

**THE ANNUAL REPORT
OF THE
COUNCIL OF ECONOMIC ADVISERS**

LETTER OF TRANSMITTAL

COUNCIL OF ECONOMIC ADVISERS,
Washington, D.C., January 20, 1966.

THE PRESIDENT:

SIR: The Council of Economic Advisers herewith submits its Annual Report, January 1966, in accordance with Section 4(c) (2) of the Employment Act of 1946.

Respectfully,



GARDNER ACKLEY,
Chairman.



OTTO ECKSTEIN



ARTHUR M. OKUN

CONTENTS

	Page
CHAPTER 1. APPROACHING FULL EMPLOYMENT.....	31
Progress Toward Full Employment.....	32
Sources of Strength.....	34
The Recent Record.....	38
The Balance of the Economy Today.....	39
Balance of Output and Potential.....	39
Balance of Investment and Saving.....	42
Financing Balanced Expansion.....	44
Pattern of Credit Flows and the Demand for Funds.....	44
Position of Financial Institutions.....	46
Position of Borrowers.....	47
Monetary Policy.....	49
The Current Fiscal Program.....	52
The Impact of 1965 Budget Actions.....	52
Fiscal Plans for 1966-67.....	53
The Outlook for Economic Activity.....	54
Gains by Sector.....	55
Key Role of Business Fixed Investment.....	56
The Impact of Defense.....	58
The Need for Flexibility.....	60
Contingencies in 1966.....	60
Longer-Run Outlook.....	62
CHAPTER 2. PROSPECTS FOR COST-PRICE STABILITY.....	63
Determination of the Price Level.....	63
The Price Record.....	65
Supply and Demand in the Product Markets.....	67
Operating Rates of Industries.....	67
Backlog of Orders.....	69
Supply and Demand in the Labor Markets.....	71
Outlook for Labor Markets in 1966.....	73
Employment Goals.....	75
Labor Cost Trends.....	76
Wages.....	78
Productivity and Unit Labor Costs.....	79
Costs and Prices in Selected Problem Areas.....	80
Food.....	81
Nonferrous Metals.....	82
Machinery.....	83
Construction.....	85
Medical Services.....	86
Outlook for Cost-Price Stability in 1966.....	87
Guideposts for Noninflationary Price and Wage Behavior....	88
Increasing Importance of the Guideposts.....	88
The Guideposts Restated.....	89
Exceptions to the General Guideposts.....	91

	Page
CHAPTER 2.—Continued	
Guideposts—Continued	
Short-Run and Trend Elements in Productivity.....	91
Guidepost Policy on Prices.....	93
CHAPTER 3. STRENGTHENING HUMAN RESOURCES.....	94
Education.....	94
Building the Ladder of Educational Opportunity.....	96
Active Manpower Policies.....	99
Training Programs.....	99
Improving the Efficiency of the Labor Market.....	99
Raising Labor Productivity.....	100
Health.....	100
Cost of Illness.....	102
Public Policy and Legislative Accomplishments.....	103
Equality of Opportunity.....	107
Prosperity: A Condition for Negro Progress.....	108
Civil Rights Laws and Economic Discrimination.....	109
Economic Cost of Discrimination.....	110
Reduction of Poverty.....	110
Changes in Poverty: 1959-64.....	111
Income Maintenance.....	114
CHAPTER 4. AREAS FOR FURTHER LEGISLATIVE PROGRESS IN 1966..	116
The Urban Environment.....	116
Improving Our Cities.....	117
The Abatement of Pollution.....	119
Programs for Pollution Abatement.....	120
New Federal Leadership in Pollution Abatement.....	123
Efficiency in Transportation.....	124
Cost-Oriented Rates.....	126
Comprehensive Policy Planning.....	128
Flexibility in Transport Investment.....	128
Speed of Response to Technological Change.....	129
Maritime Policy.....	129
CHAPTER 5. PROGRESS AND PROBLEMS IN AGRICULTURE.....	131
Commercial Agriculture in the 1960's.....	132
Structural Changes.....	133
Farm Income.....	134
Poverty in Agriculture.....	134
The Export Market.....	136
Farm Commodity Stocks.....	137
Farm Policy in the 1960's.....	138
The Food and Agriculture Act of 1965.....	138
National Commission on Food and Fiber.....	139
CHAPTER 6. THE INTERNATIONAL ECONOMY.....	140
The Less Developed Countries: Progress, Problems, and Policies.	140
Foreign Assistance.....	141
Improving Trade Prospects.....	144

CHAPTER 6.—Continued	Page
Recent Change in the Developed Countries	145
The Growth of International Trade	146
Problems of Rapid Growth and Integration	146
Developments in 1965	148
Improving the International Monetary System	149
The Adjustment Process	150
International Liquidity Arrangements	155
U.S. Balance of Payments	160
Measures of Deficit or Surplus	160
Developments and Policies in the 1960's	163
Growth of Private Capital Outflows	163
The February 1965 Program	165
Program for 1966	167
U.S. Trade Position	167
Conclusion	168
CHAPTER 7. THE EMPLOYMENT ACT: TWENTY YEARS OF POLICY	
EXPERIENCE	170
The Act and Its Background	170
Avoiding Depressions and Booms	172
Combating Recessions	172
Containing Inflationary Pressures	176
Evolving Problems and Policies	177
Inadequate Demand in Expansion	177
Inflation at Less Than Full Employment	178
Economic Policy Today	180
The Nature of Cyclical Instability	180
Policy for a Growing Economy	182
Prerequisites of Successful Policy	184
Information	184
Professional Knowledge	185
Public Understanding	185
Conclusion	186
APPENDIXES:	
A. Major Legislation and Administrative Actions of Economic	
Significance in 1965	187
B. Report to the President on the Activities of the Council of	
Economic Advisers During 1965	195
C. Statistical Tables Relating to Income, Employment, and	
Production	203
<i>Tables</i>	List of Tables and Charts
1. Changes in Gross National Product Since Early 1961	35
2. Changes in Employment and Income Since Early 1961	36
3. Planned and Actual Expenditures for New Plant and Equip-	
ment, 1964-65	37
4. Net Funds Raised by Private Domestic Nonfinancial Sectors,	
1953-65	45

List of Tables and Charts—Continued

<i>Tables—Continued</i>	Page
5. Relation of Selected Commitments of the Household Sector to Disposable Personal Income, 1951–65	48
6. Changes in Commercial Bank Credit, Money Supply, and Time Deposits, 1963–65	51
7. Defense Impact in Relation to GNP, Korean War Period and Current Period	59
8. Changes in Wholesale Prices, 1961–65	66
9. Manufacturing Capacity Utilization, 1964–65	68
10. Capacity Utilization and Change in Output of Selected Industries, 1964–65	69
11. Changes in Employment, 1961–65	72
12. Unemployment Rates for Selected Groups, 1960–65	72
13. Changes in Consumer Prices for Medical Care, 1947–65	86
14. Health Indicators, Selected Years, 1940–64	101
15. Economic Costs of Illness, 1963	103
16. Selected Measures of Discrimination and Inequality of Opportunity, 1965	108
17. Number of Poor Persons and Incidence of Poverty, 1959–64	111
18. Number of Poor Households and Incidence of Poverty, by Race, 1959 and 1964	112
19. Incidence of Poverty and Distribution of Poor Households, 1964	113
20. Volume of Intercity Freight Traffic, Selected Years, 1940–64	125
21. Investment of Commodity Credit Corporation in Commodities, Fiscal Years 1960–65	137
22. Net Flow of Long-Term Financial Resources to Less Developed Countries, 1960–64	141
23. United States Balance of Payments, 1960–65	164
 <i>Charts</i>	
1. Changes in Gross National Product Since 1961	33
2. Business Inventory-Sales Ratio	37
3. Gross National Product, Actual and Potential, and Unemployment Rate	41
4. Investment and High-Employment Saving	43
5. Free Reserves	50
6. Selected Interest Rates	51
7. Consumer Prices	66
8. Wholesale Prices	67
9. Backlog of Manufacturers' Unfilled Orders for Durable Goods in Three Postwar Expansions	70
10. Changes in Compensation, Prices, and Productivity in the Private Economy	77
11. World Trade and Reserves	157
12. U.S. Balance of International Payments	161
13. Role of Federal and State and Local Governments in the Economy	175

Chapter 1

Approaching Full Employment

THE AMERICAN ECONOMY took a giant step in 1965 toward the achievement of the Employment Act's goals of "maximum employment, production, and purchasing power." It was the fifth year of uninterrupted economic expansion, and the second year of declining unemployment as output moved closer to the economy's growing productive potential.

Since the Revenue Act of 1964 became effective, the economy has shown new vigor. Living standards have risen at an unprecedented rate, and businessmen have found new and stronger incentives to expand and modernize their productive facilities. Employment has forged ahead dramatically, enlarging job opportunities, particularly for the young and the less advantaged groups in the labor force. As the year closed, the unemployment rate was 4.1 percent, within inches of the 4 percent interim goal set by the Kennedy Administration in the 1962 Economic Report and below any rate achieved since the mid-1950's. Meanwhile, despite some pressures on prices for particular commodities, the over-all price record remained far better than in that earlier period. In addition, last year witnessed significant progress toward equilibrium in the balance of payments.

Today, our vigorous economy is in a strong position to carry the new burdens imposed by expanded national defense requirements. With another large advance in total production ahead, defense needs will be met while consumer living standards again improve strongly and the capital stock is further enlarged. Indeed the *increase* in output available for civilian uses this year is expected to be one of the largest in our history.

National security, of course, has first priority on the budget and the first claim on production. It certainly represents a less welcome use of our national output than would Federal civilian programs or the private spending that would come from tax reduction. Progress will continue in building the Great Society, but the pace of Federal civilian programs reflects the current urgency of national defense.

Furthermore, rising defense requirements clearly complicate the task of economic policy. The stimulative fiscal policies of recent years have achieved their mission. Consumer spending and investment demand have both been invigorated. The same logic that called for fiscal stimuli when demand was weak now argues for a degree of restraint to assure that the

pace of the economy remains within safe speed limits. Measures to moderate the growth of private purchasing power are needed to offset, in part, the expansionary influence of rising defense outlays if intensified price and wage pressures are to be avoided. A combination of such measures—affecting excise tax rates and the timing of individual and corporate tax payments—is thus a key proposal in the President's fiscal program.

At the same time, the Administration looks toward further declines in unemployment during the year ahead—indeed, to the lowest level since 1953. These ambitious targets are a renewed expression of confidence in the vigor, adaptability, and productivity of our private economic system—a confidence which has been richly reaffirmed and rewarded in the past 2 years by the Nation's smooth progress and efficient performance in approaching full employment. Nonetheless, this is a year of many uncertainties: the advance into the new territory of still lower unemployment must be made with care; meanwhile, defense requirements could shift suddenly in either direction in the months ahead. Fiscal policy stands ready to meet any changing needs and unanticipated developments, and will look to assistance from monetary policy in maintaining flexibility.

This chapter reviews the recent record of progress toward full employment, appraises the current state of the economy, evaluates the outlook for gross national product and employment in 1966 in the light of fiscal and monetary policies, and explores future contingencies. Chapter 2 examines in detail the outlook for price-cost stability. Problems of the U.S. balance of payments are reviewed in Chapter 6.

PROGRESS TOWARD FULL EMPLOYMENT

Nearly 5 years of expansion have yielded a gain of \$190 billion in gross national product (GNP). Revised historical estimates of our national product through 1964 were published last August by the Department of Commerce, and updated provisional estimates for 1965 were released at the start of this year; these new estimates give a more accurate picture of the growth of GNP and the relationship of its components. They show that total GNP advanced at a 7.0 percent annual rate in the last 4¾ years. After adjustment for the modest upward drift in prices, the average annual rate of growth of real output over this period was 5.5 percent.

When measured from the peak year of 1960 to 1965, real growth averaged 4.5 percent, in sharp contrast to the 2.4 percent annual rise from 1953 to 1960. This rapid growth in the United States exceeds the target rate for the 1960's established collectively by the member countries of the Organization for Economic Cooperation and Development (OECD). At mid-decade, the Secretary General of the OECD reported to the Ministers, "During the period 1960-65, gross national product for OECD countries taken together has increased at a somewhat higher rate than that needed

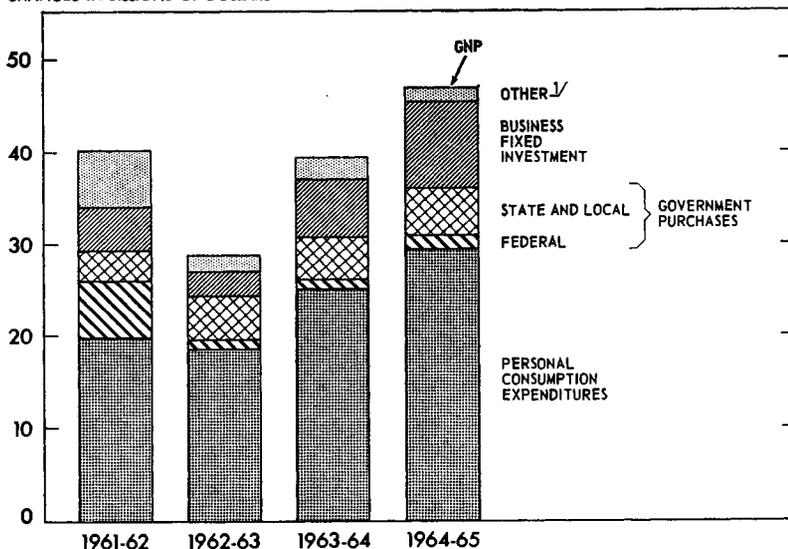
to meet the target of 50 percent for the decade 1960–1970 [4.1 percent a year] set by the Ministers in 1961.” The United States accounts for virtually all of the surplus above the target rate. In contrast to the decade of the 1950’s, when most OECD countries enjoyed virtually uninterrupted expansion while the United States suffered periodic downturns, it has been the United States that has experienced continuing strong expansion thus far in the 1960’s.

Sustained and balanced progress is the hallmark of the current expansion. But the pace of the advance has varied over time (Chart 1). In the initial recovery period from the 1960–61 recession, output rebounded sharply; the unemployment rate, which had been 7 percent early in 1961, fell rapidly late in the year, reaching 5½ percent by mid-1962. The upswing was spurred by the characteristic shift from liquidation to accumulation of inventories, and by higher Federal Government spending, partly associated with the 1961 Berlin crisis. However, the expansion then faltered when fixed investment outlays failed to take over as the main expansionary force in the economy. As the growth of total output slowed, unemployment threatened to be stuck on a 5½ percent plateau. The Kennedy Administration was convinced that adequate total demand could reduce

Chart 1

Changes in Gross National Product Since 1961

CHANGES IN BILLIONS OF DOLLARS



✓ RESIDENTIAL STRUCTURES, CHANGE IN BUSINESS INVENTORIES, AND NET EXPORTS OF GOODS AND SERVICES.

SOURCE: DEPARTMENT OF COMMERCE.

unemployment at least to 4 percent without inflation. To accomplish this objective, it developed a comprehensive program of tax measures, including lower personal and corporate tax rates, depreciation reform, and an investment tax credit. The personal tax cuts raised after-tax earnings and spurred more spending by consumers. The corporate measures added further to private investment incentives and to the volume of investible funds.

The economy responded well to these measures, and especially to the major tax cut of February 1964. GNP rose by nearly \$40 billion in 1964, compared with the gain of almost \$30 billion in 1963, and the unemployment rate fell to 5.0 percent by the end of the year.

Statistical analysis of the impact of the tax reduction suggests that it was responsible for nearly the entire \$10 billion step-up in the annual increase of GNP. The reduction in tax liabilities in 1964 boosted the after-tax incomes of households and businesses. Spending by these sectors, particularly consumer outlays, rose in response to these larger after-tax incomes. This higher spending increased sales, employment, and earnings. Larger earnings, in turn, provided the basis for still more consumption spending. Investment was also stimulated by gains in business sales and higher capacity utilization. By early 1965, the contribution of the tax cut in lifting consumption and investment spending was more than \$20 billion (annual rate). Since the effects of the tax cut cumulate through time, its contribution has grown further, reaching \$30 billion by the end of 1965.

As 1965 opened, the remaining lift from the Revenue Act of 1964 was not in itself sufficient to assure a sustained reduction in unemployment. Consequently, a good opportunity was presented for a long-awaited reduction in excise taxes and a liberalization of Social Security benefits, both of which were desirable on equity grounds. These actions were proposed in the fiscal 1966 budget, presented in January 1965. In combination with expected modest increases in other expenditures, they more than offset the normal growth of Federal revenues, and thus provided a net fiscal stimulus for calendar 1965. The stimulus was planned for the second half of the year since heavy stocking of steel inventories in anticipation of a strike was expected to stimulate demand early in the year and subsequently to be reversed.

The fiscal actions in 1965 were a success. The economy did move further toward full employment, even more rapidly than anticipated; yet demand did not outstrip capacity to produce.

SOURCES OF STRENGTH

Personal consumption and business fixed investment, the two types of spending expected to be most responsive to the major 1964 tax reduction, surged ahead in 1964 and 1965. Buoyancy in these sectors outweighed sluggishness in residential construction outlays and moderation in inventory investment (Table 1).

TABLE 1.—Changes in gross national product since early 1961

Expenditure group	1961 I	1963 IV	1965 IV ¹	Percentage change per year	
				1961 I to 1965 IV ¹	1963 IV to 1965 IV ¹
	Billions of dollars ²				
Gross national product.....	503.6	603.6	604.6	7.0	7.3
Personal consumption expenditures.....	328.4	379.5	440.1	6.4	7.7
Private business fixed investment.....	46.0	56.5	73.2	10.3	13.8
Change in business inventories.....	-3.5	8.1	7.0	(³)	(³)
Residential structures.....	21.7	27.0	27.2	4.9	-1.3
Net exports of goods and services.....	6.6	7.3	7.4	(³)	(³)
Government purchases of goods and services.....	104.3	124.3	136.6	6.3	6.0
Federal.....	55.4	64.4	69.7	5.0	4.0
State and local.....	49.0	59.9	66.9	7.8	8.0

¹ Preliminary.

² Seasonally adjusted annual rates.

³ Percentage change not computed because of small or negative base.

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

Sources: Department of Commerce and Council of Economic Advisers.

Consumption

The consumer was a bulwark in the strong general economic gains of 1964 and 1965. Except for the fourth quarter of 1964, when strikes curtailed automobile sales, consumption grew by \$7 billion or more in every quarter of this period. Only twice before, once at the start of the Korean war and again at the beginning of 1959, had quarterly increases of this size occurred.

A notable feature of the recent sharp advance in consumption expenditures is its pervasiveness. The sharpest relative increases occurred in purchases of durables, which are generally most sensitive to fluctuations in the growth of income. From the end of 1963 to the end of 1965, real expenditures on automobiles topped all previous records, rising on average by 11 percent a year. Yet this strong rise was closely paralleled by outlays for other durables. And real outlays on both nondurables and services rose at an unusually strong 5½ percent annual rate.

Consumers were able to take these forward strides because of rapid gains in their purchasing power. Real disposable income grew at an average annual rate of 6.3 percent in the 2 years after the 1964 tax cut, in contrast to the growth rate of 3.9 percent in the preceding 2 years. The consumer continued to be a dependable performer in the economy. During the past 2 years, the rise of almost \$61 billion in consumption amounted to 91 percent of the \$66 billion increase in disposable income. Spending on consumer goods and services has typically absorbed approximately this proportion of increases in disposable income, when allowance is made for some lag in adjustment to unusually large income gains.

The largest beneficiaries of the rapid rise in income were workers rescued from unemployment. Other consumers also benefited, although less dra-

TABLE 2.—Changes in employment and income since early 1961

[Seasonally adjusted]

Series	Unit	1961 I	1963 IV	1965 IV ¹	Percentage change per year	
					1961 I to 1965 IV ¹	1963 IV to 1965 IV ¹
Civilian labor force:						
Employment.....	Millions of persons.	² 66.6	69.3	73.0	2.0	2.6
Unemployment.....	do.....	² 4.9	4.1	3.2	-8.4	-12.1
Personal income:³						
Total (before taxes).....	Billions of dollars.	406.6	475.6	546.0	6.4	7.1
Wage and salary disbursements.....	do.....	270.9	318.8	368.1	6.7	7.5
Disposable (after taxes).....	do.....	354.8	414.0	480.3	6.6	7.7
Corporate profits:³						
Before taxes.....	do.....	45.0	60.8	⁴ 74.6	⁴ 11.9	⁴ 12.4
After taxes.....	do.....	24.4	33.8	⁴ 44.5	⁴ 14.3	⁴ 17.0

¹ Preliminary.² Adjusted for comparability with subsequent data.³ Quarterly data at annual rates.⁴ Profits data relate to 1965 III.

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

matically, through lower taxes, higher wages, and fuller work schedules (Table 2). Thus, expansionary fiscal policies were translated for most Americans into rising standards of living—more and better provision of the physical necessities, the social amenities, and the personal conveniences of civilized life. Real consumption per capita (1958 prices) grew over the 2-year interval by \$190—as much as in the preceding 8 years.

Investment

A buoyant economy with rising sales and operating rates, surging profits, and the incentives of tax reduction gave new stimulus to business to expand and modernize capacity. The result was an 11½ percent jump in outlays for business fixed investment in 1964 and a 15½ percent spurt in 1965. These gains compare with an average annual rate of increase of 7½ percent in the preceding 2 years.

Investment plans were repeatedly revised upward in 1964 and 1965 as business confidence grew. The second time that businessmen reported spending plans for a given quarter—in the Department of Commerce-Securities and Exchange Commission survey—their plans exceeded the first anticipations. Their actual outlays invariably topped the second anticipations (Table 3)—a clear indication of the general availability of capital goods. In sharp contrast, during 1956 and early 1957, businessmen were not able to invest as much as they had planned because of bottlenecks in construction and delivery of equipment.

The stepped-up pace of final sales in 1964 and 1965 also required additional inventories. Nevertheless, the \$5.4 billion accumulation of nonfarm stocks in 1964 was unusually small in relation to the advance in final sales as inventory-sales ratios declined during most of the year. During

TABLE 3.—Planned and actual expenditures for new plant and equipment, 1964-65

[Billions of dollars, seasonally adjusted annual rates]

Quarter	Planned expenditures		Actual expenditures
	Middle of preceding quarter	Middle of current quarter	
1964: I.....	40.8	41.2	42.6
II.....	42.7	43.4	43.5
III.....	44.3	44.6	45.6
IV.....	46.2	46.7	47.8
1965: I.....	47.9	48.8	49.0
II.....	49.6	49.6	50.4
III.....	50.8	51.2	52.8
IV.....	53.0	54.8	(1)

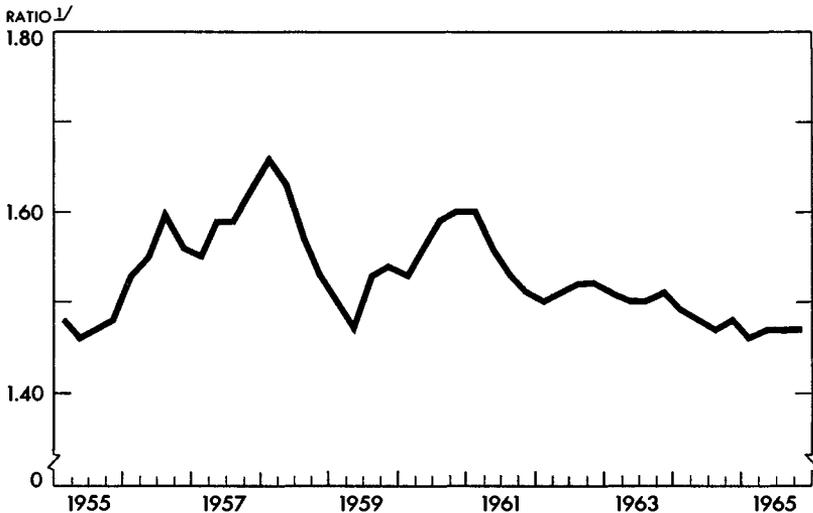
¹ Not available.

Sources: Department of Commerce and Securities and Exchange Commission.

1965, quarterly rates of inventory investment reflected temporary influences: the post-strike rebuilding of automobile inventories, the buildup of steel stocks, and the backlog of exports associated with the dock strike, early in the year; and, on the other hand, liquidation of steel stocks in the closing months. For 1965 as a whole, however, nonfarm inventory investment of \$7.1 billion was in line with the growth of final sales. As Chart 2 shows, inventory-sales ratios remained remarkably stable throughout the past 4 years, in marked contrast to the cyclical ups and downs in the late 1950's. In recent

Chart 2

Business Inventory-Sales Ratio



¹/RATIO OF MANUFACTURING AND TRADE INVENTORIES TO SALES; BASED ON SEASONALLY ADJUSTED QUARTERLY AVERAGES OF MONTHLY SALES AND END-OF-MONTH INVENTORIES.
SOURCE: DEPARTMENT OF COMMERCE.

years, businessmen's sales expectations were validated or surpassed by performance; moreover, prudent management helped to keep stocks closely geared to sales.

Residential construction was the only major component of private spending which remained weak in 1964 and 1965. In the 1961-63 period, the average annual addition of 1.46 million units to the private housing stock exceeded by an unusually large margin the average annual rate of net family formation (870,000). Excess supply developed in particular housing markets, especially in the West and in high priced apartments in scattered other locations. Thus, the upswing in residential construction activity ended early in 1964. The number of private housing starts fell from an annual rate of 1.7 million units in the first quarter of 1964 to a low of 1.4 million units in the third quarter of 1965. The real value of home construction held up somewhat better—because of a shift toward bigger and better quality new homes. Nevertheless, residential construction added practically nothing to the growth of GNP—even in current prices—in 1964, and was again a conspicuously lagging sector in 1965.

THE RECENT RECORD

The strength of the advance in 1965 was exceptional and surpassed expectations. The Council's Annual Report of 1965, which contained one of the more optimistic forecasts current at that time, estimated a gain of \$38 billion in GNP for the year—the midpoint of a \$33-43 billion range. In contrast, the actual gain was a record \$47 billion.

The major reason for the unforeseen gain was the unusually large revision in investment plans. Evidence available at the beginning of 1965 pointed to a rise in business fixed investment for the year which would be close to, but not quite match, the increase in 1964. The actual advance, however, totaled \$9½ billion, substantially exceeding the \$6 billion rise in the preceding year. Federal purchases of goods and services rose by \$1½ billion for the year as a whole, compared with the \$½ billion increase that had been anticipated. Consumption outlays exceeded the Council's original estimate, but this was primarily because of higher disposable income that, in turn, reflected the greater strength of other sectors.

The extraordinary strength of demand became more clearly established as the year 1965 progressed. Much of the unusually large advance in the opening quarter was attributable to the rebound from the strike in the automobile industry, which had depressed output in the closing quarter of 1964. Even though automobile output retreated in the second quarter, GNP advanced strongly. Sharp increases in fixed investment in the third and fourth quarters reinforced continued rapid rises in consumption.

Finally, defense outlays added to demand, particularly from the second to the fourth quarter, when they rose by \$2.8 billion. About \$1 billion of this rise came from the military pay increase enacted in September.

Moreover, the prospect of further substantial increases in Federal defense expenditures was a major factor contributing to buoyant expectations and investment demand in the second half of the year.

Thus, gains in GNP grew to \$13 billion each in the third and fourth quarters of 1965. The advance in the fourth quarter was especially remarkable in view of the liquidation of steel inventories, at an annual rate of about \$2 billion, following the September labor settlement. Although the impact of the slowdown in steel production was evident in the industrial production index in September and October, the index rose strongly thereafter; for the year as a whole, it was 8 percent above the 1964 average.

The strength of spending lifted the economy toward more complete use of its resources. Under the influence of favorable fiscal and monetary policies, the economy has achieved the best balance of over-all demand and productive capacity in nearly a decade.

THE BALANCE OF THE ECONOMY TODAY

The potential output of the American economy has continued to grow rapidly in the past 5 years. Aggregate demand, however, has advanced even faster. Output has risen to within 1½ percent of the economy's estimated potential. Meanwhile, private investment has forged ahead to match high-employment private saving. The good balances of demand with potential output and of investment with high-employment saving are two related measures of our progress.

BALANCE OF OUTPUT AND POTENTIAL

In 1965, the American economy achieved fuller utilization of its vast human and physical resources than at any time since 1957. Jobs were provided for more persons able and willing to work, thus leading to a more equitable distribution of the Nation's output and reducing the ranks of those unfairly condemned to a meager subsistence because they cannot find work. More and more Americans have had the chance to exercise their preference for employment rather than doles. Adult males had an unemployment rate of 5.7 percent in 1961. The rate fell to 2.6 percent by the end of 1965, not because attitudes toward work were uplifted, but because opportunities for work widened greatly.

A high-employment economy generates benefits for the rest of the Nation as well as for the previously unemployed. The additional output directly attributable to the efforts of the reemployed is just one part of the larger output that accompanies increased employment. In addition, productivity is higher as a result of improved utilization, primarily reflecting the more efficient use of overhead labor, such as clerical, professional, maintenance, and managerial employees.

Improving employment opportunities also attract more persons into the job market and thus add to the measured labor force. Manpower supplies

are further increased in periods of advancing activity by the lengthening of the work week, as part-time employees are converted to full-time and as overtime work increases.

In the last four Economic Reports, the Council has discussed the concept of potential GNP, defined as the volume of goods and services that the economy would ordinarily produce at the interim target unemployment rate of 4 percent. The measurement of potential GNP must incorporate the effects of the higher productivity, the larger labor force, and the fuller work schedules which accompany reduced unemployment.

Potential GNP does not stand still. Over time, population trends add to the number of persons in the labor force. Furthermore, increases in the quantity and quality of capital, advances in technology, and improvements in the quality of labor raise the potential productivity of the labor force.

The evidence indicates that, from the mid-1950's and into the early 1960's, the potential labor force grew at the rate of about $1\frac{1}{4}$ percent a year. Normal growth of man-hour productivity for the entire work force (including Government as well as private workers) was $2\frac{1}{2}$ percent a year. Hours worked a year trended downward at a rate of nearly one-fourth of 1 percent annually. Thus, potential GNP grew by $3\frac{1}{2}$ percent a year.

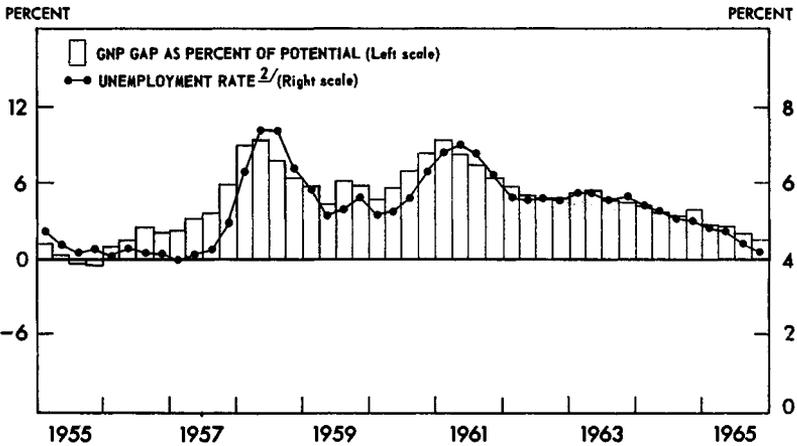
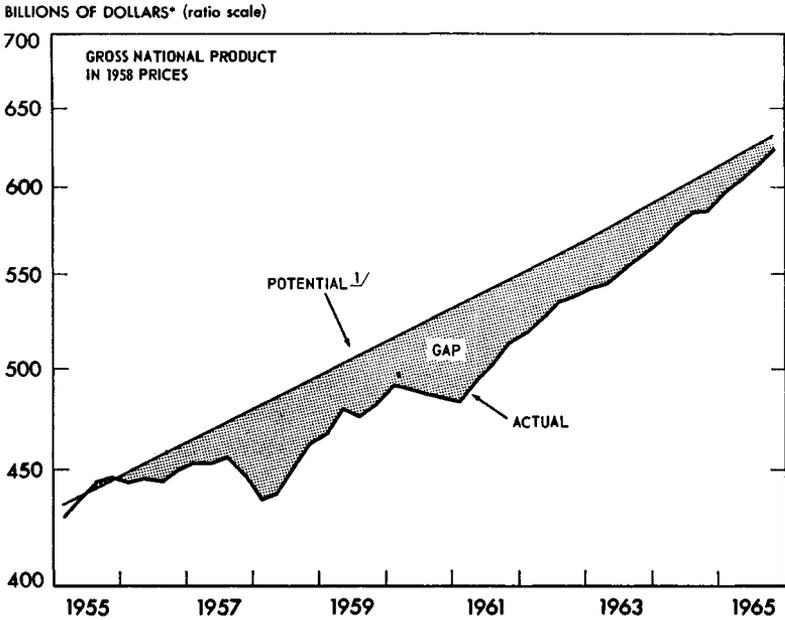
For recent years, a real growth rate of actual GNP somewhat greater than $3\frac{1}{2}$ percent has been required to hold the unemployment rate constant. Hence, the Council last year raised its estimated rate of growth of potential GNP to $3\frac{3}{4}$ percent, beginning in 1963. More rapid growth of the labor force will further increase the growth rate of potential GNP in the years ahead. During 1966, the Department of Labor will release a study, summarizing the results of extensive research on the prospects and patterns of growth by 1970.

The disparity or "gap" between potential and actual output (Chart 3) represents the goods and services foregone because of the underutilization of resources. The persistent gap since the mid-1950's has meant a total of \$260 billion (in 1958 prices) in lost output. This loss was at a peak annual rate of \$50 billion in the first quarter of 1961. The gap was reduced during the next few years. It shrank dramatically in 1965, reaching \$10 billion, in the final quarter when the unemployment rate was $4\frac{1}{4}$ percent.

During the second half of 1965, unemployment fell somewhat more rapidly than would have been expected from the rate of advance of real GNP. It now appears likely that the unemployment rate will reach 4.0 percent while the trend calculation still shows a small GNP gap. Recent experience has been influenced by the expansion of the armed services and of Government antipoverty programs for training young unskilled workers, both of which have a stronger effect on unemployment than on output. Despite the discrepancy between the estimate of the gap and the movement of unemployment that emerged late in 1965, it is clear that the Council's estimates of the potential GNP associated with 4 percent unemployment have been close to the mark throughout the expansion. Potential

Chart 3

Gross National Product, Actual and Potential, and Unemployment Rate



* SEASONALLY ADJUSTED ANNUAL RATES.
 $\frac{1}{2}$ TREND LINE OF 3% THROUGH MIDDLE OF 1955 TO 1962 IV; TREND LINE OF 3% THEREAFTER.
 $\frac{2}{2}$ UNEMPLOYMENT AS PERCENT OF CIVILIAN LABOR FORCE; SEASONALLY ADJUSTED.
SOURCES: DEPARTMENT OF COMMERCE, DEPARTMENT OF LABOR, AND COUNCIL OF ECONOMIC ADVISERS.

output has proved to be quantifiable within a sufficiently narrow range to justify its use as a key concept in the analysis of stabilization problems and policies.

The 4 percent unemployment rate has been viewed consistently by the Administration as an interim target obtainable by aggregate demand policies *alone* without sacrificing essential price stability. But aggregate demand policies have *not* been alone. Other public and private policies have improved the functioning of markets and the skills of the labor force, as Chapters 2 and 3 explain in detail. These policies have now made prudent a reduction in the unemployment rate to a level below 4 percent.

BALANCE OF INVESTMENT AND SAVING

The resurgence of private demand in 1965 was marked by an improved balance of investment and private saving.

As statistically measured, total national saving—personal saving, gross business saving, and the net surplus of Federal, State, and local governments—is always necessarily equal to private investment (except for whatever statistical discrepancy may creep into the measurement of income and product flows). Total gross national income equals the value of spending for current production—consumption, government purchases, and investment. Saving is that part of total income which is neither spent for personal consumption nor used for government purchases. Therefore, it must equal the value of spending for the remaining portion of GNP, i.e., investment.

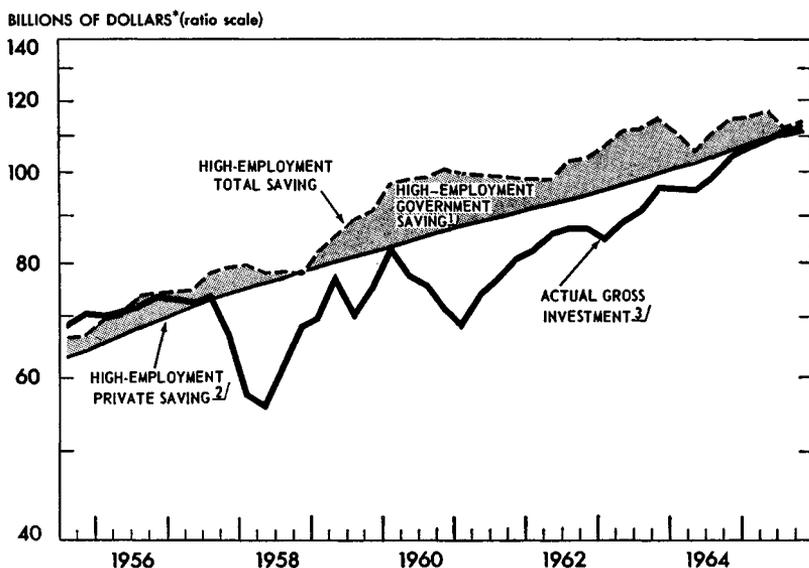
This equality of saving and investment will hold whether the economy is depressed or fully employed. But the economy can have high employment only if actual investment demands of businesses are large enough to match the amount that consumers, businesses, and governments wish to save at high-employment incomes. If actual investment falls short of high-employment saving, total spending will fall short of high-employment output. Because of insufficient demand, production will be held to some lower level where a smaller volume of saving does match the forthcoming investment.

Actual gross investment did, in fact, fall short of high-employment saving for nearly 8 years after 1957. Balance between the two was finally restored during 1965. Much of the discrepancy prior to 1965 is attributable to a fiscal policy that would have yielded excessively large surpluses at high income levels. Since investment demand was not strong enough to match this excessive Federal high-employment surplus, lower incomes resulted.

A comparison between actual private investment and estimated total high-employment saving from 1956 to 1965 is given in Chart 4. At high employment, total private saving would be expected to remain a fairly stable fraction of GNP, between 15½ and 16 percent. It will, of course, vary from year to year, reflecting changes in the personal saving rate, changes in tax rates and transfer payments that would alter the share of disposable income in GNP, and shifts in corporate dividend policies or in depreciation allowances.

Chart 4

Investment and High-Employment Saving



* SEASONALLY ADJUSTED ANNUAL RATES.

1/ FEDERAL HIGH-EMPLOYMENT SURPLUS PLUS STATE AND LOCAL ACTUAL SURPLUS.

2/ 15¼ PERCENT OF TREND GNP IN CURRENT PRICES.

3/ GROSS PRIVATE DOMESTIC INVESTMENT PLUS NET FOREIGN INVESTMENT.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

Nevertheless, no great variation would ordinarily be expected; total private saving is approximated on the chart at 15¾ percent of potential GNP. Private saving thus appears as an almost straight line in the chart since potential GNP (even in current dollars) grows rather smoothly. State and local governments typically stay very close to balanced budgets on a national income accounts basis. Their contribution to high-employment saving is approximated by their actual small surpluses or deficits.

The Federal contribution to total high-employment saving is measured by its high-employment surplus, a concept that has been explained in previous Annual Reports. It is the excess of Federal revenues that would be generated by high-employment incomes over actual Federal expenditures, adjusted for the reduced level of unemployment compensation.

The unevenness of the total high-employment saving line is due almost entirely to fluctuations in the high-employment Federal surplus. This reflects the major changes in fiscal policy during the post-1957 period. The dip in 1958 is a result of vigorous fiscal measures to stimulate recovery from recession; the steep rise in 1959 and 1960 marks an extremely restrictive fiscal policy. This rise is reversed in 1961 and early 1962, reflecting expenditure measures taken by the Kennedy Administration to stimulate recovery and strengthen defense, as well as the 1962 depreciation reform

and investment tax credit. The line turns up sharply late in 1962 as a result of leveling expenditures. The Revenue Act of 1964 shows up in a sharp decline in saving, as do the late 1965 excise tax reduction, social insurance liberalization, and step-up in defense purchases.

These fiscal measures have brought total high-employment saving down from excessive levels. Equally important, they have had a decisive impact on the investment side of the balance. Investment demand looked particularly weak in 1962 and 1963, and there were doubts that it could reach the range of 15½ to 16 percent of GNP, even at high employment. In that event, sizable and persistent Government deficits would have been required to achieve high employment. But the experience of the past 2 years has refuted these pessimistic assessments of the strength of private demand. With stronger consumer markets and higher after-tax profits, business fixed investment has broken out of its earlier lethargy. Balance was restored in 1965 between private investment and private high-employment saving, demonstrating that high employment was in fact achievable without substantial, permanent Government deficits.

FINANCING BALANCED EXPANSION

The availability and cost of credit significantly influence spending. Stable prosperity must have a sound underpinning of credit. And the appropriate growth of credit is an important element in the over-all balance of the economy.

The appropriate amount of credit expansion depends on a variety of factors including (1) the balance between total demand and potential output in the economy—with proper allowance for the role of fiscal policy; (2) the structure and position of financial institutions; and (3) the ability of borrowers to absorb further debt. Only from an over-all view of the needs of the economy can the appropriate growth of credit and the appropriate role of monetary policy be evaluated.

The Federal Reserve System exerts a major influence on the cost of credit and the rate of growth of credit from all financial institutions. The reserve credit it supplies is particularly significant, because it provides the base for a multiple expansion in commercial bank credit to borrowers, thereby affecting all credit markets. Reserve credit is the keystone of the system, although it is only a small portion of total credit. It rose by only \$3.8 billion in 1965, compared with almost \$55 billion of funds supplied by financial institutions as intermediaries and the total of almost \$72 billion raised in all credit markets.

PATTERN OF CREDIT FLOWS AND THE DEMAND FOR FUNDS

The flow of funds through financial markets accelerates when the pace of economic activity is stepped up. The similarity in the behavior of credit flows between the current upswing and the two weaker preceding

expansions is striking. In 1965, however, total credit flows to private domestic sectors rose somewhat faster relative to GNP than in earlier periods of prosperity—primarily in response to the growing external financing needs of businesses (Table 4).

TABLE 4.—*Net funds raised by private domestic nonfinancial sectors, 1953–65*

Period	Net funds raised as percent of GNP ¹	Types of credit as percent of funds raised ¹				
		Consumer credit	Bank loans to business ²	State and local government obligations	Corporate securities	Home mortgages ³
Expansion years:						
1955	8.94	17.98	14.89	9.27	13.48	34.83
1956	7.78	10.74	18.40	9.20	18.10	33.13
1959	8.46	15.65	13.45	11.00	12.71	31.78
1962	7.89	12.44	10.86	11.31	11.54	29.41
1963	8.47	13.43	12.02	13.43	7.21	30.46
1964	8.88	12.37	13.62	10.57	9.68	28.32
1965 ⁴	9.61	13.71	19.57	10.02	10.79	23.42
Downturn or early recovery years:						
1953	5.84	18.31	-3.76	17.37	24.41	35.21
1954	5.92	5.09	(⁵)	20.37	23.61	43.06
1957	6.96	8.47	5.86	14.33	28.66	28.01
1958	6.39	.70	3.15	18.18	27.27	34.27
1960	6.55	13.64	8.79	10.91	15.15	31.82
1961	6.52	5.01	6.49	14.45	20.94	33.63

¹ Net funds raised by private domestic nonfinancial sectors include, in addition to types of credit shown here, mortgages on multi-family dwellings and on farm and commercial land and buildings; and acceptances, commercial and finance company paper, and Commodity Credit Corporation (CCC) loans.

² Bank loans to nonfinancial business not classified elsewhere.

³ Mortgages on one- to four-family homes.

⁴ Preliminary estimates.

⁵ Loans were less than \$50 million.

NOTE.—Data are based on flow of funds accounts.

Source: Board of Governors of the Federal Reserve System.

The composition of borrowing during the current expansion has also been similar to that of other recent expansions, although the sources of funds have differed. Consumer credit and bank loans to business have risen substantially, relative to other types of borrowing. When employment and income are high, a larger proportion of households' income typically is spent for durable goods and housing which are likely to be financed by credit. The share of GNP going into inventories and plant and equipment also rises, spurring business borrowing, particularly from banks.

Households

Borrowing by households has been rising significantly since the end of 1961. As a proportion of disposable personal income, however, it reached a peak of 6.5 percent in 1963; this figure had been surpassed only in 1955 and 1959. Since 1963, the proportion has edged down to about 6 percent. Nevertheless, borrowing remains large relative to consumers' "capital" expenditures. Even though there has been a rapid advance in

consumer expenditures on durable goods, total household expenditures for durable goods plus home construction have been smaller relative to disposable income than in previous expansions since the Korean war.

Households have simultaneously stepped up their borrowing and the growth of their financial assets. Households' financial assets have grown annually by 10 to 11 percent of disposable income since 1962, compared with slightly below 9 percent in 1955–56. Higher incomes have made more households both creditworthy and able to save. Moreover, the growing importance of contractual saving, through insurance and pension funds, has often led even the same households to add both to their financial assets and to their liabilities.

Business

While borrowing by households and State and local governments maintained a fairly rapid pace in 1965, it was the financial demands of businesses which accounted for the acceleration in credit flows. Last year, business capital expenditures significantly outpaced the strong rise in gross retained earnings, and the ratio of capital outlays to retained earnings rose abruptly. Indeed, it exceeded the ratio for all years in the post-Korean period, except 1956. External financing, however, rose even more sharply, reaching a new high relative to gross retained earnings that surpassed even the 1956 relationship. This strong rise is partly attributable to the growing volume of funds committed by corporations to uses other than capital outlays. In the past 2 years, corporations have markedly increased their net extensions of trade and consumer credit. Meanwhile, corporate holdings of liquid assets have declined steadily as a proportion of their financial assets. Consequently, corporations are now less able to economize on liquid assets in order to provide for other uses of funds.

A number of special factors in 1965 also contributed to the sharp increase in business borrowing. Inventories were rising rapidly and foreign investment by corporations was unusually high early in the year.

All in all, the volume of borrowing was not significantly out of line with past experience. Furthermore, the total demand for goods and services—supported in part by the expansion of credit—was in good balance with the supply capabilities of the economy in 1965.

POSITION OF FINANCIAL INSTITUTIONS

Sustainable growth of credit depends on the sound operation of financial institutions. As new types of financial “intermediation” evolve to meet new needs, more lending and institutional saving will take place. Such credit growth will occur smoothly if financial institutions adjust to innovations without assuming dangerous risks.

During the current expansion, the most striking institutional change in the financial area has been the rapidly growing role of commercial banks.

Total bank credit has risen at an average rate of 8½ percent a year since the end of 1960, while total credit to nonfinancial sectors of the economy has risen by 7 percent a year. Commercial banks have accounted for over one-third of total funds raised in credit markets during recent years, in contrast to the one-sixth share in earlier post-Korean periods of prosperity. The larger proportion of credit flowing through the commercial banking system has resulted from various influences: first, a sequence of increases in the ceiling rates of interest permissible on time and savings deposits, which has enabled the commercial banks to compete more aggressively for deposits and thus to expand their lending; second, the greatly expanding scope of bank lending and investment practices; and third, the more liberal policy pursued by the Federal Reserve System in supplying bank reserves.

Much of the recent growth of bank deposits has taken the form of time certificates of deposit. Another sizable increase in such certificates and in commercial bank lending can reasonably be expected in the early part of this year, in response to the increase last December in the maximum permissible interest on time deposits. Nevertheless, banks which have expanded lending greatly on the basis of short-term certificates of deposit have at times found it costly to raise needed funds when the certificates mature in quantity. This experience should introduce more caution in the pursuit of new business.

Savings and loan associations and mutual savings banks have borne the brunt of competition from commercial banks. Meanwhile, the demand for mortgages, in which such institutions customarily place most of their funds, has grown less rapidly than other types of credit, and yields on mortgages showed little change during most of the 1960's. Consequently, some savings institutions eager for growth, have sought higher yielding and occasionally more risky outlets for investment while repeatedly raising their dividend or deposit rates. In order to prevent the assumption of excessive risk by savings and loan associations, the Federal Home Loan Bank Board strengthened its surveillance and issued several new selective regulations in the past year.

The President's current legislative program includes proposals to reform the structure of financial regulations, to give regulatory agencies a greater variety of enforcement powers, and to increase deposit insurance coverage. This important legislation includes proposals that will make regulations over various types of financial institutions more consistent with each other, thus fostering competition while providing the authority to curb speculative excesses. These same objectives have prompted legislative recommendations to allow Federal chartering of mutual savings banks for the first time.

POSITION OF BORROWERS

Rapid growth in borrowing by households and businesses relative to their incomes raises the question whether still more debt can be readily absorbed

without threatening an abrupt cutback in future spending. Danger signals are commonly sought in three basic types of indicators: growth of the ratio of debt repayment to income or of total debt to total assets; growth of "easier" credit terms, such as smaller downpayments, longer maturities, or higher appraisal values; and growth of certain losses, such as foreclosures or defaults.

The ratios of household debt repayments or income commitments to disposable personal income have risen over the past 12 years (Table 5).

TABLE 5.—*Relation of selected commitments of the household sector to disposable personal income, 1951-65*

Year	Percent of disposable personal income			
	Repayments of instalment debt	Repayments of instalment and mortgage debt	Basic fixed commitments ¹	Basic fixed commitments and essential outlays ²
1951.....	10.2	12.0	16.3	57.7
1952.....	10.7	12.7	17.0	58.3
1953.....	11.1	13.2	17.8	57.6
1954.....	11.8	14.3	19.0	59.1
1955.....	12.2	14.7	19.5	58.5
1956.....	12.7	15.3	20.1	58.5
1957.....	12.9	15.8	20.6	58.9
1958.....	12.6	15.7	20.6	59.3
1959.....	12.6	15.8	20.7	59.1
1960.....	13.1	16.4	21.5	59.7
1961.....	13.1	16.4	21.5	59.5
1962.....	13.1	16.4	21.6	59.2
1963.....	13.6	17.2	22.5	59.7
1964.....	13.9	17.3	22.7	59.2
1965.....	³ 14.2	³ 17.8	(4)	(4)

¹ Consists of repayments of instalment and mortgage debt, tenant rent, and property taxes on households.

² Essential outlays consist of consumer outlays for food, clothing, utilities, and local public transportation.

³ Based on first 2 quarters.

⁴ Not available.

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

Most of the rise is accounted for, however, by widening use of instalment credit rather than the rise in the average repayment burden for families using credit. Almost one-fourth more families, particularly young parents, are now using instalment credit. Debt repayment, however, is only one type of commitment undertaken by households. Whether households are overextending themselves must be viewed in terms of a broader concept of commitments including other contractual obligations and essential consumer outlays. When viewed in this way, the measure of "burden" has been roughly stable. Certain claims on income substitute for others: mortgage payments for rent, and automobile payments for some purchased transportation.

Use of aggregate ratios can hide distributional problems. Surveys suggest that families which have a relatively small amount of liquid assets account for a large proportion of the instalment debt outstanding; their creditworthiness is established by their earnings rather than their accumu-

lated assets. However, there was a slight decline from 1954 to 1965 in the proportion of families which have as much as 20 percent of their disposable income committed to instalment debt repayments.

“Easier” terms of credit may be either a warning signal of excessive credit expansion or a welcome evolution. The widening availability of credit has been a key feature of American financial development over the long run. Certain types of lending that were once considered “risky”—such as consumer instalment credit—have proven to be quite sound and profitable. Other such innovations have come at a rapid pace in recent years.

Delinquency rates on consumer credit have varied in the post-Korean period—mainly reflecting fluctuations in economic activity—but they have remained consistently well below their 1950–53 level.

In contrast, the rate of mortgage foreclosures has shown a distinct upward trend during the past 15 years. From World War II through the Korean war, the inflation of real estate values bailed out poor credit risks and held down mortgage defaults. Subsequently, foreclosures on conventional mortgages began to rise, but they have increased only slightly since 1961. Much of the uptrend in the over-all foreclosure rate since 1961 has taken place in Federal Housing Administration (FHA) insured mortgages which had been written with unusually liberal terms. Thus, FHA procedures and regulations have recently been tightened. By any reasonable criterion, today’s over-all foreclosure rate on home mortgages, about $\frac{1}{2}$ percent a year, is not out of line with the risk premium that such assets carry.

Nevertheless, a sharp drop in incomes could certainly have unfavorable financial repercussions. Despite the strong position of financial institutions and the insurance of various types of deposits and mortgages, the quantity of outstanding credit is an element increasing the economy’s vulnerability to cumulative declines if aggregate demand is permitted to collapse. Well-timed fiscal and monetary policies to maintain economic stability hence become even more important.

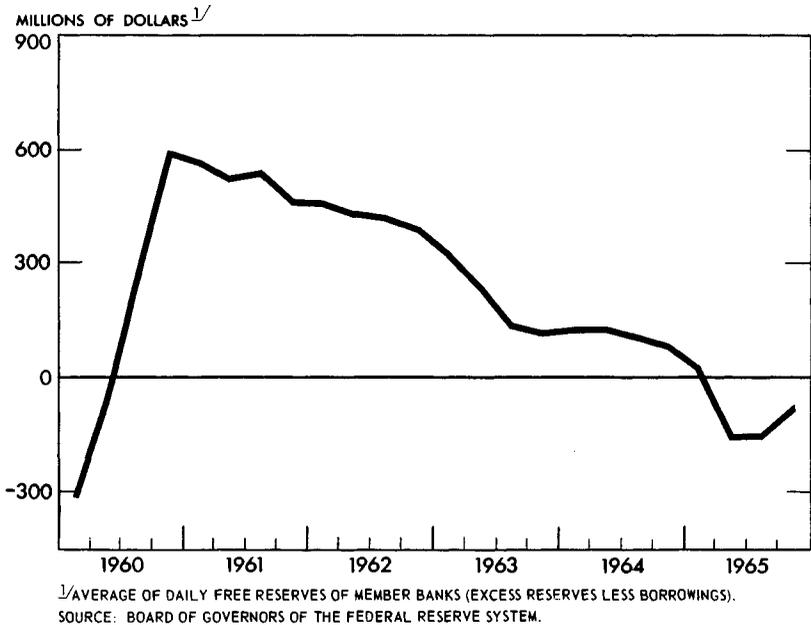
MONETARY POLICY

The growth of total credit in the current expansion has contributed to the improved balance between total spending and potential output. Until mid-1965, the cost and availability of credit remained unusually stable for a period of strong advance in economic activity. The increase in the discount rate announced last December 5 was the first monetary policy action aimed specifically at domestic credit flows.

Previous movements toward less ease in monetary policy had been directed primarily toward restraining the flow of funds abroad for balance of payments reasons. The discount rate increase in November 1964 was aimed at forestalling outflows of short-term capital threatened by an increase in the British Bank rate. Reserve availability was again reduced after new balance of payments measures were announced last February (Chart 5). Following this move, free reserves remained almost continuously in the

Chart 5

Free Reserves



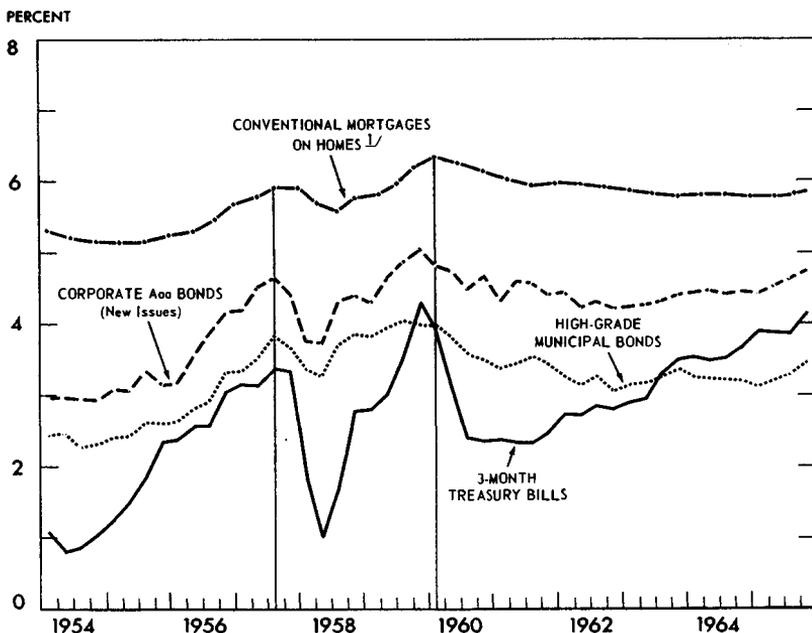
negative range (i.e., borrowings from the Federal Reserve System exceeded member bank holdings of excess reserves).

From October 1964 to the end of 1965, Treasury bill rates rose by nearly 1 percentage point, almost equaling the total rise in the discount rate. Moreover, in 1965, long-term interest rates turned up after a period of remarkable stability (Chart 6). Yields on newly issued corporate and State and local bonds began to rise in the first quarter of the year as the volume of new issues expanded rapidly, relative to the supply of funds. Short-term funds remained readily available during the spring and summer, buttressed by the exceptionally large cash flow to particular industries (such as automobiles and steel) early in the year, by funds repatriated from abroad in connection with the new balance of payments measures, and by net repayments of Treasury debt during this period. After mid-summer, however, these funds had largely been absorbed, and virtually all interest rates began to rise more substantially. Expectations were buoyant, corporate security flotations began to grow again, and the Treasury became a net borrower.

Furthermore, despite a rapid growth of total bank credit and of deposits at commercial banks (Table 6), rising interest rates reflected both surging credit demands and firmer monetary policy. During 1963 and 1964, most of the reserves needed by the commercial banking system to meet credit demands were supplied through the open market operations of the Federal

Chart 6

Selected Interest Rates



¹/ SERIES BEGINS IN 1954; NEW AND EXISTING HOMES THROUGH 1960 I, AND NEW HOMES ONLY THEREAFTER.

NOTE: VERTICAL LINES SHOW GNP PEAK QUARTERS: 1957 III AND 1960 I.

SOURCES: FEDERAL HOUSING ADMINISTRATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE AND STANDARD & POOR'S CORPORATION.

TABLE 6.—Changes in commercial bank credit, money supply, and time deposits, 1963–65

[Based on seasonally adjusted data]

Item	Percentage change (annual rate) during						
	1963	1964	1965				
			Year ¹	I	II	III	IV ¹
Commercial bank loans (excluding inter-bank) and investments.....	8.0	8.4	10.0	12.4	10.6	4.8	10.9
Investments:							
U.S. Government securities.....	-4.8	-1.1	-6.2	-11.7	-12.8	-8.3	7.8
Other securities.....	19.9	10.6	15.2	14.5	20.0	13.3	10.1
Loans (excluding interbank).....	11.6	11.8	14.8	20.8	16.4	7.0	12.0
Money supply and time deposits ²	8.2	7.9	9.8	8.5	7.2	11.0	11.0
Money supply ³	3.8	4.3	4.8	1.5	3.8	6.2	7.6
Time deposits ⁴	14.7	12.8	16.0	17.4	11.5	16.8	15.0

¹ Preliminary.

² Changes based on averages of daily figures for last month in period.

³ Currency outside banks and demand deposits.

⁴ Time deposits at all commercial banks.

Source: Board of Governors of the Federal Reserve System.

Reserve System. During the first three quarters of 1965, however, open market operations supplied a smaller proportion of the growth in banks' required reserves—resulting in slower growth of nonborrowed reserves. More reserve needs were met by borrowing at the discount window. Reduced availability of reserves tended to moderate the growth of bank credit.

THE CURRENT FISCAL PROGRAM

The strong advance of the economy over the past 2 years is reflected in a remarkable rebound of Federal revenues following the 1964 tax reduction. From the close of 1963 to the final quarter of 1965, Federal revenues advanced by about \$9 billion; yet during this period, tax reductions of \$16 billion had taken effect through the Revenue Act of 1964 and the Excise Tax Reduction Act of 1965. As Federal expenditures grew very modestly in 1964 and early 1965, the budget on the national income accounts basis swung quickly into balance and showed a surplus exceeding \$3½ billion in the first half of 1965. Its subsequent retreat to a \$2½ billion deficit in the second half of the year resulted from several important deliberate stimulative measures plus the unforeseen rise in defense spending.

THE IMPACT OF 1965 BUDGET ACTIONS

The President proposed excise tax reduction in last January's budget; his specific recommendations were submitted to the Congress in May and the legislation was enacted 1 month later. The final act called for \$4.6 billion of reductions in several stages extending to 1969. The first stage took effect immediately in mid-June and reduced taxes by \$1¾ billion (annual rate), mostly on consumer durable goods.

In line with recommendations by the President, the Social Security Act was amended by the Congress last July. In addition to the initiation of medical insurance for the aged, which will take effect this July, and increased payroll tax rates, effective January 1, 1966, the legislation provides for increased old-age benefits which were made effective retroactively to January 1, 1965. The retroactive portion of increased benefits, amounting to \$885 million, was disbursed in September. The liberalization raised transfer payments thereafter by more than \$2 billion annually.

Furthermore, once payments on 1964 tax liabilities were completed last spring, a final dividend of personal tax reduction provided by the Revenue Act of 1964 helped to lift disposable income in the second half of 1965. These measures, together with the unexpectedly strong rise of Federal purchases, provided expansionary actions totaling \$10½ billion (annual rate) in the second half of 1965. With normal semiannual revenue growth of a little more than \$3½ billion at high employment, there was a net fiscal stimulus of about \$7 billion in the second half of 1965.

Scheduled tax changes are having a marked restrictive fiscal impact in the first half of 1966, as the rise in payroll taxes of nearly \$6 billion far outweighs the expansionary influence of the \$1¾ billion "second-stage" of excise cuts that took effect at the start of 1966. On the other hand, further increases in defense expenditures will be stimulating the economy in this period, and will continue to do so throughout the next 18 months. The combined effect of budgeted expenditures, including the benefits that will begin under hospital insurance in July, and tax laws now in effect would be more stimulative than now seems appropriate for the period ahead.

FISCAL PLANS FOR 1966-67

The objective of promoting balance between over-all demand and productive capacity pointed to tax cuts in recent years when demand was inadequate. That same criterion now calls for tax action to moderate the growth of private spending. In line with these principles, the President has asked the Congress to enact promptly four measures affecting tax payments.

The first of these would reform the withholding system for individual income taxes and place the income tax more firmly on a "pay-as-you-go" basis. The present system, with a single 14 percent rate, overwithholds from some low-income individuals and underwithholds from many other taxpayers, requiring large final settlements the following year. The proposed graduated rate schedule and other modifications will reduce both underwithholding and overwithholding. Once in effect, the new system will siphon off \$1.2 billion (annual rate) from disposable income for the rest of 1966.

The second proposal would place corporate tax payments also on a more nearly current basis. Under present law, corporations with tax liabilities exceeding \$100,000 are scheduled to pay only 68 percent of the estimated tax due on 1966 incomes by the end of the calendar year, with the remaining 32 percent not paid until the first half of 1967. There is already a formula under existing law that would move corporations to a current basis by 1970. It is now proposed to accelerate this step-up to achieve current payment status within 1967. This action would increase cash payments to the Treasury by an estimated \$1 billion this spring and \$3.2 billion in the spring of 1967, reducing the carry-over of unpaid liabilities into 1967 and 1968 by comparable amounts.

The rescheduling of corporate tax payments will not add to final tax liabilities nor will it alter after-tax profits in either business or national income accounting. It will nonetheless reduce the availability of internal funds for investment and should thus have a moderating influence on investment demands, particularly in the light of firmer credit conditions.

A third proposal to put tax payments on a more current basis affects the social security taxes of the self-employed. It calls for quarterly declarations, paralleling those of the individual income tax, instead of a single large pay-

ment at year end. It also more nearly parallels the treatment of wage earners, whose social security taxes are collected on a current basis through withholding. The proposal would increase revenues by \$100 million in each of the fiscal years 1966 and 1967. It will reduce disposable income by \$400 million (annual rate) in the second half of this calendar year.

The fourth proposal affects excise taxes. In view of the large revenue involved in the excise taxes on automobiles and telephone service, they were scheduled to be cut gradually in the Excise Tax Reduction Act of 1965. The Congress is being asked to reschedule the reduction to meet current economic needs. Each step in the present timetable, commencing with the January 1, 1966 instalment, would be shifted forward 2 years. The reinstatement will restore \$0.9 billion of revenues, and the postponement of the scheduled January 1967 cuts will avoid a further revenue drop of \$0.6 billion next year.

With these measures, both the actual and high-employment budgets on the national income accounts basis are expected to be approximately in balance in fiscal 1967. Over the full budget planning period to the first half of 1967, Federal expenditures are estimated to rise about \$17½ billion from their level in the second half of 1965. The increase includes \$6 billion in defense purchases, \$6½ billion in transfers, and \$3 billion in grants to States and localities. Normal revenue growth at high employment will total about \$11½ billion over this period. Meanwhile, tax measures that have already been enacted and those now proposed will result in a net addition of \$7 billion to Federal revenues.

The aim of fiscal policies in the next 18 months is to preserve the sound expansion enjoyed in 1965—to maintain a strong and healthy prosperity; to promote a cautious movement toward lower unemployment without moving so far or so fast that bottlenecks and inflationary pressures arise.

THE OUTLOOK FOR ECONOMIC ACTIVITY

In the light of the fiscal program outlined above, GNP for 1966 is expected to be within a \$10 billion range centered on \$722 billion, given the \$675.6 billion level now estimated for 1965. At the midpoint of this range, the advance would be \$46½ billion, virtually identical with the gain scored in 1965. No major departure is expected from the 1.8 percent increase of over-all prices in 1965, as explained in Chapter 2. Thus, total real output should advance by nearly 5 percent in 1966.

Civilian employment, which rose by 1.8 million persons in 1965, should register a similar large increase this year. In addition, the armed services will expand by 300,000. On the other hand, the total labor force will rise strongly. The unemployment rate, which averaged 4.6 percent in 1965, should decline this year to about 3¾ percent, the lowest rate since 1953.

GAINS BY SECTOR

While strong demands will be characteristic of most sectors of the economy, defense spending and business fixed investment will provide the major thrust to over-all demand. The special implications of these sectors are explored in more detail below. In brief, the increase in Federal purchases made necessary by the Vietnam situation will deliver a major stimulus to the economy, accounting for most of the prospective \$7 billion rise in total Federal purchases. Business expenditures for fixed investment will rise strongly again in 1966, although the advance is not expected to match the 15½ percent increase of last year. According to present indications, capital outlays are likely to exceed the 1965 total by about \$7 billion.

State and Local Government

State and local government purchases, a particularly reliable component of GNP, are expected to rise by about \$5 billion, continuing their recent trend. They will receive continuing support from growing Federal grants that meet pressing needs for public services.

Inventories

Last year's inventory investment of \$7 billion (1958 prices) was in line with the real growth of \$29 billion in final sales. Still, irregular and special factors in the automobile and steel industries added a little, on balance, to inventory investment last year. In the absence of such special influences, a fractional decline from last year's rate is probable in 1966.

Homebuilding

The fundamental demographic factors influencing residential construction will not change significantly in 1966: the increase in the number of households is expected to be about the same as the 1960-65 average. Financing conditions may be less favorable, since conventional mortgage rates began to rise last September for the first time in 5 years and some further increases appear possible. On the other hand, the excess supplies of new housing in selected areas seem to be dwindling. On balance, the value of residential construction is likely to change little in 1966.

Consumption

Consumer outlays depend primarily on the growth of disposable income. Unlike 1964 and 1965, tax reductions and increases in transfer payments will provide no net stimulus to consumer incomes this year. Between 1963 and 1965, cuts in personal income taxes added about \$10 billion directly to consumer take-home pay, and government transfer payments increased by nearly \$4 billion. This year, transfer payments are expected to rise strongly, paced by the launching of the hospital insurance

program. However, social insurance taxes are higher, the new withholding system will moderate the growth of after-tax income, and the second stage of excise reduction will be adding very little to household purchasing power once the President's proposals are enacted. Nevertheless, rapid gains can be expected in disposable income this year owing to strong increases in wages and salaries, interest, dividends, and self-employment incomes.

Little change in the personal saving rate is anticipated for 1966. The saving rate of 5.4 percent in 1965 was close to the average of recent years. Consumer confidence and spending intentions remain high. Allocation of income among various types of consumer goods may shift moderately. The fraction of disposable income spent on automobiles and parts may decline somewhat from the exceptionally high 6.4 percent in 1965 (which included purchases deferred by the late-1964 strike). Prospects seem particularly bright, however, for durable goods other than cars; color television sets are a notable example. Sales of nondurable goods other than food should also rise strongly and continue to reflect upgrading of quality.

In sum, consumer expenditures are expected to account for about 60 percent of the rise in GNP this year, compared with their 63 percent share in the 1965 advance.

KEY ROLE OF BUSINESS FIXED INVESTMENT

This year, business fixed investment is again expected to be one of the two major expansionary forces in the economy. After 2 years of rapid increases, it reached 10½ percent of GNP late in 1965. This surge followed a period of weak investment dating from 1958 and extending into the early years of the current expansion. The proportion of GNP devoted to nonresidential fixed investment averaged only 9.2 percent from 1961 to 1963, well below the 9.6 percent average during the preceding decade.

Major Determinants

The revival of fixed investment in the past 2 years can be traced to improvements in three major determinants of investment demand. First, the economic expansion has raised final demands relative to the stock of productive facilities. In manufacturing, for example, 91 percent of capacity was utilized in 1965, in contrast to an average of 85 percent in the preceding 10 years. To avoid bottlenecks, delays, and lost sales, businessmen now have the incentive to build capacity in advance of rising demand. Second, the generation of internal funds through profits and depreciation has facilitated corporate financing, while monetary policy has enabled external financing needs to be satisfied readily. Third, the anticipated future returns from investment have been enhanced by the prospect of continuing economic expansion and by the investment tax credit, the liberalized depreciation rules, and the lowered corporate income tax rates.

This year, financing conditions may be less favorable, after-tax profits are unlikely to repeat last year's exceptional 20 percent spurt and available internal funds will be held down by the new corporate payments schedule. Nevertheless, the major determinants of investment spending suggest that capital outlays should rise strongly again in 1966. According to the investment anticipations reported in the Government survey last November, the annual rate of plant and equipment spending by nonagricultural businesses in the first half of 1966 will exceed the full-year 1965 level by \$6 billion, or by 11½ percent. The rise is expected to continue in the second half of the year. Nonresidential fixed investment for the entire year will probably be slightly above 10½ percent of GNP.

Longer-Term Prospects

The current strength of investment demand provides new evidence and, at the same time, raises new issues concerning the longer-term prospects for capital outlays. Nagging doubts about a possible secular weakening of capital spending have now been resolved. Yet, it is obvious that business fixed investment cannot continuously grow twice as fast as GNP, as it did in 1964 and 1965, and that it cannot always be a propelling sector of demand. Nor is it certain that the economy can regularly maintain the current 10½ percent investment share at full employment, a share which matches the postwar peak.

Some of the current strength in investment demand may represent a catching-up after a period marked by slow growth of plant and equipment capacity and by aging of the capital stock. From 1957 to 1963, manufacturing capacity grew less than 3½ percent a year. This kept pace with actual manufacturing output but was considerably less than the normal full-employment growth of manufacturing output. As the economy returns to full employment, additional capital facilities are needed to complement higher employment and output. The same catching-up process occurs in the modernization of the capital stock. Prolonged economic slack leaves the Nation with older productive facilities. Because the Great Depression and World War II reduced investment drastically, the average age of capital rose from about 16.5 years in the mid-1920's to over 21 years by the end of 1945. Rapid investment during the first postwar decade reduced the average age of the capital stock to 17 years by 1957. This trend was subsequently altered by the sluggish pace of investment. Now, however, businessmen have stronger incentives to make up for lost time in their pursuit of modernization programs.

Even after catching-up is finished, several factors are likely to be working to strengthen investment demand. A higher prospective return can stimulate "capital deepening", i.e., investment that provides each worker with more capital. Profitability will be higher owing to the investment tax credit and lower corporate income tax rates, as well as improved prospects

for sustained full utilization. Some cost-cutting investments which would not have been profitable in the past may now yield an expected after-tax return high enough to justify the required outlay.

In addition, a more rapidly growing labor force can add to investment demand, providing full employment is maintained. In that event, unless capital is expanded more rapidly, each worker would have fewer tools. Businessmen will find it profitable to equip the additional workers. If businessmen respond fully, the extra growth of capital stock will match the additional growth of employment. Over the remaining years of the 1960's, the labor force is expected to grow about one-half of 1 percent faster, on average, than its yearly growth rate of 1.3 percent in the past decade. Adding an extra 0.5 percent to employment in any year, and providing the new workers with the usual amount of equipment and facilities would require a matching 0.5 percent increment to the capital stock. It would take an addition of about 5 percent to the current annual total of investment to provide that extra capital.

To be sure, the possibility cannot be ruled out that a part of the strength of current investment might be associated with overly optimistic expectations by some businessmen. Errors can be made in investment decisions because such decisions are necessarily forward looking and based on anticipations of future profits and sales. On the other hand, market experience does provide incentives and information about recent and prospective developments. And businessmen have increasingly used scientific techniques to rationalize their capital budgets. Business investment programs in the past 2 years seem to have added to capital in the right places and in appropriate amounts, as discussed in Chapter 2. Programs planned for 1966 should continue these trends.

THE IMPACT OF DEFENSE

National defense outlays will be the other major expansionary force this year. The upward movement in defense spending alters a pattern of stability maintained from mid-1962 into 1965. During that period, the national defense establishment was considerably modernized and better equipped; yet over-all defense expenditures were stable or declining. Since the economy was expanding rapidly, the percentage of GNP channeled into defense purchases declined from 9.2 in 1962 to 7.4 in the first half of 1965.

We are not now engaged in wartime mobilization, nor entering such a mobilization period. The present defense buildup is vastly different in size from the mobilizations at the outset of World War II or the Korean conflict. When the United States entered World War II, it had to build a military establishment almost from scratch; and the Korean war followed a period of rather thorough demobilization and de-emphasis of defense. In both cases, the outbreak of hostilities required a fundamental reevaluation of the country's defense posture, leading to vast increases in expenditures.

Ever since the Korean war, the United States has given greater attention to the requirements of military preparedness in an uneasy world. After Korea, defense expenditures dropped sharply from their peak rate of nearly \$50 billion, but they have never fallen below \$38 billion. In contrast, they had totaled \$13 billion in 1949. Since 1953, the country has invested mightily in defense; it has continually rolled over its stock of defense goods and equipment to take advantage of new developments in weapons systems and has maintained general purpose defense capabilities. The Vietnam conflict, therefore, finds us well prepared. The procurement and personnel increases are modest by earlier standards and by comparison with total supply capabilities.

The percentage increase in defense expenditures this year will slightly exceed that in over-all national output. Defense purchases of goods and services, which were 7.5 percent of GNP in the fiscal year ended June 1965, are expected to average 7.6 percent in both fiscal 1966 and fiscal 1967 (Table 7). This contrasts markedly with the buildup after the outbreak of

TABLE 7.—*Defense impact in relation to GNP, Korean war period and current period*

Period and fiscal year	Budget expenditures for national defense (billions of dollars)	Federal purchases of goods and services for national defense	
		Amount (billions of dollars)	Percent of GNP
Korean war period:			
1950	13.0	12.7	4.8
1951	22.5	21.7	7.0
1952	44.0	41.8	12.4
1953	50.4	48.8	13.6
Current period:			
1965	50.2	48.8	7.5
1966 ¹	56.6	53.0	7.6
1967 ¹	60.5	56.6	7.6

¹ Estimates.

Sources: Bureau of the Budget, Department of Commerce, and Council of Economic Advisers.

the Korean war when defense outlays more than tripled in 2 years and rose from under 5 percent of GNP in fiscal 1950 to over 12 percent in fiscal 1952.

The increase in purchases for defense of \$6 billion this calendar year represents nearly 13 percent of the increase in GNP. These outlays will exert a broad fiscal stimulus. Indeed, because they directly and immediately add to GNP, defense purchases tend to have a somewhat larger and more rapid economic effect than a tax reduction (or increase in transfers) of the same size, which must be respent before it can stimulate production. Although not as general as most tax cuts would be, even the direct impact of defense is felt throughout the economy. This is evident in the distribution of added defense expenditures among various types of products. About 35 percent of the step-up in defense expenditures for 1966 is for direct personnel

costs—pay and allowances—of the increased number of military and civilian personnel. An additional 10 percent of the total increase is for training, food, lodging, clothing, and transportation costs directly associated with the increased manpower. Another 22 percent represents gasoline, ammunition, ordnance, and similar mass-produced production-line items. A further 18 percent can be attributed to large, sophisticated weapons systems, such as aircraft, ships, and missiles.

Defense procurement by itself will not be placing extreme demands on particular industries, although textiles and selected other industries receiving increased defense orders are already experiencing high operating rates as a result of buoyant private demand.

The present Defense Materials System, which has been in effect since the end of the Korean war, will continue to deal with allocation problems. It gives priority to defense and defense-related orders in the event of any conflict with civilian orders for the same materials or for use of industrial capacity, and allots certain categories of controlled materials on the basis of priority. With the economy operating considerably below capacity, these priorities and allocations have been routinely executed in the past without bumping private demands to any noticeable extent. With operating rates now higher than before, there may be some cases where the execution of civilian orders will be somewhat delayed. However, these will be exceptional, and will not be such as to require alteration in our present machinery for materials priorities and allocations.

THE NEED FOR FLEXIBILITY

Economic policy for 1966 is guided by a thorough and realistic assessment of the outlook for the economy and by the objective of maintaining a well-paced advance. Fiscal policies for 1966 have been fashioned in the light of an evaluation of both the strength of private demand and the moderating influence of monetary policy. Clearly, fiscal and monetary policies must be closely coordinated, and effective coordination has prevailed in the past 5 years. The Administration regretted that the discount rate increase last December interrupted that pattern. Consultations between the Federal Reserve and the Administration continue, helping to assure that monetary and fiscal policy together will provide appropriately for sustained and balanced expansion. Both are keenly aware of uncertainties in the outlook and are prepared to respond to emerging developments.

CONTINGENCIES IN 1966

This year, the economy will be moving into new territory as rates of unemployment reach the lowest levels in more than a decade. While prospects are excellent that this course can be safely traversed, there can be no certainty. The defense program introduces an especially important set of uncertainties into the outlook. The budget is based upon a careful judg-

ment of the defense requirements imposed by our commitments in Vietnam and throughout the world. Nevertheless, these requirements could change in the year ahead—in either direction. Finally, private demand is a constant source of uncertainty. Its particular strength in 1965 was a surprise. This buoyancy has been recognized in the forecast for 1966, but the accuracy of such an evaluation cannot be guaranteed.

In considering these uncertainties, it is important to appreciate the internal resistance of the economy to disturbances, as reflected in the record of recent years. To be sure, the economy can be pushed into boom or recession by sufficiently potent forces. But it is a mistake to view the path of economic activity as a tightrope from which one false step would mean spiralling inflation or cumulative contraction. One important sector of the economy, residential construction, lagged behind during most of 1964 and again during much of 1965; nevertheless, its sluggishness was barely noticeable in the aggregate pattern of activity. The strikes in the automobile industry in the fourth quarter of 1964 left a clear mark on the output of that quarter, but had no lasting effect on the vigor of expansion. Nor did the recent strong buildup and subsequent absorption of steel inventories disturb the over-all pace of economic activity.

Production and employment have shown stability in the face of volatile movements in financial markets. The sharp plunge of stock prices in the late spring of 1965 presumably was associated with a marked shift in investors' sentiment; yet spending for goods and services by consumers and business remained remarkably unaffected by the gyration.

Perhaps the clearest recent example of the economy's inherent stability was its response to the deliberate stimulus of tax reduction. The 1964 tax cut was indeed massive, but the response was gradual and the effect in lifting national output was spaced out over many quarters. Meanwhile, labor markets adapted and investment responded to create new capacity which permitted a remarkably balanced, noninflationary advance.

While the economy's own adaptation is the first line of defense, economic policy has a major role to play in countering disturbances. The program outlined earlier in this chapter is designed to meet the prospective needs of the Nation. But major changes in the outlook during the year could require new actions by the Administration, the Congress, and the Federal Reserve System. If military needs should prove to be larger than is anticipated in the fiscal 1967 budget—or if private expenditures should advance sharply so as to endanger price stability—further fiscal or monetary restraints would be necessary to prevent the rise in total demand from outpacing the growth in productive capacity. The President has indicated that he will not hesitate to recommend further tax increases in such circumstances.

On the other hand, a peaceful conclusion of the Vietnam hostilities could point to a reversal of policy actions premised on rising military spending. It would offer the welcome opportunity to encourage private expenditures

by reducing taxes once again or to add to high-priority Federal expenditures for civilian programs now limited by defense requirements. It could also point toward easing monetary policy.

LONGER-RUN OUTLOOK

In the longer run, defense will not continue to contribute as strongly to aggregate demand as in 1966. The current defense buildup meets an exceptional need and will be reversed as soon as reduction of world tension permits. In the years ahead, moreover, investment will certainly not rise consistently as fast as it will this year. It may even decline as a proportion of GNP. Yet, the factors determining investment do not point to a slump in capital outlays, provided that alert policies preserve the general health of the economy.

Shifting patterns of defense and capital outlays need not throw the economy off its track. The maintenance of steady advance at full employment does not require a growth of demand as strong as that needed to eliminate slack. The economy would face serious inflation if such strong expansionary pressures continued for very long. But continual growth of demand is needed to maintain balance with potential output. Strength in other types of spending will be required to lead that growth in the future.

New sources of strength may be generated elsewhere within the private economy. In particular, later in this decade, more vigor can be expected from residential construction, an important component of private investment which for demographic and temporary reasons has been conspicuously lagging. Moreover, if additional demand is needed, fiscal policy can help through new or expanded productive civilian programs or through tax reduction to support consumer purchasing power.

The prospects for sustained expansion thus continue to be favorable for the longer run. Even so, our ability to counter recession can and should be improved. Long-needed reforms in the unemployment insurance system are one important step that should be taken this year. There is also a good opportunity now to intensify discussion and study of the type of tax action which could best combat the threat of recession. A social consensus on this issue would help to avoid prolonged debate in a time of urgency.

Both in meeting surprises and in laying systematic plans, the lessons learned in the last 5 years will remain relevant. The American economy has demonstrated its capacity for strong growth and its ability to move steadily ahead, as long as a reasonable balance between total supply and over-all demand is maintained. The promotion of such a balance will remain the basic task of domestic fiscal and monetary policies.

Chapter 2

Prospects for Cost-Price Stability

AS THE ECONOMY enters its sixth year of uninterrupted expansion and its third successive year of high growth, the gap between potential and actual production is fast disappearing. Unemployment is near 4 percent, and operating rates in many industries are moving close to preferred rates. The past 5 years have demonstrated that the economy can operate free of recurrent recession. Now the United States is entering a period that will test whether sustained full utilization of our human and physical resources is possible without the injustice, dislocation, and decline in competitive position that accompany inflation.

History alone is not reassuring. Still, there are sound reasons for confidence that a higher degree of cost and price stability can be achieved at high employment than during previous such periods since World War II. The pattern of economic activity shows superior balance. Productivity gains are larger and more extended. Private attitudes in key wage and price decisions are considerably more responsible. New competition from abroad reinforces keen domestic competition for markets, and new policies of active manpower development are permitting the fuller use of our human resources.

If both full employment and price stability can be maintained, the United States will enjoy continuing real growth that will provide abundant resources to meet simultaneously the demands of national security and of domestic welfare. The last few years have shown what the American economy can do when its progress is free of interruption. Incomes from wages and profits have leaped ahead. With over-all unemployment down sharply, the disadvantaged groups that suffered most during the period of slower growth are improving their positions. If the economy remains on its path of balanced growth, it will be an engine of great social progress, and—together with the Great Society programs—will move us steadily closer to our ideals. But only if inflation can be avoided will prosperity be sustainable and the economy achieve its full promise.

DETERMINATION OF THE PRICE LEVEL

The relation between the volume of economic activity and the price level is not simple. As a first approximation, the classical law of supply

and demand leads one to expect that the change in the price level will depend mainly on the size of the gap between capacity and actual output. The more production falls short of potential—i.e., the greater is excess productive capacity—the further prices should drop. Conversely, when demand outruns aggregate supply, the imbalance should raise prices. History shows that things are rather more complicated. For example, the second half of 1955 was a period when there was no gap between potential production and actual production, yet the GNP deflator—our most comprehensive indicator of the price level—rose little. In 1957 and 1958, when the gap was beginning to assume considerable size, the GNP deflator rose substantially. The GNP deflator rose at a fairly steady and modest pace, both in the years when the gap was large—in 1958–61—and when it narrowed substantially—from 1961 to 1965. Clearly, more detailed analysis is necessary.

Some important components of the price level have risen continuously over the years, particularly in construction, services, and Government. Other components of the price level, especially agricultural and some raw material prices, are influenced by supply conditions which move relatively independently of the general economy.

The industrial component of the price level has proved to be most systematically responsive to the general degree of prosperity. But even industrial prices cannot be accurately predicted by reference to levels of activity alone. For example, industrial prices have been much more stable for any given degree of utilization of industrial capacity in the last 5 years than in the preceding decade.

Industrial price movements are mainly determined by four elements:

First, prices move roughly parallel with the basic cost trends. This does not mean that the causation runs wholly from costs to prices. Both are subject to many common influences; moreover, prices directly influence costs because wage increases respond in part to price and profit levels. But clearly, other things equal, higher costs tend to raise prices.

Second, the state of demand affects prices. When markets are weak and part of capacity is idle, list prices are discounted and may even be lowered. Delivery periods are shortened, quality may be raised, freight absorbed, and other terms of the transaction changed. When markets become stronger, business finds it easier to raise prices. Once shortages develop and industry is unable to keep shipments in pace with desired purchases, the likelihood of price rises becomes very much greater.

Third, the nature of the price-setting process of an industry can influence the price changes associated with any given set of cost and demand conditions. In highly concentrated industries, where a few producers or a single price leader can determine prices, the response may be quite different from that in an industry of many small firms, where wholly impersonal market forces keep supply and demand in balance through price adjustments. Differences are especially great in bad times. In competitive industries, prices are likely to fall; in concentrated industries, production is more likely

to be cut back, with only limited price adjustments. When markets are roughly in balance, the sequence and magnitude of price changes is less predictable. What happens in the more concentrated industries depends on the price policies followed by the principal producers. The Government's price guidepost is an attempt to avoid inflation resulting from industry's use of discretionary pricing power.

Expectations and attitudes also affect actual price changes. An economy accustomed to price stability is less vulnerable to inflation. Price adjustments to changing conditions come more slowly and moderately, and include both pluses and minuses. It is free of the inventory hoarding that adds to inflationary demands. And speculation in commodities does not raise raw material costs. Conversely, when an inflationary psychology takes hold, inventory hoarding and anticipatory placing of orders accentuate any market imbalances and further raise costs of production and distribution.

Finally, in a mixed economy such as ours, Government actions have an important effect on industrial prices. Fiscal policies help determine the over-all size of markets. The Government is the biggest customer for many industries and hence the largest single influence on demand. It also affects competitive conditions through tariff policies, quotas, and other forms of protection, through regulatory policies, stockpile, and commodity stabilization policies, and in other ways. If the objective of price stability is given recognition in the full range of economic policies, prices will be more stable.

THE PRICE RECORD

Our over-all price record during the present expansion has been remarkable—unmatched by any industrialized nation. But during 1965, the record developed some blemishes; prices, as measured by any of the major indicators, advanced more rapidly.

After increasing at an average annual rate of 1.3 percent between 1960 and 1964, the GNP deflator rose by 1.8 percent in 1965. The most prominent elements in this acceleration were more rapid increases in the deflators for construction, nondurable goods, and the Federal Government (reflecting the large military pay increase in 1965).

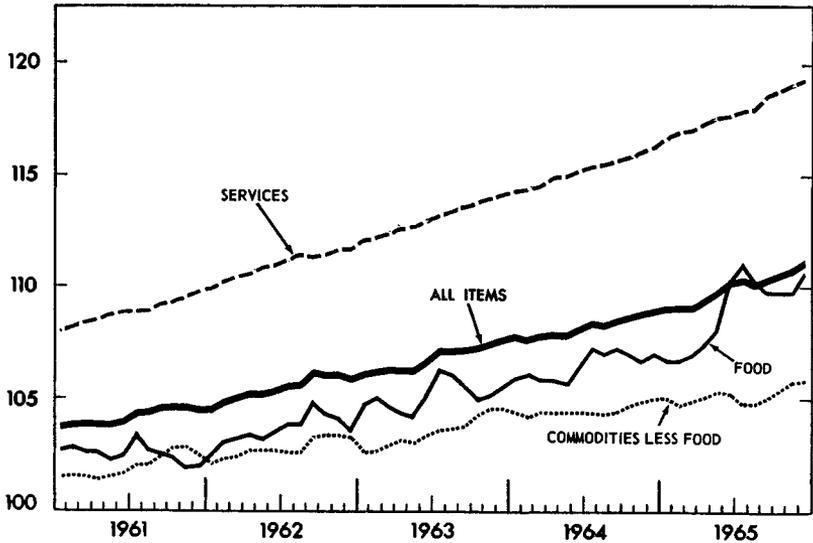
Consumer prices rose at an average annual rate of only 1.2 percent a year from 1960 to 1964, but by 1.7 percent in 1965 (Chart 7). Substantial advances in the prices of food, apparel, and footwear were mainly responsible for the faster rise. The reduction of excise taxes mitigated the increase of the index by 0.2–0.3 percent.

The wholesale price index increased 2.0 percent from 1964 to 1965 after 4 years of stability (Table 8 and Chart 8). Farm and food products accounted for over half of this increase. Industrial prices, which had remained virtually constant from 1960 to 1964, moved up by 1.3 percent last year. Increases were found particularly in nonferrous metals, nonelectrical machinery, fabricated structural products, gas fuels and petroleum, lumber, fertilizer materials, hides and skins, and manufactured animal feeds.

Chart 7

Consumer Prices

INDEX, 1957-59 = 100



SOURCE: DEPARTMENT OF LABOR.

In some respects, price behavior in 1965 showed a continuation of the healthy pattern that has characterized the present expansion. Prices in such important sectors of manufacturing as automobiles, steel, and electrical machinery remained essentially stable, and there were still many declines.

TABLE 8.—Changes in wholesale prices, 1961–65

Commodity group	Percentage change ¹		Contribution to total change (percent) ¹	
	1961 to 1965	1964 to 1965	1961 to 1965	1964 to 1965
All commodities.....	2.2	2.0	100	100
Farm products.....	2.5	4.3	12	23
Processed foods.....	4.4	4.1	29	30
All other than farm products and processed foods (industrials).....	1.7	1.3	59	47
Textile products and apparel.....	2.1	.6	7	3
Hides, skins, leather and leather products.....	2.8	4.4	2	3
Fuels and related products, and power.....	-1.8	1.9	-7	7
Chemicals and allied products.....	-1.7	.7	-5	2
Rubber and rubber products.....	-3.3	.4	-2	(²)
Lumber and wood products.....	5.4	.5	7	(²)
Pulp, paper, and allied products.....	1.1	.9	2	2
Metals and metal products.....	5.0	2.8	31	19
Machinery and motive products.....	1.4	.8	12	7
Furniture and other household durables.....	-1.5	-.5	-3	-1
Nonmetallic mineral products.....	-.1	.2	(²)	(²)
Tobacco products and bottled beverages.....	4.4	.3	5	(²)
Miscellaneous products.....	6.8	1.6	10	3

¹ Based on preliminary data for December 1965.

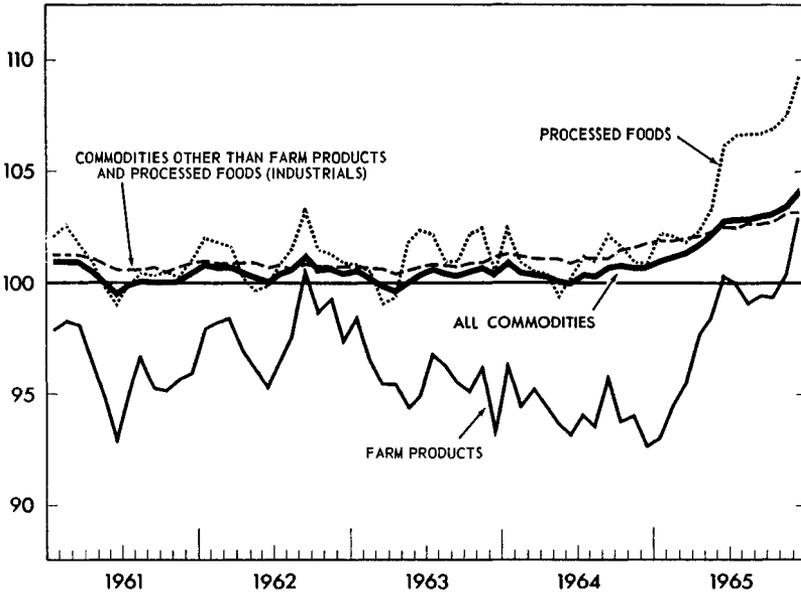
² Less than 0.5 percent.

Source: Department of Labor.

Chart 8

Wholesale Prices

INDEX, 1957-59 = 100



SOURCE: DEPARTMENT OF LABOR

Some of the increases reflected nonrecurring factors. The rise in prices of nonferrous metals reflected increases of world prices which do not influence adversely our competitive position. And the sharp rise in food prices in large part reflected production cycles in agricultural products.

SUPPLY AND DEMAND IN THE PRODUCT MARKETS

The fiscal and monetary policies outlined in Chapter 1 are intended to assure that total civilian and military purchases of goods and services do not exceed the economy's ability to produce. But price pressures can also develop from imbalances within specific sectors. If prices do not fall in sectors where potential supply exceeds demand as readily as they increase where demand outruns supply, imbalances in the composition of demand will raise the price level.

In recent years, measures have been developed which can serve as rough indicators of the supply-demand relationships of specific industries.

OPERATING RATES OF INDUSTRIES

Operating rates of industries are a direct measure of the relation between production based on current demand and the capacity to produce. Although the concept of capacity is an elusive one, most producers seem

able to give it quantitative meaning, and also to identify a rate of utilization of that capacity which is "preferred"—presumably a level of operation which management feels can be sustained efficiently for an extended period.

Starting from a low of 77 percent at the beginning of the expansion (compared with an average preferred rate of 92 percent), the seasonally adjusted average rate of utilization of manufacturing capacity as measured by McGraw-Hill rose by 6 points, to 83 percent at the end of 1961. During the following year, a parallel growth of output and capacity kept utilization rates rather steady. In 1963, output began to rise faster, raising average utilization to 88 percent by the end of 1964.

The strength of industrial investment in 1965 enabled capacity in manufacturing to increase by an estimated 5½ percent. Manufacturers increased output dramatically without running into significant bottlenecks. The average operating rate climbed to 89 percent by the end of the year as the gain in the rate of output accelerated under the impetus of investment and military demand.

The pattern of investment last year contributed to the general balance between output and capacity. Of the four industries which were operating at or above their preferred rates in December 1964, two subsequently succeeded in building up their productive capacity by more than the growth of output (Table 9). Others, which were operating below preferred rates at the end of 1964, added more slowly to capacity in 1965, so that they, too, came closer into balance.

In four industries, high demand has raised production beyond preferred utilization rates. In three of these industries, particularly large increases of investment are planned for the first quarter of 1966.

TABLE 9.—*Manufacturing capacity utilization, 1964-65*

Industry	Output as percent of capacity ¹		Preferred rate (percent) ²
	December 1964	December 1965	
Total manufacturing ³	88	89	92
Iron and steel.....	88	75	91
Nonferrous metals.....	98	103	95
Machinery.....	87	91	91
Electrical machinery.....	84	91	93
Autos, trucks, and parts.....	95	93	96
Other transportation equipment.....	80	93	88
Fabricated metals and instruments.....	87	94	92
Stone, clay, and glass.....	80	85	88
Chemicals.....	85	85	90
Paper and pulp.....	94	93	97
Rubber.....	96	94	94
Petroleum and coal products.....	91	91	95
Food and beverages.....	86	84	86
Textiles.....	96	98	96
Miscellaneous manufacturing.....	88	89	94

¹ Data for 1964 except iron and steel from McGraw-Hill; estimates for iron and steel for 1964 and all industries for 1965 by Council of Economic Advisers after consultation with McGraw-Hill.

² From McGraw-Hill survey of business plans for new plant and equipment, April 1963.

³ Not comparable with data in Table C-34 because of differences in methods of computation.

Sources: McGraw-Hill Publishing Company, Board of Governors of the Federal Reserve System, and Council of Economic Advisers.

When the operating rate for all manufacturing averages (say) 2 points below the preferred rate, there will be less price pressure if each individual industry shows a similar 2-point gap between its actual and its preferred rates than if some are above preferred rates and some far below. While there are always some differences among industries, the balance was unusually favorable in 1965. Sectoral balance can be measured by the weighted average of the absolute amounts by which the gap between each industry's own operating rate and its own preferred rate exceeds the gap between the operating rate for all manufacturing and the preferred operating rate for all manufacturing. This average "excess gap" was 1.7 percentage points in 1965, down from 2.9 in 1964. In contrast, the average "excess gap" was 6.6 in 1955, reflecting the severe sectoral imbalance of that high employment year. Investment expected in 1966 will raise manufacturing capacity by about 7 percent. This should keep the average operating rate essentially unchanged from 1965. The sectoral composition of rates should also continue in general balance.

For the nonmanufacturing sectors of the economy, less information is available on capacity utilization. Indexes prepared at the University of Pennsylvania show that operating rates outside of manufacturing rose by 1 to 4 points in the last year, as output rose substantially (Table 10). Output is expected to rise again considerably in 1966, but the anticipated high rates of investment should generate rapid growth of capacity as well.

TABLE 10.—*Capacity utilization and change in output of selected industries, 1964-65*

Industry	Capacity utilization (percent) ¹		Percentage increase in output, 1964 to 1965 ³
	1964	1965 ²	
Coal mining.....	64	68	4
Metal mining.....	78	81	6
Stone and earth minerals.....	94	97	6
Electric utilities.....	90	91	8
Gas utilities.....	94	96	5
Services ⁴	95	96	(5)

¹ Output as percent of the trend line through peaks in output, except for services.

² Average of first 3 quarters.

³ Average of available months in 1965 over average of equivalent period in 1964. Based on seasonally adjusted data.

⁴ Includes air and rail transport, office space rental, and residential housing. For method of computation, see R. Summers, "An Index of Capacity Utilization in Service Industries," Wharton School of Finance.

⁵ Not available.

Sources: Wharton School of Finance and Board of Governors of the Federal Reserve System.

BACKLOG OF ORDERS

In those industries where production is based significantly on orders (mainly durable goods industries), the relation of orders to shipments provides further indication of the state of demand relative to supply in the market. Since producers wish to translate an irregular flow of orders into a smooth production schedule, some backlog of orders is normal and desir-

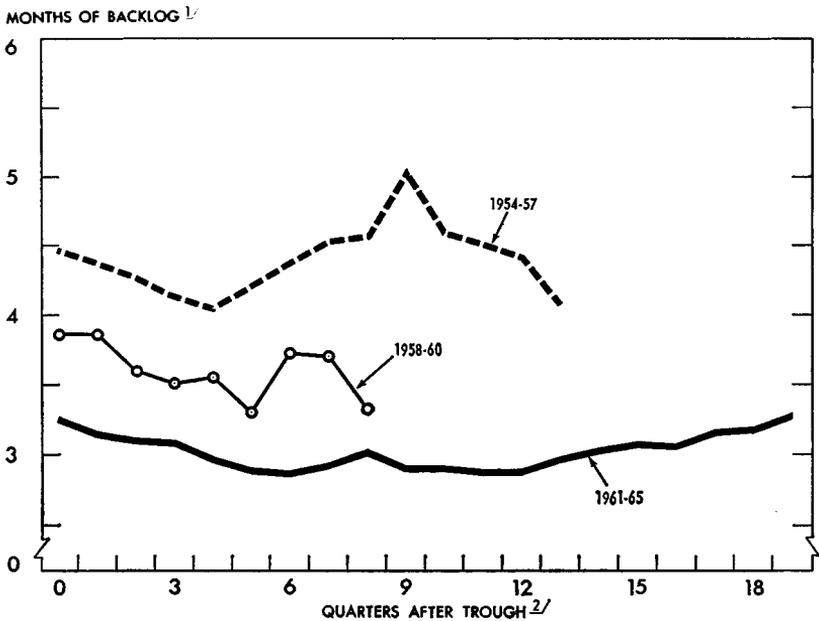
able. But when the ratio of unfilled orders to shipments increases rapidly, it may indicate that demands are exceeding producers' present supply capabilities, or that buyers are placing orders for future delivery farther ahead.

During recent years, the ratio of unfilled orders to shipments in the durable goods industries as a group has been roughly constant, equal to a backlog of about 3 months. In the two previous expansions, the orders backlog was both substantially higher relative to sales and considerably less stable (Chart 9). The average backlog reached 5 months in 1956, indicating the clear presence of excessive demand in some sectors.

Today, there is only isolated evidence of undue buildups of orders. The absolute volume of unfilled orders has increased in almost every industry. But the over-all increase in the backlog relative to shipments over the last 12 months was moderate. Increases of up to 0.3 month occurred last year in all durable goods industries except primary metals, where the backlog declined by 0.2 month, reflecting the steel adjustment. In the 1954-57 expansion, the backlog for the entire group of durable goods industries rose by as much as 0.9 month in a 12-month period.

Chart 9

Backlog of Manufacturers' Unfilled Orders for Durable Goods in Three Postwar Expansions



^{1/} RATIO OF UNFILLED ORDERS (END OF QUARTER) TO SHIPMENTS (QUARTERLY AVERAGE); EXCLUDES INDUSTRIES WITH NO ORDERS. BASED ON SEASONALLY ADJUSTED DATA.

^{2/} TROUGH QUARTERS FOR GNP WERE 1954 II, 1958 I, AND 1961 I.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

In 1966, order backlogs are likely to increase somewhat further under the impetus of rising demand. But the rapid rise of capacity should generally permit shipments to respond to rising orders, preventing the emergence of major price pressures from this source. However, this indicator of demand pressures will need to be followed closely. Should order books lengthen substantially, the efficient and moderate inventory policies that have kept orders at reasonable levels could be altered, leading to imbalances in industrial markets.

SUPPLY AND DEMAND IN THE LABOR MARKETS

Cost-price stability cannot be achieved if the supply of labor is inadequate to allow production to respond freely to demand. When workers having the needed skills are readily available for employment, industry is able to utilize its physical capacity fully and efficiently. When major labor shortages develop, they may be translated into production bottlenecks that limit the supply of finished products and thereby result in demand pressure on prices. Alternatively, or in addition, tight labor markets put upward pressures on labor costs, as unions press for excessive wage increases and employers bid against each other for the skills in short supply, and as employers are forced to hire less qualified workers with resulting lower productivity.

The growth of the U.S. labor force has accelerated since 1962. From 1955 to 1962, the average annual increase was 825,000. During the last 3 years, it averaged 1.2 million, and in 1965 the increase was 1.4 million. This acceleration resulted mainly from the high birth rates following World War II and the increased participation of women in the labor force, partly in response to more favorable job opportunities.

The employment gains of recent years have been large and widely distributed. Every labor force group has benefited from the sustained economic growth which has created an average of more than 1.3 million additional jobs a year since 1961. During the past 2 years, especially large gains have been made by teenagers, adult nonwhites, the long-term unemployed, and the unskilled. This pattern gives testimony not only to the power of high economic growth to bring benefits to inexperienced and disadvantaged workers, but also to the ability of employers effectively to absorb such workers into productive employment. If this pattern can continue, the supply of labor will be sufficient to meet manpower needs without serious bottlenecks.

The capacity of labor markets to adjust can be seen from a study of employment gains by occupation. In 1965, for example, employment in professional and technical occupations rose by 333,000; but in 1964 there had been only 150,000 unemployed workers whose last employment was in these occupations. Since there was a reduction of unemployment of such workers of only 17,000 between 1964 and 1965, a minimum of 316,000 new professional and technical employees must have come from among new entrants into the labor force, from upgrading, or through hiring of unemployed whose

last employment was in some other type of occupation. Similar comparisons can be made for other occupations.

Negroes and teenagers found better job opportunities as the labor market tightened (Table 11). When the job market was slack and output grew

TABLE 11.—Changes in employment, 1961–65

Type of change and period	Total ¹	Teenagers	Nonwhites	Adult whites
<u>Change in employment (thousands of persons):</u>				
1961-62 ²	1,203	237	159	813
1962-63	963	-38	137	847
1963-64	1,548	268	246	1,075
1964-65	1,822	558	267	1,038
<u>Percentage change in employment:</u>				
1961-62	1.8	4.6	2.3	1.5
1962-63	1.4	- .7	1.9	1.5
1963-64	2.2	5.1	3.4	1.9
1964-65	2.6	10.0	3.6	1.8
<u>Percent of total employment change:</u>				
1961-62	100.0	19.7	13.2	67.6
1962-63	100.0	-3.9	14.2	88.0
1963-64	100.0	17.3	15.9	69.4
1964-65	100.0	30.6	14.7	57.0

¹ Detail shown will not add to totals because of duplication (nonwhites include some teenagers).

² Data for 1962 are adjusted for comparability with data for 1961.

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

Sources: Department of Labor and Council of Economic Advisers.

only enough to create jobs for the normal increase in the labor force, adult whites secured the largest share of new jobs. But in 1965, when over-all employment increased by a very large 2.6 percent, nonwhite employment rose by 3.6 percent, and teenage employment increased by 10.0 percent, representing nearly one-third of the total additional employment.

These employment gains, combined with the changes in the labor force, resulted in an improvement in the pattern of unemployment. Unemployment rates for white teenagers fell despite the great influx of this group into the labor force, and rates for nonwhite adults fell to 5.8 percent by the end of 1965. Nonwhite teenagers were an exception; their rates remained very high (Table 12).

TABLE 12.—Unemployment rates for selected groups, 1960–65

[Percent]

Period	Teenagers		Adults			
	White	Nonwhite	Men	Women	White	Nonwhite
<u>Annual average:</u>						
1960	12.4	22.1	4.7	5.1	4.3	9.1
1961	13.8	25.4	5.7	6.3	5.3	11.2
1962	12.0	23.7	4.6	5.4	4.2	9.8
1963	14.0	28.4	4.5	5.4	4.2	9.3
1964	13.3	26.2	3.9	5.2	3.8	8.2
1965	12.2	25.3	3.2	4.5	3.3	6.6
1965: IV ¹	11.1	27.1	2.8	4.2	2.9	5.8

¹ Based on seasonally adjusted data.

Sources: Department of Labor and Council of Economic Advisers.

OUTLOOK FOR LABOR MARKETS IN 1966

So far, the ability of both workers and employers to adjust rapidly to changing economic conditions has permitted the economy to move toward full employment without experiencing significant labor shortages which could retard growth or endanger price stability.

As production has expanded and the hiring of certain skills has become more difficult, managements have resorted to the normal procedures used in prosperity to economize on skilled labor: redesigning and subdividing of specific jobs; upgrading of experienced employees to more skilled classifications; intensifying on-the-job training for younger workers; stepping up investment to modernize facilities; wherever possible, concentrating the increase of production in plants in areas of labor surplus; hiring women for jobs usually filled by men; recruiting workers abroad; hiring students on a part-time basis; and raising starting salaries.

According to data recently gathered by the Department of Labor, noticeable shortages were reported only among engineers, teachers, technicians, skilled metal workers, and certain kinds of repairmen. Shortages of some of these types of workers have been common for some years, but they have not interfered with rapid gains in production.

Some difficulties in recruiting labor have been reported by employers in medical services, restaurants, and laundries. Employment in household services actually declined between 1964 and 1965. These are generally the low-wage sectors of the economy. Hourly earnings in laundries, for instance, are more than 40 percent lower than those in manufacturing and 30 percent below the earnings in wholesale and retail trade. When unemployment was high, these low-wage employers could count on an ample supply of labor. But it is inevitable that as unemployment is reduced they will encounter stronger competition for labor from higher paying employers. If the past is any guide, the low-paying establishments will solve their labor problems by more extensive hiring among the groups with relatively high unemployment rates—nonwhites and youths—by raising their wages more rapidly than other firms, and by mechanization and more efficient use of their employees.

Job openings in interstate recruitment with the U.S. Employment Service rose sharply at the end of 1965 and were about 65 percent higher than in the same period of 1964, but there were still 224 active job applicants registered with public employment offices for every 100 registered job openings. Pilot surveys of job vacancies in 1965 indicate that, on an over-all basis, available opportunities were still lagging behind the number unemployed. However, the index of help-wanted advertising in 52 cities compiled by the National Industrial Conference Board reached a record high at the end of last year. Our present information system on job vacancies is little more than fragmentary. A comprehensive set of vacancy statistics, comparable to those collected in other countries, would be a most useful tool of analysis.

The further reduction in unemployment expected this year seems likely to follow the 1965 pattern, with perhaps even greater relative gains made by the long-term unemployed, older workers, unskilled workers, and non-whites. Employment of teenagers can be expected to increase sharply. Additional women may be drawn into the labor force. And migration from agriculture and from depressed areas may accelerate. These are the principal remaining sources of labor for industrial expansion.

The enlistment or conscription of young men into the armed services reduces the supply of civilian labor. By the end of 1966, about 20 percent of the male labor force in the 20–24 year old category will be in the armed services. This represents only a small increase from the 17 percent prevailing figure in 1964, before the current buildup. A relatively large part of the increase in the armed services in 1966 will be in the 16–19 year age group. But with the substantial labor force growth, the percentage of this age group in the armed services by December 1966 should be little different from the 14 percent figure in 1964. The increase in military personnel is expected to total about 300,000 in 1966. This is modest, compared with the Korean war period, when over a million men joined the armed services in 9 months, about 2 million in 2 years.

The current military increases are coming in sectors of the labor force where unemployment rates are high. In December 1965, unemployment among males 20–24 years old was 5.3 percent (unadjusted for seasonality), 1.5 percentage points above the national average for the entire labor force, and unemployment of males in the 16–19 year group was 12.4 percent. In short, men removed from the civilian labor force to go into the armed services are coming from parts of the labor force where they should be more readily replaceable.

Our labor markets will be able to support a large further expansion of the economy. But as production rises and unemployment falls, it will become more difficult for employers to find exactly the right man for each new job. The need for upgrading, for on-the-job training, and other changes in employment practices will become greater. Public and private manpower policies will face their greatest challenge.

As shortages of some skills have begun to develop, programs to train highly skilled people have been intensified under the Manpower Development and Training Act. For example, current activities include an on-the-job training contract with the Chrysler Corporation to train automobile mechanics, and a contract with the National Tool, Die, and Precision Machine Association to double the number of tool and die trainees. Many contracts are presently under negotiation to provide skilled workers for such defense industries as aircraft, ordnance, and electronics. Also, improvement in the Employment Service will help to fill job vacancies.

Active manpower policies are discussed in detail in Chapter 3. They have already contributed importantly to making the labor force better suited for

present job requirements. Their importance will become even greater in 1966.

EMPLOYMENT GOALS

The 1962 Annual Report of the Council specified an interim unemployment target. It was stated that "in the existing economic circumstances, an unemployment rate of about 4 percent is a reasonable and prudent full employment target for stabilization policy. If we move firmly to reduce the impact of structural unemployment, we will be able to move the unemployment target steadily from 4 percent to successively lower rates . . . circumstances may alter the responsiveness of the unemployment rate and the price level to the volume of aggregate demand. Current experience must therefore be the guide." It was made clear that this goal "should be achievable by stabilization policy alone. Other policy measures . . . will help to reduce the goal attainable in the future below the 4-percent figure."

The unemployment rate has now virtually reached the interim target and is projected to fall below 4 percent in 1966. There is strong evidence that the conditions originally set for lowering the target are in fact being met, and that the economy can operate efficiently at lower unemployment rates. The quality of the American labor force has been improving steadily. In 1957, the last year in which unemployment was 4 percent, workers had an average of 11.6 years of schooling; by 1965 they had 12.2 years. Whereas 33 percent of all workers had no more than 8 years of education in 1957, the figure had fallen to 23 percent by 1965. The ease of attaining a given over-all unemployment rate is increased by this higher educational achievement. To be sure, jobs may now require, on the average, more education than they did in 1957. Nevertheless, it is highly significant that, if the unemployment rate for every education group were the same now as it had been in March 1957, the over-all unemployment rate would be 0.4 percentage point lower than it was in 1957.

Partly offsetting the better educational preparation of today's workers is the increasing number of young and relatively inexperienced men and women who now constitute a larger proportion of the labor force than they did in 1957. These workers normally have higher unemployment rates than older, experienced workers. As a result, if every age and sex group in 1965 had the same unemployment rate as in March 1957, the over-all unemployment rate would now be 0.1 percentage point higher than it was in 1957.

The training and manpower policies instituted since 1961 are beginning to reduce the attainable level of unemployment both by raising the employability of workers and by directly altering their labor force status. During 1966, an average of about 300,000 youths will be engaged in special work and training programs. If most of these youths would otherwise have been unemployed, the programs would be reducing the national unemployment rate by about 0.1 to 0.2 percentage point. The absorption of these

workers does not appreciably reduce the supply of labor available for other jobs while they are in training; it does increase their suitability for other employment when their training is completed.

The substantial increase in the number of young men entering military service will have a direct impact on the attainable unemployment rate of civilians. On the assumption that most of the added young men in the armed services in 1966 would otherwise have been in the civilian labor force, but that most of the jobs they would have filled can readily be filled from among the unemployed, the attainable unemployment rate would be lowered by about 0.2 percentage point.

The improved ability of the economy to sustain lower unemployment without inflation arises not only from developments in the labor market. Other factors, which could not be taken into account when the interim target was first set, are equally relevant: the fact that so fine a balance could be maintained between production and capacity—both over-all and by sectors—as the economy moved toward full employment; the higher productivity gains; the increasing keenness of international competition in our markets; the more responsible attitudes displayed by business and labor in wage and price decisions; and the dependability and prudence of consumer and business decisions.

Thus the economic circumstances which accompanied a 4 percent unemployment rate in 1957, or which it was assumed in 1962 would accompany such a rate, now correspond to a lower national unemployment rate. While we will find satisfaction in reaching the interim target, it would be incorrect to identify this accomplishment with full attainment of the goal of an employment opportunity for every American willing and able to work.

Our target should be steady progress, at a pace which permits the economy to adapt to decreasing unemployment rates and growing demand in the product markets. Private and public policies should be able to preserve the reasonable cost and price stability which is necessary for sustainable progress.

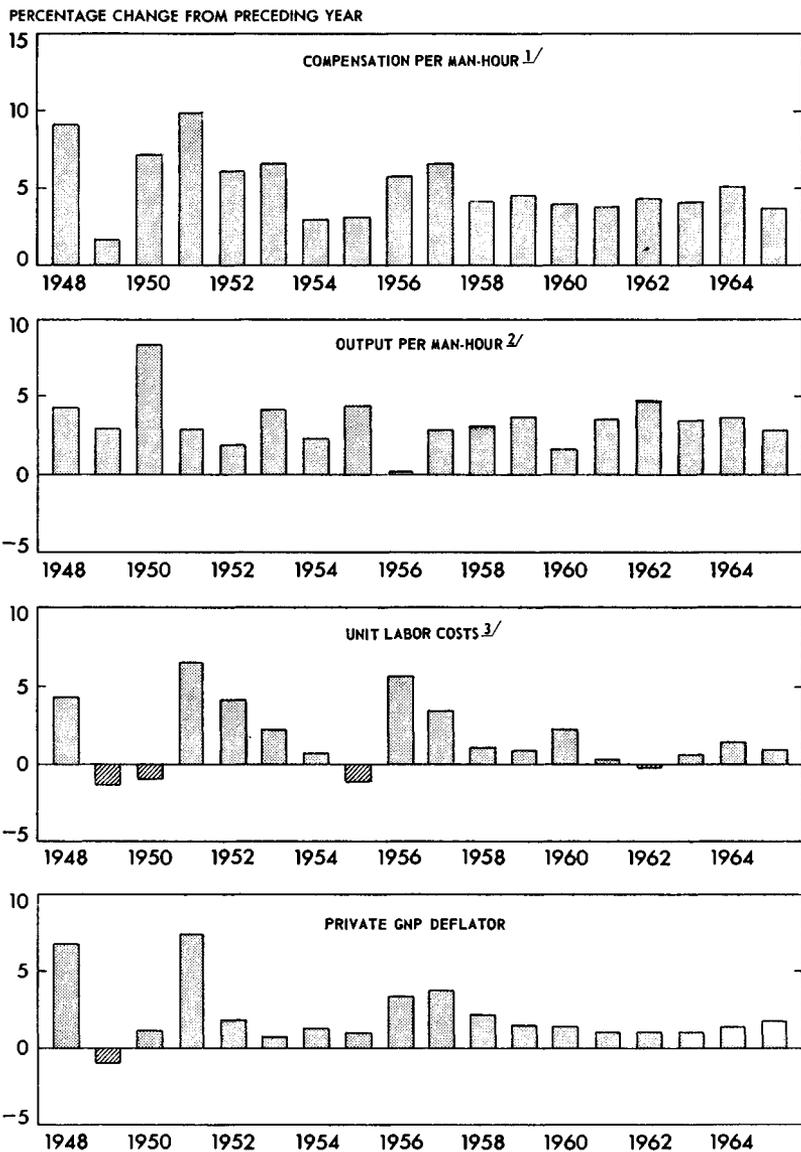
LABOR COST TRENDS

Labor costs per unit of output are an important determinant of over-all cost and price changes. In the postwar period, their widely varying movements have frequently been associated with similar changes in the price level (Chart 10).

Labor costs per unit of output reflect both hourly compensation and output per man-hour or productivity. Increases in compensation raise unit labor costs; increases in productivity lower it. Whether labor costs per unit of output rise during the particular period depends on the relative balance between increase of compensation and of productivity.

Chart 10

Changes in Compensation, Prices, and Productivity in the Private Economy



^{1/} TOTAL COMPENSATION DIVIDED BY ALL PERSONS MAN-HOURS WORKED.

^{2/} PRIVATE GNP DIVIDED BY ALL PERSONS MAN-HOURS WORKED.

^{3/} COMPENSATION PER MAN-HOUR DIVIDED BY OUTPUT PER MAN-HOUR.

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

WAGES

Wage movements of recent years must clearly be characterized as moderate. During the first 4 years of the expansion, gross hourly earnings of manufacturing workers rose at an average annual rate of 3.2 percent; corrected for overtime, the annual increase averaged 2.7 percent. Outside of manufacturing, the record is more varied. In mining, gross hourly earnings increased at an average annual rate of only 2.4 percent, and in wholesale trade at a rate of 3.3 percent; but in construction the average yearly increase was 3.8 percent and in retail trade 3.9 percent. When account is taken of increases in fringe benefits, the corresponding figures for total compensation per man-hour would in most cases undoubtedly be somewhat higher. Nevertheless, when combined with the strong yearly gains in productivity, the average increase in total hourly compensation was consistent with relative stability of average unit labor costs throughout the economy.

During the past 12 months, wages have been rising at a pace little different from that of earlier years. Gross hourly earnings of manufacturing workers rose in 1965 by 3.1 percent, and the yearly increase of straight-time earnings was 2.8 percent. In the nonmanufacturing sector, most industries had somewhat larger increases than in the earlier expansion years. Between November 1964 and November 1965, hourly earnings increased by 3.1 percent in mining and in wholesale trade, 4.5 percent in construction, and 5.3 percent in retailing.

The many collective bargaining contracts signed during 1965 were characterized, by and large, by a relative moderation of gains in wages and fringe benefits. In some industries—aerospace, for example—the negotiated increases exceeded somewhat the Council's guideposts for noninflationary wage behavior. But in other industries—steel, rubber, maritime trades, New York newspapers, aluminum—the results of the contracts either fell within or were close to the guidepost standards. The settlement in rubber provided an increase of 3.2 percent, that in aluminum 3.5 percent, and the important steel settlement also 3.2 percent. The pay increase for Federal workers likewise fell within the guideposts. A special Labor Department analysis of the major contracts (those covering 10,000 workers or more) that were concluded during the first 9 months of 1965 indicates that the average yearly wage adjustment resulting from these contracts was 3.3 percent; for contracts covering a period longer than a year, the adjustment was smaller—only 2.7 percent. This analysis considered only wage changes; inclusion of fringe benefits might raise these figures by three-fourths of a percentage point.

In construction, the 1965 contracts—as in previous years—generally resulted in higher wage advances than elsewhere. Between October 1964 and October 1965, union wage scales increased, on the average, by 4.1 percent. Construction is clearly an industry that raises serious problems for wage-price stability.

The generally satisfactory record of 1965 wage contracts has important implications for wage trends in 1966. Many industries have negotiated long-term agreements. The only major industries which will negotiate new contracts in 1966 will be electrical machinery, telephone, and construction; major reopenings could take place in railroads and coal mining. Because of the relatively light calendar of expiring contracts, the basic pattern of wages for most key industries has already been set for 1966.

It is likely, however, that compensation will rise more rapidly in the low-wage and largely nonunionized sectors of the trade and service industries. Many workers at the bottom of the economy's wage structure now face opportunities of moving into more advantageous jobs. Accordingly, wage increases in the low-paid sectors are likely to exceed the average wage rise in the economy as a whole. As indicated by the 5.3 percent increase of hourly earnings in retail trade between late 1964 and late 1965, this has already been occurring.

PRODUCTIVITY AND UNIT LABOR COSTS

A key element in the impressive U.S. record of price stability has been the high rate of productivity advance. Based on tentative figures for 1965, productivity in the private economy (real total private GNP divided by total private man-hours worked) has grown at an average rate of 3.6 percent a year since 1960. Because of these large productivity gains, average annual increases of 4.2 percent in compensation per man-hour have raised average unit labor costs in the private economy by only 0.6 percent a year.

This record contrasts sharply with the experience in the short expansions of the mid-1950's. In the period between the business cycle peaks of 1953 and 1957, unit labor costs increased by 2.1 percent a year; compensation per man-hour rose by 4.6 percent a year while output per man-hour advanced only 2.4 percent a year. In 1956 and 1957, an average annual increase of 4.5 percent in unit labor costs exerted a strong upward push on prices. Between the 1957 and 1960 cyclical peaks, average hourly compensation gains were more moderate—4.2 percent a year—but since productivity was rising at a rate of only 2.7 percent, labor costs were pushed up by 1.4 percent a year.

Manufacturing productivity figures based upon the index of industrial production of the Federal Reserve Board show output per employee man-hour rising by 4.0 percent a year since 1960. Comparing this figure with the 3.6 percent average advance in hourly manufacturing compensation implies that unit labor costs in manufacturing were lower in 1965 than in 1960.

According to preliminary figures for 1965, productivity in the entire private economy increased by about 2.8 percent—below the average for the whole expansion and slightly below the historical average for the entire post-war period. Compensation per man-hour in the private sector rose by 3.7 percent, resulting in an increase of 0.9 percent in unit labor costs. Productivity in manufacturing, based upon the industrial production index,

rose by 3.8 percent and hourly compensation increased by only 3.0 percent. Thus, unit labor costs in manufacturing decreased by 0.8 percent last year.

The good record of productivity during the past 5 years was aided by the sustained expansion of output that has boosted operating rates. As operating rates improve, capital and overhead labor are more effectively utilized. These oversized gains in productivity cannot be expected to continue indefinitely. As preferred operating rates are reached and surpassed, older, less efficient standby equipment must be used, and less-skilled labor must be hired and trained. Partly offsetting this, new and more efficient plant and equipment will be continually coming into use. On balance, therefore, the rate of increase of productivity can be expected to gravitate toward its long-run trend, and the more modest gain in 1965 undoubtedly reflects this.

The exact value of the trend rate of productivity growth—that rate which technological advance, the constantly improving quality of the labor force, and the growing capital stock can sustain—is difficult to ascertain. To isolate the “underlying” trend, adjustments for all short-run factors would be required. But these adjustments cannot be made perfectly. Nor is it likely that the “true” trend would remain precisely constant over time. The factors determining productivity growth have not been and will not be historical constants.

A long-run historical average provides one estimate of the trend rate of productivity growth. The postwar average, from 1947 to 1965, is 3.3 percent. But this may reflect especially favorable factors in the immediate postwar years. On the other hand, the much lower average of 2½ percent for the longer period from 1919 to 1965 is subject to the suspicion that it seriously understates the higher trend in the depression-free postwar period.

The productivity trend can also be estimated from data for the shorter postwar period, using sophisticated statistical techniques to adjust for the short-run factors. Several such techniques have been employed by the Council to obtain the best possible estimate of the postwar trend rate of growth of productivity. While these different methods do not yield identical estimates, for the private sector they fall within the range of 3.0 to 3.3 percent a year.

In 1966, the increase of productivity is expected to continue close to its trend value, though not likely to exceed it. The increase in employer payroll taxes which occurred on January 1 will raise average employment costs this year by about two-thirds of 1 percent. The expected rise in productivity, however, should hold the average increase in unit labor costs to about 1½ percent for the entire private economy. These costs should be approximately stable in manufacturing.

COSTS AND PRICES IN SELECTED PROBLEM AREAS

Some sectors in the economy pose particular problems for the achievement of cost-price stability, either because of especially unfavorable long-

term cost trends or because of potential market imbalances. Five of these areas are examined here: agricultural and food products; nonferrous metals; machinery; construction; and medical services.

FOOD

From 1961 to 1964, consumer food prices rose by only 1.0 percent a year while all other consumer prices were rising by 1.3 percent. But from December 1964 to December 1965, prices of food increased by 3.5 percent while other consumer prices rose by 1.6 percent. The same pattern is even more evident at the wholesale level. Between December 1964 and December 1965, prices of processed food rose by 8.5 percent and of farm products by 11.1 percent. These increases accounted for two-thirds of the total rise in the wholesale price index over this period.

About three-fourths of the rise in retail food prices in 1965 can be attributed to a 13.5 percent advance in meat. There were smaller price increases in poultry, fish, dairy products, and bakery products. On the other hand, prices of fruits and vegetables declined by 3.1 percent during the year, after reaching a peak in the spring.

At the wholesale level, meat prices rose by 29 percent in 1965, in response to a 34 percent rise in livestock prices. Particularly large increases were registered in hog prices, but cattle prices were also up substantially.

These sharp increases were the result of a combination of rapidly growing demand for meat and an unfavorable supply situation. Rising personal incomes and a growing population increase the demand for meat. Supplies, on the other hand, are relatively inelastic in the short run because of the long time period required to expand livestock breeding stocks.

Hog production was reduced during the second half of 1964 and in 1965 as a result of depressed prices received by hog producers in 1963 and 1964. The resultant high pork prices led consumers to switch to poultry and other meats; although beef production increased, supplies were not sufficiently responsive to keep beef prices from rising. Because of the much shorter period required to produce poultry, the supply of broilers responded rapidly to satisfy part of the substantial increases in demand. Thus, poultry prices rose much less than beef or pork prices in 1965—by 7.2 percent in 1965 at the wholesale level and 9.3 percent at the farm.

In the past, hog production has expanded when hog prices were favorable in relation to feed (mostly corn) costs. The hog-corn price ratio has been extremely favorable to producers in recent months. But the increasing importance of nonfeed costs (labor, overhead, etc.) in hog production has made the hog-corn ratio a less reliable indicator of future production. Nevertheless, the evidence indicates that hog producers are now responding to favorable prices; farmers intend to raise 7 percent more pigs during December 1965–May 1966 than they did one year earlier. Thus, while hog prices will probably continue strong throughout the first half of this year, they should begin to decline in the second half when the expanded

spring crop is marketed. Beef production will increase slightly in 1966, but beef prices will probably continue at their high levels through most of the year.

General prosperity was a contributing factor to the rise in food prices in 1965, but supply conditions certainly were the major element. This year should witness a less rapid increase in food prices than was experienced during 1965. Meat prices may rise further in the first half of the year, but some relief is expected in the second half when expanded supplies reach the market. Citrus fruits and fresh vegetables should have lower average prices in 1966 than in 1965 if normal weather prevails. Poultry is also expected to be cheaper.

The rise in farm and food prices has had some limited spillover into the industrial sector. Although the extent of automatic wage escalation with consumer prices is very much reduced from prior years, the wages of about 2 million workers have been raised by the faster rise of consumer prices in 1965.

NONFERROUS METALS

In the last 2 years, consumption of nonferrous metals by U.S. industry has risen substantially. The prices of these primary metals have advanced rapidly, with aluminum ingot up 6.5 percent from December 1963 to December 1965, copper ingot 16.1 percent, pig lead 28.1 percent, pig tin 33.3 percent, and slab zinc 11.1 percent. These increases produced higher prices for fabricated products and were an important factor in the over-all increase of industrial prices.

Earlier in the postwar period, the Government accumulated large stockpiles of a wide variety of materials, including many of the nonferrous metals. Consistent with long-range security objectives, substantial supplies of materials can be made available to help to meet the requirements of the increased military effort and an expanding civilian economy. In the coming year, the availability of the stockpiles should help to prevent a repetition of the imbalances in the markets of certain of these materials that occurred during the last 2 years.

Copper was particularly affected when expanding world demand, coupled with production setbacks resulting from strikes and political troubles in the Republic of the Congo, Zambia, and Chile, caused wide price swings in the secondary markets.

The Government has repeatedly eased pressures by releasing surplus copper from its stockpile. In January 1965, 20,000 tons, and in April 100,000 tons, were released for sale to commercial users. The Mint obtained 30,000 tons in December 1964 and 110,000 tons last October from the stockpile for its coinage needs. After price increases in October by major foreign producers, the President announced a 4-point program, including the release of an additional 200,000 tons of copper from the stockpile; controls on the

export of copper scrap; removal of the 1.7 cent tariff on imported copper; and a request to the Commodity Exchange of New York to raise margin requirements to curb speculative trading in copper futures. In January of this year, export controls were extended to virtually all copper and copper products.

The outlook for copper remains highly uncertain because of political factors abroad. Government policy will continue to strive to maintain supplies adequate for rising military and civilian demands.

Domestic production of lead and zinc has recently been insufficient to satisfy high demands, and surplus metal was released from the stockpile at the request of the industry. Further, the President, on the recommendation of the Tariff Commission, revoked the import quotas which had been instituted during a period of excess supply in 1958. No imbalances are expected in 1966.

The demand for aluminum rose rapidly in 1964 and 1965. Defense requirements will continue to increase in 1966, to between 300,000 and 400,000 tons a year—double the requirements before the increased military activities in Vietnam. The industry has been operating close to capacity but supplies have been augmented by a rising flow of imports. Ingot prices began to rise in late 1963. Announcements of further price increases were made by producers in October 1965.

To help to restore balance in the market for primary aluminum, the Federal Government intensified negotiations for the orderly release of the 1.4 million ton stockpile of aluminum in excess of emergency needs. Agreement was reached with the industry, calling for sale to the industry of a minimum of 100,000 tons of aluminum a year for 10 to 12 years; in the event that added defense requirements exceed this level, additional releases can be made up to a maximum of 200,000 tons a year. This release will assure continued availability of sufficient amounts of aluminum and should preserve balance between production and demand in the market at stable prices.

MACHINERY

In the inflation of the mid-1950's, higher machinery prices played an important part in raising the wholesale price index. The index for electrical machinery increased by 16.2 percent between 1955 and 1957, construction machinery by 16.6 percent. This year will again see heavy investment spending, and the possibility of similar machinery price increases must be examined.

In December 1965, the wholesale price index of nonelectrical machinery was 11.9 percent above the 1957-59 average. In the last year, prices rose by 1.8 percent, compared with an average annual increase of 1½ percent in the preceding 6 years. Some of these increases probably reflect an improved product, not fully adjusted for in the index. But prices have also reflected sharply rising demands, expanding profit margins, and some increases in costs.

Trends of wage rates and material costs for the industry have been moderate in the past few years. Gross average hourly earnings advanced at an average rate of 3.0 percent a year from 1960 to 1964. In 1965 they were up 2.8 percent, partly reflecting the greater use of overtime. The Federal Reserve Board's index of industrial materials prices rose by more than 1.0 percent in 1965, after 4 years of relative stability. The price of steel, a major input, rose little, in sharp contrast to the 1950's.

Profits in 1965 were appreciably above 1964. Industry profits in nonelectrical machinery in the first 3 quarters were 23 percent higher than a year earlier, to yield a 14 percent after tax return on equity.

Avoiding bottlenecks in the machinery industry depends on the expansion of capacity to meet rising demands and on the availability of skilled labor. The last 5 years have seen a steady rise in the output of machinery. In 1960, production of nonelectrical machinery was at a rate equal to 70 percent of industry capacity. Modest output increases in the next 2 years raised operating rates to 79 percent of capacity by the end of 1962. Output spurted by 12 percent in 1964, reflecting the large rise in investment expenditures, bringing the industry's operating rate to 87 percent by the end of the year. Another 12 percent gain in output occurred in 1965, as business investment rose once more, higher farm income raised sales of agricultural machinery, and defense needs called for increasing amounts of construction machinery. During the year, the nonelectrical machinery industry operated at about 88 percent of capacity, still 3 percentage points below the preferred rate. The industry's own anticipated spending on plant and equipment promises to raise its capacity about 8 percent in 1966. Thus, while utilization rates may rise, no general pressure on productive capacity is currently foreseen. Some limited segments of the industry will be straining capacity, however.

The backlog of unfilled orders for nonelectrical machinery has been relatively steady during the expansion, rising gradually from 2.6 months of shipments in 1963 to 2.8 months in 1964 and 3.2 months in November 1965. In the sensitive machine tools sector of metalworking machinery, the backlog of unfilled orders was 7.7 months in October for metal cutting tools, up from 6.8 months a year earlier. For metal forming tools, however, the backlog fell to 10.2 months, from 11.1 a year earlier. Given current operating rates, these backlogs are not unduly large.

In 1965, the industry expanded its employment by 7.0 percent, training many new workers to fill its enlarged requirements. This year, another large employment increase will be necessary, and even more new workers will have to be trained through private and public efforts.

In summary, increased nonelectrical machinery production should be able to provide the equipment needed by an expanding economy. The industry may have some difficulty finding enough skilled labor. But given the expected trends in costs, and the apparent availability of adequate physical

capacity, the large price increases which disturbed investment in the mid-1950's are not likely to recur this year.

The electrical segment of the machinery industry maintained stable prices in 1965. Prices were no higher than in 1964, and indeed were 3.2 percent below the 1957-59 average. Capacity in this industry has been ample, costs have been stable, and competition, including that from abroad, has been keen. These factors will continue to support price stability in 1966. The wage negotiations this October will affect cost trends in the future.

CONSTRUCTION

Construction is one of our largest industries. In 1965, it employed more than 4 million workers. Construction prices and wages have been rising more rapidly than in most other sectors of the economy. Between 1960 and 1965, price indexes of finished construction rose by 2.2 percent a year on the average. Over the same period, both average hourly earnings and union wage rates of construction workers were rising at an annual rate of 3.8 percent. Larger fringe benefits probably bring the increase in total hourly compensation a fraction of a percentage point higher.

Higher prices have reflected both substantial increases in employment costs and some possible widening of profit margins. Wholesale prices of construction materials have been relatively stable during most of the expansion. While estimates of labor productivity in construction are highly imperfect, they nevertheless suggest that the annual increase in output per man-hour is below the economy-wide average, and substantially below the annual increase in employee compensation.

During the past year, the rise in construction prices has accelerated. The increase in the GNP deflator in 1965 was 2.9 percent for total construction, 2.7 percent for nonresidential construction, and 3.3 percent for private residential construction. The rise for residential building is particularly disturbing in view of the fact that there has been no increase of activity in this sector for several years.

The rate of wage increase in construction has also accelerated. Between October 1964 and October 1965, the average increase in union rates of construction workers was 4.1 percent; and average hourly earnings increased during the year by 4.5 percent. Moreover, many of the construction contracts signed last year provided relatively large deferred compensation increases in 1966 and 1967. Again this year, construction costs and prices are expected to rise more rapidly than the over-all GNP deflator.

The inflationary cost and price situations in the industry reflect to some extent its prosperity, especially in its industrial and commercial sectors. They also suggest the existence of more permanent structural problems which should be of vital concern for both the industry and the community

at large. There have been many important technological changes in various sectors of the industry, but the total technical progress is clearly insufficient.

Ways must also be found to expand more quickly the supply of skilled construction labor. Restrictions on entry not only retard the growth of the industry but also have adverse social effects, since they tend to keep Negro youths out of attractive types of employment. To meet the needs of rapid growth and equality, vocational programs for skilled craftsmen must be stepped up.

There is need for institutional arrangements that will increase the geographical mobility of skilled workers. Labor mobility in construction has been reduced by the spread of locally instituted welfare and pension plans whose benefits are not "portable" from one area to another. Development of national pension and health and welfare programs as well as broader vesting and interarea portability of rights and benefits will contribute to greater mobility and more efficient utilization of the present supply of construction workers.

MEDICAL SERVICES

Persistently and strongly rising fees and charges for medical services have exerted an upward influence on the consumer price index throughout the postwar period. As shown in Table 13, medical care prices, which account

TABLE 13.—Changes in consumer prices for medical care, 1947–65

Period	Annual percentage change in consumer prices			
	Medical care			All other items
	Total	Medical services	Prescriptions and drugs	
1947 to 1953.....	4.2	4.6	2.1	3.0
1953 to 1960.....	3.7	4.0	1.7	1.3
1960 to 1965.....	2.5	3.1	-.8	1.2
1960 to 1961.....	3.0	3.7	-1.2	.9
1961 to 1962.....	2.6	3.3	-1.5	1.1
1962 to 1963.....	2.5	3.0	-.9	1.1
1963 to 1964.....	2.1	2.4	-.3	1.4
1964 to 1965.....	2.4	3.2	-.3	1.5

Source: Department of Labor.

for about 6 percent of consumer expenditures, have risen twice as rapidly as the average of all other consumer prices for most of the postwar period, and have contributed one-tenth to two-tenths of 1 percent to the rise of the index in most years.

In the most recent 5 years, medical costs have risen less rapidly than during the 1950's. This has been due primarily to the fact that prices of prescriptions and drugs have been declining. Also, the increase in charges for medical services—including doctors' and dentists' fees, eye examinations and

eyeglasses, and hospital rates—has slowed down in comparison with the earlier period.

The higher hospital and doctor charges reflected in the consumer price index may overstate the true increase in the cost of medical care when account is taken of the rising effectiveness of the care received. With the dramatic improvements in medical technology that have taken place over the postwar period, many patients get more real “services” from each day’s stay in the hospital, or each visit to the doctor, than before.

The basic sources of rising medical costs are the inadequate supply of personnel and facilities, the sharply rising cost of hospital construction and of continually more complex medical equipment, the rapid increase in salaries of medical personnel relative to productivity gains as presently measured, and the expanding demand for medical services. Although some of these conditions may be relieved in the longer run, they will not be in the immediate future. The advent of Medicare will add to the expanding demand for medical services and facilities. Thus, the urgency of public policies to augment medical care resources and to improve their organization for efficient use will be even greater.

OUTLOOK FOR COST-PRICE STABILITY IN 1966

The above review shows that the economy is making a good adjustment to the altered economic environment. With the unemployment rate at 4.1 percent and clearly moving downward, there is strong evidence that the substantial inflation of industrial prices experienced in the mid-1950’s is not recurring.

The outlook for unit labor costs is good. Although a few individual settlements may be out of line, the general advance of wages should not accelerate this year, and productivity can be expected to remain close to the trend rate. So long as costs do not move up substantially, price changes will remain limited.

Producers are generally able to meet rising orders out of growing capacity and to find the labor needed for expanding production. Competition remains keen, and imports are limiting price advances in several key sectors. There are occasional examples of shortsighted pricing policies on the part of a few firms, and there will probably be more. But most industries have learned to fear the fool’s paradise of rising prices that produce unsustainable profits, shrinking markets, and permanently higher labor costs.

With the economy now approaching full utilization of its resources, the risk of price increases becomes greater. Occasional disturbances to the supply of some key commodities are likely to occur, although their specific form cannot be foreseen. The ability of employers to redesign jobs and train additional skilled workers may not fully match the rising demands for skilled labor in all industries.

But so long as labor costs remain generally stable, difficulties in obtaining materials remain isolated, consumers and businesses retain moderate expectations, and key decisionmakers continue to respect the public interest in setting wages and prices, the prospects are excellent that the recent generally good record of costs and prices will continue.

GUIDEPOSTS FOR NONINFLATIONARY PRICE AND WAGE BEHAVIOR

Most earlier periods of high employment since World War II have been accompanied by inflation. In some of those years, the cause clearly was excessive demand. In other years, no general excess of demand was evident, yet prices continued to creep upward. The movement continued even during some periods in which—on any reasonable criterion—over-all demand was quite inadequate. The exact diagnosis remains a matter of some disagreement among economists. But almost all agree that an important part of the explanation lies in the fact that, in many industries, unions or managements or both possess considerable discretionary power to set wages and prices, and that in too many instances they have used that power to raise wages and prices in ways not consistent with basic supply and demand forces in the market.

The apparent “inflationary bias” in our wage-making and price-making institutions has been of almost continuous concern for the Council of Economic Advisers for many years. Appeals for responsibility and moderation—for taking the public interest into account in wage and price decisions—have had a perennial place in successive Economic Reports. In its Annual Report of January 1962, the Council for the first time attempted to provide private decisionmakers with rather more specific standards for judging whether their decisions were responsible and took adequate account of the public interest. These standards or “guideposts” were also designed to permit the public to reach its own conclusions concerning the degree of responsibility exercised by leaders of business and labor.

INCREASING IMPORTANCE OF THE GUIDEPOSTS

In the years since 1962, the guideposts have gained increasing significance. The slow and difficult progress in restoring equilibrium in our international balance of payments has underlined the necessity that American goods retain or improve their competitive position in export markets and in our own market. Our goal of balance of payments equilibrium in 1966 and thereafter will permit no retreat from cost-price stability.

During the recent years of still excessive unemployment and idle capacity, strong competition for jobs and markets reinforced a growing sense of responsibility on the part of labor and management. The fuller use of resources achieved last year and the excellent prospects for 1966 may reduce

that reinforcement. We now confront the task of reconciling full employment with stable prices.

The record reviewed in previous sections of this chapter makes it clear that the overwhelming majority of private wage and price decisions in recent years has been consistent with the guideposts, whatever the extent to which the guideposts may have consciously entered into the decisions reached. It is clear, however, that in many instances the guideposts have consciously affected these decisions. On numerous occasions, Government officials have specifically reminded unions or managements of the guidepost standards—either publicly or privately, either generally or with reference to specific situations. Several of the more important of these situations have attracted considerable public attention.

In January 1965, the President requested the Council of Economic Advisers to prepare an analysis of steel prices, following certain increases in such prices and at a time when important wage negotiations were pending. The Report, made public in early May, analyzed the position of the industry and the factors affecting it. It showed that wage and price decisions consistent with the guideposts would be in the interest of both labor and management and of the Nation. Later, the Government helped the two parties to reach a peaceful settlement in the steel wage negotiations. A damaging strike was avoided, and a settlement was achieved within the wage guideposts. According to the best estimates of its cost available to the Government, the settlement averaged 3.2 percent a year, computed over the full 39-month period.

Following the labor settlement, prices on tin plate were raised in October; this was accompanied by a price reduction on a new black plate, which is expected to substitute increasingly for tin plate in many uses. At the year's end, the Bethlehem Steel Company announced a \$5 a ton increase on structural steel and pilings. The Council pointed out that such an increase was not justified under the guideposts. In January, the U.S. Steel Corporation announced a smaller increase, accompanying it with price reductions on other steel products.

In October, the Council prepared a guidepost analysis of price increases initiated by producers of primary aluminum; the companies later rescinded these increases.

Also in October, the President, by threatening a veto, persuaded the Congress to enact a pay increase for civil service and postal employees of the Federal Government which was within the guideposts.

These actions and many others clearly reaffirmed the Administration's strong commitment to the guideposts as an essential pillar for price stability.

THE GUIDEPOSTS RESTATED

1. The general guidepost for wages is that the *annual rate of increase of total employee compensation (wages and fringe benefits) per man-hour worked should equal the national trend rate of increase in output per man-hour.*

2. The general guidepost for prices is that *prices should remain stable in those industries where the increase of productivity equals the national trend; that prices can appropriately rise in those industries where the increase of productivity is smaller than the national trend; and that prices should fall in those industries where the increase of productivity exceeds the national trend.*

Within a given industry, the guideposts allow for individual wage and price adjustments that do not affect the over-all wage or price level of the industry. Increases for some groups of workers or products can be balanced by reductions for others.

Observance of the guideposts would mean that unit labor costs would decline in the industries where productivity gains are above average, and rise in industries where such gains are below the national average. Average unit labor cost in the economy would remain constant. Similarly, the decrease of prices in industries with above-average increases in productivity would offset the price rises in industries with below-average productivity gains. The average level of prices would remain stable.

Adherence to the standards would mean that *all* the participants in the productive processes—employees and owners of invested capital—would share in the over-all gains in productivity created by the growth of capital equipment, improved technology, and a better educated, healthier, and more skilled labor force. This can readily be seen from a simple example. Suppose output in an industry is 1 million units, each selling at \$1, for total sales of \$1 million. Suppose labor compensation is \$600,000. If productivity and wages both rise 3 percent, and employment remains unchanged, production will expand to 1,030,000 units, which, at \$1 a unit would raise revenues to \$1,030,000. Labor compensation would rise to \$618,000. Labor would thus receive 60 percent of the added value, keeping unchanged the share of labor costs in total revenues. If prices of materials and other purchased inputs were unchanged, and the quantities used were expanded in proportion to output, then gross income of owners would rise in the same proportion as wage income. Thus, the division of income between labor and capital would remain unchanged. And with capital requirements per unit of output unchanged (as has been approximately true), the return per unit of capital would remain unchanged as well.

The actual sharing of gross corporate income between labor and capital has remained virtually unchanged since World War II. There have been repeated short-run swings, with labor's share rising in recession and falling during expansion. Thus, for example, the share of nonwage income rose from 27.2 percent in 1961 to 29.2 percent in 1965. This recent figure is virtually identical with the division of income in 1955 and 1948. The inflationary wage-price spirals of the 1940's and 1950's did not, in fact, change the distribution of income.

Public policy is and should remain neutral with respect to wage and price decisions that attempt to change the distribution of industry's income between labor and capital. But when such decisions lead to inflationary pressure, they properly become a subject of public concern.

EXCEPTIONS TO THE GENERAL GUIDEPOSTS

Some exceptions to the general guideposts are necessary to promote economic objectives. Wage increases above the general guideposts may be desirable

- where wage rates are inadequate for an industry to attract its share of the labor force necessary to meet the demands for its products;
- where wages are particularly low—that is, near the bottom of the economy's wage scales; or
- where changes in work rules create large gains in productivity and substantial human costs requiring special adjustment of compensation.

Because the industries in which unions possess strong market power are largely high-wage industries in which job opportunities are relatively very attractive, the first two of these exceptions are rarely applicable.

On the price side, increases in price above the general guidepost standard may occasionally be appropriate

- to reflect increases in unit material costs, to the extent that such increases are not offset by decreases in other costs and significantly impair gross profit margins on the relevant range of products, or
- to correct an inability to attract needed capital.

The large firms to which guideposts are primarily addressed typically have ready access to sources of capital; moreover, the profits of virtually every industry have risen sharply and are at record levels as a byproduct of the general prosperity in the economy. The second exception is thus not widely applicable in the present environment.

SHORT-RUN AND TREND ELEMENTS IN PRODUCTIVITY AND THE GENERAL WAGE GUIDEPOSTS

In the original discussion of the guideposts in the Council's Annual Report of 1962, it was pointed out that, "it is desirable to segregate the trend movements in productivity from those that reflect business-cycle forces." During the last 5 years, the economy has been closing a substantial gap between actual and potential production. This has augmented the yearly productivity gain beyond the long-term sustainable trend. Now that the economy has little gap remaining to close, the trend of productivity gains will be determined only by capital investment, an improving labor force, and technological progress. The temporarily high productivity gains that come from utilizing equipment and manpower more efficiently through higher operating rates are largely behind us.

To assure future stability of unit labor costs, wages should increase no faster than the sustainable trend of productivity.

The original formulation of the guideposts did not specify any particular trend productivity figure, but rather listed various historical averages, covering different time spans and various segments of the economy. Since the economy was just recovering from the second of two recessions in a very short interval, it was difficult to identify the trend productivity rate from the immediately preceding experience. This difficulty was compounded by speculation that the trend rate might be accelerating as a result of faster technological change, particularly the spread of automation.

In the Report of 1964, no single figure for trend productivity was specified, but in a related table the now well-known 3.2 percent appeared as the latest figure in a column labelled "Trend productivity." The figures in that column were described as the "annual average percentage change in output per man-hour during the latest 5 years." A 5-year period was chosen because, at that time, it was sufficiently long to include both the extraordinarily high productivity gains of a year of recovery (1962) and the extraordinarily low productivity gains of a year of recession (1960). Under the conditions of 1964, a 5-year average gave a good approximation of the trend productivity, because, in effect, it averaged out the ups and downs of cyclical productivity swings. These same conditions prevailed in 1964, and the 3.2 percent figure appeared for that year in a similar table in the 1965 Report. Subsequent revisions of GNP data would have made the 5-year average 3.4 percent in both 1964 and 1965.

Now that the economy is at the end of its fifth year of uninterrupted expansion, a 5-year average no longer gives a reasonable approximation of the true productivity trend. The last recession year drops out of the average, yet the unsustainable productivity gains of a year of recovery and 4 years of improving utilization are retained. If use of the 5-year average were continued this year and in coming years, the figure yielded by the 5-year moving average would rise at this time to 3.6 percent and would undoubtedly fall substantially thereafter.

An analysis of recent productivity movements was presented earlier in this chapter. It is clear from this analysis that 3.6 percent would not be an accurate measure of the true trend of productivity. Rather, it appears that the long-term trend, independent of cyclical swings, is slightly over 3 percent.

For 1966, the Council specifically recommends that the general guidepost for wages of 3.2 percent a year be continued. We make this recommendation in the light of the following additional considerations:

- (1) With the economy approaching full employment and the crucial test of our ability to reconcile our employment and our cost-price goals at hand, it would be inappropriate to raise the guidepost.
- (2) The actual productivity gain that can be expected over the next few years is not likely to be above the trend value.

- (3) The 3.2 percent rate has been consistent with the approximate stability of industrial wholesale prices which has strengthened our competitive position in the world. Now is not the time to abandon that standard.
- (4) On January 1, employer payroll taxes to finance social security and Medicare rose substantially, raising labor costs per hour by an average of two-thirds of a percent. These taxes are not included in the definition of employee compensation for purposes of the guideposts, since the rates and the benefits are determined by law rather than by collective bargaining. Nonetheless, recognition has to be taken of the extraordinary increase in these taxes at this time, which will both raise unit labor costs and yield future benefits to employees.

GUIDEPOST POLICY ON PRICES

The guideposts must continue to aim at complete stability of average domestic prices. While individual prices will rise from time to time, others must fall if upward pressure on the general price level is to be avoided. To achieve that goal in a fully employed economy will require that unions refrain from insistence on irresponsible wage settlements, and an even greater willingness by management to take the public interest fully into account in its pricing decisions. Every management with some market power must ask itself: Is a price increase justified by increases in costs? Or is it an attempt to take advantage of prosperity to widen profit margins? Those companies that incur rising costs for materials or purchased services must see if these cannot be absorbed from lowered costs elsewhere in their operations. And those companies with exceptionally favorable productivity gains must consider whether this is the time to seek to keep the gains in the form of still higher profits, or whether to share them with consumers through lower prices. Unions which are in a favorable bargaining situation must remember that wage increases that force employers to raise prices will be paid for by the workers in other industries.

Both unions and managements should reflect on the fact that if their actions create an inflationary spiral, the most likely outcome will be restrictive fiscal and monetary policies which will aim to stop further price increases but will in the process also reduce output, cut back profits, and reduce employment.

Chapter 3

Strengthening Human Resources

THE 89TH CONGRESS, in its first session, enacted a body of domestic legislation unparalleled in 3 decades. The content and purpose of the Great Society programs are not purely economic. Yet, their consequences for the economy are so profound that they must be viewed as an integral part of economic policy. Only a few of the new programs are discussed in this chapter; Appendix A contains a more complete list of legislation of economic significance enacted last year.

The common goal of the programs discussed here is to strengthen our human resources: to improve the education, health, and productivity of our working force, and to break down barriers which have prevented some citizens from the full development and use of their abilities and training.

Since these programs were undertaken, the burdens on our national resources have expanded. Even our wealthy Nation cannot realize all its goals at once. The programs begun in 1965 have already invested an additional \$1.5 billion in our human resources. The investment will rise further in 1966, but at a slower rate than initially planned. Over time, economic growth and lessened defense demands should again permit resumption of a more rapid investment in human resources. The objectives and the instruments for such investment were importantly expanded in 1965; the foundation has been laid for great progress in the years ahead.

EDUCATION

“Education will not cure all the problems of society, but without it no cure for any problem is possible. It is high among my own concerns, central to the purposes of this Administration, and at the core of our hopes for a Great Society.” With these remarks to the White House Conference on Education last July, President Johnson again affirmed education’s high priority.

Even when viewed in the narrow perspective of economic benefit alone, the direct returns to individuals and society from investment in education have been shown by recent studies to be high, and to compare favorably with the returns available from other forms of investment. Although much of the economic return from education accrues to individuals in the form of

higher productivity and earnings, education also enhances the well-being and supports the economic growth of the community that provides it. Recognition of the economic and social benefits of a literate and efficient population and an informed electorate was responsible for the adoption many years ago, and the subsequent extension and improvement, of free, compulsory education by State and local governments.

More recently, the Federal Government's interest and responsibility in the field of education have greatly expanded. In the late 1950's, a keener awareness of the critical role of science and technology in determining the Nation's economic and military strength as well as its esteem in the world prompted the Federal Government to undertake massive new support for scientific and technical education.

In the last two years, Federal support for primary and secondary education has also greatly expanded. Two closely related premises underlie the decision that exclusive reliance on State and local support for primary and secondary education is no longer adequate from the standpoint of the national interest. The first is the recognition that every community suffers from inadequate education in other parts of the country. The second is the recognition that education must be a key element in the attack on poverty to which the Nation is now committed.

The resources devoted to schooling and the resultant quality of education vary widely among areas of the United States. In 1964-65, the mean current expenditure per pupil in average daily attendance in public elementary and secondary schools was \$484; it ranged from \$273 in Mississippi to \$790 in New York. Even the high average expenditure in New York did not provide a satisfactory education for many young people in that State.

States with low personal incomes often spend relatively more on education than their wealthier neighbors. Mississippi, with the lowest absolute expenditure per pupil in average daily attendance, devoted 4.4 percent of personal income to education last year, compared with the national average of 3.8 percent. New Mexico spent 5.8 percent—the highest proportion of any State—yet its per pupil expenditure still fell short of the national average.

When nearly 6.5 million people move across State lines every year and far larger numbers move within States, it is obvious that no community is immune to the effects of substandard education in other localities. Studies have shown that areas that are losing population—particularly their young people—spend less per student on education than those which are growing. The communities gaining population—typically our larger cities—are crowded with migrants who are often inadequately prepared to assume their social responsibilities or to qualify for urban jobs.

Moreover, the Nation has accepted the fundamental objective of eradicating poverty wherever it is found. Whether or not they migrate elsewhere, inadequately educated children of poor parents are handicapped in escaping

the poverty in which they were reared. Education is the most powerful tool we have for raising the productivity and motivation of the children of poor families, and for breaking the cycle of poverty and dependency.

The tax base in communities with many poor families is often too weak to finance good schools. Even communities with more ample resources have frequently not provided schools which would encourage and assist children of the poor to make their own way out of poverty. Federal assistance clearly is required if every school district is to provide an education that is adequate for an economy of growing interdependence and for a society that is determined to eradicate poverty.

BUILDING THE LADDER OF EDUCATIONAL OPPORTUNITY

Programs adopted in 1965 will open new educational opportunities for millions of children and youths. These new programs will aid many disadvantaged children to get off to an equal start with others; assure them school facilities comparable with those of others; and remove some of the financial blocks which might prematurely halt their progress toward higher education. For persons no longer in school, the new measures will provide useful skills and training, or help to update skills outmoded by rapid technological change, thus making them more productive and preparing them for better jobs.

Much of the direct return from these new measures will accrue to the disadvantaged in the form of increased incomes which will help to lift them—and their children—out of poverty. Indirectly, all Americans will benefit through greater economic growth and reduced social tensions.

Project Head Start

Each year close to a million children from poor families begin their formal schooling. Most of these children suffer from extreme cultural and social deprivation. They have lacked the chance to build a vocabulary and to develop the other tools of learning. When they begin school, they are in a world that they do not understand.

In the summer of 1965, project Head Start—under the auspices of the Community Action Program of the Office of Economic Opportunity—was inaugurated to help these youngsters. To encourage widespread community involvement, parents and volunteers also participated in the program, which reached 560,000 preschool children at 13,400 Head Start Centers in 2,500 urban and rural communities. The summer program will be continued, and plans are being developed to extend Head Start on a year-round basis for 100,000 children in 1966.

Last summer, thousands of children had books for their own use for the first time; children whose diets typically consist of starches received fresh fruits and vegetables; many whose world had been confined to crowded slums began to explore their communities and visited zoos or museums.

Project Head Start is also concerned with a child's health. In examinations conducted as part of the program in Boston, volunteer doctors discovered that 71 percent of the children had one or more problems—pediatric, dental, or emotional—which required referral for further diagnosis and treatment. Without the Head Start program, many serious defects would have remained undetected and uncorrected for many years—perhaps to become uncorrectable.

This program will give millions of children a better chance to succeed in school. Unfortunately, however, many of these deprived youngsters will enter schools which—rather than being the best—are among the weakest in the country.

Elementary and Secondary Education

After years of controversy over Federal aid to education, the Elementary and Secondary Education Act of 1965 brought the Federal Government into a creative partnership with States and communities to improve the quality of all schools, and particularly those serving disadvantaged children. The Act authorizes more than \$1 billion annually in grants to school districts with heavy concentrations of children from low-income families. Each district is eligible for a Federal payment of up to one-half the average State expenditure per child multiplied by the number of its poor school-age children. These grants will finance special programs to meet the needs of 5 million educationally deprived children from low-income families—10 percent of the 50 million school-age children.

The Act also provides funds for books, maps, and other educational materials which many schools currently lack. More than two-thirds of public elementary schools, serving almost 10 million children, have no library.

Supplementary educational centers will be established throughout the country to bring more of the cultural resources of an area into the educational process. Regional laboratories connected with major universities will seek better ways of teaching, and will seek to promote the transfer of new knowledge to the classroom. Funds are also provided to improve the operations of State educational agencies, thus strengthening their capacity for planning and decision-making.

Higher Education

Although setbacks to the educational progress of the disadvantaged occur most frequently prior to the completion of high school, many talented students from poor families are unable to attend college for financial reasons. The Higher Education Act of 1965 established a broad program to make higher education available to all who may benefit from it. Its most important innovation is a program of educational opportunity grants of up to \$1,000 for 115,000 high school graduates from low-income families.

In addition, a guaranteed-loan program and an expanded Work-Study program will aid more than 700,000 students.

The Act will also help institutions of higher education to become more responsive to the current problems. It will encourage them to undertake community service programs, including extension, continuing education, and research programs designed to assist in the solution of community problems. It also sets up a new grant program to upgrade the academic quality of small developing colleges and establishes fellowships to encourage qualified persons to teach at these institutions.

The legislation authorizes the creation of a National Teachers Corps to augment the supply of qualified instructors in poor areas. Although the Congress did not appropriate funds to establish the Teacher Corps in 1965, the Administration continues to give this program high priority.

Most programs of direct financial aid to students have been directed toward the college-bound graduate and have failed to provide for many youths who wish to obtain training in business, trade, and technical schools. This omission will be corrected by the establishment of a vocational student loan insurance program which, when fully funded, will help as many as 100,000 students a year.

Out-of-School Programs

The 1965 legislation also strengthened several programs which provide job training and work experience as well as basic education. These programs are designed to equip workers with the skills and productivity required to raise their potential earnings.

The Neighborhood Youth Corps program encourages persons aged 16-21 to stay in or return to school by providing full-time and part-time work experience and training. It provides counseling and basic literacy training, and it places young men and women in newly created positions to do work that would normally not be done in hospitals, settlement houses, schools, libraries, and other community agencies. Almost 1,500 projects have been approved in communities throughout the Nation for the employment of 350,000 young men and women in 1966.

The Job Corps provides education and work experience in rural conservation centers and in urban training centers where enrollees live, work, and learn. About 300,000 young people have expressed interest in joining this program. It is expected that about 30,000 will be enrolled by June 1966.

The Work Experience Program is designed to demonstrate the benefits of helping heads of families with dependent children to prepare for productive employment by providing them with work experience and job training along with basic literacy instruction. In 1965, the program aided 66,000 participants with 198,000 dependents.

The Adult Basic Education program is aimed at the 7.3 million Americans age 25 and over who have less than 5 years of education. It provides basic education when a lack of schooling stands in the way of

successful training or employment. In fiscal 1965, about 38,000 adults in 15 States were enrolled. By June 1966, the program is expected to reach 229,000 adults in all the States and the territories.

ACTIVE MANPOWER POLICIES

Manpower policies have three principal objectives: to fit the unskilled for better jobs, to augment the supply of scarce skills, and to improve the efficiency of labor markets. These policies not only help individuals to achieve their full capabilities, but also add to the national productive potential. They are a continuation of the educational opportunity programs and should serve to keep the quality of the labor force advancing in pace with the demands created by technological progress.

TRAINING PROGRAMS

The Manpower Development and Training Act (MDTA) programs provide training and basic literacy instruction for unemployed (and some underemployed) persons who have had previous work experience, in order to up-grade their job skills. Between passage of the law in 1962 and the end of 1965, enrollment had reached a cumulative total of 370,000, with 315,000 in institutional training and 55,000 in on-the-job training. About 30 percent have been trained for skilled occupations and another 30 percent for clerical, sales, and service jobs.

Amendments to the MDTA in 1965 have made it possible to extend the scope and to increase the effectiveness of these training projects. The maximum period during which training allowances can be paid has been extended from 72 to 104 weeks, making it possible to train persons for more highly skilled work. Eligibility for training allowances has been broadened; and the previous limitation on the number of youths who can benefit has been liberalized.

It is appropriate that MDTA training programs have been strengthened during a period of rapidly rising employment and increasing demand for labor. Workers who are now being trained can count on finding jobs quickly and benefiting immediately from the training they receive. And the upgrading of skills for thousands of the unemployed will help to provide a more flexible and mobile labor force, thus contributing to the stability of costs and prices in our expanding economy.

IMPROVING THE EFFICIENCY OF THE LABOR MARKET

Expansion of the economy is facilitated when labor markets operate efficiently. The Federal-State Employment Service is the principal agency of our manpower policy designed to help to match people with available jobs.

Most jobs are filled by direct hiring "at the gate" and through informal contacts with relatives and friends; many others are filled with the assist-

ance of advertisements, unions, private agencies, college placement officers, and other means. But through its more than 2,000 local offices, the Employment Service maintains an active placement service for all workers desiring assistance.

A major task of the Employment Service has been to provide job counseling and placement service to those in the labor force (including new workers, the handicapped, and nonwhites) who require special assistance to enable them to compete in the job market. The Service also provides a flow of information about changing manpower requirements in local labor markets. This information is useful in planning occupational training under the MDTA; in reorientation of our vocational education programs; and in helping individuals to make rational vocational choices, and guiding them to areas of favorable employment opportunities.

A Special Task Force appointed by the Secretary of Labor has studied the operation of the Employment Service and recommended ways to make it achieve its goals more effectively.

RAISING LABOR PRODUCTIVITY

By 1985, the labor force will total about 110 million workers. On the assumption that present programs will be continued on the scale now projected, about one-tenth of these workers will be more productive because they have benefited from an MDTA or other out-of-school training program. Nearly one-half will be better educated as a result of one or more of the newly enacted programs. And these benefits will be concentrated among those individuals now least likely to climb the ladder of educational opportunity.

America has always invested heavily in education and training, and our economic achievements show that it has paid off handsomely. But the investment was not made sufficiently in all Americans, and perhaps as many as a third enter the work force ill-equipped to assume a fully productive role. The programs that have been begun will extend a more adequate investment in education and training to that third of our people.

HEALTH

America is a healthy nation, and Americans take justifiable pride in the quantity and quality of available medical services. Yet, such significant indicators of U.S. health as life expectancy, infant mortality, and the incidence of heart disease must cause concern when compared with rates prevailing abroad or when our recent progress is measured against that of other nations.

After declining steadily and dramatically throughout the first half of this century, the U.S. death rate has remained close to 9.4 per 1,000 of the population since 1955. By contrast, in a number of other industrial coun-

tries, death rates have fallen sharply during the past decade, and life expectancy at birth exceeds that in the United States by a significant margin—as much as 5 years among males. Infant mortality has declined little since 1955 and remains close to 25 per 1,000 live births, whereas it is substantially lower and falling more rapidly in many other developed countries. Changes since 1940 in selected health indicators are shown in Table 14.

TABLE 14.—*Health indicators, selected years 1940–64*

Indicator	1940	1950	1960	1964
Years				
Life expectancy ¹				
At birth.....	63.6	68.1	69.7	70.2
White.....	64.9	69.0	70.6	71.0
Nonwhite.....	² 53.9	60.7	63.6	64.1
At age 45.....	26.9	28.5	29.4	29.7
White.....	27.3	28.9	29.7	30.1
Nonwhite.....	² 22.8	24.8	26.2	26.6
Deaths per 1,000 live births				
Infant mortality rate				
Total.....	47.0	29.2	26.0	24.8
White.....	43.2	26.8	22.9	21.6
Nonwhite.....	73.8	44.5	43.2	41.1
Deaths per 10,000 live births				
Maternal mortality rate				
Total.....	37.6	8.3	3.7	3.3
White.....	32.0	6.1	2.6	2.2
Nonwhite.....	77.4	22.2	9.8	9.0
Deaths per 1,000 population				
Death rates				
All causes.....	10.8	9.6	9.5	9.4
Diseases of cardiovascular system.....	4.1	4.9	5.2	5.1
Cancer.....	1.2	1.4	1.5	1.5
Influenza and pneumonia.....	.7	.3	.4	.3
Accidents.....	.7	.6	.5	.5
All other.....	4.1	2.4	1.9	2.0

¹ Life expectancy figures in first two columns are for 1939–41 and 1949–51, respectively.

² Negroes only.

Source: Department of Health, Education, and Welfare.

Between 1910 and 1940, the death rate from influenza and pneumonia was reduced by 55 percent, and since 1940 it has been halved again. Maternal mortality has been cut by nearly 95 percent over the past half century and by 60 percent during the last 15 years. Since 1940, however, death rates from heart disease and cancer have each increased by one-fourth; the U.S. rate for heart disease is among the highest in the world. Mortality rates among males in the productive age bracket of 40 to 54 years are substantially and consistently higher in the United States than in other industrial countries and almost twice the rate in Sweden.

Foodborne diseases are being increasingly recognized as a leading cause of acute sickness in this country and probably account for more illness than all other environmental elements combined. Salmonellosis—the most serious such disease—now is much more widespread than it was 15 years ago because of inadequate controls in new methods of food production and processing. Further, almost one-third of the U.S. population is drinking water which is not assured of meeting minimal standards.

COST OF ILLNESS

The total cost to society of illness and premature death cannot be accurately measured, if for no other reason than our inability to quantify the value of human life or the cost of suffering, pain, and grief. It is impossible to say, on the basis of economic criteria alone, how much should be spent on health care, research, and facilities. Nevertheless, at close to full employment of our resources—particularly of scientific and technical manpower—a decision to spend more for health implies spending less elsewhere. The issue facing the Nation is not whether better health is desirable, but how best to allocate resources within the health area and between health and all other competing uses.

Outlays for health are important in building and maintaining a productive labor force as well as in improving the lives of people and the quality of our society. The productivity of American workers could not have reached its present height if, in the past, there had not been investment in medical knowledge, in disease prevention, and in treatment and rehabilitation. Yet the potential return from further health investment remains large.

The annual expenditure on all health and medical care services in this country increased from \$13 billion in 1950 and \$27 billion in 1960 to approximately \$40 billion last year. Such expenditures now amount to 5.9 percent of the gross national product (GNP). Private spending for personal health care—more than \$26 billion last year—accounts for about 6.1 percent of personal consumption expenditures.

In 1963, disease and mortality during the year cost society the potential product of 4.6 million man-years of work. Direct public and private expenditures for personal health care associated with illnesses in that year amounted to about \$22.5 billion, whereas the indirect costs from output lost totaled almost \$24 billion. These figures make no allowance for the much larger losses in that year that were due to deaths occurring in earlier years or the present value of economic losses in future years resulting from current illness or death. Recent estimates of the direct and indirect costs associated with certain specific illnesses in 1963 are summarized in Table 15.

TABLE 15.—*Economic costs of illness, 1963*

(Millions of dollars)

Diagnostic category	Total costs	Direct expenditures ¹	Indirect costs ²	
			Mortality ³	Morbidity
Economic cost of illness: Total.....	46,303	22,530	2,731	21,042
Mental, psychoneurotic, and personality disorders.....	7,036	2,402	10	4,624
Diseases of circulatory system.....	6,413	2,287	1,226	2,920
Diseases of digestive system.....	5,502	4,158	123	1,220
Diseases of respiratory system.....	4,887	1,581	139	3,166
Injuries.....	3,755	1,703	242	1,811
Diseases of nervous system and sense organs.....	3,242	1,416	300	1,526
Neoplasms.....	2,614	1,279	484	851
Other.....	12,855	7,723	207	4,925

¹ Includes only hospital and nursing home care and services of physicians, dentists, nurses, and other health professionals associated with 19 major diagnostic categories; excludes drugs, medical research and facilities construction, training expenditures, and other nonpersonal health services.

² Equivalent to the value of lost output.

³ Losses in 1963 due to deaths throughout that year; no allowance made for present discounted value of future losses.

Source: Department of Health, Education, and Welfare.

PUBLIC POLICY AND LEGISLATIVE ACCOMPLISHMENTS

The rapid growth of demand for medical services is a consequence of a multitude of factors, some of which are strongly influenced by public policy. Rising incomes, better education, urbanization, expanding insurance coverage, the changing age structure of the population, and the increased availability and effectiveness of health services are all raising demand. Supply has not kept pace with the expansion of demand, and at present the supply of most health services falls short of the Nation's needs as determined by reference to medical standards of adequacy. Deliberate public and private action—including new and more efficient forms of organization—are required to increase the supply and accessibility of these services. But to improve the health of our population, it is not enough to graduate more doctors or build more clinics. Programs are also required to translate medical needs into effective demand for health services. At the same time, there must be greater coordination between demand-creating policy measures and those aimed at improving the supply and distribution of medical services and facilities.

Average figures conceal large differences in the incidence of illness and the availability of medical services within the United States. The distribution of doctors, for example, continues to vary widely from region to region and between urban and rural communities. Some differences in the distribution of facilities and the utilization of health services are consistent with an efficient allocation of resources and varying personal consumption patterns. However, existing disparities in both the supply and effective demand seriously affect the relative availability and accessibility of health care throughout the country and among different income groups. Thus, high morbidity and mortality rates resulting from causes that have

been successfully controlled in other groups still exist for nonwhites and the poor. Mortality rates among nonwhite infants more than 1 month old are almost three times as high as those for white infants. Poverty and its attendant circumstances are a major source of increased health hazards and, despite a popular desire to believe otherwise, low income is often a serious barrier to obtaining medical care. The 1960–62 National Health Survey found that the number of physician visits a year for children from families with annual incomes below \$2,000 was only 40 percent of the number for children from high-income families.

The Administration's basic health goal, as stated by the President, is "to assure the availability of and accessibility to the best health care for all Americans, regardless of age or geography or economic status." To meet this goal, four types of effort are necessary: (1) expanding medical knowledge through increased basic research in the life sciences; (2) faster dissemination of new information and techniques to health practitioners, health policymakers, and the public; (3) more and better organized health facilities and manpower, including research laboratories and medical schools, general hospitals and nursing homes, highly trained specialists and nursing aides; and (4) improved financing of medical services.

The first session of the 89th Congress passed a dozen major bills in the health field, designed to strengthen and improve health services in all four ways.

Medical Research

Total medical and health-related research expenditures in 1965 amounted to almost \$1.9 billion—nearly 9 percent of the Nation's outlay for all research and development. Expenditure on medical research was more than ten times that in 1950, representing an annual increase of almost 18 percent. Federal support rose from 45 percent to 64 percent of the total, but the Government's role in the direct conduct of such research declined slightly—from 22 percent to 17 percent. Public investment in health research is channeled mainly through the National Institutes of Health (NIH) whose budget for research, research facilities, and training has grown from less than \$100 million 10 years ago to over \$1 billion today. NIH support now accounts for two-fifths of all medical research expenditures in the United States.

Dissemination of Medical Knowledge

Our knowledge of life processes and of new methods of preventing and treating disease has rapidly moved ahead of our ability to apply this knowledge widely to the health needs of the Nation. Shortening the interval between the discovery and general application of medical advances is perhaps the single most important way to improve the productivity of the medical care industry.

Today, one cancer patient in three is being saved, but wider use of existing knowledge and techniques could save half the victims of this disease. More extensive use of new detection and diagnostic procedures and improved means of reaching and treating patients could reduce deaths from cervical cancer by 25 percent by 1970 and by 80 percent a decade from now. Instrumentation now in existence or being perfected could forestall many of the 400,000 strokes which occur each year.

To help close such gaps between knowledge and application, the Congress took a number of important steps in 1965. The Heart Disease, Cancer, and Stroke Amendments authorize support for a network of regional medical complexes. (The three diseases noted in the title of the Amendments account for 70 percent of all deaths in the United States.) The grants will assist hospitals, universities, and other institutions to establish cooperative programs for research, training, and demonstration. Such programs will bring new scientific advances more quickly to America's practicing physicians and their patients.

Medical Facilities and Manpower

A country's health standards change as income grows, knowledge accumulates, and concepts of adequacy evolve. Our current requirements for medical facilities and manpower reflect not only changes in the size and composition of the population and shifting patterns of disease and disability, but also a growing consensus that access to high-quality services is a right of all citizens.

Since passage of the Hill-Burton legislation in 1946, more than \$7.7 billion, including a Federal share of \$2.4 billion, has been invested through this program to provide additional hospital and nursing-home capacity of more than 340,000 beds. New general-hospital capacity is now being made available nationally at the rate of about 30,000 beds a year. Nevertheless, it is estimated that about one-third of the general-hospital capacity in the country is obsolete; a majority of the obsolete facilities are in metropolitan areas where two-thirds of the Nation's population live. Facilities containing 260,000 beds are in need of immediate modernization or replacement and those containing another 130,000 beds will require modernization before 1975. In dollar terms, current modernization needs of general hospitals have been estimated at more than \$6 billion, compared with new general-hospital requirements of less than \$1 billion. New financing techniques must be found to facilitate the modernization of hospitals, particularly in the large urban areas where deficiencies are now largest and where existing Federal programs have their smallest impact.

There are also large and rising needs for medical manpower. Part of this need is being met through organizational changes that raise the productivity of doctors, dentists, and nurses. For example, the development of group practice arrangements, the use of more elaborate (and more expensive) hospital and office equipment, reductions in travel time, and the

employment of paramedical personnel to perform routine or less complicated procedures have made it possible for doctors to render more and better service to larger numbers of patients than ever before.

The ratio of physicians to the population of the United States has been approximately constant since before World War II. The proportion actually engaged in clinical practice—as opposed to teaching and research—has declined markedly, however. Despite measures to economize on the use of physicians' time, a substantial decline in their availability would impose strains on the cost and quality of medical services. To maintain the existing ratio of doctors to population, it would be necessary for admissions to medical schools to increase approximately 50 percent during the next decade. The Health Professions Educational Assistance Act of 1963 authorized a program of grants and loans in support of medical schools and students. In 1965, for the first time, Congress established a scholarship program for needy students in the health field, and added a four-year grant program for the improvement of teaching programs in the health professions.

Too frequently, today, the administration and organization of public health services are badly fragmented. Measures to stimulate better coordination of Federal, State, and local efforts in planning for and providing these services and the gradual replacement of prevailing categorical programs with comprehensive community health services would be desirable.

Financing Medical Care

Private health insurance has made a major contribution to the better financing of health costs. The proportion of Americans with some form of private health insurance has risen from 9 percent in 1940 to 80 percent today. But gross benefits from such insurance covered only 25 percent of total expenditures for personal health needs in 1965. Furthermore, those most in need of assistance in meeting medical payments are frequently unable to buy insurance. Only about one-third of persons in families with annual incomes under \$2,000, and about one-half of all elderly persons, were covered by any type of private hospital insurance in 1963. Yet these groups spend a particularly large fraction of their low incomes for health. In 1961, average medical expenses amounted to 10 percent for families with annual incomes between \$1,000 and \$2,000, compared with 4 percent for families with incomes between \$10,000 and \$15,000.

Among the most important actions of the 89th Congress was the provision of health insurance for the aged under Social Security. Medicare will protect families against the economic risk of major medical expenses in old age. Benefits for 17 million Social Security beneficiaries, plus benefits from general revenues for almost 2 million additional elderly persons not covered by Social Security, will amount to about \$3.5 billion in 1967 and will cover at least 40 percent of the total medical costs of the aged. The basic program consists of hospital insurance, extended care, and home health

services for the aged, financed through a separate trust fund supported by employee and employer payroll taxes. A voluntary, supplementary program covers physicians' fees and other services and is financed through monthly premiums (currently \$3) by individuals over 65, which are matched equally by a general revenue contribution.

The legislation also greatly improved the quality and expanded the coverage of State medical assistance programs. The Kerr-Mills program for the aged was expanded to cover a total of about 8 million needy persons, including, for the first time, the blind, the disabled, and dependent children.

The 1965 Child Health amendments will make more health services available to expectant mothers, infants, and children, including crippled and retarded children. The progressive extension of crippled children's and child health services to youngsters throughout each State is required by 1975. Previously, these programs were aimed primarily at rural areas, but in the future they will provide equal assistance for low-income families in urban centers. Family planning services will also be strengthened.

EQUALITY OF OPPORTUNITY

Not all groups of Americans share equally in their country's prosperity. In 1964, the average income of nonwhite families was only 56 percent of the average income of white families. This and similar figures provide telling indicators of the task that the Nation still faces in assuring equality of opportunity and achievement for all its citizens (Table 16). They also indicate an incredible waste of our human resources.

Three important and distinct types of discrimination help to explain the difference between white and nonwhite incomes.

Discrimination results in lower wages for Negroes (who comprise 90 percent of the nonwhite group) even when they are doing the same kind of work as whites. Available data show that Negroes receive less income in every industry, in every occupation, and at every level of education.

Discrimination also excludes many Negroes from higher-paying jobs that would fully utilize their talents or training. Negroes are frequently forced to hold jobs that whites with the same experience and training would not ordinarily hold; and Negroes suffer from higher unemployment rates within all skill categories.

Finally, part of the income difference is explained by past discrimination which has lowered the potential productivity of Negroes by providing less investment in human resources for them than for their white contemporaries. This type of discrimination is manifested by lower expenditures for schools and health facilities in Negro neighborhoods.

Low family incomes are a product of these factors; but low incomes would tend to perpetuate these factors even if discrimination were eliminated. Low incomes for poor whites also result in lesser educational achievement,

poorer health, fewer skills, and consequently higher unemployment. To promote real equality, Negroes must break through the barrier of discrimination; but this will not be sufficient. They must also break out of the cycle of poverty.

TABLE 16.—*Selected measures of discrimination and inequality of opportunity, 1965*

Selected measure	White	Nonwhite
Income ¹		
Median income of families.....	\$6,858	\$3,839
Percent of households in poverty ²	17.1	43.1
Percent of families with incomes of \$10,000 or more.....	24.1	8.3
Education		
Median years of school completed, males 25 years of age and over.....	12.0	9.0
Percent completed high school, persons 20-24 years of age.....	76.3	50.2
Male.....	75.6	51.3
Female.....	77.0	49.4
Percent college graduates, persons 25 years of age and over.....	9.9	5.5
Labor force participation rate (percent of noninstitutional population)³		
Male.....	78.6	76.0
Female.....	37.0	46.1
Employment (percent of total civilian employment)³		
White-collar occupations.....	47.5	19.5
Craftsmen-foremen occupations.....	13.5	6.7
Unemployment rate (percent of civilian labor force)³		
Adult males.....	2.9	6.0
Adult females.....	4.0	7.4
Teenagers.....	12.2	25.3

¹ Data relate to 1964.

² Households are defined here as the total of families and unrelated individuals.

³ Relates to persons 14 years of age and over.

Sources: Department of Commerce, Department of Health, Education, and Welfare, and Department of Labor.

PROSPERITY: A CONDITION FOR NEGRO PROGRESS

A combination of social and economic change is necessary to correct the disparities between Negroes and whites. But prosperity is also an essential requirement because it creates and opens up jobs for the disadvantaged. This has been effectively demonstrated by postwar experience.

During the period of slow economic growth in the middle and late 1950's, the absolute gap between Negro and white incomes and employment widened. In 1952, the median income of nonwhite families was 57 percent of the median income of white families, and the unemployment rate for nonwhites was 4.6 percent, compared with a rate of 2.4 percent for whites. By 1958, the median income of nonwhite families had fallen to 51 percent of that of white families, and the unemployment rate of nonwhites had risen to 12.6 percent, compared with 6.0 percent for whites.

In 1964, a high-growth year, the median income of white families increased 4.7 percent over 1963, and that of nonwhites, 10.8 percent; the income gap narrowed in both percentage and absolute terms as income of

nonwhites rose by \$374 and that of whites by \$310. As a result, the median income of nonwhites rose from 53 percent of the median income of whites in 1963 to 56 percent in 1964. The gains in median incomes were representative of increases throughout the income scale. In 1964, the proportion of nonwhite families with incomes of more than \$10,000 rose from 5.7 percent to 8.3 percent, but it was still far below the figure of 24.1 percent for white families. The proportion with less than \$3,000 dropped from 43.1 percent to 37.3 percent. Final data for 1965 will not be available for several months, but preliminary indications suggest that incomes of Negroes again rose substantially.

The progress of the last two years confirms a crucial lesson. A prosperous economy and the labor demand that it generates are potent forces for eliminating discrimination and income differentials even though they cannot create equality. Improved Negro purchasing power will not fully overcome the effects of discrimination, but it will have a beneficial influence.

CIVIL RIGHTS LAWS AND ECONOMIC DISCRIMINATION

The 1964 Civil Rights Act contains several important provisions that alter those conditions which make discrimination possible. Its Title VII directly outlaws discrimination in hiring, firing, conditions of work, apprenticeship, or training. The Equal Employment Opportunity Commission was established to carry out these provisions. The Commission began operation in July 1965 and in its first 100 days processed more than 1,300 complaints. Hiring attitudes will not change abruptly, but the Civil Rights Act makes an important, direct attack on this basic barrier to full equality.

Negroes are also at a disadvantage in the housing market. Many Negroes live in substandard housing because their incomes are low; but others are forced to do so by direct discrimination. While 57 percent of nonwhite households with annual incomes of less than \$4,000 live in substandard housing, only 27 percent of whites at these same income levels live in such housing. Among households with more than \$4,000 a year, 6 percent of the white families live in substandard housing, compared with 20 percent for nonwhite families. Discrimination in housing forces Negroes to pay higher rents and in many places to attend inferior schools. The President has announced that he will ask for legislation to prevent discrimination in private sales or rental of housing.

To help Negroes achieve equality of educational opportunity, the Civil Rights Act authorizes the Attorney General to file suit for the desegregation of public schools and colleges upon receipt of written complaints from parents unable to bring their own actions. After 10 years of slow progress following the Supreme Court decision outlawing segregated schools, the pace of integration has now accelerated; but segregated housing continues to retard this process. In addition to eliminating segregation, the Government is trying to improve the quality of Negro education by its new programs

for primary and secondary education, Project Head Start, and other anti-poverty programs. Also, Title VI of the Civil Rights Act assures that access to schools, hospitals, and other federally aided facilities will not be denied to anyone on the basis of his race.

ECONOMIC COST OF DISCRIMINATION

Although economic losses are not the major reason for eliminating discrimination, they serve to emphasize its economic cost to all Americans. When there is a surplus of labor of all types and skills, eliminating discrimination results mainly in a redistribution of income. The economic cost of discrimination becomes most evident when there is near full employment of the white labor force.

If economic and social policies could be specifically designed to lower Negro unemployment to the current unemployment level of whites, the resulting gain in GNP would be \$5 billion. Part of this gain would be in wages of the new Negro employees, and part would accrue as other forms of income. A further gain would result if all Negroes were able to obtain jobs which would better utilize their abilities and training.

National output can be further expanded by improving the average level of productivity of each individual. Education and training are two of the most important means to this end. If the average productivity of the Negro and white labor force were equalized at the white level, total production would expand by \$22 billion. If both unemployment rates and productivity levels were equalized, the total output of the economy would rise by about \$27 billion—4 percent of GNP. This is a measure of the annual economic loss as a result of discrimination. Of course, to achieve this increase in output, some resources would have to be devoted to investment in the human capital of America's Negro citizens. But this would be an investment yielding important economic as well as social returns for the entire Nation.

REDUCTION OF POVERTY

Investment in human resources is a means to an end, not an end in itself. It is a means to rising living standards, to greater opportunity for individual achievement, and to the abolition of poverty. Thus, the pursuit of an effective program of human resource development and the pursuit of successful antipoverty measures are closely related processes.

Five years of prosperity and continued economic expansion have contributed significantly to reducing the number of people who live in poverty. Between 1959 and 1964, the number of persons defined as poor decreased from 38.9 million to 34.1 million (Table 17). As a result both of further economic growth and of the new antipoverty programs, the data for 1965 will undoubtedly show a further drop in the number of poor.

A fully employed economy is—and will continue to be—a powerful weapon in the war against poverty. However, full employment alone is not suf-

TABLE 17.—Number of poor persons and incidence of poverty, 1959–64

Year	Total persons ¹	Poor persons	
		Number ¹	Incidence of poverty (percent) ²
Millions of persons			
1959.....	176.5	38.9	22.1
1960.....	179.5	40.1	22.3
1961.....	181.4	38.1	21.1
1962.....	184.4	37.0	20.1
1963.....	187.2	35.3	18.9
1964.....	189.7	34.1	18.0

¹ Data relate to March of following year. Excludes inmates of institutions and a small number of children under 14 years of age who live with families to whom they are not related. (There were about 200,000 such children in March 1965.) Includes members of the armed forces in the United States living off post or with their families on post.

² Incidence of poverty is measured by the percent that poor persons are of the total.

NOTE.—Poverty is defined by the Social Security Administration poverty-income standard; it takes into account family size, composition, and place of residence. Poverty-income lines are adjusted to take account of price changes during the period.

Sources: Department of Commerce and Department of Health, Education, and Welfare.

cient. The purpose of the Economic Opportunity Act of 1964 is to promote investment in the health, education, training, and work experience of the poor which will enable them to contribute more effectively, and thereby to earn incomes more comparable to those in the rest of society.

Many public and private programs exist to help to eradicate poverty and to aid the needy. The Office of Economic Opportunity (OEO) was established by the 1964 Act to coordinate these efforts, and to develop new approaches to combat the multiple causes of poverty. Several of the Administration's antipoverty programs are discussed in the section on education. In addition, OEO's Community Action Programs—discussed in the Council's 1965 Report—are mobilizing local and Federal resources to aid the poor. This year, important new data on the incidence of poverty are presented which illustrate the progress of the past 5 years.

CHANGES IN POVERTY: 1959–64

In order to assess progress and to evaluate alternative approaches effectively, it is necessary to have a clear-cut quantitative definition of poverty. Last year, the Social Security Administration developed the present definition, which takes account of differing family size and composition and differences between living conditions in urban areas and on farms. This new poverty-income definition is based on a minimum, nutritionally sound food plan designed by the Department of Agriculture for "temporary or emergency use when funds are low." The food costs in this subsistence plan are used to determine the minimum total income requirements for different-sized families. Budget levels for farm families are reduced by 30 percent to allow for lower cash expenditures required where home-grown food is available and to recognize the lower cost of farm housing. Computed in

this way, the 1964 poverty-income line for nonfarm individuals was \$1,540; for farm individuals, \$1,080. Four-person nonfarm families were defined as poor if their money income was below \$3,130; for farm families of this size, the poverty-income line was \$2,190. Income standards for past years were adjusted to take account of price changes during the 1959-64 period. Although no statistical definition of poverty is available which fully recognizes such factors as regional differences in the cost of living and which allows for differences in asset-holdings of families, there can be little dispute that almost all people with incomes at or below these minima are indeed poor.

The new figures on the number of poor show clearly the relationship between over-all economic conditions and the incidence of poverty. In 1959, poor persons represented 22.1 percent of the total noninstitutional population. By 1964, the number had dropped by 4.8 million, to 18.0 percent of the population. For the 1959-64 period as a whole, the incidence of poverty declined by 0.6 of a percentage point a year. From 1959 to 1962, a period which included a recession, the number of poor declined by an average of 633,000 persons a year. During the subsequent two years of expansion, the average decrease was 1,450,000 a year.

TABLE 18.—Number of poor households and incidence of poverty, by race, 1959 and 1964

Item	All poor households		White		Nonwhite	
	1959	1964	1959	1964	1959	1964
Millions						
Number						
Total households ¹	13.4	11.9	10.3	9.1	3.0	2.8
Unrelated individuals.....	5.1	5.1	4.1	4.2	.9	.9
Under 65 years of age.....	2.6	2.3	1.9	1.8	.7	.5
65 years of age and over.....	2.5	2.8	2.2	2.4	.2	.4
Families of 2 or more.....	8.3	6.8	6.2	4.9	2.1	1.9
With no children under 18 years of age.....	3.0	2.3	2.4	1.9	.5	.3
With children under 18 years of age.....	5.3	4.5	3.7	3.0	1.6	1.5
Percent						
Incidence of poverty²						
Total households ¹	24.0	19.8	20.7	17.1	52.2	43.1
Unrelated individuals.....	47.4	42.0	45.4	40.2	59.3	53.0
Under 65 years of age.....	36.8	31.2	32.9	28.5	54.8	44.0
65 years of age and over.....	68.1	59.3	67.2	57.2	78.5	79.3
Families of 2 or more.....	18.4	14.2	15.1	11.5	49.6	39.1
With no children under 18 years of age.....	16.4	11.7	14.6	10.8	37.8	22.5
With children under 18 years of age.....	19.7	16.0	15.5	12.0	55.3	47.7

¹ Households are defined here as the total of families and unrelated individuals.

² Incidence of poverty is measured by the percent that poor households are of the total number of households in the category.

NOTE.—Poverty is defined by the Social Security Administration poverty-income standard; it takes into account family size, composition, and place of residence. Poverty-income lines are adjusted to take account of price changes during the period.

Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Department of Health, Education, and Welfare.

TABLE 19.—*Incidence of poverty and distribution of poor households, 1964*

Type of household ¹	Incidence of poverty (percent) ²	Percentage distribution of poor households
All households.....	19.8	100.0
Farm households.....	30.0	9.1
Nonfarm households:		
Head 65 years of age and over.....	38.0	34.7
Head under 65 years of age:		
White:		
Male head.....	8.1	23.7
Female head.....	31.3	16.0
Nonwhite:		
Male head.....	28.2	8.9
Female head.....	60.2	7.6

¹ Households are defined here as the total of families and unrelated individuals.

² Incidence of poverty is measured by the percent that poor households are of the total number of households in the category.

NOTE.—Poverty is defined by the Social Security Administration poverty-income standard; it takes into account family size, composition, and place of residence.

Sources: Department of Commerce, Department of Health, Education, and Welfare, and Council of Economic Advisers.

A similar improvement can be seen in the number of poor households (including unrelated individuals as one-person households). Their number fell from 13.4 million in 1959 to 11.9 million in 1964. This represented a drop in the incidence of family poverty from 24.0 percent to 19.8 percent (Table 18).

The encouraging record of progress is marred, however, by the figures for particular groups. The total number of poor, unrelated individuals over 65 years of age increased by 300,000 during the 1959–64 period. This increase is explained by the fact that the total number of unrelated individuals over 65 years of age increased by 1 million during this period. The incidence of poverty among such individuals actually declined, however.

The number of large families with 5 or more children living in poverty also showed no decline, remaining constant at about 1.1 million. The total number of poor children in such families, however, decreased slightly during the 5-year period.

Progress in alleviating poverty has also been slow among families headed by females (including women living alone). In 1959, there were 5.4 million such poor households; in 1964, 5.5 million.

The total number of poor, nonwhite households declined by 200,000 between 1959 and 1964. The largest declines were among childless, nonwhite families and single persons under 65. However, in 1964 almost 48 percent of all nonwhite families with children were still living in poverty.

Although the incidence of poverty is far higher among nonwhites, the aged, and white families headed by females than for the population generally; however, families headed by white males below age 65 accounted for nearly one-fourth of all poor households in 1964 (Table 19).

Encouraging progress has been made during the last 5 years, but the dimensions of poverty in America are still disturbing. Expanded investment in human resources and the eradication of racial discrimination are vital parts of the total antipoverty program. However, for the aged and for families headed by females, continued improvement of income-maintenance programs remains the major route out of poverty, since most of them are not—and cannot be—active members of the labor force.

INCOME MAINTENANCE

Over the last 30 years, the United States has developed a set of public income maintenance programs for many families who need assistance in order to maintain adequate standards of living. In fiscal year 1965, an estimated \$20 billion of the \$40 billion total spent on these public transfer payment programs went to persons who were, or would otherwise have been below the poverty-income line; these payments helped to raise some 3 million households out of poverty, but about 12 million units still received insufficient income to meet the minimal living levels now used to define poverty. People who remained poor received about \$10 billion of all public transfer payments. To eliminate completely the poverty-income gap—the amount by which total money income falls short of meeting the poverty-income standard—would require that almost \$12 billion be added to the income of the poor.

In 1964, of the 34.1 million persons who failed to meet the Social Security Administration poverty-income standard, 14.8 million (43 percent) were children under 18 years of age, 5.4 million (16 percent) were 65 years old or over, and 13.9 million (41 percent) were neither aged nor children under 18. Public assistance payments (including those under State-local general assistance programs) went to only 7.3 million of these people, just over one-fifth of the noninstitutionalized needy. (Some aid was also provided to 500,000 additional persons in institutions and to almost 270,000 aged persons who received help only in meeting their medical bills.)

About 26 million poor persons were not receiving aid under public assistance programs in June 1965: 11.5 million poor children, their 7 million parents, and about 3.5 million aged. The remainder of the unaided poor were adults aged 18–64 without dependent children.

Eight million poor persons were aided by other Federal income maintenance programs, including an estimated 6.7 million of the 19.8 million beneficiaries under Social Security (OASDI). The remainder received payments under such programs as unemployment insurance, veterans' pensions and compensation, Railroad Retirement, and workmen's compensation. The highest proportion of needy persons aided by income-maintenance programs is found among those aged 65 or over and those under 18. While there are a large number of programs that help the poor in the 18–64 age range, large gaps in coverage exist under present arrangements. About half of the poor now receive no public transfer income.

In addition to the large gaps in coverage under existing public assistance programs, the benefits paid to the eligible poor are often extremely low. Most persons now receiving assistance do not receive enough to enable them to live at even a minimum subsistence level. For example, the average annual total income of aged public assistance recipients is \$970 a person; of blind recipients, \$1,110 a person; of disabled recipients, \$910 a person; and for families with dependent children, \$1,680 a family (four persons). For a mother and three children, this amounts to only \$1.15 a day for each person, to cover the costs of food, shelter, clothing, and all the other necessities of life.

Increasing concern about these problems is producing a variety of new income-maintenance proposals. One approach would make public assistance coverage more comprehensive and assure all recipients more adequate benefit levels. Another approach is the institution of uniformly determined payments to families based only on the amount by which their incomes fall short of minimum subsistence levels. Such a system could be integrated with the existing income tax system. This plan is now receiving intensive study by many scholars. It could be administered on a universal basis for all the poor and would be the most direct approach to reducing poverty. In future years, these and other proposals deserve further exploration.

Chapter 4

Areas for Further Legislative Progress in 1966

LAST YEAR'S legislative achievements mark a major milestone in the social and economic progress of the American people. The President's program for 1966 contains fewer items of economic legislation; yet it includes major proposals relating to several key areas of the economy. This chapter presents three areas of importance for the domestic economy in which there are new proposals, and provides some of the relevant economic background. The economic background for other new proposals is developed in Chapters 1, 3, and 6.

THE URBAN ENVIRONMENT

Every large metropolitan area is a cluster of communities, usually consisting of a central core city plus surrounding suburbs. Almost without exception, the central core cities, which are the heart of the metropolitan area, have experienced a gradual process of physical and economic deterioration. Partly as a result of people's desire for more space and homeownership, and made possible by the development of the automobile, central cities have been losing middle- and upper-income families to the suburbs. This movement accelerated when cities became caught in a vicious spiral of spreading slums, rising crime, and worsening congestion. Once a neighborhood began to deteriorate, it did not pay any individual landlord to attempt to stem the decline; the private return on new investment fell, since little extra rent could be charged for better apartments in slum areas. This deterioration was accentuated by housing shortages after World War II and by the artificial shortages created by racial discrimination in housing which preserves a captive market for dilapidated slum buildings in large cities all over the United States. As a result, primarily two groups of people have tended to remain in core cities—the very rich, who can afford to live in luxury apartments, and the poor, especially minorities who have no choice but to live in the limited housing available to them.

This process has created an almost impossible financial situation for many cities. They have had to bear public assistance payments and other welfare costs for the low-income groups in the slums, as well as to continue

to provide mass transportation, fire and police protection, and education; but their tax base has failed to expand correspondingly as the high- and middle-income groups and some industry and commerce have fled the city—a departure speeded by rising tax rates.

Although housing deterioration is perhaps the most important single factor contributing to the decline of central cities, it is but one of many handicaps facing downtown areas. Many families have moved to the suburbs, but their jobs have not moved to the same extent. This means that an increasing number of individuals must commute to work in the central city. Compounding this problem has been the increase in urban land values which encourages taller buildings with dense occupancy. As the buildings become larger, the number of people who have to be transported to a particular point expands, putting an additional strain on the transportation system. Congestion, with all of its ramifications, is the result. Since builders do not have to bear the costs of bringing workers from low density suburban areas to very high density central cities in rush hour peak periods, these costs fall upon local governments which must make large investments in transportation facilities. From the point of view of efficiency, these investments often should have been in facilities for mass transit. Instead, for many reasons, they have been primarily in automobile expressways, which only increase the congestion in the center.

Many of the problems of central cities, such as air pollution, can be traced to the increasing size and density of America's urban population. In small cities or rural areas, automobile fumes are not a serious problem, since the natural cleaning capacities of the air are enough to eliminate noxious fumes. As the number of automobiles increases, the natural capacities of the air to purify itself are reached and surpassed. Similar factors are evident in water supplies. As population densities rise, local wells and streams become inadequate. Water has to be brought from increasingly distant areas at rising cost.

In small cities, extensive city parks and open areas are less necessary, since individuals can easily reach natural recreation areas; but in major metropolitan centers, natural recreation areas may be many miles away. As a city grows, parks, playgrounds, and other recreational resources become more necessary, but they also become much more expensive because of high land values in the core. Although recreational areas and open spaces can be supplied privately, the importance of outdoor areas for calm, healthy living means that these goods should not be confined strictly to those able to pay the price.

These formidable problems have made it necessary for the Federal Government to attempt to stimulate the search for new and creative solutions.

IMPROVING OUR CITIES

The Housing and Urban Development Act of 1965, the Cabinet Department created last year, and 1964 legislation in the areas of mass

transportation, civil rights, and economic opportunity constitute a major Federal effort to aid urban development.

The strategy for improving our urban environment embodied in this legislation has a double emphasis. First, it focuses on the quality of residential neighborhoods, including both the adequacy of housing and the suitability of the related community facilities. Second, while retaining flexibility to meet the separate needs of central cities and suburbs, it views them as an interrelated area and insists that public and private efforts follow consistent and coordinated plans comprehending the entire urban complex, if they are to receive Federal support.

Federal mortgage insurance, public and low-rent housing programs, and urban renewal have long had influence upon the pattern of metropolitan development. The Housing and Urban Development Act contains additional tools for dealing with these problems. It provides assistance for community facilities ranging from neighborhood centers to city parks and playgrounds. The open space program will be expanded by grants for urban beautification. Grants to cover interest charges on loans for the acquisition of land for public facilities in advance of its development—before speculative influences inflate prices—should reduce future problems in this area as well as encourage long-range plans for efficient land use.

The Act also continues the urban renewal program and authorizes an additional \$2.9 billion in grants. It strengthens requirements for workable programs and emphasizes the importance of building codes, zoning ordinances, local tax policies, and development standards. It provides grants to municipalities to help to defray the costs of enforcing codes and, where necessary, demolishing unsound structures.

A major innovation in the Act is the program for rent supplements. Under this program, more than 250,000 units of new or rehabilitated housing are scheduled to be approved over the next 4 years. The Federal Government will pay nonprofit, cooperative, and limited-dividend owners of private property the difference between fair market rents for their units and one-fourth of an occupant's income. Like interest subsidy programs, rent supplements can help to encourage construction and rehabilitation of adequate housing for low-income families.

The destruction of old neighborhoods as a result of urban renewal frequently involves high human costs. New public housing and rent supplement programs facilitate the purchase or rehabilitation of older housing and thus help to maintain and restore existing neighborhoods. Moreover, newly authorized grants for projects of code enforcement in deteriorating areas may conserve older residential neighborhoods and prevent or retard the development of slums. Joint administrative action by the Urban Renewal Administration and the Federal Housing Administration since early 1964 has resulted in the rehabilitation of over 48,000 units; another 90,000 are currently undergoing rehabilitation.

Where substandard housing has blighted a whole area, however, the most economic approach often is to clear the entire area, to provide space for new housing or other uses consistent with an over-all urban plan. Relocation payments to ease the hardships incurred by such clearing were liberalized in 1964, and the 1965 Act extended such payments to families displaced by the construction of mass transportation systems, by community and neighborhood facilities programs or advance land acquisition, as well as by urban renewal or public housing programs.

The President's new proposals for 1966 legislation contemplate the planned rebuilding, on a demonstration basis, of large areas of a number of cities of all sizes, enlisting local and private resources along with new measures of Federal assistance. The details of the program will be presented in a separate message.

The establishment last year of the Department of Housing and Urban Development did not itself add to the list of Federal policy instruments available to our cities. But it will make all these instruments and the new ones to be proposed more effective by providing an organizational focus for a unified Federal approach to metropolitan redevelopment, change, and growth. It will assure that all Federal programs that affect the city and its people will be brought to bear effectively to solve the city's problems.

THE ABATEMENT OF POLLUTION

Contamination of the environment is a problem of major national proportions. Polluted streams are found in all sections of the country. They increase the cost of obtaining fresh water supplies for municipalities and industry; they impair the recreational and aesthetic values of our areas of greatest natural beauty; and they destroy useful aquatic life. Air pollution is found in every major metropolitan area. Buildings and vegetation are damaged; transportation and communication are delayed; the attractiveness of our cities is reduced; and chronic health damage may result. Obsolete methods of solid waste disposal create problems in both urban and rural areas. The approaches to major cities are marred by unsightly accumulations of automobiles. The burning of rubbish in open dumps causes air pollution, and the careless use of refuse for land fill causes extensive stream pollution. Pesticides in water and soil have been found harmful to all forms of life.

It is not difficult to understand why an industrial society produces excessive amounts of pollution. For most resources, users are charged amounts which represent the value of these resources to others; indeed, this is a basic reason for the efficiency of a market economy. In the case of pollution, however, those who contaminate the environment are not charged in accordance with the damage they do. Thus, the cost of a municipality's discharge of raw sewage into a stream is borne not by the local residents but by

potential downstream users. And the cost of discharge of sulfurous fumes into the air by a thermal electric plant is not borne by the users of electricity but by the citizens who breathe the polluted air. Public policies must be designed to reduce the discharge of wastes in ways and amounts that more nearly reflect the full cost of environmental contamination.

Water pollution is primarily a product of organic wastes in the process of decomposing and of the phosphates, nitrates, and other minerals contained in discharges. The decomposition of organic wastes removes oxygen from the water, limiting its capacity to support fish and wildlife and its desirability for recreation. The inorganic substances cause water hardness, stream discoloration and odor, and the growth of algae. Damage from pollution is suffered by municipalities, industries, agriculture, and fisheries that cannot use contaminated water, and by individuals as a result of the aesthetic and recreational losses. Costs of treatment by municipalities and industries are a measure of the first type of damage; lower property values in the vicinity of polluted waters indicate aesthetic losses. An exact value cannot yet be placed on these losses. The capital cost of additional plants for municipal sewage treatment to the extent necessary to allow the use of streams for other than disposal of wastes is estimated at \$20 billion over the next 10 years; recreational losses alone are estimated to be in excess of \$6 billion a year.

Air pollution also has considerable impact on the health and welfare of the Nation. More than half is from automobiles, and most of the remainder from industry, electric power generation, and refuse burning. The costs of property damage alone have been estimated as exceeding \$11 billion a year; aesthetic and health damages substantially increase this cost.

Improper disposal of garbage, rubbish, and junk automobiles has imposed costs on neighboring residences and industries. Installed incinerator capacity would have to be increased 50 percent, at an estimated cost of \$280 million, to bring disposal in all cities to the minimum Public Health Service standards for air pollution. Since the Korean war, a stock of more than 2½ million junk automobiles has been accumulated in farmers' fields, garage lots, junkyards, or along highways. These junk piles have become so offensive that a number of cities, such as St. Paul and Oklahoma City, have removed them to isolated locations.

PROGRAMS FOR POLLUTION ABATEMENT

Governments have recognized the damages from pollution and have acted in several ways to prohibit or limit the dumping of untreated wastes. First, both State and Federal statutes authorize the regulation of waste disposal to improve the quality of the environment. Second, most municipalities provide public facilities for the collection and treatment of waterborne wastes; in addition, the Federal Government provides financial assistance to municipalities for the construction of such facilities, and for devices to measure air pollution. It would be desirable, wherever feasible, to add

as a third method a system of economic incentives to abate waste discharges. Incentives might include fees or charges levied against a pollutor in accordance with the damages caused by his pollutants.

The existing programs have been partially successful. In many areas, raw sewage and industrial wastes are no longer freely dumped into streams, often as a direct result of Federal proceedings. Half of the total population now lives in cities and towns where municipal sewage at least receives treatment to remove solid matter. Reports on air quality, based on new monitoring systems, have increased community awareness of the pollution problem, and have led to some programs of abatement. The extent—and results—of Federal concern, however, have been limited.

Enforcement of Water Quality Standards

Federal agencies have been concerned with water pollution since passage of the Rivers and Harbors Act of 1899 prohibiting discharges that impeded navigation. This and succeeding legislation of the same kind had little effect on dumping of municipal and industrial wastes, however. Not until the Federal Water Pollution Control Act of 1948 provided Federal authority to require the elimination of waste discharges in interstate waters were effective abatement policies inaugurated at the Federal level. The 1957 and 1961 Amendments strengthened and broadened the enforcement powers to deal with pollution problems within the confines of one State (upon the invitation of the State government). "Enforcement" begins with collecting evidence that the pollution endangers the health or welfare of specific persons, continues with a conference of control agencies leading to a schedule of remedial measures, and, if necessary, culminates in public hearings and court action to effect the remedial measures.

As a result of 37 actions taken under this procedure, there have been significant improvements in water quality. Between 1957 and 1965, completed Federal enforcement actions at 10 specific locations resulted in the reduction of pollution to an acceptable level. For example, in the Corney Creek drainage basin of Arkansas-Louisiana, oil field brines were brought under control so as to reduce significantly chloride pollution destructive to agriculture and fishing. In the Animas River in Colorado and New Mexico, radioactive uranium milling wastes that contaminated water supplies were brought under control. In the lower Columbia River, significant progress has been made in cleaning up parts of the river fouled by pulp and paper wastes and municipal discharges.

The conference procedure, however, is cumbersome and time consuming. Abatement has seldom taken place within 3 years of public notice of Federal surveys, and half of the actions begun as long ago as 1957 have not yet been completed.

The long delays in some cases result from the technological problems involved in achieving adequate treatment of particular wastes. But most of

the delays follow from difficulties with organizational and financial arrangements among Federal, State, and local governments. Municipalities frequently refuse to band together to construct area-wide treatment systems, so as to take advantage of economies in larger pipeline and plant operations. Communities operating independently have experienced delays in getting voter authorizations for financing, or have not constructed adequate plants because of local limitations on borrowing. Enforcement schedules have had to be set to take account of such local problems.

The enforcement action to curtail pollution in the Potomac River illustrates these problems of finance and organization. The first session of the conference of control agencies was held in 1957. Water quality has improved somewhat since then. But raw sewage continues to be dumped into the river because certain local treatment facilities were not constructed and arrangements for combining the facilities of a number of Virginia communities were not worked out. Not until the construction last year of the large Dulles Airport sewer were several Virginia communities finally integrated into the District of Columbia system.

More rapid progress is possible. The 1965 Water Quality Act established a program and a new agency—the Water Pollution Control Administration in the Department of Health, Education, and Welfare (HEW)—to consolidate and expand enforcement activities. States are required to set water quality standards on their portions of interstate waters, and to establish enforcement procedures by July 1, 1967, or else the new agency must do so. Water quality below these standards is subject to the Federal abatement proceedings without detailed proof of specific damages. As a consequence, enforcement procedures can take place concurrently on all interstate waters and an accelerated approach to acceptable water quality can result.

Enforcement of Air Quality Standards

The Clean Air Act of 1963 provides for cooperation between State and Federal agencies in dealing with air pollution and establishes an enforcement procedure similar in the first stages to that for water pollution. The program has not been in operation long enough to have had substantial effects on air quality. In 1965, the Act was amended to require that national standards be set for automobile exhaust emissions on 1968 model cars.

Federal Financial Assistance for Pollution Abatement

Enforcement actions have been combined with financial incentives. The Water Pollution Control Act provides for technical assistance, matching grants for the construction of waste treatment facilities, and assistance on comprehensive or area-wide planning of treatment facilities. The extent of financial assistance is limited, however. Because of restrictions on the dollar amount provided to any one city, on average only 20 percent, of State and local authorities' total expenditures on treatment, and only about 5 percent of large cities' expenditures, have been covered.

The combination of clumsy enforcement procedures and limited incentive grants has so far been insufficient to give promise of cleaning up water pollution within a reasonable period. Adequate treatment is now provided for the wastes in areas containing only 38 percent of the population; at the present rate of construction, new facilities will little more than keep pace with the growth of population.

An extended program was authorized by the last session of Congress. Legislation increased the total authorization of Federal grants for treatment facilities and relaxed somewhat the dollar limits on individual grants. Additional Federal assistance was included in the Economic Development Act of 1965 and as part of the programs of the Department of Agriculture and of the Department of Housing and Urban Development. Federal help is also available for monitoring and controlling air pollution, for research activities on water and air pollution, and for demonstration projects for the control of wastes from storm sewers. But grant limits are still restrictive, and the research cannot be expected to produce immediate results.

Rubbish, Garbage, and Junk Automobiles

Solid waste disposal has long been a service of local government; recently, some Federal aid has been provided for extending this service. The Department of Housing and Urban Development will help communities plan for solid waste disposal programs and for the construction of facilities. Research and equipment demonstrations have been organized in HEW and the Department of the Interior following last year's Solid Waste Disposal Act.

Last year's Highway Beautification Act calls for the screening or removal of junk yards from areas adjacent to federally assisted highways. This is essential as a beginning attack on the problem, but much more can be done in the reuse of waste materials. The emphasis in this legislation is on screening the junk from view, rather than moving it through the scrap utilization process. Unless it is moved more rapidly, the increasing number of automobiles to be junked will engulf more and more of our countryside in the next few years. Research on new methods of melting and shredding junk automobiles for economical use by the steel industry shows long-term promise for keeping the junk automobile problem within manageable dimensions.

NEW FEDERAL LEADERSHIP IN POLLUTION ABATEMENT

Leadership begins with setting the example: Federal facilities should demonstrate the nature and extent of practical pollution abatement. In an Executive Order of November 17, 1965, the President required that water pollution from all Federal facilities be controlled. Despite budgetary stringency, expenditures for waste treatment at Federal installations are being stepped up in the year ahead. A similar order on air pollution from Federal installations is forthcoming.

Federal leadership could be more effective if the recently required water quality standards for interstate waters could be extended to cover waters entirely within one State, and if the existing enforcement procedures could be accelerated. If information on waste discharge could be obtained from all polluters when necessary, stream deterioration could more effectively be predicted and prevented.

Pollution control can be truly effective only if it covers all sources in a river basin, and only if it is based on the relationships between stream quality at any one location and the discharges at all upstream locations. Methods must be devised to assure that upstream treatment is coordinated with downstream water use. The Government is taking the lead in experiments to achieve such coordination. For the Potomac River—hopefully, pollution-free by 1975—the Government has proposed that the enforcement action be accelerated by bringing together the localities in four States to begin treating the pollution problem as a river basin problem. The President has announced that he will propose to extend the example of the Potomac, in order to demonstrate how entire river basins can become scenic and recreational assets.

Although it must assist in eliminating the large backlog of capital requirements, the Federal Government cannot and should not finance local waste treatment indefinitely. In the long run, localities should collect revenues from the polluters, adequate to sustain the system and to expand it in line with normal growth. Charges based on use of treatment facilities provide long-run incentives for the abatement of pollution. Effluent charges on polluters in sections of the river where there is no municipal treatment could have a similar effect: when waste discharges cost the industrial firm a certain amount for every pound discharged, the volume of wastes will be reduced and the revenue collected will help to pay for collective treatment.

Existing Federal programs for pollution abatement, even when strengthened by the new measures to be proposed, cannot be expected by themselves to eliminate the pollution problem in this country. If—unlike our fathers—we are to leave a cleaner America to those who follow, then pollution abatement has to become not only a more pressing concern of localities, States, and the Federal Government, but also an urgent concern of corporate and individual policy.

EFFICIENCY IN TRANSPORTATION

The national transportation system is a crucial element in our economy. Personal mobility of Americans is unparalleled, because of both public transportation and the private automobile. Freight transportation, with which this discussion is primarily concerned, created the first and biggest of the common markets, thus permitting other industries to capitalize upon the economies of specialization and large-scale production.

Since World War II, the productivity of our transportation industries has increased—with Government support—through an impressive number of innovations. The postwar development of long-haul trucking has added new flexibility in service, time-in-transit, and origins and destinations served. The emergence of air travel has not only vastly increased the mobility of millions of Americans but also has permitted overnight coast-to-coast movement of mail and high-value freight. New high-pressure, large-diameter pipelines have lowered the cost of moving oil and provided the benefits of natural gas to cities many hundreds of miles away from the gas fields. Improved barge equipment has substantially increased productivity of carriers on the inland waterways.

As a result of these innovations, the different forms of transportation have experienced varying growth rates, high for motor carriers and oil pipelines and low for railroads. As shown in Table 20, railroad freight traffic did not participate at all in the growth of the total transportation market between 1950 and 1960. The railroad share of total ton-miles declined at an average rate of nearly 1 percentage point a year from 1940 to 1960. Meanwhile, the share of motor carriers rose steadily. Since 1960, however, the market share of the railroads has been stabilized. This has followed in part from imaginative new services—such as truck trailers on flat cars and three-decker automobile carriers—and from concurrent reductions in rail rates.

TABLE 20.—*Volume of intercity freight traffic, selected years, 1940-64*

Transport agency	1940	1950	1960	1961	1962	1963	1964
	Billions of ton miles						
Number of ton miles ¹							
Total ²	619	1,063	1,314	1,310	1,371	1,450	1,531
Railroads.....	379	597	579	570	600	629	666
Motor vehicles.....	62	173	285	296	309	332	³ 347
Inland waterways.....	118	163	220	210	223	234	250
Oil pipelines.....	59	129	229	233	238	253	266
	Percent						
Percentage distribution ⁴							
Total ²	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Railroads.....	61.3	56.2	44.1	43.5	43.7	43.4	43.5
Motor vehicles.....	10.0	16.3	21.7	22.6	22.6	22.9	³ 22.7
Inland waterways.....	19.1	15.4	16.8	16.0	16.3	16.1	16.3
Oil pipelines.....	9.6	12.2	17.4	17.8	17.3	17.5	17.4

¹ Estimates.

² Total includes airways freight, not shown separately in this table.

³ Preliminary.

⁴ Percentage distribution based on unrounded data.

Source: Interstate Commerce Commission.

The emergence of new forms of transportation and the resulting changes in traffic patterns are only the more dramatic manifestations of technical change. Truck trailers have steadily increased in size; freight cars have become bigger, lighter, and smoother riding; and jets have replaced piston

aircraft. All of these innovations have provided more ton-miles of transport per unit of capital and labor.

Private initiative has been facilitated by public investment in transportation facilities, such as in the Interstate Highway System and the Federal Airways System. Recently, public investment has taken the form of direct aid to innovation; for example, for the development and demonstration of high-speed rail passenger trains in the Northeast corridor between Boston and Washington. The extent of Federal involvement is reflected in the more than \$5 billion expended during 1965 on domestic transportation programs, such as highway construction, river and harbors navigation aid, and airways operations and construction.

While these dramatic changes have been taking place, Federal policy has also been evolving. Although the formal philosophy of regulatory policy has not been reshaped since 1920, many changes have been taking place through decisions in individual cases and legislative amendments. Four main directions of Federal policy appear to be emerging: (1) the development of a rate structure more oriented toward costs; (2) the planning of transportation to provide comprehensive services; (3) promoting the adjustment of transport investment to meet changing demand requirements; and (4) speeding the response to new technical opportunities.

COST-ORIENTED RATES

Rates charged by carriers are the signals that guide shippers to select that form of transportation which minimizes transportation costs for a particular shipment. Intelligent shippers always balance carrier rates against service advantages in terms of time-in-transit, warehousing, shipment size, and possible freight damage. Shippers can be counted upon to make the most economical choices, from their own standpoint. But these choices will not necessarily be the most economical from the standpoint of the national economy unless carrier rates truly reflect the cost to the economy of the service, including provision for adequate carrier profits. Hence, one condition for transportation efficiency is a cost-oriented rate structure.

Yet transportation rates still depend in part on so-called "value of service." This is usually defined in terms of value of shipment—rates are higher for diamonds than for coal shipments of the same size. Rates are also set sometimes by carriers and approved by the regulatory commissions to preserve historical divisions of traffic among modes of transport. Reductions in rates made possible by reductions in costs are often opposed and may be disallowed, because they are not in line with value of service or because they are destructive of existing traffic shares.

In recent years, competing carriers have increasingly sought to prevent rate reductions based on costs. For example, in 1964 the Interstate Commerce Commission (ICC) handled 4,959 protests on rate adjustments. About 90 percent (4,415 protests) involved rate reductions and three-fourths

(3,654) were from competing carriers rather than customers. Such a distribution of protests reflects an attempt to orient regulation to the settlement of disputes between competitors on tonnage shares. Although protests before the ICC Board of Suspension were involved in only about 2½ percent of the 203,721 rates filed with the ICC in 1964, the controversial rate reductions have been the important cases.

A major example of the attachment to rates based on existing divisions of tonnage, rather than to rate reductions permitting the introduction of cost saving innovations, is illustrated by the ICC case, *Coal to New York Harbor*. Multiple carload service, which allowed considerable cost savings, was one alternative means of shipment for more than 20 million tons of coal annually to East Coast electric generating stations. The alternative—proposed by the railroads—was to reduce rates on higher-cost single carload service, but only on the 10 million tons competitive with oil. The Commission approved the selective rate reductions on the carload service, since multiple carload rates “would have application to all coal received by utilities, only a part of which is vulnerable to displacement by oil,” and thus would include more extensive rate reductions than necessitated by demand conditions. The historical pattern of rates was protected until competitive forces finally brought about across-the-board reductions and the lower-cost multiple carload service in 1963.

For maximum economic efficiency, rates should be related to costs, but not to an arbitrary allocation of costs. Railroads and pipelines require large, indivisible capital inputs such as rights-of-way and terminals. These indivisibilities result in relatively high fixed costs, which, if allocated over each traffic unit on an arbitrary basis, result in average costs unrelated to the variable expenses of additional traffic. These average costs do not and cannot serve as a rigid basis for rate making.

“Cost-oriented rates” in the true economic sense are related to the economist’s concept of marginal cost—the increase in total expenses as a result of carrying additional ton-miles of traffic. In order to ensure efficiency, marginal, rather than average, cost should be the principal regulatory criterion in applications for rate reductions. Some traffic, on which rate reductions are not proposed, will pay more than marginal cost and in this fashion fixed costs will be met. But where competition and new technology dictate rate reductions, competitive rates could be lowered to the level of marginal cost. The gains for users from allowing rates to be appropriately geared to costs include lower rates on a larger volume of shipments. On railroad transportation alone, according to an independent estimate, savings from possible rate reductions would come to more than \$400 million a year.

At the same time, costs should reflect the value of all resources required to provide the service. Federally provided transportation facilities have continually expanded. Users should pay their fair share of the cost and maintenance of the highways, waterways, and airways facilities. As it is, there

are uneven payments from different classes of users—some making substantial payments and others none at all. Adequate user charges should be instituted in the interest of both equity and over-all transportation efficiency. The President's Budget Message again proposes new or increased transportation user charges.

COMPREHENSIVE POLICY PLANNING

Because there is competition among types of carriers for substantial portions of the freight tonnage, policies affecting one segment of the industry impinge upon other segments. A comprehensive approach to transportation recognizes the costs and services of each component part, and develops rate and service policies that provide transportation at minimum costs to the Nation. This approach is now followed, to some extent, by the independent regulatory commissions and the Executive Branch of the Federal Government, and is effected through considerable informal policy coordination. But it must be extended by organizational reform.

Each one of a number of executive agencies is now responsible for an aspect of transportation policy. An effective means for promoting transport development will be to combine all the major programs now within the Executive Branch in a single Department of Transportation—as the President has proposed. This will include the transportation activities now under the Department of Commerce, as well as the promotional and safety functions in aviation, urban mass transit, and maritime shipping. The new Department will be an effective instrument for the coordinated development of a national transportation system.

FLEXIBILITY IN TRANSPORT INVESTMENT

Traditionally, common carriers have a duty to serve. Regulation has institutionalized that obligation with controls over entry and abandonments. The rationale for such controls has been partially undermined, however, by technological changes, particularly in intercity trucking. Trucks now can quickly bring service to shippers without the large fixed investment required in railroading or pipelines. Regulatory policy has not yet fully capitalized upon this flexibility of truck capital and operations.

While controls over entry and abandonment are surely desirable, considerably more flexibility would seem to be appropriate in this period of promising technical developments—particularly in railroads and trucks—in order to free private initiative to perform its traditional function of economizing. More liberal standards for the modification of the scope of service offered by a carrier, and particularly for the abandonment of unneeded railroad service, could allow a competing service—if available and more efficient—to handle the traffic. Investment capital is scarce; if capital can be withdrawn from little used service, capacity can be expanded in the areas of profitable growth.

SPEED OF RESPONSE TO TECHNOLOGICAL CHANGE

Growing efficiency in transportation requires that new technological opportunities be seized promptly. With a constantly changing technology, the lag between average practice and the best possible practice is critical, and reducing this lag will increase productivity gains. Prompt adoption of new technical opportunities enhances the returns to the public and to the carrier from private initiative in innovation.

The nature of the problem is illustrated by the case of the "Big John" freight car service. The Southern Railway announced in June 1961 that shipments of grain would be made in new, four-compartment aluminum cars, each able to transport 90 tons. The service was to consist of 450-ton shipments in groups of five "Big John" cars, at rates approximately 60 percent below the prevailing carload rates. This service was suspended and appealed through the courts to the Supreme Court twice, once on the matter of continuing suspension beyond the maximum 7-month period, the second time on the reasonableness of rates. Rate reductions were permitted in 1963 on a provisional basis pending final action. Only after the final court review—in September 1965—were the rates found to be "just and reasonable."

Difficulties of this type will be mitigated as cost-oriented rates and flexibility in investment become more integral parts of regulatory policy. The benefits of the "Big John," for example, extend beyond the carrier and the shipper to the economy of the region served. Consumer savings, estimated at \$30–\$40 million annually, on meat, bread, butter, and milk have occurred in the Southern Railway region from the expansion of the livestock and grain industries. No economy can be fully efficient if it takes 4 years to determine pricing for such new innovations.

Other innovations cut across carrier types, as in the trailer-on-flat-car service. New technological opportunities could be fully exploited by removing obstacles to combinations of modes of transport and by more ready acceptance of shipper and carrier-owned equipment by railroads and motor carriers.

MARITIME POLICY

A special relationship has long existed between the Government and the maritime industry. For reasons of defense, the Federal Government provides extensive assistance to our merchant marine. In the past year, an Interagency Task Force completed a comprehensive study of U.S. maritime policy. Its many recommendations were designed in part to improve the competitive position of the industry. Bulk ships of a new and specialized construction would be built and subsidized, enabling their operators to compete for commercial bulk cargoes. In addition, cargo preference would be modified and ultimately eliminated.

Operating subsidies would be restructured by adding incentives to reward efficiency. Operators of unprofitable, subsidized passenger operations would

be encouraged to phase out their operations. Greater operating freedom in route selection would be granted to U.S. operators, and a reduction of detailed Government supervision would be instituted.

The subsidy for U.S. shipyard support would be related to national emergency need for shipyard capability. Beyond that need, ships could be built either in the United States or abroad, whichever was more economical for the ship operator.

In view of the major restructuring of maritime policy recommended in the report, the maritime industry and maritime specialists both within and outside Government have been asked to study the proposals. Their reactions and suggestions will serve as a constructive basis for implementing new directions in this portion of transportation.

Chapter 5

Progress and Problems in Agriculture

AGRICULTURE is one of the most progressive segments of the American economy. Productivity has grown faster there than in any other major economic sector. U.S. agricultural abundance is the envy of the world. Yet incomes of most farm families continue to fall short of those earned in other occupations. And agricultural employment is steadily declining. This paradox is a perennial source of confusion and protest.

For many years our commercial farms have had a total capacity to produce far in excess of the ability of our markets to absorb at reasonable prices. The causes of this are not hard to understand. As incomes have expanded, an ever smaller fraction of them has been used to buy the products of our farms. Over the past 50 years, disposable real income per capita in the American economy has nearly doubled; per capita consumption of farm products has risen by only 17 percent. As we become more affluent, we eat better and dress better. But most of our additional income goes for other goods and services that require little or no input from farms. Because the "income elasticity" of demand for farm products is low, the fraction of the labor force engaged in agriculture would be expected to decline as total incomes rise.

This relative decline in the need for farmers' services has been greatly intensified by another essential fact: the productivity of farm workers has been increasing much more rapidly than productivity in the economy generally. Because of the slow growth of demand and the rapid increase in productivity, there has been a persistent tendency for farm products to be overproduced, depressing farm prices. But the "price elasticity" of demand is likewise low: lower market prices do not result in greatly increased consumption of most farm products in the U.S. market.

Exactly 50 years ago, the American farm population reached its peak—32.5 million people—32 percent of the total population. One American farm worker produced sufficient food and fiber to supply himself and 7 other people. Today, farm people total less than 13 million and make up 6.4 percent of the population. Each farm worker produces enough food and fiber to meet the needs of more than 33 persons.

The steady and rapid decline in the demand for farm labor and the natural increase of the farm population have meant that agriculture is rapidly expelling a sizable fraction of its actual and potential workers.

Since 1940, 25 million people—on the average, 1 million a year—have left the farm. Although the vast migration from farm to nonfarm occupations and from rural to urban areas proves that mobility is high, the outward movement has never been fast enough to improve significantly the economic position of farm labor relative to labor in the nonfarm economy. Despite programs designed to minimize the income gap, farm incomes historically have been depressed relative to incomes elsewhere.

Today, incomes of many farm families are low, particularly incomes of those who live on small inefficient farms and who have been unable to adapt to modern agricultural technology. However, a substantial number of farmers who have successfully adapted and who produce the bulk of our food and fiber are realizing incomes nearly equal to what their resources could earn off the farm.

For many low-income persons, a move to nonfarm occupations is not possible. Some farm residents are too old, do not have or cannot acquire the necessary skills, or simply lack the resources needed to finance a change. Consequently, the least mobile portion of the farm labor force remains stranded in eddies of rural unemployment or underemployment—on small farms, or in barely remunerative rural nonfarm occupations. Poverty is one of rural life's most urgent yet neglected problems. And some of those who do move to cities in hope for a better life often find themselves ill equipped for the jobs that are available and socially unable to adjust to the ways of urban life.

Farm people who are able to migrate successfully usually earn more than they could in farming. Those who remain are helped as well, since the transfer of labor out of agriculture reduces the excess resources which hold down average farm incomes.

These few basic considerations oversimplify the complex factors at work in U.S. agriculture and the difficult issues involved in framing agricultural policy. Some of these issues and complexities are discussed in the sections which follow: the changing importance of labor, land, and purchased inputs in farming; the potentially vast but uncertain world market for our farm products; the increasingly separate problems of commercial agriculture and of rural poverty; and the various public policy approaches for dealing with these problems.

COMMERCIAL AGRICULTURE IN THE 1960'S

Midway through the 1960's commercial agriculture is a highly efficient, competitive industry adjusting to market forces and a rapidly changing technology. Labor and, to a lesser extent, land are being replaced by such other inputs as fertilizers, insecticides, machinery, and equipment. Bigger and faster machines enable the individual farmer to operate on a larger scale. Thus commercial farms are becoming fewer in number and larger in size.

Between 1950 and 1965, farm output increased by 35 percent while the quantity of total inputs rose by only 3 percent. Output would have risen more if there had not been production control programs. The production gains were achieved with 11 percent less cropland and 45 percent fewer man-hours than in 1950. But the use of fertilizer more than doubled, and somewhat more mechanical power was employed. Today, 56 million acres of cropland are withheld from production through Government programs—about one-sixth of the crop acreage in the United States.

Productivity per acre has grown rapidly. Crop production per acre in 1965 was 18 percent greater than the 1959–61 average. Wheat yields rose by 12 percent, cotton 19 percent, and corn 29 percent. Increases in yields will continue as farmers adopt the new technology constantly being devised by university and Department of Agriculture scientists, agricultural chemical companies, and machinery manufacturers.

STRUCTURAL CHANGES

The economic development of U.S. agriculture is producing two distinct sectors—one expanding and one contracting—within the farm economy.

The contracting sector, presently comprised of about 2 million farms with gross annual sales of less than \$10,000, is characterized by a rapidly declining number of farms. It has been the source of much of the labor flow from agriculture. The decrease in the total number of farms between 1960 and 1965 is estimated at 573,000—with most of this decline resulting from a decrease in the number of full-time farms with annual sales of less than \$5,000. Many of these small units disappeared through consolidation with other farms; some grew in size and entered agriculture's expanding sector. This trend of declining numbers of small farms is expected to continue.

The expanding sector, made up of farms with annual gross sales in excess of \$10,000, is growing rapidly. Many of the farmers in this sector are realizing returns nearly comparable with what their resources could earn in nonfarm occupations. During 1960–65, the number of farms in this sector increased by one-fifth, to slightly more than 1 million, or 31 percent of all farms; the share of farm marketings provided by these farms rose from 73 percent of the total to an estimated 83 percent. Yet the farms in the expanding sector typically remain family enterprises: the percentage of family farms (farms with families as risk-taking managers and using less than 1.5 man-years of hired labor) has not changed since 1960.

Adjustments in agriculture's expanding sector have required greatly increased amounts of financial capital. Total farm indebtedness has increased more than 50 percent since 1960, largely in the form of higher farm real estate debt. Rapid farm consolidation has required additional real estate credit as well as shorter term credit for equipment and working capital. Active bidding for available farm land has helped to raise agricultural land values by 6 percent during the past year. The average value of real estate per farm now exceeds \$50,000. Increased land values permitted farm pro-

prietors' equities to grow to record levels in 1965. Although the increasing ratio of farm debt to total farm assets and incomes is evoking some concern, foreclosure rates remain very low.

FARM INCOME

Gross farm income, including marketing receipts, Government payments, and nonmoney income from farms, has risen steadily since 1960. Gross income in 1965 totaled \$44.4 billion, an increase of more than 5 percent from 1964 and 17 percent from 1960. Total marketing receipts in 1965 rose sharply above those in 1964, largely as a result of higher prices for meat animals. Receipts from crops increased moderately, reflecting higher prices and larger marketings of vegetables and oil crops. Direct Government payments to farmers are estimated to have been \$250 million more than the \$2.2 billion paid in 1964.

Realized net farm income (excluding net inventory change) in 1965 is estimated at \$14.1 billion, nearly 9 percent above 1964 and the highest since 1952. On a per farm basis, operators' realized net income in 1965 reached a record \$4,175, a 12 percent increase over 1964 and 41 percent higher than in 1960.

The 1966 prospect for commercial agriculture appears favorable, owing in large part to continued prosperity in the nonfarm sector. Rising levels of income at home and abroad will strengthen the demand for many farm products. The Food and Agriculture Act of 1965 will provide some income gains to farmers. Net farm income is expected to rise moderately. Much of this gain will accrue to the 1 million farms in agriculture's expanding sector.

POVERTY IN AGRICULTURE

Even in a prosperous economy, many rural people are unable to earn a satisfactory living in agriculture. Estimates based on the 1960 Population Census indicate that 4.9 million farm people in 1959 were living in poverty, as defined by the Social Security Administration's poverty-income standard. Many of these were families living on low-production farms, seriously undercapitalized in equipment and livestock. Today, nearly all families operating full-time farms with gross sales of less than \$2,500 a year fall into this classification; many of those with annual sales of between \$2,500 and \$5,000 are also poor. Families on most of these farms derive relatively little benefit from Government price and income support programs.

Underemployment is the common malady of the farm poor. Their hope for a more adequate income lies in their ability to obtain work off the farm. For some, this requires migration to localities where nonfarm jobs are available. For many, it means occupational migration—remaining on the land but earning a livelihood from some occupation other than farming.

But others, for health, age, or financial reasons, may find neither type of migration possible. These persons constitute the "hard core" of rural poverty. Their problems are the most intractable of all.

Both occupational and geographic migration have been occurring at a rapid pace in recent years. Net migration from farms during the early 1960's is estimated at 816,000 people annually. Preliminary data from the 1964 Census of Agriculture indicate that much of this movement occurred in the Mississippi Delta and other areas of the South.

Included in this migration have been large numbers of Negro farm families—a group with a particularly high incidence of poverty. Between 1960 and 1964, the numbers of nonwhites on farms decreased by 35 percent whereas the white farm population fell by 14 percent. Nonwhites account for one-third of the total decline in the farm population since 1960.

Although the number of farm people in poverty has declined substantially in recent years, this has resulted more from outmigration than from an improvement in the earnings of low-income farmers. Some of those who give up farming earn more adequate incomes in their new jobs and thus escape poverty. Those less fortunate in their search for other employment may drop out of farm poverty only to find themselves among the nonfarm poor.

Prosperous conditions in the nonfarm economy have aided many of the farm poor by facilitating their transfer to higher paying jobs outside of agriculture. Government programs emphasizing education and regional economic growth will also assist rural low-income people. The Manpower Development and Training programs are providing some persons with the skills necessary to compete effectively for nonfarm jobs. During the summer of 1965, 156,000 rural children participated in Project Head Start. The Economic Opportunity Act of 1964 provides health facilities, day camps, and special education programs for children of migrant workers. Education in rural areas will be improved through the Elementary and Secondary Education Act of 1965 which allocates Federal funds to school districts with heavy concentrations of children from low-income families. The Public Works and Economic Development Act of 1965 authorizes funds for regional economic development programs in low-income areas. The Department of Agriculture's newly established Rural Community Development Service will facilitate the extension to rural areas of services provided by Government programs.

But the remaining tasks are great. In 1964, the incidence of poverty among farm households was 30 percent, compared with 19 percent for non-farm families. Money income that year for poor farm households averaged \$954; income for other farm households averaged \$5,671.

Farm poverty exists in many rural areas of the United States but is particularly prevalent in the South and in Appalachia. Scattered but significant farm poverty persists in the Ozark region and some areas of the Southwest and Northwest. Migrant and other hired farm workers continue

to be among the most disadvantaged people in America. National prosperity scarcely touches the lives of these individuals.

THE EXPORT MARKET

The export market for U.S. farm products has grown rapidly in recent years. Strong foreign demand and measures to assist some exports have raised the value of total farm exports by more than 35 percent since fiscal 1960. In fiscal 1965, agricultural exports accounted for 17 percent of the cash receipts from farm marketings; in recent years, the foreign market has taken two-thirds of our total annual wheat production, nearly two-thirds of rice, almost one-half of soybeans, one-third of cotton, and nearly one-fourth of tobacco.

Between 1959-61 and 1965, feed grain exports rose by 56 percent; soybean exports increased by 66 percent. Today, the United States provides nearly half of all feed grains moving in world trade. In 1965, shipments of soybean meal, a component in animal feeds, were more than three times those in 1959-61. The large gains in these exports reflect the growing affluence of the developed world and the increased preference by consumers for the better foods derived from these products—cooking and table fats, poultry, eggs, dairy products, and meats. If access to the markets of the developed countries can be maintained, the United States will continue to be an important supplier of these products.

Exports of wheat and tobacco have grown much less rapidly than shipments of feed grains and soybeans; and cotton exports have fluctuated sharply in recent years. Export competition in these products is likely to increase in the future. Greater competition in the world wheat market may come from traditional wheat exporters; and larger supplies may be expected from Western Europe. Several developing countries view cotton and tobacco exports as important sources of foreign exchange, and they may provide larger supplies to the world market. Increased competition from foreign producers of synthetic fibers may also restrict the growth of U.S. commercial cotton exports.

Most U.S. farm exports are sold commercially for dollars, although sales through special export programs at noncommercial terms are also very large. Concessional exports in 1964 through the Food for Peace program accounted for two-thirds of wheat exports, two-fifths of milled rice shipments, and about one-fifth of cotton and edible vegetable oil exports. In fiscal 1965, the total value of farm exports was \$6.1 billion, of which approximately 73 percent constituted dollar sales. Since 1959-61, dollar sales have risen by 47 percent and shipments through Food for Peace by 21 percent.

The dollar excess of agricultural exports over imports contributed \$439 million to the U.S. trade balance in fiscal 1965. The local currencies generated by Food for Peace sales conserve dollars through their use in payment

of some U.S. Government expenses abroad. Long-term dollar credit sales of Food for Peace shipments will generate exchange earnings in future years.

FARM COMMODITY STOCKS

Because of large export demands and recent modifications of domestic commodity programs, the size and composition of U.S. Government controlled stocks of farm products have undergone substantial change in recent years. The repository of these products accumulated under price support programs is the Commodity Credit Corporation (CCC). This agency acquires products during periods of excess supplies and adds to market supplies when demand warrants, thereby contributing to price stability at the farm and retail levels. Reserves held by the CCC have proven valuable in times of national and international emergency. But excessive stocks are burdensome to taxpayers and cause concern among our international trading partners.

Between June 30, 1960 and mid-1965, total CCC investment in farm products declined by approximately 13 percent (Table 21). Total investment in wheat and wheat products, rice, feed grains (corn, barley, grain sorghums, and oats), and peanuts declined by 41 percent. By mid-1965, carryover stocks of wheat were the smallest since 1953. Strong foreign demand, particularly from developing countries with food shortages, should lead to further reductions in grain inventories.

TABLE 21.—*Investment of Commodity Credit Corporation in commodities, fiscal years 1960–65*
[Millions of dollars]

Fiscal year	Total	Feed grains ¹	Wheat and products	Cotton ²	Tobacco	Other commodities
1960.....	7,323	3,122	2,615	889	418	280
1961.....	7,039	3,360	2,707	352	388	232
1962.....	6,657	2,594	2,292	840	305	626
1963.....	7,257	2,450	2,329	1,470	437	570
1964.....	7,098	2,489	1,798	1,750	667	394
1965.....	6,387	1,968	1,433	1,898	826	261

¹ Includes corn, barley, grain sorghums, and oats.

² Includes upland and long staple.

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

Source: Department of Agriculture.

Stocks of cotton and tobacco have continued to grow. By mid-1965, Government held stocks of upland cotton totaled 11.9 million bales, valued at \$1.86 billion—a supply adequate to meet domestic mill requirements for more than 15 months at 1964 consumption rates. A further increase of 2 million bales is expected by August 1966. Government held stocks of tobacco have more than doubled since 1962. Clearly, stocks of these commodities are excessive. The prospect for reducing them rests on the 1965 cotton and tobacco legislation which is designed to lower production and raise total consumption.

FARM POLICY IN THE 1960'S

The dominant problem in agriculture, as manifested by a long history of farm legislation, is that average farm income is low relative to incomes in the rest of the economy. The income problem exists primarily because the capacity to produce has grown more rapidly than consumption. Under present demand conditions, too many resources are committed to farm production in the United States.

One set of policies has approached this problem from the supply side—by attempting to reduce the resources used in production through various controls and land retirement programs. Other measures have been designed to expand domestic and foreign demand for American farm products. Few of the programs of the past three decades have been unqualified successes. Many have produced income benefits; all have provided experience useful in improving old policy tools and forging new ones.

THE FOOD AND AGRICULTURE ACT OF 1965

The Food and Agriculture Act of 1965 is based upon experience gained from these policies of the past. It recognizes the national goals of a prosperous, efficient agriculture and of abundant, moderately priced food for consumers. It reflects the fact that agriculture must export to remain prosperous and therefore that American farm products must remain competitive on world markets. It recognizes the increasing productivity of American agriculture and the need to withdraw excess resources from production in order to balance supply and demand at reasonable prices. Yet it provides flexibility to meet present and future needs for food and fiber.

The legislation deals with the problem of excess supplies in agriculture and the need to divert some farmland from crop production. Through the Cropland Adjustment Program, up to 40 million acres of farmland can be shifted from crop production to other uses. The land adjustment contracts, running for a period of up to 10 years, promise to move land out of production at less Government cost than would be required under annual diversion programs. The Program will also help to meet the rapidly growing demand for land for recreational and conservation uses.

The 1965 agricultural legislation continues the trend of American farm policy toward lower price supports and a modified system of direct payments to producers. Direct payments, for several years a part of domestic wool and sugar programs, have only recently been applied to major farm commodities. In 1961, a modified version of this principle, together with low price supports and land diversion payments, was implemented for feed grains. Later, it was applied to wheat; the 1965 legislation applies it to cotton.

This approach separates to a substantial degree the price mechanism from the income support operation. Price supports are set at low levels, and pro-

ducers' incomes from the market are supplemented by direct Government payments. Consumers enjoy favorable food and fiber prices, producers realize adequate incomes, and exporters can compete more effectively in the world market.

The principle of direct payments is illustrated by the cotton provisions of the Food and Agriculture Act. For the 1966 crop, the average cotton support price to producers will be set at 21 cents a pound, compared with 29 cents in 1965. Producers who participate in the program and divert some land from cotton production to soil conserving uses will receive a direct payment of approximately 9½ cents a pound on that part of their production used domestically. This lower support rate will permit cotton to move abroad without the export subsidy required in previous years—equal to 5.75 cents a pound for the 1965 crop. Domestic mills will also be able to purchase cotton at lower prices. Larger total consumption of American cotton should result.

The Act gives the Secretary of Agriculture important new flexibility in the administration of commodity programs. This will assure that the programs can be adapted to changing production and market conditions.

NATIONAL COMMISSION ON FOOD AND FIBER

Existing agricultural programs do not end the search for sound farm policy, but provide a good base upon which to build. This search will be carried on aggressively within the Government and by the President's newly established 30-member National Advisory Commission on Food and Fiber. The Commission is to make a penetrating and comprehensive study of agricultural and related foreign trade policies of the United States. This review will consider consumer interests, the welfare of agricultural suppliers, producers and processors, and the national interest. It is expected that the recommendations of this group will move American agricultural policy further toward the objectives of abundant farm products at reasonable prices, parity of opportunity for farm people, and efficient use of our agricultural resources.

Chapter 6

The International Economy

THE WORLD ECONOMY has shown remarkable progress during the two decades since the end of World War II. In the developed countries, economic expansion has been far more rapid and steady than ever before. The less developed countries have also experienced unprecedented growth. Yet in this latter group, absolute levels of income remain disturbingly low, and few countries show clear promise of attaining adequate, self-sustaining economic growth in the near future. The world's single most important—and most intractable—economic problem lies in the less developed countries of Africa, Asia, and Latin America.

In the period between the two World Wars, the recognized common economic problems of the industrial countries were economic stagnation, large-scale unemployment, and wide fluctuations in output and prices. Today, these problems have essentially been mastered. But these countries are now confronted with the problems of determining how their economies can successfully adjust to the requirements of an increasingly integrated world economic system and how international monetary arrangements can best serve to assist and facilitate this adjustment.

The first major section of this chapter briefly considers some of the problems of the less developed countries and ways the industrial countries can help to solve them. Next, the evolving integration of the world economy and the new problems associated with it are sketched. The chapter then discusses the changes in economic and financial policies needed to ease the mutual adjustment of countries to balance of payments disturbances and to provide for the adequate and dependable growth of international liquidity. Finally, it treats the U.S. balance of payments and the policies adopted to restore the international equilibrium of the U.S. economy.

THE LESS DEVELOPED COUNTRIES: PROGRESS, PROBLEMS, AND POLICIES

Since 1950 the less developed countries of Africa, Asia, and Latin America as a group have increased their real production at an estimated average rate of 4½ percent a year. However, population growth in these countries has also been rapid—between 2 and 3 percent a year. As a result, the annual

rise in real output per person has averaged roughly 2 percent—well below the rate in the developed countries. Moreover, very few of the less developed countries could maintain even this pace of economic expansion without considerable assistance from abroad; despite this aid, there appears to have been some slowdown in their growth in recent years.

Aggregate figures conceal significant differences among the less developed countries. In a number of them—for example, Israel, Jordan, Taiwan, and Thailand—real output from 1957 to 1964 increased by 7 percent a year or more. In others—Indonesia, Lebanon, Morocco, Paraguay—output failed to keep pace with population increases.

FOREIGN ASSISTANCE

Capital

To achieve an adequate pace of economic growth, most developing areas of the world require more capital than they can accumulate from domestic savings or can raise externally on commercial terms. Foreign aid can therefore contribute to economic development. But the way the recipient countries use their resources is much more important. Consequently, as a condition for its bilateral development assistance, the United States stipulates that the recipient country adopt policies which effectively utilize local resources.

The less developed countries are themselves financing the major part of their development needs. In recent years, three-fourths of their gross investment has come from domestic savings. Table 22 shows their sources

TABLE 22.—*Net flow of long-term financial resources to less developed countries, 1960-64*
(Billions of dollars)

Source	1960	1961	1962	1963	1964
Net flow to less developed countries ¹	7.2	8.6	8.2	8.9	² 9.7
Bilateral flow from countries: ³					
From DAC countries: ⁴					
Official: Total.....	4.2	5.2	5.4	5.7	5.6
United States.....	2.5	3.2	3.4	3.6	3.3
Private: Total.....	2.3	2.6	1.9	2.0	2.6
United States.....	1.0	1.1	.8	.7	1.3
From other countries:					
Other industrial countries ⁵.....	.1	.2	.2	.2	(⁶)
Communist countries.....	.2	.3	.4	.4	(⁶)
Flow from multilateral organizations ⁷.....	.3	.3	.4	.7	.8

¹ Excludes loans and credits of 5 years maturity or less. Loans are net of repayments.

² Estimate.

³ Bilateral grants and loans.

⁴ Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) consists of Austria, Belgium, Canada, Denmark, France, Federal Republic of Germany, Norway, Portugal, United Kingdom, and United States. (Sweden joined DAC in July 1965.)

⁵ Australia, Finland, New Zealand, South Africa, Sweden, and Switzerland.

⁶ Not available.

⁷ Disbursements by multilateral organizations to less developed countries.

NOTE.—In addition to receipts shown in this table, the less developed countries receive contributions from nonindustrial countries, notably Kuwait.

The table does not net out private capital flow from less developed countries to developed countries.

Detail will not necessarily add to totals because of rounding.

Source: Organization for Economic Cooperation and Development.

of foreign capital. Although the total has increased somewhat, official bilateral aid has been stable in recent years.

Estimates of the foreign exchange requirements of the less developed countries vary widely, but they all indicate the need for a substantially increased inflow of foreign capital. The World Bank staff recently estimated that over the next five years the less developed countries could effectively use \$3–4 billion a year more than is currently available to them.

The need to finance existing foreign indebtedness is an important and growing claim on the foreign exchange resources of the less developed countries. About half of their gross capital inflow is offset by \$6 billion of payments for amortization and interest on loans and dividends on investments. In July 1965, the major countries extending aid agreed in principle that more grants and softer loans are required.

The International Development Association (IDA), an affiliate of the World Bank, is one of the international organizations which meets the needs of developing countries for capital on soft terms—interest-free loans, a modest service charge, and a repayment period of 50 years. The IDA's resources are derived from contributions by the economically advanced member countries and from the earnings of the World Bank. The Association must have additional funds from its members if it is to continue even its current level of operations.

In 1965, President Johnson announced U.S. support for an intensified program of economic and social development in Southeast Asia. The United States pledged \$200 million to the \$1 billion capital of a new multilateral lending institution, the Asian Development Bank, designed to foster the economic development of the region. In addition, the United States has indicated its willingness to provide \$100 million for a special fund for soft loans and grants for Southeast Asian development, if other countries will join in such a venture.

Private foreign investment also makes a crucial contribution to the less developed countries. It provides not only capital but associated technical and managerial skills. As economic growth begins, private investors—where they are welcome—will respond to opportunities for investment. For example, in three countries with successful growth records—Greece, Israel, and Taiwan—the inflow of private foreign capital rose from 1.8 percent of gross national product (GNP) in 1957 to 3.1 percent in 1963.

Agricultural Production and Food Aid

The recent slowdown in economic growth in some less developed countries can be ascribed to the failure of their agriculture to expand sufficiently. Indeed, in Latin America and in the Far East, per capita food production is below levels reached prior to World War II.

America's agricultural abundance has long been used to help to meet the food needs of the less developed world. Our food aid program, Food for

Peace, is also important in the promotion of economic growth and has helped by freeing resources for industrial development. But food aid must not be allowed to impede the development of agriculture, since, in many countries, agriculture may be the most rapid route to general economic growth. Moreover, such progress in agriculture is essential to the long-run solution of foreign food shortages. If the gap between food needs and production in the less developed countries continues to widen at the rate of the past few years, even the United States with its vast food-producing capacity will not be able to fill it.

This year, in addition to the Food for Peace program, the United States will institute a special assistance program to help foreign lands expand their agricultural output.

Human Resources

The less developed countries are seriously handicapped by shortages of trained manpower—indeed, illiteracy is a major problem. Since 1957, the less developed countries have increased their investment in education by an average of 15 percent a year. The United States is assisting educational development through some 350 educational projects in 65 developing countries and in the past 3 years has financed the construction of approximately 210,000 classrooms to accommodate 6.7 million students. Substantial assistance has been given to develop teacher training colleges, to modernize educational systems and curricula, and to link educational programs to the manpower requirements of these countries.

The U.S. Government is now joining a new worldwide endeavor of educational cooperation and assistance, emphasizing the educational needs of school-age children and encouraging more of our teachers and school administrators to serve abroad.

The United States has long been deeply committed to improving health conditions in the less developed countries. Major support is provided to the health programs of the United Nations, its specialized agencies, and five multilateral regional organizations. Total international health obligations of the U.S. Government will amount to approximately \$270 million in the current fiscal year and are scheduled to rise substantially next year. However, our potential for technical assistance in this field is only now being fully mobilized by the Federal Government. New programs will give priority to the development of a cadre of U.S. international health workers and to helping the less developed countries train more health workers themselves. The United States will also increase substantially its support for the eradication of communicable diseases and for the provision of potable water supplies in many regions of the world.

Child malnutrition increases susceptibility to infectious diseases. In many countries, this combination kills half of all children before the age of five. Physical and mental retardation of the surviving malnourished youngsters frequently is permanent. To assist developing nations in their

efforts to meet the nutritional needs of many additional millions of children, U.S. programs will be substantially expanded this year.

Rapid population growth compounds economic and social problems in the less developed countries. As a result of deliberate efforts to limit the size of families, population growth rates have leveled off or are falling in Hong Kong, Singapore, and Taiwan. Korea, Pakistan, Tunisia, and Turkey also have initiated programs. But in the less developed world as a whole, population growth is continuing at an increasing rate.

In the short run, population control can limit the number of dependent children supported by each member of the labor force. But it will be some time before it can have an appreciable impact on total numbers. Over the longer run, it can ease problems of unemployment and underemployment and raise individual productivity.

To help countries which request U.S. assistance with their population problems, the United States will mobilize and make available technical and financial resources, including the support of training programs for foreign personnel who can in turn train the thousands of individuals required to carry forward family planning programs.

IMPROVING TRADE PROSPECTS

Both the advanced and the emerging nations must give greater attention to policies to accelerate the growth of the export earnings of the less developed countries. For these countries as a group, export earnings yield four times as much foreign exchange as do all loans, grants, and direct investments from abroad. Yet these nations are not fully sharing in the tremendous growth of world trade. The reasons for this are to be found largely in the sluggish secular growth of demand for their traditional primary products. Although exports of manufactured products from less developed countries doubled between 1953 and 1964, foodstuffs, raw materials, and petroleum nevertheless accounted for 85 percent of their total shipments in 1964. Rising domestic demand, inflation, and overvalued exchange rates in some countries have also adversely affected sales abroad.

Most less developed countries are vulnerable to short-term export instability. For individual primary commodities and primary exporters, a major source of instability has been the wide and erratic movement of prices. The less developed countries need greater assurance that development programs will not be vitiated by unpredictable declines in export earnings which are beyond their control. International agreements for some commodities, such as coffee, represent one technique for dealing with this problem.

Financial arrangements to help to offset shortfalls are another technique. Three years ago, the International Monetary Fund (IMF) established a special drawing arrangement for compensatory financing of short-term fluctuations in members' export earnings. Only three countries have thus far used the facility, since price trends of primary commodities were generally favorable to producers throughout 1963 and much of 1964. In view of

recent price declines, more applications may be expected. The United States and other governments are now considering new ways to provide additional short- and long-term financing to offset export shortfalls.

Liberal commercial policies by the developed countries will contribute to world economic development. A successful Kennedy Round will benefit the less developed as well as the developed countries. However, there will remain room for further tariff reductions and import liberalization of special significance for development. Many advanced countries could abolish or relax a number of import restrictions without causing economic dislocation. Recent studies indicate that general tariff reductions, even on those manufactures which are protected by low duties, might ultimately yield a significant increase in exports of less developed countries. The developed countries could also contribute to their own growth and that of the less developed countries by reducing agricultural protectionism. Moreover, nontariff barriers to imports, such as quantitative restrictions and the high consumption taxes which some countries impose on tropical products (coffee, cocoa, and bananas) for purely fiscal reasons, frequently place a serious burden on the less developed countries.

RECENT CHANGE IN THE DEVELOPED COUNTRIES

The main problem of the developed countries in the 1960's is not how to promote growth but how to avoid stunting growth in dealing with the balance of payments and domestic price stability.

The rapid postwar economic growth of the developed countries may be due to basic structural and technological changes which only future economic historians will be able to distinguish clearly. But there can be no question that growth has been spurred by two highly visible developments. First, and more important, the governments of most countries have assumed an active responsibility to promote expansion and growth, guided by a new understanding of how government policy affects economic activity. Second, in many countries of Europe and in Japan, a dynamic source of expansion and modernization has been the growth of export markets, stimulated by the dramatic postwar movement toward economic integration. Rapid growth in each country has provided expanding export markets for the products of others, in a chain of mutually supporting expansion.

A number of postwar institutions have contributed to integration: the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF), and the Organization for Economic Cooperation and Development (OECD). Through their efforts, import quotas on trade in manufactured products have been largely abandoned; tariffs have been greatly reduced; the principal currencies have become convertible. Moreover, great new free trade areas have been created, especially the European Economic Community (EEC) and the European Free Trade Association (EFTA). By the beginning of 1966, internal tariffs within the EEC and EFTA had been reduced by 80 percent.

THE GROWTH OF INTERNATIONAL TRADE

As a result of all of these developments, international commerce has flourished. In the decade from 1954 to 1964, exports of the advanced industrial economies grew by an extraordinary 117 percent, and exports of the less developed areas rose by 59 percent.

To be sure, uncertainties within Europe are now having their impact both on further integration within the EEC and on the external relations of the EEC, including the current Kennedy Round of trade negotiations. The pace of integration and especially the movement toward more liberal world trade have been slowed. The Kennedy Round is at a virtual standstill.

The American commitment to the Kennedy Round—the boldest and most significant effort to liberalize the world trading structure yet undertaken—is as firm as ever. But the protracted internal crisis of the EEC has prevented any significant negotiations with that group of states since last summer. The longer this paralysis continues, the more uncertain are the prospects. The negotiating authority provided by the Trade Expansion Act expires in less than 18 months. If these important negotiations are to yield their full potential benefits, meaningful deliberations must resume, at the latest, early this spring. Were the Kennedy Round to fail, the world would have missed a unique opportunity for further reduction of trade barriers against both industrial and agricultural products and for a further widening of world markets to the benefit of both the developed and developing nations.

The United States is also giving increased attention to the lowering of barriers to trade with the countries of the Soviet bloc. For both political and economic reasons, this country has not fully participated in the steady expansion of East-West trade during the past decade. U.S. trade with the Soviet bloc amounted to barely 1 percent of total U.S. foreign commerce in 1964. Last year, the President's Special Committee on U.S. Trade Relations with East European Countries and the Soviet Union recommended an expansion of peaceful trade with the European Communist countries and urged that the President be given discretionary authority to remove trade restrictions against those countries.

The President has indicated that he will ask Congress for selective authority to grant most-favored-nation treatment to imports from the countries of Eastern Europe, including the U.S.S.R. While no sudden expansion of trade is likely, the opportunities for increased trade may prove significant for individual firms and products.

PROBLEMS OF RAPID GROWTH AND INTEGRATION

The new economic dynamism of the developed countries of the free world has brought great gains—but also problems. These problems have both domestic and international dimensions, closely interrelated.

The main domestic problem in most countries today is that of reconciling prosperity with stability of costs and prices. This has been a problem for all the countries of Western Europe at one time or another in the past 2 decades. But even though wage rates and other money incomes rose at a rapid pace, increases in labor costs were often restrained by extremely rapid improvements in productivity. In fact, in Germany and Italy, as well as in Japan, they held stable or fell in the early 1950's as a result of the rapid gains in productivity that went with the development of new industries and processes, the modernization of obsolete equipment, and the great expansion of the size of domestic and international markets. Moreover, there were labor resources to be drawn from domestic sectors of low productivity—and often from such sectors in other countries—which restrained upward pressures on wages. But now productivity gains are slowing down from phenomenal to merely exceptional; sources of low-cost labor are harder to come by; and the income demands of labor and other groups continue to increase. Rapid growth and full employment are more generally accompanied by upward pressure on costs and prices.

Internationally, the problem of adjusting to rapid growth has taken complex forms. The closer integration of international markets and increased freedom of payments have been among the main sources of domestic growth in many countries. But they also have contributed to strains in the balance of international payments.

Growth rates, while generally high, have not been the same in all countries, and internal price levels have not changed equally. Large structural changes accompanying and responsible for growth in some of the countries have altered their international competitive position. Tax systems have been adjusted, with resulting effects on prices of imports and exports. The formation of EEC and EFTA has affected members and nonmembers differently. Profound changes associated with the termination of colonial status have affected the markets and obligations of several European nations. The costs of defense and aid commitments vary significantly among countries.

All of these factors have considerably affected the external transactions of each of the industrial countries, at times creating large surpluses or deficits in trade or government payments.

Reduction of government restrictions, the convertibility of currencies, increasing knowledge of opportunities abroad, growing confidence in existing governments, larger supplies of investible funds, and rapid growth of markets have brought a spectacular expansion of international capital movements. The flow of capital has also been affected by national policies to restrain inflationary pressures, by the differences in the development of national capital markets, by country-to-country differences in profits and interest rates, and, on occasion, by hopes or fears of currency revaluations. Although international flows of capital have contributed to world economic

growth, they have at times created problems for both the importing and the exporting country.

Thus for the capital account as well as the current account, the closer economic integration of the newly dynamic Western economies has been a source of severe balance of payments strains. And measures taken by Western European Governments to deal with deficits have been a major factor behind the occasional slowdowns in the pace of economic expansion.

In the past 15 years, many potential strains have been effectively masked by large U.S. deficits. They have allowed most other countries to maintain rapid expansion while still gaining reserves. Even so, there have been serious deficits at various times in France, Canada, Italy, Japan, and the United Kingdom. Had the U.S. international payments been in equilibrium during this period, many more potential strains would have become visible. Once the umbrella of the U.S. deficit is removed, the problems of adjusting to rapid growth and change in a world of relatively free trade and payments may become more evident and more difficult to resolve.

DEVELOPMENTS IN 1965

Many of the problems of mutual adjustment were brought into sharp focus during 1965, as payments positions of major countries underwent particularly large and rapid changes. For the United States, there had been a sudden increase in the deficit in late 1964 and early 1965. Following President Johnson's program of corrective measures in February 1965, however, the balance of payments showed a major improvement.

The payments position of the United Kingdom remained precarious from the autumn of 1964 until the late summer of 1965, causing heavy speculative attacks on the pound. However, as a result of forceful measures taken by the British Government to defend the value of its currency—aided by large-scale financial assistance from the IMF and, on a cooperative basis, from major nations—pressures on the pound subsided significantly by the autumn, and the United Kingdom has continued to regain reserves. The British Government, moreover, has given convincing evidence that it will take all steps needed to bring its payments position into balance by late 1966. Meanwhile, the German surplus, which had been of serious concern for several years, was eliminated in 1965.

However, at the very time that the large deficits of the two major reserve currency countries were being reduced and the troublesome German surplus corrected, new problems of payments imbalance emerged elsewhere. Italy, in particular, developed very sizable surpluses. A surplus also appeared in Japan. At the same time, France had a surplus even larger than that of 1964.

These divergent developments were in many cases closely related to the policies adopted by the various countries to affect domestic demand. In the United States, to be sure, the payments imbalance was reduced substantially

without impeding domestic expansion. For the United Kingdom, however, restrictive domestic measures were part of its program to bring the payments deficit under control, as well as to counter inflationary pressures at home. In Italy and Japan, the brakes previously applied to their expanding economies, to help counter payments deficits and domestic inflation, had proved in some respects too effective. Such policy measures as were taken in 1965 to revive demand brought only relatively slow progress. In France, also, the larger surplus position was clearly associated with a low rate of economic expansion, reflecting the Government's hesitation to take more active stimulative measures because of the fear of possible inflation. On the other hand, burgeoning domestic demands clearly contributed to the elimination of Germany's surplus.

The policies adopted by various countries to deal with domestic and balance of payments problems had, in turn, significant implications for the growth prospects of other countries, both developed and less developed. To the extent that such policies depressed export markets, there was danger that world economic growth would be impeded.

The challenge to the developed nations as a group is to find mutual arrangements and institutions that can support healthy economic growth and at the same time maintain reasonable external equilibrium in a world community of increasing interdependence.

IMPROVING THE INTERNATIONAL MONETARY SYSTEM

Soundly functioning international financial arrangements should permit countries to make necessary adjustments to changes in their external payments positions with minimum impairment of the broader objectives shared by all nations: relatively full employment, a satisfactory rate of economic growth, an efficient allocation of international resources, and reasonable price stability. These arrangements should provide for a satisfactory expansion of total international reserves and liquidity as an underpinning for a growing volume of trade and payments. And they should command such widespread confidence that international transactions will not be disrupted by excessive speculation, or by sudden and unpredictable shifts from one form of international reserve asset into another.

Balance of payments adjustment, reserve creation, and maintenance of confidence are, of course, closely interrelated. Under the prevailing system of fixed exchange rates, it usually requires time to correct payments imbalances in a way that is consistent with the achievement of basic objectives. This means that countries need sufficient reserves or credit to provide a reasonable margin of safety for dealing with actual or potential deficits. If reserves or credit facilities are inadequate, even surplus countries may feel impelled to follow unduly restrictive policies. Moreover, too small a margin of safety may encourage undesirable speculative flows,

adding further to the need for liquidity. Too large a volume of liquidity, on the other hand, could be inflationary. Improvements in the adjustment process which would reduce imbalances—without sacrifice of broader objectives—would cut back liquidity needs and strengthen confidence.

During the past year, these closely related matters have received intensive consideration in discussions concerned with ways of improving the international monetary system—by the IMF, the OECD, the leading industrial countries known as the Group of Ten, and various bodies associated with the UN and the EEC.

The discussions within the Group of Ten and in Working Party 3 of OECD have been of particular importance. A report examining the issues raised by various proposals to create new reserve assets was submitted to the Group of Ten last summer by a working group under the chairmanship of Rinaldo Ossola of Italy. With this study completed, the Finance Ministers and Central Bank Governors of the Group of Ten, at the time of the Annual Meeting of the IMF Governors last September, requested their deputies to “determine and report to Ministers what basis of agreement can be reached on improvements needed in the international monetary system, including arrangements for the future creation of reserve assets, as and when needed. . . .” The deputies are to report on their progress this spring. Meanwhile Working Party 3 is to accelerate its study of ways to improve the adjustment process.

As soon as a basis for agreement has been reached among the Ten, negotiations on means to improve the international monetary system would then proceed to a second stage in which all members of the IMF would have a more direct opportunity to voice their views. The following two sections present some of the issues involved in the study of the adjustment process and in the negotiations to improve international liquidity arrangements.

THE ADJUSTMENT PROCESS

The Council's Annual Report for 1964 described at some length the balance of payments adjustment process which operated—or was supposed to have operated—in a relatively automatic fashion under the 19th century gold standard. It pointed out that this method of adjustment relied on the maintenance of a rigid link between changes in countries' gold holdings and internal monetary conditions, in nations without active fiscal policies, and could only work by subordinating domestic welfare to the requirements of external balance.

Such a system is neither possible nor acceptable in the modern world. All nations today follow discretionary policies directed toward multiple objectives, internal as well as external. Quite appropriately, they are reluctant to resolve payments problems at the expense of economic growth, high employment, and price stability. But in today's interdependent world, the independent pursuit of individual countries' objectives can often bring

their policies into conflict and produce results against the interests of all. A satisfactory balance of payments adjustment process requires a high degree of international cooperation.

At any given time, some countries will be in deficit while others will be in surplus. For the world as a whole, deficits and surpluses will be roughly equal. Under existing international liquidity arrangements, the main exception reflects additions to the stock of monetary gold, which allow some surpluses not offset by deficits elsewhere.

Some swings in country payments positions are bound to occur. And when the imbalance represents only a temporary departure from equilibrium, or when appropriate corrective measures take time to become fully effective, forcing an immediate restoration of balance may involve excessive economic and social costs. Moreover, where the *level* of a country's reserves is chronically excessive (or deficient) in relation to its needs, that country may appropriately run a deficit (or surplus) over a longer period. Thus, persistent U.S. deficits during the early 1950's were clearly in the interests of all countries.

Nevertheless, if a deficit continues too long or becomes too large, the strength of the country's currency can be impaired. There is, in fact, an absolute limit of any country's ability to continue in deficit; eventually, it must run out of reserves as well as borrowing capacity.

Built-in pressures to correct surpluses are less powerful. A country that continually runs a surplus deprives itself of the real resources that would have accrued to it had it exported less or imported more. As the surplus persists, this cost becomes increasingly burdensome relative to the benefits derived from additional accumulations of reserves.

However strongly they may wish to, all or most countries cannot run surpluses simultaneously. If they try, some are bound to find their actual balance of payments positions falling short of what they had desired. Unrealistic payments targets can thus lead to destructive policy competition among countries. Countries must determine their adjustment policies in the light of balance of payments targets that are mutually compatible.

Alternative Means for Dealing with Imbalances

What are the broad strategies a country can adopt when confronted with an imbalance in its international payments?

First, it may simply let the imbalance persist, at least for some time, and rely on financing. For a deficit country, this entails either a drawing down of reserves or borrowing; for a surplus country, a rise in reserves or deliberate lending.

Second, a country can seek to correct the payments imbalance by fiscal and monetary measures that affect the total level of internal demand. For countries in deficit, a restriction of demand would be designed to reduce

imports and increase exports. If monetary policy is used to achieve restraint, higher interest rates may also deter monetary outflows or even induce net capital inflows.

Third, countries can make varying use of selective measures specifically directed at external transactions—for example, import surcharges or quotas, direct restrictions on capital movements, or disincentive devices like the U.S. Interest Equalization Tax. On the other hand, surplus countries may remove existing restrictions or use special incentives to induce net capital outflows.

Fourth, a variety of other internal measures can be used. These include selective internal policies to improve a country's productivity, efficiency, or financial structure; changes in the "mix" of different kinds of policy instruments, notably as between fiscal and monetary policy; and wage-price policies.

Fifth, countries can, under the IMF Articles of Agreement, resort in some instances to adjustments of their exchange rates.

None of these options represents an ideal or fully feasible solution under all circumstances. Reliance on financing may merely postpone needed corrective action. Measures to affect total internal demand may conflict with domestic objectives. Direct restrictions on international trade and payments may interfere with efficient resource allocation. Other selective measures may not be available in time or not be sufficiently powerful to bring about the desired correction. Finally, various disadvantages are inherent in exchange rate adjustments, and governments are properly reluctant to resort to them—particularly reserve currency countries.

Criteria for Selection

Despite these drawbacks, any one of these options may prove the most desirable—or least undesirable—under particular circumstances; and in many cases, a combination of strategies may be called for. What, then, determines which policies are appropriate for a country in a given situation? Major relevant considerations include the following:

First, the nature of the underlying ailment is important. If either deficient or excessive internal demand is a major cause of the imbalance, then measures to affect such demand may provide the best solution. If part of the underlying difficulty is connected with a deterioration in a country's competitive position, various selective measures to improve productivity and resource mobility may be called for. If the difficulty stems from speculative or other unusual capital flows, use of selective instruments might be far more efficient than resort to general measures. And to the extent that the payments imbalance stems from broad structural differences in capital markets—such as those that exist between the United States and continental Europe—the longer-term solution lies in improving the efficiency of the less fully developed capital markets.

Second, any given strategy for achieving balance of payments equilibrium should as far as possible be consistent with the attainment of broader objectives. Often, this presents no problem. For example, if a country suffers from both internal inflation and a payments deficit, policies to restrict overall demand may achieve internal and external objectives simultaneously. Similarly, a country seeking to reduce an external surplus and to expand internal demand can usually use general fiscal and monetary measures to meet both objectives.

Even in these cases, however, difficulties in the choice of instruments can sometimes arise. For example, the United Kingdom in 1965 had both an external deficit and excess domestic demand. Nevertheless, there were also indications that the country's competitive performance was suffering from low productivity. The U.K. authorities therefore combined measures to restrain domestic demand with more specific steps to improve the country's competitive position, including measures to encourage productive investment over the long run. Or a surplus country with lagging internal demand may be suffering from upward cost and price pressures. In this case, resort to incomes (price-cost) policies, reductions in tariff barriers, and other special devices may be required to avoid price increases that might inhibit vigorous use of expansionary monetary and fiscal policies.

More difficult situations arise where deficits are accompanied by domestic underemployment, or surpluses by inflation. In recent years, the first of these situations has been characteristic of the United States, the second of Germany. The United States has leaned more heavily on fiscal policy to stimulate demand, making it appropriate to use a somewhat less expansionary monetary policy than would otherwise have been desirable. This, together with the Interest Equalization Tax and voluntary restraint on foreign lending and investment, has helped to dampen capital outflows. Germany, on the other hand, has been advised by the OECD to combat its domestic inflation more actively through tighter fiscal policies and to pursue a relatively easier monetary policy in order not to attract funds from abroad.

Third, there are differences in the effectiveness of given policy instruments in various countries. For example, where international transactions constitute a relatively high proportion of total transactions, and where both exports and imports tend to be highly responsive to variations in domestic incomes, even relatively mild measures to influence total demand may rather quickly bring about the desired adjustment in the balance of payments. Thus, in a country like the Netherlands, where imports equal about 40 percent of GNP, primary reliance on instruments to affect over-all demand may frequently be entirely appropriate for payments adjustment and entail a relatively small economic cost. But in many other countries, the foreign sector accounts for a much smaller proportion of total national transactions; in the United States, for example, imports are only 3 percent of GNP. If this country were to place sole reliance on general demand

measures to achieve a given balance of payments result, a relatively large change in total demand would be necessary, exposing the economy to severe inflation or unemployment. Even where *both* domestic *and* external payments conditions call for either restrictive or expansionary measures, the “dose” appropriate for the domestic economy may not be strong enough to correct the payments imbalance—or it might be too strong.

Fourth, the effects on other countries must be considered. For example, the industrial countries as a group should clearly be concerned with the impact that their measures will have on the less developed countries. Moreover, the effect of particular corrective measures taken by one industrial country could be cancelled if similar measures were taken by others, or could be sharply reduced by other “rebound” effects.

The Division of Responsibilities for Adjustment

Surplus countries tend to argue that the primary task of bringing about adjustment must necessarily lie with deficit countries, since it would be unreasonable to expect the surplus countries to suffer such inflation as might be induced by expansionary actions on their part. Deficit countries, on the other hand, argue that if they bear a greater share of the responsibility for adjustment, this imparts a deflationary bias to the world economy.

There is no *a priori* case for assigning a greater share of the responsibility to either deficit or surplus countries. Countries in either situation should be willing to use the instruments at their disposal in the most effective way. There could be specific situations where a larger share of the responsibility should be assumed by either deficit or surplus countries, but this should be subject to careful international consideration.

Possibilities for Improving the Adjustment Process

The past few years have seen significant gains in international consultation and cooperation in balance of payments adjustments. Nevertheless, the fact remains that balance of payments surpluses and deficits in recent years have often been very large and that the adjustment techniques currently used are far from perfect. There is need, and wide scope, for further improvement.

One obvious area of improvement involves the development of additional policy instruments as well as more efficient use of existing instruments. In particular, there is a major need in many countries for making fiscal policy a more flexible tool of economic policy. Much more imaginative use could also be made of different techniques of monetary management. Furthermore, surplus countries have considerably more scope for reducing trade barriers and broadening capital markets.

It may be possible to develop some general guidelines regarding appropriate balance of payments adjustment that could prove helpful in the context of international discussions. Such guidelines should be flexible and

informal, and sufficiently comprehensive to permit effective selection of policy tools in the light of all the considerations set forth above: the nature of imbalances; the full range of economic objectives; differences among countries; and effects of each country's policies on other nations.

In any case, much can be done to improve further the existing mechanisms of international consultation and cooperation to help to assure that the measures used by individual countries are best suited to the interests of the international community as a whole.

INTERNATIONAL LIQUIDITY ARRANGEMENTS

Improvements in the adjustment process alone cannot assure that the international monetary system will work smoothly. In the words of Secretary of the Treasury Henry Fowler “. . . a new and crucial challenge is presenting itself with growing urgency before the nations of the free world—the challenge of assuring ample liquidity to support expanding world trade in the years ahead.” He stated that “. . . there will be . . . bilateral and multilateral talks at all levels as we move ahead toward exploring this most complex problem and toward reaching some kind of workable consensus. There is . . . no fixed timetable. But we are moving ahead—and we will spare no effort to speed our progress toward a sensible and workable solution.”

The Need for Adequate Growth in International Liquidity

How large is the volume and growth of monetary reserves and other forms of liquidity needed to support a smoothly functioning system of international transactions? There is no simple answer to this question. In approaching it, however, several key distinctions need to be kept in mind.

The great bulk of international transactions takes place among private traders, bankers, or other intermediaries. Predominantly, these transactions involve the major trading or “vehicle” currencies—the dollar and the pound sterling. Over the years, the volume of private working balances in these currencies has tended to grow along with the volume of international transactions. A continuing net flow of dollars into foreign private hands sufficient to satisfy such legitimate private business needs is thus likely to be desirable.

A second need for international liquidity arises from the desire of monetary authorities to hold reserves and other forms of liquidity to enable them to settle payments deficits that might develop. Of course, monetary authorities normally have the option of obtaining credit on conditional terms when the need arises. In recent years, credit facilities have been greatly expanded, notably through improvements in the medium-term lending operations of the International Monetary Fund and through cooperative arrangements among central banks; and further improvements should prove possible in the future. But countries also want “unconditional liquidity,” either in the form of gold or reserve currencies or of assured lines of credit (such as the fully automatic drawing rights on the Fund).

Moreover, as the absolute volume of international transactions rises, the size of potential deficits also increases. This is why most countries seek to enlarge their reserve positions over the years, at least modestly.

There are now three principal ways in which net additions to international reserves occur: (1) through the flow of newly available gold into official national reserves; (2) through enlargement of countries' automatic drawing rights at the Fund; and (3) through increases in the holdings of U.S. dollars by the monetary authorities of other countries.

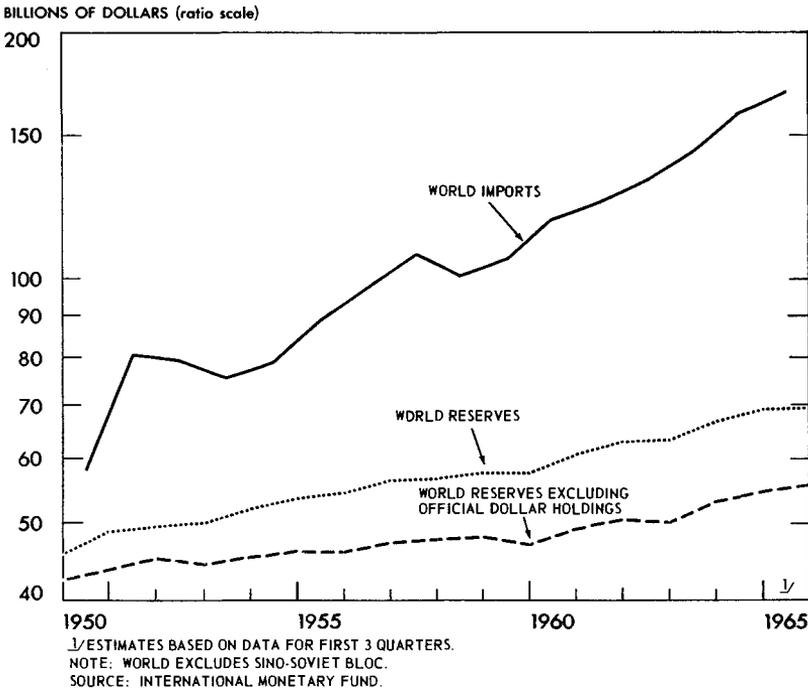
Increases in the aggregate gold holdings of monetary authorities are the oldest way of creating reserves. And they are the only way that does not usually depend on the emergence of a balance of payments deficit for one or more countries. From 1960 through 1964, gold contributed about \$700 million annually to over-all reserve growth of the free world. Recognition that Fund automatic drawing rights constitute international reserves is very recent; net additions in them averaged about \$150 million a year during 1960-64. The other major contribution to over-all reserve growth—increases in foreign official claims on the United States—averaged about \$1 billion a year over this period. There has been virtually no net expansion since the early 1950's in official holdings of sterling, the second major reserve currency.

Expansion of world reserves through a growth of dollar holdings worked well in the earlier postwar years, when official reserves outside the United States were low. However, the United States can now no longer continue to run large-scale balance of payments deficits without endangering confidence in its own currency. Thus dollars cannot contribute to growth of world reserves as they have in the past. Moreover, to the extent that foreign monetary authorities convert existing dollar holdings into gold, the net volume of international liquidity actually declines.

It was against this background that the United States acted with new determination last year to bring its payments into equilibrium. As it succeeds in this effort, however, the international monetary system is faced with a dilemma. Gold alone will not add sufficiently to official reserves to insure a smoothly functioning payments system. Prudent planning, therefore, calls for the development of additional kinds of reserve assets that could add to international liquidity independently of the balance of payments deficits of particular countries.

According to preliminary indications, growth in the world's total reserve assets slowed markedly in 1965 (Chart 11). There is little to suggest that the annual growth of about \$2 billion in the years prior to 1965 had been excessive. Moreover, there is a strong presumption that, over time, the growth of international trade and the world economy will be hampered unless there is a continuing expansion in the total volume of reserve assets. Hence, the United States took the initiative in the summer of 1965 in urging an intensified exploration of the possibilities for agreement on the development of a new reserve asset.

World Trade and Reserves



Ways of Creating Additional Reserve Assets

At least two major, and potentially complementary, approaches to the creation of additional reserve assets are likely to receive serious attention in current world discussions. The first calls for the creation of a completely new reserve unit. Each participating country would be issued given amounts of the new units from time to time, and rules would be set for their use. The unit could be backed by a guarantee against depreciation in terms of gold and would be counted in "owned" reserves. Creation of the new unit would require formal international agreement and would thus offer clear evidence that the participating countries were joined in a major and deliberate effort to provide for an appropriate growth in international liquidity.

A second method would build on the procedures for reserve creation already available in the Fund. It would expand automatic drawing rights on the Fund. The additional drawing rights would be immediately usable as new reserve assets by member countries. This approach would not necessarily require revision of the Fund's Articles of Agreement.

Under reserve unit schemes, participating countries provide backing for the unit in terms of their national currencies and undertake to accept the units from one another. In the case of new Fund automatic drawing rights, member countries might be asked to provide lines of credit to the

Fund to assure that the Fund itself could readily supply the amounts and types of currencies required by members exercising their drawing rights. In either case, however, one basic principle holds: the acceptability of the new reserve asset will fundamentally depend on the willingness of participating countries to view it as a form of international money.

Each approach—"reserve unit" and "drawing rights"—has distinctive characteristics that can make it particularly useful for certain purposes. In many respects, the two approaches need not differ greatly in effect. What is important in assessing the numerous specific versions and combinations of these two approaches that have been proposed is to see how they deal with certain key questions. These include the following:

(1) *By whom and in what manner shall decisions regarding the new reserve assets be made?*

As Secretary Fowler stated before the Annual Meeting of the Governors of the International Monetary Fund,

It is true that only a limited number of countries hold the bulk of the official reserves of the world. No doubt these countries, including my own, have deep interests and responsibilities of a unique kind in the system by which reserves are generated and regulated. But other countries, which are not large reserve holders, also have legitimate and vital interests in these matters. This is why all the countries of the free world have a fair and reasonable claim that their views must be heard and considered at an appropriate stage in the process of international monetary improvement.

There are various types of decisions regarding international monetary arrangements that need to be made. A basic "constitutional" decision has to be taken regarding the nature of the new arrangements. Thereafter, decisions will be required from time to time on various operational matters, such as the amounts of new assets to be created. The procedures for settling these various questions might differ.

Whatever the precise arrangement, it seems highly desirable that the Fund play a central role in the decision-making process. As has been well stated in the Ossola Report, "The Fund's prestige and experience as a monetary institution make it the natural center for new functions involving deliberate creation of reserve assets and provide assurance of its capacity to conduct, and keep distinct, conditional lending and deliberate reserve creation."

(2) *To whom shall the reserve assets be distributed?*

The distribution of new reserve assets poses difficult problems which will require further discussion and study. While there is no simple answer, certain principles are clear. All countries need reserves, and an effective system of reserve creation should give all an opportunity to add to their holdings. At the same time, the large industrial countries, other developed nations, and the less developed countries have special needs and characteristics that must be reflected in any over-all arrangements. Furthermore, such arrangements should be sufficiently flexible to permit an increasing degree of participation by countries as they meet certain relevant standards.

IMF quotas provide one benchmark which might be considered in the initial distribution of new reserve assets.

While no distribution can be set forth as ideal, the nations of the world can be expected to develop an equitable plan which will meet the recognized need for growth of reserves. Every nation has a clear interest in its own share of new reserve assets, but it has an even greater stake in the development of an effective system for reserve creation that will encourage the pursuit of economic growth and liberal trade policies.

(3) *What should be the relationship between new reserve assets and existing types of reserve assets, and what techniques are required to achieve an appropriate relationship?*

Any new type of reserve asset that might be created should clearly be attractive enough so that countries will wish to hold it. But it must not be so attractive as to displace existing forms of reserve holdings, for it would then fail in its primary purpose of adding to over-all liquidity.

One proposal to enhance acceptability has been to link the *creation* of a new reserve unit in a rigid proportion to each country's gold holdings. Such a rigid link to gold in the creation of the unit is clearly undesirable, however. It would be inequitable, penalizing countries that now hold a low proportion of their total international reserves in gold. It would, moreover, provide incentives for all countries to increase the ratio of gold to total reserves. By thus affecting the willingness of countries to hold existing reserve currencies, it could lead to an undesirable shrinkage in world liquidity.

Alternatively or additionally, it has been suggested that the *use* of the new reserve unit in settlements should only be permitted in association with a specified quantity of gold. The same considerations that apply to a gold link in creation also raise doubts about the proposal for a link in use. Moreover, any rigid link with gold would tend to enhance the importance of gold in the monetary system, and thereby to assign a new reserve unit second-class citizenship.

If there is no close link to gold, what is required to make a new reserve unit readily acceptable? One possibility might be an agreement that countries would accept such units as full legal tender, to be considered "as good as gold." Or, an agreement might provide for specific limits on the obligation of creditor countries to accept the reserve units in settlement. Special procedures might also be adopted to prevent countries from using the new units to change the composition of existing reserves in a way that might lead to a reduction in total liquidity.

Creditor limits are automatically incorporated in the procedures for expansion of automatic drawing rights at the Fund. Moreover, their relationship with gold and reserve currencies poses no problems.

(4) *Does the method used in creating a new reserve asset allow for the proper expansion in liquidity, and for a flexible response to changing needs?*

Both proposals cited would permit substantial additions to liquidity. However, a separate new reserve unit may be essential as part of a program to

assure adequate increases in liquidity. Such a unit might also be more easily recognized as constituting "owned" reserves, and might therefore make countries feel more "liquid" than would corresponding command over automatic drawing rights.

Expansion of drawing rights, on the other hand, might be arrangeable on a more flexible basis. Moreover, to the extent that countries may be reluctant to allow their holdings of reserve units to decline but are willing to make active use of automatic drawing rights, the latter might at times actually prove to be more "liquid," in the sense of providing resources when needed.

Concluding Comments

While reserves in the form of units and drawing rights have much in common, the characteristics that give each of the approaches special usefulness in particular situations suggest that both have a constructive role to play in reserve creation.

In any event, it is essential that the negotiations provide for (1) efficient as well as equitable rules for the creation, distribution, and use of new assets; (2) smooth integration of new assets within the existing framework; and (3) the appropriate degree of expansion in the over-all volume of international liquidity which will foster sound world economic growth.

U.S. BALANCE OF PAYMENTS

The U.S. balance of payments moved significantly closer to equilibrium in 1965. In considerable part, this reflected the effects of the President's program announced in February. The improvement was primarily manifested in a substantially reduced outflow of private capital, which more than offset a drop in the trade surplus (Chart 12).

MEASURES OF DEFICIT OR SURPLUS

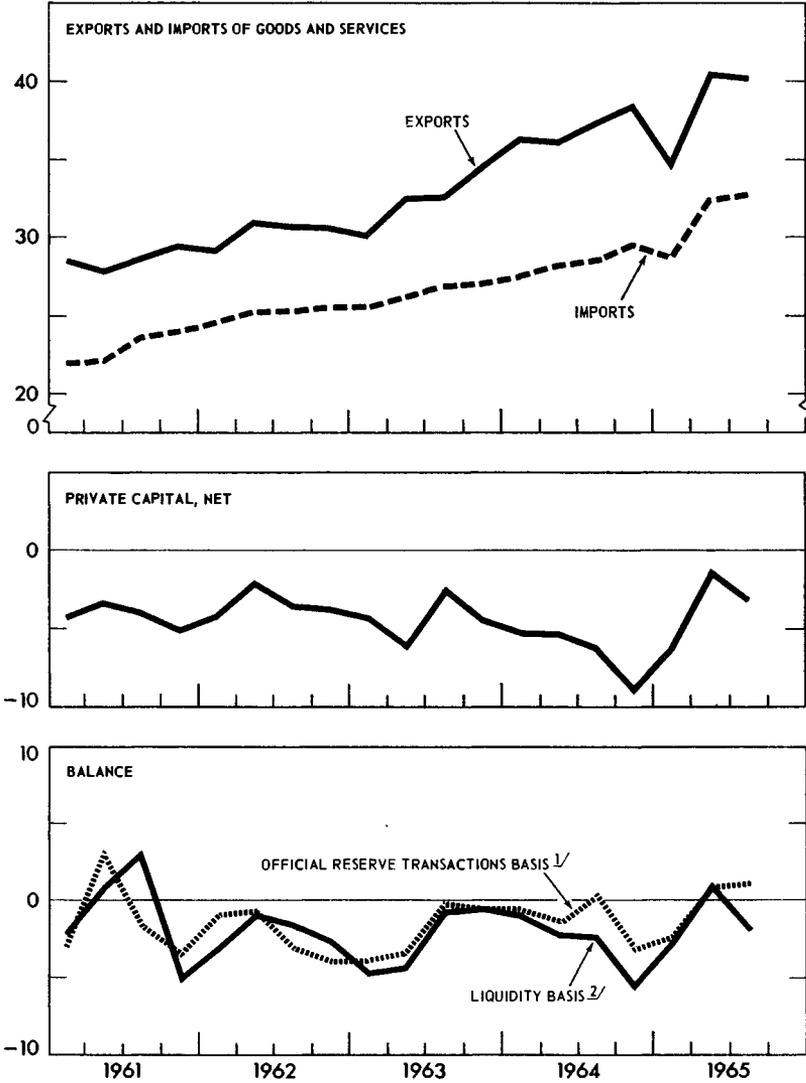
In a fundamental sense, a country's external payments cannot be in satisfactory equilibrium unless the domestic economy is in reasonable balance and its basic national and international economic objectives are being met. In a more immediate sense, however, equilibrium in external payments relates to a country's international reserve position and to its ability to maintain the value of its currency in international transactions. Statistics on a country's international transactions, summarized in its balance of payments accounts, bear only on the more immediate concept of equilibrium.

Balance of payments accounts summarize a system of double-entry book-keeping. The total of debits equals the total of credits; the net difference is zero. Thus any positive or negative balance—a surplus or deficit—includes only selected payments and receipts. A variety of such measures has been used in recent years, including among others the "basic balance," the "balance on regular transactions," the "liquidity balance," and the "balance on official reserve transactions" ("official settlements"). No single concept

Chart 12

U.S. Balance of International Payments

BILLIONS OF DOLLARS*



* SEASONALLY ADJUSTED ANNUAL RATES.

1/ EQUALS CHANGES IN LIQUID AND NONLIQUID LIABILITIES TO FOREIGN OFFICIAL HOLDERS AND CHANGES IN OFFICIAL RESERVE ASSETS CONSISTING OF GOLD, CONVERTIBLE CURRENCIES, AND THE U.S. GOLD TRANCHE POSITION IN THE IMF.

2/ EQUALS CHANGES IN LIQUID LIABILITIES TO FOREIGN OFFICIAL HOLDERS, OTHER FOREIGN HOLDERS, AND CHANGES IN OFFICIAL RESERVE ASSETS CONSISTING OF GOLD, CONVERTIBLE CURRENCIES, AND THE U.S. GOLD TRANCHE POSITION IN THE IMF.

SOURCE: DEPARTMENT OF COMMERCE.

is best for all analyses. The measure that is most appropriate for one country at one time may be less appropriate under other circumstances.

All definitions of the balance of payments surplus or deficit relate to changes in a country's reserve assets. By any definition, a contribution to surplus is recorded whenever the reserve holdings of our monetary authorities are increased by gains in gold, claims on the IMF, or liquid assets in convertible currencies. But the measures of balance also take into account changes in certain claims that could be exercised against our reserves.

Various types of assets differ in the extent and directness of their claim on U.S. reserves. Liquid claims on the United States held by foreign monetary authorities may at any time be presented for gold, and thus directly expose us to the possibility of reserve losses. Privately held liquid U.S. assets of foreigners can readily be turned into official claims. And nonliquid dollar assets held by foreigners can be sold and thus converted into liquid holdings. Indeed, in a world of convertible currencies, any marketable claim held abroad is to some degree a potential claim on our reserves. Dollar holdings of Americans could even flow abroad in a crisis and flow back as a demand for gold. It is difficult to select the group of assets that should count as claims on our reserves (with an increase contributing to a U.S. deficit). It is mainly on this point that the alternative measures of the deficit or surplus divide.

In 1965, after a careful review of its present and foreseeable situation, the U.S. Government decided to place primary stress on two measures of its general balance of payments performance—the “liquidity balance” and the “balance on official reserve transactions” (“official settlements”).

The liquidity balance spotlights the liquid claims of foreigners, both private and official, against the United States. The potential exposure of the United States is measured by the volume of such liquid claims, and any increase in them (not offset by a growth of reserve assets) is recorded as a U.S. deficit. Thus, the line is drawn between liquid and nonliquid foreign dollar holdings.

The official settlements balance, however, draws the line between the dollar holdings of foreign monetary authorities (whether liquid or nonliquid) and those of private foreign holders. If privately held foreign liquid claims on the United States increase (and there are no other offsetting transactions), this is treated as an inflow of private capital, rather than as an addition to the deficit, which it is under the liquidity definition. The official settlements concept, in other words, concentrates on the dollar claims that foreign monetary authorities have acquired (or relinquished)—usually in the process of maintaining the parity of their currencies.

After years of sizable deficits on liquidity balance, averaging \$3 billion between 1958 and 1964, the U.S. deficit appears to have been reduced to about \$1¼ billion in 1965. The deficit as measured by official settlements moved from an average of about \$2 billion in the early 1960's to \$1.2 billion in 1964 and remained at approximately that level in 1965.

Gold purchases from the United States in 1965 bore little direct relationship to the U.S. deficit in that year. Net sales of U.S. gold jumped from \$0.1 billion in 1964 to nearly \$1.7 billion in 1965. About \$260 million represented a transfer to the IMF in connection with the enlargement of our quota. Primarily, however, these sales resulted from decisions on the part of a few countries to convert dollars accumulated in earlier years and a concentration of payments surpluses in countries that do not wish to increase their dollar holdings. More than half of the total could be attributed to the purchases of one country—France—although Spain and Austria also completed sizable purchase programs.

During 1958–64, the official settlements deficit was, on the average, nearly \$1 billion lower than the liquidity measure, reflecting the growth in private foreign liquid claims on the United States. The two measures were very close in 1965 when private dollar holdings did not advance as rapidly. The behavior of private demands for dollars in the years ahead will provide additional evidence as to the relative significance that should be attached to the liquidity and official settlements measures in guiding the United States to a sustained external payments equilibrium.

DEVELOPMENTS AND POLICIES IN THE 1960'S

When the Kennedy Administration took office in 1961, the United States had just recorded the largest payments deficit of any year in the postwar period. The country was losing gold rapidly and incurring a large buildup of liquid claims abroad that threatened further losses. Action was imperative. The result has been a series of measures of increasing severity and scope, to meet a problem that proved more intractable than was believed earlier. The measures taken through 1964 were fully reviewed in earlier Reports of the Council. Further significant measures—discussed below—were taken in February and December of 1965.

As a result of these measures, and of other developments, the U.S. payments position strengthened. The basic trading position and earnings on investments improved especially. Over this period, the surplus on non-military goods and services increased from \$6.8 billion in 1960 to \$9.1 billion in 1965 (Table 23). Despite rising prices and wages abroad, drastic economies were achieved in military expenditures abroad, and offsetting sales of military equipment were increased sharply; these improvements were sufficient to offset the net increase in Government grants and capital outflows. Moreover, such grants and capital outflows are now almost completely tied to the export of U.S. goods and services.

GROWTH OF PRIVATE CAPITAL OUTFLOWS

The outflow of U.S. private capital rose from \$3.9 billion in 1960 to \$6.5 billion in 1964. Through this outflow, the United States was acquiring a large volume of foreign assets and adding rapidly to its net international own-

TABLE 23.—United States balance of payments, 1960–65

(Billions of dollars)

Type of transaction	1960	1961	1962	1963	1964	1965: First 3 quarters ¹
						<i>Seasonally adjusted annual rates</i>
Balance on goods and services	4.1	5.6	5.1	5.9	8.6	7.1
Balance on nonmilitary goods and services.....	6.8	8.2	7.6	8.2	10.6	9.1
Balance on trade.....	4.8	5.4	4.4	5.1	6.7	4.6
Balance on services.....	2.0	2.8	3.1	3.1	4.0	4.5
Net travel.....	-1.3	-1.2	-1.5	-1.7	-1.6	² -1.8
Income on direct investments.....	2.4	2.8	3.1	3.1	3.7	4.3
Other.....	.9	1.2	1.5	1.7	1.9	2.0
Military expenditures, net.....	-2.7	-2.6	-2.4	-2.3	-2.1	-2.0
Remittances and pensions.....	-.7	-.7	-.7	-.8	-.8	-1.0
Government grants and capital, net.....	-2.8	-2.8	-3.0	-3.6	-3.6	-3.3
Government grants and capital.....	-3.4	-4.1	-4.3	-4.6	-4.3	-4.4
Transactions involving no direct dollar outflows from the U.S.....	-2.3	-2.9	-3.2	-3.7	-3.6	-3.6
Dollar payments to foreign countries and international institutions.....	-1.1	-1.1	-1.1	-.8	-.7	-.8
Scheduled repayments on Government loans.....	.6	.6	.6	.6	.6	.8
Nonscheduled repayments on Government loans.....	.1	.7	.7	.3	.1	.3
Other capital, net.....	-3.5	-3.5	-2.4	-3.8	-5.8	-3.6
U.S. private capital, net.....	-3.9	-4.2	-3.4	-4.5	-6.5	-3.6
Long-term, net.....	-2.5	-2.6	-2.9	-3.7	-4.4	-4.7
Short-term, net.....	-1.3	-1.6	-.5	-.8	-2.1	1.0
Foreign nonliquid capital, net.....	.4	.7	1.0	.7	.7	(³)
Errors and omissions.....	-1.0	-1.0	-1.2	-.4	-1.2	-.5
LIQUIDITY BALANCE.....	-3.9	-2.4	-2.2	-2.7	-2.8	-1.3
Plus: Increase of liquid dollar claims of non-official foreigners.....	.3	1.1	.2	.6	1.6	1.0
Less: Increase in nonliquid liabilities to foreign official monetary institutions ⁴.....			.3	-.1	(³)	
OFFICIAL SETTLEMENTS BALANCE.....	-3.6	-1.3	-2.2	-2.0	-1.2	-2
						<i>Unadjusted totals</i>
Gold (decrease +).....	1.7	.9	.9	.5	.1	1.5
Convertible currencies (decrease +).....		-.1	(³)	-.1	-.2	-.5
IMF gold tranche position (decrease +).....	.4	-.1	.6	(³)	.3	-.1
Foreign monetary official claims (increase +).....	1.4	.7	.7	1.6	1.1	-.7
Net purchases of nonmarketable convertible bonds and notes (increase +).....				.7	.4	.2
Other liquid claims (increase +).....	1.4	.7	.5	1.0	.7	-.9
Net purchase of nonmarketable nonconvertible bonds and notes (increase +) ⁴.....			.3	-.1	(³)	

¹ Preliminary indications for some components available for the fourth quarter suggest that most of the figures shown in this column are a reasonable approximation to the annual total. Significant exceptions are foreign monetary official claims, which rose substantially, and liquid dollar claims of nonofficial foreigners, which declined late in the year. Consequently, the official settlements deficit for 1965 is estimated to be approximately the same as for 1964.

² Estimate.

³ Less than \$50 million.

⁴ Provisional.

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

Source: Department of Commerce.

ership position as well as to its future receipts of interest, dividends, and re-mitted profits. But the assets acquired through this investment were largely illiquid, and were obtained by parting with liquid assets that added to both private and official claims against us. The U.S. reserve position declined continually.

The growth of U.S. private capital outflow is not difficult to explain. As market integration has progressed and as individuals and businesses have become increasingly familiar with international financial operations, there has been a natural tendency for capital to become more mobile, and more responsive to market forces.

U.S. corporations have shown an increasing interest in business operations overseas and have been sending a rising flow of funds abroad to build and equip new plants and distribution facilities. The extremely rapid growth of incomes, particularly in Europe, Canada, and Japan, has greatly expanded consumer demand, especially for manufactured goods. Wage rates generally are lower abroad, and when American management and technology are exported the productivity of foreign labor is frequently brought close to the U.S. level, making American enterprises in other countries often extremely profitable. The virtual disappearance of internal tariffs in the EEC and EFTA, while external tariffs are retained, has created a large and expanding market which can be readily served by large-scale production in Europe. Of course, direct investment abroad is also made for the purpose of developing or expanding sources of raw materials, often for use in the firm's operations in the United States or elsewhere.

With few exceptions, U.S. money and capital markets are much better developed and freer from restrictions than those abroad, and this attracts foreign borrowers. In part because of this better organization, interest rates and flotation costs are considerably lower in this country. Consequently, there is a tendency for foreigners seeking capital to look to U.S. markets and for interest-sensitive funds to move abroad in search of higher returns.

Long-standing interest rate differentials, and the growing mobility of capital, were important factors in the spurt of long-term portfolio lending that occurred in 1962 and 1963. New foreign security issues in the U.S. market doubled from 1961 to 1962, and the acceleration continued in early 1963. This growth was arrested by the introduction in mid-1963 of the Interest Equalization Tax (IET), which raised the effective interest rate for most foreign borrowing here. Meanwhile, other capital flows began to accelerate, offsetting much or all of the gains from the IET. Bank loans rose sharply, from \$1.5 billion in 1963 to \$2.5 billion in 1964. Direct U.S. investment abroad also accelerated in 1963 and 1964.

THE FEBRUARY 1965 PROGRAM

At the beginning of 1965, it was evident that the rapid rise in capital outflows was creating growing problems for the U.S. balance of payments. Accordingly, the program announced by the President on February 10 applied the IET to most bank loans with a duration of a year or more to borrowers

in developed countries, asked for a 2-year extension of the IET, and attempted in other ways to stem the outflow of private capital through the voluntary cooperation of American business.

U.S. banks and other financial institutions were asked to observe appropriate "guidelines" with respect to their foreign operations in 1965. Banks were asked by the Federal Reserve System to limit the increase in their claims on foreigners in 1965 to 5 percent of the value of their outstanding foreign credits as of December 31, 1964. Top priority was to be assigned to *bona fide* export credits, and second priority to credits to less developed countries. A related program was applied to credits and investments abroad by nonbank financial institutions.

Under the part of the program administered by the Department of Commerce, about 500 large nonfinancial corporations were asked to make a maximum effort to expand the net balance of (a) their exports of goods and services plus (b) their repatriation of earnings from the developed countries less (c) their capital outflows to such countries. They were also asked to bring liquid funds back to the United States.

Although considerable skepticism was initially expressed—particularly abroad—regarding the effectiveness of a voluntary program, it is now clear that the response was excellent. The net outflow of U.S. private capital declined from \$6.5 billion in 1964 (and an annual rate of \$8.9 billion in the fourth quarter) to an annual rate of \$3.6 billion in the first three quarters of 1965. Short-term capital—both bank and nonbank—accounted for a great part of this dramatic shift: the movement of such funds changed from a net outflow of \$2.1 billion in 1964 to a net inflow at an annual rate of \$1.0 billion in the first three quarters of 1965. The success of the voluntary program in shifting the movement of short-term funds was reinforced by the intensified demand for funds in the domestic market, as a result both of sharply rising activity and some tightening of monetary policy.

The U.S. payments deficit in 1965 was adversely affected by certain unusual transactions of the United Kingdom. As a part of the U.K. program to protect the pound, the British authorities converted certain holdings of U.S. securities. Together with the deferment of payments on intergovernmental debts, these transactions reduced U.S. net receipts by well over \$½ billion, on both the official settlements and the liquidity basis.

Despite good over-all results of the payments program, the volume of U.S. direct investment outflows were at a record high in 1965. In the first three quarters, they reached an annual rate of \$3.4 billion, compared with a 1964 total of \$2.4 billion. However, they declined substantially during the course of 1965. Since such outflows are usually planned long in advance, and businesses were not asked to interrupt projects already underway, a lag in the response to the February program was expected. Nevertheless, there was disquieting evidence that plans for direct investment in 1966 remained at a high level. With the sharp reversal in the trend of bank lending abroad, direct investment became the primary area of concern.

PROGRAM FOR 1966

By the autumn of 1965, it was clear that the February program had been successful and that a substantial improvement in the balance of payments had been achieved. Nevertheless, even further improvement was necessary if payments equilibrium was to be attained. Consequently, decisions were announced in December to reinforce and renew the existing programs for 1966. Further attention was placed on encouraging U.S. exports, on promoting foreign tourism and foreign investment in the United States, and on minimizing the effect on the balance of payments of Government transactions. But the principal focus of the supplementary steps had to be on the further containment of direct investment outflows.

Consequently, new guidelines for direct investment were developed for nonfinancial corporations. Each of about 900 individual corporations was asked to hold its combined 1965 and 1966 direct investment outflows (plus earnings retained abroad) in specified advanced countries and mineral exporting nations to no more than 90 percent of the total of these items in the years 1962-64. This will permit an increase of about 35 percent in the average annual outflow of direct investments in 1965-66 over the average annual rate in the 1962-64 base period. A joint target was set for the years 1965 and 1966 in order not to penalize firms which had cut back in 1965, and in order to seek greater restraint by those which had invested more heavily last year. Direct investment in 1966 under the program would be lower than in 1965, though it would remain high relative to outflows of earlier years.

Financial institutions were given guidelines for 1966 that permitted about the same outflow as had been suggested for 1965. The guidelines provided for nonbank institutions were somewhat more detailed than those for 1965. New arrangements with the Canadian authorities were announced on the understanding that continued exemption from the IET would not threaten the goals of the U.S. program.

Efforts to reduce even further the impact of Government activities on the balance of payments will continue in 1966. Net overseas defense expenditures have been quite successfully reduced since 1960. Unfortunately, expanding defense needs will prevent further reduction in 1966. The bulk of Government aid will continue either to be given "in kind," with no dollar flows, or tied to procurement in the United States.

U.S. TRADE POSITION

The outstanding performance of U.S. trade in the 1960's has been strongly supported by our excellent price record, as well as by the rapid expansion of output and incomes abroad. However, the slowdown of economic expansion in Europe and Japan contributed to a reduced trade surplus in 1965. The January-March dock strike not only redistributed the time pattern of sales (somewhat inflating the 1964 level), but also caused a sizable loss of export sales.

Imports showed an unusually large gain in 1965; both manufacturing goods and raw materials rose substantially. Only agricultural imports declined, primarily because of lower prices for such commodities as coffee, sugar, and cocoa. Many U.S. firms, fearing a possible steel strike, turned in part to foreign suppliers in 1965, raising steel imports to about \$1.2 billion—an all-time high. In addition, the rapid expansion of the U.S. economy in 1965 brought a larger rise in our imports than in previous years. The boom in the home market may also in some cases have reduced the interest of American producers in finding or serving markets overseas, particularly where their production made full use of existing capacity or labor.

The 1965 decline in the trade surplus was not the result of any basic deterioration in our competitive position. Our price performance in 1965 continued to match that of our major trading partners, so that we retained the relative advantage achieved in earlier years.

CONCLUSION

Over the longer run, the policies required to assure equilibrium in the U.S. balance of payments will be influenced by many factors, including—among others—the growth rates of our major trading partners throughout the world, the extent to which European nations learn to rely actively on fiscal as well as monetary policy as a means of adjusting over-all demand, the development of capital markets in Europe, changes in the indispensable foreign exchange costs of national security, our rate of technological innovation, our record of productivity growth and price stability, and the progress of improvements in international financial machinery.

If our current account surplus continues to expand, a renewed growth of capital outflows could be compatible with over-all payments equilibrium. For the present, however, the volume of capital outflows likely to occur in the absence of any measures to moderate them would clearly be inconsistent with equilibrium in our external payments. Given that private capital outflows must be contained, the selective measures currently in use seem, for the present, an essential component of our policy. Compared with reliance solely on restrictive general monetary measures that might conceivably hold down capital flows to the same extent, the selective credit techniques have the obvious advantage of allowing monetary policy to respond to the needs for domestic credit, as well as to affect the 5-10 percent of total credit that flows abroad.

The selective approach is consistent with an appropriate composition of the private capital outflow. The exemptions in the IET and the priorities established in the voluntary programs protect the access of less developed countries to U.S. capital. The Federal Reserve program, moreover, gives priority to export financing, which could be squeezed under a highly restrictive monetary policy. By increasing the cost of borrowing in the United States, the IET contains its own escape valve: countries in urgent need of new U.S. capital issues are still free to enter our markets; the less

urgent needs are screened out. The guideline approach of the voluntary programs tends to permit the business firms and banks themselves to select the most attractive investment opportunities; the investments foregone would yield a smaller return than the average for all new U.S. foreign investments.

The voluntary program continues to permit growth in both the ownership of U.S. productive facilities abroad and of the U.S. loans outstanding abroad. But it keeps that growth within the bounds permitted by the U.S. current surplus and the cost of essential defense and aid. The voluntary program remains the foundation of improvement in the U.S. balance of payments this year.

Our efforts to achieve full equilibrium in 1966 should also benefit from the improved situation for sterling; in 1965, special transactions by the United Kingdom accounted for roughly half of our deficit. Prospects are also strengthened by recent understandings established with Canada on the handling of its capital needs from the United States. Strong domestic expansion will continue to increase imports this year, and defense expenditures abroad will have to rise in 1966. Nevertheless, the United States has the determination and the means to continue the sharp improvement effected last year in bringing its balance of payments into equilibrium.

Chapter 7

The Employment Act: Twenty Years of Policy Experience

THERE WERE great expectations and not a few qualms when the Employment Act was signed into law on February 20, 1946, following enactment by heavy bipartisan majorities in both houses of Congress. This year, which marks the 20th anniversary of that enactment, is a suitable occasion to review our experience under the Act, to take stock of where we stand today, and to consider the challenges ahead.

THE ACT AND ITS BACKGROUND

The legislation of 1946 set forth the following declaration of policy:

The Congress declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.

In making this declaration, the Congress recognized that the billions of independent spending and saving decisions of a free economy could well result in levels of total demand either short of full employment or in excess of productive capacity. Furthermore, it took the view that Government policies could play a constructive role in improving the stability and balance of the economy.

The Act was a product of the experiences of the Great Depression and World War II. The Depression shook but did not destroy the faith in an automatic tendency of the economy to find its proper level of operation. In the early 1930's, public works and other antidepression programs were justified as temporary "pump priming," to help the private economy get back on its track after an unusual and catastrophic derailment. And the departure from orthodox fiscal principles was made with regret and without complete consistency. The Government expenditures explicitly designed to

combat depression necessarily increased budget deficits; but this implication was veiled by financing these outlays through an "extraordinary" budget. Meanwhile, taxes were raised, and salaries and housekeeping expenditures cut in the regular budget, thereby reducing the over-all stimulation of Government measures.

The relapse of the economy in 1937 into a sharp decline from a level still far below full employment gave rise to conflicting interpretations. To some, it proved that pump priming and Government deficits had undermined the confidence of the business community and thereby only worsened the situation. Others, however, concluded that it pointed to the need for larger and more sustained fiscal and monetary actions to revive the economy. In drawing this conclusion, economists were buttressed by the writings of J. M. Keynes, who offered a theoretical explanation of the disastrous depression. The Keynesian conclusions received additional support during World War II because they offered a satisfactory explanation of why the high deficit-financed defense expenditures of that period not only wiped out unemployment but went beyond to create inflationary pressures.

Memories of the disastrous 1930's were very much in the public mind as World War II was drawing to an end. Many active proponents of "full employment" legislation in 1945 and 1946 feared a relapse into depressed levels of economic activity like those of the 1930's, once military spending ended. They looked toward Federal public works spending as a peacetime replacement—at least, in part—for the wartime defense outlays.

The opponents of "full employment" legislation had several reservations and objections. Some feared that it would mean a statutory blessing for perpetual budgetary deficits, soaring public expenditures, and massive redistribution of income from upper to lower income groups. There were doubts that Government actions could and would on balance raise employment; and there were fears that these actions would lead to regimentation and would jeopardize the free enterprise system. The proponents of legislation, on the other hand, argued that the Act would merely provide a setting essential to the proper functioning of the free enterprise system because a depressed economy heightened social tensions, discouraged innovation and initiative, dulled competition, and undermined confidence.

The legislation which finally emerged from this discussion wisely abstained from diagnosing depression as the disease and public works as the cure, but instead concentrated on establishing the principle of continuing Government responsibility to review and appraise economic developments, diagnose problems, and prescribe appropriate remedies. And it placed major responsibility squarely upon the President, who was asked to discuss his execution of that responsibility in an Economic Report to be transmitted to the Congress at the start of each year.

The Act also established two agencies—the Council of Economic Advisers in the Executive Branch and the Joint Committee on the Economic Report (later named the Joint Economic Committee) of the Congress—with inter-

related but separate responsibilities. These institutions have each filled a vital and previously missing role in their respective branches of Government—they have provided a coordinated overview of the economic impact of the entire spectrum of Government tax, expenditure, monetary, and other activities. To maintain the emphasis on advice and coordination, the Joint Economic Committee was not given any substantive legislative responsibility nor the Council any policy-executing duties. Both agencies have participated actively in the counsels of Government; both have conscientiously striven for a thoroughly professional economic competence and approach in their respective reports and recommendations; and both have contributed to the public understanding of economic issues.

Today's economic policies reflect the continuing impact of the Employment Act in all the years since its inception. And our accumulating experience is certain to be reflected in the policies of the future. This chapter reviews the development of policy in the past 20 years and outlines the present relationship between economic analysis and economic policy.

AVOIDING DEPRESSIONS AND BOOMS

The Congress proved wise in its decisions to state goals broadly and to concentrate on continuing review, analysis, and proposals, since the specific problems that actually arose were somewhat different from those which many supporters of the Employment Act had anticipated.

Although an important part of the impetus for the Employment Act derived from the prolonged depression of the 1930's and the resulting fear of stagnation in the American economy, this problem did not prove to be the primary challenge to economic policymaking under the Act. Indeed, immediately after World War II, excess-demand inflation proved to be the key problem. Subsequently, policy was focused on the age-old problem of limiting the size and duration of cyclical swings. Only much later and in a much different and milder form did stagnation arise as a live issue.

Thus, much of our experience under the Act consisted of policy actions to combat recession—lest it turn into depression—and to contain excess demand pressure—lest it generate inflationary boom.

COMBATING RECESSIONS

A series of relatively short and mild recessions required Government attention in the postwar period. The problem of cyclical declines was not unexpected by the framers of the Employment Act, nor was it new to the American economy. In the period between 1854 (the beginning of the business cycle annals of the National Bureau of Economic Research) and World War II, we had experienced 21 periods of recession or depression. Our postwar record is blemished by 4 additional periods of contracting economic activity—1948–49, 1953–54, 1957–58, and 1960–61.

Compared with the previous cyclical record, the postwar recessions have been far shorter, considerably milder, and substantially less frequent. Postwar recessions ranged in duration from 8 to 13 months; the average duration of previous declines had been 21 months, and only 3 had been shorter than 13 months in length. Measured by the decline in industrial production from peak to trough, postwar recessions ranged in magnitude from 8 percent to 14 percent. By comparison, in the interwar period, the declines ranged from 6 to 52 percent; three of the five contractions exceeded 30 percent and only one was less than the 14 percent maximum of the postwar period. During the past 20 years, the economy has spent a total of 42 months, or 18 percent of the time, in periods of recessions, far less than the 43 percent applicable to the 1854–1939 era.

Discretionary Policies

This improvement in the postwar record of the economy was aided by the deliberate discretionary steps taken by the Government to modify the impact of business downturns and thereby to prevent cumulating declines into depression. The speed and force of these actions—in both the fiscal and monetary areas—varied among the recessions. Thus, in 1949 little new fiscal action was taken, partly because inflation was viewed as a key problem even during the decline, and partly because Government measures taken the previous year were expected to have a considerable impact on the economy: the tax reductions of 1948 were supplying large refunds, and large expenditure increases were forthcoming under the recently enacted Marshall Plan. The Federal Reserve did act to reduce reserve requirements in a series of steps during the spring and summer of 1949, reversing a two-year rise in short-term interest rates.

In 1953–54, as military outlays declined and aggregate activity retreated, the principal expansionary influence came from previously scheduled reductions of corporate and personal income taxes. But some new action was taken to reduce excise taxes and to speed up expenditures. All three major instruments of monetary policy—reserve requirements, the discount rate, and open market operations—were used to encourage the expansion of credit-financed expenditures. Meanwhile, the Administration planned larger fiscal steps that might be taken if the recession seemed likely to be prolonged. Significantly, in 1954, the bipartisan character of expansionary fiscal policies was established for the first time, as the Republican Administration of President Eisenhower adopted measures that had previously been linked to the New Deal and Keynesian economics.

In 1958, the recession was considerably deeper than its two postwar predecessors and both the Eisenhower Administration and the Congress were more vigorous in taking action. An important concern of earlier years—that business confidence might be disturbed by Government recognition of a recession—seemed insignificant since the sharp recession was obvious to all.

Several important measures were taken. The benefit period for unemployment compensation was temporarily extended. Grants to States under the Federal highway program were enlarged and accelerated, and other programs in the budget also were expanded or rescheduled to provide an earlier stimulative effect. The Government also acted to spur housing activity by financial operations in the mortgage market and by altering terms on Government-guaranteed home mortgages. The important measures were launched near, or after, the trough of the recession. Thus, in retrospect, policy helped most to strengthen the early recovery rather than to contain or shorten the recession. Nevertheless, in view of the general recognition that the Government would be running a substantial deficit in any case, these additions to Federal outlays were a significant reflection of changed attitudes toward the role of fiscal policy.

Monetary policy also played a constructive role in the 1957–58 recession, once the monetary authorities moved to ease credit 3 months after the peak in economic activity. Thereafter, Federal Reserve actions contributed to a revival in housing and other investment by promoting a sharp reduction in interest rates, both short- and long-term.

The first fiscal measures to deal with the 1960–61 recession were taken with the inauguration of President Kennedy in January 1961, when the recession had just about run its course. Nevertheless, improvements in the social insurance system, rescheduling of Federal expenditures, and expanded programs (including defense and space) were an important stimulus to the recovery during 1961. In contrast to the delay in taking fiscal measures, the Federal Reserve reversed a tight money policy early in 1960, prior to the downturn.

Not all discretionary changes in taxes or expenditures have contributed to economic stability. Indeed, some steps taken to pursue national security or social goals had destabilizing economic impacts, which were not always appropriately offset. Previously scheduled payroll tax increases took effect in 1954, 1959, and 1962, and drained off purchasing power in recession or in initial recovery. In 1953, defense outlays declined and triggered a recession before offsetting expansionary policies were adopted.

Structural Changes for Stability

On the whole, discretionary fiscal and monetary actions made a distinct positive contribution in limiting declines. Even more important in this respect was the strengthened inherent stability of the postwar economy.

In large measure, this can be traced simply to the greater size of the Government relative to the total economy: that is, the increased importance of Government expenditures—both purchases of goods and services and transfer payments. Government outlays do not participate in the downward spiral of recession; because of its borrowing capacity, the Federal Government—unlike businesses and households—can maintain its spending in the face of declining income receipts. Although State and local governments do

not have equal immunity from the need to tighten their belts, they have been able to maintain their growing spending programs relatively unaffected during the mild postwar recessions.

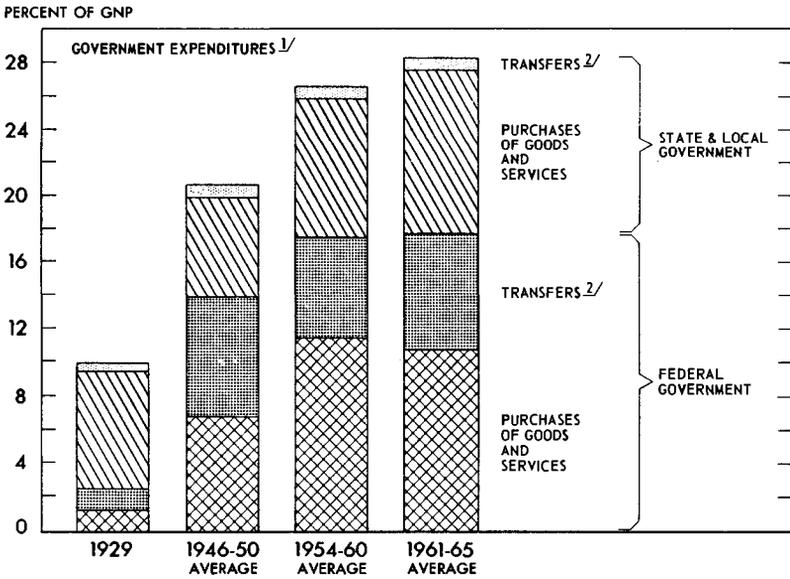
The increased relative importance of Government outlays is shown in Chart 13. Social insurance and national defense have added especially to the postwar totals of Federal outlays. State and local outlays have been rising rapidly in an effort to catch up with neglected needs and to keep up with the desires of a wealthier society for improved public services.

The contribution to the stability of the economy resulting from a high level of Government expenditures, insulated from revenue declines, has been augmented by the cushions to private purchasing power provided by the built-in fiscal stabilizers.

When private incomes and employment decline, purchasing power is automatically supported by both a decline of Federal revenues and an increase in unemployment compensation payments. Transmission of the virus of deflation is thus impeded. During postwar recessions, the progressive Federal personal income tax has not had to demonstrate its full stabilizing effectiveness because of the mildness of dips in personal earnings. There have, however, been sharp declines in corporate incomes; the Federal Treas-

Chart 13

Role of Federal and State and Local Governments in the Economy



1/ NATIONAL INCOME ACCOUNTS BASIS.

2/ TRANSFER PAYMENTS, NET INTEREST, AND SUBSIDIES LESS CURRENT SURPLUS OF GOVERNMENT ENTERPRISES.

SOURCE: DEPARTMENT OF COMMERCE.

ury has shared about half of the drop in profits, thereby helping to bolster dividends and to cushion cash flow, and hence investment outlays.

A number of improvements in our financial structure were developed in the 1930's to assure that financial collapse and declines in economic activity would not generate a vicious downward spiral as they did after 1929. These important financial mechanisms include Federal insurance of private deposits; the separation of commercial and investment banking functions; the Federal Reserve's increased ability to provide banks with reserves in time of crisis; and the joint work of the Federal Reserve and the Securities and Exchange Commission to reduce harmful speculation in the stock market. The very existence of these structural changes has contributed to stability by improving confidence.

With the help of the more stable structure of the economy, recessions in the postwar era have been limited to declines in investment spending (and, in 1953-54, Federal outlays). Consumer incomes have not declined significantly, and hence households have maintained their spending in recession. With the nearly two-thirds of GNP represented by consumer expenditures insulated from decline and with a solid foundation of public outlays, declines in private investment have not cumulated. In contrast, the Great Depression generated a decline of consumer outlays of 40 percent from 1929 to 1933, and the shrinkage of consumer markets aggravated and reinforced the collapse in investment spending.

CONTAINING INFLATIONARY PRESSURES

The desirability of price stability was clearly recognized in the legislative discussion of the Employment Act. But few considered the danger of postwar inflation nearly as great as the opposite danger of relapse into depression. The legislation itself emphasized the objectives of using resources fully and attaining high employment. It did not explicitly label price stability an objective of policy, although this was implicit in the Act and fully reflected in the policies of every Administration. Nevertheless, concern has been expressed at times that policies for "maximum employment" might allow demand to press too hard on available resources, thus biasing the American economy toward inflation.

In the wartime environment, inflationary pressures of excess demand had been suppressed by direct controls on prices and by rationing. It turned out, however, during the years immediately following World War II that these measures had served partly to postpone—rather than to eliminate—significant demand pressures. Substantial backlogs of demand emerged in the 1946-48 period. Consumers and businesses possessed large accumulations of liquid assets to finance the rebuilding of their depleted stocks of household appliances, machinery, and equipment, and their houses and plants.

Thus, contrary to expectations, the initial years of the postwar era were marked by excessive rather than inadequate demand. In this environment, living standards of consumers, the productivity of labor, and the capacity

of businesses rose rapidly. But so did the price level, with a jump of 31 percent in consumer prices from June 1946 to August 1948. Automatic fiscal stabilizers helped to contain the growth of private after-tax incomes, and were reflected in budgetary surpluses during the period. The economic policymaking machinery set up under the Employment Act may have moderated pressures to cut taxes drastically. Meanwhile, monetary policy was tied to a policy of supporting Government bond prices and was not free to combat inflation.

During the Korean war, however, the Government acted vigorously to counter inflationary tendencies close to their source. The March 1951 Federal Reserve-Treasury "accord" unleashed monetary policy. Selective controls on consumer instalment credit and on home mortgages were instituted. The enactment of three large increases in income and profits tax rates in 1950 and 1951 is one of the better examples of timely fiscal policy. These actions reflected, in part, recommendations by the Council of Economic Advisers and hearings and reports of the Joint Economic Committee.

Right after the outbreak of hostilities, prices had risen sharply in a flurry of consumer and business buying and, as a result, prices and wage ceilings had been imposed early in 1951. Once the restraining influence of over-all fiscal and monetary policies was fully felt, there was little pressure on the ceilings, and the economy was able to meet the peak defense demands of the emergency without inflationary strain.

The immediate postwar period and the early months of the Korean war are the two blemishes of clearly excessive demand on our postwar record. Apart from these two intervals, wholesale prices have shown a net increase of only 2 percent in the postwar era. In 1956 and 1957, the only other periods of marked price increases, over-all demand was not generally excessive. That inflation raised new issues, which are discussed below. In view of the whole postwar record, it can hardly be said that the Employment Act has biased policy toward inflation.

EVOLVING PROBLEMS AND POLICIES

During the postwar era, the American economy has remained free of the malignant diseases of depression and run-away inflation. And the rate of economic growth has considerably exceeded its long-term average. The objectives of the Employment Act, however, have not always been fully met. In particular, experience has demonstrated that the avoidance of depression did not guarantee the achievement of "maximum employment" and the avoidance of excess-demand booms did not assure the maintenance of price stability.

INADEQUATE DEMAND IN EXPANSION

The strength of private demand in the early postwar years and then again immediately after the Korean war led to a reassessment of the tasks of

stabilization policy. After a decade of postwar experience, suspicions arose that the typical problem would be to contain rather than to stimulate private demand.

Any such conclusion was soundly refuted by the facts of the ensuing years. With the backlogs met, and with a marked decline in the rate of family formation, private demand weakened in the late 1950's. The economy's performance weakened correspondingly because Government did not act to compensate. Thus, while unemployment had averaged 4.2 percent of the civilian labor force in the first postwar decade, it remained above that level every month between late 1957 and October 1965, averaging 5.7 percent.

The problem of inadequate demand in expansion, which became the primary focus of fiscal action in the 1960's, was a new challenge to policy-making under the Employment Act. In the first postwar decade, each time the economy advanced or rebounded from a recession, it reached the neighborhood of full employment. The policymakers had been ready in the early postwar years to deal with noncyclical problems of submerged prosperity or stagnating production. They had seen maximum employment as a moving target which could be maintained only through a substantial growth of output. Both the Council of Economic Advisers and the Joint Economic Committee had given these issues repeated attention in the late 1940's and early 1950's. But until the late 1950's, no experience had been encountered to distinguish the problem of full employment from that of cyclical prosperity.

Then came a sequence of disturbing events: the 1957-58 recession followed a year of slow advance; the 1960-61 recession began from a peak far below full employment; and the expansion that began in 1961 seemed to be running out of steam after little more than a year.

During the initial years of this period, Government policy maintained vigilance against excessive buoyancy of demand when that was no longer the problem. Restrictive fiscal and monetary actions choked off the recovery of 1958-60. The shift to an expansionary fiscal policy by the Kennedy Administration early in 1961 was designed primarily to initiate a thriving recovery. A determined policy strategy to assure complete recovery was first formulated when the economy faltered in 1962.

The combination of fiscal stimuli to consumer demand and direct tax incentives to investment, together with monetary actions permitting an ample rise in credit, promoted a vigorous and sustained expansion after 1963. The inherent strength of both consumption and investment demand appeared in a new light, once the Revenue Act of 1964 exerted its invigorating influence.

INFLATION AT LESS THAN FULL EMPLOYMENT

Another problem encountered at times during the postwar era has been the tendency of prices to rise even in the absence of over-all excess demand pressures. This tendency reflects structural characteristics of the Ameri-

can economy. The economy is not made up of fully competitive labor and product markets in which large numbers of buyers and sellers interact and respond passively to prices. On the contrary, in many industries both unions and businesses exercise a considerable degree of market power. As a first result, wages and prices are both somewhat rigid in a downward direction. To the extent that prices rise more readily in response to excess demand than they decline in the face of excess supply, the price level is given an upward bias, which can become particularly acute if there are sharp shifts in demand among various sectors of the economy. Secondly, because of market power, some firms augment increases in costs originating elsewhere and unions can escalate their wage demands if prices begin to rise. Third, firms can use a strong market position to widen margins in a period of prosperity even if there are no upward pressures on their costs. Fourth, in the nature of the collective bargaining process, key wage bargains in some industries may tend to establish a pattern applied elsewhere. In particular, if the industries with key wage bargains happen to have excess demands and very strong profits, the pattern will tend to pull wages upward more rapidly throughout the economy.

An important, broadly oriented study by the Joint Economic Committee analyzed the workings of these important influences in the 1956–57 inflation. In that period, excess demands that were present in machinery and equipment, automobile, and metals industries led to price increases that were not offset elsewhere. Large wage settlements in these industries with high demand and high profits had pattern-setting effects on many other contracts, thus adding to costs on a broad front.

Rising prices that originate from such a process can affect expectations, jeopardize the stability and balance of an expansion, and create inequities and distortions just as readily as demand inflation. But measures to restrain these price increases by reducing over-all demand will enlarge unemployment and impair the productivity record so important to cost-price stability over the longer run. Policies to improve the operations of markets, increase resource mobility and accelerate technical change can help to increase the economy's resistance to rising prices. But in a world where large firms and large unions play an essential role, the cost-price record will depend heavily upon the responsibility with which they exercise the market power that society entrusts to them.

The need for responsible private action was brought to public attention in the Economic Reports of President Eisenhower's second Administration. Through the major innovation of the guideposts in the Kennedy and Johnson Administrations, this need has since been focused and developed into a national policy to enlist the force of public opinion to maintain cost-price stability. The emergence of such a policy has been all the more important in recent years because of the balance of payments problem that has persisted alongside the domestic need for more expansion.

ECONOMIC POLICY TODAY

Two decades of economic analysis and policy experience have shaped the development of a revised economic policy. By some, current policy has been labeled the "new economics." It draws heavily on the experience and lessons of the past, and it combines both new and old elements. Current policy represents a coordinated and consistent effort to promote balance of over-all supply and aggregate demand—to sustain steady balanced growth at high employment levels with essential price stability.

This approach to policy has several key aspects, not entirely novel by any means. First, it emphasizes a continuous, rather than a cyclical, framework for analyzing economic developments and formulating policies. Stimulus to demand is not confined to avoiding or correcting recession, but rather is applied whenever needed for the promotion of full-utilization and prosperity. Second, in this way, it emphasizes a preventive strategy against the onset of recession. Third, in focusing on balance of the economy, this policy strategy cannot give top priority to balance in the budget. When private investment threatens to outrun saving at full employment, a Government surplus is needed to increase total saving in the economy while restrictive monetary policy may also be called for to restrain investment outlays. When, as in recent years, private saving at full employment tends to outrun actual private investment, the balance should be corrected by budget deficits and expansionary monetary policy. Fourth, it considers the budget and monetary conditions in the framework of a growing economy, recognizing that revenues expand and thereby exert a fiscal drag on demand unless expansionary actions are taken; similarly, it recognizes that money and credit must expand just to keep interest rates from rising. Fifth, this strategy emphasizes the use of a variety of tools to support expansion while simultaneously pursuing other objectives. Manpower policies, selective approaches to control capital outflows, as well as general fiscal and monetary measures, are all part of the arsenal. Sixth, it calls for responsible price-wage actions by labor and management to prevent cost-inflation from impeding the pursuit of full employment. Finally, it makes greater demands on economic forecasting and analysis. The job of the economist is not merely to predict the upturn or the downturn but to judge continuously the prospects for demand in relation to a growing productive capacity.

THE NATURE OF CYCLICAL INSTABILITY

An industrial economy is vulnerable to cumulative upward and downward movements in activity, so evident in our long-term record. While they can have diverse specific causes, these cyclical fluctuations can be explained as the result of imbalances between the rate of growth of productive capacity and the rate of growth of final demands that make use of productive capacity.

During periods of prosperity, a considerable part of the Nation's output is used to increase productive capacity through investment in plant and equipment and business inventories. If demand keeps pace, sales expand and the new capacity turns out to be profitable. Businessmen find that their decisions to increase capacity have been validated and they continue to pursue expansionary investment policies. If, on the other hand, inventory stocks are built up far in advance of need—on the basis of overly optimistic sales forecasts or as an inflation-hedge—businessmen will subsequently wish to cut back their rate of accumulation. Similarly, if outlays for business fixed investment add to productive capacity faster than demand expands, overheads on new capital cut into profits, inducing business firms to trim their capital outlays. Even if businessmen continue to add somewhat to their productive capacity, the mere decline in the rate of expansion can mean an absolute reduction in the demand for capital goods and for output to go into inventories. Payrolls and purchasing power are thereby curtailed and a decline in total demand can result. Thus a slowdown in economic activity is converted into a definite downturn—a recession or depression.

Imbalance can arise because businessmen in the aggregate invest too much and overbuild, creating more capacity than the economy can—even at best—put to productive use. Or alternatively it can stem from “underbuying,” a growth of final demand too slow to make use of even moderate additions to capacity. In principle, cyclical movements can also be triggered by overbuilding of new homes and consumer durables.

Overbuilding of inventories—partly encouraged by expectations of rising prices—was probably the key factor in the first postwar downturn, which occurred in 1948. That experience demonstrated that a situation of high total demand could deteriorate rapidly into recession without any change in the basic underlying factors in the private economy or any restraining shift in public policy. In 1953, the sharp decline in defense outlays reduced final demands and precipitated recession; productive capacity became temporarily excessive and investment spending declined. In 1956–57, rapid growth of productive capacity was associated with an investment boom; meanwhile, final demands grew very slowly. It is not possible to deliver a clear verdict on whether more vigorous growth of final demand would have justified the high investment levels then obtaining. But with the slow growth of demand that actually occurred, there was an abrupt decline in plant and equipment spending as well as inventory investment in 1957. In 1959–60, the rate of expansion of capacity (including inventories) was not excessive measured against the capabilities of the economy; the failure of the economy to support that growth of capacity must be attributed to “underbuying,” the inadequate expansion of final demand, in an environment of restrictive fiscal and monetary policies.

In the future as in the past, policies to avert recession cannot wait until imbalances develop and the signs of a downturn are clear. The fact that economic activity is rising cannot be an assurance of continued growth if

the expansion is too slow to match the growth of productive capacity. Nor can a strong level of investment be relied on to sustain expansion if it threatens an excessive growth of productive capacity. Recognizing these tasks, Government must apply its fiscal and monetary policies continuously to sustain and support a balanced expansion, sometimes by moderating the strength of an excessive investment boom, sometimes by adding to the strength of lagging final demand. The best defense against recession is a policy to sustain continued expansion. In a free economy, fluctuations in private demand will inevitably occur, and the Government will not always have the wisdom or the ability to counteract them. Continued expansion cannot be guaranteed, but recurrent recession need not be accepted as a necessary fact of economic life.

POLICY FOR A GROWING ECONOMY

In order to achieve the goal of maximum employment, the Government must coordinate all its policies to take account of the persistent growth of the economy's potential output.

The Problem of Fiscal Drag

One consequence of economic growth is that budgetary policies become more restrictive if they stand still. If tax rates are unchanged, Federal revenues will grow continuously as the economy expands. Meanwhile, if Federal expenditures are held constant in the face of growing revenues, the Federal budget will exert a continuing "fiscal drag" on private demand.

Either increased expenditures or reduced tax rates can offset this influence. A total of these two types of stimulative actions which exactly matched the dollar amount of normal revenue growth would provide a precise offset to fiscal drag (and would leave unchanged the high-employment surplus, discussed in Chapter 1).

A simple mechanical offset to fiscal drag is not, however, a satisfactory rule for fiscal policy. When aggregate demand threatens to exceed the supply capacity of the economy, some fiscal drag should be allowed to operate. On the other hand, waning strength in private demand points to fiscal action that would more than offset the drag, effecting a desirable decline in the high-employment surplus.

Furthermore, tightness or ease of monetary policy is important in determining appropriate fiscal actions. There is an analog to drag in the monetary area: A growing economy generates rising demands for liquid assets and increasing needs for borrowing. If monetary policies stand still in the sense of holding supplies unchanged, continually tighter credit conditions and higher interest rates will be the result.

Accelerating Growth

The growth of the economy is a major influence on policy; the opposite side of the coin is the major role of policy in influencing potential economic

growth. The larger the amount of current output invested in physical and human resources, the more rapidly productivity and the productive capacity of the economy will increase.

A number of policy choices can speed growth by shifting resources into various types of investment. Public investment in human and physical resources can yield rich returns in more rapid economic growth. Some public investments, such as those on research and development, encourage complementary private investment. Outlays for manpower training improve labor skills and productivity. Throughout our history, investment in education has been one of the key contributors to growth. Private investment in plant and equipment is a key determinant of our industrial capacity. It can be stimulated by easing monetary policies. It can also be encouraged by selective tax reductions, such as the investment credit and depreciation reform of 1962 and the reductions in corporate tax rates in 1964 and 1965.

When the economy is below full employment, any stimulative measure is likely to add to private investment, thereby contributing to the growth of potential, as well as to actual, output. But, at full employment, more resources can be devoted to capital formation only if current consumption is restrained. A policy strategy to accelerate growth may therefore point to higher personal income taxes or similar measures to hold consumption below what would otherwise be appropriate.

Choices of Tools

Economic policy has many tools available in pursuing the goals of full employment, rapid growth, price stability, and balance of international payments. The full range of economic objectives must be reflected in the selection of policies to meet particular circumstances.

Policy instruments differ in their impact. Sometimes policy tools can advance the economy toward more than one goal. For example, manpower policies help to maintain price stability at high employment and to promote economic growth. Conflicts may occur, however. For example, high interest rates impinge particularly on investment both at home and abroad, hence somewhat reducing foreign capital outflows but also reducing aggregate demand and slowing economic growth. In the case of potential conflicts, instruments must be used more selectively; for example, moderate changes in interest rates can be supplemented by taxes on foreign investment, like the Interest Equalization Tax.

The potential for timely results differs for various policy instruments. Monetary policy can be altered readily, although its full economic impact will not be immediate. While some restraint or speedup in Federal outlays can be applied by Executive authority alone, tax rate changes must, of course, be approved by the Congress. The speed of congressional action on tax changes has varied. It acted rapidly to increase taxes in 1950, and to reduce excise taxes both in 1954 and 1965. On the other hand, it took

13 months to enact the comprehensive Revenue Act of 1964. Tax revision can help to avoid the necessity for abrupt changes in Federal expenditures, which could require stopping a project before its conclusion or starting a new one with inadequate planning.

Given the possibility for achieving needed short-run stimulus or restraint through changes in taxes, transfer payments, or monetary policy, decisions on expenditures for public services can rest on basic judgments of costs and benefits of public and private spending. The availability of this choice permits resources to be devoted to the highest priority uses.

PREREQUISITES OF SUCCESSFUL POLICY

Choice of the right policy action demands full information about the state of the economy and understanding of its workings. And execution of stabilizing policy requires public understanding and acceptance.

INFORMATION

An important requirement of economic policymaking is a firm and timely knowledge of where the economy stands. Spurred by the need for prompt and enlightened decisions, the Federal statistics program has made rapid forward strides in the postwar period, and now provides a much better gauge of current economic developments. Of the 369 monthly series now carried in *Economic Indicators*, the statistical summary prepared by the Council and issued by the Joint Economic Committee, only 60 percent would have been available by the monthly publication date at the time *Economic Indicators* was launched in the late 1940's.

In addition to the information on current developments, a number of anticipatory surveys have been instituted which provide important information on the probable future course of the economy. Outstanding among these is the Commerce-Securities and Exchange Commission survey on plant and equipment; additional important clues to future developments come from the Commerce inventory survey and the Census quarterly survey of consumer buying intentions. Important information also is obtained from private sources including the University of Michigan's Survey Research Center, the National Industrial Conference Board, and McGraw-Hill, Inc.

Yet, our data are not completely satisfactory. The revisions of the national accounts last summer gave evidence of how much we learn later that could have been helpful on a current basis. There are any number of areas—capital stock and capacity, productivity, employee fringe benefits, job vacancies, among them—where there are important gaps and weaknesses in our quantitative information which can be remedied only by expansion of our statistical programs.

Not all the information useful to the Council comes from published sources or takes the form of numbers. The Council, as enjoined by the Act, finds it most useful to consult regularly with business and labor. These

consultations provide valuable information and opinions, and also allow the Council to explain and clarify Administration views.

PROFESSIONAL KNOWLEDGE

Facts are the essential raw materials for analysis, but they require intelligent processing to be useful in guiding policy. The ability of economists to diagnose and forecast on the basis of current facts and to evaluate the impact of alternative policy measures is a key determinant of what policy can do to maintain stable balanced growth.

Our economic knowledge has made great advances in the past generation, but many important questions remain, answers to which should be and can be improved through further research.

There are many quantitative uncertainties in forecasting the strength of private demands. Some of these were illustrated in 1965 when the improvement in profits and sales—coupled with the shifting defense picture—generated a more rapid and greater surge in investment demand than was foreseen initially. Furthermore, the linkage between monetary policy actions and changes in ultimate spending also require more exploration. And even in areas that are more readily quantified, such as the impact on GNP of changes in Government purchases and personal tax reductions, there remains a considerable range of doubt about the timing of the impacts and the specific influences on consumption and investment.

Departing from the domain of aggregative output effects, we need a better understanding of many more specialized problems, such as the functioning of labor markets—how job vacancies are filled, how skill shortages are met, and how excess supplies in one area are ultimately absorbed elsewhere. Such knowledge can be a useful guide to the possibilities for expanding output and employment while avoiding bottlenecks.

But while much remains to be learned about our economy, it would be a disservice to understate the power of economic analysis, and to underrate the substantial contribution of the profession to the successful course of our economy in the postwar period. The Employment Act provided the framework in which this professional contribution could be rendered and be given its proper place in the framing of public policy.

PUBLIC UNDERSTANDING

Not all of the needed improvements in knowledge and understanding are of a technical character. Even though viewed as correct by the professional analyst, policies cannot be applied effectively unless the Congress and the public at large understand how the proposed measures intend to further desirable objectives.

If policy proposals of the Administration are to be converted into legislation, they must be convincing to the Congress. Twenty Annual Economic Reports have explained the rationale for the programs of four Presidents. And the Joint Economic Committee has rendered invaluable service

in contributing to an understanding of general economic policy and specific proposals. The principles of fiscal policy and their implications for tax and expenditure legislation have been central to the Nation's economic education in the past 20 years. The great increase in understanding is best seen in the sophisticated current level of public discussion.

Proper understanding of policies by the public, moreover, contributes to the very success of the policy measures. In the absence of public understanding, there can be perverse reactions. If people read policies to maintain price stability as an announcement that inflation has arrived, rather than an exercise of determination to avoid it, destabilized prices may be the result. If people see steps to combat recession as a sign of panic rather than a support to the economy, this too can have adverse psychological effects. In particular, a firm appreciation by the American people of the rationale of wage-price guideposts is essential to make them effective and to limit the need for active participation by Government. It is the public that gets hurt by irresponsible wage-price decisions, and public reaction can be the best reminder to those with market power of their social responsibility.

CONCLUSION

As the primary objective set by the Employment Act is being reached, new problems move to the fore and are receiving increasing attention in public policy. These include the efficient use of the Nation's human and natural resources, the conquest of poverty and suffering, the reconstruction of our cities, and the many other tasks set forth in the preceding pages of this Report. And undoubtedly in the pursuit of the goals of the Employment Act during the next 20 years, policymakers will encounter a new range of problems, no more completely foreseeable now than were the issues of today in 1946.

While important problems remain, we are nonetheless at an historic point of accomplishment and promise. Twenty years of experience have demonstrated our ability to avoid ruinous inflations and severe depressions. It is now within our capabilities to set more ambitious goals. We strive to avoid recurrent recessions, to keep unemployment far below rates of the past decade, to maintain essential price stability at full employment, to move toward the Great Society, and, indeed, to make full prosperity the normal state of the American economy. It is a tribute to our success under the Employment Act that we now have not only the economic understanding but also the will and determination to use economic policy as an effective tool for progress.