies of industrial materials, foodstuffs, and light manufactures. The United States and other industrial economies will directly benefit from these increased exports in lower production costs and cheaper consumer goods. And any single country will find its ability to compete in export markets seriously impaired if, through its own restrictive policies, it denies itself these gains.

Certain domestic economic programs in developed economies can have side-effects detrimental to the interests of the less developed nations. In the case of the United States, for example, oil import controls have restricted purchases of petroleum from overseas areas. Subsidized agricultural exports from the United States compete in world markets with the agricultural exports from other nations. More recently, for balance of payments

reasons, the United States has limited overseas defense and AID procurement with the result that the dollar earnings of several developing countries have been reduced.

Cooperation among industrial nations in establishing a framework of world trade responsive to the interests of developing economies is essential. The United States has taken an active role in promoting this cooperation. It is attempting to prevent further deterioration of the prices of key primary products by negotiating effective commodity agreements where practicable and by exploring international credit mechanisms for damping short-run fluctuations in the export earnings of the primary producing countries. The U.S. objective is a worldwide solution, which might include selective international commodity agreements, compensatory financing arrangements, and economic programs designed to encourage diversification in the primary producing economies. The International Coffee Agreement negotiated in 1962 is an example of efforts along these lines.

The United States was instrumental in securing the negotiation of a long-term Cotton Textile Agreement at the February 1962 meeting of the GATT Cotton Textile Committee. This Agreement regulates the conditions under which importing countries may impose measures to prevent the disruption of their domestic markets, and provides for the relaxation of quotas in the restricted EEC markets on cotton textile imports from the less developed countries. Ultimately, of course, the general objective of U.S. foreign economic policy is a trading world free of quantitative restrictions.

The Trade Expansion Act of 1962 provides a major tool for the development of open and nondiscriminatory trading throughout the free world. The new authority granted to the President under the Act will be used to the full to obtain freer access to protected markets, not only for the United States and the other industrial nations, but for the developing nations as well.

The industrial nations of the free world are agreed on the urgency of achieving greater cooperation in supporting the development efforts of the less developed nations. This consensus was clearly expressed in the final communique of the 1962 Ministerial Meeting of the OECD, which recognizes that trade and development policies are closely linked and calls special attention to the need for integrating aid programs more closely with other efforts to stabilize and expand the foreign exchange earnings of developing countries.

NEW PROBLEMS FOR THE UNITED STATES AND THE WORLD ECONOMY

Greater integration of the world economy promotes efficient division of labor among countries and promises high rewards in economic welfare for all nations: a freer flow of goods among nations unburdened by discriminatory barriers to trade; movement of capital across national boundaries rela-

tively uninhibited by currency restrictions; an increasing volume of economic assistance to raise living standards in the developing nations. All these represent progress toward our economic objectives.

But these developments are also posing new problems for policy and subject all countries to new constraints on independent domestic actions. Freer trade unifies world markets, and competition in unified markets will not permit any nation's prices to get far out of line without reducing sales drastically. Freer capital movements and currency convertibility tend to create world capital and money markets in which domestic interest rates cannot deviate too much from those abroad without encouraging large flows of capital. Foreign aid and direct investment, moreover, may limit the national advantages of new products and techniques, as the innovations are quickly transmitted to foreign economies.

The greater integration of the world economy is occurring only gradually; but the limits such a development may place on independent national action should be anticipated and faced squarely.

CORRECTING IMBALANCES IN INTERNATIONAL PAYMENTS

International transactions may be expected in the future to reflect more rapidly and more fully than in the past divergences among nations and continents in economic developments—in prices, costs, economic growth, interest rates, profitability, demand, availability of natural resources, or technical progress. These divergences will be speedily reflected in imbalances in international payments. Yet the process of adjustment to fundamental imbalances in international payments has not yet been correspondingly improved. Indeed some mechanisms of adjustment which have been important in earlier periods are less available today, because their use conflicts with other national or international goals.

The *ad hoc* imposition and relaxation of trade and exchange controls on private transactions, so frequently used for correcting imbalances a decade ago, are increasingly, and properly, eschewed by the major trading nations.

External imbalances can frequently be eliminated by changes in domestic economic activity. Lower aggregate internal demand will generally lower imports, while higher domestic demand will spill over into imports. Sometimes these consequences help to stabilize the domestic economy: inflation is checked by an emergence of an external deficit, or recession is cushioned by a balance of payments surplus. In these cases, internal policy measures to restore domestic equilibrium also tend to restore external balance. But in other cases, this mechanism for adjusting the balance of payments conflicts sharply with universally accepted domestic economic objectives—full employment and stable prices. For in these cases it requires domestic incomes to fall when they are already too low and unemployment to rise when it is already high. Or it requires money incomes and prices to rise further even when they may be already rising too rapidly. In the United States, such

policy would often be inconsistent with the mandate of the Employment Act of 1946, and many other countries have similar commitments to maintain both a high level of domestic activity and reasonable price stability. Moreover, for reasons already discussed, it is doubtful whether depressing the level of domestic activity could eliminate for more than a brief period a deficit in international payments of a country as large and central to the world economy as is the United States.

Exchange rate adjustments are sanctioned by the Articles of Agreement of the International Monetary Fund for the purpose of correcting "fundamental" imbalances. But in practice, the exchange depreciation required to restore balance in the short run generally exceeds what is required over a longer period of time, when labor and capital can adjust to the new structure of relative prices and exchange rates. Such adjustments thus create new imbalances in the future. Moreover, anticipation of changes in exchange rates between freely convertible currencies stimulates enormous flows of speculative capital and disrupts normal transactions. For this reason, in the world as a whole exchange rate adjustment is a remedy that cannot be used very often without creating more imbalances than it solves. The dollar, in particular, is so widely held abroad as a store of value by official and private institutions that an adjustment in its gold content would gravely disturb the international payments system. U.S. policy, repeatedly reaffirmed, is to maintain the present gold parity of the dollar.

Several methods for eliminating imbalances remain open, but they operate only slowly.

Modest and gradual price adjustments offer some prospect for correcting imbalances without courting either rapid inflation or high unemployment. Countries in payments surplus might allow factor costs to rise more rapidly than productivity, while countries in deficit keep increases in money incomes within the bounds of productivity, permitting some prices to fall. Rising export prices in surplus countries and stable or falling prices in deficit countries could, in time, eliminate payments deficits and surpluses. In fact, equilibrating price adjustments are quite consistent with over-all price stability if appropriate price changes in export and import-competing sectors are offset by changes in other domestic and import prices.

The competitive response of private business to inroads of foreign products in traditional markets, both at home and abroad, can be a powerful equilibrating factor. Selective price adjustment is only one possible response. Changes in product design, improvements in service, and better credit terms can all play an important role. An example is the response of U.S. automobile design to sharp increases in imports of foreign cars several years ago. Government efforts to spur exports can also be used to reduce imbalances. But once various countries are on a par in this respect, overly competitive use of special government incentives would be inefficient for the world as a whole and ineffective for individual nations.

Transactions of central governments are an increasingly important element in international payments, and governments can gear their own international transactions to the requirements of external balance. The size of these government expenditures can be altered, but generally only at the sacrifice of national objectives. Governments of countries with payments deficits can attempt to minimize the impact of their transactions on the external deficit, while countries in surplus free their government expenditures from artificial restraints. For example, deficit countries can tie government transfers to foreign countries to their own goods and services, and domestic suppliers can be given preference in government projects. Since 1959, the United States has tied an increasing share of its foreign aid expenditures to procurement of goods and services in the United States; and in the past year, the preference accorded domestic suppliers over foreign suppliers was increased for much government procurement. Preferences and restrictions of this kind are inappropriate for surplus countries.

While such policies can be used to restore external balance, in practice they are difficult to impose and to remove with the speed and flexibility desirable for that purpose. Moreover, as government programs increase in size, the problem of allocational inefficiencies arising from differential treatment of public and private transactions becomes more acute. Although a policy of tied aid may be unavoidable under conditions of external deficits, it has the twofold disadvantage of reducing the efficiency of a given level of aid and of shielding some export industries from foreign competition. As its balance of payments position improves, the United States has indicated its willingness to discuss with other countries various possibilities for general untying of government expenditures.

The available means of eliminating imbalances in international payments take time, some of them much time, to achieve substantial results. Meanwhile, large and persistent imbalances in payments could compel deficit countries to adopt policies not only at variance with their own economic objectives but also harmful to the rest of the world.

INTERNATIONAL ECONOMIC COOPERATION

In order to protect basic objectives in both domestic and foreign economic policy, it is therefore of the utmost importance that nations cooperate (1) to remove causes of imbalance, (2) to provide adequate finance to permit nations to weather temporary though sometimes prolonged periods of imbalance, and (3) to strengthen the international monetary system, particularly against speculative attacks on major currencies. Notable innovations and adjustments have been made in the past few years in all these dimensions of international cooperation, but important work remains to be done.

All three modes of international cooperation are important and all are difficult, but the instruments and institutions of cooperation of the first

kind are quite different from those of the other two. To remove sources of imbalance, nations must consult with each other concerning domestic policies which affect their international payments; and they must stand ready to modify their internal and external policies in order to maintain or restore balance. To finance imbalances, including those resulting from exchange speculation, requires mutual agreement among nations to lend to each other, or to assure adequate supplies of international reserve assets which each country will accept in settlement of international accounts.

To a certain extent, one of these methods of cooperation takes the place of the other. The better the coordination of national policies, the greater are the chances of avoiding payments imbalances or of correcting quickly those that arise, and the smaller is the need for facilities to finance large and long imbalances. Conversely, the better the facilities for financing payments deficits, the less urgent it is to coordinate policies in order to eliminate them quickly.

Whichever method is emphasized, international economic cooperation requires consensus on objectives and machinery for coordination.

Over a decade ago the major trading countries agreed, in the GATT, on the broad outlines of a world trade environment beneficial to all. The GATT expresses the joint recognition that mutual benefit will be achieved by eliminating barriers to trade. Yet it is based on the premise that trade liberalization can take place without jeopardizing external balance only if all participants lower barriers together—or if countries in surplus lower barriers more rapidly than those in deficit. The Trade Expansion Act of 1962 is designed to continue and strengthen this principle of reciprocity.

Recently, new steps have been taken toward closer harmony of objectives and policies. The EEC is showing how greater economic integration and greater cooperation in economic and financial policy go hand-in-hand. Similar steps—less formal, less comprehensive, more tentative—are under way for other and wider groups of nations.

In November 1961, the Ministerial Council of the OECD announced that the 20 member nations had pledged themselves to aim at a growth of output, for the group as a whole, of 50 percent over the decade of the 1960's. The Ministers pointed out that this growth would not only increase the economic welfare and strength of North America and Western Europe but would lead to an increased flow of resources to the developing countries throughout the free world. This growth objective has given new meaning and unity to the important and detailed work of the Organization and its committees. In the words of the Secretary-General, the OECD can help:

— to develop common understanding of the problems of each country, and the way it is tackling them, so that each country knows what others are doing;
— to provide a means for improving policy by comparison and joint examination of the alternative approaches to common problems which may be found in different countries;
— to explore the inter-relations and inter-actions of plans or expectations in the different countries;

— to arrange concerted action when this is appropriate to deal with the problems which arise.

The committees of the OECD discuss many aspects of economic policy, e.g., manpower, agriculture, industry, trade, and payments. Through its Economic Policy Committee, consisting of senior officials from member countries with responsibilities in the fields of economic and financial policy, information is exchanged on future economic prospects and policies in the member countries. The annual country examinations by the OECD and by the International Monetary Fund (IMF) also provide forums for exchanging information and advice on economic prospects and policies. Balance of payments developments and related national policies are continuously discussed in the IMF, at monthly meetings of central bankers at the Bank for International Settlements in Basle, and in Working Party 3 of the OECD Economic Policy Committee. In addition, the United States has held annual Cabinet-level economic talks with Canada and Japan during the past two years. All these international discussions represent important advances in the exchange of information across borders and in the consideration of the interactions between the economic policies of different countries.

COORDINATING ECONOMIC POLICIES

Many sources of payments imbalance can be eliminated with little sacrifice of basic objectives, national or collective. Mutual consultation can lead to better timing of monetary and fiscal measures taken for purposes of internal stabilization. Differences among nations in taxation that promote undesirable capital movements can be eliminated. National policies can be better harmonized in a variety of fields, e.g., agricultural prices and subsidies, export credit and export promotion, remission of internal taxes on exports, social insurance, wage-price policies, antimonopoly regulations, and amounts and terms of development assistance. The first purpose of international coordination of policies is to take these steps.

However, beyond some point, efforts to eliminate imbalance by coordinating national policies are bound to conflict with basic objectives of one or more of the nations or of the group as a whole. Troublesome capital movements can often be avoided or reduced by bringing interest rates in major countries into closer alignment; but this may mean untimely monetary restriction within some countries and unwelcome monetary expansion in others. Correction of imbalance by adjustments in trade balances may require prices to rise in some countries or to fall in others; both may be unacceptable to the governments concerned.

Some of these conflicts may be avoided by suitable variation among countries in the mixture of policies. For example, a surplus country battling domestic inflation by tight monetary policy and high interest rates will attract more foreign funds and increase still further its external surplus; if

tight fiscal policy is used instead, its interest rates need not aggravate the payments imbalance. Similarly, a country, like the United States today, facing simultaneously a payments deficit abroad and a slack economy at home, can emphasize fiscal rather than monetary measures for domestic expansion.

The need to coordinate policies is not a wholly new burden on nations. After all, circumstances by themselves sooner or later compel a certain rough coordination of policies. In the end, deficit countries must take actions to correct external imbalance. Deliberate consultation and coordination can result in more timely and more symmetrical adjustments, with surplus countries sharing the burden of adjustment. But international cooperation must also include ways to accommodate desirable divergence in national policies, resulting from differences in national objectives and national circumstances.

STRENGTHENING THE INTERNATIONAL MONETARY SYSTEM

Even with close coordination of economic policies, imbalances in international payments can and will develop. Changes in consumer tastes, improvements in technology, and other factors will require continuing adjustment to changing international payments. Because generally acceptable processes of adjustment are necessarily slow, such imbalances may persist for some time. Their emergence and persistence can, in some cases, create doubts about the ability of governments to maintain existing exchange rate parities, and may lead to large and erratic speculative flows of capital. Indeed, speculative considerations can come to play a part in every international transaction, frequently overriding in importance normal motivations for foreign trade and investment. Unless disruptive speculation can be discouraged or offset by official actions, it could undermine the international payments system.

Speculative attacks on the principal currencies of the world can be contained, and even prevented, if the major governments together make clear their intention to maintain currency parities, both by individual and by multilateral action. A principal line of defense of a nation's currency is its gold and foreign exchange reserve; these reserves should be used when necessary. In his balance of payments message in early 1961, the President pledged the full strength of the U.S. gold reserve to the defense of the dollar.

National reserves can be significantly supplemented with drawing rights on the International Monetary Fund, established for the express purpose of assisting countries in temporary balance of payments difficulties. The $1.5 billion drawing of the United Kingdom in August 1961 and its full repayment by July 1962 demonstrate the size and flexibility of support which the IMF can give to the payments system. The participation of the IMF on very short notice in more than $1 billion of support given to Canada in late June indicates the speed with which it can act. The IMF was sub-

stantially strengthened in October when an agreement to supplement its resources came into force. Ten leading industrial countries have agreed to lend up to $6 billion to the IMF if such extra funds should be needed "to forestall or cope with an impairment of the international monetary system." This is especially important to the United States, for it makes available to the Fund resources adequate to assure the world that the United States could make full use of its Fund quota, should that ever be necessary.

The benefits of an efficient payments system accrue to all the principal trading nations, which have joint responsibility not only for making adjustments to correct international payments imbalances, but also for defending the payments system while orderly adjustments are taking place. This elementary fact is being increasingly recognized and accepted, as is shown by the new IMF borrowing arrangement and by other recent bilateral and multilateral actions. The United States and the United Kingdom joined the IMF in providing massive support for Canada during its exchange crisis in mid-1962. Advance debt repayment and U.S. borrowing in foreign currencies, already discussed, have been important cooperative methods of reducing the accumulation of short-term dollar assets by foreign authorities.

In 1961, for the first time since the 1930's, the U.S. Treasury resumed operations in foreign exchange markets for the purposes of preventing or correcting unsettling movements in spot and forward exchange rates. These operations have proved helpful in coping with reversible flows of funds and in cushioning the impact on exchange markets of potentially disturbing international political developments, such as the Berlin Crisis.

In February 1962 the Federal Open Market Committee of the Federal Reserve System decided to operate in foreign exchange markets on the System's own account. The resources of the Federal Reserve reinforce those of the Treasury and greatly increase the flexibility of U.S. foreign exchange operations. During the year, the Federal Reserve entered into "swap" arrangements (whereby equivalent currency claims on, and liabilities to, another central bank can be created by mutual agreement) totaling $900 million with nine central banks in Europe and Canada and with the Bank for International Settlements. At the end of the year, most of these arrangements were on a stand-by basis, the technical problems of their creation and use having been successfully tested.

Foreign exchange operations, whether by the Treasury or the Federal Reserve, are undertaken only in close cooperation with the foreign central banks directly concerned. The monthly meetings of central bankers at Basle, which are attended by senior officials from the Federal Reserve System, keep foreign exchange developments under careful review and consider methods for handling disturbances. This review encompasses developments in the London gold market, where international disturbances are sometimes reflected in a sharp rise in private purchases of gold.

During the past few years, therefore, progress has been made in developing new methods for dealing with some of the international monetary problems of the new world economy. But some incompletely resolved problems still face us, and new developments are continually calling for new solutions. Constant attention and continuing study are necessary and are being given to ensure that the international monetary system responds to the challenges of a highly complex and rapidly changing world economy.

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