Chapter 1

The Sustained Expansion of 1961-64

AS 1965 BEGINS, most Americans are enjoying a degree of prosperity unmatched in their experience, or indeed in the history of their Nation. In 1964, some 70 million of them were at work, producing $622 billion worth of goods and services.

The gains of four years of uninterrupted economic expansion had brought fuller pay envelopes, greater sales, larger dividend checks, a higher standard of living, more savings, and a stronger sense of security than ever before. Over that period industrial production grew at an average annual rate of 7 percent, and the total output of all goods and services (valued in constant prices) increased at an average rate of 5 percent (Table 1). These gains brought jobs to 4 million more persons and raised total consumer income after taxes by 6 percent a year. And all this was accomplished with essentially stable prices.

That the extent and duration of these gains exceeded the two preceding postwar expansions can be seen from Chart 1. Indeed, in a few months, the duration of this expansion will have surpassed any other on record—except only the prolonged advance before and during World War II.

AN OVER-ALL VIEW OF THE EXPANSION

This gratifying record reflects the strength and elasticity of the private economy, and its favorable response to a series of policy measures deliberately designed to invigorate it. The upturn in 1961 was quick and strong, in part through an early recovery of private demand and in part through forceful policy actions. Prompt steps to boost consumers' purchasing power, taken by President Kennedy's Administration, were later reinforced by increases in Government expenditures necessary to strengthen America's basic defenses and to achieve the precautionary buildup required by the Berlin crisis.

Following the rapid recovery, the outlook appeared favorable in early 1962. Many observers, recognizing that there were special explanations for the weakness and brevity of the recovery of 1958–60, expected a return of the vigorous expansionary strength of 1954–57. In fact, conditions had changed. The backlogs of demand for housing, consumer durable goods, and additions to manufacturing plant and equipment, which had existed

TABLE 1.—*Changes in selected measures of economic activity during the current expansion*

[Seasonally adjusted except as noted]

Measure	1961 I	1964 IV	Absolute change	Percentage change: Total	Percentage change: Per year
	Billions of dollars, annual rate				
Gross national product:					
Total:					
Current prices	501.4	633.5	132.1	26.3	6.4
1964 prices	524.9	629.4	104.5	19.9	5.0
Private:					
Current prices	452.1	568.4	116.3	25.7	6.3
1964 prices	468.4	565.3	96.9	20.7	5.1
	1957–59=100				
Industrial production:					
Total	103.7	134.4	30.7	29.6	7.2
Manufacturing	103.1	135.2	32.1	31.1	7.5
Durable	99.1	135.4	36.3	36.6	8.7
	Millions of persons				
Employment and unemployment: [1]					
Civilian labor force	71.4	74.4	3.0	4.2	1.1
Employment	66.6	70.7	4.1	6.2	1.6
Nonagricultural	60.9	66.4	5.5	9.0	2.3
Unemployment rate (percent)	*6.8*	*5.0*	*−1.8*	----------	----------
Private nonagricultural payroll employment	45.0	49.1	4.1	9.2	2.4
	Billions of dollars, annual rate				
Personal income:					
Total (before taxes)	407.2	502.2	95.0	23.3	5.8
Wages and salaries	271.5	339.9	68.4	25.2	6.2
Disposable (after taxes)	355.6	442.0	86.4	24.3	6.0
Consumer purchasing power [2]	355.6	424.6	69.0	19.4	4.8
Corporate profits:					
Before taxes plus inventory valuation adjustment	39.2	[3] 58.1	[3] 18.9	[3] 48.2	[3] 11.9
After taxes	19.5	[3] 32.0	[3] 12.5	[3] 64.1	[3] 15.2
Corporate purchasing power [4]	19.5	[3] 31.1	[3] 11.6	[3] 59.5	[3] 14.3
	1957–59=100, unadjusted				
Prices:					
Consumer	103.9	[5] 108.6	4.7	4.5	1.2
Wholesale	101.0	100.8	−.2	−.2	−.1

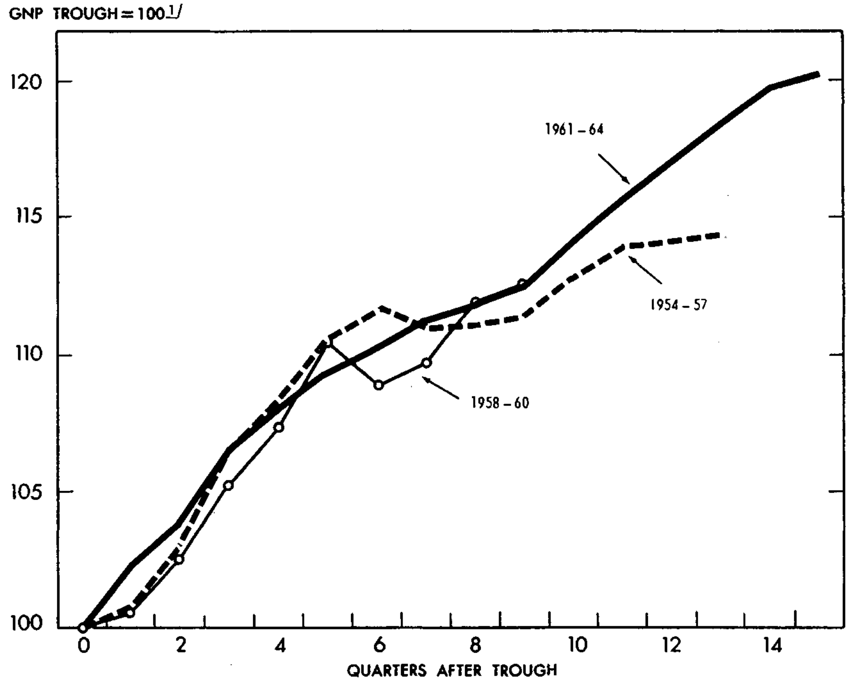
[1] Labor force data for 1961 I adjusted for comparability with data for 1964 IV.
[2] Disposable personal income (current prices) divided by the implicit price deflator of personal consumption expenditures on a 1961 I=100 base.
[3] Data for 1964 III and change from 1961 I to 1964 III.
[4] Corporate profits after taxes (current prices) divided by the implicit price deflator of "private nonresidential construction plus producers' durable equipment" on a 1961 I=100 base.
[5] Average of October–November data.

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

Sources: Department of Commerce, Department of Labor, Board of Governors of the Federal Reserve System, and Council of Economic Advisers.

Chart 1

Real GNP in Three Postwar Expansions



1/ BASED ON SEASONALLY ADJUSTED DATA, IN CONSTANT PRICES.
TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

in 1954–55, were gone. Even after the expansionary fiscal measures of 1961, the Federal budget remained more restrictive than it had been in the 1954–57 period. Holdings of liquid assets were considerably lower relative to income than in the years prior to 1955, partly as a result of years of tighter monetary policy.

In the course of 1962, the pace of expansion slowed. By mid-1962 it had become apparent that, given the level and structure of Federal tax rates, the strength of private demand would be insufficient to carry the economy up to full employment of its resources. Consequently, President Kennedy announced in August that he would propose a major tax bill in 1963, reducing the rates of personal income and corporate profits taxes from levels which had been determined in large part by the need to fight the postwar and Korean inflations. The year 1963 saw prolonged debate over this measure, and enactment came only in February 1964. But by mid-1963, increasing confidence that prosperity would be maintained with the aid of the expected tax cut, the continuing support of an expansionary monetary policy, the fuller response of business investment to the 1962 tax measures, and the strong demand for automobiles once again began to accelerate the pace of expansion. Thus, as the Revenue Act of 1964 became effective, the economy was already moving ahead strongly.

THE ECONOMY IN 1964

In its Report a year ago, the Council of Economic Advisers found that ". . . the outlook this year calls for a significant acceleration in the growth of output. At the midpoint of the forecast range, current-dollar GNP for 1964 is estimated to increase 6½ percent above the level of 1963, and the real GNP, about 5 percent . . . the more rapid expansion of production in 1964 should lower the unemployment rate. By the end of the year, it is expected to fall to approximately 5 percent." These expectations were realized. Gross national product (GNP) for the year as a whole exceeded that of 1963 by 6½ percent, and the unemployment rate in December was 5.0 percent.

The optimistic forecast for 1964 depended on the tax cut, and its fulfillment is a measure of the tax cut's accomplishments.

Between the final quarter of 1963 and the final quarter of 1964, business fixed investment rose by 9 percent. This confidence in expanding markets proved to be justified. Strengthened by the tax cut, consumer spending rose exceptionally rapidly and steadily during the year. Gains of total production ran close to $10 billion a quarter, until the fourth quarter when strikes at General Motors and Ford plants reduced production and held down consumer purchases. But by year end, the effects of the strikes were overcome. Retail sales in December ran a strong 8½ percent above sales a year earlier. The dip in the growth of industrial production had been more than erased, and employment in December was 1.8 million above the same month in 1963.

These four years of expansion have demonstrated that the American economy is capable of sustained balanced growth in peacetime. No law of nature compels a free market economy to suffer from recessions or periodic inflations. As the postwar experience of Western Europe and Japan already indicates, future progress need not be interrupted even though its pace may vary from year to year. We need not judge the life expectancy of the current expansion by measuring the time it has already run. The economy is in good health, and its prospects for continued expansion are in no wise dimmed by the fact that the upswing began four years ago rather than one or two years ago.

PROBLEMS UNSOLVED

The expansion of economic activity during the past four years has carried virtually every economic indicator to a new record level. But this in itself is no cause for complacency. In a growing economy, it should be a matter of course to set new records month by month and quarter by quarter; to be meaningful, economic achievements must be gauged against capabilities and objectives.

Unfortunately, the balanced growth of the U.S. economy in recent years, unlike the sustained progress of other industrial economies, has occurred at too low a level. The excessive unemployment and idle capacity with which the current U.S. expansion began have not yet been fully erased. Unemployment at 5.0 percent of the civilian labor force is far better than the 7 percent rate of spring 1961. But 5.0 percent represents 3.7 million persons seeking work. If unemployment today were at the interim target of 4 percent, the number without jobs would have fallen below 3 million, and the labor force would be considerably larger than it is today, as emerging job opportunities encouraged more people to seek work. Consumer incomes and corporate profits would both be considerably higher. The "gap" of $25–$30 billion that still remains between the Nation's actual output and its potential output would be closed. The size of this gap—4 percent of our current potential—is a measure of the primary challenge for economic policy: achieving maximum employment, production, and purchasing power.

A second challenge—not new, but more fully recognized than ever before—lies in the contrast between our great over-all prosperity and the poverty and misery which still afflict too many families, and in the contrast between our great material achievements and the quality of our private and public lives.

A third challenge of pressing importance lies in the fact that, despite considerable progress, we have not yet regained equilibrium in our balance of payments.

The remainder of this chapter has three main tasks: first, to dissect the character of the sustained expansion of 1961–64; second, to assess the contribution of fiscal and monetary policies to the successful record of these years; and, third, to review the accompanying changes in our international payments position and the policies that have contributed to the gains we have made.

THE ANATOMY OF THE EXPANSION

The remarkable characteristic of the current expansion is not the degree to which it has carried us toward our objective of full employment. Previous expansions have done as well or better in this respect. Rather, its most remarkable feature is its durability. This can be attributed in important part to the balance maintained among the various components of private demand; to the balance maintained between production and sales, thus avoiding excessive inventory accumulation; to the balance maintained between the expansion of demand and the expansion of productive capacity to satisfy that demand; and to the balance maintained among wages, prices, and productivity. Imbalances in one or more of these respects brought earlier expansions to an end. Some ended when inventories became top-heavy; others when a major industry had expanded too fast, and its retrenchment was not offset elsewhere; still others when growth of demand generally failed to keep pace with growth of capacity. The key to sustained full employment lies in preserving balance as over-all demand moves closer to the economy's full capacity.

Since 1961, the expansion of demand has been persistent and pervasive, but production has stayed short of supply capabilities. Placement of orders has advanced only moderately ahead of production and shipments, so that unfilled orders have grown gradually. Capacity has expanded along with production, without bottlenecks or overbuilding.

Businesses have followed a prudent employment policy, avoiding both overstaffing and the need for sudden heavy hiring. This, in turn, partly explains the steady gains in productivity throughout the expansion. Increases in production have been large enough to utilize the net gain in the labor force and to make inroads into unemployment.

With no significant buildup of unfilled orders, and with production not making full use of capacity, price increases from generally excessive demand have remained remote. With wage increases matching productivity gains, labor costs per unit of output have remained unusually stable, and any general upward pressure of costs on prices has been avoided. Thus the purchasing power of personal and business incomes has risen steadily and strongly.

The patterns of year-to-year change in total GNP and in its several major expenditure components are shown in Table 2 and Chart 2. The most striking aspect is the renewed fast expansion between 1963 and 1964, following the distinct slowing down of growth that occurred between 1962 and 1963. The table shows that a major acceleration of consumption expendi-

TABLE 2.—*Changes in gross national product in the current expansion*

[Billions of dollars]

Expenditure group	1961 to 1962	1962 to 1963	1963 to 1964 [1]
Gross national product	37.5	27.7	38.4
Personal consumption expenditures	19.5	18.2	24.2
Nonconsumption expenditures	18.0	9.5	14.2
Residential construction	2.5	1.6	.8
Private business fixed investment	3.9	2.7	5.7
Change in business inventories	4.0	−1.5	−.7
Net exports	−.6	.4	2.3
Government purchases of goods and services	8.3	6.3	6.1
Federal	5.5	1.8	.9
State and local	2.9	4.4	5.1

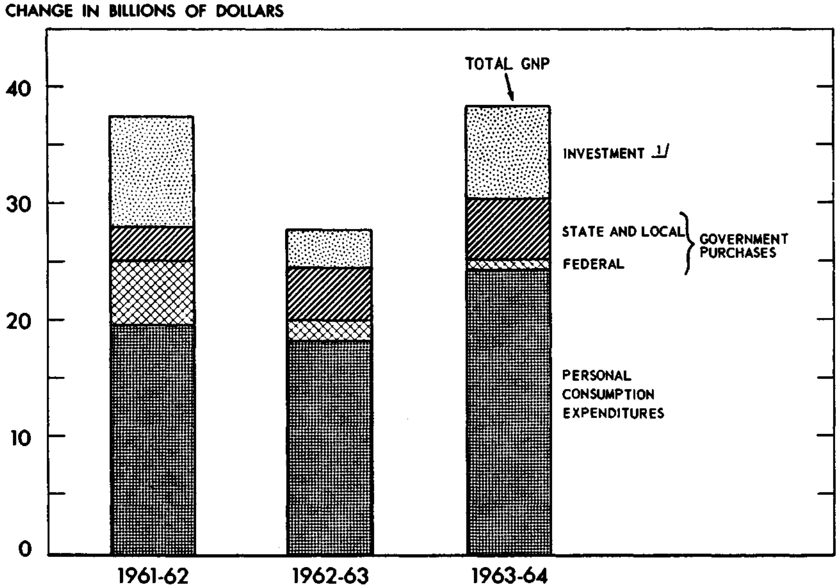
[1] Preliminary estimates.

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

Source: Department of Commerce.

Chart 2

Changes in Gross National Product Since 1961



1/ GROSS PRIVATE DOMESTIC INVESTMENT AND NET EXPORTS.
SOURCE: DEPARTMENT OF COMMERCE.

tures, and a substantial rise in business fixed investment and State and local government spending, were the main elements in the faster expansion of 1964. It also shows that the slowdown in 1963 reflected a smaller growth of every element of spending except net exports and State and local outlays.

The following sections review in some detail the record of the expansion for each of the major categories of private expenditure. Then, the record is detailed in terms of the behavior of income shares; the contribution of credit; the pattern of wages, prices, and productivity; and the record of employment. Because of their importance in this expansion, the contributions of fiscal and monetary policies are reserved for separate treatment in the next major part of the chapter.

THE DEPENDABLE CONSUMER

Consumers, in the aggregate, purchase roughly two-thirds of our total output. And when total output increases, the larger part of the increase is accounted for by consumer buying. Yet changes in consumer spending rarely provide the fundamental force behind large or prolonged expansions or contractions of output.

Mainly, consumers alter their total buying in response to variations in their total income after taxes (disposable income). Indeed, in each year since 1949, consumer spending has ranged between 92 percent and 94 percent of disposable income, averaging close to 93 percent.

This means that if we are to understand the main variations in consumer buying we must look to the sources of changes in disposable income.

Changes in disposable income usually reflect increases or decreases in total production, for the largest part of consumer income is earned from current production. Occasionally, however—and 1964 was a notable case—disposable income increases independently of production, particularly through alteration in consumer tax rates. Reduced tax rates leave available to consumers a larger part of the income that they earn from any given level of total output. The resulting increase in their buying then stimulates more production and, through higher incomes, still further increases in consumer buying and production. Just such a pattern of response to the 1964 tax cut is examined in more detail below.

In the absence of tax rate changes, the fundamental force moving total production ordinarily is found in changes in the total of *nonconsumption* expenditures—the building of new plants and the purchase of new machines, the accumulation of business inventories, the construction of new houses and apartments, net exports to foreign countries, and government purchases of goods and services.

Occasionally, to be sure, a shift in the intensity of consumer buying appears to be spontaneous—reflecting the typical consumer's mood of optimism or pessimism, his favorable or unfavorable response to new designs of the Diors of Detroit, or a sudden interest or loss of interest in air conditioners or color television. Sometimes, changes in the terms and availability of consumer instalment credit play a role. And a variation of even a half percentage point in the consumption-income ratio currently means a $2 billion change in consumer buying.

Ordinarily, however, variations of disposable income are the major cause of changes in consumption. But consumers typically do not adjust their spending at once to higher levels of disposable income. If disposable income increases in one quarter, the resulting increase in consumer spending usually spreads out into several succeeding quarters.

This pattern of consumer behavior has been evident in the present expansion. Although disposable income increased rapidly through the second quarter of 1962, consumers did not react fully and immediately, and the saving rate thus rose. In the rest of 1962, disposable income grew less rapidly, but the delayed effects of the rapid increases in disposable income during 1961 (combined with consumers' apparently favorable response to the new automobile models) led to continued good increases in consumption expenditures. The saving rate declined, reaching 6.6 percent in the first quarter of 1963.

Thus it was largely the temporary decline in the saving rate during 1962 that underwrote the expansion between mid-1962 and mid-1963. As Table 2 shows, nonconsumption expenditures increased between 1962 and 1963 by only $9.5 billion, compared with a gain of $18.0 billion from 1961 to 1962. But consumer spending, still under the impetus of the earlier income rise, moved up with little loss of momentum. At the end of 1963, the saving rate again moved upward as growth of disposable income accelerated. At this point, the tax cut of 1964 became a major influence on consumer spending.

INVESTMENT AND CAPACITY UTILIZATION

Business fixed investment—including expenditures on new plants, machines, and equipment—rose strongly from 1961 to 1962, moved more sluggishly between 1962 and 1963, then rose vigorously in 1964. Over the whole expansion, from the first quarter of 1961 to the fourth quarter of 1964, the increase averaged 8 percent a year and accounted for 26 percent of the increase in total nonconsumption expenditures.

The average rate of utilization of manufacturing capacity was about 78 percent in the first quarter of 1961, 14 percentage points below the average rate of 92 percent preferred by managements. By the second quarter of 1962, the rapid gains in manufacturing output had raised the utilization rate to about 86 percent. Thereafter, slower gains in output were roughly matched by increases in capacity. Investment rose gradually, in part responding to the incentives provided by the 1962 tax measure. But capital outlays were relatively low and were presumably not primarily directed toward an expansion in capacity. The utilization rate was still 86 percent in late 1963. Beginning at the end of 1963, the promise—and then the fact—of accelerating gains in output brought a substantial stepping up of investment. By the third quarter of 1964 the average utilization rate had moved up to 88 percent, and investment in manufacturing had risen 18 percent over that of a year earlier.

Investment expenditures thus accelerated in response to a growth in demand for final products, gradually rising operating rates, improving rates of profit and cash flow (augmented by the new depreciation guidelines, the investment tax credit, and the reduction in tax rates), the continued ready availability of credit at relatively stable rates of interest, and a realistic and justified confidence in the continued strength of the economy.

Moreover, the machinery and construction industries generally have had little difficulty in satisfying the growing stream of orders for capital goods. This contrasts sharply with conditions in 1955–57, when capital goods industries lacked adequate capacity to meet demand (Table 3). In 1955 when the expansion of fixed investment began, the surge of new orders quickly exceeded the capabilities of the machinery and other capital goods industries. Capacity was soon strained, and unfilled orders climbed rapidly. Inflationary pressures developed in the capital goods industries and spread elsewhere, interacting with large wage increases throughout industry to raise costs and prices.

Investment expenditures in 1956–57 added to capacity throughout the private economy at a substantial rate. It is not clear whether that rate of

TABLE 3.—*Expenditures for manufacturing plant and equipment, and related data, 1955–57 and 1961–64*

[Based on seasonally adjusted data]

Period	Expenditures for manufacturing plant and equipment (percentage change per year during period)	Manufacturing utilization rate (percent) [1]		Backlog of unfilled orders for machinery and equipment (months) [2]	
		Beginning of period	End of period	Beginning of period	End of period
1955 I [3]–1955 IV	32	87	92	3.70	4.32
1955 IV–1956 III	37	92	87	4.32	4.62
1956 III–1957 III	3	87	86	4.62	4.31
1961 II [3]–1962 II	7	81	86	3.43	3.22
1962 II–1963 IV	9	86	86	3.22	3.33
1963 IV–1964 IV [4]	20	86	87	3.33	[5] 3.58

[1] Output as percent of capacity. See Appendix Table B-35, footnote 1, for source.
[2] Ratio of unfilled orders to shipments.
[3] Trough quarter of manufacturing plant and equipment expenditures used.
[4] Preliminary.
[5] Based on October-November averages.

Sources: Department of Commerce and Securities and Exchange Commission (except as noted).

growth of capacity could have been maintained in all industries had total demands kept pace with the economy's potential. But in fact, demand weakened outside the capital goods sector, partly because of restrictive monetary and fiscal policy actions taken to stem price increases. Over-all operating rates fell sharply during 1956, while the investment boom continued. With the growth of final demand falling far short of the growth of capacity, the incentives for investment ultimately waned and the economy moved into recession in 1957.

In 1961–64, by contrast, utilization rates expanded both more slowly and more evenly as among industries. Investment responded more moderately, and the backlog of machinery orders consequently remained relatively low and stable.

INVENTORIES

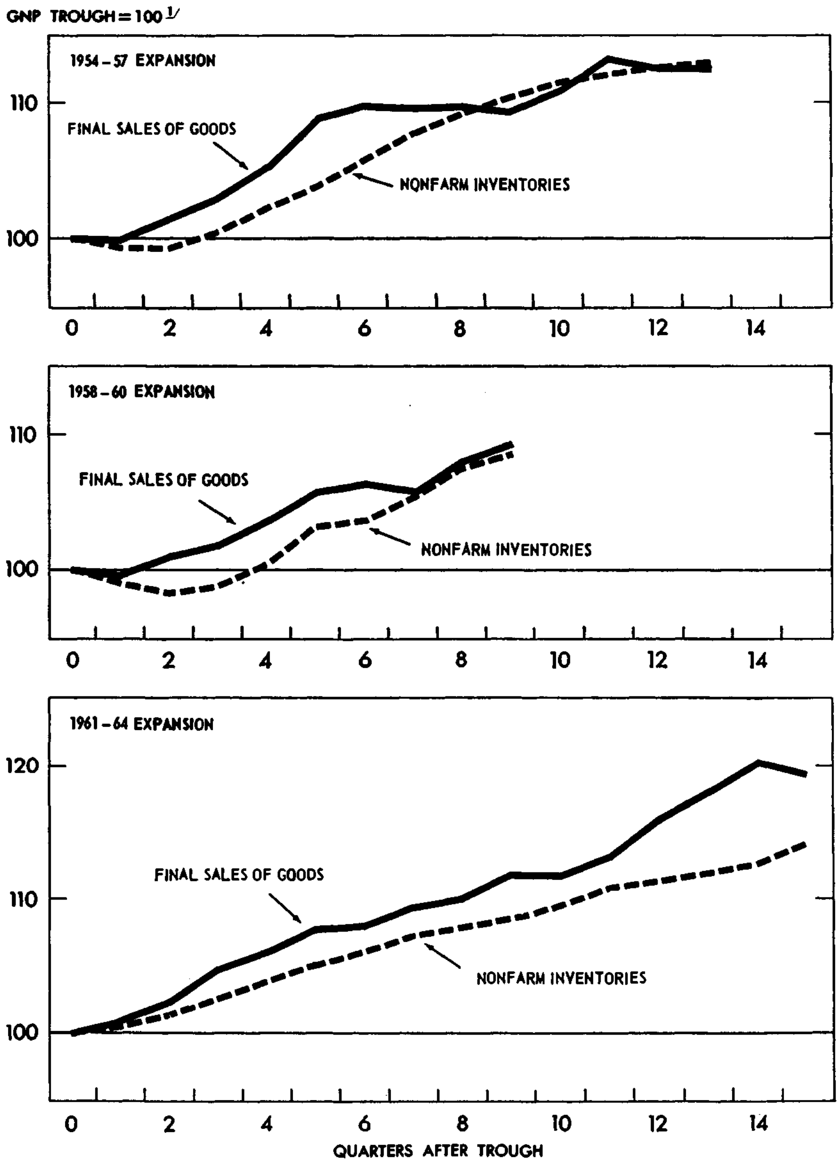
Inventory investment has contributed significantly to the balance and duration of the current expansion. Although it is usually one of the most volatile components of GNP, aggravating rather than smoothing swings in output and employment, inventory accumulation during the past fifteen quarters fluctuated more moderately and its movements were less perverse in timing than in other postwar expansions.

The relative steadiness and moderation of inventory investment are shown in Chart 3, which compares movements of nonfarm inventories and of final sales of goods in the three expansions since the Korean war. (Final sales of goods are total GNP less inventory accumulation and the production of services.)

During the past fifteen quarters, the percentage growth of inventories typically fell short of the growth of final sales. In other words, over this

Chart 3

Inventories and Final Sales of Goods In Three Postwar Expansions



1/ BASED ON SEASONALLY ADJUSTED DATA IN 1954 PRICES; INVENTORIES AT END OF QUARTER AND TOTAL SALES FOR QUARTER. TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.

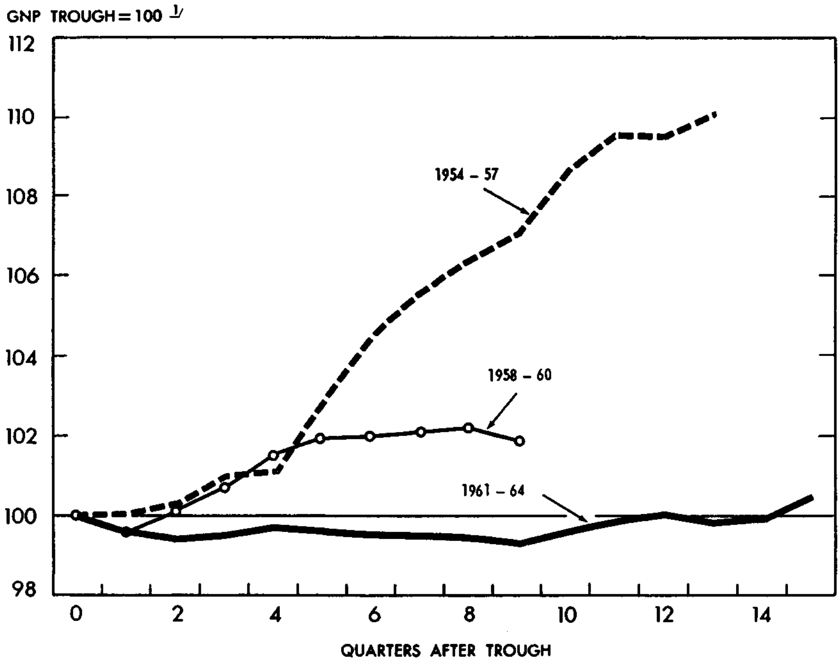
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

period the ratio of inventories to sales declined. In each of the two preceding expansions inventories declined at first, then rose at roughly the same rate as sales until about the sixth quarter of expansion; thereafter, they continued to rise even after the trend in sales appeared to warrant little further inventory accumulation. These mounting imbalances between inventories and sales meant higher costs and risks of inventory holding, and set the stage for a liquidation of inventories when final sales turned down.

There are several reasons for the favorable relation between inventories and sales in the present expansion. First, final sales have moved ahead fairly steadily throughout the period. Second, forces which might motivate an expansion of inventories beyond the immediate needs of businesses have been minimal. Inflationary fears have been absent and, as a result, there has been little speculative inventory buying. Chart 4 shows the stability of wholesale industrial prices in recent years, contrasting sharply with the rises in 1955–56. Since capacity has been ample in relation to the volume of orders, businessmen have been assured of prompt deliveries, and normally have had little reason to hoard inventories. The short and stable lead-times

Chart 4

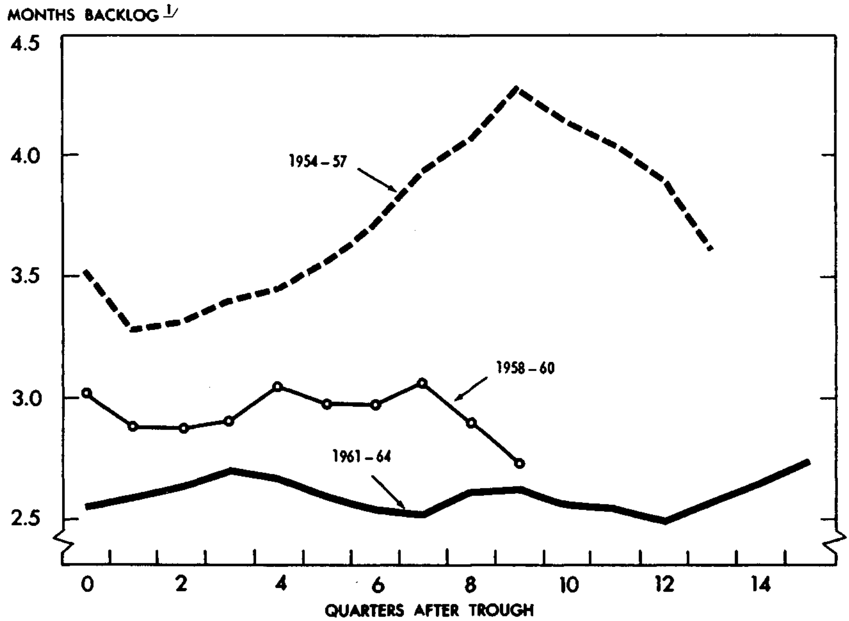
Wholesale Prices of Industrial Commodities In Three Postwar Expansions



1/ TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.
SOURCES: DEPARTMENT OF LABOR AND COUNCIL OF ECONOMIC ADVISERS.

Chart 5

Unfilled Orders For Durable Goods in Three Postwar Expansions



1/ BASED ON SEASONALLY ADJUSTED MONTHLY AVERAGES. RATIO OF UNFILLED ORDERS TO PEAK SHIPMENTS TO DATE. TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

between orders and shipments of durable-goods industries as a group in the current expansion are in contrast to the longer and more variable lead-times in the two preceding expansions (Chart 5). Third, the effects of improved methods of inventory control, including especially the use of computers, may now be sufficiently widespread to influence the behavior of inventories.

Additions to inventories were extraordinarily modest in 1964. As shown by Chart 3, sales maintained a very rapid pace, while—until the fourth quarter—inventory accumulation proceeded at the slowest rate since the beginning of the expansion. Reductions in inventory-sales ratios were general. Although lead-times lengthened somewhat, as shown in Chart 5, businessmen were apparently achieving desired inventory levels with a modest rate of inventory investment.

RESIDENTIAL CONSTRUCTION

Expenditures for new private nonfarm residential construction climbed rapidly for six quarters from the first quarter of 1961; they then rose steadily, though more slowly, to a peak in the first quarter of 1964. During the rest of 1964 they tapered off. In each of the two preceding expansions, residential construction had grown even more rapidly at first; then, after only four or five quarters of expansion, it had begun a fairly steady decline.

Throughout the current expansion, funds for mortgage investment have been readily available at stable or declining rates of interest. This record diverges substantially from that of the two preceding expansions, when a scarcity of mortgage funds and sharply higher mortgage rates contributed materially to the premature decline of residential construction.

Practically the entire rise in residential construction during 1961–63 was in multi-unit starts and mostly in structures with 5 or more units. The proportion of multi-unit to total housing starts rose from 24 percent in 1958 to 36 percent in 1964. Single-family starts rose very slightly from early 1961 into 1962; since then they have decreased gradually, but fairly steadily, to, or perhaps below, the number in the first quarter of 1961. Multi-unit starts, by contrast, rose strongly from mid-1960 to late 1963; during 1964 they, too, declined.

Demand for apartments has risen with the increasing number of couples who, with children grown and away from home, find suburban houses inconvenient. Also, the number of young couples not yet ready for single-family houses is beginning to increase. Heavy apartment-building has occurred both in cities and in suburbs, the location determined in some cases by urban renewal, and always by land costs and degrees of traffic congestion. Particularly favorable provisions of the tax laws and innovations in financing and management techniques also have had an important influence on apartment-building in recent years.

During the four years 1961–64, housing starts totaled about 6 million, an excess of about 3 million over the net gain in households, or an average excess of more than 700,000 units a year. This excess is the highest four-year average in the postwar period.

The net addition to the stock of housing is, of course, usually smaller than the number of new units built. During the decade of the 1950's, demolitions and conversions accounted for an average decline of 300,000 units a year. The recent extensive activity in road-building and clearance for urban renewal and for private commercial and apartment-building in cities suggests that losses from demolition are now substantially larger than in the 1950's.

Nevertheless, it is probable that in recent years the net housing stock has grown more rapidly than the number of households, creating a considerable volume of vacancies and abandonments. However, there is no evidence that any serious surplus has occurred in the types of housing units or the areas where most new building occurs. To be sure, vacancies have reached unduly high levels in certain local markets; foreclosures and mortgage delinquencies have been high in a few areas; and substantial concessions have had to be granted on the terms of mortgages on some new apartment houses that have not rented well. In several local markets the absorptive capacity for high-rent units has been reached, at least temporarily, and lenders are more cautious about making financing commitments. Over the Nation as a whole, however, vacancy rates, delinquencies, and foreclosures have remained relatively low and stable.

The slowdown in new construction has come at a time when the general economy is expanding vigorously. This means that readjustments to correct possible local imbalances will not be aggravated by falling incomes and reduced over-all demand for housing. A vigorously expanding economy is able both to absorb and to facilitate temporary readjustments in particular sectors.

INCOME SHARES

The division of income between labor and capital has undergone little or no change in the past decade, other than changes associated with fluctuations in the level of business activity. Recent experience continues that pattern.

To determine whether wages are growing at the expense of profits, or vice versa, analysis has to be confined to the private business sector of the economy, and—for lack of data—to the corporate sector. Changes in this sector, in any case, dominate movements in the whole economy. After subtracting corporate indirect taxes, the entire corporate gross product can be divided between employee compensation and the gross return to capital: profits before taxes, interest, and capital consumption allowances.

The shares of labor and capital in total corporate gross product (after indirect taxes) have displayed a stable pattern since 1954. By and large, the capital share moves closely with the utilization of capacity (Chart 6); correspondingly, the labor share moves opposite to capacity utilization.

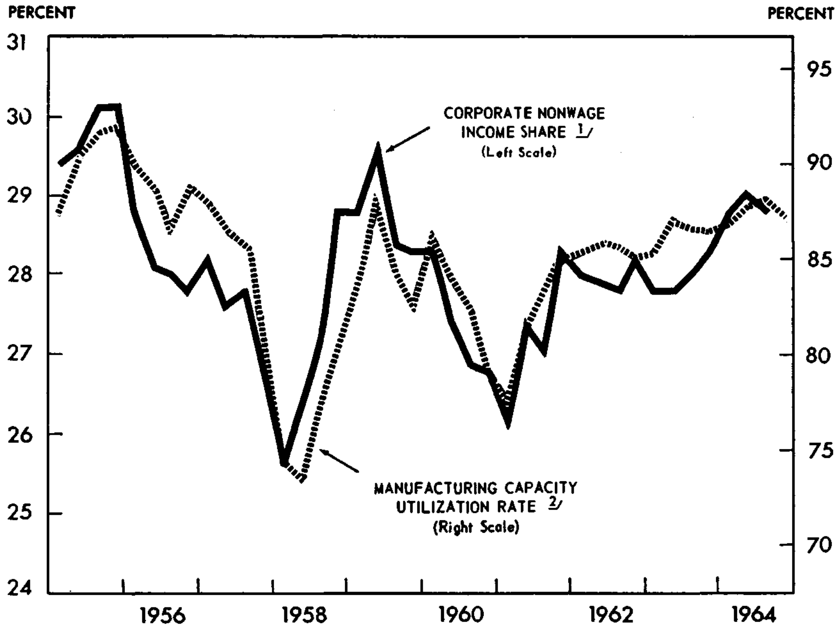
When utilization is low, firms carry excess overhead labor and run production processes at less than optimal rates. As a result, cost per unit of output rises, and the return to capital falls. Likewise, when production and the utilization of capacity increase, cost per unit of output falls and the return to capital rises. Since 1955, the relative share of labor in corporate gross product has ranged between a high of 74.4 percent in the first quarter of 1958 and a low of 69.9 percent in the second half of 1955, and has been free of any discernible trend, once adjustment is made for differing degrees of utilization.

The share of capital in gross corporate product rose to 29.0 percent in the second quarter of 1964, but it remained below peak proportions attained in 1955 and 1959. The capital share can be expected to continue to rise slightly as the economy moves toward full potential production, but this will not indicate a trend to a higher share for capital at full utilization of capacity than was the case earlier.

In the early part of each of the two previous expansions since the Korean conflict, the absolute magnitude of net corporate profits, before and after taxes, grew extremely fast (faster than the total return to corporate capital).

Chart 6

Income Shares and Capacity Utilization



1/ CORPORATE PROFITS BEFORE TAXES (INCLUDING INVENTORY VALUATION ADJUSTMENT), CAPITAL CONSUMPTION ALLOWANCES, AND INTEREST AS PERCENT OF CORPORATE GROSS PRODUCT LESS INDIRECT TAXES.

2/ OUTPUT AS PERCENT OF CAPACITY.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS. SEE TABLE B-35 FOR SOURCE OF MANUFACTURING CAPACITY UTILIZATION RATE.

During the remainder of each expansion, profits steadily declined—both in absolute amount and as a share of income. In the current expansion, the gains of corporate profits were slower, but they were sustained without significant interruption, reflecting the fact that utilization rates moved upward more steadily. This, clearly, has contributed to the continuing expansion of investment.

Corporate profits before taxes were 9.5 percent of the total national income in the first quarter of 1961, held around 10.6 percent from the first quarter of 1962 through the third quarter of 1963, and averaged 11.3 percent of national income in the first three quarters of 1964. (Preliminary evidence suggests that profits dipped in the fourth quarter, primarily because of the automobile strikes.) As a result of changes in corporate tax rates, the share of corporate profits after tax rose a little faster—from 4.7 percent of total national income in the first quarter of 1961 to 6.2 percent in the third quarter of 1964.

Total employee compensation (including that from unincorporated businesses, governments, and institutions) rose from $294 billion in the first quarter of 1961 to $371 billion in the third quarter of 1964, or by 26 percent; but as a share of total national income, it remained close to 71 percent through the whole period. After taxes, however, total employee compensation has actually risen as a share of national income since the fourth quarter of 1963.

CREDIT

Availability of credit

A sustained growth of credit has helped to maintain the over-all advance in spending. Total new funds raised by individuals, businesses, and State and local governments have advanced relatively steadily, by close to 20 percent a year, since the first quarter of 1961. During each of the two preceding expansions, borrowing rose sharply during the first five or six quarters—at an average annual rate of about 50 percent in the first period and 90 percent in the second—and then declined during the remainder of the expansion. Thus the increase of credit in the current business upswing is less notable for its rate of growth than for its persistence.

The prolonged advance in residential construction activity reflected, in part, an easing of mortgage credit terms. The total volume of mortgage credit outstanding accounts for about 40 percent of the total outstanding debt of the nonfinancial sectors of the economy. It has risen at an average annual rate of more than 10½ percent since the end of 1960 (as shown in Table 4). This is faster than private debt in any other category.

A major factor in this ready availability of mortgage credit has been the rapid growth of consumer and business time and savings deposits, in response to the higher rates of return paid since early 1962 by commercial

TABLE 4.—*Expansion of selected types of credit in three postwar expansions*

Period	Percentage changes in credit outstanding [1]			
	Bank loans to business [2]	Corporate bonds [3]	Mortgages	Consumer credit
1954–57 expansion:				
1954	−0.6	7.3	12.2	3.4
1955	16.2	5.6	14.3	19.6
1956	18.3	6.9	11.2	9.0
1957	4.0	11.0	8.4	6.2
1958–60 expansion:				
1958	1.6	8.9	9.7	.4
1959	12.2	4.3	11.1	14.2
1960	5.8	4.8	8.4	8.7
Current expansion:				
1961	3.4	6.0	9.4	2.9
1962	9.0	5.8	11.2	9.5
1963	10.1	4.3	11.7	10.7
1964	8.9	4.3	10.7	10.0

[1] Based on flow-of-funds accounts.
[2] Bank loans to nonfinancial business.
[3] Corporate bonds valued at par.

Source: Board of Governors of the Federal Reserve System.

banks (following successive increases in the permissible ceiling rates). A large proportion of these funds has been channeled into the mortgage market. At the same time, the continued substantial flow of funds to savings institutions other than commercial banks which, by law and custom, invest a large part of their funds in the mortgage market has also been important.

A second factor contributing to the ease of all long-term credit markets has been the moderate nature of the expansion in demands from business for external financing. With cash flow exceeding fixed investment outlays, as indicated in Table 5, and accumulation of inventories moderate, business firms have "financed themselves" to a greater degree than previously. Consequently, the volume of corporate bonds outstanding has expanded less rapidly, on the average, during recent years than during the preceding two expansion periods; and the amount of bank loans outstanding to business has expanded only slightly faster, despite the greater strength of the current expansion. Meanwhile, the cost of business borrowing at banks has been virtually unchanged, and interest costs on newly issued corporate bonds have fluctuated within a narrow range.

With relatively moderate demands for credit from business customers, financial institutions have had more funds available for mortgages, State and local government securities (at interest rates well below the last expansion period), and consumer credit. Outstanding consumer credit has grown at an average rate of about 8 percent a year. This growth roughly matches the average rate since 1953 but, as shown in Table 4, without the sharp fluctuations of the earlier periods.

In the first three years of the current expansion period, growth in bank credit outstanding accounted for about 30 percent of total new funds raised

TABLE 5.—*Sources and uses of corporate funds in three postwar expansions*

End of period	Internal funds (billions of dollars)	Uses as percent of internal funds		
		Plant and equipment	Inventories	Increase in financial assets
1954–57 Expansion:				
1954	19.8	113.1	(1)	15.2
1955	26.6	91.0	25.2	74.1
1956	27.8	107.6	27.3	27.0
1957	28.0	116.8	7.5	19.6
1958–60 Expansion:				
1958	26.0	101.5	(1)	43.5
1959	31.1	89.1	21.2	57.6
1960	29.1	105.8	8.6	36.1
Current Expansion:				
1961	29.7	99.7	4.4	59.9
1962	35.2	90.9	12.5	51.1
1963	36.8	91.8	10.1	56.5
1964	40.9	95.8	7.8	51.1

[1] Inventories declined.

NOTE.—See Appendix Table B–68 for data used in computing percents shown in this table.

Source: Department of Commerce.

(including Federal Government borrowing). In 1964, the proportion probably fell somewhat as monetary policy became slightly less easy. Nevertheless, these are unusually high proportions for an expansion, partly reflecting the larger proportion of consumer savings placed in commercial banks and the active competition of banks for funds through the device of time certificates of deposit.

Volume of debt and liquidity

In the course of four years of relatively expansionary monetary policy, the total outstanding debt of the nonfinancial sectors of the economy (excluding the Federal Government) has risen at an average annual rate of 8½ percent, compared with a 5½ percent rate of increase in GNP. Aggregate consumer debt, including home mortgages as well as instalment and other types of household credit, has experienced particularly rapid growth. In appraising this growth, it is important to bear in mind that the outstanding amounts of home mortgages and instalment credit were abnormally low at the end of World War II. Since then, family use of credit has become a much more commonly accepted and widespread phenomenon, linked especially to widening home ownership. Thus, it would be perfectly normal to expect a steady rise in the ratio of the *outstanding debt* to income. Nevertheless, the ratio of the *net increase* in such debt—i.e., net new borrowing—to income has been relatively stable. As long as there is no persistent tendency for the ratio of new borrowing to income to rise, it is a matter of arithmetic that, although the ratio of outstanding debt to income will rise with steady growth of income, the rise would taper off and eventually cease, as the stock of outstanding debt approaches its new normal relationship to current income.

Furthermore, the increase of debt has a counterpart in the growth of assets held by individuals and businesses, much of it in liquid forms, such as bank deposits and share accounts. Consumers in particular increased their holdings of liquid assets rather abruptly during 1962 and 1963, and the ratio of their liquid assets to income is now well above the levels prevailing during the latter part of the 1950's. As interest rates on time and savings deposits rose relative to those on securities, consumers responded by changing the composition of their assets into these more liquid and now higher yielding forms. Business holdings of liquid assets have also increased, but proportionately less than business sales.

Quality of credit

In a prolonged period of healthy expansion and relatively plentiful credit, the tendency of financial institutions to confine credit extension to their traditional customers is reduced. This is clearly desirable so long as resources remain available and it does not lead to a large number of loan defaults, soaring prices of earning assets, or unsustainable burdens of debt relative to income.

In the current expansion, the ratio of net extensions of instalment credit to disposable income has remained below the peak ratios in 1955, 1959, and 1960, despite a temporary rise from early 1962 to mid-1963. Furthermore, data from consumer surveys suggest that, although a growing proportion of households is using credit, the typical ratio of debt to income has not risen. Meanwhile, the growth of liquid assets has increased the creditworthiness of many households.

The quality of mortgage credit is more difficult to evaluate because its characteristics differ widely from one geographic area to another. Although defaults and real estate foreclosures have risen somewhat, they remain quite low, and much of the increase is concentrated in a few localities. Mortgage delinquency rates have recently shown little change.

The soundness of the credit structure depends fundamentally on continued gains in income and on the liquidity and diversification of the portfolios of lending institutions. The latter must be primarily the responsibility of the institutions concerned, but supervisory authorities also have an important role in helping to prevent deterioration in the quality of credit.

WAGES, PRICES, AND PRODUCTIVITY

Sustained economic expansion during the past four years was accompanied by a healthy balance among wages, prices, and productivity. Wholesale prices in 1964 averaged no higher than in 1960; consumer prices rose 1.2 percent a year; the growth in productivity was fairly steady, averaging 3.5 percent annually for the private economy; and wage gains kept up with, but did not outdistance, the trend in productivity. As a result, unit labor costs showed no general increase over the four-year period; income shares were free of distortions arising from inflation; and restrictive policies to curb an inflationary spiral were unnecessary.

The period was, essentially, inflation free. The small increases in the consumer price index and in the over-all "implicit deflator" for GNP must be interpreted in the light of the conceptual limitations of these measures.

None of our price indexes can reflect all of the improvement that occurs in the quality of goods, nor can an index make allowance for the rise in the value of the dollar that comes from the development of new products.

Further, the GNP deflator must include "prices" for the Government sector, even though there is no objective measure of public output. The "price" series for the public sector really measures the costs of inputs and cannot reflect the increase that occurs in productivity in Government. To a smaller extent this is also true for most of construction and some services.

Although the effects of these factors on our price indexes cannot be measured, their direction is clear. Their presence makes it doubtful that the actual purchasing power of the dollar changed perceptibly in the period 1961–64.

Over-all record

The rise in straight-time average hourly earnings in manufacturing during 1964 was about 3.0 percent, compared with 2.6 percent a year for the entire period 1960–64. Fringe benefits, of course, are not included. Whenever such benefits rise faster than wage rates, hourly earnings data understate the percentage rise in total average hourly compensation. Since 1960, total compensation per man-hour (including fringe benefits) has increased about 3.3 percent a year in manufacturing and 3.6 percent in the private economy as a whole. In 1964, the increases were 3.0 percent and 3.8 percent, respectively.

A special study of key labor agreements that were concluded during 1964 in 11 major industries showed a median increase in hourly compensation of 3.5 percent a year over the life of the contracts; most of these increases fell within a range of 2 percent to 5 percent.

The character of this expansion helps to explain this good wage-price-productivity record. As noted before, the expansion of demand has not overtaxed the economy's capabilities to produce. Balanced growth of output among sectors has prevented pressures for price and wage increases that might have resulted had there been capacity bottlenecks or shortages of manpower in particular industries. Price stability has made for prudent investment policies with respect to inventories and plant and equipment, and these policies in turn have reinforced the price stability.

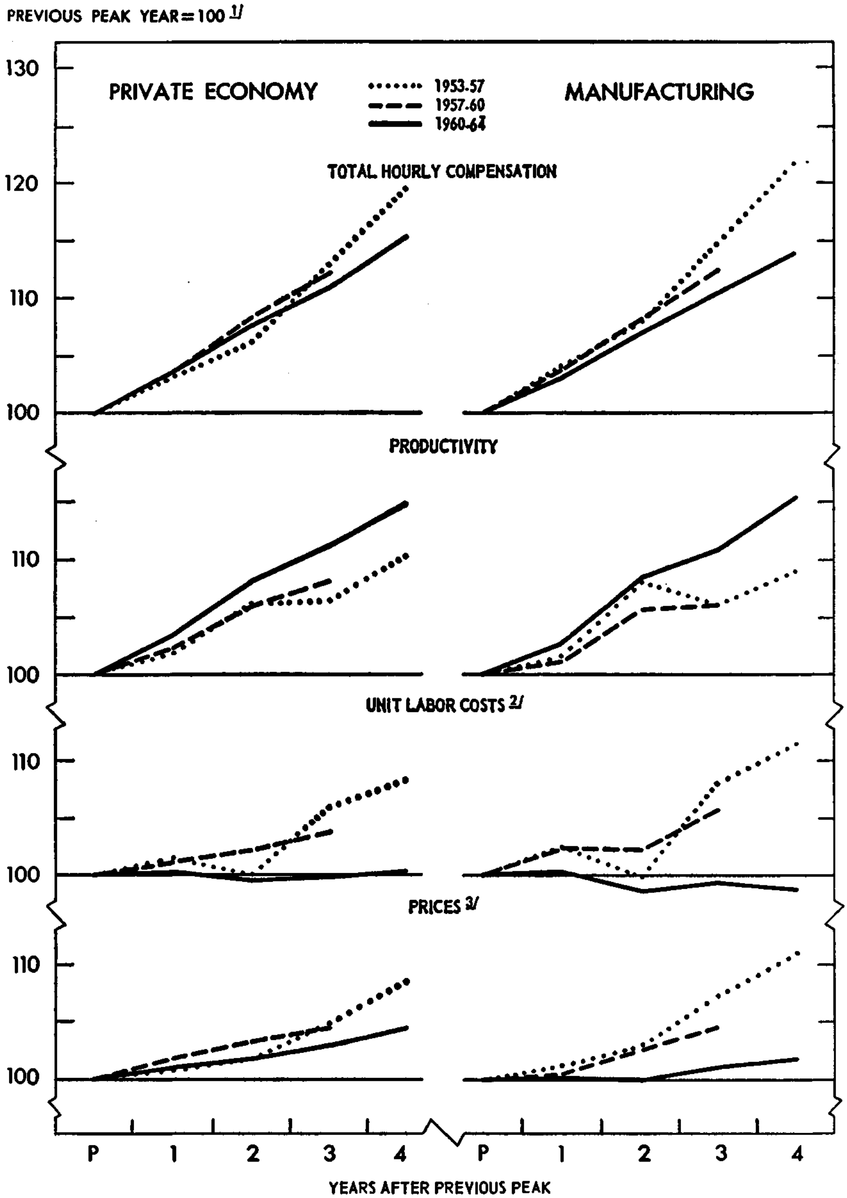
Where pressures for higher prices have occurred (particularly in primary metals), their source has ordinarily not been found either in excess domestic demand or in higher labor costs in our own economy. Sharp increases in prices of nonferrous metals in 1964 were caused largely by unsettled political conditions in supplying countries and by interruptions of production as a result of strikes. By the year's end, moreover, the prices of some metals had receded well below the peaks reached during the year.

Comparison with previous expansions

The course of wages, prices, productivity, and unit labor costs for both total manufacturing and the total private economy in the years since the prerecession year of 1960 is compared in Chart 7 with movements in the two "peak-to-peak" periods—1953–57 and 1957–60. The upward surge of wages, unit labor costs, and prices in the final two years of the 1953–57 period and the steady climb of costs and prices during 1957–60 are in clear contrast to the stability of the past four years. (In measuring price movements for the total private economy and for manufacturing, the "implicit deflators" prepared for calculations of "real" GNP were used. These deflators do not move identically with the wholesale price index, but they are consistent with the output and compensation data that are used.)

Chart 7

Compensation, Productivity, Unit Labor Costs, and Prices in Three Postwar Periods



1/ PREVIOUS PEAK YEARS WERE 1953, 1957, AND 1960.

2/ RATIO OF TOTAL HOURLY COMPENSATION (FOR EMPLOYEE MAN-HOURS) TO PRODUCTIVITY (FOR ALL MAN-HOURS).

3/ IMPLICIT DEFLATORS FOR THE TOTAL PRIVATE AND MANUFACTURING SECTORS OF GROSS NATIONAL PRODUCT.

SOURCES: DEPARTMENT OF LABOR AND COUNCIL OF ECONOMIC ADVISERS.

The moderate gain of about 3.6 percent a year in hourly compensation in the total private sector during the present expansion compares with an advance averaging 3.9 percent a year in 1957–60 and 4.5 percent in 1953–57.

The rise in output per man-hour from 1960 to 1964 was larger and more evenly sustained than in the previous two periods considered. Gains in output per man-hour in the private sector in 1960–64 averaged 3.5 percent a year, compared with 2.5 in 1953–57 and 2.7 in 1957–60.

Strong gains in output and productivity typically take place during the recovery from a recession; they stimulate investment and extra hiring by business in anticipation of further gains in output. After the recoveries of 1955 and 1958, expected gains were not realized, the advance of productivity was retarded, unit labor costs were increased, and profits were squeezed. Especially in 1955–57, this helped to upset the balance among costs, prices, and income shares, and aggravated the wage-price spiral.

The better record of productivity performance during the past four years is in large measure the result of a sustained expansion of output that has kept operating rates moving upward. Total private output rose at an average annual rate of 4.1 percent a year from 1960 to 1964, or about 1½ times the average rate of about 2.7 percent during the two earlier periods considered. The difference in manufacturing is even more striking, with output gains averaging 4.8 percent a year since 1960, compared with about 1¼ percent a year in the two earlier periods.

The steady gains in productivity and the moderate wage increases have held unit labor costs practically unchanged in the total private economy during the past four years and have resulted in a slight net reduction in manufacturing labor costs. Similarly, the implicit price deflators have risen very little, as Chart 7 makes clear.

Prices by industries

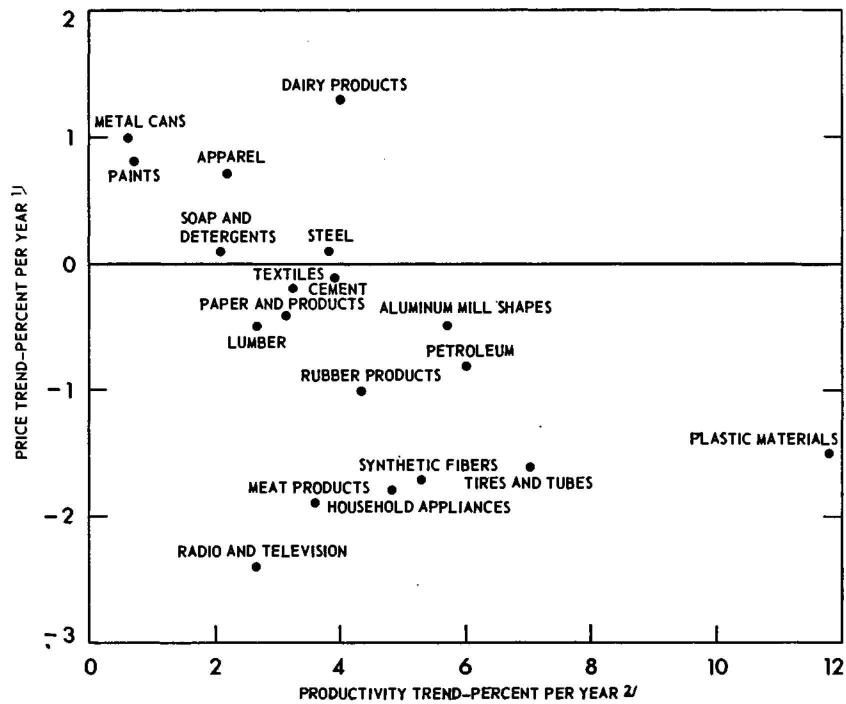
Over-all price movements are the result of a continuous stream of price changes in individual industries—upward and downward. In industries where productivity rises slowly, unit labor costs tend to rise, while in industries where productivity rises more rapidly, unit labor costs tend to fall. During periods of expansion, industries with rising unit labor costs can easily pass them along in higher prices. But achievement of over-all price stability requires that savings resulting from faster than average increases in productivity be passed along in lower prices. Chart 8, which compares price and productivity trends for 19 manufacturing industries for which satisfactory physical output data are available, suggests that both developments have generally occurred during the current expansion.

However, in some instances, industries with large productivity gains made only token reductions in prices, or even raised them. Except where these movements reflect divergent movements in nonlabor costs, such cases give an upward bias to the over-all price level. Moreover, they tend to produce

Chart 8

Price and Productivity Trends

19 MANUFACTURING INDUSTRIES



1/ AVERAGE ANNUAL PERCENTAGE CHANGE IN WHOLESALE PRICE INDEX, 1959-64.
2/ AVERAGE ANNUAL PERCENTAGE CHANGE IN OUTPUT PER EMPLOYEE MAN-HOUR, 1959-64.
SOURCE: COUNCIL OF ECONOMIC ADVISERS (BASED ON DATA FROM DEPARTMENT OF LABOR AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM).

unusually high profits (as in the automobile industry) which serve as inviting targets for wage increases that exceed the general, economy-wide trend of productivity gains. If such wage increases were generalized, over-all price stability would be threatened.

Despite occasional exceptions—as in automobiles and construction—the general pattern of recent wage and price changes has closely approximated the Government's wage-price guideposts.

To be sure, the guideposts have not been completely effective either in stimulating all warranted price reductions, or in preventing some individual wage and price increases that are not in accord with their criteria. Nevertheless, the very fact that representatives of both labor and management have often explicitly indicated their compliance with, or tried to justify any deviations from, the guidepost standards suggests that these standards have had a useful influence.

In addition to any direct influence that they may have had on the wage and price policies of unions and managements, the guideposts have helped to create a new climate of opinion. Many groups in our society now have a better understanding of the relationships between costs and prices. There is increasing realization that it is appropriate—indeed necessary—to consider whether a proposed course of action, if followed by others in similar circumstances, would be consistent with over-all stability. Decision makers in unions and managements are increasingly aware both of the fact that their decisions affect the public interest and of the fact that the public is interested in their decisions.

EMPLOYMENT AND UNEMPLOYMENT

In early 1961, the unemployment rate was close to 7 percent and it had continuously exceeded 5 percent during the three preceding years. New jobs were not being created fast enough to keep up with the expanding labor force.

From 1961 to 1962, the expansion of output was rapid, but gains in productivity also were high, as is typical after a recession. Nonetheless, employment increased by 1.2 million (Table 6). Because growth of the labor force

TABLE 6.—*Changes in employment, 1961–64*

Type of change and period	Total [1]	Teenagers	Nonwhites	Adult whites
Change in employment (thousands of persons):				
1961–62 [2]	1,203	237	159	813
1962–63	963	−38	137	847
1963–64	1,548	268	246	1,075
Percentage change in employment:				
1961–62	1.8	4.6	2.3	1.5
1962–63	1.4	−.7	1.9	1.5
1963–64	2.2	5.1	3.4	1.9
Percent of total employment change:				
1961–62	100.0	19.7	13.2	67.6
1962–63	100.0	−3.9	14.2	88.0
1963–64	100.0	17.3	15.9	69.4

[1] Detail shown will not add to totals because of duplication (nonwhites include some teenagers).
[2] Data for 1962 are adjusted for comparability with data for 1961.

NOTE.—Teenagers include those 14–19 years of age; nonwhites, 14 years of age and over; and white adults 20 years and over.

Sources: Department of Labor and Council of Economic Advisers.

was relatively small, the over-all unemployment rate fell from 6.7 percent to 5.6 percent. From 1962 to 1963, employment increased by less than one million—enough to absorb the increase in the labor force but not enough to reduce the unemployment rate.

In 1964, the faster rate of economic expansion brought an increase of 1.5 million jobs. Since this was in excess of the increase in the labor force, the unemployment rate fell to 5.2 percent for the year as a whole (and to 5.0

percent by the end of the year). There was a net gain of 1.7 million nonagricultural jobs, but falling agricultural employment opportunities—continuing a long-term trend—offset 0.2 million of the increase.

Employment among teenagers and Negroes

Between 1962 and 1963, when employment rose only enough to offset the increase in the labor force, job gains were heavily concentrated among adult whites (20 years of age and older). Teenage employment actually declined, and increases for Negroes were limited.

The situation was different in 1964. There was a dramatic shift not only in the size but also in the character of the employment gains. Negroes and teenagers began to find jobs in larger numbers, and their percentage of the total increase in employment was considerably above that in 1963.

These data illustrate an unhappy fact: When the job market is slack and production grows only enough to create jobs for the normal increase in the labor force, adult whites secure the largest share of the new jobs, while unemployment among teenagers and Negroes is high and probably rising. (Similarly, during recessions, when the absolute number of jobs declines, Negroes and teenagers suffer the heaviest employment losses, and their unemployment rates rise much faster than those of adult whites.) As long as jobs are scarce and job applicants abundant, many employers give automatic preference to adult whites. Those without previous job experience and members of minority groups go to the end of the hiring line.

Growth of the teenage labor force in 1964 far exceeded any previous increase, but jobs for teenagers increased even more, and the over-all unemployment rate for this group—still far too high—fell only slightly. Better education and vocational preparation of teenagers, and reduced discrimination against minority groups, can significantly enlarge the employment opportunities open to any individual teenager or Negro. But adequate and permanent improvements in the high unemployment rates of these groups clearly require that recessions be avoided and that economic expansion be sufficiently rapid to keep over-all unemployment low.

Unemployment in areas of chronic depression

In 1960, 19 major labor market areas in the United States had substantial and persistent unemployment, with rates of 6 percent or higher, and an unemployment history much worse than the national average. From 1961 to 1963, unemployment in these areas declined from 10.3 percent to 6.4 percent, but a major part of the decline was due to a shrinking labor force. Some workers moved to other areas, and others simply withdrew from the labor force.

From 1963 to 1964, there was a further decline in unemployment, to 5.5 percent, but there was a significant change: the labor force in these areas reversed a five-year decline and started to increase. The labor force rose by 33,000 and employment increased by 62,000.

Although the 1964 record of gains in employment is heartening, the American economy still faces major employment problems:

(1) Five percent of the labor force, 3.7 million persons, remains unemployed.

(2) The increase in the civilian labor force, which has averaged about 1 million a year over the past four years, is expected to average 1½ million a year between 1964 and 1970.

(3) In 1965, the number of 18-year-olds will increase by almost 1 million; and growth of the teenage labor force will be approximately 500,000—double its growth in 1964.

(4) The unemployment rate for Negroes remains more than double that for whites.

(5) Unemployment is far too high in many local labor markets.

While full solution of these and related problems requires many kinds of policies, the maintenance of a high rate of growth in over-all demand is a necessary and crucial element.

CONTRIBUTION OF FEDERAL FISCAL AND MONETARY POLICIES

Federal policies have made a major and continuing contribution to the great achievements of the American economy during the past four years. These policies were not laid down in one master plan early in 1961 and then carried out on a predetermined schedule. There have been delays, surprises, and a need to adapt policies to changing events; but policies have had a unified direction and strategy. They have consistently reflected a number of basic ideas shared by those responsible for Federal economic policies. These basic ideas include the following:

(1) A firm belief that the United States must make optimum use of the tremendous productive capacity of its economy; conversely, an abhorrence—for both human and economic reasons—of the waste of resources and opportunities involved in a prolonged underutilization of that capacity;

(2) A recognition that Federal purchases, taxes, and transfer payments are a major force, along with monetary policy, in determining the strength of the total market demand for productive resources;

(3) A full understanding of the key role of private investment in total market demand and in the long-term growth of incomes, and of the need for adequate profit incentives to stimulate this investment;

(4) A recognition that expanding consumption is necessary if increasing investment and over-all growth are to be maintained;

(5) A belief that vigorous efforts are necessary to restore equilibrium in the balance of payments;

(6) A determination to achieve reasonable price stability in order to preserve equity at home and to improve our international competitive position both at home and abroad,

(7) A conviction that, if they are to be effective, policies cannot respond passively to what has already transpired, but must try to foresee and shape future developments, remaining flexible and ready to change speed or direction yet holding to fixed goals;

(8) A belief that the American people share these ideas and are ready to support imaginative but carefully considered innovations in public policy.

These basic ideas have been applied during the past four years in a number of areas of economic policy. The following sections relate to their application in the fields of fiscal and monetary policy.

FISCAL POLICY, 1961–64

The instruments of fiscal policy—purchases of goods and services, transfer payments, subsidies, grants-in-aid, and taxes—are the Government's most powerful tools for expanding or restraining over-all demand. Federal purchases of goods and services are directly part of market demand, and—through their impact on production, employment, and income—encourage further private consumption and investment expenditures. Taxes, transfers, subsidies, and grants-in-aid affect consumption and investment through their influence on disposable personal income, after-tax profits, incentives, and State and local expenditures.

The basic task of Federal fiscal policy is to help to provide a total market demand for goods and services that neither exceeds nor falls short of the economy's productive capacity at full employment. Maintaining this continuous balance between demand and capacity normally involves two basic requirements. First, since total productive capacity grows steadily over time, total demand also must grow. Second, since fluctuations in private demand occur independently of Federal policy, these fluctuations must be offset in order to avoid dips or surges that could touch off recession or inflation.

Since 1960, a third requirement has been added as the result of earlier failures to meet the first two: the need to eliminate the large gap that developed in the late 1950's between potential output and demand. Thus, in the last four years the main challenge to U.S. policy has been to stimulate a massive growth in total demand, sufficient not merely to *keep up* but to *catch up* with the growth of productive capacity. During the past four years, fiscal policy has been dominated by this purpose. In addition to a growth of $21 billion in Federal expenditures (first quarter 1961 to fourth quarter 1964), reductions in tax liabilities now in effect leave about $16 billion more a year in private hands than would be the case under 1960 tax rates.

As previous Annual Reports have shown, the stimulus provided by a given budget cannot be measured by the realized surplus or deficit. Since tax revenues and some expenditures automatically vary with economic activity, the realized surplus or deficit reflects the automatic effect of these variations, as well as discretionary actions on the part of the Federal Government. To distinguish the two effects, revenues and expenditures are calculated at a fixed level of economic activity—usually the full-employment level. At any given time, the larger the surplus at full employment, the more restrictive is fiscal policy; changes in the full-employment surplus or deficit indicate whether fiscal policy has, on balance, moved in an expansionary or a restrictive direction. This concept cannot measure perfectly the effect of a given budgetary change because it does not reflect changes in the composition of the budget. Moreover, a rise in the level of the budget may have a stimulating effect even with no change in the full-employment surplus. But the full-employment surplus is the best simple measure available and is a useful tool of analysis.

For the calendar year 1960, the Federal budget, on a national income and product account basis, showed an actual surplus of $3.5 billion, but the full-employment surplus was about $13 billion (Chart 9). Given the extent of the unutilized human and material resources, this surplus obviously needed to be reduced.

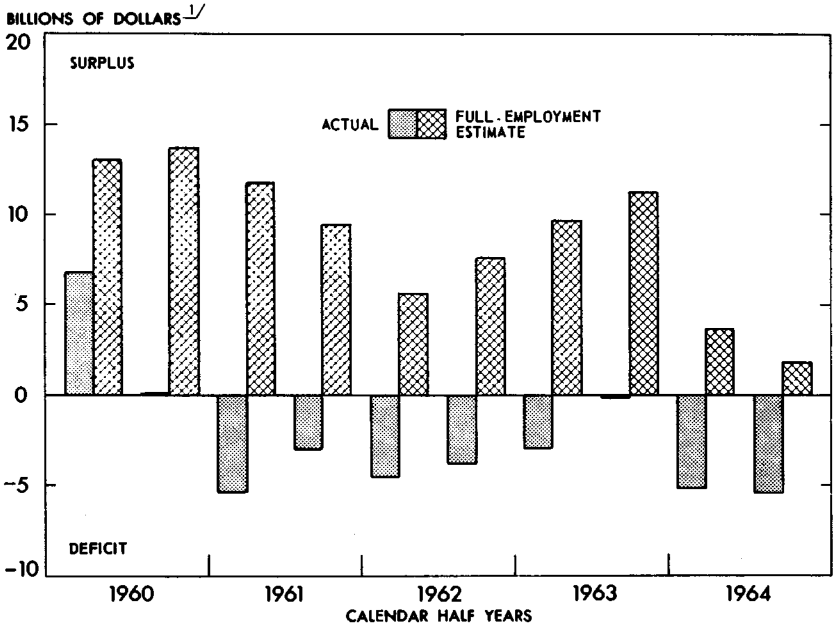
During 1961 a sharp increase in expenditures had an expansionary impact on the economy. As this increase was in excess of built-in gains in revenue at full employment, a first step was taken toward reducing the full-employment surplus. After the initial increase, the growth of expenditures continued at a substantial though slowing pace through the following two years. From the first quarter of 1961 to the fourth quarter of 1963, total Federal expenditures, which include transfer payments, subsidies, interest, and grants-in-aid, as well as purchases of goods and services, increased by $17 billion, or roughly 17 percent. These expenditures, undertaken primarily to strengthen defense and space programs but also to provide for unmet civilian needs, directly raised the level of aggregate demand and were highly stimulating to the rest of the economy.

The stimulus of fiscal policy was not limited to the expenditure side of the budget. Two tax-reducing measures were adopted to provide a needed long-run stimulus to lagging private investment. New depreciation guidelines were announced in July 1962, and an investment tax credit was enacted by Congress in the Revenue Act of 1962. The net effect of these two measures was to increase by $2½ billion the annual cash flow to corporations and to increase appreciably the after-tax rate of return on new investment projects, thus providing a needed long-range stimulus to investment. Through a combination of expenditure increases and tax reductions, the full-employment surplus was reduced to about $6½ billion in 1962.

Chart 9

Federal Surplus or Deficit: Actual and Full-Employment Estimates

NATIONAL INCOME ACCOUNTS BASIS



1/ SEASONALLY ADJUSTED ANNUAL RATES.

SOURCES: DEPARTMENT OF COMMERCE, BUREAU OF THE BUDGET, AND COUNCIL OF ECONOMIC ADVISERS.

Although it had been hoped that these measures, together with an accommodating monetary policy, might stimulate sufficient recovery of private spending to bring total demand to full-employment levels, events proved otherwise. Unemployment fell to 5.6 percent by the beginning of 1962 but then held close to that unsatisfactory level. Major expansionary fiscal action was needed to strengthen and sustain the upswing.

Thus in August 1962, President Kennedy reported to the Nation that a major tax reduction would be proposed to accelerate the economy's progress toward full employment. This recommendation constituted a milestone in the use of fiscal policy to meet the requirements of the Employment Act, as well as a dramatic innovation in the choice of fiscal instruments.

However, Congressional action on the proposal was not completed in 1963. Since Federal expenditures were not rising as rapidly as in the two preceding years, the full-employment surplus began to rise again. Thus the Federal Government provided no further stimulus to the economy as full-employment revenues rose (because of the normal trend growth of full-employment GNP) more rapidly than expenditures.

By the fourth quarter of 1963, the full-employment surplus reached $11 billion, and even the realized budget, on a national income and product account basis showed a surplus. At the same time, output remained about $30 billion short of potential and the unemployment rate at 5.6 percent.

The aggregate demand generated by business, consumers, and governments had not been adequate to move the economy even close to full employment. The future course of the expansion was in doubt, and enactment of President Kennedy's tax cut recommendation had become increasingly urgent.

REVENUE ACT OF 1964 AND ITS EFFECTS

Under the vigorous leadership of President Johnson, the tax-reduction bill was enacted early in 1964. At 1964 levels of income, personal income tax liabilities were cut by $6.7 billion and corporate profits tax liabilities by $1.7 billion. With further reductions in rates taking effect in 1965, the cuts in liabilities will be $11 billion for individuals and $3 billion for corporations. Withholding rates on wages and salaries were reduced from 18 percent to 14 percent in one stage in early March 1964, rather than in two stages. This meant that most of the tax reduction was immediately reflected in consumers' disposable incomes.

The Council's 1964 Annual Report estimated that a personal tax cut of nearly $9 billion would result in a direct increase of more than $8 billion in consumption. Subsequent rounds of spending and respending would add another $10 billion to consumption—producing a tax cut "multiplier" of about two. Thus, through increased consumption alone, GNP would ultimately be raised by more than $18 billion above what it would have been in the absence of the tax cut.

The evidence to date indicates that this expectation is being borne out. After rising to 7.9 percent in the second quarter of 1964, the ratio of personal saving to disposable income had fallen back to a relatively normal 7.1 percent in the third quarter, suggesting that the gains of disposable income resulting from tax reduction were already being largely spent for the purchase of consumer goods and services. (A jump in the saving rate in the fourth quarter appears to be attributable to delayed deliveries of automobiles as a result of strikes.) The tax cut directly added $7.7 billion to disposable income in 1964, and the addition was running at an annual rate of $9½ billion by the end of the year. The Council estimates that the total increase in consumer spending alone resulting from the tax cut's impact was $9 billion in 1964, and had reached an annual rate of $13 billion by the end of the year. Subsequent rounds of spending and respending will bring the full impact on consumption in 1965 and beyond.

From 1963 to 1964, GNP grew 4.5 percent after adjustment for price changes. The above calculations suggest that, in the absence of the tax cut, the growth would have been only 3.0 percent, even if it is assumed that without the tax cut all expenditures other than consumption would have been just what they in fact were.

These figures, however, underestimate the full beneficial effects of the cut. Tax policies were also prominent among the factors that helped to generate a $5.0 billion advance (current prices) in business fixed investment between the fourth quarters of 1963 and 1964. The depreciation reform and the investment credit of 1962 continued to provide added strength to capital spending. The Revenue Act of 1964 reduced the basic rates of corporation taxes and, by increasing consumer demand, gave businessmen added assurance of sustained expansion and expanded markets. This assurance was a stimulating factor, even before tax cuts added to sales or cash flow. As the tax cut raised cash flows and operating rates during the year, business investment plans were revised upward.

Since the full effects on business investment of greater sales, improved profits, and larger cash flow are accomplished only after a substantial lag, and since part of the tax cut becomes effective in 1965, much of the rise in investment stimulated by the 1964 tax cut is still ahead of us. This extra investment will have multiplied effects on total production through the route of expanded incomes and larger consumer spending.

MONETARY POLICY IN THE EXPANSION

Monetary policy operates by changing the availability and cost of credit to businesses, consumers, and governments. These changes are accomplished most directly by affecting the reserves available to commercial banks; but through its impact on bank policies and financial markets, monetary policy affects the general credit structure of the economy.

Monetary policy's impact on expenditures, and thus on employment, comes when businesses, consumers, or governments—finding borrowing (or liquidation of financial assets) easier or harder, less costly or more costly—are induced to spend more or less than they would otherwise have spent.

Tools and objectives

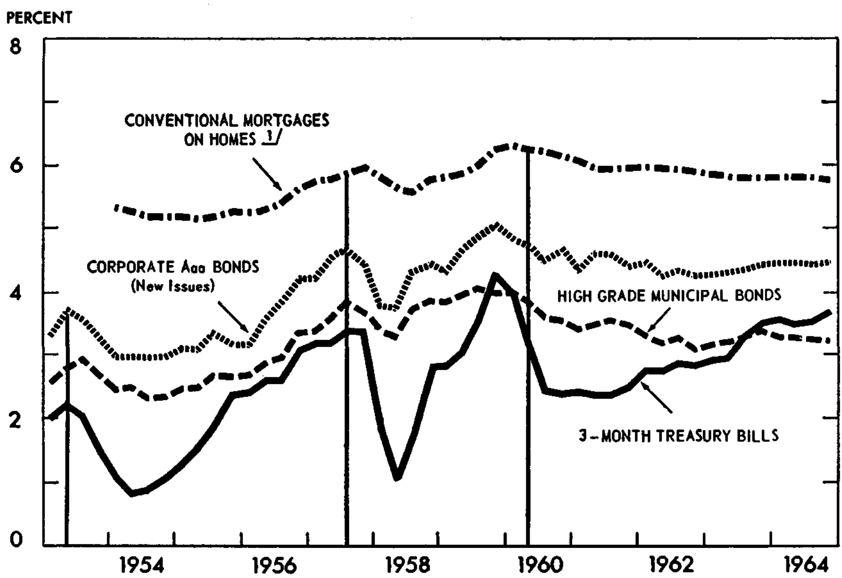
Throughout the current expansion, monetary policy has supported the objectives of fiscal policy by maintaining a ready availability of credit, thus accommodating an expansion of demand. It has pursued this objective while meeting the requirement to maintain an appropriate relationship between short-term interest rates in the United States and in other major money markets in order to dampen the outflow of volatile short-term funds. As many European countries have been using monetary policy to restrain demand, their central banks have maintained higher interest rates than would have been appropriate in the United States. Although U.S. short-term interest rates have been nudged upward to prevent an outflow of interest-sensitive funds seeking higher rewards abroad, policy has endeavored to avoid transmission of these pressures to the long-term market (more crucial for domestic investment) and to maintain a ready availability of credit relative to demand.

The success of this policy can be seen most clearly by comparing the pattern of yields that has emerged during the current expansion with that during previous upswings (Chart 10). During the recession of 1960–61, the Treasury bill rate was kept considerably higher than in either the 1954 or the 1958 recession. Subsequently, however, bill rates rose more gradually, and monetary policy remained—in many respects—significantly easier than in previous expansionary periods. However, the general level of interest rates is higher than at any period since the early 1930's.

One indication that credit conditions have remained relatively easy during the current expansion is the fact that commercial banks have consistently been kept in a positive net free reserve position, in sharp contrast to the expansions of 1954–57 and 1958–60 (Chart 11). As credit demand has strengthened, total bank reserves have been steadily increased by Federal Reserve operations to prevent the banking system as a whole from having to borrow heavily to meet the increase in required reserves. The annual growth in total reserves, adjusted for changes in reserve requirements, has

Chart 10

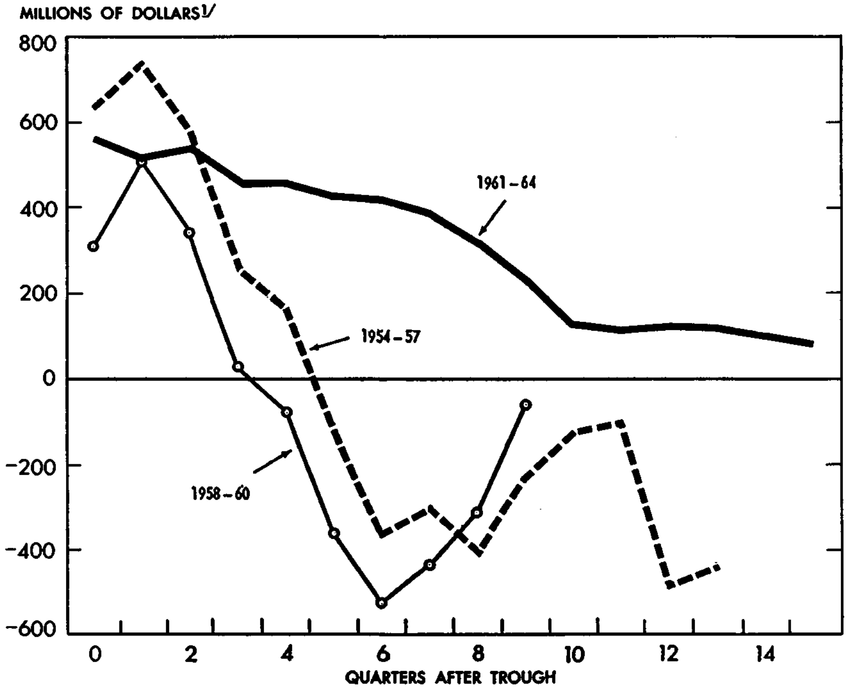
Selected Interest Rates



1/ SERIES BEGINS IN 1954; NEW AND EXISTING HOMES THROUGH 1960 I, AND NEW HOMES ONLY THEREAFTER.
NOTE: VERTICAL LINES SHOW GNP PEAK QUARTERS; 1953 II, 1957 III, AND 1960 II.
SOURCES: FEDERAL HOUSING ADMINISTRATION (FHA), BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE, AND STANDARD AND POOR'S CORPORATION.

Chart 11

Free Reserves in Three Postwar Expansions



1/ AVERAGE OF DAILY FREE RESERVES OF MEMBER BANKS (EXCESS RESERVES LESS BORROWINGS).
TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

averaged 3.6 percent since the end of 1960, in contrast to an average growth of 1.8 percent during the preceding seven years. The initial steps to maintain this expansion of reserves, while short-term rates were being raised, came when the Federal Reserve began providing reserves in part through open market operations in Treasury notes and bonds in early 1961.

Successive increases in maximum permissible interest rates on time and savings deposits in January 1962, July 1963, and November 1964 served the double purpose of permitting domestic banks to compete more effectively with foreign banks for deposits and of channeling private savings and business liquidity into time and savings deposits. These funds then flowed, in large part, into longer-term loans and securities, maintaining a downward pressure on longer-term yields. In the process, these higher ceiling rates also permitted commercial banks to compete more actively for domestic funds. This contributed to the growth of bank deposits relative to other forms of asset holding and of bank credit relative to other sources of lending.

The expansion in total bank credit has exceeded the growth of bank reserves, as time deposits—which now require a reserve backing of 4 percent—have risen relative to demand deposits, which require a backing of 12 to 16½ percent. Since the end of 1960, bank credit has risen at an average rate of 8 percent a year, thus increasing somewhat faster than the advance in GNP, in contrast to previous business upswings.

The need to raise short-term interest rates for balance of payments reasons prompted a series of shifts toward moderately less credit ease. These occurred in December 1961, June and December 1962, May–July 1963, and August 1964. In July 1963 and November 1964, the discount rate was increased as well. While short-term rates were raised, the steps taken to assure the availability of adequate credit helped to protect longer-term interest rates. As shown in Chart 10, longer-term yields fell little during the 1960 recession, but they have been steadily resistant to upward pressures during the expansion.

Debt management policies of the Treasury also have been directed toward supporting short-term interest rates. In each of the past four years, the volume of bills issued by the Treasury accounted for half or more of the total increase in the marketable debt. Meanwhile, the Treasury used advance refunding operations to counteract the tendency for the passage of time to shorten the maturity of the Federal debt.

Policy in 1964

In the past year, monetary policy continued to serve domestic expansion while helping to protect against outflows of short-term capital—its effectiveness reinforced by growing public understanding of its objectives. The basic guidelines of monetary policy remained essentially unchanged between July 1963 (when the discount rate was raised from 3 to 3½ percent to support other new balance of payments measures) and the late summer of 1964. At that time, the Federal Reserve moved to reduce reserves slightly in order to tighten further the reins on the outflow of dollars. On November 23, following the rise in the British bank rate, the Federal Reserve announced an increase in the discount rate to 4 percent as a precautionary move to forestall capital outflows. This was accompanied by a rise in the bill rate to about 3.8 percent.

Despite these moves to raise short-term interest rates for balance of payments purposes, yields on long-term securities remained remarkably stable during the year. There was a brief period of rising yields in March, reflecting uneasiness over possible sharp increases in demands for credit after the tax cut, and again in September and October over the implications of the British balance of payments problem. But in each instance, yields subsequently receded; at the year end, average yields on long-term Treasury bonds were within .02 percentage points of their low for the year.

Meanwhile, bank credit grew by 7.9 percent, almost exactly matching the expansion in 1963. The money supply, which had increased by 3.8 percent in 1963, grew by 4.0 percent in 1964, despite the sharper step-up in growth of GNP. The growth of money supply plus time and savings deposits of commercial banks was slower in 1964 than in the preceding year, when time and savings deposits grew more rapidly in response to the appreciable relative rise in interest rates paid on them, and when monetary policy was easier.

APPROACHING EXTERNAL BALANCE

During the past four years, the external payments position of the United States improved. For most of 1964, the balance of payments deficit on regular transactions ran at an average annual rate of little more than half the $3.9 billion recorded in 1960 (Table 7). However, while the improvement was substantial and occurred during a period when the U.S. domestic economy enjoyed strong and sustained expansion, it is by no means enough. Moreover, it now appears that an unusual combination of factors resulted in a sizable rise in the deficit during the fourth quarter. Thus, the balance of payments continues to require serious attention.

When the Kennedy-Johnson Administration took office in early 1961, the United States had just experienced its third successive year of large payments deficits. Such deficits did not mean that the country was "living beyond its means" in terms of its use of resources or that the wealth position of the United States was impaired, for our exports of goods and services were substantially in excess of our imports and our total assets abroad were rising faster than our liabilities. The deficit did, however, represent a decline in net U.S. liquidity that could not be permitted to persist, particularly in view of the special role of the dollar as a major reserve currency. There were indications, moreover, that the underlying competitive position of U.S. export products had been deteriorating for a number of years, suggesting possible further increases in the payments deficit. And in late 1960, international currency markets had become unsettled as speculative outflows of short-term dollar funds increased and the price of gold on the London gold market rose sharply.

The need for action to improve the U.S. external balance was thus readily apparent. At the same time, however, doubts were being widely expressed that an improvement in the payments position would be feasible if the new Administration were to pursue its announced goal of renewing economic expansion. Indeed, the view was widely held that the rise in imports normally associated with economic expansion would necessarily worsen our international accounts.

This view was rejected by the Administration. Instead, policies were based on a fundamental conviction that sound growth of the domestic economy was compatible with longer-run improvement in the balance of payments. Only a strong, resilient, and dynamic economy, characterized by reasonable price stability, would permit the gains in productivity and provide the spur to innovation needed for an underlying improvement in our international competitive position. Moreover, a vigorous and dynamic U.S.

TABLE 7.—*United States balance of payments, 1960–64* [1]

[Billions of dollars]

Line	Type of transaction	1960	1961	1962	1963	1964: First 3 quarters
	Regular transactions:					*Seasonally adjusted annual rate*
1	Balance on goods and services	3.9	5.6	5.1	5.7	8.1
2	Balance on trade	4.7	5.4	4.4	5.0	6.4
3	Merchandise exports	19.5	19.9	20.6	22.0	24.7
4	Commercial exports of goods	17.5	17.7	18.2	19.3	21.8
5	Exports of goods financed by Government grants and capital	1.9	2.2	2.4	2.7	2.8
6	Merchandise imports	−14.7	−14.5	−16.1	−17.0	−18.3
7	Balance on nonmilitary services	1.8	2.7	3.0	2.9	3.8
8	Investment income, net [2]	2.3	3.0	3.3	3.3	4.0
9	Other commercial services, net	−.8	−.7	−.8	−.9	−.8
10	Service exports financed by Government grants and capital	.3	.4	.5	.6	.6
11	Military expenditures, net [3]	−2.7	−2.6	−2.4	−2.2	−2.1
12	Remittances and pensions	−.7	−.7	−.7	−.8	−.8
13	Government grants and capital outflows	−3.4	−4.1	−4.3	−4.5	−4.2
14	(Transactions involving no direct dollar outflows from the United States)	−2.3	−2.9	−3.2	−3.6	−3.5
15	(Dollar payments to foreign countries and international institutions)	−1.1	−1.1	−1.1	−.9	−.7
16	Scheduled repayments on U.S. Government loans plus changes in associated liabilities	.6	.7	.7	.7	.7
17	Long-term private capital, net	−2.1	−2.2	−2.6	−3.2	[4] −3.3
18	U.S. capital, net [5]	−2.5	−2.6	−2.9	−3.6	−3.6
19	Foreign capital, net	.4	.4	.3	.3	[4] .3
20	Short-term private capital, net	−1.4	−1.4	−.7	−.8	−2.0
21	Errors and omissions	−.8	−1.0	−1.1	−.3	−.5
22	*Balance on regular transactions*	−3.9	−3.1	−3.6	−3.3	−2.0
						Unadjusted total
23	*Balance on regular transactions before seasonal adjustment*	−3.9	−3.1	−3.6	−3.3	−1.5
24	*Special Government transactions, net*	(6)	.7	1.4	1.3	.4
25	Debt prepayment and advances on military exports	(6)	.7	1.2	.7	.2
26	Net sales of nonmarketable, nonconvertible bonds and notes	--------	--------	.3	(6)	−.1
27	Net sales of nonmarketable, convertible bonds and notes	--------	--------	--------	.7	.3
28	*Balance including receipts from special transactions other than convertible securities*	−3.9	−2.4	−2.2	−2.6	−1.4
29	*Balance including receipts from all special transactions*	−3.9	−2.4	−2.2	−1.9	−1.1
30	Gold (decrease, +)	1.7	.9	.9	.5	(6)
31	Convertible currencies (decrease, +)	--------	−.1	(6)	−.1	(6)
32	IMF gold tranche position (decrease, +)	.4	−.1	.6	(6)	.4
	Changes in selected liabilities:					
33	To foreign central banks and governments (increase, +)	1.4	.7	.5	1.0	−.1
34	To private holders and international and regional organizations (increase, +)	.3	1.1	.2	.6	.9

[1] Excludes U.S. military grant aid and subscriptions to the IMF.
[2] Includes Government.
[3] Military expenditures abroad less military sales.
[4] Includes increase in U.S. Government liabilities associated with Columbia River development project.
[5] For detail see Table 8.
[6] Less than $50 million.

NOTE.—See Appendix Table B–79 for additional detail.
Details will not necessarily add to totals because of rounding.

Source: Department of Commerce.

economy could be an attractive magnet for private investment funds, thereby leading to an improvement in the U.S. capital account. While maintenance of the dollar as a strong reserve and trading currency required that major attention be given to the balance of payments, it was recognized that the strength of the dollar depends fundamentally on the continued vigor of the American economy in a setting of stable prices.

It was clear, however, that economic expansion alone could not bring about the needed improvement in our external position, particularly in view of continuing U.S. commitments for the defense of the free world and assistance to the developing countries. An array of special policy measures was thus required to permit simultaneous progress toward domestic expansion and external balance, in ways that would minimize any conflict with the basic longer-range U.S. goal of growing freedom in world trade and payments. Only a flexible and imaginative combination of a wide range of policy instruments could serve these purposes.

The various actions taken to raise domestic demand and to adapt monetary policy to the dual requirements of external balance and domestic expansion have been discussed above. Other measures taken in 1961 and 1962 and reinforced in mid-1963 included more direct efforts to stimulate exports, to reduce the Government's contribution to the payments deficit through its overseas expenditures, to reduce outflows of private capital, and to moderate the growth of tourist outlays abroad. New techniques were devised for financing the deficit in ways that would minimize gold outflows and strengthen confidence in the dollar. In addition, increased cooperation among financial and economic authorities here and abroad helped to strengthen the defense of international currencies against speculative attacks.

The record of the past four years has demonstrated the essential validity of this approach. While imports of goods and nonmilitary services did, in fact, rise by about $5 billion, in line with the expansion of the domestic product between 1960 and 1964, exports of goods and services (excluding exports financed by the Government and including earnings on investments abroad) increased by nearly $7½ billion. Gross outflows of Government capital have continued to rise moderately, but the net impact of all Government programs on the payments deficit has been reduced by about $1.1 billion. The over-all improvement in the balance of payments attributable to these various factors approaches the total payments deficit in 1960.

Despite these gains, the decline in the deficit has been less rapid than had been hoped in 1961. The principal reason has been the relatively large rise in private capital outflows—an element of the balance of payments which might have been expected to advance less rapidly or even to decline in a period of rising domestic activity. While changes in the capital account are interrelated with other components in the balance of payments—for example, some capital outflows serve directly to finance our exports—and therefore should not be viewed in isolation, the over-all magnitude of capital outflows by mid-1963 had become clear cause for concern. This led to the adoption of special remedial measures, notably the imposition of the Interest Equalization Tax on purchases of new and outstanding foreign securities by U.S. investors.

In 1964, with foreign demands strong, the combination of influences and measures referred to above produced a continued reduction in the U.S. deficit on regular transactions. Further, this smaller deficit was financed to an unusually large extent by increases in private rather than official holdings of short-term balances, and outflows of gold were the smallest since 1957. Moreover, the strength of the multilateral currency arrangements worked out in recent years was dramatically demonstrated late in 1964 when, following a massive speculative attack against sterling, a $3 billion credit was extended to the United Kingdom by an 11-nation group and the Bank for International Settlements, with the United Sates taking a prominent part.

The progress achieved during 1964 further strengthened confidence in the dollar. Yet there are clouds in the record for the year that cannot be ignored and that raise new questions for the future. In particular, U.S. purchases of newly issued foreign securities as well as long-term bank loans to foreigners were unusually large in the latter part of the year, operating to produce a higher deficit in the fourth quarter.

The remainder of this chapter will deal with a number of key elements in the changing international position of the United States during the past four years: the gains in U.S. exports and in our competitive position; the reduction of net outflows on Government account; the shifting pattern of private capital flows; the development of new methods of financing our deficit; and the progress in international financial cooperation. The related discussion in Chapter 2 will then look toward the future of the U.S. balance of payments as well as toward the longer-range directions of international trade, aid, and financial arrangements and policies.

GROWTH OF U.S. EXPORTS

The growth in U.S. exports during the past four years—and especially since the middle of 1963—has been a most welcome development. Between 1960 and 1964, commercial exports increased by $4.3 billion, and those financed by Government grants and capital accounted for a rise of nearly $1 billion more (Table 7). Although a small part of this growth must be attributed to special circumstances, such as extraordinary wheat sales to Eastern and Western Europe last winter, the expansion was, for the most part, broadly based in commodity composition and augurs well for the future. Moreover, it was widely spread around the world, with sharp increases to all major areas.

Several reasons explain the substantial improvement. Production and incomes have grown rapidly in most of the world, raising total world trade. Moreover, the competitive position of American products has been improved by price stability at home. These factors have been reinforced by various Government programs to promote exports and by the practice of tying an increasing proportion of U.S. foreign assistance funds to purchases in the United States.

The dollar value of free world exports rose at the rate of 6 percent a year from 1960 to 1963, and by 10 percent, or $14 billion, between mid-1963 and mid-1964. It is now double what it was only ten years ago. This increase in trade reflects continuing prosperity and economic growth abroad, particularly in Europe and Japan, and during the last two years in many raw material producing countries.

As the world's largest exporting and importing nation, the United States has benefited from the rapid growth in world trade. During the past year, however, not only have our total exports increased sharply; they have increased somewhat more rapidly than the exports of many of our competitors. Our recent export performance thus appears to reflect at least some improvement in our relative competitive position.

A full evaluation of changing competitiveness in world markets is, of course, extremely difficult. International competitiveness involves many dimensions. Quality, product design, promotion expenditures, financing arrangements, service facilities, delivery terms—all play some role in determining which exporter receives an order. But it is clear that the movement of U.S. prices relative to those of our competitors is a matter of great importance. And in recent years, the record of U.S. prices has been excellent. Since 1958, wholesale prices of industrial products have risen less in the United States than in any other industrial country—although devaluations in France and Canada helped to offset the impact of higher domestic prices on these countries' exports. Unit labor costs in manufacturing have also risen less here than in any other major country.

But while our domestic costs and prices have been more stable than those of our major competitors in recent years, our relative share of total world trade in manufactured goods—which had fallen rather sharply until 1959—continued to decline moderately for several years thereafter. This in part reflected the fact that movements of export prices differed in some countries from movements of over-all industrial prices. In addition, the creation of the European Economic Community (EEC) and the European Free Trade Association (EFTA)—which the United States welcomed—and the accompanying progressive elimination of internal tariff barriers within each group of countries were bound to result in increased trade within the EEC and the EFTA. This increase served to expand total international trade and tended to hold down or reduce the share, though not the total value, of exports from nonmember countries. However, the U.S. share of total world exports of manufactures, *excluding intra-EEC trade,* and its share of total exports of all commodities have been stable or slightly improving since 1959.

The apparent improvement in the competitive performance of American products has been aided by a number of Government programs to promote exports. The export expansion drive has assisted several thousand American firms to enter export markets for the first time. Through Trade

Centers and the sponsorship of commercial exhibits, the Department of Commerce has helped American businessmen to introduce their products abroad; the insurance and financing programs of the Export-Import Bank have been a further aid. Policies to promote price stability, reviewed in the next chapter, are obviously of utmost significance for the continuing growth of U.S. exports as well as for the improvement of our ability to compete with imports of manufactured foreign goods. But while all of these policies have proved helpful in stimulating exports, private initiative alone can provide the new and improved products, at moderate prices, which are essential to continuing strength in the American export position.

GOVERNMENT PAYMENTS ABROAD

The major elements in the Government's payments abroad are military expenditures in support of our forces stationed overseas and grants and loans under foreign assistance programs. These are the transactions over which the Government is able to exert most direct control, and stringent efforts have been made to reduce their impact on the balance of payments.

Since 1960, net military expenditures abroad have been reduced from $2.7 to $2.1 billion, while direct payments abroad under Government economic assistance programs have been cut from $1.1 billion to $700 million—an over-all saving of $1 billion. This improvement has been brought about without curtailing assistance to the developing countries and without sacrificing military commitments to our allies, and despite repeated foreign crises which have required increased outlays for security. It reflects primarily the results and effects of a further tying of foreign aid procurement to U.S. sources, streamlining of our overseas military forces, and increased cash sales of military equipment to friendly countries.

CAPITAL MARKETS AND CAPITAL FLOWS

While the over-all balance of payments position of the United States has shown definite improvement in the last four years, total net private U.S. capital outflows have registered a substantial expansion. As Table 8 indicates, they amounted to $4.2 billion in 1961, declined to $3.4 billion in 1962, but then rose again to a seasonally adjusted annual rate of $5.5 billion in the first half of 1963. Although a sharp reduction was recorded in the second half of 1963, net private capital outflows in 1964 were again very large and probably exceeded the 1963 total.

Large capital outflows have in part been required to finance growing U.S. exports. Moreover, the establishment of convertibility and the growing confidence in the continued freedom of international payments have led to a substantially greater international mobility of capital and a related tendency toward increased integration of international financial markets. In this context, our highly efficient, relatively low-cost, and readily accessible long-term borrowing facilities have undoubtedly tended to add to the net

TABLE 8.—*Recorded private United States capital outflows, 1960–64*

[Millions of dollars [1]]

Type of capital	1960	1961	1962	1963 First half	1963 Second half	1964 First half	1964 Third quarter
				Seasonally adjusted annual rates			
Total net capital outflows	3,885	4,180	3,434	5,530	3,084	5,662	[2] 4,867
Long-term	2,537	2,624	2,881	4,478	2,668	3,164	[2] 3,655
Direct investment	1,674	1,599	1,654	2,190	1,586	2,184	2,076
New issues of foreign securities	555	523	1,076	1,858	642	682	564
Redemptions	−201	−148	−203	−186	−204	−184	−152
Transactions in outstanding securities	309	387	96	302	−204	−268	−148
Long-term bank claims	155	136	127	322	1,156	614	1,044
Other long-term claims	45	127	131	−8	−308	136	[2] 271
Short-term [3]	1,348	1,556	553	1,052	416	2,498	1,212
				Unadjusted annual rates			
Bank credits	610	912	327	122	782	1,010	372
Commercial credits	163	153	79	174	342	252	400
Liquid funds	579	454	175	622	−516	1,114	208
Other items	−4	37	−28	24	−82	12	−168

[1] Outflow, +; inflow, −.
[2] Financing of $255 million to Canada for Columbia River power development is included but not multiplied in deriving the third quarter annual rate.
[3] Breakdown of short-term capital in part based on estimates by the Board of Governors of the Federal Reserve System.

Source: Department of Commerce (except as noted).

drain on our balance of payments. At the same time, the emergence of a highly developed international money market has greatly increased the volatility of interest-sensitive short-term funds.

Outflows of direct investment have shown a continuing rise; by 1964 they were one-third higher than in 1961. The share going to Western Europe also continued to expand; in 1964 it was approximately two-thirds of the total. The desire of American companies to establish or expand productive facilities close to rapidly growing European markets and inside the EEC tariff walls continued to provide the major incentive.

In contrast to this pattern of steady growth in direct investments, U.S. purchases of new foreign securities have undergone wide fluctuations in recent years. The volume of new foreign issues in our markets bought by Americans, which had averaged about $500–$600 million between 1959 and 1961, rose dramatically in 1962 to $1.1 billion and then in the first half of 1963 soared further to an annual rate of almost $2 billion. Following the Administration's announcement in July 1963 of its intention to ask for enactment of an Interest Equalization Tax, it dropped sharply to an annual rate of about $600 million and remained at this level until the autumn of 1964. After the actual enactment of the Interest Equalization Tax in September 1964, there was a renewed spurt of new security issues by Canadians (who are exempt from the Tax). However, for 1964 as a whole, both the total of new foreign security issues and Canadian borrowings were sharply below the rate reached in the first half of 1963.

Partly offsetting the decline in new issues of foreign securities has been a sharp rise in outflows of long-term bank credit since the spring of 1963. Whereas such loans had averaged about $140 million from 1960 to 1962, their adjusted volume reached an annual rate of almost $1 billion in the second half of 1963, without counting certain large takeovers of commercial claims from U.S. corporations. These outflows receded somewhat in the first half of 1964, but rose to new high records later in the year.

The burgeoning of long-term bank loans over the past year and a half clearly has reflected, among other factors, a spillover of demands from U.S. security markets following the Interest Equalization Tax proposal. Further impetus toward increases in such lending has been provided by tighter credit in a number of foreign countries as a result of restrictive measures taken in these countries early in 1964. These factors have also accounted for an important share of the substantial recent volume of short-term bank loans.

Outflows of U.S. owned liquid funds were very large in 1960, but receded between 1961 and 1962 as speculative pressures subsided and as short-term interest rates rose. Following the increase in the discount rate and in interest rate ceilings on time deposits in mid-1963, an actual inflow of liquid short-term funds was recorded.

During the early part of 1964, however, a gradual tightening of money market conditions abroad resulted in a renewed outflow of liquid U.S. funds to Canada and Europe. The total outflow of liquid funds subsided in the third quarter. Thereafter, the movement of these funds appears to have followed an irregular course in response to a variety of partly conflicting influences, including seasonal influences, the unsettlement of international money markets as a result of the sterling crisis, and the changes in central bank rates here and abroad.

FINANCING THE DEFICIT

As has already been indicated, the long-run strength of the American dollar depends on the strength of the U.S. economy. More immediately, however, the strength of the dollar abroad is intimately related to the magnitude of the U.S. balance of payments deficit and to evidence that the deficit is being controlled and reduced. It also affects—and in turn is affected by—the manner in which the deficit is financed.

During the past several years, the United States, in cooperation with a number of countries in Western Europe, has developed a variety of new techniques for financing deficits and absorbing surpluses. These new mechanisms have reduced the pressure on the gold reserves of deficit countries and provided a greater variety of acceptable assets to surplus countries. Thereby, deficit countries have been given more adequate time to carry out necessary internal and external adjustments—within a framework of sustained growth and with minimum resort to measures inimical to the expansion of the free movement of goods and capital among nations. At the same time, surplus countries have been given greater opportunities for pursuing policies needed for orderly progress toward international payments equilibrium. The new financing measures are not, however, substitutes for progress in reducing the U.S. deficit.

In the past four years, there has been a striking shift in the roles played by changes in U.S. monetary reserves and in foreign holdings of short- and medium-term dollar liabilities in financing the remaining deficit. In 1960, a decline of over $2 billion in monetary reserve assets (mainly gold) financed more than half of our deficit, while liabilities to foreign official accounts also rose sharply. In 1964, however, despite a continuing deficit, the outflow of gold was small, and there was only a moderate rise in foreign official holdings of liquid claims on the United States. Instead, partly as a result of more attractive short-term interest rates in the United States and continuing confidence in the dollar, foreign private businesses (including commercial banks) and individuals added to their holdings of liquid dollar assets. Such additions to private holdings of dollar assets in the United States financed about half of the U.S. deficit on regular transactions in 1964.

To mitigate mounting balance of payments difficulties, the United States began in 1959 to arrange for substantial advance repayments on loans made to its European allies in the immediate postwar period. These advance repayments have continued. Since 1962, the United States has also sold special medium-term, nonmarketable securities to foreign governments. These bonds and notes, frequently denominated in the holder's currency, offer an attractive alternative to further accumulation of gold or short-term liquid dollar assets in the official reserves of surplus countries.

In addition to these special bilateral arrangements, the United States began last year to make more direct use of the International Monetary Fund (IMF), by drawing foreign currencies and selling them to countries wishing to repay the Fund. Such IMF transactions, in effect, financed (net) about $260 million of the U.S. deficit in 1964.

Neither our use of IMF resources nor the conclusion of special transactions with surplus countries has directly reduced the U.S. deficit on regular transactions. However, our ability to negotiate such arrangements and other countries' willingness to participate in them have been both a reflection and a source of confidence in the dollar.

BROADENED INTERNATIONAL FINANCIAL COOPERATION

The success of the United States in reducing its deficit and in developing improved methods of financing the deficit that still remains has helped to create an atmosphere conducive to increased cooperation among the world's central banks and financial officials. Such cooperation, in turn, has strengthened the existing network of international monetary arrangements.

Within the past few years the facilities of the IMF have been broadened, and agreement has been reached on the advisability of an increase in its resources. In addition, the major industrial countries included in the "Group of Ten" have declared their readiness to supply to the IMF up to $6 billion of additional convertible currencies under the provisions of the General Arrangements to Borrow; these supplementary facilities were first utilized in 1964 in connection with the provision of IMF assistance to the United Kingdom. Moreover, a network of reciprocal currency, or "swap", arrangements among the major central banks has been developed since 1962, primarily as a means of dealing with temporary speculative pressures. Such currency swaps make possible flexible and coordinated intervention in both spot and forward foreign exchange markets by monetary authorities in the several countries. At the same time, the international gold pool has served to reduce speculation in gold markets and thus helped to conserve gold for monetary use. Frequent consultation among treasury and central bank representatives of the major industrial countries has improved the ability of these officials to respond smoothly and effectively to actual or potential disturbances in the international exchange markets.

During the past year, the capacity of these strengthened international arrangements to deal decisively with sudden or sustained pressures against major currencies was put to two severe tests. In March, the United States, together with the IMF and several European countries, moved quickly to provide a $1 billion package of credit to shore up Italy's then shaky balance of payments; and, as noted earlier, a series of cooperative arrangements was worked out in November to alleviate pressures on the British pound.

Cooperation among financial and economic authorities throughout the world is, of course, also needed to create conditions that will discourage the development of such pressures in the first instance. Cooperation can foster a smoother and more responsive process of balance of payments adjustment within an environment conducive to economic growth and increased freedom of international trade and payments. Progress along these lines has been made in recent years through frequent and constructive discussions in a variety of forums, including the IMF, committees of the Organization for Economic Cooperation and Development, and the monthly meetings of central bank governors at Basle held under the auspices of the Bank for International Settlements.

Encouraging as these steps toward greater international monetary cooperation have been, it is clear that much remains to be done to improve the process of international payments adjustment and that there is scope for further strengthening of existing cooperative arrangements as well as the international monetary mechanism. Various proposals designed to accomplish these purposes are discussed in Chapter 2.