Chapter 2

Sustaining Prosperity in 1965 and Beyond

LAST YEAR, responding to the largest fiscal stimulus ever provided in peacetime, businesses, workers, and consumers moved the American economy strongly forward toward full realization of its vast productive potential. The year 1965 promises to be the fifth year of continued economic expansion—an unprecedented record—bringing further substantial gains in output, personal incomes, and corporate profits. Yet, as the year opens, unemployment remains too high and will continue to be our major economic problem. As a consequence, Government policies must still be directed to closing the existing gap between current production and potential.

Meanwhile, the Nation's economic potential will be expanding rapidly as productivity forges ahead and as record numbers of young people enter the work force. Policies to provide education and skills are vital to help them meet the needs of today's labor market. It is essential that these young people enter the ranks of the employed. If this challenge is met, the new workers will become eager consumers, helping to maintain high employment levels with their demands for houses, cars, and other goods and services. Partly because of their spending, private demand may become somewhat stronger than it has been in the recent past. But the prior requirement and the continuing need are for expansionary fiscal and monetary policies that will help to open job opportunities for new labor force entrants and for the currently unemployed. The prospects for 1965 and available clues for the longer run are analyzed below, followed by an evaluation of the policies required to capture the benefits of our expanding economic potential.

Our best defense against recurrent recession is a strong offense—constant efforts to sustain expansion through general fiscal and monetary measures. But recessions do not always cast their shadows far in advance. Insurance is needed against a sudden downturn. By planning now for tax and expenditure measures that can be quickly enacted and executed should the need arise, we can lessen the possibilities of recessions and minimize their severity should they occur.

Full employment and rapid growth must be pursued along with reasonable price stability. It is essential that the notable recent parallel between private wage-price decisions and the public guideposts be maintained. The significance of wage-price decisions for the achievement of all our economic goals is discussed later in this chapter.

Prospects and policies for the domestic economy must also take account of international economic objectives. The final section of this chapter considers the requirements for policies to improve the balance in our international transactions, to remove barriers to world trade, to aid less developed countries, and to strengthen the international monetary system.

A recurrent theme of the chapter is that the task of moving toward several goals is far more demanding than the single-minded pursuit of just one. In order to attain our domestic production and employment goals in a climate of price stability, and at the same time to progress toward a better international economic order, we must make the wisest use of the full range of policy instruments.

THE GAP BETWEEN ACTUAL AND POTENTIAL GNP

The economy today has room for—and need for—more employment and more production. The Employment Act's objectives of "maximum production" and "maximum employment" can only be achieved together. Unemployment is wasted manpower. Moreover, idle men are generally accompanied by idle machines. Thus, when the economy is marked by excessive unemployment, it is producing below its full potential. The distance between our actual and our potential gross national product (GNP) is one measure of the cost of high unemployment to the whole Nation.

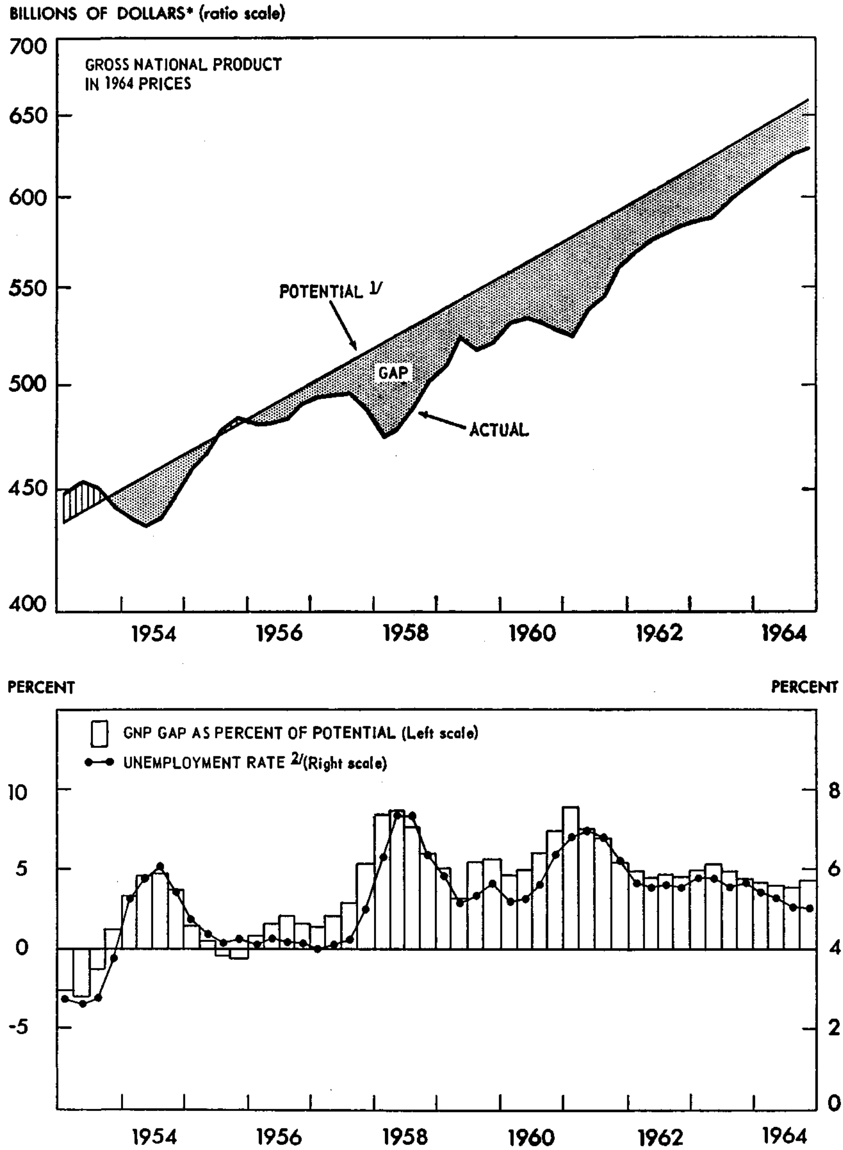
The potential GNP of the U.S. economy measures the volume of goods and services that our economy could produce if the unemployment rate were at the interim target of 4 percent. Potential GNP cannot actually be observed when unemployment is above 4 percent; and to estimate it is an inherently difficult task. Even the best use of available data and of statistical and economic techniques will leave a margin of error in the calculation. Nevertheless, decisions on policies to stimulate or restrain the over-all level of economic activity require a judgment on the gap between current and potential production.

The Council has continuously examined the current and prospective growth of potential in light of new data and emerging developments in the economy. In its past three Annual Reports, the growth of potential GNP since mid-1955 has been approximated by a trend line rising at a rate of 3½ percent a year. It now appears that the growth of potential has recently stepped up: A real growth rate of actual GNP somewhat greater than 3½ percent has been required to prevent a rise in the unemployment rate.

The precise causes of the recent pattern are not definitely established. We may have already begun to experience a more rapid growth of the labor force; the growth trend of productivity may have increased modestly; or these two factors may have operated in combination. Nor is it yet clear just when the recent pattern began. Despite these unsettled issues, the best estimate of recent potential growth must be placed somewhat above 3½ percent and below 4 percent. In line with this conclusion, Chart 12 shows the growth rate of potential GNP as 3½ percent from 1955 through 1962 and 3¾ percent thereafter.

Chart 12

Gross National Product, Actual and Potential, and Unemployment Rate



*SEASONALLY ADJUSTED ANNUAL RATES.

1/ 3½% TREND LINE THROUGH MIDDLE OF 1955 TO 1962 IV; 3¾% TREND LINE THEREAFTER.

2/ UNEMPLOYMENT AS PERCENT OF CIVILIAN LABOR FORCE; SEASONALLY ADJUSTED.

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

Potential GNP includes the output that could be produced by people who would leave the ranks of the unemployed and also by many who are not currently counted in the labor force but who would be at work if unemployment were reduced to 4 percent. Some people who are ready and willing to work have concluded that jobs are not available; they are not actively seeking employment and are therefore not counted as unemployed. According to past evidence, such "hidden unemployment" is concentrated among women, young males, and older men. Men in the 25–54 age bracket have a permanent attachment to the labor force; their labor force participation rates remain close to 97 percent regardless of changes in the availability of jobs. Participation rates of all the remaining age-sex groups are substantially lower and are sensitive to changes in employment opportunities. These relationships are indicated in Chart 13 which shows labor force participation rates and the corresponding employment-population ratios each year since 1952 for males aged 25–54 and for all other age-sex groups combined.

Furthermore, productivity would be higher in a full-employment economy than it actually is today; this is also reflected in the estimate of potential GNP. In periods of underutilization, output per worker is depressed because of the overhead nature of some clerical, professional, and managerial employment and because plant and equipment are being operated at inefficient rates. During periods of movement toward full employment, rapid gains in productivity reflect the fact that both workers and machines are operating more fully and more efficiently.

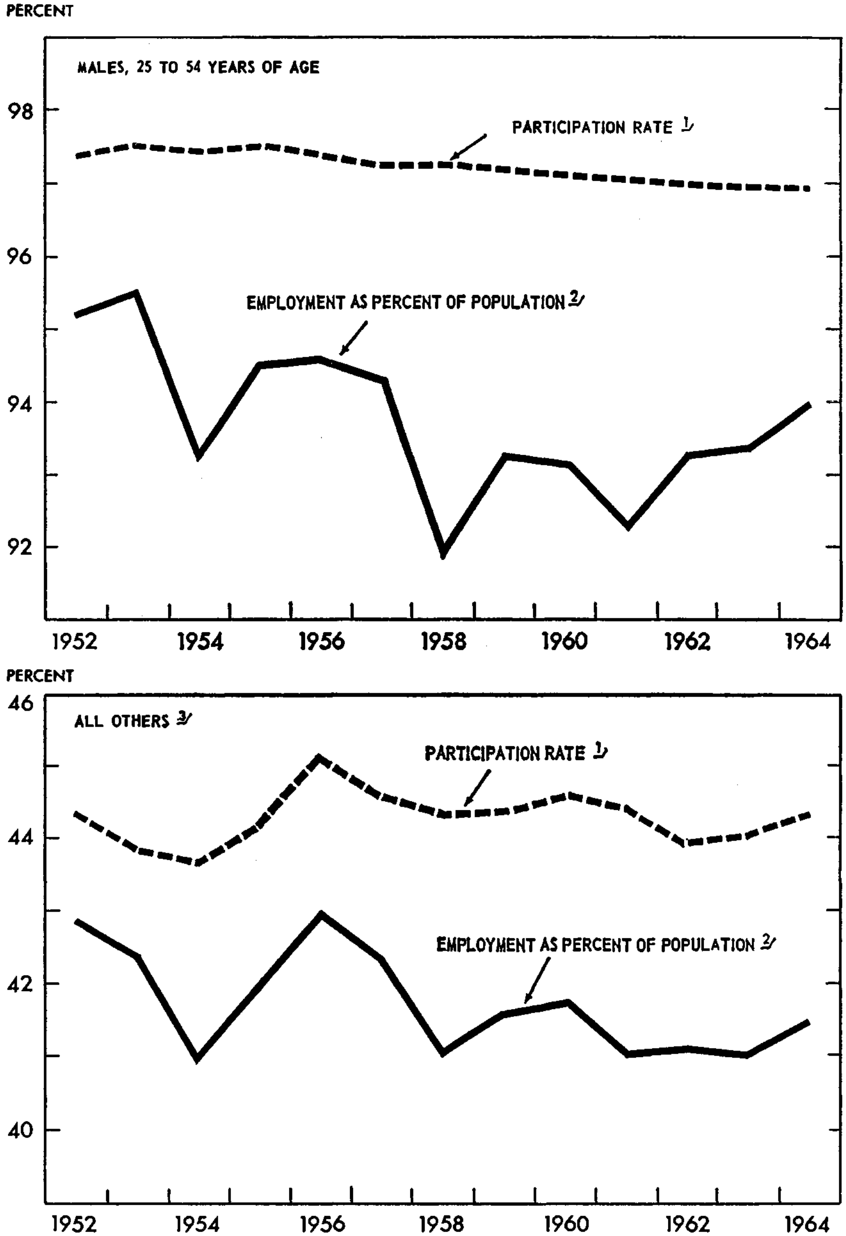
Actual GNP for 1964, at $622 billion, was $27 billion or 4 percent below estimated potential. In the first quarter of 1961, the gap was $51 billion (in 1964 prices) or 9 percent of potential. Thus, the current expansion has substantially narrowed the gap; its present size indicates the remaining distance to full realization of potential.

The Council's estimate of potential GNP reflects the belief that the economy could operate at a 4 percent unemployment rate today without substantial strains on either labor supplies or plant capacity. Operating rates in industry show the presence of capacity to fill additional demands. Labor supplies are generally abundant in most labor markets. While unemployment rates vary widely among different age-sex groups in the population, rates are consistently above those of 1956, when the over-all unemployment rate was 4.2 percent.

The ease of attaining a given global unemployment rate can be affected by major shifts in the composition of the labor force. Some groups, like teenagers and uneducated adults, typically have relatively high unemployment rates; a large increase in their numbers relative to the total labor force would be expected to make the attainment of a given over-all unemployment goal more difficult. In fact, there have been moderate shifts in the composition of the labor force in the direction of *age-sex groups* with typically higher unemployment rates. But there have also been shifts toward

Chart 13

Labor Force Response to Employment



1/ PERCENT OF NONINSTITUTIONAL POPULATION IN THE LABOR FORCE (INCLUDES ARMED FORCES).
2/ PERCENT OF NONINSTITUTIONAL POPULATION HAVING EMPLOYMENT (INCLUDES ARMED FORCES).
3/ INCLUDES FEMALES, 14 YEARS OF AGE AND OVER; MALES, 14 - 24 YEARS AND 55 YEARS AND OVER.
SOURCE: DEPARTMENT OF LABOR.

education groups with lower unemployment rates. If every *age-sex group* now had the same unemployment rate it experienced in March 1957, the over-all unemployment rate would be 0.2 percent *higher* than it was then. On the other hand, if every *education group* now had the same unemployment rate it experienced in March 1957, the global unemployment rate would be 0.3 percent *lower* than it was then.

The interim target of a 4 percent unemployment rate is attainable, given the required level of demand for goods and services. By improving labor market information, skills, and formal education, the manpower policies discussed in Chapter 3 can facilitate the transition to a 4 percent unemployment rate and can, in the future, let us attain even lower rates.

OUTLOOK FOR 1965

Evidence on the economic outlook for GNP and prices has helped to guide the formulation of this year's economic policy proposals. In turn, the President's program has an important influence in strengthening the prospects for sustained prosperity with price stability in 1965.

PROSPECTS FOR GROSS NATIONAL PRODUCT

With congressional enactment of excise tax reduction, social insurance liberalization, and other key fiscal proposals as scheduled in the President's program, GNP for 1965 is expected to lie within a $10 billion range centering on $660 billion. At the midpoint of this estimated range, the dollar growth in GNP this year would equal the increase of $38 billion in 1964. But because GNP has risen in the past year, matching the dollar gain of 1964 would mean a percentage increase about half a point less than the 6½ percent registered in 1964. In constant prices, the increase in output is likely to exceed the growth of potential, reducing the gap moderately.

The range from $655 billion to $665 billion recognizes the limited precision of economic forecasting. Although the midpoint of the projected range in the Council's last Annual Report was within $1 billion of actual GNP for 1964, such accuracy cannot be counted on every year. Economists are still far from a complete understanding of the determinants of consumer and business spending. Nor do they yet have completely accurate measures of recent trends and levels of economic activity, so important to an assessment of the near future. Moreover, unforeseen events external to the domestic economy can have important effects on business activity. The evident shortcomings and pitfalls in forecasting highlight the need for constant surveillance of changes in output and employment and for flexibility in economic policy.

The available evidence points to new gains in expenditures by consumers, businesses, and governments. The increases in the components should reinforce one another; they sum up to the prospective increase in GNP.

Government. Purchases of goods and services by State and local governments are likely to be nearly \$5 billion higher than in 1964, maintaining their recent upward trend and benefiting from further expansion of Federal grants-in-aid. Federal purchases of goods and services are expected to increase by about \$½ billion this year. In fact, 1965 will mark the first year since 1950, and only the second year since 1940, in which State and local purchases will exceed those of the Federal Government.

Business fixed investment. Business outlays for durable equipment and new construction were stronger in 1964 than surveys of business intentions had initially indicated. Prospects are excellent for a further expansion in 1965. Capacity utilization rates in manufacturing, although still below preferred levels in almost all industries, are above those of a year ago. These improved rates, together with the sales increases expected by manufacturers, validate the investment made in 1964 and provide incentives for further expansion. In addition, lower corporate taxes have raised the after-tax yield of investment. Furthermore, the gross cash flow retained by business remains high in relation to capital outlays, thus permitting new investment to be financed with comparative ease.

The survey of intentions to invest--jointly conducted by the Department of Commerce and Securities and Exchange Commission—indicates that new plant and equipment expenditures in the first half of 1965 will be approximately \$3½ billion (annual rate) above those in 1964. For the year as a whole, the advance in business fixed investment should come close to, but probably not match, last year's rise of \$5½ billion.

Inventory investment. Inventory accumulation in 1964 was surprisingly modest. Indeed, despite the stronger gains in final sales, such investment was lower in 1964 than in 1963. Inventories today seem unusually conservative relative to prospective sales, and are expected to rise somewhat more rapidly this year. Accumulation may exceed last year's rate by about \$2 billion.

Residential construction. The value of residential construction in 1964 was \$1 billion higher than in 1963, but it moved downward during the course of the year. It seems unlikely that outlays for home building this year will substantially exceed those in 1964: housing starts in the final quarter were a little below the annual average; overbuilding of apartments occurred in some localities. On the other hand, sales of new single-family homes have held up well and basic forces appear strong enough to prevent a further decline in home building. Family incomes are high and rising. With a plentiful supply of funds on hand, savings and loan institutions and other financial intermediaries will continue to welcome qualified mortgage loan applicants. Although the number of housing starts may be lower than in 1964, the average value per start is likely to rise. Thus, total outlays on new private residential construction in 1965 are expected to show little change from 1964.

Consumption expenditures. Consumption expenditures are likely to rise at a slightly more rapid rate than disposable personal income. Full adjustment to the tax cut should bring down the saving rate below the 7½ percent of 1964. The excellent reception of the 1965 auto models and the continued strength of used car prices augur well for new car sales. The exceptionally strong rise in household durables last year is not likely to be duplicated in 1965, though sales should advance further. The proportion of consumption composed of services and nondurable goods is likely to rise in 1965 from its 1964 value.

In 1964, disposable income was boosted substantially by the tax cut; this year, less fiscal stimulus is in prospect. Gains in household purchasing power will depend mainly on incomes generated by advances in the expenditure categories discussed above. In all, increases in consumption expenditures should account for about two-thirds of the rise in GNP.

Quarterly pattern

The pattern of advance during the course of this year will have an important influence on the continued balance of the expansion. Backlogs of demand resulting from the strikes in the automobile industry in the autumn of 1964 are likely to add strength to over-all production in the current quarter. On the other hand, Federal fiscal measures, including the excise tax reduction and social insurance liberalization, should strengthen the advance in the second half of this year. While the outlook for business fixed investment and consumer buying inclinations is necessarily more uncertain for the later months of the year, the evidence does not suggest a weakening.

Conditions in the steel industry present the chief visible threat to prospects for a balanced pattern of quarter-to-quarter advances. Manufacturers are likely to continue to augment their stocks of steel during the next few months as a defense against a possible strike after May 1. In the event of a strike, added inventories of steel would provide a useful reserve, permitting continued production of fabricated products. Nevertheless, a steel strike of significant duration would have unfavorable effects on over-all income and production, as the economic annals of 1956 and 1959 demonstrate.

If a collective bargaining settlement is reached near the deadline without a work stoppage, stocks of steel will be reduced during the second half of the year. Under such conditions, a rapid rise in activity during the next few months might be followed by much smaller advances during the rest of the year, possibly accompanied by increasing unemployment. It is particularly difficult for economic policy to deal with such a transitory situation—either on the upside or the downside. Thus, a prompt and responsible settlement in the steel industry is important for sustained, balanced advance in 1965.

Employment

Expected output gains in 1965 are likely to increase employment substantially, but not quite as much as last year, when more than 1.5 million jobs were created. The expected increase in the labor force is nearly as large as the prospective gain in jobs; normal demographic trends are expected to bring in 1.3 million net new entrants and recent improvements in job opportunities may add to that number. Some decline from the 5.2 percent unemployment rate of last year is likely in 1965.

OUTLOOK FOR PRICES

The size of the existing gap and the prospects for GNP suggest that widespread pressures on the supply capabilities of the economy are not likely to emerge this year. There are good prospects for extending in 1965, our recent record of price stability, just as it was maintained last year when production accelerated and unemployment declined. Wholesale prices are more volatile than consumer prices, and they are likely to show earlier movements. For this reason, the discussion below is concentrated on the outlook for wholesale prices this year.

The industrial component of the wholesale price index rose by 0.6 percent between the fourth quarter of 1963 and the fourth quarter of 1964. This increase was modest, particularly when compared with the rise of 3.2 percent a year between the final quarters of 1954 and 1957. But it was the largest rise over four quarters since early in 1960, and raised wholesale industrial prices back to the peak reached at that time. Hence, it is important to ask whether these prices have begun a renewed upward trend. The significance to be attached to the recent movements depends in part on their breadth, the character of the force behind them, and the indirect effects they might be expected to have on other prices.

An examination of price movements during the past year in the major industrial commodity groups (Table 9) shows that the over-all rise in average wholesale industrial prices was primarily the result of large price increases in nonferrous metals and in steel scrap. These two groups together account for an increase in the industrial index equal to nine-tenths of the total rise. In large part, the rise in nonferrous metal prices reflected curtailment of supplies as a result of strikes and political crises affecting important world production centers. These price increases have already spread to fabricated metal products.

The only other major commodity group to contribute more than 0.1 percentage point to the rise in the over-all index was nonelectrical machinery. The price rise for this group was 1.6 percent during the past year. Because of the low rate of productivity advance in this industry, prices have typically risen, with increases averaging 1.0 percent annually in the last several years.

Price movements of the remaining commodity groups were almost evenly divided between rises and declines, and generally consistent with their pattern of recent years. The steady downward trend in prices of electrical machinery and equipment, petroleum, and rubber products contrasts with their upward direction in previous expansions.

TABLE 9.—*Changes in wholesale industrial prices, by major commodity groups, fourth quarter of 1963 to fourth quarter of 1964*

Commodity group	Weight in total industrial index (percent) [1]	Change in price index, 1963 IV to 1964 IV	
		Percentage change	Contribution to total change (percentage points)
Total industrial products	100.00	0.6	0.59
Metals and metal products [2]	17.14	3.2	.54
Nonferrous metals and scrap (excluding aluminum)	3.00	13.9	.42
Iron and steel scrap	.42	28.6	.12
Semifinished and finished steel	4.56	−.7	−.03
Aluminum ingot, mill shapes and fabricated products	1.20	.7	.01
Nonelectrical machinery	9.64	1.6	.15
Textile products and apparel	10.32	.4	.04
Chemicals and allied products	8.88	.9	.08
Motor vehicles and parts	6.69	.8	.05
Passenger cars, trucks, and busses	5.30	−.7	−.04
Motor vehicle parts and accessories	1.38	6.6	.09
Hides, skins, leather and products	1.85	2.2	.04
Lumber and wood products	3.62	.6	.02
Furniture and household durables	5.38	.4	.02
Nonmetallic mineral products	3.79	.5	.02
Tobacco and beverage products	3.23	.0	.00
Pulp, paper, and allied products	6.44	−.4	−.03
Electrical machinery	6.25	−1.1	−.07
Miscellaneous products [3]	4.54	−1.3	−.06
Rubber and products	1.97	−2.1	−.04
Fuels and related products, and power	10.36	−1.2	−.13

[1] As of September 1964 with 1958 quantity weights.
[2] Includes some groups not shown in this table.
[3] Includes transportation equipment other than motor vehicles and parts.

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

Source: Department of Labor.

These facts indicate that the recent increases in wholesale industrial prices should not be viewed as a harbinger of further advances this year. The ample capacity for expansion of output in most manufacturing industries is shown by Table 10. Actual operating rates in December 1964 exceeded preferred rates in only rubber and textiles, although nearly all industries were using more of their capacity than a year earlier. The rubber industry benefited from record automobile production, while new cotton legislation enabled the textile industry to compete more effectively with imports while expanding exports. Despite high operating rates, prices in both of these industries declined in 1964.

Twelve of the industries, including all durable goods industries except nonferrous metals, can still increase operating rates by 2 or more points before reaching preferred levels. Moreover, most industries have been steadily increasing capacity; and the planned levels of manufacturing investment for 1965 point to continued rapid expansion of capacity, sufficient to produce the expected gains in output without significant increases in operating rates.

TABLE 10.—*Operating rates and backlog of unfilled orders in manufacturing industries: 1963 and 1964*

[As of December]

Industry	Operating rate (percent) [1]		Preferred operating rate (percent) [2]	Preferred rate less operating rate (percentage points)	Backlog of unfilled orders (months) [3]	
	1963	1964		1964	1963	1964
Total manufacturing	85	88	92	4	2.36	[4] 2.52
Iron and steel	70	88	91	3	1.35	2.09
Nonferrous metals	90	95	95	0		
Machinery	82	88	91	3	2.65	2.89
Electrical machinery	78	84	93	9	2.93	3.08
Autos, trucks, and parts	89	94	96	2		
Other transportation equipment	80	79	88	9		
Fabricated metals and instruments	84	88	92	4	2.37	2.64
Chemicals	80	79	90	11		
Paper and pulp	90	93	97	4		
Rubber	92	96	94	−2		
Stone, clay, and glass	77	79	88	9		
Petroleum and coal	90	93	95	2		
Food and beverages	80	79	86	7		
Textiles	95	97	96	−1		
Miscellaneous manufacturing	88	86	94	8		

[1] Output as percent of capacity. Data for 1963, excluding iron and steel, from McGraw-Hill; estimates for iron and steel in 1963, and all industries in 1964, by Council of Economic Advisers, after consultation with McGraw-Hill, Department of Economics.
[2] McGraw-Hill survey data for December 1962, the latest available.
[3] Ratio of unfilled orders to shipments (seasonally adjusted) for those industries for which detail is available.
[4] November.

Sources: McGraw-Hill Publishing Company, Department of Commerce, and Council of Economic Advisers.

The ease with which manufacturing industries have been meeting rising demands is also indicated by the relatively mild increases in the ratio of order backlogs to shipments from December 1963 to December 1964. These increases, following declines during 1962 and 1963, left over-all manufacturing backlogs no higher relative to shipments than at the end of 1961. On the basis of the prospects for GNP reviewed above, backlogs would not be expected to grow significantly in most industries this year.

Continued stability of unit labor costs during the current expansion (reviewed in Chapter 1), and particularly in manufacturing from 1963 to 1964, has helped to hold down prices. Prospective labor supplies should assure against any widespread tightness in labor markets and should exert a restraining influence on wage settlements. Moreover, the current concern with work rules and job security tends to reduce the "pattern-setting" effect of large wage settlements in key industries.

Furthermore, the revised depreciation guidelines, investment tax credit, and corporate tax reduction have strengthened after-tax cash flow in many industries and aided price stability. For example, the contribution of these

Federal fiscal measures to cash flow in the steel industry was the equivalent of a 3 percent price increase in 1964.

Thus, many important factors are working to preserve wholesale price stability. Price increases from demand pressures are likely to be limited to a few specialized areas, such as occurred in nonferrous metals in 1964; and price reductions can be expected elsewhere—particularly in industries with rapidly increasing productivity. But there are areas in the economy where management and labor possess the market power to exercise some discretion in their price and wage decisions, and, in particular, to make inflationary decisions even in the absence of excess demands. With responsible decisions by business and labor, 1965 should see continued price stability.

GROWTH PROSPECTS FOR THE LONGER RUN

The growth of potential GNP depends on long-run demographic, economic, and technological factors that are partly beyond the control of public and private policies. But it is also influenced by a variety of public and private decisions that can and should be made with a view to their effect on the growth of productive capacity. Some of these policies are referred to below. Growth rates of potential output vary from country to country, and in our own history they have differed considerably from period to period. Potential GNP grew rapidly in the early postwar years and then more slowly after the Korean conflict. Under current policies, potential output seems to be accelerating and will probably continue to speed up between now and 1970, reflecting the increases in labor force and long-run productivity.

LABOR FORCE

The labor force is expected to grow much more rapidly during the remainder of the 1960's than it has in recent years. Apart from increases in participation rates that would be induced by improved employment opportunities, the expected annual growth to 1970 is 1.7 percent, or about 1.4 million persons, a major acceleration from the yearly average of 1.2 percent, or 0.9 million persons, in the past nine years.

Different age-sex groups are expected to grow at different rates. The projected increase in the number of males between the ages of 25 and 54 years is only 0.7 percent a year from 1964 to 1970. The rest of the labor force—all female participants and male participants aged 14 to 24 and 55 years or more—will be increasing at the much higher rate of 2.4 percent. The fraction of the total labor force made up by males in the 25–54 age group fell from 45 percent in 1955 to 42 percent in 1964. And this downward trend will continue during the remainder of the 1960's. The tremendous growth of the other groups presents an important challenge to the manpower policies discussed in the next chapter, since these groups may be more difficult to absorb into the ranks of the employed. The more rapid over-all expansion of the labor force will increase the growth rate of potential output in the years ahead. It emphasizes the economy's need for—and its capacity to meet—a steady and substantial growth of demand.

PRODUCTIVITY

Productivity has increased rapidly in the current expansion. But this is typical of a period of improving utilization rates, since labor and capital are used more efficiently. The recent performance does not provide clear evidence that the long-run trend of productivity growth has changed, but there is some evidence that it may have risen slightly in recent years.

A gradual improvement in the trend of productivity growth may be expected from our sustained expansion and higher investment. Higher rates of investment increase the quality as well as the quantity of available productive capital, since the latest technology is embodied in new machinery and equipment. Periods of expansion are also favorable to the introduction of new and improved products and processes that may raise productivity without requiring substantial capital investments.

While all these factors have effects that are predictable at least in direction, their quantitative impact is gradual and defies careful measurement.

The prospects for growth of the labor force and productivity suggest that the increase of potential GNP in 1965–70 will exceed the 3½ percent annual rate of the 1955–62 period and even the 3¾ percent rate estimated currently. Indeed, over the next five years it is likely to average about 4 percent a year, a rate approaching that of the early postwar period.

In the long run, with policies promoting growth as well as full utilization, it should become possible and desirable to surpass even this growth rate.

PRIVATE DEMAND

Whether our rapidly growing potential GNP will be fully realized as actual GNP during the remainder of this decade will depend upon the strength of aggregate demand. And aggregate demand, in turn, will reflect both Federal policies and the strength of spending by other sectors—households, businesses, and State and local governments. The buoyancy of private spending will determine whether Federal policies need to be relatively expansionary or restrictive in pursuing full employment with stable prices.

Fluctuations in the long-term strength of private demand have changed the tasks of Federal policies in the past. During 1947–53, private demand was exceptionally strong and restrictive government policies were needed much of the time to keep demand from pressing too hard on capacity.

The United States emerged from World War II with depleted and aging stocks of homes, household durable goods, automobiles, and plant and equipment, reflecting the low levels of private investment during the Great Depression and the wartime emergency restrictions on civilian purchases. The war also generated a large accumulation of liquid assets by consumers and business firms. With a strong desire for rebuilding and updating their stocks of durable goods and with the financial ability to translate this desire into effective demand, the American consumer and businessman were eager spenders. The military and industrial build-up associated with the Korean conflict intensified the ebullience of the economy and prolonged the adjustment of stocks into the 1954–57 period.

The economic environment since 1957 has differed significantly from that of the previous decade. A persistent gap has developed between potential GNP and actual GNP. The immediate reasons for the existence of this gap are fairly evident. First, restrictive full-employment surpluses in the Federal budget emerged. Second, private demand has not been sufficiently buoyant to overcome the fiscal drag of these potential surpluses. There has been no accumulated backlog of demand for housing, consumer durable goods, or business capital. And—although there has been no dearth of youngsters and oldsters—the number of new families in the market for houses, furniture, appliances, and cars has grown at only a modest pace.

We are now on the threshold of a more rapid increase in the number of persons reaching working age. Just as this will accelerate the potential output of the economy, so too will it add to the underlying strength of private demand for a range of business and consumer investment goods.

There is no assurance, however, that the increase in effective demand for goods and services will synchronize precisely with the added productive potential represented by the surge of new entrants to the work force. Indeed, the demographic patterns for the next decade, coupled with information on the broad spending habits of different age groups, suggest that the strengthening of private demands will be most significant in the 1970's. But these projections also suggest there should be a steady, if less spectacular, growth in private demand during the remainder of this decade. There is also a promising possibility that private demand will be stimulated by the sharply rising research and development expenditures of recent years.

Spending by individuals

The forthcoming changes in the age-structure of the population will have their primary influence on over-all demand by affecting spending for durables and housing. Purchases of new houses almost invariably involve a large element of long-term credit. Since this is repaid gradually out of normal saving, the homebuyer is not obliged to curtail his current consumption expenditures. Purchases of cars and household durable goods are typically financed by credit or past savings, and expenditures on these durables may in part add to, rather than replace, other types of spending. Thus, particularly strong demand for houses and durables can raise total spending by individuals relative to total income.

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Individuals are most likely to be in the market for homes and durables in the period between marriage and the age at which their children are grown. On the other hand, families in the 45–64 age group are likely to be high savers, with the major need for durables behind them and the prospects of retirement coming into view. When people retire, they generally have low current incomes and draw down their life savings, thereby once again contributing to demand relative to their incomes.

The high birth rates of the postwar period will strengthen the demand for automobiles sooner than they will affect housing; indeed, they have already helped to invigorate both new and used car markets. The first postwar babies are already of driving age and, in the last half of this decade, the number of persons in the 20–24 age group will rise sharply (Table 11). The favorable population factor, continued preferences for multiple-car ownership, and a large volume of replacement demand (now about 5½ million a year) will all contribute to a rising potential demand for automobiles during the rest of the 1960's and into the 1970's.

TABLE 11.—*Population 20 years of age and over, by selected age groups, 1960 estimate, and 1965–75 projections*

[Millions of persons; as of July 1]

Age group	1960 estimate	Projections		
		1965	1970	1975
Total, 20 years and over [1]	111.1	117.6	126.8	137.2
20–24 years	11.1	13.6	17.1	19.1
25–34 years	22.9	22.4	25.2	31.1
35–44 years	24.2	24.5	23.0	22.5
45–64 years	36.2	39.0	41.9	43.4
65 years and over	16.7	18.1	19.6	21.2

[1] Includes armed forces overseas.

NOTE.—Detail will not necessarily add to totals because of rounding.
See Table B–20 for additional population data.

Source: Department of Commerce.

Rapid growth during the rest of this decade of persons in the 20–24 age group will contribute to the demand for multi-family dwellings, since these people are typically renters. Meanwhile, people in their late twenties will also be increasing in number, although less sharply, and will be starting to buy their own homes. Between 1970 and 1975, population developments should have a major impact on the demand for new housing as the 25–34 age group swells by almost 6 million persons, as shown in Table 11.

The typically high-saving group—persons aged 45–64—will grow only slowly, and its relative importance will decline throughout the 1965–75 decade. The number of persons over retirement age meanwhile will rise by one-sixth. Thus to some degree over the next five years and to a greater extent in the 1970's, population trends should contribute to a strong demand for residential construction and for consumer goods and services relative to total incomes.

Continued rapid expansion of actual output and job opportunities is required to translate this latent spending, suggested by population trends, into effective demands. With full employment still some distance away and with unemployment already high among younger workers, Government policies must continue to be expansionary and manpower policies must be diligently pursued so that jobs and incomes can be made fully available to these workers. If these people obtain jobs, their demands for goods and services will help to maintain full employment.

Business fixed investment

If the economy successfully meets the challenge of attaining and maintaining full employment, the stepped-up growth of the labor force will also have favorable effects on the strength of investment demand. With more men on the job, more tools would be needed to outfit them efficiently. If, over the next five years, two million additional private jobs are created to match the more rapid growth of the labor force, the economy would, on that account, require roughly $25 billion of extra capital. This would be a major addition to investment demand. On the other hand, if labor should be in excess supply—if the economy fails to attain full employment—the incentives for increasing capacity and economizing on labor would weaken.

Although more uncertain than the population trends, another factor that could stimulate investment in the coming decade is the speeding of technological innovation. Research and development expenditures have quadrupled in the last decade and are continuing to rise, although less rapidly.

The reservoir of commercially exploitable technology can be expected to increase during the remainder of the decade. New technical developments will spur businessmen to replace older equipment more rapidly and to purchase equipment capable of producing entirely new products. On the other hand, some innovations may make capital equipment more efficient and thus reduce the amount of investment needed to create any given amount of capacity.

In the early postwar years, business fixed investment (in 1964 prices) typically exceeded 11 percent of GNP. Since 1958 it has constituted only about 9 percent of our national output, and also a smaller fraction of gross retained earnings of corporations. For the remainder of this decade, investment is likely to contribute more strength to the economy than it did typically in the 1958–63 period, but it cannot be expected to match its early postwar performance, when heavy backlogs added to demand.

Conclusion

The bulk of evidence points to a moderate and gradual strengthening of underlying demand on the part of consumers and businesses. Expenditures for goods and services by State and local governments should also continue to serve as an expansionary force in the years ahead. Over the longer run, these developments may gradually alter the appropriate direction of fiscal and monetary policy. Over the next few years, private demand will need the support of expansionary Federal policies if we are to attain full employment and realize our more rapidly growing potential.

POLICIES FOR PROSPERITY

Prosperity requires achieving and maintaining a balanced advance of demand and productive capacity. Notwithstanding the long historical record of periodic recessions or depressions, there is much evidence in economic analysis and in postwar experience, both here and abroad, that such a balance can be sustained.

Experience and logic also warn us, however, that balanced growth seldom sustains itself automatically. Fiscal and monetary policies must be continuously adjusted to keep the aggregate demand for goods and services in line with the economy's growing capacity to produce them. Flexible use of monetary and fiscal measures is one of the factors responsible for the steadiness of postwar economic progress in other industrial countries of the free world. It has also played an important role in our expansion since 1961.

The U.S. record of recent years is gratifying. But it would be much more gratifying if it had occurred with unemployment rates steadily in the neighborhood of 4 percent, and with industrial operating rates near the levels preferred by industry for maximum efficiency. The record gives us great reason to hope that the U.S. economy is capable of steady and balanced advance at more satisfactory rates of utilization of manpower and industrial capacity. The same wisdom and flexibility in public and private policies which have sustained this expansion could sustain growth at roughly the same pace but at a higher level. The manpower and other policies described in Chapter 3 would then have a particularly important role to play; combined with the price and wage policies described later in this chapter, they could assure that expansion would proceed at stable prices.

That unemployment has fallen only to 5 percent after four years of steady economic expansion is clear evidence of the immense and growing productivity of the American economy. Basically, this should be a cause for hope rather than for despair. But it takes adequate total demand, and adequately growing total demand, to harness this potential to the needs and wants of the American people.

FISCAL POLICY TO SUSTAIN EXPANSION

Fiscal policy is the Federal Government's most powerful instrument for influencing total demand. Changes in Federal purchases of goods and services can have an important effect on over-all economic activity. Similarly, variations in Federal taxes and transfer payments have major influence on the flow of after-tax earnings to private spending units.

As discussed in Chapter 1, the full-employment surplus is a useful measure of the over-all impact of the Federal budget on economic activity. Changes in this surplus indicate whether the Federal budget is becoming more or less expansionary. When aggregate demand needs a stimulus in order to achieve full employment, it is appropriate to reduce the full-employment surplus. When a restrictive influence is called for, the full-employment surplus should be raised.

As our productive capacity grows through time, so do Federal tax revenues at full employment. Indeed, the percentage growth in Federal revenues tends to exceed slightly the growth in potential GNP. Consequently, if Federal tax rates are unchanged and expenditures grow less rapidly than potential output, the full-employment surplus tends to rise, restricting the expansion of total demand. When the economy is threatened with excessive demand, this restrictive influence is desirable. But it is not appropropriate when the economy is well below full employment. The need for fiscal measures to prevent undesired increases in the full-employment surplus also provides opportunities to pursue important national goals: by expanding or initiating vital Federal programs, by assistance to State and local governments, or by further tax reductions or increases in transfer payments to individuals.

Uses of expanding revenues

Many national needs will be met only if the Federal Government takes the lead. While increasing efficiency within the Government will serve to hold down the growth of budget expenditures, it is to be expected that Federal nonmilitary outlays will increase in 1965 and the years beyond. Some of these outlays will be public investments in physical capital and human resources. Grants are also likely to rise as the Federal Government assists State and local governments in strengthening public services that are best provided at the local level. Transfer payments will increase, as a compassionate society strives to aid the needy and to provide greater security for all its citizens. And a growing and more prosperous population will need and desire improved public services as part of a higher standard of living.

Tax reduction also offers attractive benefits. It provides opportunities for raising living standards through private consumption. Furthermore, lower income tax rates can strengthen the incentives to undertake risks, to work, and to exercise initiative. Thus tax cuts can invigorate markets and encourage the supply of new products and services through private enterprise.

Choices and requirements of budget policy

The allocation of our potential growth in revenues should reflect national priorities. To the extent that a democratic society desires to make additional resources available to meet pressing public needs and wants, increased Government outlays are called for. Alternatively, tax rate reductions give priority to private uses of resources. The criteria for this choice are not primarily economic. But economic analysis clearly indicates that, unless excess demand threatens, the Nation's fiscal dividend must be allocated between increased outlays and reduced taxes. Only in this way can fiscal policy promote sustained prosperity.

Fiscal policies for other objectives

Fiscal policies to achieve and maintain full employment must be shaped to permit simultaneous progress toward other economic objectives, including more rapid growth of potential output and improved international balance. Fortunately, fiscal policy is a versatile kit of tools. Through changes in the structure of taxes and the composition of public expenditures, it can contribute to these other goals.

The recent reductions in corporate tax rates, the investment tax credit, and depreciation reform, by increasing both financial resources and profitability, have stimulated investment and have contributed to the growth of potential output. The composition of public expenditures this year will put increased emphasis on education, which will improve the skills of the labor force and will speed technological advance. Federal expenditures for resource development, transportation, and research will open up profitable new investment opportunities for private enterprise. Such fiscal steps to raise the rate of growth are particularly important in periods when downward adjustments of interest rates are limited.

Similarly, financial measures directly affecting the international area, such as changes in the tax treatment of foreign earnings enacted in 1962 and proposed measures to improve the tax treatment of foreign portfolio investment in the United States, can influence capital flows and hence the balance of payments. Finally, special taxes, such as the Interest Equalization Tax, can be appropriately used under some conditions. Such special taxes cannot be properly considered basic elements of long-run policy, since they qualify the freedom of international trade and capital movements. In particular circumstances, however, they can be the least costly and least disruptive way of dealing with temporary pressures.

Current fiscal program

With the economy currently below full-employment levels, continued rapid expansion of output is called for in 1965. Federal budgetary policy has been designed with this need in mind. Past fiscal measures lowering individual and corporate taxes will continue to strengthen the economy this year. The income tax cut will reach its full effect on consumer demand and have added influence on investment. In addition, new fiscal actions to sustain the expansion of the economy are set forth in the President's proposed budget.

In accordance with the Revenue Act of 1964, tax rates on 1965 incomes will be lower than those last year. Most of the tax cut's direct effect on disposable income, however, was experienced beginning in March 1964 when the withholding rate fell from 18 percent to 14 percent. This year, taxpayers will benefit from twelve rather than ten months of lower withholding, but the withholding rate will be unchanged. Hence, the "second stage" of the personal income tax cut will provide very little fresh stimulus. Indeed, when final settlements of 1964 taxes are made this spring, tax refunds will be reduced by more than $1 billion from last year's level, because the withholding rate was lowered in 1964. Nevertheless, the consumption-increasing effects of the original gain in disposable income have not as yet been fully realized. Expenditures out of the initial gain in income, in turn, lead to higher income in a continuing, but diminishing, chain. The time lags in this process are such that as much as one-fourth of the full annual consumption effect of the tax cut—or a gain of $5 billion—remains to be felt during 1965.

Favorable repercussions on investment should also continue. With the stimulus of improved operating rates, higher before-tax profits, and lower corporate taxes, business fixed investment rose strongly during 1964. Since even more substantial lags exist in investment spending, and since corporate profit tax rates are reduced by another 2 percentage points in 1965, tax reductions are continuing to strengthen fixed capital outlays.

Fiscal 1966 budget

In addition to the stimulating effects of past fiscal policies, the President's budget program for fiscal 1966 calls for several new expansionary actions. First, an excise tax reduction of $1¾ billion is proposed to take effect on July 1, 1965.

After substantial recent reductions in corporate and in individual income taxes, it is appropriate to direct further tax relief at excises this year. Present excises were imposed, in many instances, as wartime emergency measures. In some instances, their collection is cumbersome and inefficient. Purchases of taxed products by low-income families may result in these families paying a higher tax in relation to their income than is paid by other consumers. Finally, excises may affect relative prices in a manner that reflects neither costs of production nor social judgments, except in cases where they serve in lieu of "user charges," such as the gasoline tax earmarked for highways, or where they result from a deliberate social decision to restrain the consumption of certain products, such as liquor and tobacco.

Excise tax cuts will raise the real purchasing power of disposable incomes, provided that they are passed on to consumers in lower prices, and this gain will produce essentially the same chain of effects as income tax reduction. But price reduction is vital to the full effectiveness of excise reduction. If prices do not fall, the resulting gain will be in profits rather than in consumer income. Half of the gain in corporate profits would be returned to the Government in higher profit taxes, thus cutting the effective excise tax reduction by one-half. The remainder would offer no direct stimulus to consumer demand and would provide at best a weak and inefficient incentive to investment. Prompt price reductions for the affected products are of crucial importance and can be expected to be brought about by competitive forces.

A second expansionary influence for 1965 is the proposed social insurance legislation. Liberalization in social security benefits amounting to more than $1¼ billion a year is to be enacted by midyear and will be effective retroactively to January 1, 1965. For the sound long-run financing of the social security trust funds, a rise in payroll tax rates and a revision in the tax base are scheduled for January 1, 1966.

Finally, Federal outlays (as shown in the national income and product accounts) will rise in 1965 by $3½ billion over and above the social insurance liberalization. Most of the increase will be in the form of larger transfer payments and grants-in-aid to State and local governments, rather than purchases of goods and services; and much of the increase will occur in the trust funds rather than in the administrative budget. Some new and expanded activities—many of which are discussed in the following chapters—are provided for in the budget; their cost is partly offset by economies in less urgently needed programs.

The excise tax cut and social insurance liberalization will stimulate consumer spending in the second half of this year. The expansionary actions in the President's program will more than offset the full-employment growth of Federal revenues and thus will reduce the full-employment surplus during 1965. The full-employment surplus is scheduled to increase in the first half of 1966 because of the rise in payroll taxes. Therefore, the rate of economic advance in the next eighteen months will reflect, to an increasing degree, the strength of private demand. The record of this period should test the economy's ability to advance in high gear with a small, but no longer declining, full-employment surplus.

The response of the economy to this test could call for revisions in budget policy. If private demand should show signs of cumulative weakness, it would be appropriate to provide new fiscal stimulus. Alternatively, if private demand should strengthen markedly and threaten to strain productive capacity, fiscal and monetary policies should be shifted in a restrictive direction.

Policies can respond to unanticipated developments as they emerge. But they would be faced by a dilemma if price-wage pressures were to threaten our record of price stability while the economy remained below full employment. Under such circumstances, restrictive measures might offer a weak antidote to inflation by making the environment less favorable for price increases; but at the same time these policies could have a sharply adverse effect on employment and could impair the productivity gains that permit higher wage rates within a framework of constant unit labor costs.

FISCAL POLICY TO COMBAT RECESSION

Flexibility in fiscal policy is especially important when the economy is suddenly threatened with recession. Continuing policies to strengthen expansion supply a solid first line of protection against recurrent recession. But imbalances can develop in a free enterprise economy, and can trigger costly and cumulative downturns in business activity. Automatic fiscal stabilizers help to cushion the economy in a period of declining activity. But they must be supplemented by strong and prompt discretionary fiscal actions if we are to minimize the severity of recessions.

Flexible use of fiscal policy requires cooperative efforts by the Administration, the Congress, and the public. The Administration is determined to recognize the problem candidly and to take decisive action promptly when economic activity is faltering. The Congress contributes by being prepared to consider the President's proposals with all possible speed. The public—consumers, business, and labor—can be expected to regard constructive Government policies to combat recession as a source of strength rather than as a reflection of weakness. The bright prospects for continued expansion this year offer an opportunity to review the available means for such cooperative action, so that our defenses will be strong when and if they are tested in the future.

Costs of Recessions

Even minor recessions have huge costs. In the postwar period, the United States has successfully avoided a recurrence of the seriously depressed conditions of the 1930's, but it has experienced four recessions which caused personal hardship for millions of Americans. During the course of these recessions, on average, real GNP fell by more than 3 percent; the unemployment rate rose by 2 percentage points; and corporate profits fell by more than 25 percent. In the years most heavily scarred by recession, the number of people unemployed long enough to exhaust their unemployment compensation benefits rose by 840,000; the number of families with incomes below the $3,000 poverty line rose by 400,000; and the number of families receiving general assistance payments rose by 70,000.

Automatic Stabilizers

These recessions would have been far more costly had it not been for the "built-in" fiscal stabilizers of our modern economy. During recession, Government purchases resist the decline in private outlays. Moreover, Government transfer payments rise as unemployment increases; and tax collections fall as corporate profits and wages decline. Thus, the Federal tax-transfer system automatically draws less purchasing power out of the private sector.

In postwar recessions, built-in stabilizers have worked primarily through changes in corporate profits, the corporate tax yield, and transfer payments.

The 1960–61 recession can serve as an illustration. During that recession, national income fell by $4.5 billion (annual rate), but personal income actually rose by $5.2 billion. Corporate profits bore the brunt of the decline, but reductions in corporation tax liabilities helped to maintain dividends. Increased transfer payments, including a $1.4 billion (annual rate) rise in unemployment benefits, offset some losses in earnings.

Strengthening the unemployment compensation system deserves high priority among possible steps to increase the automatic resistance of the economy to recessions. The most important reasons for improving the system are to increase individual security and reduce the unnecessary human costs of unemployment. But a strengthened system would also sustain consumer purchasing power more effectively, thereby reducing the amount of unemployment as well.

At present, the unemployment insurance system excludes about one-fifth of all workers; a particularly unfortunate omission is employees of small firms who are by no means immune to unemployment. Furthermore, average benefits presently amount to only about 35 percent of average wages in covered employment; in 1939, the average benefit was more than 40 percent of average covered wages. Finally, with the present maximum duration of benefit payments, a particularly large number of recipients exhaust their benefits during a recession period before new employment opportunities develop. During 1961, about 2.4 million workers exhausted benefits despite the relatively rapid upturn in business activity from the 1960–61 recession. A series of Administration proposals for strengthening the unemployment compensation system is being sent to Congress this year.

Discretionary Actions on Taxes and Expenditures

Although automatic stabilizers do much to moderate recessions, they cannot be relied on either to prevent them or to turn the tide. Federal taxing and spending measures that reduce the full-employment surplus can, however, be effective in reversing recession.

As the President has stated, ". . . *if* recession were to threaten, a well-timed tax cut would be one of our most effective measures." Therefore, he is asking Congress to consider how a temporary income tax reduction can be "well-timed" to combat recession. The President is suggesting that Congress itself evaluate its procedures and determine the best way to reinforce the Nation's confidence that an anti-recession tax proposal would be considered and voted on promptly.

Accelerated Government spending can also provide powerful assistance to the economy if recession should threaten. As noted in Chapter 1, rapid increases in Federal outlays were called for in 1961 to strengthen national security; these outlays also helped to spur recovery from the recession. In the future, we cannot count on new public expenditure requirements to develop just at the time of recession. Nevertheless, there are many continuing public needs which provide opportunities for expanding Federal outlays if additional fiscal stimulus becomes appropriate. These opportunities must be grasped promptly if they are to have maximum effectiveness. Yet such increases in spending should not commit the Government to a higher level of outlays than would otherwise be desirable, once the economy recovered.

Advance planning makes possible a careful selection of those expenditure programs which could be most efficiently and most rapidly expanded in time of recession and contracted after recovery. This would assure that agencies have workable anti-recession plans on hand, permitting speedier action by the Administration and Congress and improving the efficiency of stepped-up expenditures.

The anti-recession possibilities of a wide range of Federal programs will be reviewed by the Administration this year. Certain maintenance, rehabilitation, and modernization activities on Federal facilities, or on State and local facilities assisted by Federal grants, provide opportunities to push funds rapidly through already existing "pipelines." Unlike certain traditional public works, many of these activities could be expanded readily, employing workers without previous similar job experience and not requiring commitment to a long-term program. Various training and community service programs might also be intensified appropriately, since the poverty-stricken and the unskilled are doubly disadvantaged in times of slack economic activity.

Benefits of timely anti-recession actions

If action could be taken in time, either temporary tax cuts or the acceleration of selected Government programs—or the two in combination—potentially have the speed and power to repel recessions. The time patterns of the postwar recessions of 1953–54, 1957–58, and 1960–61 illustrate the possible benefits of quick action after a downturn has been diagnosed. In 1953, evidence of weakening in the economy was available by June and the forces of recession were evident by September. Symptoms of the 1958 recession were clear by November 1957; in 1960, the downturn in the economy was widely recognized by September. A tax reduction, enacted within the first quarter after recession became apparent, would have provided a substantial lift to consumer spending in the following quarter. This boost might have converted the last months of decline into the initial months of recovery. The major expansionary effect of the tax cut would then have strengthened the advance over the next few quarters.

The need for stimulation does not disappear as soon as the economy turns up. Indeed, many policy actions in the past have been designed to strengthen the early stages of recovery. Even with such measures, the unemployment rate was 6.4 percent three quarters after the 1958 trough and still 5.8 percent in the following quarter. In 1961–62, the comparable unemployment readings were 6.2 percent and 5.6 percent.

Thus, in recent recessions, had prompt expansionary action been possible, it could have limited the drop in output and employment, might well have shortened the duration of the decline, and would clearly have strengthened recovery.

A future recession might differ from its postwar predecessors. There is no definite assurance that a future downturn would be recognizable—or would be recognized—as rapidly. On the other hand, neither can we be sure that the decline would—in the absence of policy—be as short and as shallow. The best possible guarantee against a severe recession is corrective action taken promptly, before depressive effects can cumulate and reinforce themselves.

Furthermore, it may actually be possible in some instances to prevent recessions before a downturn appears. If the economy seemed poised on the brink of a downturn, and excess capacity and ample labor supplies were available, prudence would call for prompt expansionary steps, which might head off recession altogether. Under such circumstances, prompt measures would be appropriate even if future demands proved somewhat stronger than expected.

Summary

Both our increasing appreciation of the effectiveness of fiscal policy, and the continual improvement in the detail, accuracy, and timeliness of our economic information, strengthen the conviction that recessions can be increasingly avoided and ultimately wiped out.

Policies designed to maintain continued healthy expansion—through tailoring the expected growth of total demand to the expected growth of productive capacity—should lessen the chance that imbalances might arise which could touch off recessions. But unexpected events and miscalculations will still occur. When this happens, we must be prepared to act promptly. It will be easier to deal with recessionary tendencies, and in some cases even avert an impending downturn, if the Congress is ready to act quickly on requests for temporary tax cuts and if expenditure programs are ready for prompt submission to the Congress. This readiness would provide a strong and comprehensive insurance policy, backing up the continuous application of fiscal and monetary policies to sustain prosperity.

ROLE OF MONETARY POLICY

The degree to which fiscal policy should be stimulative or restrictive depends in part upon the monetary policies being pursued at the same time. Just as tax reduction stimulates private spending, so the ready availability of credit contributes to increased private outlays. In particular, spending for major durable goods—new housing, business plant and equipment, automobiles, and major household goods—is likely to depend in part upon the availability of credit and its cost. In an economy characterized by idle resources, expansionary monetary policy is desirable. It helps to strengthen private demand; at the same time, it contributes to the growth of productivity by encouraging investment for the purpose of developing and marketing new products and adopting up-to-date production techniques.

Growth of liquid assets

Over the long run, growth of economic activity must be supported by the continued expansion of monetary assets, since individuals and businesses need a growing volume of liquid balances for transaction purposes as their income and spending increase. The need for growth in liquid assets also results from investors' desires to hold some part of their wealth in assets that are readily accessible and free of risk.

Liquid assets can take a variety of forms, and new institutions are continually evolving to meet these needs. During the past thirty years, savings and loan associations and mutual savings banks have come to play an important role as competitors with commercial banks for the time and savings deposits of the public. Similarly, business firms frequently invest short-term funds in Treasury bills and in a wide and growing variety of other "money market" paper. Nevertheless, monetary assets provided by the commercial banking system continue to play a crucial role, since checks drawn on demand deposits constitute the most important medium of exchange for transacting day-to-day business. The growth of liquid assets, and particularly of the money supply, should keep pace with expanding requirements over the long run in order to support growth and economic advance.

Monetary expansion and gold reserves

As demand deposits and time and savings accounts at commercial banks expand over time, these banks are required to hold a growing volume of reserves which are largely deposited with the Federal Reserve System. Under current law, the Federal Reserve is required to hold gold certificates equaling at least 25 percent of the total of its deposits and outstanding notes, which constitute the major part of our currency. At the turn of the year, the gold holdings of the Federal Reserve amounted to about 28 percent of its liabilities in the form of deposits and notes. Apart from any changes in the U.S. gold stock, the provisions of current law would shortly circumscribe our freedom of action in achieving needed growth in our money supply. Although the Federal Reserve has the authority to waive the gold cover requirement, such a temporary expedient would not be a satisfactory response to a long-range need.

Monetary policy is formulated by responsible officials with a view to the public interest, and the presence of a mechanical limit on monetary expansion is inappropriate. Such a limit is either irrelevant—when the gold stock is far above the legal minimum—or harmful—when the gold stock acts as an arbitrary restraint. Consequently, the President has proposed that the Federal Reserve Act be amended to require gold cover only for Federal Reserve notes and not for deposits in Federal Reserve Banks. This will assure continued opportunity for monetary growth and for needed flexibility in the operation of monetary policy. In addition, it will emphasize the full availability of our gold stock, at its fixed price of $35 an ounce, to defend the dollar in international markets.

Limitations and opportunities for monetary policy

Monetary policy must serve both the domestic objectives of full employment and more rapid growth and the international objective of balance of payments equilibrium in the framework of a stronger international trade and payments system. Greater availability and lower costs of credit and liquidity help to stimulate total demand and economic growth. However, if U.S. interest rates—particularly short-term rates—were permitted to fall significantly below those in other international financial centers, domestic funds would tend to flow abroad in search of higher yields. Thus, the freedom of expansionary monetary action is necessarily limited when the Nation is determined to correct a balance of payments problem.

The constraints on the use of monetary policy for domestic purposes are related to the particular circumstances of the United States in recent years. Over the longer run, it may well be possible to increase the freedom of monetary policy. As the fabric of international cooperation is strengthened by continuing consultation, in such forums as the Organization for Economic Cooperation and Development (OECD), it should be possible to deal more fully with issues involving the interdependence of countries in setting their national economic policies. One important question is whether most of the world would be better off domestically—and no worse off internationally—if the industrial nations as a group had somewhat lower interest rates (offset in some countries by more restrictive fiscal policies).

This question may become particularly relevant in 1965, when the success of anti-inflation programs in some European countries, together with a slowdown in their domestic expansion, may encourage them to shift to a more expansionary policy. Some European countries are considering tax reductions for this purpose; an easier monetary policy and lower interest rates might be equally effective and could contribute to a better international structure of interest rates.

Despite the present international constraint, flexible use of the full range of instruments of monetary policy can continue to support domestic expansion. A combination of adjustments in maximum interest rates on deposits, open market operations in a wide range of securities, and changes in bank reserve requirements have been used in recent years to help to reconcile domestic and international objectives.

Through continued ingenuity in the choice of techniques, monetary and debt management policies in 1965 can meet international requirements and, at the same time, provide readily available credit to meet the needs of a noninflationary expansion. Thus, while fiscal policy must once again be the main contributor to the growth of demand, it can be supported by monetary policy.

WAGES, COSTS, AND PRICES

Maintaining essential price stability in 1965 must be a national objective of high priority. The record of price stability in recent years has made possible a substantial improvement in our ability to compete in world markets. This record has also contributed to a balanced advance and has kept fiscal and monetary policies free to be expansionary. Furthermore, price stability has promoted equity by preserving the purchasing power of people with fixed incomes and liquid assets.

We have not yet succeeded in reaching our employment goals in this environment of stable prices. The ability to reconcile full employment and price stability will have a major influence on our long-term ability to grow, to maintain a leading position in the world, and to build a better life for all Americans. Now, with improved prosperity and reduced margins of idleness, our institutional arrangements for setting prices and wages face a stiffer test in avoiding tendencies toward inflation.

Our institutions are adapted to modern technology, which, in many industries, requires an enormous scale of operation and huge investment in productive facilities and distribution systems. The resulting large firms necessarily possess substantial market power, and may be in a position to raise prices even when demand does not exceed supply. Still, the discipline of competition is always at hand. Competition from abroad often challenges industries with heavy domestic concentration. Competition between industries selling substitutable products reinforces competition within industries. And antitrust enforcement helps to promote competitive behavior. Thus, the pricing process reflects both the exercise of discretionary market power and the influence of impersonal market forces.

In labor markets, unions have been formed to allow workers to bargain on equal terms with these large firms. Many unions have become powerful, and they are in a position to hold their own in the periodic collective bargaining process. Although they are constrained by market forces, powerful unions can, and sometimes do, obtain wage increases that outrun productivity even when labor supply is relatively abundant.

Because flexible and competitive market forces are not alone in affecting prices and wages, a modern economy needs new policies to reconcile the objectives of full employment and stable prices.

In one way or another virtually every advanced country has devised policies aimed at this reconciliation. Several nations have pursued such policies for many years. In December 1964, the United Kingdom launched a major new venture aimed at the cost problems which have contributed so much to her economic difficulties: leaders of business and labor signed a declaration of intent to pursue price, wage, production, and employment policies that will result in over-all price stability and an improved competitive position.

Because of differences among nations in political and economic systems, each country must find a solution appropriate to its own institutions. The U.S. economy is larger than the others and, as a result, many of our industries, including heavy industries requiring large scales of operation, are more competitive than in Western Europe or Japan. Major discretionary market power is found less frequently here, but it is found in important industries which have a wide and pervasive influence on prices and wages elsewhere through emulation and direct cost-push.

Price-wage guideposts

To deal with the problem of reconciliation—achieving noninflationary price and wage behavior under prosperous conditions—the Council's Annual Report in 1962 advanced the guideposts which were endorsed by President Kennedy and have been firmly restated by President Johnson.

The basic guideposts are simple and straightforward and contain an inescapable economic logic.

1. *The general guide for wages is that the percentage increase in total employee compensation per man-hour be equal to the national trend rate of increase in output per man-hour.*

If each industry follows this guidepost, unit labor costs in the over-all economy will maintain a constant average.

2. *The general guide for prices calls for stable prices in industries enjoying the same productivity growth as the average for the economy; rising prices in industries with smaller than average productivity gains; and declining prices in industries with greater than average productivity gains.*

If each industry follows this guidepost, prices in the economy will maintain a constant average.

Some exceptions to these guideposts are necessary to promote an efficient allocation of resources and a high rate of growth, and to redress inequities which have kept certain workers at the bottom of the wage scale. Wage increases above the guidepost level may be necessary where an industry is unable to attract sufficient labor to meet the demands for its products, where wages are particularly low, and where changes in work rules create large gains in productivity and substantial human costs requiring special adjustment of compensation. Because the industries in which market power is concentrated are largely high-wage industries with a relatively low long-term rate of increase of employment, the first two of these exceptions are rarely applicable.

On the price side, increases in price above the guidepost may be necessary to allow for increases in nonlabor costs or to correct an inability to attract needed capital.

Each of these exceptions has a symmetrical counterpart calling for downward departures from the guideposts. Wages should rise less than the guidepost rate where an industry suffers from above-average unemployment and where wages are exceptionally high for the type of work. Price increases should be smaller—or price decreases larger—where unit nonlabor costs fall, where capacity is too large, and where profits are based on excessive market power.

The guideposts are not meant to preclude the possibility of a change in distribution of income between labor and capital in industry. Where one side or the other is able to increase its share of industry income, but not at the expense of the public, the national interest need not be involved. However, it should be kept in mind that in most concentrated industries the division of income between labor and capital remained essentially unchanged all through the wage-price spirals of the 1950's. The repeated attempts to alter income shares proved self-defeating: neither side gained, and both lost through higher prices, weaker markets, reduced profits, and lower employment.

Table 12 illustrates the postwar experience with prices, wages, and productivity in the United States. Recent changes in employee compensation have conformed to productivity gains much more closely than in the 1950's, and price increases have been much more modest.

The guideposts offer a standard for responsible business, labor, and Government leadership in an environment of informed public opinion. They are an attempt to operate our economy as it is—without controls, without wholesale fragmentation of our large, successful enterprises—and to maintain stable prices while using our resources, our capital, and our labor to their full potential. They are in the tradition of America, asking those to whom the society has entrusted economic power to exercise it in ways consistent with the national interest.

TABLE 12.—*Changes in productivity, wages, and prices in the private economy since 1947*

Year	Productivity [1]	Trend productivity [2]	Total compensation per man-hour	Prices		
				Implicit GNP deflator	Wholesale	Consumer
	Percentage change [3]					
1948	3.6		8.6	6.8	8.3	7.7
1949	2.8		2.5	−.8	−5.0	−1.0
1950	7.1		5.7	1.2	4.0	1.0
1951	2.5		9.3	7.9	11.4	8.0
1952	2.2	3.7	5.9	1.6	−2.8	2.2
1953	4.0	3.7	5.8	.6	−1.4	.8
1954	1.8	3.5	3.3	.8	.2	.4
1955	4.4	3.0	2.9	.9	.3	−.3
1956	.2	2.5	6.1	3.1	3.2	1.5
1957	3.5	2.8	5.9	3.5	2.9	3.5
1958	2.4	2.5	3.6	1.7	1.4	2.8
1959	3.6	2.8	4.6	1.6	.2	.8
1960	2.0	2.3	3.6	1.2	.1	1.6
1961	3.4	3.0	3.6	1.0	−.4	1.1
1962	4.5	3.2	4.0	.7	.3	1.2
1963	2.9	3.3	3.1	1.2	−.3	1.2
1964	3.1	3.2	3.8	1.4	.2	1.3

[1] Output per man-hour for all persons; labor input based primarily on establishment data.
[2] Average annual percentage change in output per man-hour during latest five years.
[3] Percentage change from previous year, except trend productivity.

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

Large corporations and labor unions can—and generally do—use their power to play a constructive role in our economy. At the same time they must be accountable for their actions to public opinion, and must recognize that the public will ask "Why?"

—when a union insists on a wage settlement that, if universally applied, would mar the price record of the economy;

—when a firm or industry agrees willingly to a wage settlement above the guideposts which it then translates into higher prices for its products;

—when a firm or industry with extraordinary productivity gains fails to share the benefits with consumers in the form of lower prices;

—when a firm or industry with average productivity gains chooses to raise its prices.

INTERNATIONAL ECONOMIC POLICIES

The formulation of domestic economic policies must take account of the impact of these policies on the economies of other countries and on our international relations. A strong U.S. economy promotes growth and prosperity abroad. At the same time, a vigorous and growing world economy and expanding world trade contribute to our own growth, stability, and vitality.

High among immediate U.S. priorities is the necessity for further strengthening of our international payments position. While devoting special attention to balance of payments problems, we will also continue to work actively toward the attainment of longer-range international economic goals: liberalizing the world's trading arrangements; strengthening the economies of the less developed countries; and further improving international monetary arrangements.

In all of these areas, important progress has been made in the recent past, but major tasks remain. This section outlines near-term and longer-run policies for carrying out these tasks.

BALANCE OF PAYMENTS: PROSPECTS AND POLICIES

The U.S. payments position showed further improvement between 1963 and 1964 while the economy was registering major gains in income and employment. But even more substantial reductions in the payments deficit must remain among the key objectives of national economic policy.

Longer-run prospects

Evidence accumulated during the past year generally confirms the conclusion of last year's Annual Report of the Council that the longer-term prospects for continued improvement in the U.S. payments position are favorable.

With domestic prices remaining essentially stable, it should be possible to consolidate and extend the recent improvement in the competitiveness of our exports. Moreover, exports will be aided in coming years by continued strong growth of incomes abroad. Demands for labor-saving investment goods—in the development and production of which the United States has traditionally pioneered—should increase. The stronger position of primary producing countries, furthermore, may continue to add significantly to these countries' demands for American products.

Income from past investments abroad should continue to rise rapidly. Further progress is also being made in the reduction of the balance of payments cost of military and other government transactions overseas. At the same time, however, our persistent deficit on tourist account will continue to reflect rising incomes at home and growing interest in foreign lands. U.S. imports, too, will grow as our economy expands. But it is encouraging that the growth of U.S. imports in recent years has been somewhat smaller than might have been expected on the basis of experience in earlier periods of economic expansion. This apparently reflects, in part, the improved competitiveness of American products.

The future course of U.S. direct investment abroad will be influenced by conflicting forces. Sustained prosperity in the United States may encourage investment at home rather than abroad. An increasingly less receptive attitude on the part of a number of foreign countries toward an expansion of American ownership may deter direct investment. At the same time, however, American firms still have strong incentives to expand their facilities or open new ones in widening foreign markets, particularly the European Economic Community (EEC).

New issues of foreign securities in the U.S. market, as already noted, were restrained by the Interest Equalization Tax in 1964. Revisions that are being recommended in the U.S. tax treatment of earnings of foreign investors in the United States should encourage increased purchases of U.S. securities. Current efforts to improve and enlarge capital markets abroad should also bear fruit over the longer run, although foreign demands on U.S. capital markets are likely to remain substantial for some time to come.

Problems and policies

While the analysis of key factors underlying our basic payments position leads to a favorable over-all appraisal, there are various uncertainties in the more immediate future that are cause for concern. The very large gains in our trade balance recorded since early 1963, for example, may be difficult to repeat. Moreover, the factors mentioned earlier which gave rise to exceptionally large capital outflow in late 1964, while expected to have less force in coming months, might tend to delay satisfactory progress toward balance in our international accounts. Thus, the Administration is currently undertaking an intensive assessment of our near-term balance of payments prospects and their implications for policy. The results of this assessment will be the subject of a special Presidential message in the near future.

It is clear that continued U.S. success in maintaining cost-price stability associated with rapid gains in productivity is fundamental to improvement in our balance of payments. Also required are sustained efforts to promote American exports and to encourage tourism within the United States by both Americans and foreigners. And, for the time being at least, we cannot relax the various special measures now in force, such as the tying of foreign aid, which are designed to keep the balance of payments cost of U.S. Government expenditures abroad at the lowest practical level consistent with our foreign policy and national security objectives.

With the help of appropriate policies, we must move decisively toward international balance, thereby reinforcing the position of the dollar as the world's major reserve currency. As we succeed in this endeavor, we can expect to encounter some demand by both private and official foreign holders for additional short-term dollar assets needed to help to meet their growing liquidity requirements. Under such circumstances, the United States can reasonably supply a limited volume of additional dollars in keeping with the ultimate objective of equilibrium in its payments position.

Two broad principles will continue to govern our choice of policies. First, policies directed at the balance of payments must remain coordinated with our over-all national economic policies. Second, truly effective measures to strengthen the balance of payments of any major trading and investing nation—especially a key-currency country—cannot be devised by individual countries in isolation. The burdens and benefits of adjustment must be shared by deficit and surplus countries. Indeed, further progress toward reasonable balance of payments equilibrium among all countries requires close cooperation among economic policy-makers here and abroad.

TRADE

The growth of world trade is strongly influenced by the commercial policies which trading nations pursue, individually and collectively. The reduction or elimination of barriers to trade and measures for its further expansion were intensively discussed in two major international forums during the past year—the General Agreement on Tariffs and Trade (GATT) and the United Nations Conference on Trade and Development.

Kennedy Round

The Kennedy Round of trade negotiations opened formally in Geneva last May and got under way in earnest toward the end of the year. The objectives of the United States, whose participation in these negotiations was made possible by the Trade Expansion Act of 1962, are a 50 percent cut in tariffs on as wide a range of industrial products as possible, the substantial liberalization of trade in agricultural products, the reduction or removal of nontariff barriers to trade, and the opening of greater trade opportunities to the less developed countries.

The working hypothesis adopted by the GATT nations is to apply 50 percent tariff reductions across the board to industrial products which are not specifically excluded by the participating countries. In November, after many months of intensive preparatory work, the major trading nations submitted their "exceptions lists," identifying the products which they wished to withhold from all or part of the 50 percent tariff cut. Successfully passing this major milestone implicitly reaffirmed the commitment of the major trading nations to a substantial lowering of tariff barriers.

Progress has been slower in the negotiations on agriculture. The United States has insisted from the start of the preparatory discussions that agricultural products, as well as industrial products, must be included in the forthcoming negotiations. From the standpoint of both its own interest and that of the world trading community, the United States is concerned lest, in the process of eliminating intra-EEC barriers on trade in agricultural products, the EEC countries erect new external restrictions. It is important that further development of the EEC contribute to the growth of over-all world trade as well as to the expansion of commerce within the Community. The United States remains eager to negotiate tariff and other trade concessions with the EEC countries which will cover agriculture as well as industry. Our objective is to achieve meaningful tariff concessions that will expand world trade.

According to the principles laid down by the GATT Ministers, the less developed countries are not expected to offer full reciprocity for the concessions extended to them by the developed countries. These countries will stand to benefit from the elimination of tariffs on tropical products and also to some extent from the reductions in tariffs on industrial products and the liberalization of agricultural trade.

As 1965 opens, the United States looks forward to successful negotiations in the Kennedy Round. These negotiations, expected to run through the current year and perhaps into 1966, will be complex and difficult, for the stakes are high—involving as they do the vital interests of 40 or more participating nations. Success will stimulate trade expansion and closer economic cooperation, stepping up worldwide productive capacity and efficiency and contributing to rising incomes and greater human welfare in all countries; failure would risk the onset of a new wave of protectionism.

The years immediately ahead may be among the most dramatic and rewarding in our continuing drive for trade liberalization begun thirty years ago.

UN Conference on Trade and Development

The United Nations Conference on Trade and Development (UNCTAD) provided a forum primarily for the less developed countries to express their views on the present legal and institutional framework governing world trade, and to make a series of suggestions for trade policies to promote economic development. The Conference was the first of its kind, and revealed a striking unity among 77 less developed countries in urging changes in the existing order. Permanent machinery—a Trade and Development Board—has been established under the United Nations for the continuing study of related trade and development problems. The UNCTAD participants also agreed to hold a similar formal conference in 1966, and every three years thereafter. In the meantime, the United States and other advanced countries are engaged in a major reexamination of their individual and collective economic policies toward the less developed countries.

The UNCTAD focused attention on many trade and development issues of particular interest to the developing countries. Recommendations adopted by the Conference without dissent dealt, among other things, with the removal of obstacles to the expansion of developing countries' exports; the promotion of trade among developing countries; studies of means to provide additional compensatory and supplementary financing to offset short- and long-term losses of export earnings; and a study of an interest equalization fund to encourage the use of previously untapped international financial resources.

The proposal that developed countries grant generalized tariff preferences to the exports of manufactures and semimanufactures from developing countries was strongly pressed at the UNCTAD. The Conference was unable to agree on a positive recommendation regarding preferences, but the issue remains of primary concern to the developing countries and is receiving further study.

The United States has chosen to play a major role in the organization of post-UNCTAD activities. We are hopeful that these sessions will be profitable for all concerned, and that they will be used to advance the widely shared objective of a more rapid expansion of trade and economic development throughout the world.

FOREIGN AID

U.S. foreign assistance policy is based on both humanitarian and national security considerations. It also is based on two premises regarding the development process: first, that external assistance plays a vital role in furthering economic growth, frequently providing the difference between satisfactory growth and stagnation; second, that such assistance can only complement efforts by the recipient nations in their own behalf.

In recent years the United States has increasingly concentrated its aid in those countries that have the best prospects for growth and that demonstrate a willingness and ability to help themselves, thereby ensuring that our assistance will make a maximum impact in promoting economic development. Such aid serves a variety of purposes: to help to broaden the capital base of developing countries; to facilitate the transfer of skills and knowledge through technical assistance; and, in some instances, to assist in the maintenance of the political and economic stability that is a prerequisite for economic growth.

In Latin America, our development loans and technical assistance are channeled through the Alliance for Progress as part of a broad cooperative effort by the nations of the Western Hemisphere. Outside the Western Hemisphere, major recipients of U.S. development assistance include India, Pakistan, Turkey, and Nigeria. In those countries still faced by immediate threats to their security, military assistance—amounting to more than one-fourth of total U.S. foreign aid—supports local defense forces, thus freeing a portion of the recipients' domestic resources for development purposes.

In the years ahead, gross aid disbursements must continue to rise if the current momentum of economic development of the poorer nations is to be maintained and accelerated. Consequently, the United States is pressing for greater aid contributions from those advanced countries that can clearly afford larger programs, as well as for a general easing of the terms on aid loans, i.e., for lower interest rates and longer maturities. As the public and private external debt burdens of the less developed countries mount, the need for lengthening the maturity and grace periods of future loans becomes more urgent.

Private investment from developed countries is another and, in the long run, perhaps more important, potential source of capital—as well as of technical and managerial skills—for less developed countries. To stimulate greater U.S. private participation in economic development activities, the Agency for International Development (AID) offers U.S. businessmen a wide range of investment guarantees, local currency loans, and special services by AID Missions abroad. The Administration has also proposed an investment tax credit for U.S. firms investing in developing countries.

The United States is gradually eliminating AID assistance programs in a number of countries, such as Taiwan, where rising incomes and expanding investment opportunities are now attracting substantial and increasing domestic savings and relatively hard loans from abroad. In the near future, other nations can be expected to make the same transition, though, in still others, successful development may require larger imports of capital in the short run.

Successful and balanced growth in low-income areas is a complex evolution in which social, political, technical, and human change are all interwoven. Such growth cannot be attained instantaneously, but there have been solid accomplishments. In helping 75 countries to help themselves, we are engaged in an undertaking of indefinite duration but also of inestimable importance to the current and future economic and political health of the entire world.

INTERNATIONAL MONETARY ARRANGEMENTS

During 1964, questions regarding the future of international monetary arrangements came to the forefront of public discussion. Two thorough studies of the present functioning and the future needs of the system were completed last August, one prepared by the Deputies of the Finance Ministers and Central Bank Governors of the leading industrial countries known as the "Group of Ten," the other by the staff of the International Monetary Fund (IMF). These formed the basis for a number of steps taken at the Annual Meeting of the Governors of the Fund that promise to improve the functioning of world monetary arrangements. The studies also led to frank and open discussions of those longer-run issues on which agreement had not yet been reached. The actual course of monetary developments during the year, moreover—notably those connected with the defense of the British pound against speculative attacks—helped to bring both the strength and the limitations of existing monetary arrangements into even sharper focus.

As the Council's Annual Report for 1964 pointed out, a properly functioning international monetary system should promote steady growth of the world economy. It should (a) minimize disruptive and speculative conversions of foreign exchange into gold and prevent such conversions from reducing international liquidity; (b) encourage adjustment of imbalances by both deficit and surplus countries in ways that avoid imparting either a deflationary or an inflationary bias to the world economy, and that foster greater freedom of international transactions; (c) make adequate but not excessive financial resources available to permit achievement of these objectives. The reports of the Group of Ten and the IMF examined present and prospective international monetary arrangements from each of these viewpoints.

Areas of substantial agreement

The two reports (which reached broadly similar conclusions) revealed a wide range of issues on which the financial authorities of the major industrial countries are in substantial agreement. No abrupt change in present institutional arrangements was considered either necessary or desirable. Thus, the report of the Group of Ten stressed that the existing international monetary system based on fixed exchange rates and the established price of gold has "proved its value as a foundation on which to build for the future." It also declared that *over-all* liquidity "seemed fully adequate under present circumstances to cope with possible threats to the stability of the international payments system." At the same time, it suggested that the growth of world trade and payments is likely to require larger liquidity in the future, involving further increases in credit facilities, and, in the longer run, "possibly" calling for some new form of reserve asset.

For the nearer term, there was substantial agreement that growing liquidity needs could largely be met by a further expansion of credit, reinforced by increasingly close cooperation among monetary and other financial authorities. The network of bilateral and multilateral credit facilities that has been built up in recent years—including reciprocal swap arrangements, *ad hoc* central bank support operations, and the issuance of special medium-term bonds to creditor countries for reserve purposes—has proved a flexible and highly effective instrument for expanding usable liquidity, particularly when needed as a defense against sudden speculative attacks. Further use of such devices was recommended, given proper safeguards. At the same time, stress was placed on the likelihood of enlarged future needs for the use of medium-term credits from the IMF. The two reports therefore recommended—and the Governors of the Fund subsequently directed—that consideration be given to a moderate general increase in Fund quotas (probably of about 25 percent) and to appropriate additional selective quota increases.

As a means of encouraging the economical and efficient use of gold, the Fund report favored the handling of new quota subscriptions so as to "mitigate the repercussions of gold payments on the gold reserves of the contributing members and of the reserve centers that may be affected." The report of the Group of Ten took a similar position. In the case of the United States, such mitigation would seek to limit reductions in U.S. gold holdings occasioned by the increase in IMF quotas to the amount of the United States' own gold contribution—a contribution that would carry with it an equivalent assured drawing right on the Fund. If, by contrast, other countries bought gold from the United States in order to make their contributions to the Fund, U.S. reserves and the total of world reserves would be reduced.

In discussing credit facilities, the reports also noted that there had as yet been little provision for long-term lending for monetary purposes. Some of the Deputies of the Group of Ten suggested, therefore, that in certain exceptional cases, countries with large and growing reserves might properly extend longer-term loans to other industrialized countries in need of additional reserves. Such long-term loans might in certain instances be in the general interest of all the industrial countries. Appropriate long-term adjustment by a low reserve country may be more effective when that country pursues a gradual return to payments surpluses than when it attempts an abrupt balance of payments improvement that requires severe deflationary measures and could disrupt international trade. Such long-term arrangements could be attractive to lenders, provided that the loan could be shifted to a country in a stronger reserve position if the reserve position of the original lender should decline substantially.

Any expansion of credit facilities, of course, also carries significant risks. Undue reliance on the use of such facilities may delay the initiation of corrective actions—on the part both of deficit and of surplus countries—that are appropriate to bring payments positions into better balance. Such risks are increased if insufficient information is available regarding the total volume of actual credit extensions.

To deal with such problems, and to provide a firmer basis for the further expansion of credit facilities, the Group of Ten agreed that bilateral financing and liquidity creation should be subject to "multilateral surveillance," to be conducted primarily under the auspices of the OECD. This will essentially involve a more regular and systematic exchange of information on the means of financing both deficits and surpluses. At the same time, the Group of Ten suggested intensive further study of the nature of the adjustment process in international payments and of the optimal "mix" of monetary, fiscal, incomes, trade, and other policies for the achievement of both internal and external objectives. Such a study—also under OECD auspices—is now under way.

Some major questions remaining to be resolved

Looking toward the possible future need for a new type of reserve asset to supplement gold and foreign exchange, the Group of Ten established a study group on the Creation of Reserve Assets. Broadly speaking, the study group was asked to examine and compare two general approaches. One approach would introduce a new reserve unit by formal decision of the member countries of the Group of Ten. While such a new unit could take a variety of forms, one proposal which has been put forward is for a collective reserve unit closely linked to gold in its creation and use.

A second major approach would be based on acceptance and further development of gold tranche and similar claims on the IMF as international reserve assets. There are several techniques by which the total of reserve assets in this form can be varied in accordance with economic and financial conditions as they affect the reserve needs of Fund members, particularly the industrial countries which account for the bulk of the movements in international reserves.

It is natural that the views of individual countries with respect to future arrangements should reflect their current positions and problems. Despite this divergence, there is probably general agreement that a system of reserve creation must avoid exposing surplus countries to inflationary pressures from an excess of liquidity in the hands of deficit countries. At the same time, procedures for reserve creation and international lending must be sufficiently flexible to permit payments imbalances to be corrected in a way that gives full recognition to the importance of economic growth and flourishing trade.

Questions raised by more recent experience

The defensive capabilities of the international monetary system were demonstrated late in 1964 by the decisive moves to counteract the sudden speculative attack on sterling. The ability and determination of the international financial authorities to mobilize needed resources on short notice provided impressive backing for the conclusions of the Group of Ten and IMF reports that existing arrangements are fully capable of coping with major speculative attacks.

Yet the events of 1964 underlined the fact that the international monetary system has further problems to solve. Foremost among these is the question of improving the balance of payments adjustment process through policies—pursued by both deficit and surplus countries—that are consistent with steady economic growth, reasonably stable prices, and freedom of international transactions. Some of the measures adopted in 1964 to deal with imbalances, though justified by circumstances, would clearly be inconsistent with basic objectives if maintained for long. We must continue to work toward the proper mix of facilities to finance imbalances and policies to correct them.