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

LETTER OF TRANSMITTAL

COUNCIL OF ECONOMIC ADVISERS,
Washington, D.C., January 25, 1968.

THE PRESIDENT:

SIR: The Council of Economic Advisers herewith submits its Annual Report, February 1968, in accordance with Section 4(c) (2) of the Employment Act of 1946.

Respectfully,



GARDNER ACKLEY

Chairman.



JAMES S. DUSENBERRY



ARTHUR M. OKUN

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Sustaining Prosperity: Record and Prospects

THE U.S. ECONOMY recorded further progress in 1967. Despite a pronounced inventory adjustment in the first half of the year, expansion continued through an unprecedented seventh consecutive year. The unemployment rate remained at its lowest level in more than a decade—averaging 3.8 percent for the second straight year. The value of the Nation's total output of goods and services—gross national product (GNP)—rose \$42 billion to a level now estimated at \$785 billion; after allowance for price changes, GNP grew by $2\frac{1}{2}$ percent.

Expansionary fiscal and monetary policies worked to sustain expansion when private demand was sluggish in the first half of 1967. The rebound of the second half reflected the contribution of these forces. As 1968 opens, fiscal policy remains highly stimulative, and it is now overly expansionary in an economy again growing at a rapid pace. The ready availability of credit for housing and other high-priority needs is in jeopardy today, after a rapid rise of interest rates in the second half of 1967.

To avoid a return to severe credit stringency, to promote price stability, and to safeguard the balance of payments, the President is asking Congress to make enactment of a tax surcharge the first order of business in 1968. The outlook for 1968 and its dependence on tax action is set forth in this Chapter. A more detailed discussion of fiscal and monetary policy—past, present, and future—is the subject of Chapter 2.

The unsatisfactory price performance of 1966 continued through 1967; consumer prices again rose nearly 3 percent. The task of decelerating price and cost increases and of gradually restoring price stability, while maintaining high employment, is a key assignment for economic policy in 1968, as Chapter 3 makes clear. Poverty in our cities has received increasing attention. Chapter 4 discusses this and other pressing problems involved in assuring the opportunities of all Americans to obtain adequate health care, housing, and education. The balance of payments was a serious problem in 1967, especially in the closing months. The President has set forth a comprehensive new program to deal decisively with our payments deficit. The key international aspects of our economy are discussed in Chapter 5.

ECONOMIC ACTIVITY IN 1967

Employment expanded in 1967 and the real incomes of American families continued to grow. The purchasing power of the average American—personal disposable income per capita, corrected for price changes—rose 3.2 percent, less than the 3.9 percent annual rate of the 1961–66 period, although well above the 2.3 percent average yearly advance for the entire postwar period.

INCOME AND EMPLOYMENT

Most of the income gains of households came from increased employment and higher wage rates. Incomes from social insurance benefits were also an important contributor; they rose \$5 billion, partly reflecting new and expanded programs of health insurance. Dividends, interest, and rental incomes advanced moderately. The income of farm proprietors, however, declined \$1¼ billion from its record level of 1966.

The civilian labor force registered an unusually large gain of nearly 1.6 million from 1966 to 1967, and the growth of civilian jobs kept pace. The number of workers on nonfarm payrolls increased by 2.1 million. Manufacturing employment rose only 150,000, the smallest advance since 1963. But private nonfarm employment outside manufacturing increased about as rapidly as in 1965 and 1966, with a gain of 1.2 million. Government employment—predominantly State and local—advanced 750,000. The Armed Forces expanded by an additional 325,000. Total compensation of employees increased \$34 billion or 8 percent, reflecting the combination of higher employment and increased wages and fringe benefits.

Corporate profits fared less well in 1967. For the year as a whole, profits before tax are now estimated at \$80 billion, down nearly \$4 billion from 1966 although well above any previous year. The dip in profits interrupted a sustained six-year advance, which had provided a sharp contrast with the 1950's, when profits did not increase significantly in any two consecutive years. Profits typically decline in a period of slow expansion partly because lagging productivity growth tends to raise unit labor costs. In early 1967 the erosion of profits was accentuated as sluggish output and sales followed a period of particularly rapid growth of capacity and other overhead elements.

PRODUCTION

The growth of output in 1967 was not impressive by the standards of recent years. The 2½-percent increase in real GNP—total output, after adjustment for price changes—was the smallest since 1961, and far short of the 5½-percent yearly average of 1961–66.

Growth rates differed widely among sectors. Industrial production rose only 1 percent from 1966 to 1967, as manufacturing industries bore the brunt

of the inventory adjustment and capital goods slowdown. Durable goods output was particularly affected. In the breakdown of real GNP by major product classes, durable goods output rose less than one-half of 1 percent for the year as a whole, while output of nondurable goods rose $3\frac{1}{2}$ percent. The real volume of new structures actually declined from 1966 to 1967. Services registered the largest yearly gain, an advance of $4\frac{1}{2}$ percent in real terms.

PATTERN WITHIN THE YEAR

The annual record for 1967 does not tell the whole story, for there was a marked change of pace between the first and second halves of the year.

Inventory Adjustment in the First Half

The performance of the economy during the first half of 1967 was dominated by a massive adjustment in the rate of inventory accumulation. In many respects, the first half of 1967 resembled other periods of inventory adjustment. But this time the marked reduction in inventory investment did not cumulate into a decline in over-all economic activity.

An inventory adjustment is generated by excessive growth of stocks in relation to sales. In a smoothly expanding economy, production and sales tend to move approximately in parallel, with production exceeding final sales by about 1 percent. This margin allows for the larger inventories of goods at all stages in the pipeline—raw materials, work-in-process, and finished products—that are needed as production and sales advance. When producers are optimistic about sales, they tend to step up their production. If actual demands fail to live up to expectations, sales fall below production by an abnormally wide margin, and inventories pile up.

Such a pattern evolved in 1966. Early in that year, demand was advancing at an unusually rapid pace, led by major increases in defense outlays, an investment boom, and rising consumer expenditures. Business expectations were buoyed up by the vigor of demand. Production expanded steadily. But as the year developed, the optimistic expectations of producers were not completely fulfilled. Final sales slowed down, in part because of monetary and fiscal policy actions designed to moderate the pace of advance. Residential construction fell sharply during the course of 1966, reflecting an extreme shortage of mortgage credit. In the closing months of the year, the end of the plant and equipment boom and a sudden rise in consumer saving weakened over-all demand.

As production continued to increase, the rate of inventory accumulation soared. In the fourth quarter of 1966, inventory investment reached a record \$18.5 billion (annual rate). The absolute level of stocks was not greatly excessive in relation to final sales, but the rate of inventory investment had to be decreased sharply to limit further accumulation.

A sharp reduction in the rate of inventory investment tends to weaken final sales as well. When firms cut back production to curb the growth of inventories, the workweek is shortened and some workers are laid off. The cutback of employment lowers household incomes, thereby dampening consumer buying. Meanwhile, declining operating rates in industry weaken incentives for business fixed investment. The process tends to feed on itself. As a result of the initial effort to bring production into line with sales, final demands slow further, and inventories must be curtailed even more to restore balance between stocks and sales.

Inventory adjustment was a basic feature of the four postwar recessions: 1948-49, 1953-54, 1957-58, 1960-61. In each of those periods, real GNP fell between 1½ and 4 percent over a period of two to four quarters, and the unemployment rate rose to 6 percent or more. But the inventory adjustment of 1967 did not lead to a recession. Real GNP was virtually unchanged from the fourth quarter of 1966 to the first quarter of 1967 and then resumed its advance. The unemployment rate remained in a narrow range close to 4 percent throughout the slowdown.

From the fourth quarter of 1966 to the second quarter of 1967, inventory investment fell \$18 billion to a near-zero rate. In absolute size (although not as a percentage of total output), this was the largest drop ever over a two-quarter period. Nevertheless, GNP continued to advance, although the pace slowed markedly, as seen in Table 1.

TABLE 1.—*Changes in gross national product and Federal sector of the national income and product accounts since second quarter 1966*

(Billions of dollars, seasonally adjusted annual rates)

| Item | Change | | |
|---|-----------------------|-----------------------|------------------------------------|
| | 1966 II to 1966 IV | 1966 IV to 1967 II | 1967 II to 1967 IV ¹ |
| Gross national product..... | 25.4 | 13.0 | 32.5 |
| Change in business inventories..... | 4.5 | -18.0 | 8.5 |
| Final sales..... | 21.0 | 31.0 | 24.1 |
| Personal consumption expenditures..... | 12.2 | 15.9 | 11.7 |
| Business fixed investment..... | 4.1 | -1.3 | 2.3 |
| Residential structures..... | -4.9 | 2.2 | 4.8 |
| Net exports..... | -1.1 | 1.0 | -1.3 |
| Government purchases of goods and services: | | | |
| Federal..... | 6.6 | 8.0 | 2.5 |
| State and local..... | 4.0 | 5.2 | 4.1 |
| Federal sector, national income and product accounts: | | | |
| Receipts..... | 7.0 | -.5 | 8.1 |
| Expenditures..... | 13.5 | 10.9 | 4.7 |
| Defense purchases..... | 7.2 | 6.9 | 1.8 |
| Other purchases..... | -.7 | 1.1 | .7 |
| Other expenditures..... | 6.9 | 2.9 | 2.2 |
| Surplus or deficit (-)..... | -6.5 | -11.4 | 3.4 |

¹ Preliminary.

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

Sources: Department of Commerce and Council of Economic Advisers.

An unusually large increase in final sales provided the thrust for continued expansion. As shown in Chart 1, the \$31 billion advance in final sales over the two quarters represented a marked acceleration from the pace of the preceding three quarters. In fact, the gains in final sales in each of the first two quarters of 1967 had been exceeded only in the booming fourth quarter of 1965 and the first quarter of 1966.

This acceleration in final sales was due mainly to the stimulus provided by rising Federal expenditures and expansionary monetary policy. As recorded in Table 1, Federal defense purchases (annual rate) rose \$6.9 billion between the fourth quarter of 1966 and the second quarter of 1967. Meanwhile, Federal transfer payments to persons—principally for increased social insurance and health benefits—rose \$3½ billion. While Federal outlays advanced rapidly, receipts remained on a plateau, partly because the slowdown of economic activity automatically held down the tax base. The Federal deficit, which had been \$3 billion (annual rate) in the fourth quarter of 1966, rose to a postwar record of nearly \$15 billion in the second quarter of 1967. Federal receipts and expenditures, and the accompanying surplus or deficit, are cited throughout this Annual Report as they are recorded in the Federal sector of the national income and product accounts. These measures are closely comparable to the new concept of the “expenditure account,” described in *The Budget of the United States Government, Fiscal Year 1969*.

The strongly expansionary fiscal program supported the growth of personal incomes and hence of consumption. Although the saving rate remained high during the first two quarters of 1967, consumer outlays increased \$16 billion, nearly matching the growth of disposable income.

The easing of monetary policy in the closing months of 1966 was clearly reflected in the recovery of residential construction in the first half of 1967—a major contrast with its previous rapid decline.

The monetary stimulus during this period came from a deliberately expansionary policy. The fiscal stimulus reflected primarily the continued rapid expansion of defense purchases and rising outlays from previously enacted social insurance legislation. But some discretionary fiscal steps to strengthen expansion were taken—early restoration of the investment tax credit and a rescheduling of some Federal outlays that had been postponed in the fall of 1966.

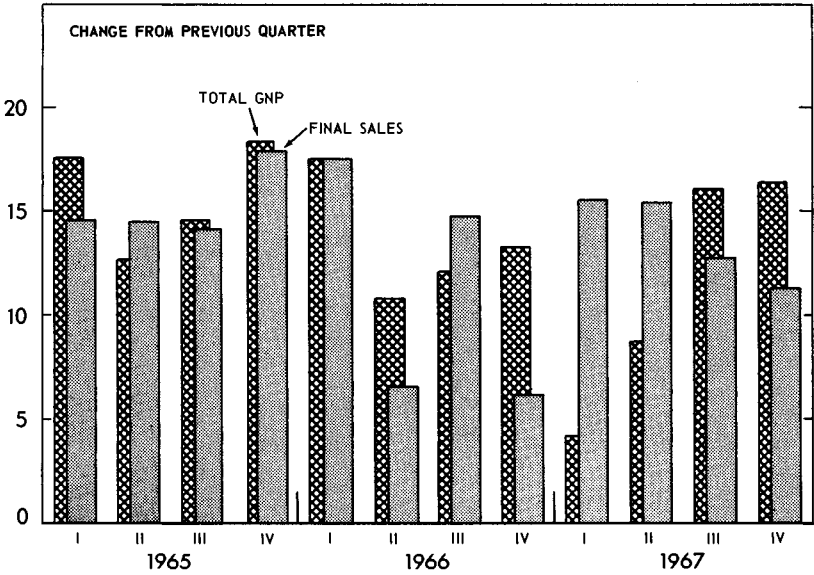
The balance between stocks and final sales improved during the first half of 1967. Inventory investment bottomed out by midyear with no significant liquidation of total stocks and with a continued advance in over-all economic activity.

While the avoidance of recession was a major favorable development, it cannot be read as an indication that the business cycle is dead. On the contrary, the sharp inventory swing showed the continued vulnerability of the economy to cyclical forces. It was only because fiscal and monetary policy were operating in a stimulative direction that the expansion endured.

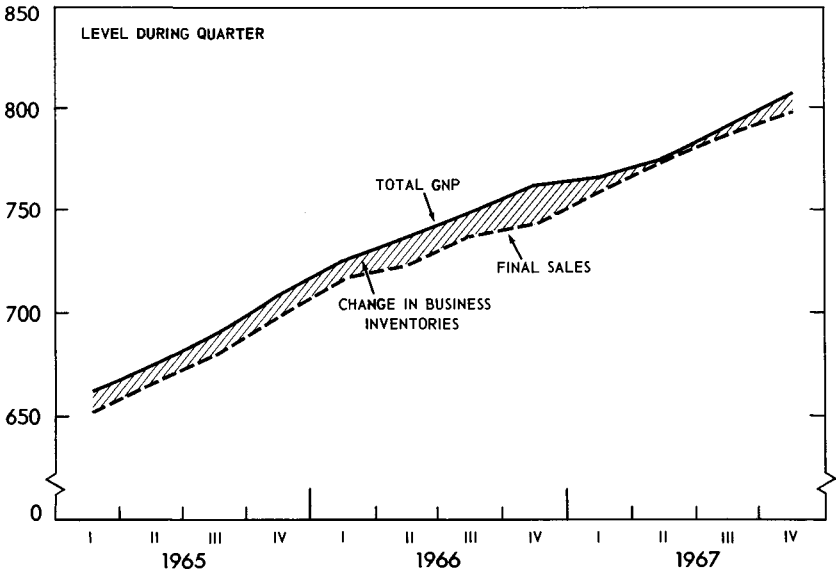
Chart 1

Total Gross National Product and Final Sales

BILLIONS OF DOLLARS*



BILLIONS OF DOLLARS*



*SEASONALLY ADJUSTED ANNUAL RATES.
SOURCE: DEPARTMENT OF COMMERCE.

Rebound in the Second Half

The slowdown ended in the spring. Thereafter, the economy maintained a brisk pace for the remainder of 1967. The only marked departure from this course occurred during September and October, when major work stoppages—most notably, the strike at the Ford Motor Company—held activity back.

As sales kept rising and confidence returned, inventory accumulation was gradually resumed. This turnaround accounted for most of the difference in the pace of activity between the first and second halves of the year. Homebuilding outlays continued to rise dramatically, surpassing their 1965 level in the last quarter of 1967. Business fixed investment showed signs of an upturn. Final sales increased substantially, but not as rapidly as in the first half. Federal purchases for defense advanced much more moderately and the growth of consumer spending slowed. The saving rate rose further, in part because of the limited availability of new automobiles in the fourth quarter.

GNP rose \$32½ billion from the second to the fourth quarter. In real terms, the advance was 4½ percent (annual rate). The Ford strike held down the rise in GNP by an estimated \$4 billion and curtailed the annual rate of real growth by 1 percentage point over this period.

As strikes were settled at Ford and elsewhere, the economy ended the year on a strong note. Industrial production displayed an especially vigorous upsurge and finally surpassed its earlier peak of December 1966. According to preliminary data, the new orders and shipments of durable goods manufacturers rose by 12 percent and 13 percent, respectively, over the final two months of 1967, and exceeded the all-time monthly records set in 1966. Over the same two months, personal income increased by \$12 billion and nonfarm payroll employment rose by 900,000. To a large extent, the extraordinary size of these gains represented post-strike recovery rather than underlying growth forces. Nevertheless, the economy was advancing rapidly as 1968 began.

THE COMPOSITION OF OUTPUT

Shifts in the pattern of demand among major sectors of the private economy in 1967 generally worked toward restoring the balance that had been upset in 1966. The years 1961–65 had been characterized by a remarkably balanced expansion among the various sectors: Inventories advanced in line with sales; business fixed investment, though rising rapidly in 1964 and 1965, was geared appropriately to the expansion of markets; homebuilding rose to a high level, which was maintained for an unusually long period; net exports advanced strongly; and consumer spending kept pace with rapidly growing incomes.

In 1966, however, this orderly pattern was interrupted. In particular, marked imbalances arose in the various areas of investment. Business capital spending continued to rise rapidly, and began to add to capacity at a rate

exceeding the long-term sustainable growth of demand. Inventory investment reached record levels, and stocks outpaced sales. Residential construction declined sharply as the flow of mortgage credit dwindled. Net exports slipped badly as consumers and business turned to foreign sources for products which the domestic market could not supply.

INVESTMENT SECTORS

The economy became better balanced as the composition of investment moved toward a more normal pattern (Chart 2).

Business Fixed Investment

Business fixed investment has averaged 9.8 percent of GNP during the entire post-Korean period. The share rose from the beginning of 1964 to the end of 1966, ultimately reaching a peak of 10.9 percent. The unusually sharp increase in plant and equipment expenditures was finally ended by the slowdown in over-all expansion, the suspension of the investment tax credit in the fall of 1966, and monetary stringency. Business capital spending dipped a little for a time, but it remained essentially on a high plateau in 1967. By yearend, its share had fallen to 10.4 percent of GNP.

Inventory Investment

During the past 15 years, inventory investment has fluctuated markedly around an average level of 1 percent of GNP. As noted earlier, it accelerated sharply in 1966 to reach the unsustainable rate of 2.4 percent of GNP at yearend. In the second quarter of 1967, inventory investment was negligible. It recovered thereafter, reaching a rather normal 1.1 percent of GNP in the fourth quarter.

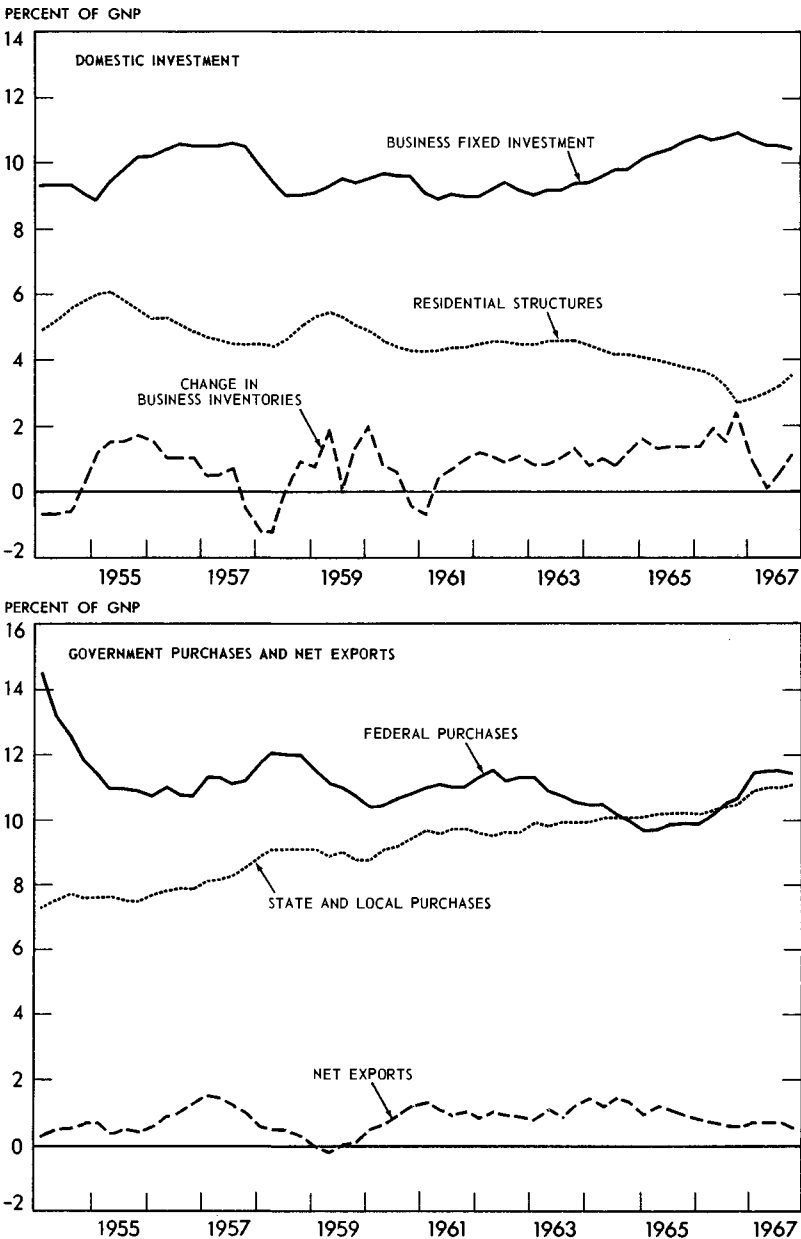
Residential Construction

During the period 1961-65, expenditures on residential construction activity averaged 4.3 percent of GNP, and private nonfarm housing starts averaged just under 1.5 million units a year. As a result of monetary tightness, homebuilding declined sharply during 1966, with housing starts falling to an annual rate of 0.9 million units in December. Residential construction expenditures fell from 3.7 percent of GNP in the first quarter to a low of 2.7 percent in the fourth quarter.

The year 1967 witnessed a steady and spectacular recovery in residential construction, reflecting renewed availability of mortgage financing and strong underlying demand. By the fourth quarter, the share of homebuilding in GNP had increased to 3.5 percent.

Chart 2

Selected Shares of Gross National Product



NOTE.—BASED ON SEASONALLY ADJUSTED DATA.
SOURCE: DEPARTMENT OF COMMERCE.

Net Exports

Exports of goods and services exceeded imports by an average of 1.1 percent of GNP during the 1961–65 period. Demands for imports rose sharply in 1966, and the share of net exports in GNP dropped to a low point of 0.6 percent in the fourth quarter of 1966. During the first three quarters of 1967, net exports recovered somewhat and averaged 0.7 percent of GNP. In the fourth quarter, however, a disturbing new decline in net exports was registered, as sluggishness of demand abroad held U.S. export sales on a plateau, while the economic rebound at home generated a renewed growth of imports.

GOVERNMENT

Purchases of goods and services by State and local governments have risen steadily and rapidly during the post-Korean period, supported in part by the strong expansion of Federal grants-in-aid. State and local purchases amounted to 7.5 percent of GNP in 1954, advanced to 9.7 percent in 1961, increased further to 10.4 percent in 1966, and reached 11.1 percent of GNP in the fourth quarter of 1967. The total growth of State and local purchases has been fairly steady. But employment has accelerated in recent years, with increases of nearly 600,000 workers in both 1966 and 1967. State and local payrolls absorbed about two-fifths of the growth in the total civilian labor force in these two years.

Federal purchases of goods and services have shown much more erratic movements, reflecting marked shifts in defense requirements. As a share of GNP, they reached a post-Korean low of 9.7 percent in the second quarter of 1965, but have been rising since then because of the conflict in Vietnam. Still, by standards of earlier years, Federal purchases as a share of GNP are currently not particularly high. In the fourth quarter of 1967, they amounted to 11.4 percent of GNP, not much different from the 11.1 percent average share in 1955–61 and far below the 15.7 percent share at the close of the Korean war.

PERSONAL SAVING

Beginning in the fourth quarter of 1966 and persisting throughout 1967, individuals have been saving an especially large share of their after-tax incomes, and thus have been spending a reduced share on consumer goods and services. At current income levels, an increase of 1 percentage point in the saving rate corresponds to a \$5½ billion reduction in consumer spending. The ratio of personal saving to disposable personal income was 7.1 percent in 1967. Table 2 shows that this is unusually high by standards of recent years, although not in comparison with 1956–58. In the analysis of current data, it must be recognized that revisions in the national accounts have, at times in the past, markedly changed the initial estimates of the saving rate. But other statistical evidence also suggests that saving in 1967 was much higher than in previous years.

TABLE 2.—*Disposition of disposable personal income in selected periods, 1956–67*

[Percent]

| Category | 1956–58 average | 1959–64 average | 1965 | 1966 | 1967 ¹ |
|---|--------------------|--------------------|-------|-------|-------------------|
| Disposable personal income..... | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Personal consumption expenditures..... | 91.1 | 92.2 | 91.7 | 91.6 | 90.3 |
| Durable goods..... | 12.8 | 13.0 | 14.0 | 13.8 | 13.2 |
| Autos and parts..... | 5.4 | 5.7 | 6.3 | 5.9 | 5.4 |
| Other durables..... | 7.3 | 7.3 | 7.6 | 8.0 | 7.9 |
| Nondurable goods..... | 44.0 | 42.3 | 40.5 | 40.8 | 39.9 |
| Food and beverages..... | 23.9 | 22.3 | 21.0 | 21.0 | 20.3 |
| Other nondurables..... | 20.1 | 19.9 | 19.5 | 19.8 | 19.6 |
| Services..... | 34.3 | 37.0 | 37.3 | 37.0 | 37.1 |
| Interest paid and transfer payments to foreigners..... | 2.1 | 2.3 | 2.5 | 2.6 | 2.6 |
| Saving..... | 6.9 | 5.5 | 5.8 | 5.9 | 7.1 |

¹ Preliminary.

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

Sources: Department of Commerce and Council of Economic Advisers.

A significant part of the rise in the saving rate in 1967 may be attributable to a decline in the proportion of disposable income spent on automobiles from an average of 6.0 percent in 1963–66 to 5.4 percent in 1967. The proportion in 1963–66 seems unusually high, and the decline in 1967 may be partly the backwash of that earlier experience. Moreover, it is quite normal in light of past performance for a decline in the share of income spent on autos to be associated with a rise in the saving rate.

A variety of other factors, many of them short run in character, may also have influenced saving. The recent increase in the saving rate may have been caused, in part, by the Medicare program introduced in mid-1966. This program contributed \$4 billion to disposable income in 1967. Some part of these benefits must have covered health care which otherwise would have drawn down personal saving.

Developments in financial markets may also have affected saving. During 1966 households bought large amounts of bonds; as a result, the growth in their holdings of liquid assets—such as currency, demand deposits and saving deposits—was curtailed. During the course of 1967, however, consumers rebuilt their liquidity at a rapid rate. To a degree, this was accomplished by a shift in the composition of financial assets away from less liquid types of securities, but in part the additional liquidity may have been accumulated through increased saving.

Some economists have also suggested that consumer saving is likely to be unusually high in the period immediately following an acceleration of prices. They cite 1948, 1951, and 1952 as precedents.

While few of these factors would imply a permanently higher saving rate, past evidence indicates that a reversion to a more normal rate is most likely to occur gradually rather than abruptly.

BALANCE OF SAVING AND INVESTMENT

The shift in saving and investment demands in 1967 can also be viewed in terms of the balance of total investment and saving in the aggregate economy.

The difference between gross private investment and gross private saving is, in principle, always matched by the surplus or deficit of Federal, State and local governments. In fact, a statistical discrepancy generally creeps into the measurement of these flows and prevents complete realization of the definitional equality (Table 3).

In 1966, despite its unbalanced composition, gross private investment amounted to 16.2 percent of GNP, a quite typical share for a full employment year. It exceeded the total saving of individuals and corporations by a small margin. This small excess of private investment over private saving was essentially matched by the moderate surplus of State and local governments. Federal receipts, meanwhile, virtually equalled expenditures; thus the Federal Government neither drew down nor added to total national saving.

TABLE 3.—*Gross saving and investment in selected years of relatively high employment, 1952–67*

| Source or use of saving | Percent of gross national product | | | | |
|---|-----------------------------------|------|------|------|-------------------|
| | 1952 | 1956 | 1965 | 1966 | 1967 ¹ |
| Private sector: | | | | | |
| Gross investment..... | 14.9 | 17.1 | 16.3 | 16.2 | 14.5 |
| Business fixed investment..... | 9.1 | 10.4 | 10.4 | 10.8 | 10.5 |
| Residential structures..... | 5.0 | 5.2 | 3.9 | 3.3 | 3.1 |
| Change in business inventories..... | .9 | 1.1 | 1.4 | 1.8 | .6 |
| Net foreign investment..... | —1 | .4 | .6 | .3 | .3 |
| Gross saving..... | 15.4 | 16.2 | 16.2 | 16.1 | 16.5 |
| Personal saving..... | 5.2 | 4.9 | 4.0 | 4.0 | 4.9 |
| Gross business saving..... | 10.2 | 11.3 | 12.2 | 12.1 | 11.5 |
| Excess of private saving or investment (—)..... | .5 | —9 | —1 | —1 | 1.9 |
| Government sector: | | | | | |
| Federal surplus or deficit (—)..... | —1.1 | 1.4 | .2 | (?) | —1.6 |
| State and local surplus or deficit (—)..... | (?) | —2 | .2 | .4 | (?) |
| Government surplus or deficit (—)..... | —1.1 | 1.2 | .4 | .4 | —1.6 |
| Statistical discrepancy..... | .6 | —3 | —3 | —3 | —3 |

¹ Preliminary.

² Less than 0.05 percent.

³ Less than —0.05 percent.

Sources: Department of Commerce and Council of Economic Advisers.

For the year 1967, however, gross private investment amounted to an unusually low 14.5 percent of GNP. Inventory accumulation, residential building, and net foreign investment were all below their average shares of recent years. Meanwhile, personal saving was unusually large as a share of GNP. While a drop in the share of gross business saving provided a partial offset, total private saving as a share of GNP still rose in 1967. The resulting large excess of private saving over private investment implied a comparable major swing toward deficits in the Government sectors. The surplus of State and local governments vanished, and the Federal sector recorded a deficit amounting to 1.6 percent of GNP.

The expansionary fiscal position helped to offset the weakness of private demand and thus to maintain the economy at essentially full employment. If fiscal and monetary policies had been less expansionary, the sag in private demand would have lowered output, employment, and incomes; saving and investment would then have come into balance at lower levels of economic activity.

As the 1967 experience demonstrates, under conditions of unusual weakness in private demand, a large Federal deficit at full employment can help to sustain total demand at an appropriate level. Table 3 also contains the data for 1952, which was similar to 1967 in this respect. But, under conditions of strong private demand, a similarly expansionary budget would be inappropriate, causing inflationary pressures and requiring monetary restraint to curb investment demand. Some of the major factors operating to produce the excess of private saving in 1967 were clearly temporary; these included the inventory overhang at the beginning of the year and the lingering impact of tight money on residential construction. The relative weakness of private demand in the first half of 1967 gave way to growing strength in the latter part of the year, and this is continuing into 1968.

RESOURCE USE IN 1967

Although real GNP increased only 2½ percent from 1966 to 1967, the average unemployment rate did not rise. The growth of the economy's supply capabilities generally allows output to increase about 4 percent per year with constant utilization rates. A growth of actual output much below that rate would normally be expected to be accompanied by a rise in the unemployment rate. But this did not occur last year.

Much of the production slowdown early in the year was reflected in a decline of average hours worked per man rather than in a reduction of employment. For 1967 as a whole, average hours worked per man in private nonfarm employment were 1.3 percent below the high level of 1966. Firms correctly viewed the slowdown as temporary and they were reluctant to release the skilled labor which had been so difficult to find in 1966.

For the private economy, man-hour productivity appears to have risen only 1.4 percent in 1967. A decline in utilization rates normally holds down the growth of productivity. Moreover, business firms were apparently still mak-

ing up shortages of professional and managerial workers. For example, employment of nonproduction workers in manufacturing grew 1.7 percent in the first half of the year when output was falling.

Labor Force

The unemployment rate for 1967 as a whole was held down by the shortened workweek and the slowdown in the rate of productivity growth, even though the growth of the labor force exceeded normal demographic trends by a wide margin.

From the fourth quarter of 1966 to the second quarter of 1967, there was a moderate decline in the number of women in the labor force and the total civilian labor force grew only slightly. As the pace of economic expansion quickened in the second half, an unusually large number of women entered the labor force and the expansion of adult female employment accounted for over 80 percent of the increase in total civilian employment. This parallel movement of labor force participation and employment is the chief reason why the unemployment rate did not rise significantly in the first half nor decrease notably in the second half.

It should be noted that the unemployment data for 1967 are difficult to interpret and to compare with former years because of the introduction of an improved questionnaire in the monthly survey of employment. There is some evidence that the new procedures may result in a measured unemployment rate slightly below that yielded by the old questionnaire. Thus it is possible that, on a strictly comparable basis, unemployment would have registered an increase of about 0.1 percent of the labor force from 1966 to 1967.

As shown in Table 4, there were only small changes in the demographic and occupational patterns of unemployment rates in 1967. The unemployment rate of nonwhite men continued the steady decline that has taken place since 1961—although the rate is still more than twice that for white men. The unemployment rate increased somewhat for adult females, both white and nonwhite. It also rose further for nonwhite teenagers, the only group that has not experienced a significant decline in unemployment since 1961.

The burden of unemployment remains rather heavily concentrated among nonwhites, who represent 21 percent of the unemployed, but only 11 percent of the employed. Many of these workers suffer particularly from discrimination, lack of education, and inadequate skills and experience. Much of the unemployment in other groups stems from short layoffs, voluntary quits, and—particularly in the case of women and teenagers—from frequent temporary movements into the labor force.

Many workers did have difficulty in finding jobs in 1967, but many employers were still having recruiting problems, even though the labor market was less strained than in 1966. While there was room for an increase in the workweek at the end of the year, labor markets were not generally characterized by excess supplies of labor.

TABLE 4.—*Employment and unemployment by demographic and occupational groups, selected years, 1961–67*

| Group | Unemployment rate (percent) ¹ | | | | Percentage distribution of employment status, 1967 | |
|---------------------------|--|------|------|------|--|---------------------------|
| | 1961 | 1965 | 1966 | 1967 | Employment | Unemployment ² |
| Total..... | 6.7 | 4.5 | 3.8 | 3.8 | 100.0 | 100.0 |
| Demographic groups: | | | | | | |
| White..... | 6.0 | 4.1 | 3.3 | 3.4 | 89.2 | 78.6 |
| Teenagers..... | 15.3 | 13.4 | 11.2 | 11.0 | 6.9 | 21.3 |
| Adult males..... | 5.1 | 2.9 | 2.2 | 2.1 | 53.8 | 29.1 |
| Adult females..... | 5.7 | 4.0 | 3.3 | 3.8 | 28.6 | 28.1 |
| Nonwhite..... | 12.4 | 8.1 | 7.3 | 7.4 | 10.8 | 21.4 |
| Teenagers..... | 27.6 | 26.2 | 25.4 | 26.4 | .8 | 6.9 |
| Adult males..... | 11.7 | 6.0 | 4.9 | 4.3 | 5.8 | 6.5 |
| Adult females..... | 10.6 | 7.5 | 6.6 | 7.1 | 4.2 | 8.1 |
| Occupational groups: | | | | | | |
| White collar workers..... | 3.3 | 2.3 | 2.0 | 2.2 | 46.0 | 29.6 |
| Blue collar workers..... | 9.2 | 5.3 | 4.2 | 4.4 | 36.7 | 49.8 |
| Service workers..... | 7.2 | 5.3 | 4.6 | 4.5 | 12.5 | 17.3 |
| Farm workers..... | 2.8 | 2.6 | 2.2 | 2.3 | 4.8 | 3.3 |

¹ Number unemployed in each group as percent of labor force for the group.

² Distribution by occupational groups relates to experienced workers.

Note.—Data relate to persons 16 years of age and over.

Detail will not necessarily add to totals because of rounding.

Source: Department of Labor.

Capacity Utilization

In contrast with employment of manpower, plant and equipment utilization in manufacturing was markedly reduced in 1967 from the strained conditions of 1966. Average operating rates fell from more than 90 percent in 1966 to 85 percent in 1967, as manufacturing capacity grew by 6½ percent while output barely increased for the year as a whole. The decline in utilization was limited to the first half of 1967—except in the case of the automobile industry where output was heavily affected by strikes. From June to December, total manufacturing production increased at an annual rate of 8½ percent, outpacing the growth of capacity; at yearend, operating rates were rising in most manufacturing sectors.

PROSPECTS AND POLICIES FOR 1968

At the end of 1967, the economy was in a strong position to move into its eighth year of uninterrupted expansion. As noted above, the composition of demand is now fairly well balanced with that of supply.

Because some slack developed during 1967, real GNP can rise in 1968 by somewhat more than 4 percent without straining resources. But a growth of demand much above that rate would tend to accelerate the increase of wages and prices. An excessive rate of growth of demand could also upset

the balance among the sectors of the economy by generating a surge of business investment, and ultimately placing renewed pressures on the capital goods industries. The financial conditions which would inevitably be associated with such developments would again severely depress homebuilding. And a new wave of imports would impair the needed improvement in the U.S. balance of payments.

In 1968, the main objectives of fiscal and monetary policy are to sustain economic expansion, to maintain reasonable balance between demand and resources in the economy as a whole and among its major sectors, to promote a return toward over-all price stability, and to support progress toward balance-of-payments equilibrium.

FEDERAL FISCAL PROGRAM

Federal expenditures in 1968 are expected to rise by about \$15 billion, considerably less than the \$21 billion increase of last year. Defense purchases, including military pay increases, are scheduled to rise only \$4 billion as compared with \$12 billion in 1967. The remaining increases in expenditures cover requirements under existing law and provide for high priority civilian programs. Nondefense purchases, also including pay increases, will rise \$2 billion. Medicaid, manpower training, and housing and community development programs will add to the total of grants-in-aid in 1968.

A scheduled increase in social security benefits in March will add \$3 billion to transfer payments for the year 1968. This increase will be offset, in large part, by a \$2 billion rise in payroll taxes, which became effective January 1. Reflecting continued growth of Medicare health benefits and ongoing retirement pensions as well as the new social security programs, total transfers to persons should rise \$5 billion.

Excluding the scheduled changes in social security benefits, the remaining expected increase in Federal expenditures is approximately equal to the normal annual growth of Federal revenues at existing tax rates. Thus, in the absence of tax rate increases, the Federal deficit would change little from its estimated level of \$12½ billion for 1967. It would remain overly expansionary in relation to the expected growth of private demand.

Accordingly, the President has again asked Congress to enact a temporary 10-percent surcharge on personal and corporate income taxes, effective April 1 for individuals and January 1 for corporations. The proposed surcharge will yield an estimated \$8 billion of additional revenues in 1968. The President is also recommending the retention of certain excise taxes, now scheduled to expire in April, in order to avoid a revenue loss of nearly \$2 billion in 1968. With the President's tax program, the Federal deficit will be reduced to an estimated \$5 billion for the calendar year. Thus the proposed tax changes will eliminate much of the expansionary thrust of the Federal budget as private demand continues to grow. The President's tax proposals are discussed in detail in Chapter 2.

ECONOMIC OUTLOOK

Assuming enactment of the President's fiscal program early in the current legislative session, GNP for 1968 is expected to approximate \$846 billion—given the \$785 billion now estimated for 1967. This projection, of course, is intended to represent the midpoint of a range of possible outcomes, rather than a precise estimate. After correction for an anticipated over-all price increase somewhat in excess of 3 percent, the midpoint estimate would imply an increase of somewhat more than 4 percent in real GNP. With this output increase and an expected growth of $1\frac{3}{4}$ percent in the civilian labor force, the unemployment rate for the year as a whole should be essentially unchanged from its current level.

Just as it was evident a year ago that 1967 had inherited a slow start from the conditions which prevailed at the end of 1966, it is equally clear now that 1968 has inherited a running start from the economic conditions of the closing months of 1967. Automobile production schedules for the beginning of 1968 are exceptionally large. The latest surveys of business plans for plant and equipment and the recent strength of new orders for machinery and equipment both point to an advance in business investment in the first half. There is also evidence that a buildup of steel inventories has already begun in anticipation of labor negotiations. Most of the catchup in automobile production is expected to be concentrated in the first quarter and the steel stockpiling in the first half.

Although the rate of advance may be excessive in the early part of 1968, prompt enactment of the President's tax proposals will insure moderate and appropriate expansion after midyear.

When the prospective pattern of economic activity is uneven, forecasting involves special uncertainties. One year ago, the Council foresaw an uneven pattern of activity for 1967, with an advance of \$47 billion in GNP for the year as a whole. The actual gain was \$5 billion smaller. Nevertheless, the Council did project a slowdown in the first half, followed by a marked rebound in the second. Developments during the year generally corresponded to this pattern.

The ability of economists to forecast is far from perfect, but a projection carefully distilled from the available evidence is indispensable in the formulation of economic policy.

OUTLOOK BY SECTORS

The over-all outlook can be better understood by examining the major expenditure categories.

Business Fixed Investment

The recovery of business fixed investment which seems to have begun late in 1967 is likely to continue at a moderate rate throughout 1968. In the

most recent Commerce-SEC investment survey—the results of which are in substantial agreement with other yearend surveys—business firms in utilities, airlines, and a few manufacturing sectors including nonelectrical machinery reported plans for considerable increases in investment in the first half of 1968. Responding to some improvement in operating rates and profits in the first part of the year, other manufacturing industries—currently planning little change in outlays for the first half of 1968—may be expected to raise their investment outlays later in the year. For the year as a whole, the gain over 1967 is expected to be about \$4 or \$5 billion.

Business Inventories

For 1967 as a whole, inventory accumulation is estimated at only \$5 billion. Inventory accumulation in the first half of 1968—spurred by the rebuilding of automobile stocks and forward buying of steel inventories—might run at twice the 1967 rate. The accumulation rate should be approximately normal in the second half of 1968, so that, for the year as a whole, the net addition to stocks is expected to total several billion dollars above that of 1967.

Homebuilding

Provided the tax increase is enacted early in 1968, the relief of pressures on financial markets should be sufficient to permit continued growth in residential building. Private nonfarm housing starts in 1968 are expected to exceed 1½ million for the first time since 1964—a substantial increase over 1967, though still below the basic demand of our expanding population. Expenditures on homebuilding and modernization of existing residences should rise through the year, and, for 1968 as a whole, exceed 1967 outlays by \$5 to \$6 billion.

The events of 1967 have shown quite clearly that housing demand is strong enough to support a high and rising level of building even when mortgage interest rates are high—provided funds are available at thrift institutions. Over the past 12 to 15 months, the monetary authorities—as explained in Chapter 2—have been especially mindful of the need to provide financial support for building activity. If they are able to maintain this course, residential building will continue to be an important stimulus to general economic expansion while providing the improved housing capacity needed in many areas of the country.

Government

Purchases of goods and services by State and local governments should rise by \$8 or \$9 billion in 1968. Here, too, part of the expected growth is dependent on the existence of financial conditions that will permit State and local governments to carry out planned construction projects.

For the year as a whole, Federal purchases are expected to rise by \$6 billion. The quarterly pattern of advance during the year is expected to

be fairly smooth, except that the third quarter rate will be enlarged by a Federal pay increase estimated at \$1½ billion (annual rate). The timing of this bulge should serve to offset some of the effect on aggregate demand of the reduction in inventory accumulation expected in the second half of the year.

Consumption

An expected gain of about \$35 billion in disposable income—consumer income after tax *and surtax*—should promote a sizable advance in consumer spending. Recent increases in consumer liquidity should reinforce the gains in income. Expenditures on household durables should receive particular support from the continued high level of homebuilding. Another contributing element is the prospective catchup in automobile sales.

For 1968, the consumer sector is clearly an area of particular uncertainty in forecasting private demand. As noted above, the saving rate has been unusually high for the past five quarters. And the latest evidence indicates that consumers are still spending cautiously. Nevertheless, the weight of past evidence would suggest that, following a period of abnormally high saving, the most likely possibility is a gradual decline in the saving rate.

The saving rate implicit in the projection of an \$846 billion GNP is only slightly below the 7.1 percent rate of 1967. The automobile catchup essentially accounts for the small projected decline. On this basis, consumer spending is expected to rise about \$33 billion in 1968.

With the prompt enactment of the President's tax proposals, the prospects outlined above suggest that, while price increases will continue to be troublesome, the U.S. economy should experience healthy and balanced economic growth in 1968.

Chapter 2

The Strategy of Stabilization Policy

THE EMPLOYMENT ACT of 1946 charged the Federal Government with the responsibility to promote “maximum employment, production, and purchasing power.” Active pursuit of these goals through the use of discretionary economic policy over the past seven years has led to new standards of economic performance. This chapter deals with some of the lessons of recent economic experience as they apply to the current and foreseeable problems facing the economy.

SEVEN YEARS OF ECONOMIC EXPANSION

Since February 1961 the United States has experienced an unprecedented period of sustained economic expansion. This long uninterrupted advance represents a marked contrast with our historical pattern of ups and downs. During the years from 1854—when the relevant economic records begin—to 1960, there were 26 periods of expansion, averaging $2\frac{1}{2}$ years in length. Each terminated with a relapse into recession or depression. The longest previous advance was the 80-month expansion that accompanied World War II; and the next longest was the anemic 50-month recovery from the Great Depression.

MEASURES OF GAINS

The present prosperity has been outstanding in strength as well as in length (Table 5). Over nearly seven years of expansion, gross national product (GNP), measured in constant prices, increased 41 percent, an average of 5.2 percent a year. The addition of \$231 billion (in 1967 prices) was greater than the entire real output of the Nation only 30 years ago. All major expenditure components shared in the increase, with the most marked advance occurring in business fixed investment.

Over the $6\frac{3}{4}$ -year period, real disposable income per capita—the after-tax spendable income of the average American, corrected for price changes—rose 29 percent, a greater gain than that of the preceding 18 years. Civilian employment increased by 9.4 million jobs. These employment gains outpaced the growth of the labor force and permitted unemployment rates to decline for all major groups of workers.

TABLE 5.—*Measures of economic activity during the current expansion*

| Series | Unit or base | Amount | | Percentage change ¹ | |
|---|--|--------|----------------------|--------------------------------|----------|
| | | 1961 I | 1967 IV ¹ | Total | Per year |
| Production: | | | | | |
| Gross national product..... | Billions of dollars, 1958 prices ² .. | 482.6 | 679.4 | 40.8 | 5.2 |
| Personal consumption expenditures..... | do..... | 316.2 | 433.2 | 37.0 | 4.8 |
| Business fixed investment..... | do..... | 44.9 | 73.2 | 63.0 | 7.5 |
| Residential structures..... | do..... | 20.9 | 21.3 | 1.9 | .3 |
| Government purchases..... | do..... | 97.6 | 140.4 | 43.9 | 5.5 |
| Federal..... | do..... | 52.2 | 74.4 | 42.5 | 5.4 |
| State and local..... | do..... | 45.4 | 66.0 | 45.4 | 5.7 |
| Industrial production..... | 1957-59=100..... | 103.7 | 159.2 | 53.5 | 6.6 |
| Income: | | | | | |
| Disposable personal income..... | Billions of dollars, 1958 prices ² .. | 341.8 | 481.8 | 41.0 | 5.2 |
| Corporate profits after tax..... | Billions of dollars ² .. | 24.4 | 47.1 | 93.0 | 10.6 |
| Per capita disposable personal income..... | Dollars, 1958 prices ² .. | 1,871 | 2,409 | 28.8 | 3.8 |
| Employment: | | | | | |
| Civilian employment..... | Millions of persons..... | 65.7 | 75.1 | 14.3 | 2.0 |
| Nonagricultural payroll employment..... | do..... | 53.5 | 66.8 | 24.9 | 3.3 |
| Unemployment rate: Total..... | Percent ⁴ | 6.8 | 4.0 | ----- | ----- |
| Males 20 years and over..... | do..... | 5.9 | 2.4 | ----- | ----- |
| Teenagers..... | do..... | 17.2 | 14.0 | ----- | ----- |
| Nonwhite..... | do..... | 12.4 | 7.6 | ----- | ----- |
| Prices: | | | | | |
| Gross national product deflator..... | 1958=100..... | 104.3 | 118.9 | 14.0 | 2.0 |
| Personal consumption expenditures deflator..... | do..... | 103.8 | 115.7 | 11.5 | 1.6 |
| Wholesale prices..... | 1957-59=100..... | 101.0 | 106.4 | 5.3 | .8 |
| Consumer prices..... | do..... | 103.9 | 117.8 | 13.4 | 1.9 |

¹ Preliminary.² Annual rates.³ 1967 IV not available; 1967 III used.⁴ Percent of civilian labor force in each group unemployed.

Note.—All data seasonally adjusted except wholesale and consumer prices.

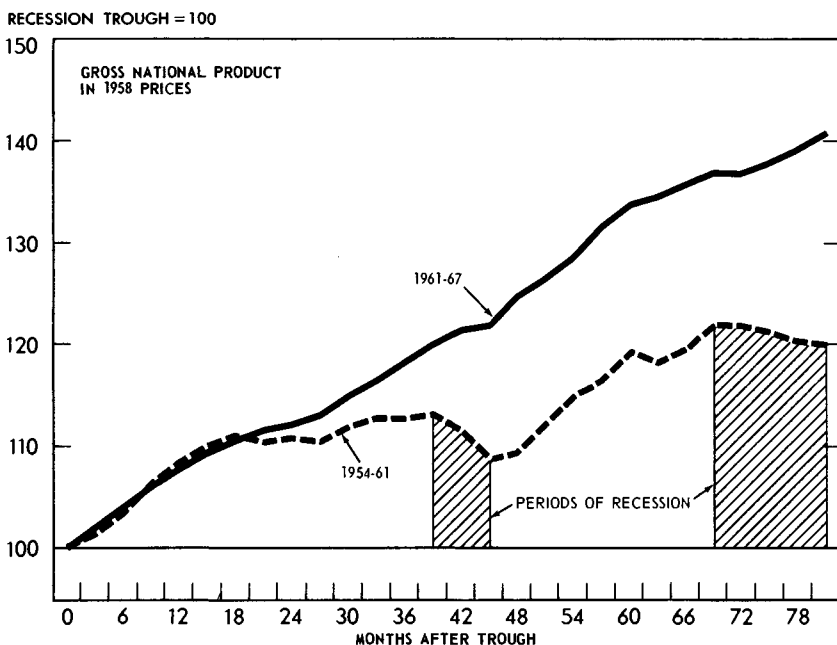
Sources: Department of Commerce, Department of Labor, and Council of Economic Advisers.

The price performance for much of the period was outstanding, although the record of the past two years is blemished. For the period as a whole, the over-all GNP price deflator rose 2.0 percent a year, the consumer price index increased at an average yearly rate of 1.9 percent, and wholesale prices rose at an annual rate of only 0.8 percent. During the preceding seven years of slow growth and intermittent recession, the annual rates of increase had been: 2.2 percent for the GNP deflator, 1.5 percent for consumer prices, and 1.2 percent for wholesale prices.

The steady and sustained growth since early 1961 contrasts sharply with the record of the preceding seven years. Chart 3 shows the path of real GNP in the current expansion in comparison with the cyclical path following the recession trough in 1954. If our real GNP in 1961-67 had plodded and bumped along as it did in the earlier period, it would have reached \$688 billion at the end of 1967 (in end-of-1967 prices). In fact, the actual per-

Chart 3

Real Gross National Product After the Recession Troughs of 1954 and 1961



NOTE.—BASED ON SEASONALLY ADJUSTED QUARTERLY DATA.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

formance of the economy topped this by \$120 billion—a difference larger than the current total of Federal purchases of goods and services.

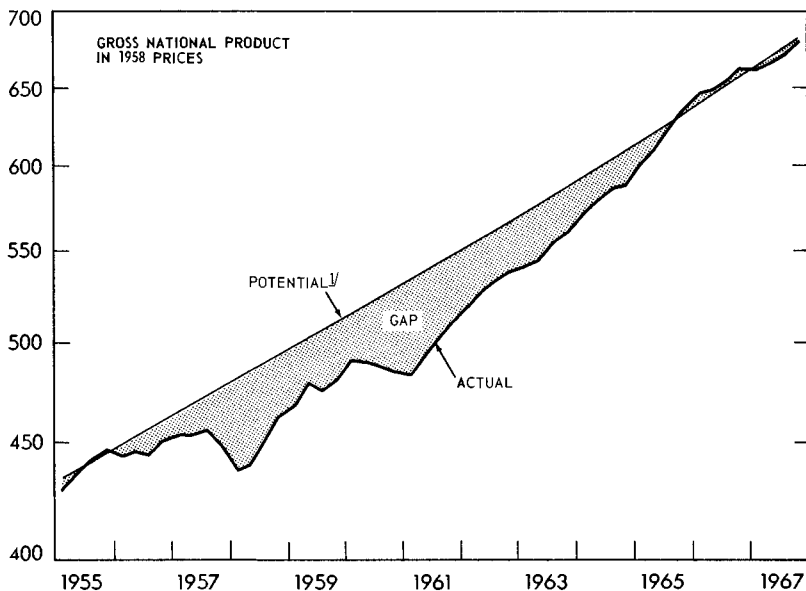
REALIZATION OF POTENTIAL

The large recent gains in output reflect the fact that over-all demand has caught up and kept up with the economy's rising productive capacity. In the late 1950's and early 1960's, the Nation was sacrificing the opportunity to consume and invest a substantial amount of the output it was capable of producing (Chart 4). Potentially productive men and machines were idle because of inadequate demand for their services. At the recession trough in the first quarter of 1961, actual GNP was \$50 billion (1958 prices) below the estimated potential output of the economy at a 4-percent unemployment rate. This "gap" was gradually reduced and finally closed in the last half of 1965. Since then, actual GNP has fluctuated in a relatively narrow range around its growing potential—exceeding it somewhat in the boom of 1966 and falling a little short during 1967.

Chart 4

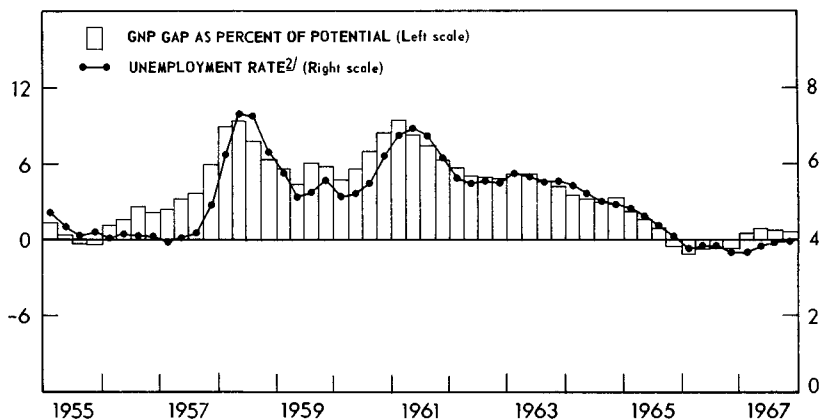
Gross National Product, Actual and Potential, and Unemployment Rate

BILLIONS OF DOLLARS* (ratio scale)



PERCENT

PERCENT



*SEASONALLY ADJUSTED ANNUAL RATES.

^{1/}TREND LINE OF 3½% THROUGH MIDDLE OF 1955 TO 1962 IV, 3¼% FROM 1962 IV TO 1965 IV, AND 4% FROM 1965 IV TO 1967 IV.

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

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

The Nation's potential output has grown by an estimated 28 percent since early 1961. The rate of increase is currently about 4 percent a year, reflecting a $1\frac{1}{2}$ -percent rise in available man-hours and a $2\frac{1}{2}$ -percent rate of increase in output per man-hour.

Available man-hours grow slightly less rapidly than the labor force. The recent normal growth trend of the labor force is about $1\frac{3}{4}$ percent a year. This is rapid by previous standards and reflects the high birth rates of the immediate postwar years. Under steady employment conditions, however, longer vacations, shorter workweeks, and an increasing employment of part-time workers—mostly women—lead to a decline of about $\frac{1}{4}$ percent in average hours worked per year. This holds the trend of growth in total man-hours to about $1\frac{1}{2}$ percent a year.

As a result of a more skilled and better trained labor force, improved management and technology, and the enlarged quantity and higher quality of the capital stock, the Nation experiences growing productivity—as measured by output per man-hour. In the postwar era, the trend in the growth of productivity in the private economy has been somewhat over 3 percent a year. However, improvements in the efficiency of Government workers are not statistically measured, and are arbitrarily taken at zero. Therefore, the trend rate of increase in output per man-hour for the total economy—private and public—is just over $2\frac{1}{2}$ percent a year. The growth rate of potential output is therefore about 4 percent a year currently. It exceeds the $3\frac{1}{2}$ -percent rate estimated for the late 1950's and early 1960's primarily because the growth of the labor force has accelerated.

The vigorous advance of aggregate demand in recent years has assured that the economy's great and growing productive potential has been generally realized in actual output and not squandered in idleness.

FISCAL POLICY IN THE 1960'S

The improved and fuller use of our productive capabilities in the 1960's has been significantly influenced by fiscal and monetary policy. It is no accident that this most successful period of sustained growth in our economic history has coincided with a new and determined commitment to apply economic policies in active pursuit of the goals of the Employment Act.

The balanced expansion of 1961–65 was strongly supported by stimulative fiscal measures. Federal tax liabilities were lowered through depreciation reform, the investment tax credit, a sharp reduction in personal and corporate tax rates, and the reduction or elimination of many Federal excise taxes. Increases in expenditures during the period provided for the introduction and expansion of high priority social programs and, in 1961–62, for stepped-up defense needs.

As discussed in detail below, monetary policy played a vital role during this period in insuring that the growing credit needs of the expanding economy were adequately met.

The rapid expansion of spending for the Vietnam conflict threw the economy off stride after mid-1965. But the economic strains inherent in the defense buildup were moderated by adjustments in policy. In particular, monetary policy played a much more active role in 1966 and 1967 than in the preceding period.

A review of fiscal policy prior to the 1960's is helpful in understanding the more recent developments.

THE HERITAGE OF CURRENT FISCAL POLICY

The conscious use of Federal tax and expenditure policy to help promote high employment and healthy growth dates back at least to the 1930's. Since World War II, fiscal policy has contributed to the improved record of economic stability both through the greater importance of automatic stabilizers and the growing use of discretionary policies.

Automatic Stabilizers

Several features of the postwar budgetary system have helped to increase economic stability passively and automatically. Because the Federal tax system relies heavily on personal and corporate income taxes, tax liabilities increase or decrease along with economic activity. A decline in activity reduces incomes, which, in turn, automatically results in reduced tax receipts even if tax rates are not changed. The fall in after-tax spendable incomes of individuals and corporations is thus cushioned by the amount of the decline in tax revenues. As a result, secondary reductions in spending are smaller than they would otherwise have been, and the ultimate decline in output and incomes is more limited. The same kind of stabilizing effect occurs, to a degree, in Federal expenditures, because certain outlays—especially unemployment benefits and welfare payments—automatically increase in a period of contracting economic activity and thus support consumer spending.

When economic activity rises, these same stabilizers work in the opposite direction. Every rise in income leads to higher tax collections which—given the level of Federal expenditures—restrict further increases in private spending. To the extent that the rise in private incomes reduces Federal outlays for unemployment benefits and welfare payments, the dampening effect is further strengthened.

Automatic fiscal stabilizers are more important now than they were before World War II. Over much of the postwar period, they have been the primary reliance of stabilization policy. To a large extent, the increased strength of the stabilizers simply reflects the higher tax rates in the postwar period, accompanying the greater importance of defense spending and the enlarged civilian responsibilities of the Federal Government. The automatic stabilizers were also made more powerful as a result of structural changes, such as the introduction of unemployment insurance and the greater reliance on progressive income taxes—receipts from which

fluctuate proportionately more in response to income changes than those from other taxes.

The frequency of recessions from 1948 to 1961 was not notably reduced from earlier times, which is not surprising. Automatic stabilizers cannot prevent a decline; they merely help to limit one once it starts. But the automatic stabilizers have helped to make postwar recessions brief and relatively mild. The workings of the automatic stabilizers created substantial Federal deficits in each postwar recession, which were accepted by each Administration as a beneficial stabilizing influence.

Discretionary Policies

Discretionary fiscal actions were also used at times to stimulate the economy during recession periods and early stages of recovery. Certain tax rates were allowed to fall as scheduled at the start of 1954, in full recognition that this would further unbalance the Federal budget. Increases in Federal expenditures helped to insure and accelerate recovery in 1958. Although these actions were taken considerably after the onset of recession, they played a constructive role in strengthening recovery.

In one major instance, discretionary fiscal actions also were taken to curb inflationary pressures of excess demand. Three separate legislative actions to raise corporate and individual tax rates in 1950-51 helped to restrain a booming Korean defense economy. Civilian budgetary expenditures were also substantially trimmed. Although most support for these actions reflected the traditional view that more money was needed simply to "pay for the war," there were many—both within and outside the Government—who understood fully the role of fiscal policy in stabilizing the economy.

The discretionary actions that were taken during the decade of the 1950's seem, in retrospect, to have worked in the right direction. The cases in which fiscal policy seems to have gone astray involve errors of omission rather than commission.

A particularly instructive case was the reliance on automatic stabilizers during the upswing from 1958 to 1960. When the economy is in an inflationary surge, restraint from the automatic stabilizers is a welcome force. Under some circumstances, however, the expansion of tax revenues that accompanies economic growth can exert an undesirable restraint. As the 1958-60 period illustrated, it can become a "fiscal drag" preventing the attainment or maintenance of high employment. Unless there is some combination of higher Federal expenditures and reduction in tax rates equivalent to the normal growth of revenues, the Federal budget becomes increasingly restrictive over time.

The possibility of reductions in tax rates was widely advocated and seriously discussed early in 1958, but no action was taken. Although expenditures rose sharply during the course of that year, they leveled off thereafter and showed no upward trend from the end of 1958 to mid-1960. Because Federal

expenditures stood still and tax rates were unchanged, the budget began to exert a significant fiscal drag. For a time, private demand strengthened enough to keep the economy advancing. But as private demand lost its vigor, the economy turned down in the spring of 1960, and the fourth postwar recession began.

BUDGETARY ACTIONS, 1961–65

When the Kennedy Administration took office, the 1960–61 recession had essentially run its course, cushioned by the automatic stabilizers and by a prompt shift to a strongly expansive monetary policy. But the Nation's output was far below its potential and the unemployment rate stood at 6.8 percent, close to a postwar record high.

The Federal sector was in deficit by $\$1\frac{1}{2}$ billion (annual rate) in the fourth quarter of 1960 on the national income account basis (which is the measure employed throughout this Report). At the same time, however, tax receipts were being held down by the major shortfall of incomes below the economy's potential. If, in fact, the economy had been operating at its potential, there would have been a Federal surplus of an estimated \$13 billion. This hypothetical measure of the "full-employment surplus" is abstract and imprecise, but it is a useful way of distinguishing between the passive operation of automatic stabilizers and discretionary shifts in the budget. If private demand weakens and the economy contracts, thereby lowering tax revenues, the actual Federal surplus will be substantially reduced (or deficit increased), even with no discretionary changes in expenditures or tax rates. But the full-employment surplus would not thereby be altered; it would continue to reflect what expenditures and tax yields would be at potential output levels. On the other hand, higher discretionary expenditures or a reduction in tax rates would be reflected in a lower full-employment surplus, as well as in an initial decline of the actual surplus.

The huge gap between actual and potential output early in 1961 was a clear signal that expansionary fiscal actions were needed. If the restraining impact of the large full-employment surplus continued, the economy's potential could be realized only through a compensating excess of private investment over private saving at potential output in an amount larger than 2 percent of GNP. That would have required extraordinary buoyancy of private demand, which did not appear to be present or forthcoming.

Expansionary Actions in 1961–62

Significant fiscal steps were taken in 1961 to stimulate the economy. A liberalization of social security benefits was accelerated and increases in public assistance were initiated. Advances in defense spending were required by growing international tensions, and these accomplished a part of the stimulative job which might otherwise have been carried out by tax cuts or strengthened civilian programs. The full-employment surplus was brought down to \$9 billion by the end of 1961. Meanwhile, the economy's early re-

covery from recession was strong and brisk, narrowing the gap between actual and potential output by some \$15 billion (1958 prices) from the first to the fourth quarter.

It was expected that this initial stimulus would touch off a strong and sustained rise in business spending. But after five years of experience with sluggish markets and excess capacity, businessmen were not prepared to raise plant and equipment spending far in advance of the growth of demand. The economy continued to advance but at a much slower pace; progress toward full employment was interrupted early in 1962. The gap between actual and potential output remained between \$25 and \$30 billion (1958 prices) and the unemployment rate hovered around 5½ percent.

Two key tax measures were adopted in 1962 to stimulate investment: depreciation rules were liberalized and an investment tax credit of 7 percent on machinery and equipment was enacted. These measures were designed for the long run and were not expected to yield large results immediately. The tax actions were combined with moderate further increases in Federal expenditures. Even so, the revenue growth of a normally expanding economy swung both the full-employment surplus and the actual deficit toward restraint in the second half of 1962.

Tax Reduction in 1964 and 1965

Against this background, President Kennedy announced in August of 1962 his intention to propose a major stimulative tax reduction, along with important tax reforms. The proposal was subsequently spelled out in the January 1963 Budget program. This was an unprecedented step; it initiated a major expansionary fiscal action at a time when the economy was neither in recession nor threatened by imminent recession, the Federal sector was in deficit, and Federal expenditures were continuing on an upward trend. The tax program was based on the diagnosis and forecast that a substantial further reduction in the Federal full-employment surplus was needed, given the state of private demand, to produce a sustained and balanced expansion of output up to the potential level.

The tax proposal was intensively debated in Congress, but action on it was not completed in 1963. Meanwhile, expenditures grew less rapidly than either the actual or potential advance of revenues and the budget became even more restrictive. The march toward full employment was resumed with the enactment in February of the Revenue Act of 1964—President Johnson's first major legislative achievement. Individuals received an average cut of one-fifth in their tax liabilities in two stages covering 1964 and 1965. The reduction for corporations was about one-tenth; combined with the earlier tax measures of 1962, corporate taxes were brought one-fifth below the level of 1961. When the cut in tax liabilities had become fully effective in 1965, it totaled \$15 billion. (By 1967 the annual saving to taxpayers due to the tax reductions in the 1964 act had grown to more than \$18 billion.)

The effects of the tax reduction on private demand were clear and dramatic. An upsurge in consumer spending indicated that most of the extra take-home pay resulting from tax reduction was being spent in the Nation's shops and markets. Responding to the vigor of consumer demand, business investment spending forged ahead. In late 1964 and early 1965 the unemployment rate dropped below 5 percent for an extended period for the first time in seven years. The estimated gap between actual and potential output was narrowed to \$11 billion (1958 prices) in the first half of 1965. The gains in income produced a huge rebound in Federal receipts, bringing the Federal sector into surplus in the first half of 1965.

New stimulative policies were prepared in the spring of 1965 in order to complete the advance to full employment. In line with the President's proposals, Congress enacted a major, phased reduction of excise taxes. The first stage took effect in June 1965, cutting taxes by \$1¾ billion (annual rate). A retroactive liberalization of social security benefits was enacted.

Summary

The over-all operation of fiscal policy from the end of 1960 to the middle of 1965 is summarized in Table 6. Expansionary fiscal actions over the period totaled \$38 billion—\$25½ billion through expenditure increases and \$12½ billion through net tax reductions. A gross total of \$15½ billion of tax cuts was offset in part by social security tax increases of \$3 billion.

If tax rates had remained unchanged, normal revenue growth (calculated at full employment) over the 4½-year period would have amounted to

TABLE 6.—*Federal fiscal actions in two periods since fourth quarter 1960*

[Billions of dollars, seasonally adjusted annual rates]

| Item | 1960 IV to 1965 II | 1965 II to 1967 IV ¹ |
|--|-----------------------|------------------------------------|
| Federal expenditure increases ² | 25.5 | 48.0 |
| Defense purchases..... | 3.5 | 25.0 |
| Other purchases..... | 7.5 | 1.5 |
| OASDHI ³ benefits..... | 5.0 | 10.0 |
| All other ^{2 4} | 9.5 | 11.5 |
| Federal tax reductions ⁵ | 12.5 | —6.0 |
| Corporate..... | 5.5 | |
| Personal..... | 8.5 | |
| OASDHI ³ payroll taxes..... | —3.0 | —8.5 |
| Indirect business..... | 1.5 | 2.5 |
| Total expansionary actions ⁶ | 38.0 | 42.0 |
| Normal revenue growth at full employment..... | 30.5 | 27.0 |
| Change in full employment surplus ⁷ | —7.5 | —15.0 |

¹ Preliminary.

² Includes adjustment in unemployment insurance benefits for change in unemployment rate.

³ Old-age, survivors, disability, and hospital and related insurance (OASDHI).

⁴ Consists of transfers other than OASDHI, grants, interest, and subsidies.

⁵ Minus sign indicates an increase in tax.

⁶ Sum of expenditure increases and tax reductions.

⁷ Normal revenue growth minus expansionary actions.

Sources: Department of Commerce and Council of Economic Advisers.

\$30½ billion. Because expansionary actions exceeded this “fiscal dividend,” the full-employment surplus was reduced by \$7½ billion. In contrast, the actual balance shifted from a fractional deficit to a surplus of nearly \$5 billion, reflecting the vigorous advance of private demand.

The precise movements of the budget during the 1961–65 period were not perfect in size or timing. But they clearly did the job of promoting orderly progress toward full employment without straining over-all productive capacity or creating serious bottlenecks.

CHALLENGES OF PROSPERITY

As of mid-1965, there was every reason to believe that the record of orderly progress could be extended. The expansion was characterized by remarkable balance in all sectors and strong forward momentum. The fiscal program and monetary policy that ruled at the time seemed appropriate to the economy’s needs. The main future task of budgetary policy appeared to be that of distributing the fiscal dividend—providing for expenditure increases and tax reductions that, in combination, approximately matched the economy’s normal revenue growth along a rising trend of full-employment GNP.

Nevertheless, the fuller use of resources posed new problems of diagnosis and policy application. Previously, the risks had been almost entirely on the side of insufficient demand; and the primary task of policy had been to provide stimulus. As the unemployment rate fell toward 4 percent, the economy entered territory that had been uninhabited for nearly a decade. There were now risks on both sides—not only of inadequate but of excessive stimulus.

No one could know precisely how fully resources might be used without unleashing inflationary forces. In 1961, the Council had set an interim target of a 4-percent unemployment rate, intending to review the possibility of adopting a more ambitious goal in light of the actual operation of the economy in the neighborhood of 4-percent unemployment.

In the period of slack, excess supply and unused productive capabilities created buyers’ markets. In such circumstances, the human costs of inadequate demand are very large while the risks of price inflation are likely to be small. As full utilization is attained, the pressures toward higher prices increase, as Chapter 3 indicates. And, if excess demand becomes widespread and sellers’ markets generally come to prevail, a wage-price spiral and accelerating inflation can result. Finding acceptable and feasible ways to reconcile high employment with reasonable price stability thus becomes a major challenge to policy in a prosperous economy.

In 1965, the Nation stood ready to face this welcome challenge. However, the task of stabilization was immensely complicated by the sharp increase in defense spending after mid-1965.

Defense and the Budget, 1965-67

A marked rise in defense spending inevitably creates problems for fiscal management, especially when the economy is close to full employment. The additional defense requirements since mid-1965 have absorbed about one-fourth of the Nation's growth in real output. Thus, the production available for private use has continued to rise. Yet the advance in defense spending has been sufficiently large to dominate the Federal Budget in this period. It accounts for the fact that we now face the need for tax increases rather than further opportunities for a welcome tax reduction.

From the middle of 1965 to the end of 1967, the increase in Federal expenditures was \$48 billion, as shown in Table 6. Some \$25 billion of this was for defense. Of the \$10 billion increase in OASDHI benefits, about \$6 billion represented the landmark social decision to provide improved health care for the aged under social security, and the balance represented normal growth in the ongoing programs. The \$10 billion increase in OASDHI benefits was more than covered by increased payroll taxes. Other nondefense expenditures increased by \$13 billion. Over the same period, normal growth of Federal revenues at full employment—at constant tax rates—amounted to about \$27 billion. In addition, there were net tax rate increases which added about \$6 billion to revenues.

All in all, with the large rise in defense outlays and the high priorities for certain public civilian programs, the \$48 billion increase in expenditures far outpaced the normal expansion of revenues plus the effect of tax rate increases. As a result, the Federal budget became very expansionary over these 2½ years, with a drop of \$15 billion in the full-employment surplus.

It should be noted that the advance of \$13 billion in nondefense expenditures other than for social insurance was only about half the normal growth of revenues other than from payroll taxes.

Fiscal Policy, 1966-67

A variety of policy measures—both fiscal and monetary—was adopted over the 2½-year period to cope with the pressures resulting from the increase in the defense budget. The design of policy actions was made especially difficult by uncertainties about the future path of defense outlays.

After the exceedingly rapid economic advance during the second half of 1965, the need for restraint in policy was clearly recognized at the beginning of 1966. An already scheduled rise in payroll taxes for social insurance amounting to \$6 billion (annual rate) took effect at the start of the year. The President's budgetary program reinforced this restraining influence with requests for a new graduated withholding system on individual income taxes, for a reversal of certain scheduled excise tax reductions, and a speedup in the collection of corporate income taxes. As enacted by the Congress in

March, these measures siphoned \$2½ billion (annual rate) from the private economy. Nevertheless, a large part of the burden of providing restraint fell on monetary policy.

The effects of tight money were evident in a sharp contraction of homebuilding during the course of 1966, which in turn contributed to a moderation of the over-all economic advance. But business investment spending proved unresponsive to monetary tightness—at least in the short run—and continued to advance at a rapid rate during the spring and summer of 1966. The investment boom put severe strain on the plant capacity and labor supplies of the machinery and construction industries. There was also danger that an excessive and unsustainable surge of plant and equipment spending might set the stage for a subsequent slump in investment demand. Finally, the investment boom added mightily to the pressures on financial markets during the spring and summer of 1966.

The dramatic decline in homebuilding, the highly disturbed atmosphere of financial markets, and the pressures of business fixed investment on capital goods industries clearly indicated that fiscal policy needed to assume a larger share of the responsibility for restraining the economy.

In the light of these considerations, the Administration in September 1966 requested a temporary suspension of the investment tax credit, initiated certain cutbacks in Federal spending, and placed stringent limits on net new issues by Federal agencies. At the same time, the monetary authorities took various complementary steps to ease the pressure on financial markets, including, in particular, a direct request to member banks to restrict their business lending. In addition, legislative and other action was taken to moderate the competition for savings—and improve the flow of credit—through the adoption of new rules governing interest-rate ceilings on time and savings accounts at banks and thrift institutions.

The suspension of the tax credit was enacted by the Congress in October. The capital goods boom halted, and business spending on plant and equipment declined slightly during the first half of 1967. The suspension of the investment credit contributed to this result, but monetary policy and the other activities cited, as well as the general slowdown of the economy, were also partially responsible. It can be argued, in retrospect, that investment demand might have slowed down adequately without suspension of the tax credit. But the impact of the September fiscal program on financial markets was clear and beneficial beyond any reasonable doubt.

Long-term interest rates responded quickly to the President's fiscal proposals and declined from the sharp peaks reached during the first week of September 1966. Subsequently, the Federal Reserve System relaxed its monetary restraints. As a result of this shift in the mix of stabilization policies, the recovery of homebuilding got a head start of several months. After the suspension of the investment credit had done its job, the credit was restored by Congress in the spring of 1967 upon recommendation by the President.

As described in Chapter 1, fiscal policy exerted a major expansionary influence in the first half of 1967 when the economy was particularly sluggish. The large and growing full-employment deficit, reinforced by an expansionary monetary policy, helped maintain the forward motion of the economy. When economic activity strengthened in the second half of the year, the President called for prompt tax action to moderate the stimulus of fiscal policy, and initiated a program to curb Federal expenditures. As Congress adjourned without acting on the proposed tax surcharge, the year ended with renewed financial strains and with the recovery in homebuilding once again threatened by credit stringency.

MONETARY DEVELOPMENTS

Through nearly five years of economic expansion, monetary policy reinforced expansionary fiscal measures. In 1966, however, monetary policy became a major restraining force. When inflationary pressures diminished late in 1966, a relaxation of credit policies was initiated and subsequently maintained through most of 1967.

BALANCED EXPANSION, 1961-65

From 1961 until late in 1965, monetary policy was consistently expansionary; it made a major contribution to the advance of the economy by accommodating growing credit demands at remarkably stable interest rates.

To be sure, short-term interest rates rose during this period, as monetary policy and debt management actions deliberately sought to keep key short-term rates in the United States reasonably aligned with those in foreign money centers so as to limit outflows of interest-sensitive funds. Long-term rates, however, were only slightly higher in mid-1965 than in early 1961 (Chart 5). Indeed, some important interest rates—those on mortgages and State and local government bonds—were lower than they had been at the beginning of the period of expansion.

A policy of monetary ease was indispensable to provide the 60-percent increase in funds raised by businesses, governments, and individuals without any substantial tightening of availability or increase in long-term rates. Meanwhile, demands for funds burgeoned mainly because of the invigoration of demands for goods and services that stemmed from an actively expansionary fiscal policy.

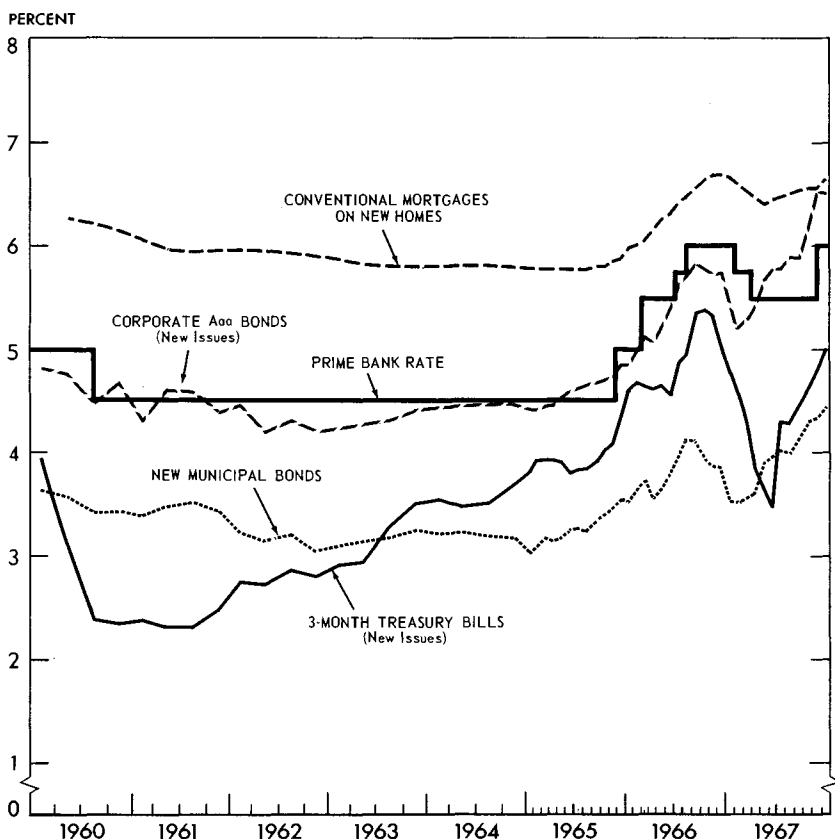
Institutional Changes

During this period, there were significant changes in the character of financial instruments and in the behavior and practices of financial institutions.

In particular, the long-term tendency for businesses to economize in the holding of demand deposits was reinforced by the development of new money market instruments, notably the negotiable time certificate of deposit (CD). Upward revisions in the maximum interest rates which Federal regulations allowed to be paid on time and savings deposits enabled commercial banks to attract large inflows of such deposits.

Chart 5

Selected Interest Rates



NOTE:—DATA PLOTTED ARE QUARTERLY THROUGH 1964, MONTHLY THEREAFTER.

SOURCES: FEDERAL HOUSING ADMINISTRATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE, AND TREASURY DEPARTMENT.

In addition to promoting the sale—mainly to corporations—of negotiable CD's of large denominations, the banks also developed various attractive forms of nonnegotiable certificates of deposit which effectively tapped household savings. While the deposits of savings and loan associations continued to grow, these institutions encountered increasingly strong competition from the commercial banks, and their share in the total flow of time and savings deposits of households declined from 49 percent in 1961 to 33 percent in 1965 (Table 7). Some of these institutions also began to experiment with special savings certificates of various kinds.

As banks and other financial institutions developed new, more convenient, and higher-yielding forms of liquid assets, they induced a continued substitution of these new liquid assets for demand deposits in the portfolios of households and businesses.

TABLE 7.—*Net inflow of household time and savings deposits to main financial institutions, 1954–67*

| Type of financial institution | 1954–60 annual average | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 ¹ |
|---|------------------------------|------|------|------|------|------|------|-------------------|
| Total net inflow (billions of dollars)..... | 11.0 | 17.4 | 23.4 | 23.0 | 23.9 | 26.4 | 18.9 | 36.6 |
| Percent of total going to: | | | | | | | | |
| Commercial banks..... | 29 | 36 | 44 | 34 | 34 | 50 | 61 | 50 |
| Mutual savings banks..... | 16 | 11 | 13 | 14 | 17 | 14 | 14 | 15 |
| Savings and loan associations..... | 51 | 49 | 40 | 48 | 44 | 33 | 20 | 32 |
| Credit unions..... | 4 | 4 | 3 | 4 | 5 | 3 | 5 | 3 |

¹ Preliminary.

Source: Board of Governors of the Federal Reserve System.

The substitution of new forms of liquid assets for demand deposits was particularly marked in corporate portfolios. Between the end of 1960 and the end of 1965, nonfinancial corporations reduced their holdings of demand deposits and currency by \$4 billion and of Treasury securities by \$3 billion, while increasing their holdings of CD's by \$17 billion.

Business firms and households were willing to reduce their money holdings relative to their holdings of other liquid assets, and relative to the volume of their transactions, only as interest rates on such assets rose. After a brief decline in 1960, short-term interest rates rose steadily, and by mid-1965 approached the peak levels of 1959. Rates offered on CD's and similar obligations by banks and thrift institutions also rose.

In the two previous expansions, rising interest rates had induced corporate treasurers to shift from demand deposits to Treasury bills. In the early 1960's, rate increases induced a further shift to CD's. However, the process differed in important respects from that which occurred in the expansion periods of the 1950's. In earlier periods, the rise in short-term interest rates was brought about through a restricted growth of bank credit. Growth of reserves was inadequate to permit demand deposits to grow in pace with GNP. And since demand deposits were then the principal source of funds to the banks, they were forced to restrict credit.

In the early 1960's—as the use of CD's expanded—bank credit increased rapidly, even though the expansion of bank reserves and of demand deposits occurred at a comparatively low rate. Since CD's carried lower reserve requirements than demand deposits, a given rise in the reserve base permitted more rapid growth of bank credit.

By raising CD ceilings, providing only a moderate growth of bank reserves, and raising the discount rate in 1963 and 1964, the Federal Reserve was able to maintain upward pressure on short-term rates without restricting bank lending. At the same time, the expansion in their time liabilities encouraged commercial banks to increase their investments in longer term assets (mainly mortgages and tax-exempt securities). This served to limit upward pressure on key long-term rates that otherwise might have risen in response to increased borrowing to finance State and local and private investment. The

outcome was consistent with the double objective of encouraging domestic expansion while preventing an excessive outflow of short-term funds to foreign markets where interest rates were higher.

The changing financial patterns that emerged during this period thus played an important part in the support of steady and balanced expansion. But these same patterns held risks for the future. A significant portion of the funds secured by financial institutions through aggressive competition was obtained from interest-sensitive investors who would be quick to withdraw their funds if interest rates elsewhere became relatively more attractive. Such risks, however, were not particularly serious for the banks, so long as over-all financial conditions continued to evolve gradually and without sudden changes in interest rate levels. On the other hand, the risks for savings and loan associations—and, to a lesser extent, for mutual savings banks—became substantially greater. Such institutions have far less flexibility than commercial banks in managing their portfolios, which are heavily concentrated in mortgages. Moreover, in an attempt to meet commercial bank competition, they had in some cases engaged in overly aggressive efforts to attract interest-sensitive funds and had thus become rather vulnerable to changes in the financial environment.

MONETARY POLICY IN 1966-67

In the latter part of 1965, as defense expenditures turned sharply upward and business investment spending began to accelerate, credit requirements mounted at an extraordinary rate. There followed a period of intense and often uneven pressure on financial markets which differed sharply from the earlier patterns of orderly adaptation to changing needs.

The period was marked by a steep upward movement in both short- and long-term interest rates (Chart 5). Indeed, long-term rates reached the highest level in over 40 years during 1966, and, after receding for a relatively brief period, advanced substantially further during the course of 1967, in some cases rising to the highest levels since the 1860's or 1870's.

While, in both 1966 and 1967, rising interest rates reflected unusually heavy credit demands, the factors giving rise to these demands differed significantly in these two years—as did the direction of monetary policy and the availability of credit.

The 1966 Credit Squeeze

The response of the monetary authorities to the extraordinary rise in credit demands in late 1965 was a clearcut shift toward a policy of credit restraint. This was signified initially by an increase in the discount rate in December 1965. At the same time the ceiling rate on CD's was raised. Thereafter, credit tightening was reinforced by increasingly limited growth of the reserve base. Monetary restriction continued until September 1966. By November, monetary policy had clearly shifted in an expansionary direction.

During the first half of the year, the nonborrowed reserves of the commercial banks grew at an annual rate of only 2.9 percent. Since banks were faced with a very strong loan demand, they borrowed reserves from the Federal Reserve banks. The money supply was thus able to increase at an annual rate of 4.6 percent. Banks also competed vigorously for CD's and for consumers' time deposits. While this competition helped to drive up rates, it also enabled banks to accommodate their loan customers. Total bank credit increased at an annual rate of 8.6 percent over this period.

To accommodate business demands, banks rationed mortgage lending and other types of credit, competed strongly for time deposits, and made inroads into their liquidity through the sale of securities. Even so, bank lending could not fully keep pace with the business demand for funds. Corporations consequently also issued large amounts of new debt securities in an effort to meet their needs. They were thus brought into increasingly active open market competition with other seekers of funds, including particularly the Federal Government and State and local governments. As a result, long-term interest rates rose markedly from late 1965 through mid-1966.

It was only after midyear, however, that monetary stringency reached its peak. During the summer months, as Federal Reserve actions actually reduced the volume of nonborrowed reserves, the spread between the 5½-percent ceiling rate on CD's and the yield on Treasury bills narrowed. Banks found it increasingly difficult to replace maturing CD's as corporations shifted to still higher yielding alternative liquid assets. Although banks increased their borrowings from the Federal Reserve and their sales of securities, it became progressively harder for them to accommodate business loan demands. Yet, in order to restrict the funds available for bank lending to business, the Federal Reserve left the ceiling rate on CD's unchanged.

The rise in open market interest rates induced by large corporate and tax-exempt security issues and by bank sales of securities attracted an unusually large share of household savings directly into market issues, at the expense of the growth of household deposits at banks and thrift institutions. The attraction became particularly strong when short- and medium-term open market rates rose above the maximum interest rates payable on CD's and savings accounts.

As was explained in more detail in the Council's 1967 Annual Report, it was the thrift institutions—and particularly the savings and loan associations—which suffered most severely from this process of “disintermediation”. Because they had only limited scope for raising the rates they offer on deposits, thrift institutions were at a special disadvantage in the ensuing competition for deposits both with open market instruments and with commercial banks.

By the third quarter of 1966, withdrawals of interest-sensitive deposits from thrift institutions had become so large that their usually sizable net inflow of funds was reduced to a trickle.

Following the various steps taken by the Administration and the monetary and regulatory authorities in September—when the credit scarcity had reached acute proportions—a calmer atmosphere was restored in the financial markets. The rate of growth of bank lending to business slowed markedly in September, and with the moderating level of business activity, continued low throughout the remainder of the year (Chart 6). At the same time, the levels of nonborrowed reserves and of demand deposits were further reduced, and banks, in adjusting to lower reserve levels, liquidated a large volume of security holdings. As monetary restraint was significantly relaxed in November, bank reserve and deposit levels stabilized. By yearend, a rapid pace of monetary expansion was underway that carried through into the following year.

In 1966, monetary policies played a major active role in determining the over-all path of economic activity. Tight credit was clearly the primary factor accounting for a sharp decline in homebuilding of \$6 billion (annual rate) from the first to fourth quarter. The impact of tight money also extended to mortgage-financed business construction as well as certain other plant and equipment expenditures. The ability of tight money to restrain the economy was clearly demonstrated in 1966, but so were its uneven impact and the troublesome side effects of a financial squeeze.

The 1967 Experience

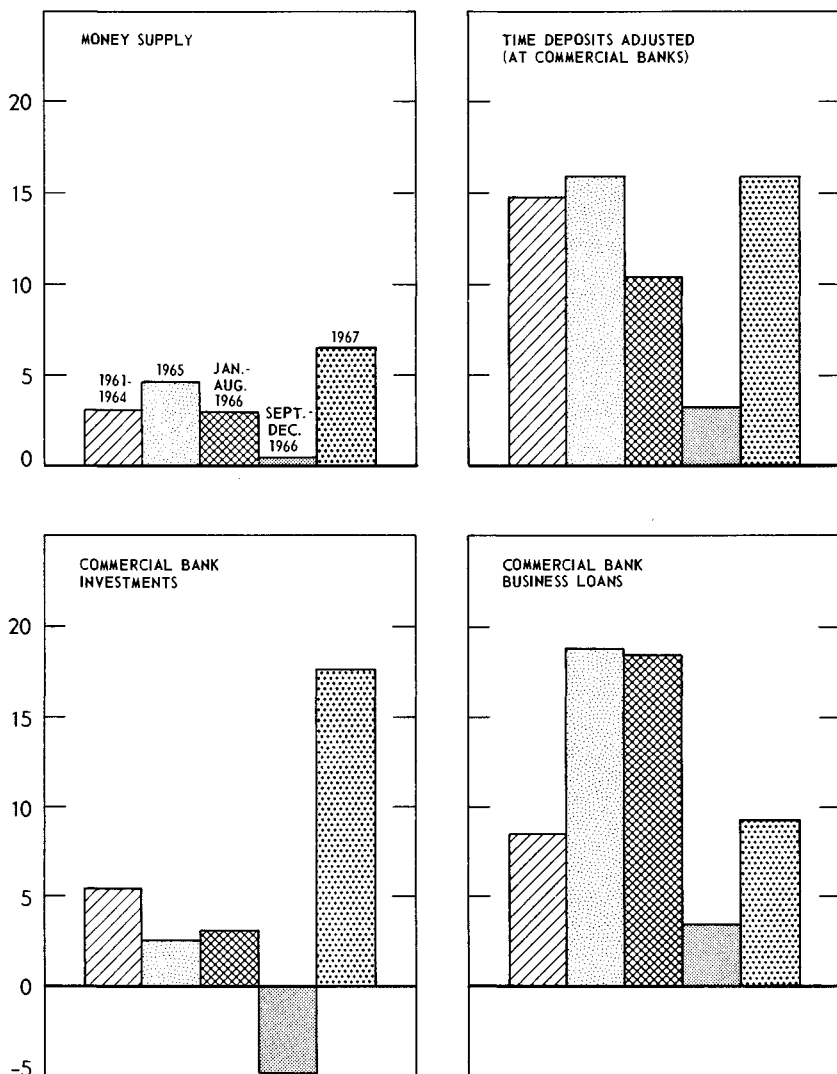
The moderation of the rate of economic advance at the end of 1966 produced a setting for monetary and credit developments in 1967 which was—in several respects—the opposite of that which had prevailed a year earlier. Plant and equipment expenditures had leveled off following a period of exceptionally rapid advance and the prospect of a substantial first half inventory adjustment was clear. This pointed to some moderation in underlying credit demands, although it could be expected that reductions in private borrowing needs would, to an important extent, be counterbalanced by a larger Federal deficit.

Further, monetary policy had turned expansionary, in order to help cushion the inventory adjustment, and to assist actively in the recovery of homebuilding. The Administration's proposal for a special income tax surcharge in the second half of the year was intended to reduce Government demands on the capital market, and to give fiscal policy a larger role in restraining demand.

In a more balanced economic and financial setting, these circumstances could have been expected to produce a marked easing in money and capital market pressures, manifested both in greater availability of credit and in moderation of the pressure on interest rates.

The actual course of financial development proved rather different. Although credit did become more easily available, pressures on the capital markets remained intense for most of the year, and interest rates resumed an upward course after only a relatively brief interruption. To a major

Changes in Money Supply, Time Deposits, and Selected Bank Assets

PERCENT CHANGE PER YEAR ^{1/}^{1/}AVERAGE ANNUAL PERCENTAGE CHANGE DURING PERIOD; BASED ON SEASONALLY ADJUSTED DATA.

NOTE.—FOR MONEY SUPPLY AND TIME DEPOSITS, BASED ON AVERAGES OF DAILY FIGURES; FOR INVESTMENTS AND LOANS, ON END-OF-PERIOD DATA.

SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

extent, these developments could be attributed to the after-effects of the unusual strains and imbalances which the financial system had experienced in 1966, as well as to congressional inaction on the President's fiscal program to correct these imbalances.

Availability and Cost of Credit

Monetary conditions— at least as measured by changes in bank reserves, money supply, and bank credit—remained easy until very late in the year. During the first 11 months of 1967, total member bank reserves increased at an annual rate of 11 percent, nonborrowed reserves by 14 percent, and the money supply by 7 percent, compared to increases of only 1.2 percent, 0.7 percent, and 2.2 percent, respectively, in the corresponding months of 1966. Total bank credit, which had shown almost no change in the second half of 1966, expanded at an annual rate of 12 percent during these months. In March, the Federal Reserve lowered reserve requirements against savings deposits and the first \$5 million of time deposits in member banks, and, in April, it reduced the discount rate from $4\frac{1}{2}$ to 4 percent.

The changed monetary environment was associated with marked improvements in the liquidity positions of thrift institutions and commercial banks. With an unusually high rate of financial saving by consumers, and with commercial banks and thrift institutions in a better position to compete effectively against open market instruments, both types of institutions experienced record inflows of time and savings deposits. Savings and loan associations were able to step up relatively rapidly their acquisitions of mortgages during the second and third quarters of the year, thus contributing greatly to the recovery of the construction industry.

Credit usually becomes cheaper when it becomes more readily available. But in 1967, and particularly during the second half of the year, there was a marked contrast between the ready availability of credit and the unusually high level of long-term interest rates.

Both short and long rates had begun to fall sharply in late 1966. Short-term rates continued to decline until early June, with the rate on 3-month Treasury bills reaching a low of $3\frac{1}{3}$ percent, compared to the peak of $5\frac{1}{2}$ percent in the previous September. Declines in other short-term rates were in the range of $1\frac{1}{2}$ to 2 percentage points.

Long-term rates, however, reached their low in late February, when they stood $\frac{1}{2}$ to $\frac{3}{4}$ percentage points below the 1966 highs. They turned upward in early April and continued to rise, with only occasional interruptions, through the rest of the year. By July, they had regained the levels of the previous fall. By yearend, they stood at the highest levels in 40 years or more, with long-term Treasury bonds yielding 5.4 percent, and highest grade corporate bonds about 6.2 percent. After midyear, short-term rates also began to move upward, and continued to do so through the remainder of the year, though they remained below the peaks reached in the fall of 1966 (Chart 5). Thus the spread between long- and short-term rates widened

significantly during the first half of the year, and, in spite of some reduction around midyear, remained relatively large in the second half. The typical pattern, when interest rates are high and rising, is for short-term rates to rise relative to long-term rates and, indeed, often to exceed them.

In attempting to explain both the unusual contrast between the relatively easy availability of credit and the sharp rise of interest rates, and the unusually wide spread between long-term and short-term rates, it is useful to begin by summarizing the more notable aspects of the demand for funds in 1967.

The Demand for Funds

The total volume of borrowing in 1967 set a new record, 33 percent above the average of 1961-64 (Table 8). To be sure, the volume of mortgage borrowing remained at the low average level of 1966—although, in sharp contrast with 1966, the movement within the year was strongly upward. Consumer borrowing—while much stronger in the second half than in the first—also remained low. Bank lending to business fell to about half the 1966 level, and was particularly small in the second half. Corporate and tax-exempt bond issues, on the other hand, both reached new record highs. Federal borrowing, too, was up considerably. State and local securities outstanding rose by \$9.8 billion, including an unprecedented \$1.3 billion of industrial revenue bonds. Some of the high 1967 borrowing, however, represented a postponement from 1966.

The Federal Government borrowed \$2.7 billion more in 1967 than in 1966. Its borrowing was unusually concentrated in the second half of the

TABLE 8.—*Net funds raised by nonfinancial sectors, 1961-67*

[Billions of dollars]

| Type of credit | 1961-64 annual average | 1965 | 1966 | | | 1967 | | |
|---|------------------------------|------|-------|----------------------------|-----------------------------|--------------------|----------------------------|-------------------------------|
| | | | Total | First half ¹ | Second half ¹ | Total ² | First half ¹ | Second half ^{1 2} |
| All nonfinancial sectors..... | 56.0 | 72.1 | 71.1 | 83.5 | 58.6 | 74.4 | 58.1 | 90.8 |
| Private domestic nonfinancial sectors.. | 46.0 | 66.0 | 62.9 | 72.4 | 53.4 | 60.9 | 60.4 | 61.5 |
| Consumer credit..... | 5.6 | 9.4 | 6.9 | 8.1 | 5.8 | 5.4 | 4.2 | 6.5 |
| Bank loans ³ | 4.7 | 13.6 | 10.8 | 13.2 | 8.4 | 5.6 | 8.2 | 2.9 |
| Commercial paper..... | .1 | — .3 | .9 | .7 | 1.2 | 2.5 | 3.9 | 1.2 |
| State and local obligations..... | 5.6 | 7.4 | 5.9 | 6.3 | 5.5 | 9.8 | 10.8 | 8.9 |
| Corporate securities..... | 5.3 | 5.4 | 11.4 | 13.6 | 9.3 | 15.1 | 14.7 | 15.6 |
| Home mortgages ⁴ | 13.8 | 16.0 | 12.5 | 14.6 | 10.4 | 12.4 | 10.7 | 14.1 |
| Other mortgages..... | 8.1 | 9.5 | 8.5 | 9.8 | 7.2 | 7.7 | 6.6 | 8.8 |
| Other..... | 2.8 | 5.0 | 6.0 | 6.1 | 5.8 | 2.4 | 1.1 | 3.5 |
| U.S. Government..... | 6.9 | 3.5 | 6.7 | 8.9 | 4.6 | 9.4 | -7.0 | 25.7 |
| Rest of world..... | 3.1 | 2.6 | 1.4 | 2.4 | .5 | 4.1 | 4.7 | 3.6 |

¹ Seasonally adjusted annual rates.

² Preliminary; includes estimate for fourth quarter.

³ Bank loans not elsewhere classified.

⁴ Mortgages on 1- to 4-family homes.

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

Source: Board of Governors of the Federal Reserve System.

year. The speed-up of corporate tax payments and the unusually large surpluses in Government agency accounts held down Treasury cash needs during the first half.

The volume of corporate security issues registered a substantial increase in volume of \$3.7 billion in 1967, even though the gap between the flow of corporate internal funds and corporate expenditures for investment was smaller than in 1966 (Chart 7). In part, the explanation for the exceedingly large volume of corporate borrowing in 1967 lies in the events of 1966; in part it reflected expectations of what might happen in 1968.

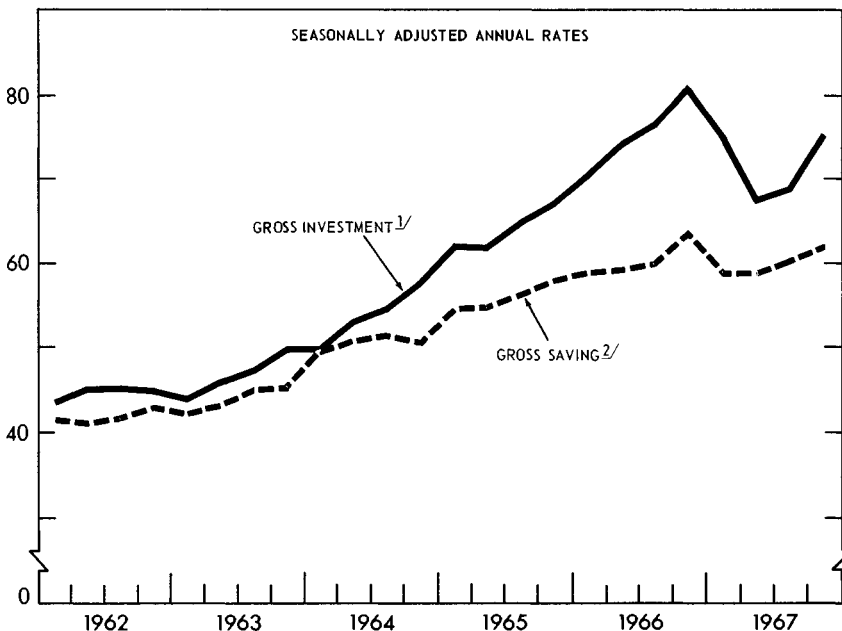
Some corporate issues were postponed during the market squeeze of 1966; further postponements may have occurred late in 1966 and early in 1967, as interest rates began to fall, and when many expected that rates would continue to decline.

A more important legacy from 1966, however, was the lesson that corporations learned about the costs of excessive dependence on commercial banks. The lesson that bank credit could become very difficult to obtain,

Chart 7

Gross Investment and Saving of Nonfinancial Corporations

BILLIONS OF DOLLARS



1/FIXED INVESTMENT PLUS CHANGE IN INVENTORIES.

2/CORPORATE PROFITS AND INVENTORY VALUATION ADJUSTMENT, LESS PROFITS TAX ACCRUALS AND DIVIDEND PAYMENTS, PLUS CAPITAL CONSUMPTION ALLOWANCES.

SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

even by highly credit-worthy borrowers, led many of them to conclude that a larger part of their debt capital should be obtained at long term. The impetus this gave to bond issues was strengthened as the expectation began to spread that long-term rates would increase as economic activity rebounded.

The President's renewed tax proposals of August brought some relief to credit markets. But, as Congress delayed action, the pressure on rates was renewed. Each time the prospects for passage of the surcharge seemed to improve, rates tended to level off; each time the prospects appeared to worsen, the rise was renewed.

The continuing and increasing prospect of a strongly resurgent economy without fiscal restraint—and therefore subject to renewed monetary restraint—strengthened the expectation of rising rates and of the possibility of a renewed squeeze on bank lending. This encouraged corporations to borrow even at exceedingly high rates.

The Imbalance in Security Markets

The impact of enlarged corporate borrowing on long-term interest rates—and on corporate rates in particular—was reinforced by the unusual distribution of demand relative to supply. On the demand side of the credit market, there was a notable bulge of corporate bond issues. On the supply side, the most notable feature was the large financial surplus of households. The two did not easily mesh.

Household accumulation of financial assets in 1967 was about 30 percent higher than in the preceding year, as consumer saving proceeded at an unusually high rate while outstanding consumer debt increased less than in 1966. Part of the increase in household financial assets took the form of contractual increases in pension and life insurance reserves. The bulk of it, however, went into liquid assets, as did most of the proceeds from the net sale by households of some \$6.7 billion of securities.

The remarkable rise in the demand and thrift deposits of households reflected the higher rate of total financial saving, the unusually low acquisition of liquid assets during the previous year, and changes in relative yields on competing forms of financial assets. Declining yields on short-term Treasury and Federal agency securities in the first part of the year made thrift deposits relatively more attractive than in 1966. In the second half of the year, the spread between thrift deposit rates and yields on competing marketable securities narrowed sharply, but households continued to rebuild liquidity. However, the flow of savings into deposits began to moderate at yearend.

The bulk of corporate bond issues over the last decade has been purchased by life insurance companies and private pension funds. In 1967, however, the volume of corporate bond issues was unusually large relative to the increase in the assets of these institutions. Consequently, corporate bonds had to be sold to buyers who commanded a limited proportion of the total available funds, and these sales could be made only at sharply rising yields.

Mutual savings banks and State and local government pension funds responded to high and rising yields by increasing their purchases. Higher interest rates—and the availability of many attractive convertible issues—apparently also induced households to increase considerably their purchases of corporate bonds.

The Situation at Yearend

Late in the year, the Federal Reserve slowed the growth of reserves and the rate of growth of the money supply declined. Inflows of time deposits also tapered off, while business loans advanced somewhat more rapidly. During November and December, banks sold Government securities in significant volume. The devaluation of sterling caused a speculative reaction in the security markets. After the November rise in the discount rate, short-term rates increased.

The year ended with interest rates far above year-earlier levels, but with credit still readily available. There was little evidence that the high rates in 1967 had as yet dampened business investment expenditures to any significant degree. And outlays on residential construction exceeded their 1963–65 average by the fourth quarter. Banks remained relatively liquid, and able to accommodate their customers without difficulty. Although mortgage markets had been fearing disintermediation for months, actual inflows into thrift institutions had slowed only moderately. Nevertheless, the spread between rates on savings deposits and those available on open market securities had narrowed significantly. Any further rise in open-market rates could seriously endanger the ability of the thrift institutions to finance an adequate level of residential construction.

PRESENT TASKS OF POLICY

As was emphasized in Chapter 1, the current and prospective economic climate is such that restraint upon the expansion of demand is vitally needed. Enactment of the President's fiscal program will provide the needed restraint, while enabling the economy to advance at a healthy rate. As explained in Chapter 3, price increases in 1968 will still be unacceptably large. But, with the tax increase, there is the prospect that price increases will decelerate during the year. In absence of fiscal restraint, however, the economy would be subject to serious inflationary pressures, or serious financial stringency—and, most probably, some combination of the two. The improved balance among the sectors that was achieved in 1967 would once again be upset.

INFLATIONARY PRESSURES WITH NO RESTRAINT

In the absence of any added restraint from either higher taxes or monetary policy, the growth of total demand in 1968 would be substantially greater than the \$61 billion forecast given in Chapter 1. The forecast assumed that the surcharge would withdraw about \$6¼ billion of pur-

chasing power (annual rate) from consumers starting in April, and that it would reduce after-tax corporate profits by \$3½ billion for the entire year.

Without the withdrawal from personal incomes, consumer spending in the second quarter and thereafter would be substantially higher than that contemplated in the forecast given in Chapter 1. Responding to the additional consumer demand, business would attempt to raise output and employment. The resulting increases in wages, dividends, and other income payments would swell consumer incomes, and, in turn, lead to still further additions to consumer expenditures. Rising consumer spending, together with the failure of corporate tax rates to rise, would add to after-tax profits, providing both incentives and means for financing more business investment expenditures than would be the case if the tax increase were enacted. It is likely, in addition, that the greater consumer and business spending would lead to more rapid accumulation of inventories.

Thus the interacting forces of consumer and business spending would, via the well-known multiplier process, generate increases in money income and total demand that would far exceed the magnitude of the surcharge.

In an economy at substantially full employment, a rapid growth of demand, far in excess of the economy's growth potential, would result primarily in rising prices and only marginally in additional output. With additional workers hard to find and employees tempted by alternative opportunities, wage rates would rise rapidly. To be sure, it might be possible to mobilize some additional manpower from among the remaining unemployed. Frictionally unemployed workers would find jobs more quickly; some seasonally unemployed workers would take second jobs; and some poorly qualified workers would be hired. Nevertheless the number of unfilled jobs would increase greatly and the recruiting difficulties of employers would be accentuated. The strains in labor supplies would slow productivity growth, and with accelerating wages, would generate rapidly increasing costs.

As discussed in Chapter 3, an acceleration of wage and cost increases would provide the impetus to keep the wage-price spiral turning long after the excessive demand had vanished. The absence of restraint not only implies a more rapid price rise in 1968, but greatly increases the difficulty of moving back to price stability in future years. It would, moreover, weaken our balance of payments by impairing our export competitiveness for years to come and by generating a rapid rise in imports. Finally, rapid expansion of demand and soaring profits would be likely to touch off a capital goods boom in 1969, if not sooner; such a development could sow the seeds of a subsequent collapse of investment in plant and equipment. Whatever additional gains in output and employment might be obtained during the inflationary boom would be paid for many times over in such a subsequent bust.

THE IMPACT OF MONETARY RESTRAINT

If there is no tax increase, the Nation would not in fact experience the unrestrained inflationary pressures outlined above. It is certain that the

expansion of demand would be checked to some degree by credit restraint. In present circumstances, the accompanying further rapid expansion of credit demand would impose severe strains on financial markets—even under an expansionary Federal Reserve policy. The competition for liquidity, the imbalances in the flows of funds, and the expectational disturbances which operated in 1967 would be intensified in 1968. With credit markets under strain on the one hand, and an economy operating under serious inflationary pressures on the other, the making of credit policy would be unusually difficult. To the extent that monetary policy accommodated credit demands in the interest of avoiding strains on the financial markets, prices and wages would rise more rapidly. To the extent that policy was aimed at moderating inflationary pressures, the more interest rates would rise and the more homebuilding would be depressed.

A monetary policy which imposed the same degree of over-all restraint on demand as the proposed tax increase could do so only at the risk of creating serious imbalances in the economy. As in 1966, the mortgage markets and the homebuilding industry would, in all probability, be more seriously restricted than other sectors of the market. They might fare somewhat better than in 1966, since the thrift institutions are now more liquid, rate ceilings limit bank competition for savings funds, and some interest-sensitive deposits have already been withdrawn. On the other hand, both mortgage lenders and builders are more sensitive than formerly to the dangers of credit restraint. Signs of increasing credit tightness could lead to a major restriction of mortgage commitments and an abrupt scaling down of building plans even before lenders found their resources seriously strained.

Credit restraint would affect other sectors as well. Mortgage-financed nonresidential construction, small businesses, users of consumer credit, and State and local capital projects would all feel the pinch. The effects of a further rise in the general level of long-term interest rates into territory unknown in this century could restrict investment and retard economic growth for a long time after the need for restraint had passed.

To be sure, sharply rising interest rates might also reduce our balance-of-payments deficits by attracting funds from abroad. But this would be only a temporary gain—one that, at best, would continue only so long as interest rates stayed at a level which disrupted our domestic economy. Moreover, if other major countries allowed their own interest rates to rise to avoid the loss of funds, they would threaten to throw not merely their own economies but the world economy into recession.

The actual course of events with no tax increase would probably involve both an increase in inflationary pressures and a tightening of credit conditions.

After a hard look at the alternatives, it has been and remains the conviction of both the Administration and the Federal Reserve System that the Nation should depend on fiscal policy, not monetary policy, to carry the main

burden of the additional restraint on the growth of demand that now appears necessary for 1968.

THE PROGRAM OF FISCAL RESTRAINT

The expenditure program in the budget for fiscal year 1969 was reviewed in Chapter 1. It is a budget consistent with a program of fiscal restraint, but it cannot alone provide the degree of restraint that is required.

Without new tax legislation, the full-employment deficit would remain close to its recent \$12½ billion rate. The health of the economy therefore requires prompt enactment of a temporary surcharge on income taxes, initially proposed by the President last January, amended last August, and reaffirmed in the current fiscal program.

Surcharge Proposal

The Administration's tax recommendation calls for a 10-percent surcharge on the income taxes of corporations, to be in effect from January 1, 1968, through mid-1969; and on the income taxes of individuals—with low-income families exempted—to be in effect from April 1, 1968, through mid-1969. For the year 1968 as a whole, the surcharge on individuals would equal 7.5 percent of annual tax liability. For the average family, a surcharge of 7.5 percent of *taxes* would amount to approximately three-fourths of 1 percent of *income*. Since the surcharge would share the progressive character of our basic income tax structure, it would take a somewhat larger percentage of the income of more affluent Americans—e.g., nearly 1½ percent for a family of four with a \$25,000 income, as indicated in Table 9. The table also shows that the surcharge would leave individual tax liabilities well below their 1963 levels.

The recommended form of the tax increase parallels the conclusion of the Subcommittee on Fiscal Policy of the Joint Economic Committee in 1966 that “. . . a uniform percentage addition . . . to corporate and

TABLE 9.—*Change in income tax liability for a married couple with two dependents, 1963–68*

| Annual wage income | Amount of tax liability ¹ | | | Change in tax liability | | Change in tax as percent of income | |
|--------------------|--------------------------------------|-------|-------------------|-------------------------|--------------|------------------------------------|--------------|
| | 1963 | 1967 | 1968 ² | 1967 to 1968 | 1963 to 1968 | 1967 to 1968 | 1963 to 1968 |
| \$5,000..... | \$420 | \$290 | \$290 | (³) | —\$130 | | —2.6 |
| \$7,500..... | 877 | 686 | 737 | 51 | —140 | 0.6 | —1.9 |
| \$10,000..... | 1,372 | 1,114 | 1,198 | 84 | —174 | .8 | —1.7 |
| \$15,000..... | 2,486 | 2,062 | 2,217 | 155 | —269 | 1.0 | —1.8 |
| \$25,000..... | 5,318 | 4,412 | 4,743 | 331 | —575 | 1.3 | —2.3 |

¹ Tax liability computation assumes minimum deduction or deduction equal to 10 percent of income, whichever is greater.

² Proposed tax surcharge of 10 percent beginning April 1; equivalent to 7.5 percent increase for the year 1968.

³ No increase for married couples with two dependents whose tax at 1967 rates is \$290 or less.

Source: Treasury Department.

personal income tax liabilities . . . to be effective for a stated period, best satisfies criteria for short-run stabilizing revenue changes.”

Obviously, other types of tax increases would also provide fiscal restraint, but they would be inferior to the proposed surcharge in many respects. Excise tax increases—if imposed on broad groups of consumer goods and services—would have a much larger relative impact on the poor. If, on the other hand, the excises were confined to luxuries, the revenue gain could not be sufficient to provide adequate fiscal restraint. Moreover, excise taxes have the disadvantage of exerting direct upward pressure on prices.

Another alternative would be to increase revenues via “loophole”-closing tax reforms. Certain reforms are desirable in themselves to improve equity and efficiency in the tax structure; these should be enacted on a permanent basis—not linked to a temporary tax increase designed to meet stabilization needs. In any case, reforms could not be enacted promptly enough to insure the needed fiscal restraint in the first half of 1968. Congressional debates on tax reform have repeatedly demonstrated that legislation in this area can be enacted only after lengthy consideration. Moreover, because tax reform measures cannot normally be incorporated into the withholding system, there would be a further lag in their contribution to revenue and restraint, even after enactment. Significant additional revenue from reform could not realistically be provided before the middle of 1969 at the very earliest. Major reforms would drastically change the situation of taxpayers who had based important economic decisions on the present law. For this reason, major reforms probably need to contain transition provisions to avoid imposing large initial losses on the affected taxpayers. This further reduces the potential of tax reform to meet present revenue needs.

Economic Impact of the Tax Increase

The increase in taxes is intended to moderate the growth of demand and to allocate a portion of the Nation’s extraordinary defense costs broadly and equitably among individuals and businesses.

As indicated above, the economic effects of a tax increase are the mirror-image of the expansionary effects accomplished by tax reduction. But a tax cut enacted when there are ample idle resources, as in 1964, has its main expansionary effect on output, with only a minor impact on prices. Under present circumstances, however, with rapidly expanding demands and essentially full employment, the main restraining impact of the tax increase will be on prices, and only secondarily on output.

Under current circumstances, the tax increase will add to Federal revenues. To be sure, under conditions of widespread slack, raising tax rates would merely lower employment and production and could even pull down incomes so much that Federal revenues would actually prove to be smaller. This is the counterpart of the proposition that, in such an economy, a tax reduction can actually increase Federal revenues by stimulating a strong economic advance. But, in the present situation, a tax increase of the magnitude

proposed will still permit a healthy expansion of employment, output, and real income. Revenues will rise substantially, as higher effective tax rates are applied to a rising revenue base.

Of course, an inflation which was not checked by either fiscal or monetary action might expand the revenue base even more rapidly. But such extra expansion would primarily reflect higher prices rather than increased production. Therefore, although revenues might conceivably then rise even more than with a tax increase, the real purchasing power of those revenues would not. Federal outlays would have to be increased to maintain the same real level of public services in the face of higher prices for the items bought by the Government.

The tax increase works to curb price increases by moderating the pressures of demand. However, like any other fiscal or monetary measure, it cannot cope immediately with cost pressures already built into the system. To be sure, some have argued that a rise in the corporate profits tax may in fact add to cost pressures, by inducing firms to raise prices in order to protect their profits from the impact of the higher tax. But any firm which was already taking full advantage of its opportunities to earn profits would have no incentive to raise its prices as a result of a higher corporate tax rate. The price which results in the largest profits *before* taxes yields the largest profits *after* taxes, regardless of the tax rate.

There may be cases—particularly among firms with substantial market power—where businessmen typically forego potentially available profits and aim at a target rate of after-tax return (based on “standard” costs and volume). In such instances—which some economists regard as quantitatively important—firms might make a one-shot price increase to reestablish the target after-tax profit when the profits tax rate rises. In such cases, the profits tax would work like an excise tax—no better and no worse. It would then reduce the growth of the real spendable incomes and the market demand of consumers rather than of business firms.

Workers, too, may wish to achieve greater wage increases to compensate for the downward impact of income tax surcharge on their take-home pay. But their wishes are not likely to be fulfilled, since firms will also have higher tax bills to pay, and will be facing less buoyant markets.

In addition to its immediate contribution to the stabilization of prices, wages, and interest rates—and to the U.S. balance of payments—the tax surcharge has major implications for the long-term management of stabilization policy. Congressional response in the weeks ahead will demonstrate the political feasibility of making fiscal policy work in the unpleasant task of restraint, as well as in the more welcome task of providing tax cuts and added public programs. The proof that taxes can be raised when necessary will strengthen the ability of the Nation to resume a long-run policy of tax reduction when the defense emergency ends.

AGENDA FOR POLICYMAKING

Recent experience reveals the benefits and costs, the potentialities and limitations of policy adjustments. Active discretionary policy is indispensable despite its imperfections. These very imperfections point to the need for flexibility in policymaking and for improvements in the techniques of diagnosis and application.

FLEXIBILITY AND FORECASTING

Large and sometimes imperfectly foreseeable increases in defense spending have recently required sizable and frequent adjustments in monetary and fiscal policies—such as the temporary suspension and early restoration of the investment tax credit. In a peacetime world, policy moves would not ordinarily need to be as frequent or as abrupt. Yet policy will not be able to stand still.

Even in the ideal situation of smoothly rising private demands—when budgetary policy merely needs to allocate the fiscal dividend of economic growth—tax adjustments will be called for from time to time. In particular, tax reductions are likely to be a frequent aspect of the annual budget program. The desirable expansion of Government expenditures will seldom equal the revenue increase accompanying high-employment growth.

Moreover, private demands will not grow smoothly at all times. Changes in consumer buying, in technology, in the growth and composition of the population, and in interregional migration can lead to alterations in the vigor of private demand. In a full-employment economy, a spurt in the growth of demand can trigger a burst of inflation, and tendencies toward sluggishness, if not offset, can cumulate into recession.

Small and temporary fluctuations will not throw the economy off course. The full-employment path is not a tightrope. Policy action cannot, need not, and—in view of the costs—should not try to offset every minor wiggle. But policy decisions must be alert to major disturbances. And they cannot be blind to the economic impact of budgetary decisions in social or national security areas. The shortcomings of our policy record under the Employment Act reflect inaction or inadequate action far more often than excessive or inappropriate action.

To carry out their tasks, policymakers must have the benefit of accurate diagnoses of the current state of demand and the best possible forecasts of prospective demand.

Indeed, forecasting of some kind is indispensable. The Government cannot avoid making fiscal and monetary policy decisions which influence the future course of the economy. Because policy cannot be devised and implemented instantly, and because its effects on the economy operate with a lag, decisions are inevitably tied to predictions. Only an illusory escape is offered by rules which suggest basing decisions on the “facts of the present” or on holding some particular magnitudes unchanged through time or

changing some magnitudes by specified preordained amounts. Such rules themselves involve some form of implicit or naive projections. And, for all their limitations, explicit forecasts carefully prepared by professional experts are demonstrably superior to implicit forecasts.

The limitations of the economist's ability to predict the future argues for prudence in policy decisions, flexibility in the use of instruments, and continuing efforts to improve the reliability of forecasting techniques. It also points up the fact that, to the policymaker, knowledge of the nature and magnitude of the uncertainties surrounding the projection can be as crucial as the best-judgment forecast itself.

The Federal Government is currently taking steps to improve the environment in which future policies will be formulated. Three of these steps are discussed below. First, as directed by the President a year ago, Federal agencies have been considering economic policies to make full use of the opportunities afforded by peace, when a welcome cessation of hostilities in Vietnam occurs. Second, new efforts are being made to improve the quantity and quality of the economic data so vital in determining the current position and future prospects of the economy. Finally, serious attention is being given to certain institutional aspects of the mortgage market, in order to improve its functioning and to insure more adequate and equitable supplies of credit for housing.

PLANNING FOR PEACE

When hostilities end in Vietnam, the subsequent reduction of defense expenditures will free resources to meet additional private and public wants. But, just as the sharp buildup of war spending has raised stabilization problems for the economy during the past two years, so too will the cutback in spending. Further, the reconversion process will be complicated by the uneven impact of the current defense effort upon various industries, geographical areas, and types of manpower.

Policy will be challenged both to smooth the transition and, most especially, to avoid the economic downturn that a large drop in defense outlays would bring, if not offset by rising demands elsewhere. With the benefit of forward planning efforts now underway, an active use of appropriate fiscal and monetary measures will be able to meet the welcome challenge of peace.

The cost of hostilities in Southeast Asia is currently estimated at about \$25 billion annually, a large dollar magnitude, although only some 3 percent of our GNP. In the post-Vietnam adjustment, the precise downward course of defense spending will depend on many dimensions of our international relations, including the nature of the peace arrangement. The committee working on this problem has studied, and is continuing to study, what this transition would look like under various assumptions as to the magnitude and the timing of the phasing down of military activities in Southeast Asia. One such assumption—and it is only an assumption, not a state-

ment of policy or a prediction—is that, over a period of time, defense outlays in real terms would return essentially to the level prevailing in 1963–65. The major part of the manpower and expenditure reductions associated with this pattern might be accomplished over a period of approximately 1½ years after hostilities cease. This assumes about as rapid a phasing down as could be reasonably expected on the basis of past experience.

In this case, the Armed Forces might be reduced by roughly 50,000 men per month over an 18-month period to about 2.6 million, a little below the pre-Vietnam level. Perhaps a quarter to a third of the discharged veterans would resume their schooling; the remainder would become full-time participants in the civilian job market. Since the Nation's job market currently absorbs about 1½ million net new entrants a year, an additional 400,000 a year for a time should not pose an insuperable problem if total demand is strong. A variety of measures to improve the training and placement of returning servicemen is now being explored.

The reduction in the Armed Forces would lower military payrolls by nearly \$5 billion over the 6-quarter period, as measured in 1967 prices. Other defense purchases—mainly items bought from private business for procurement, operation, and maintenance—might decline by about \$10 billion (1967 prices) over this year-and-one-half interval, and minor further reductions would continue for an additional year. This illustrative pattern of demobilization—which, as indicated, is about as rapid as could reasonably be expected—implies a reduction in real outlays for defense amounting to \$15 billion (1967 prices) over a year and a half.

The freed resources would become available for civilian use. But if no steps were taken to strengthen demands for civilian output, such a sharp reduction in the Federal contribution to aggregate demand would almost certainly result in a contraction of economic activity.

During the period of demobilization, fiscal actions would be required to distribute the fiscal dividend from peace as well as the dividend associated with economic growth. Over a period of a year and a half, the two might total more than \$30 billion. Thus the requirements and opportunities for fiscal action in a demobilization period would be large.

If it were still in effect, removal of the temporary surcharge now proposed by the President would be first on the agenda of possible stimulative measures. Further tax reductions would be a welcome and effective way to invigorate private civilian demands. Opportunities would also be provided to progress more rapidly on urgent social programs. As Chapter 4 makes clear, there are many areas where added public expenditures could yield a very high social return. Among them are improvements in educational opportunities and standards, the extension of health programs, the provision of more adequate housing, the control of air and water pollution, the promotion of highway beautification and safety, the elimination of urban blight, and the development of low-cost rapid transit. Some new programs might be undertaken directly by the Federal Government; others would be made effective

through an expansion of grants-in-aid to State and local governments; some would involve a partnership of public and private enterprise. Other competitors for a share of the peace dividend could include a number of possible new initiatives in fiscal policy, such as the proposal for a negative income tax and a variety of proposals for providing broad and flexible grants out of Federal revenues to States and cities. The analysis necessary to establish priorities among the various proposals is being pursued by interagency working groups.

Monetary policy would also have a key role to play. The demobilization period might provide an excellent opportunity to move toward financial conditions—in terms of both interest rates and availability—that would actively encourage investment spending in the private sector and assure a vigorous expansion of housing construction.

IMPROVEMENTS IN ECONOMIC STATISTICS

The Federal statistics recording current economic developments are the compass by which policymakers must chart their course. The United States has the most accurate, comprehensive, and detailed economic statistics in the world, based on information that has consistently improved in accuracy, speed, and coverage. Yet the need for accurate and timely statistical data to guide vital policy decisions keeps outrunning the available information.

That need is accentuated by the current state of the economy and the current aims of policy. Sustaining expansion close to the economy's potential growth path is a more difficult task than that of merely attempting to moderate wide swings in output. In a slack economy, it was often sufficient for the indicators merely to point in the right direction. Now more accurate information about the speed of the movement and the distance from full employment is called for. The need for early and careful diagnosis of the extent and location of inflationary dangers also requires comprehensive information about the price, cost, and productivity performance of various sectors of the economy. Capital markets and especially the mortgage market have taken on a key role, calling for more comprehensive data and indicators. The current importance of our international trade position places added emphasis on the need for better information about export and import prices.

The President's program for fiscal 1969 includes a number of particularly urgent improvements in economic statistics. Each improvement has been recommended because it meets these tests: that it assist current policy formulation, that the proposal be capable of rapid implementation, and that its costs be moderate, given the present budgetary stringency. These are the key items in the President's program:

(1) *Nonmanufacturing industries*—additional information on employment, wages, investments, sales, and other indicators for trade, services, and finance that will bring the data closer to the coverage and quality of the data now available for manufacturing industries.

(2) *Construction*—an enlarged effort to collect more accurate and more timely information on the value of construction activity.

(3) *Business investment*—extension of coverage of the plant and equipment survey to all nonfarm industries, and collection of separate quarterly data on business investment in plant, as distinguished from equipment.

(4) *International price competitiveness*—a better comparison of price trends of internationally traded goods.

(5) *Improved price indexes*—covering individual industries systematically, emphasizing actual transactions rather than quoted prices, and developing methods to make more adequate allowance for quality changes in our measurement of prices.

(6) *Quarterly data on national product by industry*—a new economic tableau that will ultimately provide comprehensive information on output, labor input, prices, and productivity by major sectors on a quarterly basis.

(7) *Manufacturing inventories*—expanded coverage and increased detail.

(8) *Mortgage flows and commitments*—a comprehensive system of quarterly and ultimately monthly statistics.

(9) *Bank deposits*—more adequate information on ownership and turnover to be collected by the Federal Reserve; and

(10) *Securities markets*—new information on purchases and sales by institutional investors, and more comprehensive and accurate data on new issues and retirements.

The total program of improvements, which involves an annual budget cost of about \$2½ million, could make a critical difference in guiding decisions involving billions of dollars.

REDUCING THE VULNERABILITY OF THE MORTGAGE MARKET

The recent sharp fluctuations in the availability of mortgage funds have demonstrated the need for action to reduce the excessive vulnerability of the mortgage market and the homebuilding industry to variations in monetary conditions. The basic demand for mortgage financing is expected to grow rapidly in the next few years, while the ability of thrift institutions to meet this demand may diminish as commercial banks compete more effectively for time deposits. Thus, both long-term and cyclical considerations suggest the need to strengthen the thrift institutions which supply the bulk of mortgage funds and to devise new means of attracting funds into mortgages.

In recent years, savings and loan associations and mutual savings banks have accounted for about two-thirds of total private mortgage financing. In earlier periods of tight money, mutual savings banks showed some sensitivity to monetary conditions, but savings and loan associations had little difficulty in maintaining the level of their lending activities. In 1966, however, the flow of funds to both types of institutions declined sharply.

Because their funds are primarily invested in mortgages with fairly long maturities and fixed interest charges, the thrift institutions were unable to raise their earnings enough to permit payment of interest rates in line with those available from banks and open market instruments. Earnings of commercial banks, which carry more diversified portfolios, adjust more promptly to changes in interest rates. While rate competition among financial institutions has, as noted earlier, been limited since 1966 through ceilings on the rates paid by both thrift institutions and commercial banks, thrift deposits remain in competition with corporate bonds and other "open market" instruments. Moreover, thrift institutions have lacked sufficient liquidity or "secondary" reserves to permit them to maintain an even flow of funds into mortgages when the flow of deposits shrinks. The squeeze on mortgages is intensified when commercial banks and insurance companies cut back their contributions to that market in such periods in order to take advantage of higher yielding open market investments or to continue serving their customers for business loans.

Savings and loan associations would have a stronger basic competitive position if they held more secondary reserves and more diversified portfolios. A large part of their funds comes from savers with moderate assets whose savings are not particularly rate-sensitive. These funds can appropriately be invested in long-term, relatively nonliquid assets. But when thrift institutions attract funds from rate-sensitive investors, they should hold a sufficient amount of assets which are either liquid or which mature in a shorter period than mortgages.

The scope for improved portfolio structure of thrift institutions would be enlarged through the chartering of Federal savings associations (formerly described as the Federal chartering of mutual savings banks). Pending legislation—besides providing the Federal Home Loan Bank Board with needed additional supervisory powers in this area—would enable the newly chartered thrift institutions to carry a more diversified asset portfolio than is now permissible for savings and loan associations. (Such revision would require some adjustment in the existing tax provisions governing thrift institutions, which are keyed to portfolio composition.) Adoption of the legislation would increase the institutions' over-all efficiency and competitive strength. The position of thrift institutions would also be strengthened by the further development of instruments not redeemable on demand. Such instruments enable thrift institutions to attract funds from "marginal," interest-sensitive investors at premium rates without requiring an across-the-board dividend or interest-rate increase on all other accounts. With the authorization and encouragement of the Federal Home Loan Bank Board, the institutions have in the recent past already created a considerable range of certificate and bonus accounts, with maturities ranging from as little as six months to more than 14 years.

By using these special instruments to attract interest-sensitive funds without pushing up rates on all accounts, the thrift institutions would be better

able to maintain their competitive position in tight money periods and to reduce fluctuations in their provision of mortgage funds.

New Sources of Funds

To the extent that thrift institutions shift to more diversified portfolios, the amount of funds available to the mortgage market will be initially reduced. In the longer run, however, the savings and loan associations will better serve the mortgage market by maintaining a steadier inflow of funds and by strengthening their own competitive position. Nonetheless, it is important that new channels be opened to bring funds into the mortgage market from other sources. The principal possibilities here lie in the development of techniques for tapping other sources of funds—particularly pension funds and trust accounts. These large institutional investors find it costly as well as inconvenient to manage a portfolio consisting of many individual mortgages; to acquire such a portfolio is usually far less attractive than to purchase corporate or municipal securities—which enjoy a high credit rating, tend to be carefully tailored to the investor's requirements, and are easily marketable.

It has been proposed, in this connection, that the FHA be authorized to issue, for a fee, "full recourse" guarantees for bonds issued against pools of FHA-guaranteed or VA-insured residential mortgages. Such pools of mortgages would be created by mortgage bankers, individual thrift institutions, or mortgage bond corporations that might be specially formed to take advantage of the new guarantee. This arrangement would relieve the bond buyer—but not the mortgage originator or banker—of the already small risk of delays and costs in exercising the guarantee on the mortgages underlying the bonds. These obligations would constitute a fairly attractive and marketable outlet for the funds of institutional investors, capable of competing effectively with various other open market instruments. This and other proposals for channeling funds from the bond market into the mortgage market are being actively studied within the Administration.

Reducing Legal Limitations on Interest Rates

Effective implementation of some of the steps cited above may, in practice, prove very difficult unless action is taken to modify or eliminate various existing legal limitations on interest rate charges or payments. In particular, the statutory interest rate ceilings on FHA-insured and VA-guaranteed mortgages have impeded the flow of mortgage credit. For an adequate flow, it is essential that seekers of such credit be able to compete in the capital market by offering yields comparable to those available from other borrowers. Because of the ceilings, however, the yields on FHA and VA mortgages could, during the past two years, be rendered competitive only through the use of heavy initial discounts on such mortgages. This has meant, in some cases, a sharp increase in the initial payment required of the FHA home buyer—generally imposing a much more severe burden on him than is

entailed by a somewhat higher interest rate payable over many years, especially after allowing for the partially offsetting tax benefit. More often, it has forced builders or sellers to absorb a substantially greater part of the initial financing cost, reducing their incentive to enter into the transaction.

Given the need for allowing effective yields on FHA and VA mortgages to rise above the present legal ceilings if funds are to flow into such mortgages at all when market rates are high, the lifting of the ceiling proposed by the President in his *Economic Report* would clearly be to the benefit of both buyers and sellers of residential properties. Similarly, it would be desirable if comparable remedial action were taken by the nine States (with 26 percent of the total population) that now set legal maximum interest rates on conventional mortgages at 6 percent or less. These ceilings are already inhibiting many lenders from originating or purchasing mortgages in the States involved.

Conclusion

The measures discussed here would not, of course, entirely insulate the mortgage market from the effects of tight money. But they would give mortgage borrowers an opportunity to compete with other borrowers for the available supply of funds even under tight money conditions. Funds would, of course, be available to mortgage borrowers only to the extent that they were willing to pay a competitive rate. Many buyers might still choose to defer home purchase during a period of monetary restraint, and the economy is served by such voluntary deferrals when resources are under strain. There is no reason to insulate the mortgage market completely from general credit conditions. But homebuyers as well as builders and other property sellers should not be completely frozen out simply as the result of existing institutional limitations on the mortgage market.

Chapter 3

The Problem of Rising Prices

THE MOST IMPORTANT and most gratifying economic development in 1967 was the maintenance of high employment. The most disturbing economic news was the continuation of the creeping inflation that began in 1965.

Neither the United States nor any other major industrial country has fully succeeded in combining price stability with high employment. Table 10 shows the average rise in U.S. prices during each of the four postwar periods when the unemployment rate was consistently below 4.5 percent. The price record of the current period compares favorably with the experience of earlier periods, including that of 1955–57, when the unemployment rate averaged somewhat higher.

The recent price record of the United States also compares favorably with that of other major industrial nations. Table 11 shows the average rate of price increase in the principal member nations of the OECD over the past 6½ years and the past 2½ years. For the period from January 1961 to November 1967, the U.S. record is by far the best. Since June 1965, however, three countries—Germany, France, and the Netherlands—have had better price records than the United States. But in each of these countries a slowing down of price increases has been achieved only at the expense of a loss of jobs, and, in at least the first two, a reduction of economic growth.

PRICE STABILITY AND HIGH EMPLOYMENT

The problem of rising prices is thus neither new nor confined to the United States. In some instances both at home and abroad, rapidly rising prices have reflected pressures on productive capacity from excessive demand, which ideally could have been moderated by fiscal and monetary restraint. But industrial economies have also displayed an “inflationary bias”—a tendency for prices to rise even when over-all demand does not exceed productive capacity. Since high employment of resources—especially manpower—is obviously a top priority for public policy, it is important that we learn to control this inflationary bias.

TABLE 10.—*Price increases during periods of high employment*¹

| Period | Average un-employment rate (percent) | Percentage increase per year ² | | |
|-----------------------------------|--------------------------------------|---|-----------------------|------------------|
| | | Consumer price index | Wholesale price index | GNP deflator |
| January 1947–January 1949..... | 3.8 | 5.5 | 5.7 | ³ 5.6 |
| September 1950–November 1953..... | 3.2 | 3.2 | 1.3 | 3.3 |
| May 1955–September 1957..... | 4.1 | 2.4 | 2.8 | 3.4 |
| July 1965–December 1967..... | 3.9 | 2.9 | 1.5 | 2.9 |

¹ Periods during which the monthly seasonally adjusted unemployment rate was less than 4.5 percent, except that beginning of the first period is arbitrarily taken as January 1947.

² Price change is measured between the month (quarter) prior to the first month (quarter) of the period and the last month (quarter) of the period.

³ GNP deflator for fourth quarter 1946 is estimated.

Note.—Changes in consumer and wholesale price indexes based on monthly data and changes in the GNP deflator on seasonally adjusted quarterly data.

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

TABLE 11.—*Consumer price increases in major OECD countries since January 1961 and June 1965*

| Country | Percentage increase per year | |
|---------------------|-------------------------------|----------------------------|
| | January 1961 to November 1967 | June 1965 to November 1967 |
| United States..... | 1.9 | 2.8 |
| Belgium..... | 3.0 | 3.3 |
| Canada..... | 2.3 | 3.5 |
| France..... | 3.5 | 2.4 |
| Germany..... | 2.6 | 1.7 |
| Italy..... | 4.4 | 2.8 |
| Japan..... | 5.7 | 4.3 |
| Netherlands..... | 3.8 | 2.7 |
| Sweden..... | 4.1 | 5.1 |
| Switzerland..... | 3.8 | 4.3 |
| United Kingdom..... | 3.4 | 2.8 |

Sources: Department of Labor and Organization for Economic Cooperation and Development.

INFLATIONARY BIAS IN A PROSPEROUS ECONOMY

There are several sources of inflationary bias in a high-employment economy, in which output grows in pace with and does not generally strain productive capacity.

Market Power

The first source of bias, which clearly interacts with and strengthens the others, lies in the fact that, at high employment of manpower and capital resources, the competitive pressures which limit the ability of firms and unions to raise prices and wages are weaker than in a slack economy. Some firms are likely to attempt to use their market power to widen their profit margins, and some groups of workers may attempt to raise their wages relative to wages of others. There is also an increased resistance to price reductions when costs fall or demand slackens. Wage rates seldom decline even when unemployment is widespread. But, in a generally strong economy, many groups of workers try—often successfully—to resist even any *relative* reduction in their own wages compared to those of other workers.

If a significant number of firms or unions take advantage of their market power to seek improvements in their profits or relative wages, those who have to pay higher prices or wages will seek to maintain their *absolute* positions by adding their cost increases to their prices, or their cost-of-living increases to their wages. They may even seek to restore their *relative* positions by taking a markup on cost increases or demanding wage increases as large as other workers obtained.

There are many reasons why the effective market power of large firms and unions is greater at high levels of resource use than at lower ones. At high levels of employment and capacity utilization, firms have less reason to fear that, if they raise prices, they will lose customers to competitors. For their competitors are then not in a position to take on a large volume of additional business. Similarly, when profits are high throughout the economy, there is less of a threat that new firms will enter a particular industry in response to higher prices. In wage bargaining, when union members are fully employed, organized labor is naturally less concerned that a large settlement may curtail the growth of employment. Moreover, a firm which is operating close to capacity is less willing to risk a protracted strike, and therefore more likely to accede to demands for large settlements, since it would have difficulty making up for output lost during a work stoppage.

Uneven Pressures of Demand

A second source of bias arises from the fact that—at high but not excessive over-all employment of manpower and capital resources—the pressures of demand on supply will not be equal in all sectors of either the product or labor markets. In some industries, the growth of demand may be so large that it cannot be immediately matched by additional output. This pulls up prices even where individual firms possess little or no market power. Likewise, in those labor markets that are particularly tight, the rise of wages tends to speed up even if workers are unorganized. But the rise in prices and the faster rise in wages where markets are under pressure is not automatically offset by price reductions or a slower advance of wages in the rest of the economy. Moreover, other firms which buy the products which have risen in price will pass along the cost increase—perhaps with a markup applied—and other groups of workers will try to match the wage gains secured in the tight labor markets.

An extraneous reduction of supply in a key sector—e.g., agriculture—can have similar effects. Prices then rise in that sector without falling elsewhere, leading to larger wage increases that raise costs and prices generally. Though these influences may be temporary, the wage and price movements they induce are not reversed fully when the supply problem is overcome.

Temporary Spurts of Demand

The third source of inflationary bias lies in the fact that the growth of over-all demand is unlikely to be completely smooth, even with the best of

fiscal and monetary policies. When demand is already adequate to use most productive resources, a sudden speedup in the growth of demand may create temporary upward pressures on prices and costs in a wide range of sectors. And even if such a spurt in demand is subsequently balanced out by a temporarily reduced growth of demand, costs and prices do not then correspondingly fall. Indeed, the spreading and spiraling effect of the previous cost and price increases will continue to be felt. Thus, although a spurt of demand in 1965 and 1966 was followed by a balancing slowdown, the wage-price spiral set off by the initial spurt continued to turn in the relatively slack period of 1967.

Inefficiencies and Bottlenecks

Even in an economy as efficient and progressive as ours, there are a few industries and labor markets where gross inefficiencies persist—stagnant technology, weak management, firms of inefficient size, restrictive labor practices, unnecessarily costly systems of distribution, Government policies that weaken incentives to economize, avoidable seasonality of production and employment, inadequate methods for training and recruiting workers, and similar factors. Prices or wages or both tend to rise faster in these industries than in others; in a high-employment economy this tendency is aggravated. These industries constitute a further source of inflationary bias in the sense that they offer unexploited opportunities for significant cost reductions.

Workings of the Spiral

Any of these sources—or their interaction—can easily trip off a price-wage spiral. In such a spiral, rising living costs support demands for wage increases in excess of productivity gains. The resulting bulge in labor costs is reflected in prices. Price and wage increases can continue to reinforce each other long after the initial source of inflation has ceased to operate. Thus, the spiral can continue to turn more or less on its own momentum. But, unfortunately, one or another of the basic sources of the bias is likely to provide new motive power, so long as resources remain adequately utilized.

On the other hand, the circular relationship between wages and prices can support price stability as well as a spiral. If prices remain stable, the demand for wage increases is not swollen to cover rising living costs. And if wage increases remain moderate, costs and prices may remain stable. But the stability can be broken on the side of either wages or prices. And once broken it is difficult to reestablish.

A general rise in prices and wages does not directly reduce total private demands, for the higher prices and wages provide additions to money incomes sufficient to permit the higher prices to be paid. But the spiral can be curtailed by Government policies. The existence of a wage-price spiral requires that the rate of growth of aggregate demand in money terms exceed the rate of growth of real productive capacity. If fiscal and monetary policies should fail to permit the expansion of demand in money terms necessary to “vali-

date" the price rise, real growth would not keep up with the growth of capacity. Unemployment would rise and utilization rates decline. This would lead to the gradual slowing down and termination of the spiral. Obviously, the greater the restraint through fiscal and monetary policy, the more quickly the spiral can be brought under control. But this may require an unacceptably high level of unemployment.

THE GOAL OF PRICE STABILITY

Since minimum unemployment and high utilization of our productive resources bring so many obvious benefits to the Nation and to most individuals, the temptation is great to dismiss the accompanying inflationary bias as a minor inconvenience, a cost far outweighed by the benefits. Nevertheless, price stability is an important goal because the costs of inflation are serious and pervasive. Inflation impairs economic efficiency, redistributes income capriciously, and weakens the Nation's competitiveness in world markets.

A realistic stabilization policy cannot expect to hold down to zero the average change of prices of consumer goods and services. From 1961 to 1965, although wholesale prices remained virtually constant and there was obvious slack in the economy, consumer prices rose between 1 and 1½ percent each year. Such a moderate rate of price increase, however, does not represent a significant erosion in the purchasing power of the consumer's dollar. This is especially true because improvements in quality and the introduction of new goods add to consumption opportunities even when they are not fully reflected in price indexes as reductions in prices.

Furthermore, the objective of price stability does not aim to hold any specific price constant. Within a stable average price level, there can and must be constant adjustments to changing levels and patterns of demand, to diverse movement of costs in different sectors, and to technological change. Costs and prices of some items rise; others fall. These relative price changes attract resources toward those areas where the need is greatest.

Similarly, price stability is compatible with rising wages. Labor compensation can move up in line with the average growth of labor productivity without adding to the labor costs of output. And the stability of over-all labor costs is thoroughly consistent with readjustments in the relationships among wages in different sectors and for different occupations. These changes tend to be gradual and the disparities self-correcting, as workers—particularly new entrants—are attracted into the areas where labor is in greatest demand.

The Impairment of Efficiency

Once prices start moving up on a broad front, however, the necessary relative adjustments of prices and wages become much more difficult. Some prices respond immediately to changes in underlying economic conditions, others only after a long delay, but then often with a big change. Thus, while each change may appear to correct one set of disparities, it creates others;

adjustment of the latter, in turn, creates new problems. Relative prices, wages, and profits cannot achieve the patterns appropriate to the changing needs of the economy when all of them are ratcheting upward at an uncertain and uneven rate. The efficient allocation and use of resources inevitably suffers. Thus, the objective of price stability is linked to the aim of economic efficiency.

Arbitrary Redistribution of Income

Inflation has a significant effect on the distribution of income and wealth. By and large, that impact is haphazard and inequitable from a social point of view. Some groups in the economy are more vulnerable to inflation than others; this is why inflation has been described as the “cruellest tax.”

A particularly significant income shift associated with rising prices takes place between the active participants in the economy, whose money incomes adjust more or less to rising prices, and those—such as the retired and disabled—who are not active participants. The money incomes of millions of the families in the latter group are relatively fixed at any given time and augmented little, if at all, by rising prices. Many depend on pensions and other sources of retirement income which come from accumulated savings in forms that have a fixed money value, such as savings deposits, insurance policies, or bonds. Some retired persons live on previously accumulated wealth that has a fixed money value. There are some partial offsets: interest rates on deposits tend to rise in periods of inflation, and so may the prices of common stocks and of real estate. But not everybody holds assets that rise in price or yield. Legislative changes in social security have provided considerable relief to many retired and disabled individuals at the lower end of the income range, but not to all. Nevertheless, the inactive members of the population as a group suffer losses of real income that to them are significant, even though the corresponding gains of the active group are relatively small in terms of its income.

To be sure, in a period of inflation, some workers will have the opportunity for wage gains sufficiently large to enhance their real incomes relative to other workers. Some businessmen do manage to widen their profit margins. Yet, in the ensuing spiral, neither business as a whole nor labor as a whole is likely to make permanently larger gains in real income as a result of inflation. Periods of rapid rises in both wage rates and prices have not significantly altered the long-term distribution of income between labor and business. Both groups reap their gains in a depreciated dollar, with some loss to both by sacrificing the smooth functioning of the economy. Most gains achieved by individual groups of workers are principally at the expense of other workers, and the profit gains of some industries may be obtained largely at the expense of profits in other sectors.

Improvements in the distribution of economic rewards and in equality of opportunity often occur in periods of high demand and relatively full employment. It is during such periods that persons with educational, racial,

locational, age, or physical disadvantages find the greatest opportunities to move into the mainstream of economic life, and secure their greatest relative gains. But these gains come from full employment, not from the excessive wage and price increases that may accompany it. Our objective is to achieve the gains while avoiding costly inflation.

Inflation and the Balance of Payments

As Chapter 5 makes clear, rising prices also have important international implications which—particularly at the present time—can be even more serious. If our prices rise faster than those of our major competitors, American goods suffer in world markets. An increase in the U.S. surplus of exports over imports is needed to strengthen our balance of payments and to permit the eventual relaxation of the restrictions now necessary to maintain our payments position.

A healthy trade surplus also has a direct and individual meaning for the pocketbooks of the vast numbers of American workers, businessmen, and farmers who are engaged in industries exposed to export or import competition. If costs and prices in these industries are not kept in check, markets may shrink and profits along with markets. Restriction of imports to compensate for this deterioration would be no answer, since it would lead to retaliatory curbs on our exports, and thus to reduced markets and job opportunities in our export industries.

Slowing the Trend of Rising Prices

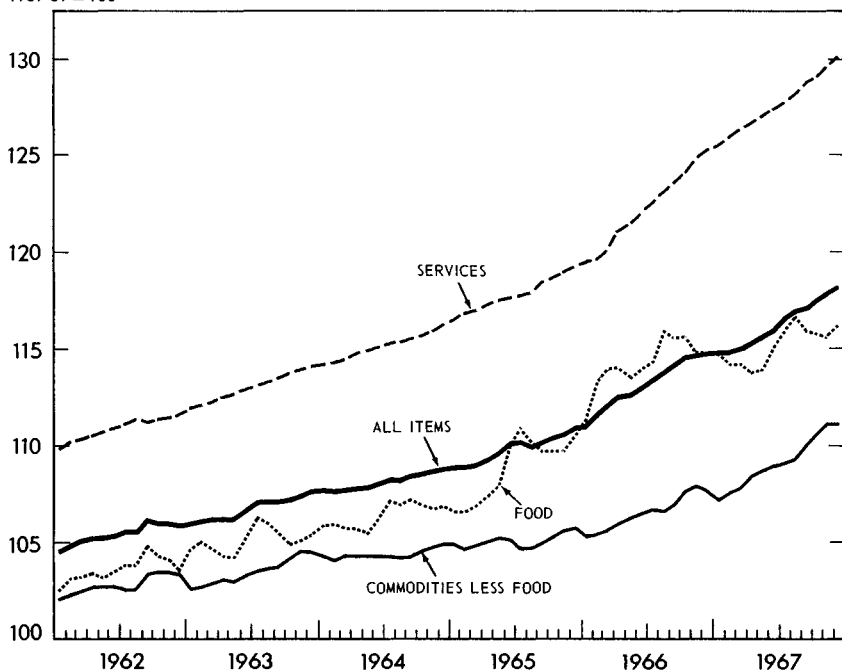
The social and economic costs of rising prices point to the pressing need to reestablish and to maintain reasonable stability of the U.S. price level. It is clear, however, that the current inflationary trend cannot be stopped abruptly. Yet it is equally clear that the trend must be slowed down. Once a deceleration is achieved, it can become self-reinforcing. As wage increases slow down, unit labor costs and prices will move up less rapidly. The successive upward adjustments of wages to prices and of prices to wages can progressively shrink. If price increases slow down in 1968 and reasonable stability is in the process of being restored, the health and strength of the U.S. economy will not be seriously impaired by the fact that prices are still rising. But a new acceleration of price increases could have serious consequences, both domestic and international.

THE RECENT RECORD

The upward movement of prices moderated somewhat during the first half of 1967, largely reflecting declines in farm prices and the sluggishness of industrial demand. But the pace stepped up again in the second half. Developments during 1967, and the prospects and problems for the years immediately ahead, can best be understood in the perspective of the entire period of economic expansion (Charts 8 and 9).

Consumer Prices

1957-59 = 100



SOURCE: DEPARTMENT OF LABOR.

PRICE CHANGES SINCE 1961

For the purpose of such an assessment, the period since 1961 can be divided into four fairly distinct segments: relative stability—1961 through mid-1965; acceleration—mid-1965 through September 1966; easing pressures—September 1966 through mid-1967; and renewed rapid advance—since June 1967 (Table 12).

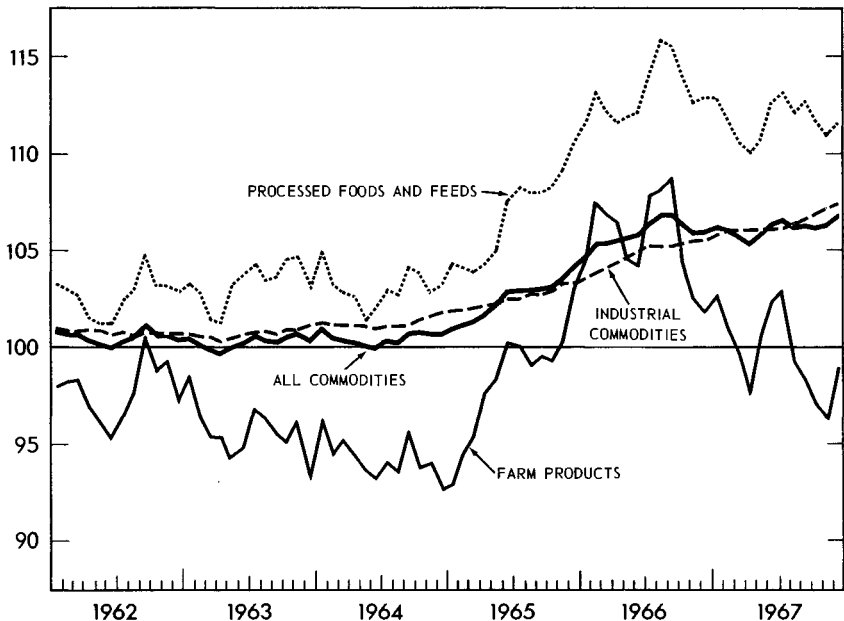
1961 Through Mid-1965

A remarkable degree of price stability characterized the early years of the 1960's. Economic activity rose along a balanced and fairly steady path. Because the margin of underutilized resources had been very large in 1961 and because it was absorbed gradually, significant economic gains did not upset the stability of prices. Some moderate pressures began to emerge in 1965; many firms were approaching their preferred operating rates, as expansion of plant and equipment lagged somewhat behind the growth of output, and profits rose sharply.

The first significant departure from price stability occurred among farm products. Throughout this period, farm prices had been falling slowly. Early

Wholesale Prices

1957-59 = 100



SOURCE: DEPARTMENT OF LABOR.

in 1965 they suddenly reversed direction, reflecting reduced domestic supplies and heavy export demand. Price increases for food at both wholesale and retail followed promptly.

Mid-1965 Through September 1966

Around mid-1965, the growth of demand for industrial products suddenly accelerated as the direct and indirect consequences of the enlarged commitment of U.S. forces in Vietnam. Manufacturing output and employment spurted sharply in the last quarter of 1965 and the first quarter of 1966, and continued to rise steadily through most of 1966.

Prices of consumer services began to accelerate, as service firms found it more difficult to obtain workers. With rising food and service prices and stronger demands for labor, upward pressures on wages intensified in both the organized and unorganized sectors. In the industrial area, the impact of demand on prices was strongest in the defense-related and capital goods sectors, where shortages of both capacity and skilled manpower were most pronounced. But prices also advanced in many other areas.

The upward pressures on prices and wages in this period reflected both the speed of the advance and the high level of resource utilization which the economy achieved. These pressures tripped off a price-wage spiral. Rising living costs and tight labor markets combined to enlarge wage increases, and the resulting bulge in unit labor costs and the stronger product

TABLE 12.—*Major price trends during selected periods since December 1960*

| Price group | Percentage change per year | | | |
|--|----------------------------|-----------------------------|-----------------------------|----------------------------|
| | December 1960 to June 1965 | June 1965 to September 1966 | September 1966 to June 1967 | June 1967 to December 1967 |
| Wholesale prices: | | | | |
| All commodities..... | 0.5 | 3.1 | —0.6 | 0.9 |
| Farm products and processed foods and feeds..... | 1.1 | 6.1 | —4.9 | —3.8 |
| Industrials..... | .3 | 2.1 | 1.0 | 2.7 |
| Consumer prices: | | | | |
| All items..... | 1.3 | 2.9 | 2.2 | 3.8 |
| Commodities..... | 1.0 | 2.3 | 1.2 | 3.5 |
| Food..... | 1.5 | 4.0 | — .6 | 1.9 |
| Commodities less food..... | .7 | 1.4 | 2.4 | 4.1 |
| Services..... | 2.0 | 4.0 | 4.2 | 4.3 |
| GNP deflator ¹ | 1.4 | 2.6 | 2.6 | 4.0 |

¹ Based on seasonally adjusted data for quarter containing month indicated.

Sources: Department of Commerce and Department of Labor.

markets generated higher prices. Rising prices in turn served as the basis for further wage advances, and further wage advances as the basis for price increases.

September 1966 Through Mid-1967

Largely as a consequence of restrictive monetary and fiscal policies and a concurrent rise in the personal saving rate, the growth of final demand slowed in late 1966. A period of inventory adjustment and sluggish over-all growth followed in the first half of 1967. The slowdown, combined with larger supplies, caused prices to fall sharply for most farm products and some other commodities traded in organized markets. To a degree, these declines were reflected in lower prices for foods and other commodities directly processed or fabricated from the less costly raw materials. Price increases also slowed in most—but not all—other areas.

The rise in prices that did occur in that sluggish period was essentially a reflection of rising costs rather than of excessive demand. However, these cost increases originated in the strong demand conditions of 1965 and 1966. Thus, the price-wage spiral continued to turn, although the initial motive force had subsided.

Second Half of 1967

As demand advanced with renewed strength in the second half of 1967, the rate of price increase again stepped up. Demand was not yet pressing on productive capacity—over-all or in most major sectors. The period of slow expansion had created enough slack so that production could respond to increasing demand without significant strain on productive resources. But costs had continued to rise throughout the period of sluggishness. The full adjustment of prices to these rising costs had been suppressed or de-

layed in the first half year. Later in the year, stronger markets and expectations of renewed expansion led businessmen to raise prices to reflect the earlier cost increases, thus turning the wage-price spiral another notch.

Because the basic inflationary force in 1967 was rising costs, the pattern of price and wage changes was rather different from that of 1966, when excessive demands were the chief inflationary force.

DEVELOPMENTS IN 1967

The rate of increase of prices in 1967 was much the same as in 1966. To be sure the annual average of wholesale prices barely rose from 1966 to 1967 in contrast with a 3.3 percent increase from 1965 to 1966. However, the increase in consumer prices slowed only from 2.9 percent in 1966 to 2.8 percent in 1967. The GNP deflator—which covers all output—rose 3.0 percent in 1967 as against 2.7 percent in 1966.

All three price indexes showed a modest deceleration when price changes are measured during the year (December to December) rather than by annual averages. For example, *during* 1967, consumer prices increased 3.1 percent compared with 3.3 percent *during* 1966. And the GNP deflator registered a 3.1 percent advance during 1967, slightly less than the 3.2 percent rise during 1966.

Increases in wages and hourly labor compensation continued at high levels in 1967. Meanwhile, productivity gains lagged, and unit labor costs rose considerably.

The discussion which follows summarizes the wage and price record of 1967.

LABOR SUPPLY AND DEMAND

Labor markets were generally not as tight in 1967 as they had been in 1966, despite the fact that the over-all unemployment rate was the same in both years. This conclusion is supported by various measures of labor market tightness, such as hours of work, new hire and layoff rates, help-wanted advertising, unfilled job openings, and insured unemployment.

Employment showed little change in the first half of the year but surged ahead in the second half. Most measures of labor market conditions reflected the changing pace of employment. For example, the number of unfilled non-farm job openings placed by employers with the U.S. Employment Service declined 23 percent from September 1966 to July 1967, then moved irregularly upward. Throughout, unfilled openings remained above 1965. Average hours per week in manufacturing, the help-wanted index compiled by the National Industrial Conference Board, insured unemployment, and new hire and layoff rates weakened from the fall of 1966 to mid-1967, then strengthened during the remainder of the year. All these measures indicated that labor market conditions eased in 1967; all except the workweek indicated that labor markets were tighter than in any year between the end of the Korean war and 1966.

The unemployment rate, however, did not rise in 1967 though it fluctuated from month to month. Changes in employment were offset to a remarkable degree by parallel changes in the labor force. The participation of women in the labor force varied considerably. When job openings waned in the first half of the year, growth of the adult female labor force stopped; when employment opportunities brightened in the second half of the year, the participation of women rose strongly, accounting for 1.1 million of the unusually large 1.5 million increase (seasonally adjusted) in the total labor force.

The rise in demand for labor and in employment during 1967 was unevenly spread among occupations and sectors, reflecting the pattern of economic activity. Manufacturing employment, after rising by about 6 percent between 1965 and 1966, declined by nearly 2 percent in the first half of the year, and at the end of 1967 was still 0.3 percent below a year earlier. There was also a small reduction in mining employment. But in the service sectors, employment rose slightly more between 1966 and 1967 than between 1965 and 1966. Employment in the professional, technical, and salaried managerial categories continued to increase rapidly.

On the whole, the balance between the composition of labor demand and of labor supply improved in 1967. In particular, the metalworking skills which had been in such short supply in 1966 were no longer so scarce. This mainly reflected the easing of demand pressures on the industries which are the largest employers of men with these skills. Total employment actually declined in 1967 in the machinery and equipment industries.

In part, the easing of shortages also reflected the fact that the structure of the labor force had another year—and the assistance of greatly expanded private and public training programs—to adjust to the job requirements of a high-employment economy.

The number of long-term unemployed declined significantly, indicating that many previously “hard-core” unemployed were moving into the mainstream of employment.

Moreover, the geographical balance of labor supply and demand also improved. For example, the number of “major” labor market areas classified as having “persistent” unemployment fell from 9 in December 1966, to 6 in December 1967. The number of “small” labor market areas with persistent unemployment fell from 60 to 57 and the number of “very small” labor market areas from 399 to 366 over the same period.

But while specific shortages were reduced and the over-all balance in the labor market was improved, labor markets remained tighter than they had been for many years prior to the surge of demand in late 1965 and 1966. Even in manufacturing, where employment was not growing, labor turnover remained relatively high. And the continuing rapid growth of demand in the professional, technical, and managerial occupations produced severe competition for workers with these abilities and skills.

Wages

The faster rise in wages that had begun in 1966 continued throughout 1967. Though marked shortages were not widespread, employers continued to compete to attract or retain experienced, well-qualified workers. Workers in relatively low-wage industries and occupations continued to have opportunities to move to better jobs, and their wages rose particularly rapidly. Unions negotiating in 1967 had the background of two years of rising living costs, low unemployment—especially for adult men—and relatively high profits to support their negotiating positions. Moreover, in 1967, union bargainers had many more large settlements by other unions—and, in some cases, large awards to unorganized workers—to point to in support of their demands. They sought to catch up with—and, if possible, to surpass—the pattern of wage increases established by other unions in earlier settlements. Thus, collective bargaining settlements in 1967 averaged about 5½ percent a year, well in excess of settlements in 1966 and far above those earlier in the 1960's (Table 13).

TABLE 13.—*Wage and benefit changes in collective bargaining situations, 1962–67*

| Type of change | Median percentage change negotiated or effective during | | | | | |
|--|---|------|------|------|------|-------------------|
| | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 ¹ |
| Most important collective bargaining situations, annual rate of increase over life of contract: ² | | | | | | |
| Wage and benefit changes negotiated during specified year: ³ | | | | | | |
| Equal timing ⁴ | | | 3.5 | 3.3 | 4.1 | 5.2 |
| Actual timing ⁵ | | | | | 4.5 | 5.6 |
| Wage changes negotiated during specified year: ⁶ | | | | | | |
| Equal timing | | 2.5 | 3.0 | 3.3 | 3.9 | 5.1 |
| All important collective bargaining situations: ⁷ | | | | | | |
| First-year wage adjustments negotiated during specified year: | | | | | | |
| All industries | 2.9 | 3.0 | 3.2 | 3.8 | 4.8 | 5.7 |
| Manufacturing | 2.4 | 2.5 | 2.0 | 4.0 | 4.2 | 6.4 |
| Nonmanufacturing | 4.0 | 3.4 | 3.6 | 3.7 | 5.0 | 5.0 |
| Wage adjustments effective during specified year, regardless of date of negotiations: ⁸ | | | | | | |
| All industries | 2.8 | 2.9 | 2.7 | 3.4 | 3.6 | 4.4 |
| Manufacturing | 2.6 | 2.7 | 2.0 | 3.4 | 3.3 | 4.0 |
| Nonmanufacturing | 3.5 | 3.2 | 3.5 | 3.4 | 3.8 | 4.8 |

¹ Based on preliminary data available in early January 1968.

² Possible increases in wages resulting from cost-of-living escalator adjustments are omitted except for any part of the escalator increase guaranteed in the contract.

³ The 1964 estimate is based on 20 key contracts which affected 2.25 million workers in 11 major industries. The 1965 estimate covers most settlements affecting 10,000 workers or more in all industries excluding construction, services, finance, and government. The 1966 and 1967 estimates cover all settlements affecting 5,000 workers or more in all industries except government.

⁴ Annual rate of increase assuming equal spacing of wage and benefit changes over life of contract.

⁵ Annual rate of increase taking account of actual effective dates of wage and benefit changes during contract period.

⁶ The estimates for 1963 to 1965 cover most settlements affecting 10,000 workers or more in all industries excluding construction, services, finance, and government. The 1966 and 1967 estimates cover all settlements affecting 5,000 workers or more in all industries except government.

⁷ All contracts affecting 1,000 or more workers. From 1962 to 1965, construction, services, finance, and government are excluded. All industries except government are covered in the 1966 and 1967 estimates.

⁸ Includes changes in wage rates negotiated during specified year, plus increases decided upon in earlier years, cost-of-living escalator adjustments, and no wage changes.

Source: Department of Labor.

An important influence on both union and nonunion wage increases in 1967 was the 12-percent increase in the Federal minimum wage and the extension of coverage to millions of additional workers.

As a result of all these factors, wage increases in most sectors—unorganized and organized—accelerated between 1966 and 1967. Gross average hourly earnings for nonsupervisory employees in the private nonfarm sector increased 4.7 percent between 1966 and 1967, up from 4.1 percent in 1965–66 (Table 14).

Gross hourly earnings in manufacturing were held down by a decline in overtime hours. Changes in the proportion of workers in high and low wage industries—the interindustry “mix”—within manufacturing also held down the average increase in earnings. Corrected for changes in overtime and for interindustry mix, average straight-time earnings for production workers in manufacturing increased 4.6 percent in 1967, considerably above the 4.0 percent increase in gross average hourly earnings based on actual employment weights, and far in excess of the 3.3 percent corrected increase in 1966. The acceleration in wage rates in 1967, therefore, was even more marked than the table indicates.

As has been the case in each of the last several years, increases in hourly earnings were largest in low-wage industries. Indeed, every sector shown in Table 14 with below average wage *levels* had above average wage *increases* (although the reverse was not uniformly true). Even within manufacturing,

TABLE 14.—*Changes in average gross hourly earnings, by industry, 1960–67*

| Industry | Percentage change per year | | | |
|--|----------------------------|--------------|--------------|---------------------------|
| | 1960 to 1964 | 1964 to 1965 | 1965 to 1966 | 1966 to 1967 ¹ |
| Total private nonagricultural employees ² | 3.1 | 3.8 | 4.1 | 4.7 |
| Manufacturing | 2.9 | 3.2 | 4.2 | 4.0 |
| Durable goods | 2.8 | 3.0 | 3.9 | 3.4 |
| Nondurable goods | 2.8 | 3.1 | 3.8 | 4.9 |
| Mining | 1.9 | 3.9 | 4.8 | 4.6 |
| Contract construction | 3.6 | 4.2 | 4.9 | 5.4 |
| Transportation and public utilities: | | | | |
| Communication | 3.8 | 3.3 | 3.2 | 3.4 |
| Electric, gas, and sanitary services | 3.5 | 4.3 | 4.1 | 4.2 |
| Trucking and warehousing | 4.2 | 3.7 | 3.6 | 3.8 |
| Local and suburban transportation | 2.9 | 3.6 | 3.1 | 4.9 |
| Wholesale trade | 3.0 | 3.6 | 4.6 | 5.5 |
| Retail trade ³ | 3.6 | 4.0 | 4.9 | 5.2 |
| Finance, insurance, and real estate | 3.3 | 3.9 | 3.8 | 5.2 |
| Service and miscellaneous: | | | | |
| Hotels, tourist courts, and motels | 4.3 | 5.4 | 5.1 | 8.4 |
| Laundries and drycleaning plants ⁴ | 3.8 | 5.6 | 5.3 | 8.1 |
| Agriculture | 2.5 | 5.2 | 8.3 | 8.7 |

¹ Preliminary.

² Includes industries not shown separately.

³ Includes eating and drinking places.

⁴ Prior to January 1964, data relate to production workers.

Note.—Data are for production workers in manufacturing and mining, for construction workers in contract construction, and for all nonsupervisory employees in other industries (except as noted).

Sources: Department of Agriculture and Department of Labor.

some of the most notable advances were achieved in such low-wage industries as textiles, apparel, shoes, and furniture.

The faster wage increases for the lowest paid industries reflects the general tendency for differentials to narrow—at least in percentage terms—when labor markets are relatively tight. During such periods, many employees in low-wage industries can find a ready market for their services in higher-paid sectors, forcing employers to raise wages rapidly in order to retain their workers. The narrowing of differentials was further reinforced in 1967 by the increase in the level and coverage of the minimum wage.

However, the tendency for wage differentials to narrow was partially offset in a number of areas by new collective bargaining agreements. There was considerable variation in the size of new contracts in 1967. One-fifth of all workers affected by new major settlements received annual increases in compensation exceeding 6 percent. Particularly large gains were secured by workers in the automotive, rubber, pulp and paper, railroad, farm implement, and construction industries—all high-wage industries.

Average hourly compensation (which includes wages, fringe benefits, and employer contributions for social insurance) for all employees in the total private economy rose 6 percent in 1967 (Table 15). The difference between the over-all increase in hourly compensation and the increase in hourly

TABLE 15.—*Changes in compensation, productivity, unit labor cost, and output price in the private economy since 1947*

| Sector and item | Percentage change per year | | | |
|--|----------------------------|--------------|--------------|---------------------------|
| | 1947 to 1966 | 1961 to 1965 | 1965 to 1966 | 1966 to 1967 ¹ |
| Total private: | | | | |
| Average hourly compensation ² | 5.2 | 4.4 | 6.9 | 6.0 |
| Output per man-hour..... | 3.4 | 3.8 | 3.1 | 1.4 |
| Unit labor cost..... | 1.7 | .5 | 3.7 | 4.5 |
| Implicit GNP price deflator..... | 2.0 | 1.2 | 2.5 | 2.7 |
| Private nonfarm: | | | | |
| Average hourly compensation ² | 4.9 | 4.0 | 6.0 | 5.8 |
| Output per man-hour..... | 2.8 | 3.5 | 2.6 | .9 |
| Unit labor cost..... | 2.0 | .5 | 3.4 | 4.8 |
| Implicit GNP price deflator..... | 2.2 | 1.2 | 2.2 | 3.3 |
| Manufacturing: | | | | |
| Average hourly compensation ² | 5.1 | 3.6 | 4.9 | 6.1 |
| Output per man-hour..... | 3.2 | 4.6 | 2.2 | .9 |
| Unit labor cost..... | 1.8 | -1.0 | 2.7 | 5.1 |
| Implicit GNP price deflator..... | 2.0 | .3 | 1.8 | (³) |

¹ Preliminary.

² Wages and salaries of all employees and supplements to wages and salaries such as employer contributions for social insurance and for private pension, health, unemployment, and welfare funds, compensation for injuries, pay of the military reserve, etc. Also includes an estimate of wages, salaries, and supplemental payment part of the income of the self-employed.

³ Not available.

Note.—Data for each sector relate to all persons.

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

earnings of production workers reflects, in part, a decline in the proportion of man-hours worked by production workers, whose average pay is lower than that of supervisory employees. Fringe benefits grew more rapidly than wages and, in addition, a small increase in 1967 in employer contributions for social insurance accounts for some of the difference.

Real Income Gains

About half of the 6-percent increase in current-dollar compensation per man-hour was eroded by the increase in consumer prices. In real terms, compensation per man-hour rose by 3.2 percent, somewhat less than in 1966, but above the average gain in recent years. Real weekly earnings of production workers—which do not include employer contributions for social insurance and other fringe benefits—increased less than 1 percent, partly as a result of lower weekly hours. This was the smallest rise since the late 1950's (Table B-31).

Productivity, Unit Labor Costs, and Profits

Along with the greater increase in hourly compensation, there was a marked slowdown in the growth of output per man-hour in 1967. In part, this reflected the reduced efficiency that occurs when capacity utilization falls. During the early part of 1967, output per man-hour actually declined, but it more than recovered as expansion resumed. For 1967 as a whole, output per man-hour for the entire private economy increased about 1½ percent. For the private nonfarm sector and in manufacturing, the rise was slightly less than 1 percent.

The large rise in compensation and the small gain in productivity resulted in an unusually sharp increase in unit labor cost, amounting to 4½ percent for the entire private sector and to 5 percent for manufacturing (Table 15). Analysis of earlier periods suggests that short-run fluctuations in the growth of productivity are not as immediately or fully reflected in prices as are changes in compensation. Thus, business, especially in manufacturing, tends to absorb higher cost resulting from temporary reductions in productivity, as well as other cost increases due to reduced capacity utilization. In 1967 this absorption meant a sizable fall in unit profit margins, not fully offset by a rise in volume. Corporate profits (before taxes) fell about 4½ percent in 1967 but remained well above 1965 and earlier years. The drop in profits was largely concentrated in manufacturing.

PRICES OF CONSUMER SERVICES

The importance of service prices is illustrated by the fact that in 1967 they accounted for nearly half the total rise in the consumer price index. Following an increase of 4.9 percent during 1966, prices of consumer services continued to advance in 1967, though somewhat less rapidly. The 3.9 percent increase in the cost of consumer services during 1967 remained far in excess

TABLE 16.—*Changes in consumer prices for services, 1965–67*

| Type of service | Percentage change | | Contribution to total change in 1967 (percent) |
|---|--------------------------------|--------------------------------|--|
| | December 1965 to December 1966 | December 1966 to December 1967 | |
| Consumer prices, all services | 4.9 | 3.9 | 100 |
| Interest and property insurance, and taxes..... | 7.4 | 3.2 | 20 |
| Public transportation and labor-intensive services..... | 6.5 | 5.8 | 59 |
| Public transportation..... | 6.4 | 3.9 | 4 |
| Medical care services..... | 8.1 | 7.9 | 29 |
| Skilled labor services ¹ | 5.2 | 4.8 | 17 |
| Other ² | 5.9 | 4.6 | 9 |
| Rent and utilities..... | 1.0 | 1.3 | 9 |
| Rent..... | 1.6 | 2.0 | 7 |
| Utilities..... | .1 | .5 | 2 |
| All other services ³ | 4.4 | 5.2 | 12 |

¹ Includes repair and maintenance services, barbers, and beauticians.

² Includes hotels and motels, domestic services, babysitters, laundries, drycleaning, and shoe repair.

³ Includes postal charges, recreational services, legal and banking services, etc.

Source: Department of Labor.

of the average annual advance of about 2 percent between 1961 and 1965 (Table 16).

The principal source of the modest slowdown in 1967 was a considerably less rapid increase in the average cost of insurance, finance, and taxes. This, in turn, reflected the fact that interest costs on new mortgages on homes did not repeat in 1967 the very sharp 12.4 percent advance recorded in the previous year, although they were rising again as the year ended. Most other consumer services continued to rise at much the same rate during 1967 as in the previous year.

In many service occupations, increases in productivity are not nearly rapid enough to offset increases in wage rates or professional salaries. The available data on average hourly earnings of service employees in some lower paid industries indicate that they received larger than average wage increases in 1967 (Table 14). Moreover, shortages of skilled personnel in other services—notably medical care—combined with strong demand to produce higher than average increases in earnings. So long as these forces continue to push service industry wages up at a rapid rate, the prices of services will continue to advance substantially.

Medical Services

Over the years, the cost of medical services has been rising more rapidly than that of other consumer services (Table 17). The increase accelerated sharply in 1966 and 1967 when the average price of these services rose at about 8 percent a year.

TABLE 17.—*Changes in medical care components of consumer prices for services, 1950–67*

| Item | Percentage change per year | | | |
|--|----------------------------|--------------|--------------------------------|--------------------------------|
| | 1950 to 1960 | 1960 to 1965 | December 1965 to December 1966 | December 1966 to December 1967 |
| Consumer prices, all services..... | 3.6 | 2.0 | 4.9 | 3.9 |
| Medical care services ¹ | 4.3 | 3.1 | 8.1 | 7.9 |
| Hospital daily service charges..... | 6.9 | 6.3 | 16.5 | 15.5 |
| Physicians' fees..... | 3.4 | 2.8 | 7.8 | 6.1 |

¹ Includes items not shown separately.

Source: Department of Labor.

Hospital daily service charges, which had been rising strongly in the 1950's and the early 1960's, spurted in 1966 and 1967.

Between 1960 and 1965, the large annual increase in nonpayroll expense per patient-day (7.0 percent) and the actual decline of 1.7 percent a year in the number of patients per hospital employee reflected in part more elaborate and expensive hospital equipment and the increased variety and intensity of care. While measured labor productivity declined, hospital wages kept pace with other service industry wages, and consequently payroll costs per patient-day increased rapidly. The result of all these cost pressures was that hospital daily service charges increased 6.3 percent annually from 1960 to 1965, while all consumer prices were rising at a 1.3 percent rate.

Physicians' fees rose 2.8 percent annually between 1960 and 1965. Combined with a small increase in productivity, this enabled physicians' earnings to rise about 4.6 percent a year. The demand for physicians' services increases steadily, the most important reason being simply the rising incomes of their patients. There is a definite tendency for higher-income families to purchase more physician visits than lower-income families. Another factor has been the growth of insurance coverage. Even before the introduction of Medicare, the portion of consumer expenditures on physicians' services that was covered by insurance more than doubled, from 12 percent in 1950 to 32 percent in 1965.

From December 1965 to December 1966, medical service prices rose 8.1 percent, a sharp increase over the 3.1 percent annual increase from 1960 to 1965. The increase from December 1966 to December 1967 was 7.9 percent. The new elements were the intensification of inflationary pressures in the economy generally, and the entry into force of Medicare and Medicaid. Hospital daily service charges rose 16.5 percent during 1966 and 15.5 percent during 1967. These price increases must have considerably exceeded the rise in hospital costs. The concurrent enlargement of the insured hospital clientele—who are less immediately sensitive to price increases because much of their costs are prepaid—made it easier for hospitals to raise their charges.

Prices for physicians' services moved sharply upward beginning in the first quarter of 1966, and then tapered off toward the end of 1967. The increase early in 1966 may have reflected a revision of fee schedules in anticipation of the introduction of Medicare and Medicaid.

Public Utilities

Prices of utility services have risen much less than those of other major services (Table 16). Table 18, discussed more fully below, shows that communication and electric, gas, and sanitary services are also the sectors where output per man-hour has grown most rapidly, and unit labor cost has fallen rather consistently.

The comparison between price changes and unit labor costs suggests, however, that public utilities have not passed the full benefit of improved productivity on to their customers. Although their capital costs per unit of output have undoubtedly risen, their profits have increased at an exceptional rate. In fact, the two utilities sectors are the only ones in Table 18 for which profits as a share of corporate output increased from 1947 to 1966. These are, of course, regulated industries, substantially protected from competition.

PRICES OF INDUSTRIAL PRODUCTS

Prices in the industrial sectors of the economy reflected with reasonable fidelity the interplay of the market forces which prevailed during 1967. During the first half of the year, the influence of rising production costs was largely masked by the easing of demand pressures, and prices showed relatively little change; in the second half, with gradually rising demand, cost pressures were more readily translated into substantial advances in prices. This pattern is observed in a wide range of manufacturing industries and in construction.

Industrial Materials

Among the industrial sectors, cost factors were least immediately significant in the case of industrial raw materials. There, the trend of demand in relation to supply was most dominant. In general, demand pressures eased, supplies were adequate, and prices moved lower for such materials as hides and skins, natural rubber, hardwood lumber, and zinc. There were, however, important exceptions for which supplies were not adequate; some prices, such as those of sulfur, copper, and nickel, rose sharply.

Nonfood Manufactures

The imbalance between supply and demand which had characterized major sectors of the economy between mid-1965 and late 1966 had been especially marked and widespread in manufacturing industries. By the same token, these industries were most affected by the easing of demand pressures in late 1966 and the first half of 1967.

Over-all demand for manufactured products grew more slowly in 1967 than in 1966, yet plant capacity grew about as rapidly. Moreover, the com-

position of demand was better balanced with productive capabilities. The easing of demand pressures, coupled with the completion of new facilities, showed up in a notably lower rate of capacity utilization (Table B-38). In the fourth quarter of 1967, manufacturing output averaged 84 percent of capacity as compared with 90 percent in the last quarter of 1966. The strain on available facilities was reduced in almost all industries. By the end of 1967, capacity utilization was again rising, but remained generally well below the rates of 1966.

While demand pressures in 1967 were weaker than in 1966, costs in manufacturing were rising rapidly. In addition to the pervasive rise in unit labor costs there were also increases in other elements of production cost including construction and equipment prices, interest costs, and freight rates for rail, highway, and inland waterway transportation.

During the first half of the year the average price of nonfood manufactures showed little change, rising about 0.5 percent between December 1966 and June 1967. With increasing demand in the second half, manufacturers in virtually all industries sought to raise prices to compensate for higher costs and to restore profit margins.

For nonfood manufactures as a whole, prices rose 1.3 percent in the second half of 1967—more than twice as fast as in the preceding six months.

Differences in the size of price increases among industries reflected the differing strength of demand, the incidence of increased costs, the extent of intra- and inter-industry competition as it affected the degree of discretion available to individual firms, and the degree to which business firms with discretionary pricing power gave weight to the public interest in their pricing decisions.

As may have been expected, the effects of changing demand were most clearly and promptly evident in the less concentrated, highly competitive industries in which individual manufacturers enjoy little discretion in their pricing decisions.

In the textile industry, for example, the decline in demand during the first half was quite severe, partly as a result of heavy overbuying during 1966. Inventories rose sharply, despite a substantial drop in the operating rate. As a result, manufacturers had to cut prices in the face of rising labor costs. The average price of cotton products fell 3 percent between December and June; synthetics also declined. In the second half, as demand increased and inventories were gradually worked off, prices rebounded, and prices of cotton products registered a net advance of 1.5 percent during the year.

In other highly competitive industries, the decline in demand and output during the first half of the year was not generally reflected in price reductions, but rather in some deferment or moderation of price increases to cover rising costs. For example, prices were not cut, but indeed raised, for household furniture, apparel, and shoes. In each case, the advance accelerated in the second half of the year, and, for 1967 as a whole, the rise in prices exceeded that for all nonfood manufactures. These are all labor-intensive

industries and hence strongly affected by rising wages. They are also low-wage industries which experienced above-average increases in compensation.

In more concentrated industries, in which sellers enjoyed a greater degree of discretion in their pricing policies, the record varied, in part reflecting the use made of that discretion.

In the tobacco industry, for example, prices were raised 5.0 percent in 1967, on top of a 4.1 percent boost in 1966. Labor costs are relatively minor in this industry, and return on equity is among the highest for any industry group.

An even larger increase was recorded in the rubber industry. In December, wholesale prices of tires and tubes were 5.1 percent above a year earlier; those of miscellaneous rubber products were 6.6 percent higher. One element in the price increase was higher labor costs—the result of a very large settlement granted after a prolonged strike. But price increases appear to have far exceeded the rise in unit labor costs. Moreover, a sharp decline in the cost of natural rubber and a small decrease for some types of synthetics offset some of the higher costs for other materials, labor, and transportation.

In a number of other highly concentrated industries, in which manufacturers ordinarily enjoy significant discretion in their pricing policies, price increases in 1967 were somewhat smaller, although above the average for nonfood manufactures. Manufacturers' prices of automobiles were raised about $2\frac{3}{4}$ percent late in the year. Prices of electrical machinery rose $2\frac{1}{2}$ percent during 1967. Average prices of steel mill products also rose nearly 2 percent. Steel is less profitable and has slower productivity growth than the other industries mentioned, but, unlike the others, had the advantage of still operating under a moderate labor settlement negotiated in 1965.

FARM AND FOOD PRICES

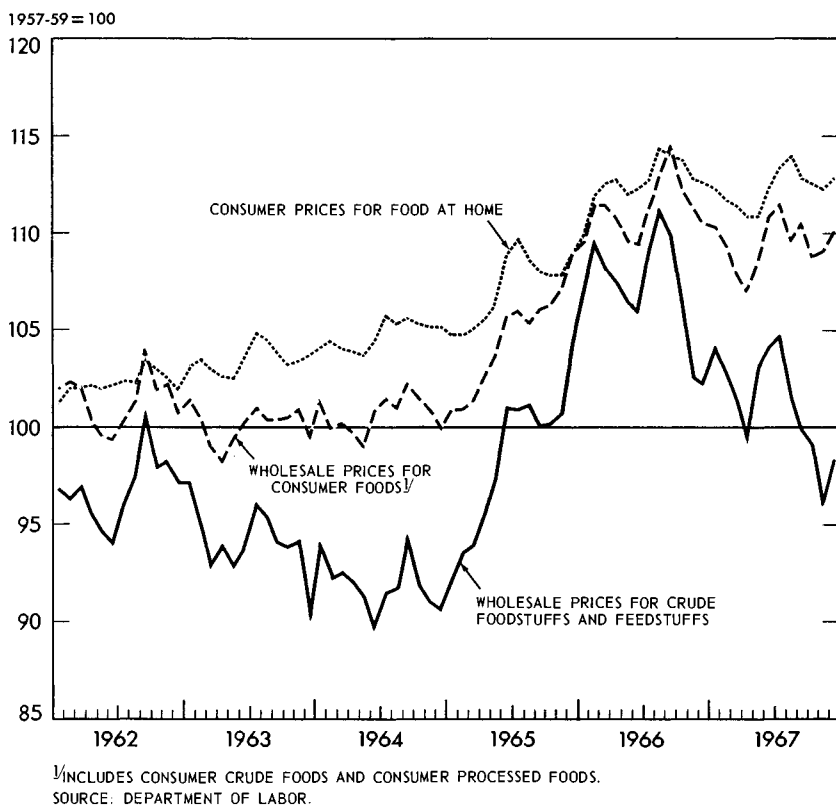
To a far greater extent than for industrial commodities and services, prices of farm products are very highly responsive to relatively small changes in the supplies available for domestic consumption. And these supplies are greatly influenced by weather conditions, Federal farm programs, and developments abroad that affect the level of U.S. exports.

During 1965 and much of 1966, domestic supplies of several major commodities were curtailed, primarily because of poor weather. In the important case of hogs, the drop in supply was a consequence of large marketings and low prices in 1963 and 1964. In the last months of 1966 and all of 1967, supplies of most farm commodities were relatively abundant—the combined result of changes in Federal farm programs, of generally excellent growing conditions, and of the response by farmers to the higher prices obtained in 1966. (One major exception was cotton, which had the smallest crop since 1895.)

Civilian consumption of food in the United States increased in 1966 and 1967 as both population and incomes grew, while military food purchases increased from the late summer of 1965 to the end of 1966 and remained

Chart 10

Food Prices



high throughout 1967. Foreign demand was strong during 1965 and 1966 but weakened in 1967 when larger crops abroad reduced the demand for U.S. farm products.

As a result of these supply and demand conditions, prices received by farmers advanced sharply between early 1965 and August 1966, reaching their highest level since the Korean conflict. They then fell rapidly, and remained below year earlier levels throughout 1967.

RETAIL PRICES

The impact of price increases for nonfood commodities at the manufacturing level on the consumer was aggravated by an appreciable widening of distributive margins, reflecting rising costs of wholesale and retail distribution. As indicated in Table 14, average hourly earnings of wholesale and retail employees rose more than those of manufacturing workers. Higher commercial rents, rising freight rates, and interest charges imposed a further burden. As a result of these factors, prices at retail generally rose somewhat faster than those at wholesale for comparable goods. In fact, during the sec-

ond half of 1967, retail prices of nonfood commodities were rising at the rate of 4 percent per year.

In the face of the decline in farm prices in 1967, retail food prices for use at home rose slightly, and restaurant prices increased sharply. As seen in Chart 10, the spread between farm and retail food prices widened in 1967. Unit labor costs rose for food processing and marketing firms as they experienced above-average wage increases. Prices of intermediate goods and services purchased by these firms were also higher. The wider margins also reflect the long-term trend of improved quality and increased refinements in processing, preparation, packaging, and distribution of foods available to consumers.

CONSTRUCTION

The measurement of construction costs presents difficult problems, but the statistics record an average annual advance of 3.2 percent since 1961. The rate of increase fluctuated somewhat during the last two years, with a slowdown in late 1966 and early 1967 when demand eased. As housing starts recovered, construction costs also resumed their usual trend.

The rise in construction prices thus has generally exceeded the advance in most other industrial sectors by a substantial margin. This is due principally to the fact that wages of construction workers have been rising more rapidly than those of other industrial workers while improvement in construction practices and techniques has lagged seriously.

While construction activity has been expanding steadily with the exception of the downturn during late 1966 and early 1967, the supply of skilled workers has not kept pace. Entrance requirements and apprenticeship rules in some construction unions have not been adequately adjusted to the requirements of a rapidly growing economy. For this and other reasons, the bargaining strength of unions in the construction industry is generally strong. At the same time, the resistance of contractors to high wage demands is reduced by the fact that construction contracts are generally let by bid, with all contractors in a given area operating under the same wage scales. During 1967, this bargaining strength was reflected in the annual wage increases of 8 percent or more provided in a number of important construction settlements.

At the same time, changes in construction techniques which would improve productivity and afford at least a partial offset to rapidly rising wages have been slow in coming. This has been especially true in many urban areas, where standards are rigidly controlled under local building codes. These codes, originally intended to protect the public against inferior design, materials, and workmanship, have been slow to adjust to the opportunities afforded by new materials and methods. They have thus retarded the advances made possible by developing technology and have preserved high-cost techniques. Both the smaller specialized contractors and the construction trade unions have resisted changes in these codes. The latter have been espe-

cially opposed to changes in the allocation of work among different categories of craftsmen and to the use of prefabricated parts.

PRICE AND WAGE POLICY

The magnitude of the stakes involved in moving promptly toward restoration of reasonable price stability is abundantly clear. It is equally evident that the steps taken to achieve this objective must not impair our other essential goals: maintaining high employment; preserving the effectiveness of free markets in allocating productive resources; and encouraging efficiency and minimizing waste.

The various policies available to improve price stability must be evaluated in the light of all these goals.

DIRECT CONTROLS

The most obvious—and least desirable—way of attempting to stabilize prices is to impose mandatory controls on prices and wages. While such controls may be necessary under conditions of an all-out war, it would be folly to consider them as a solution to the inflationary pressures that accompany high employment under any other circumstance. They distort resource allocation; they require reliance either on necessarily clumsy and arbitrary rules or the inevitably imperfect decisions of Government officials; they offer countless temptations to evasion or violation; they require a vast administrative apparatus. All these reasons make them repugnant. Although such controls may be unfortunately popular when they are not in effect, the appeal quickly disappears once people live under them.

FISCAL AND MONETARY MEASURES

Fiscal and monetary policy always plays a central role in price stabilization efforts. When over-all demand threatens to outrun supply, restrictive fiscal and monetary measures can reduce the growth of demand to keep it in line with the growth of productive capacity.

Once a wage-price spiral has developed—from whatever source—a sufficiently restrictive fiscal and monetary policy can stop it, but only at the cost of creating a rather wide margin of underutilization of resources. It is possible for a spiral to slow down gradually without a retreat from high employment. But the existence of the spiral makes it particularly important to use fiscal and monetary restraints to minimize the risk of upsurges in demand which would give the spiral new momentum.

Most economists believe that the rate of price increase would be significantly lower than it now is if we had attained the present level of unemployment more gradually. Nevertheless, few would disagree that, at the present level of resource utilization, prices would in any event rise somewhat faster than in the early 1960's. Clearly, we cannot afford to attempt to achieve price stability by returning to the unemployment conditions of those years.

Equally clearly, we need to find other policies which will serve to reduce the rate of price increase that occurs at high levels of employment.

IMPROVING MARKET EFFICIENCY

In its 1967 Report, the Council discussed at some length the possible contributions to price stability of programs to upgrade labor skills—especially of the disadvantaged groups—and to bring about a closer match between the capacities of the labor force and the needs of a changing economy. It also discussed efforts to strengthen competition, break bottlenecks, and raise the rate of productivity gains—especially in sectors where the productivity trend is now low.

Over time, these and similar measures should gradually reduce inflationary bias and thus permit the economy to achieve higher levels of utilization and lower rates of unemployment without increasing pressures on the price level. Such programs are highly important for many reasons. They offer substantial benefits over the long run and are an essential part of our efforts to combine price stability with full employment.

INCOMES POLICIES

In seeking still further ways to reconcile high employment with reasonable price stability, the governments of most industrial countries have concluded that it is necessary to develop specific policies aimed at the tendency, under conditions of high employment, for money incomes to rise faster than production—so-called “incomes policies.”

These policies seek to induce industry, labor, and possibly other groups, to avoid the irresponsible and self-defeating use of market power when the demand for their products or services increases temporarily. It is recognized that shifts in relative prices or wages should occur to bring about a needed reallocation of resources. But incomes policies encourage business and labor not to take full advantage of every opportunity to charge what the traffic will bear—in their own longer run interest and in the general interest of the economy.

The Council's Guideposts

The Council's well-known “guideposts,” first presented in January 1962, represent a form of incomes policy for the United States. The guideposts do not merely appeal for general restraint, but in addition try to provide guidance to individual unions and firms as to the specific behavior of wages and prices which would be consistent with general price stability as well as with efficient allocation of resources.

The genesis, objectives, and principles of the guideposts were reviewed in detail in the Council's 1967 Report, and need not here be elaborated. In general, the wage guidepost calls for increases in hourly compensation to

be limited to the trend rate of productivity growth for the economy as a whole. The price guidepost calls for prices to remain stable in industries in which the trend gain in productivity approximates the average rate for the economy; it points to price declines where productivity gains exceed this average; and it recognizes the need for prices to be increased as required where the improvement is lower than average.

The Council recognizes that many sellers of commodities and services have little or no discretion over the prices they can charge. In these cases, however, the workings of competitive markets may be expected to yield results similar to those prescribed by the guideposts, so long as the general movement of wages and prices is consistent with the guideposts. It is also recognized that many wages are not set by collective bargaining. But, in an environment of general price stability, these wages may be expected to move in line with the productivity guidepost, especially since many nonunion wages are tied more or less automatically to union wages.

There are, of course, many commodities whose price movements are not directly determined by the domestic wage level or by discretionary decisions of firms with market power. Imports and farm products are the most important examples. But imports, though significant in some industries, do not have a major direct impact on the general trend of costs and prices. And farm prices show no marked long-term trend, although they display wide short-term fluctuations. To be sure, such fluctuations can cause a temporary bulge in the average level of consumer prices. But that bulge would not necessarily become permanent if labor unions recognized the nature of the situation and avoided seeking immediate long-term compensatory increases.

Thus, if the guideposts were essentially observed by those firms and unions that possess discretion with respect to prices and wages, the inflationary bias inherent in a high-employment economy should be largely overcome.

Economic Validity of the Guidepost Logic

In their simplest form, the guideposts rest on three basic propositions:

1. While changes in wage rates in any particular year reflect special conditions in specific segments of the labor market, they tend to be broadly similar throughout the economy. Existing wage differentials largely reflect a whole set of institutional factors and basic differences in skill requirements or other attributes of the job, and it is reasonable that they should change rather slowly.

2. Price changes in any industry or sector are strongly influenced by unit labor costs and also reflect the influence of the value of capital used per unit of output and the prices of materials and services purchased from other industries. For the economy as a whole, the influence of purchased materials and services essentially cancels out, so that prices depend largely on wages and returns to capital—profits, interest, and depreciation. If prices move in

proportion to unit labor costs, the relative shares of wages and returns to capital will remain constant. Moreover, since the capital employed per unit of output shows little trend in most sectors, the rate of return on capital will remain stable.

3. Simple arithmetic requires that, for the average of unit labor costs in the entire economy to be stable, it is necessary that the average change in hourly compensation match, as a percentage, the average change in output per man-hour in the entire economy; and, for the average of prices to be stable, the movements of prices should conform to the movements of unit labor costs.

In defending the first two of these propositions, the Council has frequently asserted not only that they reflect the ways in which wages and prices "ought" to behave, but that they basically reflect the way in which wages and prices tend, in the long run, to behave under free-market conditions. Data have recently become available which provide additional evidence that, in fact, they do behave in such a manner.

The data in Table 18 show average annual rates of change in output, compensation, productivity, unit labor costs, and prices for major sectors of the nonfarm economy during the postwar period, 1947-66, and for each of three subperiods: 1947-53, 1953-59, and 1959-66. The beginning and ending years of each of these subperiods were years of relatively high employment, chosen so as to minimize the influence of cyclical fluctuations. The prices used are "value-added" prices—that is selling prices adjusted for changes in the prices of goods and services purchased from other sectors.

These data are subject to qualifications, largely because of difficulties in the measurement of the real output originating in a sector. Thus in finance, insurance, and real estate, much of the output is imputed rather than actually sold. In the construction sector, the nature of the available price data may lead to an understatement of the growth in real output and hence of output per man-hour. For similar reasons, there may be some understatement of real output in the service sector. However, any error in the price deflator would also affect unit labor cost and need not distort the measured difference between the rates of change in price and in unit labor cost.

The three subperiods covered in the table vary markedly in their economic characteristics. Both the first and the last periods show considerably stronger growth both in output and in productivity than the middle period. Moreover, with relatively few exceptions, the rate of increase of compensation declined from the first to the third period, as did the rate of increase in prices. Yet in each subperiod, and for the postwar period as a whole, the following facts stand out:

1. Changes in hourly compensation were markedly similar in all sectors.
2. Productivity changes, on the other hand, varied widely among the sectors. In some sectors, they also varied somewhat among the three time periods, reflecting longer-term trends or structural changes.
3. For the economy as a whole, the data indicate that, when wages rise

TABLE 18.—*Changes in selected economic indicators by industry division, 1947–66*

| Industry and period | Percentage change per year | | | | |
|--|----------------------------|---------------------|--|-----------------|---------------------------------|
| | Output ¹ | Output per man-hour | Compensation per man-hour ² | Unit labor cost | Implicit gross product deflator |
| Private domestic nonfarm economy: ³ | | | | | |
| 1947 to 1966 | 4.2 | 2.8 | 4.9 | 2.0 | 2.2 |
| 1947 to 1953 | 4.8 | 3.2 | 6.2 | 3.0 | 3.2 |
| 1953 to 1959 | 2.7 | 2.3 | 4.4 | 2.1 | 2.3 |
| 1959 to 1966 | 4.8 | 2.9 | 4.1 | 1.1 | 1.3 |
| Mining: | | | | | |
| 1947 to 1966 | 2.2 | 4.2 | 4.6 | .4 | 1.7 |
| 1947 to 1953 | 2.8 | 5.2 | 7.6 | 2.3 | 4.7 |
| 1953 to 1959 | 1.1 | 3.2 | 3.0 | —2 | 1.4 |
| 1959 to 1966 | 2.8 | 4.2 | 3.5 | —7 | —6 |
| Contract construction: | | | | | |
| 1947 to 1966 | 3.4 | 1.9 | 5.1 | 3.1 | 3.9 |
| 1947 to 1953 | 6.6 | 3.8 | 6.7 | 2.8 | 4.2 |
| 1953 to 1959 | 2.6 | 2.5 | 3.8 | 1.3 | 2.4 |
| 1959 to 1966 | 1.3 | —3 | 4.8 | 5.0 | 4.9 |
| Manufacturing: | | | | | |
| 1947 to 1966 | 4.4 | 3.2 | 5.1 | 1.8 | 2.0 |
| 1947 to 1953 | 5.8 | 3.7 | 6.8 | 3.0 | 3.0 |
| 1953 to 1959 | 1.3 | 2.3 | 4.9 | 2.5 | 2.6 |
| 1959 to 1966 | 5.8 | 3.6 | 3.8 | .3 | .6 |
| Transportation: | | | | | |
| 1947 to 1966 | 2.1 | 3.1 | 5.2 | 2.0 | 2.3 |
| 1947 to 1953 | .1 | 1.8 | 7.2 | 5.4 | 6.0 |
| 1953 to 1959 | .8 | 2.8 | 4.9 | 2.0 | 1.3 |
| 1959 to 1966 | 4.9 | 4.5 | 3.7 | —8 | .1 |
| Communication: | | | | | |
| 1947 to 1966 | 7.3 | 5.3 | 5.0 | —3 | 1.6 |
| 1947 to 1953 | 8.5 | 5.2 | 5.9 | .7 | 3.7 |
| 1953 to 1959 | 6.1 | 5.5 | 4.9 | —5 | 1.3 |
| 1959 to 1966 | 7.4 | 5.3 | 4.3 | —1.0 | .0 |
| Electric, gas, and sanitary services: | | | | | |
| 1947 to 1966 | 7.3 | 6.0 | 5.6 | —4 | 1.0 |
| 1947 to 1953 | 10.2 | 7.5 | 7.1 | —4 | 1.1 |
| 1953 to 1959 | 6.8 | 6.2 | 5.7 | —5 | 1.5 |
| 1959 to 1966 | 5.2 | 4.6 | 4.4 | —2 | .6 |
| Wholesale and retail trade: | | | | | |
| 1947 to 1966 | 4.0 | 2.7 | 4.4 | 1.7 | 1.5 |
| 1947 to 1953 | 3.5 | 1.9 | 4.7 | 2.8 | 1.9 |
| 1953 to 1959 | 3.7 | 2.7 | 4.4 | 1.6 | 1.6 |
| 1959 to 1966 | 4.6 | 3.4 | 4.3 | .9 | 1.1 |
| Finance, insurance, and real estate: | | | | | |
| 1947 to 1966 | 4.8 | 1.9 | 4.9 | 2.9 | 3.1 |
| 1947 to 1953 | 4.7 | 1.2 | 5.6 | 4.3 | 5.4 |
| 1953 to 1959 | 4.6 | 2.1 | 5.2 | 3.1 | 2.8 |
| 1959 to 1966 | 4.9 | 2.3 | 4.0 | 1.6 | 1.5 |
| Services: ⁴ | | | | | |
| 1947 to 1966 | 3.5 | 1.4 | 5.1 | 3.6 | 3.6 |
| 1947 to 1953 | 2.5 | 1.1 | 5.3 | 4.1 | 4.0 |
| 1953 to 1959 | 4.0 | 1.8 | 5.0 | 3.1 | 3.4 |
| 1959 to 1966 | 3.9 | 1.3 | 5.0 | 3.7 | 3.4 |

¹ Gross product in constant dollars.² Wages, salaries, and supplements.³ Includes government enterprises.⁴ Includes private households, agricultural services, forestry, and fisheries.

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

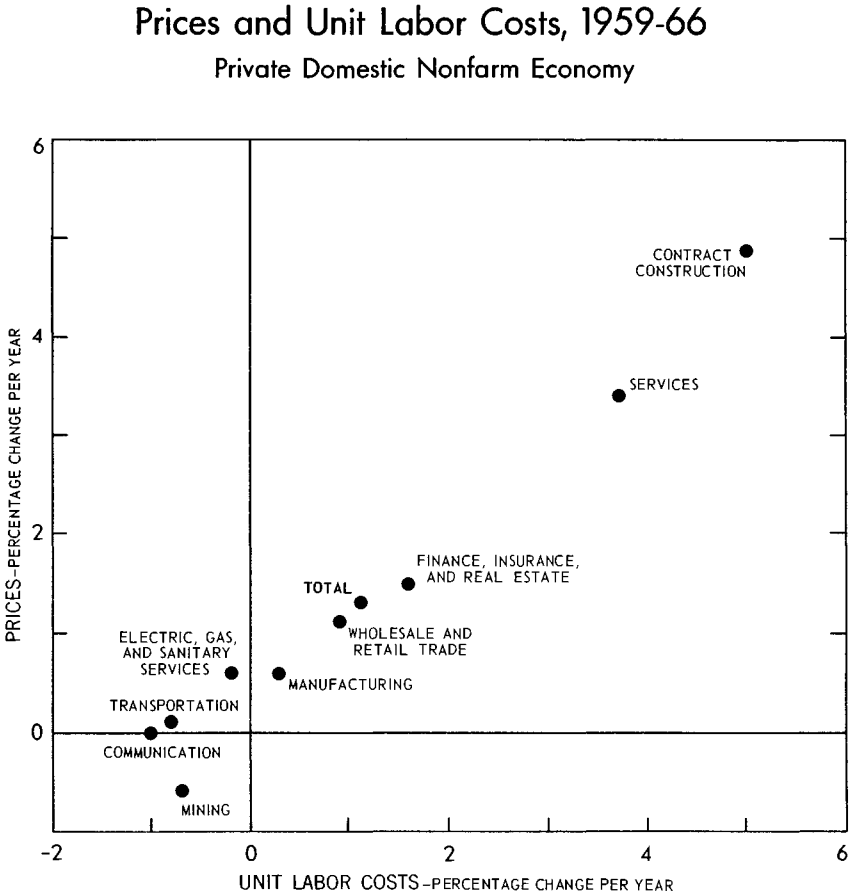
faster than output per man-hour, prices rise correspondingly with little effect on the distribution of income. With certain exceptions—notably mining, the regulated utility industries (as discussed above), and construction—price movements in the various sectors, and in the several subperiods for a given sector, conformed closely to the movements of unit labor costs. Moreover,

as Chart 11 illustrates, the agreement between changes in unit labor cost and changes in prices is particularly close for the 1959-66 subperiod.

This analysis thus supports the guidepost conclusions that price stability can be achieved and maintained only to the extent: (1) that increases in hourly compensation generally conform to the average economy-wide improvement of output per man-hour; and (2) that changes in prices in individual sectors generally conform to changes in unit labor costs in those sectors.

The former requirement was clearly violated beginning in 1965, and there have been notable exceptions to the second requirement in a few major industries throughout the 1960's. The crucial problem for 1968 and the years ahead is to find means to achieve both requirements without sacrificing other essential objectives.

Chart 11



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

Meaningful progress toward the restoration of price stability will not be easy to achieve in 1968. The policy choices must be assessed in the light of current and prospective pressures on prices and wages.

The basic forces working on wages and prices this year will be similar in many ways to those at work in 1967. Unemployment and capacity utilization will show relatively little change.

In the areas not directly affected by the market power of unions and business, the available evidence does not point to a significant net reduction in price pressures. Farm prices are likely to rise a little instead of declining as they did in 1967. Strong demand pressures will continue to pull wages up rapidly in several areas, including engineering, scientific, and technical occupations; State and local governments; and medical and hospital services—though in some markets supplies may begin to catch up with demands, with a consequent reduction in wage pressures. Moreover, the 14-percent increase in the minimum wage in 1968 will have an even greater impact than did the 1967 increases, which mainly restored the minimum wage to a more typical relationship with the average wage level in the economy.

Responsible Private Decisions

Major union settlements in 1967 provided wage and benefit increases averaging about 5½ percent a year over the life of the contracts, while average hourly compensation in the entire private economy increased by 6 percent. (These two figures are not strictly comparable. Average compensation reflects new and continuing contracts in organized sectors as well as all compensation in nonunion areas; it also reflects changes in employers' contributions for social insurance. Moreover, it is influenced by shifts in the composition of the labor force.)

If new collective bargaining settlements reached in 1968 should again average 5½ percent, the rise in average hourly compensation for the economy as a whole would be appreciably larger than in 1967. One reason is that the second- and third-year provisions of contracts negotiated in 1966 and 1967 will provide larger increases, on the average, in 1968, than were inherited in 1967 from similar provisions of earlier contracts.

Despite the favorable prospect that productivity gains in 1968 should exceed those of 1967, the pressure of rising unit labor costs on prices would continue to be strong in 1968, on the assumption of a 5½-percent average for new union settlements. And stronger demand conditions will make it easier for cost increases to be passed on in prices. Thus, there would be no prospect of any slowing down in the rate of increase of consumer prices.

In fact, several prominent settlements last year substantially exceeded 6 percent a year, and some unions have already taken this figure as their target to meet or beat in negotiations during 1968. If new union settlements were to average even higher in 1968 than in 1967, a clear acceleration of price increases would be likely in 1968.

Such an acceleration in 1968—or even a continuance of the 1967 rate of price increase—would have a major impact on the prospects for prices in 1969 and even 1970. It would push the ultimate restoration of reasonable stability farther into the future. And as the momentum of the spiral became built into attitudes, expectations, and practices of business, labor, and consumers, the restoration of stability would not merely be pushed farther into the future but would become progressively more difficult to achieve.

On the other hand, if the rise of prices slows down in 1968, there is the clear possibility of restoring reasonable price stability in subsequent years. Hence, every effort must be made to slow down the rate of price increase in 1968. This surely can only be achieved if the average of new union settlements is appreciably lower than the 5½-percent average of 1967 and if business firms avoid any widening of their gross margins over direct costs and indeed absorb cost increases to the extent feasible. A decisive slowing down from the recent rate of price advance could then take place in 1968. This would be the first step toward our target of essential stability of prices.

The Government will continue in 1968 to urge both business and labor to exercise the utmost restraint in their decisions. Such restraint will demand some immediate sacrifices. The rewards of such restraint lie in the assurance of continued high employment, a steady rise in real compensation, and healthy expansion of markets, sales, and profits. These gains may be less immediately perceptible than the costs—but no less certain and far greater in the end.

Productivity Principle

In calling for restraint in wage and price decisions, the Council recognizes that, in 1968, as in 1967, it would clearly be inappropriate to set the trend of productivity as a numerical target for wage increases. In the face of the 3-percent increase of consumer prices that occurred during 1967, it would be patently unrealistic to expect labor to accept increases in money wages which would represent essentially no improvement in real hourly income.

Nevertheless, despite the justification for compensation increases in excess of the productivity trend, such increases are inevitably inflationary. As the Council stated in its 1967 Report:

“The only valid and noninflationary standard for wage advances is the productivity principle. If price stability is eventually to be restored and maintained in a high-employment U.S. economy, wage settlements must once again conform to that standard.”

In the discussion above, the Council has outlined the pattern of price and wage decisions required in 1968 to begin progress toward the target of price stability. That target cannot be achieved in 1968. It will be achieved only when wage settlements once more conform to the productivity standard, and only when business engages in responsible price-making, which means that prices in each industry should conform to the trend of unit costs, with no widening of margins.

Government Organization To Promote Price Stability

The discussion of this chapter should make clear that the task of reconciling price stability with high employment will require sustained efforts of public policy on many fronts. The full resources of the Government should be enlisted to deal effectively with structural problems that impede economic efficiency and contribute to inflation.

The machinery of Government policymaking and administration should be adapted to keep the objective of over-all price stability clearly in focus, and to give it a high priority in the formulation and administration of Government programs throughout the entire range of Federal activities.

Consequently, as his Economic Report has indicated, the President has established a Cabinet Committee on Price Stability, consisting of the Secretaries of Treasury, Commerce, and Labor, the Director of the Budget, and the Chairman of the Council of Economic Advisers. The heads of other agencies will participate in the Committee's work as required. This Committee will be coordinated by the Council Chairman and will be served by a small professional staff. It will meet on a regular schedule, and hold special meetings to deal with urgent problems.

Its activities will include the following:

1. The Committee will prepare and publish from time to time studies in depth of economic conditions in those industries which are a persistent source of inflationary pressure, either because of inappropriate exercise of market power by labor or business, or because of inefficient or ineffective institutional arrangements, trade practices, or market institutions.

2. The Committee will study intensively, and make constructive recommendations concerning all aspects of Government policy that affect prices in particular sectors, including, among others, policies related to Federal procurement and construction; manpower and labor market programs; imports and exports; competition and trade practices; research, development, and technological changes; and the supply of natural resources to particular markets. Where appropriate, it will develop and coordinate inter-agency programs to deal with the structural problems of particular industries which make them a source of inflationary bias.

3. The Committee will work with representatives of business, labor, and the public to enlist cooperation toward responsible wage and price behavior and structural improvements that promote the achievement of over-all price stability. However, it will not become involved in specific current wage and price matters.

4. In line with these objectives, the Committee will shortly begin a series of conferences both with representatives of business, labor, and the public interest at large, and with representatives of particular industries or particular segments of labor

—to attempt to reach some consensus on appropriate general standards to guide private price and wage decisions;

—to identify remediable problems that inhibit price stability in particular areas, and attempt to design cooperative programs for private and governmental action to deal with these problems.

5. The Committee will occasionally recommend to the President and the Congress suitable legislation which would advance the objective of price stability in a free market economy.

Economic Development and Individual Opportunity

THE unprecedented prosperity of the past seven years has brought great economic progress to most Americans. Poverty has been significantly reduced; educational attainment is rising; the quality of public services has improved; and far more jobs are available to the previously disadvantaged.

But not all Americans have shared in the Nation's prosperity. About one-seventh of the population remains in poverty. And the plight of the poor is ever more sharply contrasted with the comfortable standards of living most Americans enjoy in an era of growing and widening abundance. This contrast has awakened the social conscience of the Nation; at the same time, the Nation's ability to assist the disadvantaged minority has reached new heights. The majority of our people have now achieved incomes which make the elimination of poverty a concrete, realistic, and attainable goal in our generation. For the first time in any society, the United States can afford to eliminate poverty; indeed, it cannot afford to do otherwise.

The reduction of poverty has been a continuing process in our society, fundamentally reflecting the long-term growth of output per worker—which in turn has derived from progress in technology and management, from a labor force ever better educated and more adaptable, and from the provision of more and better capital per worker. Economic growth brings great rewards; but because it comes unevenly it can be a highly disruptive process. Some industries, some occupations, some regions undergo dramatic expansion; others decline relatively or even absolutely. Whole new industries and occupations arise; many older ones are completely transformed or disappear entirely.

Many of the structural changes that lie at the heart of progress do not force individuals to change their occupations or residences. The adjustment comes as sons and daughters take up occupations different from their parents' or move to new areas. But rapid and uneven change often cannot be fully accommodated in this way. Many individuals are uprooted or find their livelihoods threatened. Some cannot make the transition which provides the opportunity for improvement. And even an adjustment occurring between generations often creates hardship when childhood background and training are inadequate or unsuited to the needs of the new order.

Thus the process which has reduced poverty has sometimes created it. It has redistributed both affluence and poverty, and in many cases has concentrated them—geographically, occupationally, and by demographic category. As those able to respond to opportunity have moved out of poverty, those left behind are increasingly the ones whose opportunities were restricted: the immobile, the aged, the disabled, the handicapped, the broken family, the poorly educated, the victim of discrimination.

Significant reduction in the number of poor people has occurred only when the economy is expanding. When economic growth is slow, poverty diminishes slowly—and often actually increases. The years from 1948 through 1953 saw rapid reduction in poverty, as have the years since 1964. By contrast, the number of individuals in poverty declined very slowly during the latter half of the 1950's.

The first part of this chapter focuses primarily on the geographical aspects of the process by which poverty has been both eliminated and redistributed—the transformation of agriculture, the growth of the city, and the redistribution of opportunity and of poverty within the city.

The second part of the chapter largely abstracts from the geographical dimensions of poverty. It deals with programs offering solutions to poverty, wherever the poor may be found.

Programs for the reduction of poverty are—and should be—in part the responsibility of local organizations and units of government. Nevertheless, even though concentrations of poverty are local, the problem is national and must be a national responsibility. Indeed, it is a national problem just because of its concentration. The forces which produce poverty in particular areas are largely beyond the influence of local governments. And the remedies needed to lift citizens from poverty cannot be successfully applied by individual communities acting alone.

THE CHANGING STRUCTURE OF OPPORTUNITIES

The social scientist needs a yardstick to measure progress in reducing economic deprivation. For statistical purposes, households are defined as poor if their income falls below the cost of a certain minimum consumption standard—\$2,185 in current prices for a nonfarm couple under 65 years of age, \$3,335 for a nonfarm family of four, and so on. A reduction in numbers by this definition is only a rough measure of progress, since social and psychological conditions associated with poverty may persist after incomes rise above the poverty line. Moreover, the income levels used in the definition cannot provide for much more than minimum necessities. Nevertheless, measured changes in the incidence of poverty over time provide a reasonable criterion of achievement, and are employed frequently throughout this chapter.

Between 1959 and 1966, the number of poor declined sharply from 38.9 to 29.7 million, or from 22.1 to 15.4 percent of the population. Substantial progress was recorded for almost every population group, but the

reduction in the number of poor farm households was especially marked. This progress, though encouraging, should not conceal the magnitude of the remaining problems nor the fact that they fall with disproportionate severity on certain groups.

Geographically, poverty is today concentrated in the central cities of our large metropolitan areas and in certain rural districts. While the proportion of poor farm households remains above the national average, the great bulk of rural poverty today is found among the rural nonfarm population. The distribution and extent of poverty have been influenced by the changing structure of employment opportunities and the massive internal migrations encouraged by these changes. One of the most significant of these changes has occurred in farming.

CHANGES IN THE FARM ECONOMY

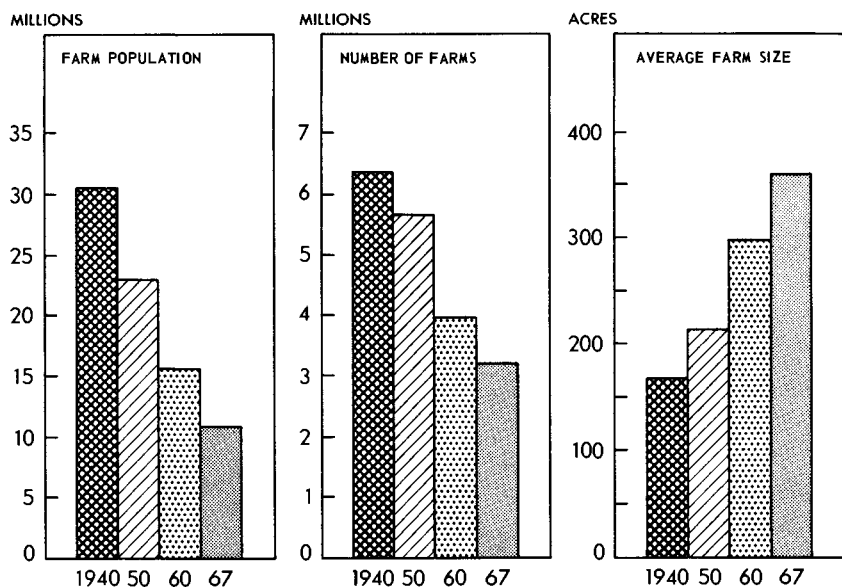
The most pervasive influence affecting employment in agriculture has been a growth of labor productivity substantially in excess of the growth of markets. Between 1940 and 1966, aggregate production inputs used in farming increased by only 8 percent, while farm output increased by 61 percent. The over-all ratio of output to inputs increased 50 percent, and the ratio of output to labor input increased by a spectacular 347 percent.

The demand for farm products has consistently increased less rapidly than the growth of incomes. Combined with sharp increases in productivity, this fact has greatly diminished the need for labor resources in farming. Further, the revolutionary increase in labor productivity could be realized only through mechanization. Because many machines could be efficiently utilized only on large farms, the full benefits of mechanization were not available to farms of smaller size. Since 1940, the number of farms has been reduced by almost one-half and the average size of farms has more than doubled (Chart 12). The farm population meanwhile has fallen by almost two-thirds; after remaining virtually unchanged in the preceding 20 years, it declined from 30.5 million in 1940 to 11.6 million in 1966.

As a result of the trends in demand and in productivity, the number of farms with sales valued at \$10,000 or more per year has been increasing, while the number of farms with annual sales under \$10,000 has declined almost one-third since 1959 (Table 19). There is a movement up the income ladder within farming as some operators of smaller farms acquire additional resources to expand their sales. But operators of the smallest farms have become increasingly dependent on off-farm employment to supplement their incomes. Farm incomes are benefited both by Government price-support operations and by direct payments. These benefits, of course, do little for farmers who have little to sell. Despite the growing prosperity of large farmers, many small farmers and farmworkers cannot earn a decent income in farming.

Industrial expansion offered many farmers and farmworkers an opportunity to raise their incomes by accepting nonfarm employment. Several

Changing Farm Structure



SOURCE: DEPARTMENT OF AGRICULTURE.

studies show that movement out of farming is much more closely related to employment opportunities and income in the nonfarm sectors than to earnings in farming. The experience of the 1960's again confirms this. Rapid economic growth was accompanied by sharp reductions in the farm population.

Poverty in the Farm Population

Farm poverty remains a serious problem, especially since most of the farm poor are ineligible for income maintenance programs as presently organized. As recently as 1959, 63 percent of all farm families had less than \$5,000 in sales and averaged less than \$3,500 of total family income (Table 19). The number of farmers in this sales class has declined sharply since then, and their off-farm earnings have increased. Operators of the smaller farms tend to be older than those of large farms, and have on the average almost 3 years less of formal education. The remaining poverty on farms is concentrated among these operators of small farms. By 1966, however, only 600,000 farm households were in poverty, a sharp drop from 1.8 million in 1959. Much of the reduction in farm poverty has resulted from migration. Some of those who moved have become members of the nonfarm poor, but the bulk of the younger migrants have increased their income potential. It is likely that

TABLE 19.—*Number of farms and farm income, by value-of-sales classes, 1959, 1964, and 1966*

| Value-of-sales class and year | Number of farms | | Cash receipts plus Government payments; percentage distribution | Farm operator family income | | |
|-------------------------------|----------------------------|----------------------------|---|-----------------------------|-----------------------------|--------------------|
| | Thou- sands of farms | Percentage distribution | | Total income | Realized net farm income | Off-farm income |
| All farms: | | | | | | |
| 1959..... | 4, 097 | 100. 0 | 100. 0 | \$4, 844 | \$2, 773 | \$2, 071 |
| 1964..... | 3, 472 | 100. 0 | 100. 0 | 6, 196 | 3, 747 | 2, 449 |
| 1966..... | 3, 252 | 100. 0 | 100. 0 | 7, 787 | 5, 049 | 2, 738 |
| Sales under \$5,000: | | | | | | |
| 1959..... | 2, 576 | 62. 9 | 13. 9 | 3, 493 | 1, 115 | 2, 378 |
| 1964..... | 2, 030 | 58. 5 | 9. 3 | 3, 860 | 946 | 2, 914 |
| 1966..... | 1, 769 | 54. 4 | 6. 7 | 4, 492 | 1, 071 | 3, 421 |
| Sales of \$5,000–\$9,999: | | | | | | |
| 1959..... | 693 | 16. 9 | 15. 5 | 4, 705 | 3, 160 | 1, 545 |
| 1964..... | 530 | 15. 3 | 10. 7 | 5, 202 | 3, 434 | 1, 768 |
| 1966..... | 446 | 13. 7 | 7. 9 | 5, 902 | 3, 989 | 1, 913 |
| Sales of \$10,000–\$19,999: | | | | | | |
| 1959..... | 503 | 12. 3 | 21. 5 | 6, 413 | 5, 091 | 1, 322 |
| 1964..... | 488 | 14. 0 | 18. 8 | 7, 482 | 5, 984 | 1, 498 |
| 1966..... | 510 | 15. 7 | 17. 1 | 8, 463 | 6, 869 | 1, 594 |
| Sales of \$20,000 and over: | | | | | | |
| 1959..... | 325 | 7. 9 | 49. 1 | 13, 420 | 11, 506 | 1, 914 |
| 1964..... | 424 | 12. 2 | 61. 2 | 17, 146 | 14, 979 | 2, 167 |
| 1966..... | 527 | 16. 2 | 68. 3 | 19, 791 | 17, 539 | 2, 252 |

Source: Department of Agriculture.

many of the older farmers who left farming remain in poverty. This is reflected in the fact that, between 1959 and 1966, the number of aged poor nonfarm households outside metropolitan areas remained nearly constant.

Hired farmworkers are also very likely to be poor. In 1966 there were 757,000 persons who had hired farmwork as their primary employment. They averaged 212 days of farmwork and an added 13 days of nonfarmwork with total wages from both sources averaging \$2,102 for the year. The hired farm work force contains a disproportionate number of nonwhites—27 percent in 1966; this contrasts with 13 percent of nonwhites in both the total farm and the total U.S. population.

The largest concentration of low-income farms and farmworkers is in the South. In 1964, 55 percent of all farms with less than \$5,000 in annual sales—but 44 percent of all U.S. farms—were located in the South. Moreover, in that year more than 53 percent of the hired farmworkers lived in the South.

Despite the revolution in agricultural technology and the attendant migration, the transformation of agriculture is not complete. The farm population will continue to decline, creating serious problems for some rural communities. The young, rather than the older farmers, will continue to be the primary migrants. This will leave behind a progressively aging population, especially among the farm poor. As a result, the natural rate of increase of the farm population will continue to fall. In 1950 the natural increase of the farm population totaled 392,000 and net emigration came to 1.5 million. By 1966 the natural increase had been reduced to 90,000 and net emigration to 858,000.

THE GROWTH OF NONFARM JOBS

The decline of employment opportunities in farming has been accompanied by a rapid growth of jobs in manufacturing and service industries. Initially concentrated in or near the large northern cities, these jobs attracted millions of migrants from rural areas.

During the economic expansions accompanying World War II and the Korean war, manufacturing employment remained highly concentrated in the heavily metropolitan areas of the industrialized States of the North—Massachusetts, New York, New Jersey, Pennsylvania, Ohio, Michigan, and Illinois. With less than 40 percent of the U.S. population, these seven States provided about 55 percent of manufacturing employment in 1953, about the same share as in 1939 when the national total was approximately half as large.

The pattern of growth in manufacturing employment changed significantly during the late 1950's. Technological advance in transportation, construction of interstate highways, expansion of trucking, construction of long distance pipelines, and the extension of coordinated electric power grids reduced the advantage of potential manufacturing sites in the large metropolitan centers. This trend was accelerated by the rapid growth of industries such as technical instruments, electronics, and small consumer appliances, whose products have high value per unit of weight and volume and thus can be shipped at relatively low transport cost. As a result, the location of industry was increasingly determined by other factors, such as relative wage rates, labor availability, local taxes, climate, and land costs.

These developments shifted the growth in manufacturing employment away from the North. Between 1956 and 1966, U.S. manufacturing employment increased 1,840,000 (11 percent). Meanwhile, in the seven industrialized States mentioned above, manufacturing employment increased only 37,000 (less than one-half of 1 percent). By contrast, during the same period, manufacturing employment grew 465,000 (26 percent) in the West and 1,026,000 (33 percent) in the South.

Nonfarm job opportunities have grown less rapidly in metropolitan areas—especially in the giant ones—than in the rest of the Nation. From 1962 to 1966, private nonfarm employment grew 5 percent a year or more in nonmetropolitan counties, regardless of the size of the largest urban center; in comparison, it rose 4 percent yearly in metropolitan counties. In the same period, total nonagricultural employment increased less than 3 percent in the 13 largest metropolitan areas.

While these figures show a general relative improvement in nonagricultural employment opportunities in the less densely settled areas, many nonmetropolitan areas were stagnant or declining. Between 1959 and 1964, there were 1,315 nonmetropolitan counties in which private nonfarm employment either declined or increased by less than 100 jobs. Large contiguous blocks of counties with declining populations are found in Appalachia, the northern portions of the Lake States, the Great Plains, and the Southwest.

The process of economic growth has been and continues to be very uneven in rural areas and in smaller cities. These are the areas where, because of dependence on one or two industries—frequently resource-based industries such as agriculture, forestry, or mining—the greatest adjustments are needed in response to shifts in the pattern of demand, technological change, or the exhaustion of resources. This uneven growth has been responsible for major shifts in population.

RECENT CHANGES IN POPULATION DISTRIBUTION

In the past ten years, significant changes have occurred in the pattern of migration and in the growth and distribution of population in the United States. These changes have both affected and been affected by the changing pattern of demand and productivity in an expanding economy. They have served both as an engine whereby poverty has been reduced, and as a force contributing to its redistribution.

Migration

The shifts in the geographical distribution of jobs noted above have been paralleled by changes in the pattern of migration. Migration to the North and to the largest metropolitan areas soared during the economic expansion of the 1940's and early 1950's, but has slowed markedly in the last ten years. Since 1960, the 12 largest metropolitan areas (those with more than 1,700,000 population in 1960) have grown only slightly more rapidly than their natural excess of births over deaths. In the North-Central States, the largest metropolitan areas grew 1.8 percent a year during the 1950's, but only 1.0 percent a year so far in the 1960's. They are now experiencing more emigration than immigration. In most regions, the metropolitan areas under 250,000 population are growing considerably more rapidly than the largest ones.

Net domestic migration to metropolitan areas declined from 668,000 a year during the 1950's to 216,000 a year in the first half of the 1960's. As Table 20 indicates, during the latter period domestic migration contributed less to the growth of metropolitan area population than did foreign migration. Metropolitan areas are still growing faster than nonmetropolitan areas, but the difference in growth rates is narrowing. Furthermore, in the 1960's the nonfarm population was growing about as fast outside as inside metropolitan areas.

From 1960 to 1965, only the North-Central region lost more migrants—foreign and domestic combined—than it gained (Chart 13). This was the result of a large net loss of whites through domestic migration, which was offset only slightly by the much reduced net domestic immigration of non-whites. During the same period the Northeast gained population through migration, although the region experienced a net emigration of domestic whites. The West continued to receive the largest gains from migration, and was the only region to gain more domestic migrants than it lost. The

TABLE 20.—*Components of population change by area, 1950–65*

| Period and area | Percentage increase per year in population | Population changes (thousands of persons) | | | |
|---------------------------------------|--|---|--------------------------|----------------------|-----------------------|
| | | Natural increase | Net gains from migration | | |
| | | | Total | Foreign ¹ | Domestic ² |
| 1950 to 1960: ³ | | | | | |
| Total..... | 1.7 | 25,337 | 2,660 | 2,660 | ----- |
| Metropolitan areas ⁴ | 2.4 | 16,336 | 8,634 | 1,955 | 6,679 |
| Nonmetropolitan areas..... | .5 | 9,002 | -5,974 | 705 | -6,679 |
| 1960 to 1965: ⁵ | | | | | |
| Total..... | 1.5 | 12,626 | 1,846 | 1,846 | ----- |
| Metropolitan areas ⁴ | 1.7 | 8,589 | 2,436 | 1,357 | 1,079 |
| Nonmetropolitan areas..... | 1.1 | 4,037 | -590 | 489 | -1,079 |

¹ Distribution of net foreign migration is estimated to be the same as distribution of gross migration from foreign countries during 1962–66.

² Estimated migration among 50 States and the District of Columbia.

³ April 1950 to April 1960.

⁴ Metropolitan areas as defined in 1967.

⁵ April 1960 to July 1965.

Sources: Department of Commerce and Council of Economic Advisers.

South was the only region in which emigration exceeded immigration among nonwhites. The South's gain through total migration was due to a large inflow of white foreign immigrants, which offset a net outward movement of both domestic whites and nonwhites.

The growth of the nonwhite population in metropolitan areas averaged 3.9 percent a year in the 1950's, but it slowed to 3.1 percent a year in the 1960's. Nonetheless, this latter rate was about twice as fast as the rate of increase of the white population, partly because the nonwhite rate of natural increase was double that of the white. In the 1960's, 32 percent of the increase in nonwhite population in these areas was attributable to migration, compared with 43 percent in the 1950's. Not since the 1940's has migration accounted for more than half of the growth of nonwhite population in metropolitan areas.

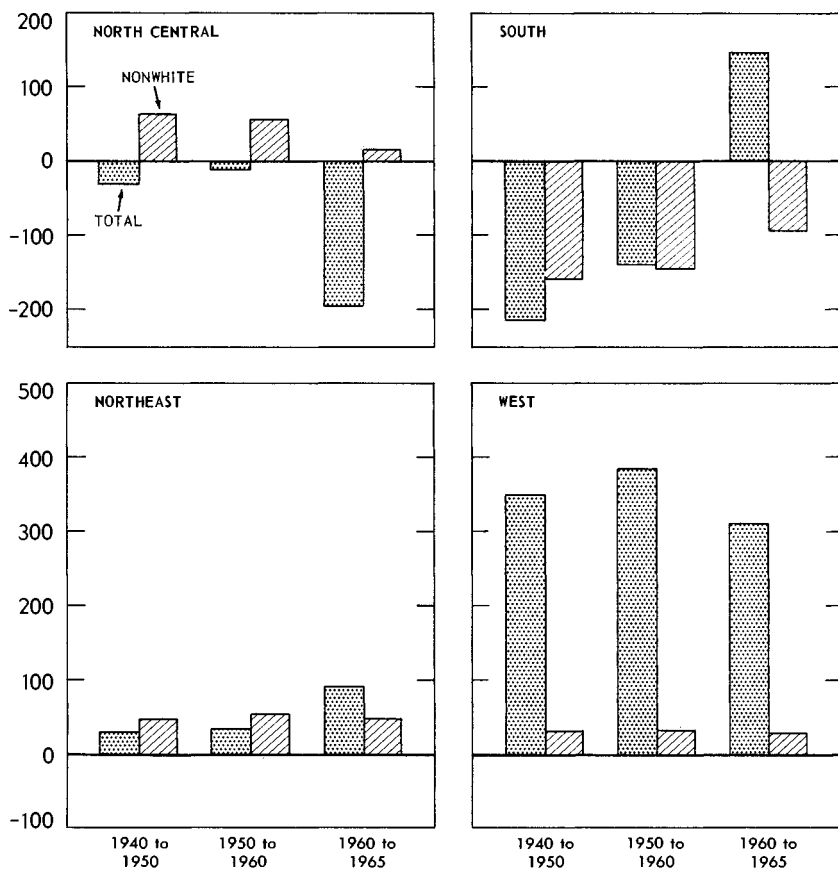
Racial Distribution Within Metropolitan Areas

Like the European immigrants of earlier times, the Negroes from the South came to the cities looking for better jobs, housing, and schools for their children. To a greater degree than their immigrant predecessors, Negroes met severe discrimination in housing. Because most of them were poor, the housing they could afford was usually in the older sections of the metropolitan area and usually in the central city. And because of discrimination, this area became a segregated ghetto. The only way in which the segregated but rapidly growing Negro community could obtain additional housing was through encroachment on the white neighborhoods at the borders of the ghetto. Racial tensions increased as the process continued. The more affluent whites moved to the suburbs, where Negroes were largely excluded.

Chart 13

Average Annual Net Migration by Regions

THOUSANDS OF PERSONS



NOTE.—DATA FOR PERIOD 1960 TO 1965 NOT STRICTLY COMPARABLE WITH OTHER DATA.
 SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

Thus, within metropolitan areas, the nonwhite population has become increasingly concentrated in the central cities while the white, middle- and upper-income population has become increasingly suburban. Since 1960, the white population in central cities has declined, while the nonwhite population has grown by 3.6 percent a year. Meanwhile, the growth rate of suburban populations has been $6\frac{1}{2}$ times the rate for central cities, and that growth has been overwhelmingly among the white population. Less than one suburbanite in 20 is nonwhite, and the white suburban population is growing more than twice as fast as the nonwhite. Between 1960 and 1966, there was an exodus of more than 3.5 million whites from central cities. Over the

same period, net migration added 1 million to the nonwhite population of central cities, and natural increase added another 1.5 million. As a result of these shifts, not only particular city areas or neighborhoods, but entire cities and counties, are becoming increasingly segregated by race.

Economic Aspects of the Transformation

Businesses, as well as the white middle class, have found suburban locations increasingly attractive. Cheaper land permits manufacturing firms to construct one- or two-storied buildings, which are usually more efficient. The suburbs also provide some escape from central city traffic congestion. Following the shift of population and manufacturing, other industries—construction, retail trade, and other services—have also grown rapidly in the suburbs. Employment gains in central cities have been largely limited to clerical, managerial, and professional positions.

The decline of the central city as a place of employment relative to the suburbs has been most typical of large northern metropolitan regions. New York City is a case in point. Between 1956 and 1966, manufacturing employment declined 15 percent in the city but increased 35 percent in the New York State suburbs. In the city, only financial institutions, State and local government, and miscellaneous service industries experienced substantial gains in employment.

Redistribution of job opportunities in metropolitan areas has increased the distance between the residence of the less-skilled, lower-income individual, often a Negro, and the potential jobs available to him. Metropolitan transit systems characteristically do not provide adequate service between central city poverty areas and the sites of suburban employment.

Changes in the Distribution of Poverty

Many migrants to the cities in recent decades were poor when they arrived. Yet, as a proportion of all households in metropolitan areas, poor households declined from 19.6 percent in 1959 to 14.9 percent in 1966. This seven-year decline in the incidence of poverty in metropolitan areas was comparable to the reduction from 29.1 percent to 23.6 percent in the incidence of poor households in other nonfarm areas. Thus, metropolitan areas continue to have less than a proportionate share of the poor; they contain 69 percent of the total nonfarm population but only 56 percent of the nonfarm poor. Within metropolitan areas, poverty is much more common in central cities than in suburbs. In 1966, the suburban population outnumbered that in central cities by 15 percent, yet there were 9.5 million poor living in central cities and 5.8 million in suburbs. About two-thirds of the metropolitan poor are white. While the white poor were distributed about equally between suburbs and central cities, about four times as many non-white poor lived in central cities as in suburbs.

IMPLICATIONS FOR PUBLIC POLICY

In recent years public interest and concern have increasingly been focused on the magnitudes and consequences of migration, on the increasing size and agonizing problems of cities, and on the continuing decline of many rural communities. In particular, many have suddenly become aware of the fact that the concentrations of poor families—and particularly of poor Negro families—in the blighted areas of major cities include large numbers who are migrants, or the children of migrants, from rural areas. In the light of these problems, questions are often raised whether the separate decisions of millions of individuals and business firms, responding to the pull of economic opportunities or the push from their absence, tend to produce an “optimum” distribution of population and economic activity: as between rural and urban areas; as among urban areas of differing size; and as among the various portions of an urban complex.

POPULATION DISTRIBUTION AND PUBLIC POLICY

These are surely important questions for our society, and they need to be studied and discussed. However, there does not appear to be available at the present time an adequate amount of information to answer them, or even a satisfactory analytical framework within which their answers can be approached in a tolerably scientific fashion. One may express his own tastes as to an appropriate population distribution; but since they are only tastes, they should not be imposed on others.

Presumably there are few who suggest that governments should undertake to “plan” the distribution of population and economic activity, and to use compulsion to influence that distribution. But it is properly pointed out that government policies of many kinds do in fact influence the attractiveness—economic and otherwise—of various locations, and that these policies could perhaps be used to influence locational decisions in a manner which would move us closer to an “optimum” distribution—assuming we knew what that was.

Many Federal activities have significant impacts on the choices of consumers and businessmen as to where they will locate their homes and places of business. Among these are the location of Federal installations; the provision of Federal funds for sewers, water supply, recreation facilities, and housing; the pattern of Federal support for highways and other transportation facilities (including intra-urban facilities); urban renewal programs; and many others.

In most cases, the Federal Government does not deliberately seek to influence the pattern of locational decisions. But there are nevertheless important impacts. Indeed, it is hard to conceive how Federal affairs might be conducted in a way that was “neutral” with respect to locational decisions. Since Government action is bound to influence location, the locational implications of alternative policies should surely be—and to some extent are—

considered in developing and administering Federal programs. A complete system of priorities, based on a concept of optimum geographical distribution of population is seldom required in order to recognize that the locational implications of one set of policies may be superior to those of another. This is quite a different matter, however, from developing policy measures specifically designed to alter existing locational patterns.

CLARIFYING SOME ISSUES

Despite the absence of a complete framework or analytical system for dealing with locational problems, it seems possible to clarify some of the issues frequently raised with respect to existing or proposed public policies that affect location, or that are aimed at the problems of particular local areas.

(1) In light of the preceding sections, it is clear that any meaningful discussion of the problems created by migration must take into account the fact that migration is an essential part of the process by which economic growth occurs and individual incomes expand. Migration does not simply redistribute poverty; it also serves to reduce poverty. By far the greatest part of migration is in response to income opportunities. The population tends to move from areas where incomes are lower to ones where incomes are higher. This shift of the population raises incomes for most migrants and probably, on balance, has a favorable effect on the incomes and job opportunities of those who do not migrate.

(2) Many problems which appear to be the problems of particular cities or rural districts are not, in fact, local problems in any meaningful sense. They represent the local outcroppings of more basic national problems—reflecting such factors as: an unequal distribution among individuals of educational opportunities and health services; the impact of technological change as it affects persons with particular skills or the lack of skills; the incidence of family instability; and a variety of social tensions associated with modern living conditions and current individual and social values. Many of these problems—such as those of education, health, training, income maintenance, and individual disability—have been properly identified, and are being dealt with, as national problems.

(3) The most difficult and potentially explosive problems of life in urban centers are those associated with racial antipathies and prejudices. The economic and social problems of our large cities would be very different were it not for the housing segregation which confines Negroes—and occasionally other national-origin or ethnic groups—to particular neighborhoods. Especially serious frictions are created as the frontiers of segregation are disturbed by population expansion. But racial discrimination is a national not a local phenomenon. Likewise, patterns of discrimination in employment and business emerge as problems for localities; but, like housing segregation, they are in fact the result of national problems of interracial attitudes.

(4) One striking factor impairing the abilities of some communities to avoid or solve problems arises from artificial and obsolete political boundaries. Such jurisdictional divisions fracture the social and economic unity of many of our communities, both urban and rural. For example, the central cities of urban areas necessarily provide many benefits to outlying areas, while being unable to assess a reasonable share of the costs of these services to residents outside the central city. The financial ability of an urban complex as a whole to solve many of its own problems may not be in question. But if inappropriate political boundaries allocate the costs unevenly, the financing of essential public services may appear an almost insoluble problem.

(5) The relation between the per capita cost of providing public services and the population size and density of a locality is one element in the evaluation of the costs and benefits of alternative population distributions. For some public services, the highest per capita cost occurs in communities which are of minimum or of maximum density. There are some services for which the per capita cost may rise steadily throughout most of the range of progression from fairly low to highest density. These include such services as abatement or control of noise, pollution, or crime; and provision of adequate outdoor recreational facilities. As the size of a community increases, the per capita cost of such services may—at least beyond some point—increase steeply. And, of course, there are some services or amenities—such as museums and libraries—for which the average cost declines almost continuously and without limit as the size of the community increases.

Some research has been done on the cost and efficiency of public services in communities of various sizes and densities. Much more research is needed in order to provide effective guidance for community planning.

(6) Substantial research efforts are also needed to appraise the costs and benefits associated with alternative locational distributions of private production and consumption—the economies and diseconomies of scale, of agglomeration and association, and of the geographical integration of various production processes, and so on. Although economists understand the nature of many of these forces, they have not progressed very far in developing the techniques of measurement.

(7) The costs and benefits—both public and private—of alternative population distributions are not natural constants. Technological and engineering changes arising from the physical, biological, or social sciences can and will alter them over time. Developments in transportation, pollution control, and construction can modify the nature of the problems of our cities. Indeed, technological expertise can and should be consciously marshalled for such purposes.

Despite the many unsettled questions on the implications of alternative population distributions, social policy does not need to stand still while awaiting answers. There are many kinds of problems—both in cities and rural areas—which can be solved, even though we lack an over-all scientific framework that spells out costs and benefits for all locational issues. Many

of the problems which appear in particular places are, as indicated, national problems for which national solutions are being pursued. National policy can direct itself toward helping cities and rural areas meet their particular problems—of housing, pollution, transportation, health, welfare, education, crime, social disorganization—wherever these problems may appear. A selected group of these problems—centering around the broader problem of poverty—is discussed in the subsequent sections of this Chapter.

Much as we may be able to contribute to solving community problems through these means, segregation and discrimination are fundamental obstacles which must be overcome if we are to make real headway in solving our urban crisis. Local political boundaries are another obstacle which must be surmounted. Neither of these problems can be solved by Federal action alone; indeed, the basic solution of each must be found at the local level. But the Federal Government can and has contributed to solving the former problem through national civil rights legislation. And it can and has contributed to the solution of the latter through support and encouragement for planning on a metropolitan or areawide basis which corresponds more closely to the economic and social reality of our communities.

THE DEMOGRAPHY OF POVERTY

The decline of poverty and the role of shifting employment patterns in the decline have been documented. The geographic aspects of the remaining poverty have also been examined. But poverty must be viewed not only in terms of geography, but in terms of demography. The incidence of poverty by family type, and the policy issues relevant to each type, are the concern of this section.

Poverty is not evenly distributed throughout the population. The aged, nonwhites, and members of households headed by a woman constitute larger fractions of the poor than of the general population (Table 21). Moreover, the rate of progress in reducing poverty has varied widely among these and other groups. Between 1959 and 1966, the number of poor nonfarm households headed by a man declined 20 percent, while the poor nonfarm households headed by women increased by 2 percent. As a result, households headed by a woman constitute a growing proportion—now nearly half—of all poor households.

The most impressive reductions in poverty have occurred among households headed by a working-age male. The number of such households declined by one-third between 1959 and 1966 as a direct result of the increasing availability of good jobs at high wages. While the number of nonfarm households in this group declined 27 percent, there was a drop of two-thirds in the number of farm households. Among the nonfarm group the decline was as rapid for nonwhites as for whites.

High employment is essential to further reduction of poverty among households with an actual or potential wage earner. Yet many poor men of

TABLE 21.—*Number of poor households and incidence of poverty, 1959 and 1966*

| Characteristics of head of household | Number of poor households (millions) ¹ | | Incidence of poverty (percent) ² | |
|--------------------------------------|--|------|--|------|
| | 1959 | 1966 | 1959 | 1966 |
| Nonfarm..... | 11.6 | 10.3 | 22.5 | 17.6 |
| White..... | 9.0 | 7.9 | 19.6 | 15.3 |
| Male head..... | 5.0 | 3.9 | 13.4 | 9.4 |
| Under 65 years..... | 3.3 | 2.4 | 10.2 | 6.8 |
| Aged (65 years and over)..... | 1.7 | 1.5 | 34.0 | 24.7 |
| Female head..... | 4.0 | 4.0 | 45.2 | 37.7 |
| Under 65 years..... | 2.2 | 2.0 | 37.8 | 30.5 |
| Aged (65 years and over)..... | 1.8 | 2.0 | 59.3 | 48.9 |
| Nonwhite..... | 2.6 | 2.4 | 48.9 | 37.5 |
| Male head..... | 1.4 | 1.2 | 39.7 | 26.9 |
| Under 65 years..... | 1.2 | .9 | 36.7 | 23.3 |
| Aged (65 years and over)..... | .2 | .3 | 64.4 | 51.4 |
| Female head..... | 1.1 | 1.2 | 69.4 | 60.8 |
| Under 65 years..... | .9 | .9 | 68.1 | 58.8 |
| Aged (65 years and over)..... | .2 | .2 | 76.3 | 69.9 |
| Farm..... | 1.8 | .6 | 40.9 | 20.8 |
| White..... | 1.3 | .5 | 34.7 | 16.9 |
| Nonwhite..... | .4 | .2 | 85.0 | 69.7 |

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

² Poor households as a percent 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.

working age must first receive training or other special assistance to enable them to raise their earnings. For those who cannot work, or who—despite training and other services—still cannot earn enough to emerge from poverty by their own efforts, adequate income maintenance programs are needed.

POVERTY AMONG THE AGED

Social insurance is the first line of protection for households in which the breadwinner retires, is disabled, experiences involuntary unemployment, or dies leaving dependent survivors. Over 23 million beneficiaries are now receiving Old Age, Survivors, Disability, and Health Insurance (OASDHI) payments at an annual rate of more than \$27 billion. For the retired aged, these payments are overwhelmingly the largest single source of income.

The incidence of poverty among aged nonfarm households fell from 46 percent in 1959 to 37 percent in 1966. One reason for the improvement is that more recent retirees had higher lifetime earnings and therefore were entitled to larger social security benefits. In addition, a rapidly growing proportion of the aged receive retirement benefits under private pension

plans. Pension recipients and their wives now constitute 18 percent of the total population, of age 65 or over, up from 7 percent in 1955.

Increases in social security benefits also deserve much of the credit for the reduction in the incidence of poverty among the aged. The 1967 Social Security Amendments expanded benefits 13 percent and raised to \$55 the monthly minimum benefit. Together these amendments will reduce the number of the aged poor by 800,000. The 1967 amendments increase income protection for all covered employees—not merely for those of retirement age. Increased survivor and disability benefits provided for in the 1967 legislation will reduce poverty among those under age 65 by 200,000.

Social security benefits have had several important side effects. The average retirement age has fallen, and a growing number of aged are now able to maintain their own households. Between 1960 and 1967, as the proportion of aged persons receiving social security benefits rose from 64 percent to 82 percent, labor force participation rates for males 65 and over fell from 33 percent to 27 percent. Since 1962, when benefits were made available to males of age 62–64, the participation rate for this group has declined even more rapidly than that for males 65 and over.

Further benefit liberalization—particularly higher minimum and widow's benefits—could sharply reduce poverty among the aged. Had Congress increased the minimum benefit to \$70, as requested by the Administration, while increasing other benefits by 13 percent, an additional 500,000 aged persons would have been freed from poverty. The additional cost of the \$70 minimum benefit would have amounted to less than 10 percent of the increase in benefits that was provided—yet it would have increased by about 50 percent the number of individuals lifted out of poverty.

FAMILIES HEADED BY WOMEN

The public assistance program—in particular, Aid to Families with Dependent Children (AFDC)—is the chief source of help for poor families with dependent children and headed by women. A majority of such families is now covered either by AFDC or OASDHI. Benefit levels under AFDC are established by the States, and are typically too low to lift families out of poverty.

Nearly all AFDC recipients either are children or are women whose family responsibilities preclude work outside the home unless child care is provided. Moreover, until amended in 1967, the law required that AFDC benefits be reduced by \$1 for each dollar of income earned by adult members of the household. This “100 percent tax rate” was sufficient to discourage all but the most determined from seeking jobs, since earnings could not add to income so long as any assistance was received. Under 1967 legislation, a welfare recipient can earn up to \$30 a month without any loss in benefits. Beyond this level, for every \$3 of earned income, welfare benefits are reduced by \$2. Although this is still a tax rate of 66⅔ percent, these changes may encourage some welfare recipients to seek gainful employment. The 1967

legislation also provides for day-care facilities and access to training for AFDC beneficiaries. Both measures are designed to make employment easier for poor mothers.

Although the new AFDC rules eliminated some egregious shortcomings in the welfare program, many recipients cannot participate in training or seek regular employment. Family responsibilities make employment impractical or unsuitable for many women. Heavy reliance must still be placed on income maintenance to ameliorate poverty within this group.

HOUSEHOLDS WITH A MALE EARNER

In 1966, there were 10½ million persons in poor households headed by working-age males who were either working regularly at full-time jobs or actively seeking work.

About 1.5 million male heads of households were poor in 1966 despite full-time employment—40 hours a week for 50 weeks or more (Table 22). Rising real wages will continue to reduce poverty among families with a fully employed male earner. The higher level and broader coverage of the minimum wage will also contribute. The continued industrialization of the South will give many workers an opportunity to take better-paying jobs. Others will improve their economic position by migrating. Continued efforts to eliminate discrimination in promotion will help many, particularly Negroes, who are poor even when fully employed.

Another 1.5 million heads of poor families worked part time or part of the year in 1966. There were 700,000 poor male household heads of working age who did not work at all, but 400,000 of these were disabled. Many who are poor because of unemployment or low wages could, given training and opportunity, earn enough to escape poverty.

Training the Disadvantaged

Many of the workers who are earning less than an adequate income are unskilled, poorly educated, or, as a result of irregular employment and discrimination, have poor work habits. But most of these workers could improve their earning capacity if they were given remedial attention.

In the last four years, manpower programs tailored to the needs of the economically disadvantaged have been greatly expanded. During the fiscal year 1968, close to a million persons, most of whom are disadvantaged, will be served by the Manpower Development and Training Act, the Job Corps, and similar programs. A great number of people who need skill training or work experience have not yet been reached. But the increase in the number of individuals served does point to the enormous progress made in a relatively short time. Many of the unemployed, although they originally lacked a marketable skill, responded to regular Manpower Development and Training Act (MDTA) programs, and have obtained employment.

But there is also a substantial hard core of unemployed workers who need more than a routine training program. For these workers, conventional train-

TABLE 22.—*The poor and their work experience, 1965–66*

[Millions]

| Age and work experience of head of household | 1965 | | 1966 | |
|--|-----------|-------------|-----------|-------------|
| | Male head | Female head | Male head | Female head |
| Total poor households ¹ | 5.8 | 5.4 | 5.6 | 5.4 |
| Aged (65 years and over)..... | 1.7 | 2.4 | 1.9 | 2.4 |
| Under 65 years..... | 4.1 | 3.0 | 3.7 | 3.0 |
| Did not work..... | .7 | 1.5 | .7 | 1.4 |
| Ill or disabled..... | .4 | .2 | .4 | .3 |
| Other reasons..... | .3 | 1.3 | .3 | 1.1 |
| Worked at part-time jobs..... | .5 | .5 | .6 | .6 |
| Worked at full-time jobs..... | 2.8 | 1.0 | 2.4 | 1.0 |
| Employed 39 weeks or less..... | .7 | .5 | .6 | .5 |
| Employed 40–49 weeks..... | .4 | .1 | .3 | .2 |
| Employed 50 weeks or more..... | 1.7 | .4 | 1.5 | .4 |

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

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.

ing programs designed for educated workers with substantial regular work experience are entirely inadequate. Training must be supplemented with counseling, health services, work experience, and basic education. Followup counseling may be necessary to encourage the work habits and self-discipline required in steady employment. There is growing evidence that on-the-job training for many disadvantaged workers will prove more successful than institutional training, but unfortunately employers do not ordinarily make positions in these programs available to the disadvantaged.

For severely disadvantaged workers, the cost of training, placement, and supplementary services may run as high as \$5,000 per trainee. The cost per worker ultimately employed is still higher, since many candidates do not complete training or stay on the job after placement. But for those workers who are successfully trained, the gain from steadier work at higher wages is great. In addition, the children of these workers find more security and better preparation for a productive life of their own. The economic benefits for society as well as for individuals are large.

The business community has hired and trained the poor in the past, but only on a limited basis. Business and government are coming to realize that business must play a vastly expanded role in making the hard-core disadvantaged employable. Government training programs alone cannot do the job—certainly not as rapidly as it must be done.

The President has announced a new program—Job Opportunities in the Business Sector (JOBS)—to bring the flexibility and imagination of the private sector into full partnership with Government on the broadest scale

possible in order to solve the employment problems of the most deprived segments of the population. Through this program, private industry will train and hire 100,000 of the disadvantaged during the next 18 months at a Federal cost of \$350 million.

Another recent innovation, the Labor Department's Concentrated Employment Program (CEP), has focused the efforts of Federal, State, and local agencies and cooperating private employers on the task of employing disadvantaged workers in poverty areas both urban and rural. Continued expansion of CEP, together with the new JOBS program, should permit a continued reduction in the number of families whose poverty derives from unemployment.

INCOME MAINTENANCE

Despite the prospective benefits from training programs and further economic growth, there will still be a need for income maintenance or income supplements for poor families headed by men of working age. In 1966, more than one-fourth of all the poor and 4½ million poor children lived in families headed by a man employed throughout the year. An additional 2½ million poor persons, including 1⅓ million children, were in families headed by men who were normally full-time workers but who suffered some unemployment.

Concern about the welfare and education of the young has prompted a number of proposals for providing additional financial support for poor families with children. Children's allowances are a device used in a great many countries, including Canada, to provide a flat payment to each child, regardless of family income. But flat allowances are a costly means of attacking poverty since most benefits do not go to the poor. Another form of income supplement—the children's minimum income allowance—would provide a grant to all poor households with children, with the amount of the grant diminishing as income rises. Nearly all of these expenditures would go to the poor. Moreover, as incomes rose, the cost of such a program would automatically diminish.

For those who suffer from chronic unemployment, a combination of income maintenance and an opportunity for work and training would appear to be needed if their poverty is to be eliminated. Many of the chronically unemployed will be able to lift themselves from poverty if aided by job training and placement. But even after job programs become fully effective, some may still need income support. And there will always be a residual group who will not be able to fill regular jobs but who can do some useful work.

The present program of Aid to Families with Dependent Children-Unemployed Parent (AFDC-UP) provides a start in meeting these needs. As amended in 1967, the program permits States to make federally aided payments to families with an unemployed father. At the end of 1967, only 21

States had elected to do so. Even among these States, benefits are often inadequate and eligibility is severely limited. Only about 60,000 families are currently benefiting from the AFDC-UP program. Under the 1967 amendments, unemployed beneficiaries are to be assigned to training programs when there is a reasonable prospect that they can be employed. Those lacking such prospects are to be assigned jobs with local public agencies.

Eliminating poverty for those who cannot work is mainly a matter of money. Eliminating poverty for those who can, given training and opportunity, earn a decent living, is a matter of money, organization, the design of effective programs, and cooperation between industry and Government.

Especially difficult problems are involved in any program designed to eliminate poverty for those who can do some useful work but whose earning capacity is limited by their abilities or by family responsibilities. An income maintenance program for any family in this in-between situation should provide some guaranteed minimum level of support. But it should also provide an incentive to work by permitting beneficiaries to retain a substantial fraction of any earnings.

Any income maintenance system runs into a dilemma in meeting these requirements. For work incentives to be highly effective, benefits probably cannot be reduced by more than about 50 cents for every dollar earned. If, in addition, the guaranteed minimum support is high enough to free most beneficiaries from poverty, payments would have to be made to some people above the poverty line. For example, if the guaranteed minimum were \$3,000, but the support benefit was reduced 50 cents for every dollar of earnings, then a man earning \$4,000 would still receive \$1,000 of his support payment. The person who was satisfied with \$3,000 would then be under no pressure to seek or accept employment. Yet if the guaranteed minimum support were lower, many beneficiaries who are willing to work but whose earning power is low or nonexistent would remain poor.

One possible solution would be to provide a relatively adequate base level of income support, but require that every recipient whose family responsibilities permitted it must accept training for private employment. If he was not capable of training, he would be required to accept work on public service projects. The recent amendments to the Social Security Act moved in that direction, requiring training for AFDC recipients (although benefit levels remain low). Such an approach does deal with the problem of the person uninterested in earning income. But it creates a variety of other problems. First, the States must make decisions concerning the personal life of the recipients—such as whether a mother should care for her children herself or place them in day care and go to work. Second, a difficult administrative problem arises. An overly generous program could generate a large volume of poorly supervised public employment of high cost but little value, but an excessively stringent, low-cost program could recreate the 19th century government workhouse.

These conflicts among objectives will not be easily resolved. But our present welfare system leaves so much to be desired that substantial progress can be made before these issues become critical. At present, the welfare system in most States is inadequate on two counts—a low support base and relatively weak work incentives. Benefit levels and incentive provisions could both be substantially improved before we would have to face the choice between generous support for the lazy and the difficulties inherent in a compulsory work program. Federal-State sharing formulas could be redesigned to reduce the wide disparities in benefits paid by different States. AFDC recipients could be offered more incentive to work and more training opportunities without compulsion. AFDC-UP could be extended to all States and eligibility restrictions could be made less severe. These and related issues will undoubtedly be considered in greater depth by the new Presidential Commission on Income Maintenance.

A more humane and generous welfare system, continued improvement in the social security system, expanded training programs for the disadvantaged, and a growing high-employment economy will all contribute to a continuing reduction in poverty. In addition, efforts to reduce poverty and to improve economic opportunity must deal with the particular problems caused by inadequacies in housing, education, and health care. These topics constitute the balance of the chapter.

HOUSING

Most Americans are aware of poverty primarily because they have seen the houses on the other side of the tracks. One view of a real slum convinces most people that “something ought to be done.” Partially because of government efforts to do something about poor housing, progressively fewer people live in dilapidated housing or occupy homes with substandard plumbing. Yet urban slums remain, and many rural families still have pitifully inadequate housing.

CHANGES IN HOUSING QUALITY

Housing statistics are only indicators of progress and of the dimensions of remaining problems. They cannot adequately describe the pleasures of better homes or the miseries of densely packed, dirty, and dreary neighborhoods. Most American families now live in adequate housing (Table 23). But 2 million American families live in dilapidated housing—dwelling units with structural defects which endanger the health and safety of the inhabitants. In addition, close to 4 million families live in units that lack basic plumbing facilities, bringing the total of substandard occupied units to 5.8 million.

Substantial progress in housing has been made since 1950. The data collected in the 1950 and 1960 censuses suggest a reduction in the number of

TABLE 23.—*Occupied housing units, by quality, 1960 and 1966*

[Thousands]

| Quality by area ¹ | 1960 ² | 1966 |
|---------------------------------------|-------------------|---------|
| Standard units..... | 44, 418 | 52, 138 |
| Substandard units..... | 8, 469 | 5, 754 |
| Metropolitan areas..... | 3, 231 | 2, 470 |
| Nonmetropolitan areas..... | 5, 238 | 3, 284 |
| Dilapidated..... | 2, 353 | 1, 995 |
| Metropolitan areas..... | 1, 052 | (3) |
| Nonmetropolitan areas..... | 1, 301 | (3) |
| Nondilapidated, lacking plumbing..... | 6, 116 | 3, 759 |
| Metropolitan areas..... | 2, 179 | (3) |
| Nonmetropolitan areas..... | 3, 937 | (3) |

¹ Based on 1960 definitions of quality and metropolitan areas.² Because of changes in methodology, data for 1960 in this table are not strictly comparable with 1950 and 1960 census data mentioned in the text.³ Not available.

Sources: Department of Commerce and Department of Housing and Urban Development.

occupied substandard units from 15.3 to 9.0 million units. Further improvement since 1960 is indicated by the data in Table 23.

Although a disproportionately large share of poor housing is located in nonmetropolitan areas, the improvement in the quality of occupied housing in such areas has been much more dramatic than in metropolitan areas. Part of this relative improvement reflects the migration to urban areas of poor farm families, many of which abandoned substandard units. It also reflects the increased availability of sewer and water facilities in rural areas.

Housing Deterioration

Improvement in the housing stock depends on rates of new construction, demolition, and other losses and deterioration of existing units. Since 1950 new construction has considerably exceeded the increase in the number of households. The difference has been largely offset by demolitions and other losses, which totaled 290,000 a year in the 1950's and 360,000 a year in the 1960's. Best available estimates indicate that more than half of these losses were of substandard units.

Despite these developments, the number of occupied dilapidated units apparently declined by less than 100,000 a year in the 1950's, and by only about 60,000 a year in the 1960's. Moreover, virtually all of this decline occurred outside metropolitan areas. Detailed data for the 1960's are not available for most areas, but surveys of New York City and some areas in Los Angeles indicate an actual increase in the number of occupied dilapidated units in those cities. The results suggest that, in large cities, much of the improvement in housing quality from new building in excess of the rate of household formation is offset by the deterioration of existing housing.

Houses deteriorate with the passage of time, but there is no natural life for a house. With sufficient expenditure on maintenance, most houses can be kept in sound condition for a long period of time. The rapid deterioration of housing in metropolitan areas has many causes, but poverty and racial segregation surely play major roles. When housing is occupied by families with adequate incomes, expenditures on maintenance to prevent deterioration are generally considered worthwhile by the owners. But people near the poverty line can pay little rent, and landlords are unlikely to find it profitable to undertake more than minimal maintenance. When segregation limits—even temporarily—the area occupied by a growing minority population, owners can increase their profits by breaking up apartments for denser occupancy, thereby hastening deterioration. Although owners may differ in their views on the most profitable maintenance policy, those who fail to provide adequate maintenance for their buildings blight the neighborhood and bring down the value of neighboring properties. When a neighborhood becomes sufficiently blighted, all owners find it profitable to mine their properties—making occupancy as dense as possible and minimizing maintenance expenditure to obtain the largest possible short-term cash flow.

THE NEED FOR FURTHER FEDERAL ASSISTANCE

In spite of these difficulties, the amount of substandard housing has been reduced. But the pace of further progress is clearly limited by the rate at which poverty and segregation can be reduced. As incomes generally rise, housing standards improve up the line: those with lowest incomes move into housing vacated by others whose incomes have risen enough to permit a move into even better housing. Most of the houses occupied today were originally built for persons in higher income classes than those who now occupy them. The process of turning over houses to the less affluent by families who move on to better—often new—housing will no doubt continue to be an important source of improvement in housing conditions.

But these market processes will work too slowly to provide, by themselves, a sufficiently large and prompt improvement in the quality of housing for all Americans. During the coming 10 years, the children of the post-World War II baby boom will enter the years of peak household formation. New housing construction for the private market in the next 10 years must total approximately 20 million units to meet the needs of these new households and to replace losses and demolitions of standard units. To produce that many units, new housing construction must average one-third higher than the current rate.

Yet even a boom of these proportions in private construction will accomplish little reduction in the number of occupied dilapidated units. Progress will be particularly slow in areas where widespread blight reduces the incentive to build new housing. For a time at least, it will be necessary to augment the rent-paying capacity of low- and moderate-income families and the

supply of housing available to them if we are to make substantial progress in improving the quality of housing.

The recently inaugurated rent supplement program is designed for this purpose. Nearly 40,000 new or rehabilitated housing units are already available, under construction, or committed under the program of rent supplements to low-income families. Private nonprofit or limited profit corporations offering decent housing to low-income families are paid the difference between the "fair market rent" of a new or rehabilitated housing unit and the rent paid by the tenant family—25 percent of the family's income.

Programs designed to improve the rent-paying capacity of low- and moderate-income families are very important, but they cannot be expected to produce a rapid increase in the supply of decent housing. The principal initial effect of a sharp increase in the demand for rental housing will be to increase rents. It will produce only a gradual response in construction of low-income housing. The response will be particularly sluggish in the near future because of the prospects of a strong middle- and upper-income private housing market.

For this reason the Government must take measures to increase directly the supply of low-income housing. Subsidized rental units have been provided for many years through the public housing program. The new "turnkey" public housing program turns over to private developers the planning, site acquisition, and construction functions in creating new public housing. Local public housing authorities, after approving the public housing plan and site, promise to purchase the completed building when it is ready for occupancy. The approach shortens the period from planning to completion by as much as 3 years, and will double the output of public housing over the next 2 years. The turnkey approach has recently been expanded to allow privately constructed public housing to be delivered to private management corporations. This program utilizes the talent in private business, and removes barriers to extended public housing that arise from the shortage of management personnel in the local public authority.

The below-market interest rate (BMIR) program also draws nonprofit corporations into providing housing for low- and moderate-income families by subsidizing interest payments through Federal purchase of mortgages bearing a very low interest rate.

The Administration has recognized the scale of effort required to put decent shelter within the reach of every American family within the next decade. As the first of ten annual steps toward a national goal of 6,000,000 federally assisted housing starts between fiscal years 1969 and 1978, the President has announced a program to start construction or rehabilitation of 300,000 housing units for low- and lower-middle income families in the fiscal year beginning in July 1968. This program will build upon successful demonstration of new approaches to public housing construction, location, and management. With greater emphasis on the role of private enterprise, the program will also require expansion of rent-supplement and interest-

subsidy techniques to reduce the monthly rental and mortgage costs of decent housing for low- and middle-income families.

A substantial increase in the scale of Federal housing programs on top of the inevitable boom in private construction would place considerable strain upon the resources of the construction industry. A successful program to eliminate substandard housing must include sweeping measures to hold down the cost of construction and to increase the supply of manpower to the industry.

EDUCATION

The United States was among the first countries in the world to commit itself to free and compulsory elementary and secondary education. The public school "movement" derived much of its strength from the desire for equality of opportunity and the traditional American hostility to distinctions based on birth. We have always cherished the image of the poor but talented youth whose education opens the door to wealth, power, and prestige. Unfortunately, the evidence indicates that we have not lived up to this high ideal.

EDUCATION AND ECONOMIC OPPORTUNITY

The connection between education and economic achievement is well documented. High school graduates have much higher labor force participation rates and much lower unemployment rates than do high school dropouts. In October 1965, 73.5 percent of white high school graduates of June 1965 who were not enrolled in college were employed members of the labor force. This compares to 49.3 percent for white nongraduates who dropped out during the 1964-65 school year.

The correlation between education and earnings is partly attributable to the association of education with other income-producing factors: ability, parental income, and family social status and connections. Nonetheless, formal education does increase earning potential. Studies indicate that reasoning ability, mechanical ability, and verbal and arithmetical skills augment earnings. These abilities are influenced by the quantity and quality of education.

An educational degree confers upon its holder an advantage in the labor market that goes beyond the skills represented by the degree. Employers sometimes use diplomas as screening devices for job applicants even where the skills learned in school are not important for job performance. This is because it is widely accepted that satisfactory completion of school programs indicates diligence and responsibility.

In view of the importance of education for earning capacity, the existing wide variations in educational attainment by race, social class, and place of residence are disturbing. About 48 percent of all college students come from families in the highest socioeconomic quartile, while less than 7 percent come from families in the lowest quartile. In 1960, high school completion rates for

males were lower for nonwhites than for whites and lower for rural than for urban residents (Table 24). Among whites outside the South, completion rates in rural areas were not far below those in urban areas. However, rural students who were nonwhite or lived in the South were much less likely to complete high school than were other groups.

This situation has improved substantially since 1960. The high school completion rate for all nonwhite males aged 20–24 rose from 39.0 percent in 1960 to 52.6 percent in 1966; for white males, it rose from 65.0 percent in 1960 to 78.1 percent in 1966. Rural and urban figures are not available subsequent to 1960; but metropolitan and nonmetropolitan figures reveal a substantial advance in all categories, with nonwhites in nonmetropolitan areas registering the greatest progress.

Nonwhites have less financial incentive than whites to complete their education. First, the lower average incomes of nonwhite families places greater pressure on the children to find a job, and not to make the sacrifice of immediate earnings required to continue their education. Second, the income gains to be expected from completing their education are smaller for nonwhites. In 1966, among white males over 25, those with one or more years of college earned 28 percent more than high school graduates. Among nonwhite males over 25, those who had attended college earned only 14 percent more than high school graduates. These figures probably reflect a combination of deficiencies in the quality of education available to nonwhites, and more severe discrimination against more highly educated nonwhites.

Despite the smaller payoff from additional education, young Negro men have made substantial gains since 1960 in completing college. Between 1960 and 1965, the percentage of Negro males 25–34 years old who had completed four years of college rose from 3.9 to 7.4. But this remains much below the white male college completion rate, which, during the same period, rose from 15.7 to 17.9 percent for the same age group.

TABLE 24.—*Percentage of males 20–24 years old who completed high school, 1960*

| Race and region | Place of residence | | | |
|------------------------|------------------------------|-------------------|---------------|------------|
| | Urbanized areas ¹ | Other urban areas | Rural nonfarm | Rural farm |
| White males: | | | | |
| Total..... | 68.0 | 68.4 | 58.4 | 57.1 |
| South..... | 67.0 | 64.3 | 53.0 | 45.4 |
| All other..... | 68.3 | 70.5 | 62.5 | 64.7 |
| Nonwhite males: | | | | |
| Total..... | 44.9 | 39.8 | 31.4 | 16.1 |
| South..... | 39.6 | 35.2 | 26.4 | 14.6 |
| All other..... | 48.2 | 52.6 | 45.7 | 33.4 |

¹ Central cities and urban fringe areas of standard metropolitan statistical areas.

Source: Department of Commerce.

The academic performances of nonwhite, of rural, and of poor youngsters are below the national average. A study conducted by the Office of Education, *Equality of Educational Opportunity* (frequently referred to as the Coleman Report), revealed that Negro students in the 12th grade are, on the average, more than 3 years behind whites in verbal facility. But this disparity is not merely a Negro problem. According to unpublished data from the Coleman study, rural students—both white and nonwhite—scored lower than their urban counterparts on verbal facility tests. Another study of high school graduates found that of students in the lowest socioeconomic quartile, only 8 percent scored in the highest academic quartile, while of students in the highest socioeconomic quartile, 44 percent scored in the highest academic quartile.

The poor academic performance of low-income and minority-group children has many causes. Family attitudes toward education are very important. Some educators believe that the years before the child enters school are the most important for his intellectual development. By the time children enter school, there are wide discrepancies in the aptitude scores of children from different social classes.

Another influence on educational performance is the general attitude of school companions. If students with culturally deprived preschool years are concentrated in certain schools, they will tend to reinforce each other's inadequacies.

With large variations in the stimulation provided by parents and companions, equal instruction for all students would inevitably result in lower educational attainment for culturally deprived children. If equal—or even nearly equal—educational achievement is society's goal, then disadvantaged youngsters must receive instruction *superior* in quality to that received by middle-class children.

In fact, nonwhite, rural, and poor children, on the average, receive no better—and, in many cases, much worse—instruction than white, urban, and middle-class children. In the South, Negro students are still largely taught by Negro teachers, many of whom in turn had received inferior education. In many poor communities educational expenditure per pupil, though perhaps high in relation to community income, is low in comparison with other areas. Expenditure per pupil tends to be lower in central cities than in the suburbs; moreover, schools in low-income neighborhoods of central cities spend less per pupil than schools in middle- and upper-income neighborhoods. In part, this is because ghetto schools frequently have difficulty retaining their staff and consequently typically have a higher proportion of inexperienced teachers than other schools within the central city.

It is extremely important to attract—and to retain—competent people into the teaching of deprived children. The Coleman Report indicates that characteristics of teachers are the most important school-related determinants of the academic performance of children. Yet the salaries of teachers are low in comparison with those in other jobs for male college graduates. In

1959, the average annual earnings of all white male college graduates aged 35 to 44 exceeded by 59 percent the earnings of white male secondary school teachers of the same age and with equivalent education. The low relative salaries of teachers helps to explain why a disproportionately small fraction of students entering teaching at the elementary and secondary school levels score above the average for all college students on intelligence tests.

The most important goal of educational policy for the disadvantaged is the improvement of the academic performance of culturally deprived youngsters. This requires the strengthened teaching of basic skills to children in preschool, elementary, and secondary education. Another goal is the removal of the financial barriers that discourage poor but talented high school graduates from going to college. A third goal is more effective preparation for employment of those students not planning to go on to college.

EDUCATION PROGRAMS

In 1965, the Federal Government initiated a massive program of compensatory education for disadvantaged children. This program, Title I of the Elementary and Secondary Education Act, provides \$1.2 billion in the current fiscal year to school districts for programs for deprived children. The funds are distributed in proportion to the number of children from low-income families in each district. In fiscal year 1967, 9 million children were served at a cost per child of \$117.

Another major program serving disadvantaged children is Head Start, a large-scale, experimental preschool project. Nearly 2 million children have benefited from the program to date. Evaluation has shown that they have registered educational, as well as social and health gains; however, the extent to which the educational gains are permanent is, as yet, unknown. The Office of Economic Opportunity and the Office of Education are initiating a new "follow-through" program to determine the best way to conserve the gains of Head Start.

The success of these and other educational programs for disadvantaged children calls for the discovery of effective techniques in compensatory education. There remain many important unanswered questions: What curricula are most effective; which teacher characteristics are most important; how should new types of equipment, such as educational television, computerized teaching aids, and language laboratories be employed? Several Federal programs encourage experimentation in and evaluation of new teaching methods.

The Government has also increased substantially its programs of financial aid for college study to students from low-income families. During 1966-67, the Educational Opportunity Grants, the National Defense Education Act loans, and the College Work-Study programs, provided nearly 700,000 separate loans and grants, averaging \$620, to college students, most of whom were from poor families. This year the Administration is proposing

consolidation of these programs to enable colleges to administer the programs together and to tailor aid more closely to the needs of the particular student. The Guaranteed Loan program of 1965 began slowly, in part because of tight money markets, but expanded rapidly during 1966-67. Private loans averaging \$837 were extended to approximately 430,000 students. The Administration is planning to expand the program further by amendments permitting lenders to charge a flat service fee for each loan.

The Upward Bound program in the Office of Economic Opportunity has provided summer school training and financial aid for high school students from poor families; the program is designed to encourage students with substantial potential but low achievement to finish high school and go on to college. In addition, the Administration is proposing a new program of tutorial and guidance services for low-income college students.

High schools need to revise their curricula in order better to serve the occupational needs of students not planning to go to college. Schools could do much more to make their vocational training and job information services more relevant to contemporary occupational opportunities. For example, though the percentage of vocational education expenditures devoted to agriculture has declined in recent years, only a small proportion of those receiving vocational training in agriculture enter farming. Courses related to future occupations could be designed so as to capture the interest of non-academically inclined youngsters. One promising approach is to permit high school students to receive credit for part-time jobs directly related to school courses. The Administration is proposing to further these objectives in a new, consolidated Vocational Education Act stressing State manpower planning, innovative schoolwork programs, and counseling and occupational information for all junior high school students.

Efforts to provide adequate supplies of trained educational manpower underlie all the programs in preschool, elementary, secondary, and vocational education. Summer institutes for teacher training and retraining, student loan forgiveness for those entering teaching, and fellowships for experienced teachers to return to the university for further training have been financed by the Government in recent years. Under the Education Professions Development Act, passed by Congress in 1967, measures are being taken to attract qualified people into teaching, to train teachers' aides, and to strengthen teacher education.

HEALTH

There are striking discrepancies in the health status of Americans of different races, regions, and income classes. The death rate of nonwhites is 45 percent higher than that of whites of the same age; life expectancy at birth is 7 years shorter. For the white population alone, infant mortality is 10 percent higher in nonmetropolitan than in metropolitan counties. And poor adults suffer considerably more activity-limiting chronic illness, work loss, and days of restricted activity than other adults of the same age.

ECONOMIC STATUS AND HEALTH CARE

These health discrepancies are due to various deficiencies in our system of medical care. For children, the number of physician visits per year varies sharply with family income (Table 25). And on the occasions when poor children do see doctors, it is usually for treatment of an obvious ailment, and rarely to receive a routine medical examination. Medical experts are firmly convinced that children who do not receive regular checkups and prompt treatment of ailments run substantially higher risks of being permanently handicapped.

Adults who are poor are more likely to have serious health problems than other adults. Ill health is linked with poverty in part because illness leads directly to decreased earnings. But low earnings—through the inadequate nutrition and shelter that accompany them—also cause ill health. Thus, poor health is both a cause and result of poverty; the two constitute a self-perpetuating cycle.

The ill health of the poor adult is not solely the result of inadequate medical care. In fact, the indigent sick person in most States can go to a free public clinic for medical attention, and many poor persons receive free or low-cost care in physicians' offices. As a result, the number of physician visits per year is not much lower for poor adults than for other adults.

Nonetheless, full equality in the number of visits to physicians would be insufficient to make poor adults as healthy as the rest of the population. Moreover, the quality of care available to the indigent may be lower than that available to middle class, paying patients. Although standards differ enormously from State to State, clinics serving the poor are often inadequately staffed and equipped, with the usual consequences—long waits, hurried and fragmented medical attention, and the absence of medical records and continuity of care.

The available statistics on health care and health status by race suggest that medical care for nonwhites is substandard. Nonwhites suffer considerably higher mortality rates than whites from medically curable illnesses, such as tuberculosis, influenza, and pneumonia. Infant and maternal mor-

TABLE 25.—*Routine medical checkups and number of physician visits for children, by selected age groups, 1963-64*

| Family income | Percent of children receiving a routine medical checkup during the past year | | Physician visits per year by children | |
|------------------------|--|---------------|---------------------------------------|---------------|
| | Under 6 years | 6 to 16 years | Under 5 years | 5 to 14 years |
| Under \$2,000..... | 21.2 | 12.0 | 3.1 | 1.2 |
| \$2,000-\$3,999..... | 34.3 | 18.4 | 4.6 | 2.0 |
| \$4,000-\$6,999..... | 44.9 | 28.0 | 5.6 | 2.7 |
| \$7,000-\$9,999..... | 54.7 | 36.8 | 6.4 | 3.0 |
| \$10,000 and over..... | 64.4 | 49.7 | 7.5 | 4.3 |

Note.—Data are based on household interviews during the period July 1963 to June 1964.

Source: Department of Health, Education, and Welfare.

tality rates, which are profoundly affected by medical care, are, respectively, 87 percent and 300 percent higher for nonwhites than for whites.

Rural residents obtain fewer medical services than metropolitan residents, regardless of race. The ratio of doctors to population is substantially lower in isolated rural counties than in counties located in or near metropolitan areas. The reluctance of doctors to practice in rural areas is understandable. Because the population is dispersed, doctors have less opportunity to specialize and to employ advanced medical techniques. They enjoy fewer cultural attractions and they may earn less. The result is that many rural communities have too few doctors.

MEASURES TO IMPROVE HEALTH CARE

Considerable improvement in the health care of medically deprived groups has been achieved by governmental finance of medical services for those too poor to pay for them. Major increases in public funds for this purpose were approved by the Congress in 1965 under two far-reaching pieces of legislation. The first, Medicare, provides for the aged a hospital insurance plan requiring no premium, and offers an optional insurance plan, covering doctors' fees and other services, in which the premium (currently \$3 a month, but rising to \$4 in April 1968) is matched by the Federal Government. About 93 percent of the aged are enrolled in this optional plan. Federal outlays for benefits under Medicare in fiscal year 1968, estimated at \$4.8 billion, will cover about half the medical care costs of the aged.

The second program, Medicaid, provides matching funds for State medical services for the poor and medically indigent. Unlike previous Federal aid through public assistance, Medicaid stipulates minimum standards of benefits for State plans which receive Federal support. Federal funds under the previous medical assistance legislation are scheduled to terminate in 1970.

The 1965 Medicaid legislation left it to the States to set upper limits to the incomes of persons eligible for payments. But rapidly rising Federal outlays caused the Congress, in 1967, to limit Federal reimbursement to payments made to families with incomes below a ceiling. By 1970, the ceiling in each State will be one-third above the highest amount ordinarily paid to a family of the same size under the State program for AFDC.

The 1965 legislation required State plans to provide inpatient and outpatient hospital services, physicians' services, laboratory and X-ray services, and skilled nursing home services for qualifying adults. Amendments passed in 1967 continue this requirement for persons receiving cash assistance, but for the medically indigent, the States can elect to provide any 7 of 14 specified services.

Forty-three States and jurisdictions are expected to have Medicaid plans by July 1968, and 48 by the end of 1969. Total medical assistance expenditures by Federal, State, and local governments for fiscal year 1968 are estimated to be \$3.6 billion, of which \$1.8 billion is from the Federal Government.

Present health care programs probably provide less than the optimum amount of health care to the young. In fiscal year 1968, less than 10 percent of the \$7.2 billion in health care outlays of the Department of Health, Education, and Welfare were directed toward children and youth under 19. Health care confers direct economic benefits through the prevention and cure of ailments which interfere with earning capacity. These benefits are especially large for children because they have their whole working lives ahead of them. Inasmuch as the enhancement of earning capacity implies greater participation in other aspects of life, the noneconomic benefits of health care expenditures may also be larger for children than for persons in other age groups.

In recent years the Federal Government programs in the area of maternal and child health have been expanding rapidly. Mothers and children in low-income families receive a variety of services under the Maternity and Infant Care, School and Preschool, Crippled Children, Maternal and Child Health Services programs, and under the health programs of Head Start and of Title I of the Elementary and Secondary Education Act. These services include free physical examinations, diagnostic services, and advice on preventive care. The 1967 amendments to Medicaid require States participating in the Crippled Children's program to make greater efforts toward early diagnosis and treatment of handicapping illnesses in young children. Treatment of illness is now provided under several of the programs, but eventually these expenses should be taken care of by Medicaid. In another area, the unusual barriers to adequate health care for migratory farmworkers are being attacked through the migrant health program. Finally, the Neighborhood Health Centers operated by the Office of Economic Opportunity provide readily accessible, comprehensive, and continuous health care and other social services to low-income families. Legislation will be proposed to provide, over the next 5 years, comprehensive medical services to needy mothers and their infants from the prenatal period through the child's first year.

These Government programs on behalf of groups now medically deprived will increase the demand for the services of physicians and other types of medical manpower. If the care received by the rest of the population is not to be reduced, the supply of these services must be increased. To augment the number of physicians the Federal Government has been giving large financial support, under the Health Professions Education Act of 1963, to medical schools undertaking expansion of their enrollment. Funds for 10 new medical schools have been provided under this program. The annual number of medical school graduates is expected to rise from 7,900 in 1965 to around 10,000 in 1973.

Increasing the supply of physicians is of highest priority for the longer run; but to achieve greater efficiency in the short run, emphasis must be placed on improvement in the utilization of physicians' services. There appear to be significant efficiency gains from group practice, from the use of more auxiliary personnel, and from use of more and better equipment,

including automated laboratories and other computer-based innovations. The trend toward group practice is being encouraged by legislation passed in 1966 which provides Government mortgage insurance for group practice facilities. The training of increased numbers of auxiliary personnel under the Allied Health Professions Personnel Training Act of 1966, the Vocational Education Act, and the Manpower Development and Training Act will also permit greater efficiency in the use of physicians and of other high-level medical manpower.

THE COMPREHENSIVE APPROACH TO COMMUNITY REDEVELOPMENT

The preceding pages have touched on some of the more pressing economic and social problems facing American communities. They have stressed that many of these problems are not merely local problems, but rather national problems which appear in concentrated form in certain communities. In particular, all are aware that there are large districts, usually within the central cities of major metropolitan areas, in which the incidence of a number of these problems is particularly high. Some rural districts show similar concentrations.

Over the years, the Federal Government has developed programs designed to share with State and local governments the costs of attacking the problems of the disadvantaged. Typically, each program was designed to deal with a specific problem. There has been growing recognition, however, that ill health, inadequate education, absence of motivation, lack of marketable skills, dilapidated housing, inadequate community and social services, and crime can interact with one another. By feeding on one another, these problems create blighted districts and areas. The more recent approach has therefore been to undertake a coordinated and simultaneous attack on all the problems in a particular locality. The Model Cities program is the newest and most promising illustration of this approach.

The goal of the Model Cities program is to transform a number of the Nation's most blighted urban areas into redeveloped communities which will demonstrate the potentialities of the coordinated approach. Last fall, 63 cities were selected to participate in the first round of Model Cities planning grants. Each city is using its grant to map out a comprehensive program to deal with poor living conditions, unemployment, and inadequate access to social services in its most blighted area. The plans must include workable mechanisms to marshal all the resources of Federal, State, and local governments, voluntary agencies, local business firms, and residents of the area. These coordinated plans will include a wide variety of Federal aids—manpower training, urban renewal, federally assisted housing, education, health, and poverty programs. These programs will continue to be available individually on a national basis. But when they are integrated, and supplemented by local resources, in an approved comprehen-

sive program for physical and social redevelopment, the Federal Government will make available supplemental grants for costs not covered by other Federal programs. The President has requested that the Congress appropriate for fiscal year 1969 the full \$1 billion which is presently authorized for the Model Cities program.

Somewhat similar efforts have been undertaken to support the coordinated redevelopment of nonurban communities through the Rural Community Development Service of the Department of Agriculture and the Economic Development Administration of the Department of Commerce. Both assist smaller communities to plan comprehensive approaches to the solution of community problems in low-income areas.

This Chapter has extensively reviewed the status of the American poor and the obstacles which must yet be surmounted in our efforts to combat economic deprivation. Poverty in the United States has been declining at an appreciable rate. With continued over-all prosperity and with well-designed comprehensive programs to broaden the opportunities of all our citizens, poverty can be reduced even more effectively in the future—to the point where it will survive only as an unpleasant memory.

The International Economy

THE EVENTS OF 1967 dramatized the importance of economic developments around the world to the progress and health of the U.S. economy. They also demonstrated both the need for international cooperation and the possibilities for achieving it. After highlighting the major developments of 1967, this chapter reviews the principles of balance-of-payments adjustment, surveys the U.S. balance-of-payments situation and policies in the light of these principles, and discusses problems and progress in the international monetary system and in the trading relations of the United States with both developed and developing nations.

A YEAR OF MAJOR DEVELOPMENTS

Developments during 1967 left a lasting imprint on the international economy. The headlines in the closing months of the year recorded the strains on the international monetary system generated by the sterling crisis and the subsequent devaluation of the pound. Anxieties and speculation in world financial markets contributed to a sharp widening of the U.S. deficit in the fourth quarter. The U.S. Government responded decisively with a major program to move our balance of payments strongly toward equilibrium.

Events earlier in 1967 paved the way for strengthening the future expansion of trade and the foundation of the international monetary system. The completion of the Kennedy Round negotiations marked the most successful effort toward reducing tariffs ever conducted under the aegis of the General Agreement on Tariffs and Trade (GATT). A major step was also taken toward the creation of a new form of international liquidity as the Special Drawing Rights (SDR) plan was agreed upon at the annual meeting of the International Monetary Fund (IMF).

Participating countries in the tariff negotiations displayed the enlightened statesmanship required to overcome particular interests for the greater general welfare of their own citizens and those of less-developed countries, which were not required to reciprocate in full. The same spirit ruled in the negotiations on liquidity, where substantial differences were resolved in the interest of international monetary progress.

During the difficult period preceding and following sterling devaluation, international consultations were conducted in the best postwar tradition;

they permitted Britain to devalue without similar actions by major competing countries which could have denied her the intended and needed benefits of the move. When nervousness and speculation threatened to disrupt world finance, the central banks of most major industrial countries expressed their determination and pledged their resources to defend the stability of the world monetary system.

The United States and other countries will continue to work cooperatively toward strengthening the foundation of world finance and expanding the network of international trade. There is a long agenda of unsolved and urgent problems. Payments adjustment still challenges the best efforts of all countries. The United States must insure the effectiveness of its balance-of-payments program and the proper management of its domestic economy. Meanwhile, countries with balance-of-payments surpluses have obligations and responsibilities to insure that they too move toward balance. All member countries of the IMF are called on to render promptly a clear verdict in favor of the creation of supplemental liquidity through the new Special Drawing Rights plan—as an unmistakable alternative to a shortage of reserves or to pressures on the price of gold. The year 1968 will be a period of testing for international financial cooperation, but it will also be a time of opportunity.

ADJUSTMENT PROCESS

Countries draw on international reserves, mostly in gold and U.S. dollars, to meet balance-of-payments needs when their payments to foreigners exceed their receipts. A country's reserve position is weakened when it incurs such deficits. On the other hand, its reserves will increase with balance-of-payments surpluses. Thus, reserves change hands as countries have payments imbalances.

Apart from the flow of gold to private holders, a deficit on the part of any country tends to have a counterpart in surpluses elsewhere in the world. Thus a loss of reserves by the United States is usually a gain for another nation; and an increase in our liabilities to official dollar-holders represents a gain in dollar reserves by some other nation. During the past decade, while the U.S. accounts have been persistently in deficit, many countries have had surpluses from time to time. But the European Economic Community (EEC) alone has had persistent surpluses of the same order of magnitude as U.S. deficits.

MUTUAL RESPONSIBILITIES

While moderate and clearly temporary deficits or surpluses need not cause concern, large and prolonged payments imbalances are normally undesirable for the proper functioning of the international monetary system. Unilateral actions by deficit countries, if forceful enough, generally can succeed in moving such countries toward balance. But the payments pattern

that results from unilateral action may not always be compatible with the broad economic objectives that all nations hold—such as high employment, sustained worldwide economic growth, a high degree of freedom of international trade and capital movements, and an adequate flow of capital to the less-developed countries.

Indeed, unless special precautions are taken to prevent such an outcome, much of the burden of corrective measures by any one deficit country could fall on countries that are already in weak payments positions, causing such countries to suffer unnecessarily and making it doubtful whether the new payments pattern could be long sustained. And there is also a danger that unilateral actions, such as tight monetary policy or restrictive budget measures, could impart a general deflationary bias to the world economy. Likewise, if corrective action is limited to surplus countries, it could in some cases add unduly to inflationary pressures.

In the light of such considerations, it is now generally recognized that the interest of all countries can best be served if payments adjustment is brought about through cooperative efforts by both deficit and surplus countries. Both types of countries bear major responsibility for such adjustments; both must seek to insure that their actions are mutually compatible and consistent with the broader aims that they share.

PRINCIPLES OF ADJUSTMENT

The particular policies and combinations of policy instruments that countries should appropriately use to achieve adjustment were outlined in the Report on the Adjustment Process by Working Party 3 of the Organization for Economic Cooperation and Development (OECD). The findings were described in the Council's 1967 Report. These policies vary, depending on the circumstances and the particular characteristics of the countries involved. There is no question, however, that deficit countries must seek to avoid excessive internal demand for balance-of-payments as well as domestic reasons. Surplus countries, similarly, have a special responsibility to maintain an adequate pace of domestic economic expansion. The Adjustment Process Report stresses, moreover, that fiscal policy needs to be given a major role in the achievement of domestic economic balance, and that there is a special need to avoid inappropriately high levels of interest rates.

There are many situations in which the choice of policies is especially difficult, because measures taken to satisfy domestic goals may run counter to international objectives, or vice versa. In such cases it may be necessary to employ new types and combinations of policy instruments. In particular, countries whose competitive position and domestic demand levels are satisfactory may have deficits due to excessive capital outflows. Such countries may find it necessary to use selective measures to limit these outflows. As the Adjustment Process Report indicated, however, "Wherever possible, it is desirable that adjustment should take place through the relaxation of

controls and restraints over international trade and capital movements by surplus countries, rather than by the imposition of new restraints by deficit countries.”

The next section outlines the major actions which the United States has taken to move its payments position decisively toward equilibrium. A number of these actions are clearly of a temporary nature. While they have been designed to hold the possible damage to individual nations to a minimum, there was no choice but to move, in part, in ways that are restrictive and thus not fully compatible with the long-run aims of expansion and efficiency of the world economy. Achievement of a viable payments adjustment consistent with these goals must in part be based on the positive element of the U.S. program, which aims at a strengthening of the U.S. economic position through appropriate fiscal, monetary, and incomes policies. But it must also rest on more decisive actions by surplus countries—and particularly those in the EEC: to assure adequate economic expansion; to encourage capital outflows and increased aid to less-developed countries; to reduce barriers to trade; and to share more fully in the cost of the common defense.

THE U.S. BALANCE OF PAYMENTS

Current policies of the United States are designed to fulfill our responsibilities in the adjustment process and to the stability of the international monetary system.

The American dollar is the major reserve asset, other than gold, of world central banks; and it is the major transaction currency of international business and finance. The ability of the United States to carry out its responsibilities as the major world bank depends on the strength of its reserve position, which has been slowly diminished by continuing large deficits.

These balance-of-payments deficits arise when the sum of U.S. expenditures abroad on imports, travel, foreign securities and loans, direct investment, and other items exceeds the inflow of such payments by foreigners.

The U.S. balance-of-payments deficit records the change in our reserve position, measured as the sum of (a) losses in our reserves, and (b) increases in selected dollar claims of foreigners. The balance is statistically measured by two alternative concepts, which differ in their treatment of foreign claims. The *liquidity deficit* counts increases in the liquid claims on the United States of all foreigners—private and public—as well as losses in reserves. The *official settlements deficit* counts increases in all claims of foreign official monetary authorities—but not in private holdings of dollars—in addition to reserve losses.

Many of the transactions which contribute to the deficit involve the acquisition of productive foreign assets. The Nation does not lose wealth by such

transactions, but it does sacrifice liquidity—much like an individual drawing down his bank account to buy promising growth stocks. A nation which holds its international assets primarily in liquid form loses opportunities for productive investment. On the other hand, every nation—particularly the one that serves as the world's bank—needs an adequate margin of liquidity.

THE RECENT RECORD

The United States has had a balance-of-payments deficit almost continually since 1950. During the early part of that period, the entire U.S. deficit was beneficial to the rest of the world because it helped replenish the depleted reserves of other countries; and it could be tolerated by the United States because we had started the postwar era in an extremely strong reserve position.

Beginning in 1958–59, the situation changed. The U.S. deficit increased, while the acute shortage of dollars abroad was easing. From 1960 to 1965, the deficit was reduced progressively (Table 26 and Chart 14). But a deficit

TABLE 26.—United States balance of payments, 1961–67

[Billions of dollars]

| Type of transaction | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 | 1967, first 3 quarters ¹ |
|--|------|------------------|------------------|------|------|------|---|
| Balance on goods and services..... | 5.5 | 5.0 | 5.9 | 8.5 | 6.9 | 5.1 | 5.4 |
| Balance on merchandise trade..... | 5.4 | 4.4 | 5.1 | 6.7 | 4.8 | 3.7 | 4.3 |
| Military expenditures, net ² | -2.6 | -2.4 | -2.3 | -2.1 | -2.1 | -2.8 | -3.1 |
| Balance on other services..... | 2.6 | 3.1 | 3.1 | 3.9 | 4.2 | 4.3 | 4.1 |
| Remittances and pensions..... | -.7 | -.8 | -.9 | -.9 | -1.0 | -1.0 | -1.4 |
| Government grants and capital, net..... | -2.8 | -3.0 | -3.6 | -3.6 | -3.4 | -3.4 | -4.2 |
| U.S. private capital, net..... | -4.2 | -3.4 | -4.5 | -6.5 | -3.7 | -4.2 | -5.1 |
| Foreign nonliquid capital, net..... | .7 | 1.0 | .7 | .7 | .3 | 2.5 | 3.9 |
| Errors and omissions..... | -.9 | -1.1 | -.3 | -.9 | -.4 | -.3 | -.9 |
| BALANCE ON LIQUIDITY BASIS..... | -2.4 | -2.2 | -2.7 | -2.8 | -1.3 | -1.4 | -2.3 |
| Plus: Foreign private liquid capital, net ³ | 1.0 | -.2 | .6 | 1.6 | .1 | 2.4 | 1.9 |
| Less: Increases in nonliquid liabilities to foreign monetary authorities ⁴ | | .3 | (⁵) | .3 | .1 | .8 | 1.4 |
| BALANCE ON OFFICIAL RESERVE TRANSAC- TIONS BASIS..... | -1.3 | -2.7 | -2.0 | -1.5 | -1.3 | .2 | -2.9 |
| Gold (decrease +)..... | .9 | .9 | .5 | .1 | 1.7 | .6 | 1.2 |
| Convertible currencies (decrease +)..... | -.1 | (⁵) | -.1 | -.2 | -.3 | -.5 | 1.2 |
| IMF gold tranche position (decrease +)..... | -.1 | .6 | (⁵) | .3 | -.1 | .5 | (⁴) |
| Foreign monetary official claims (increase +)..... | .7 | 1.2 | 1.7 | 1.4 | .1 | -.8 | 2.6 |

¹ Average of the first 3 quarters at seasonally adjusted annual rates, except as noted.

² Military expenditures less transfers under military sales contracts.

³ Includes changes in Treasury liabilities to certain foreign military agencies during 1961–62 and to international non-monetary institutions.

⁴ Average of the first 3 quarters on an unadjusted annual rate basis.

⁵ Included above under foreign nonliquid capital.

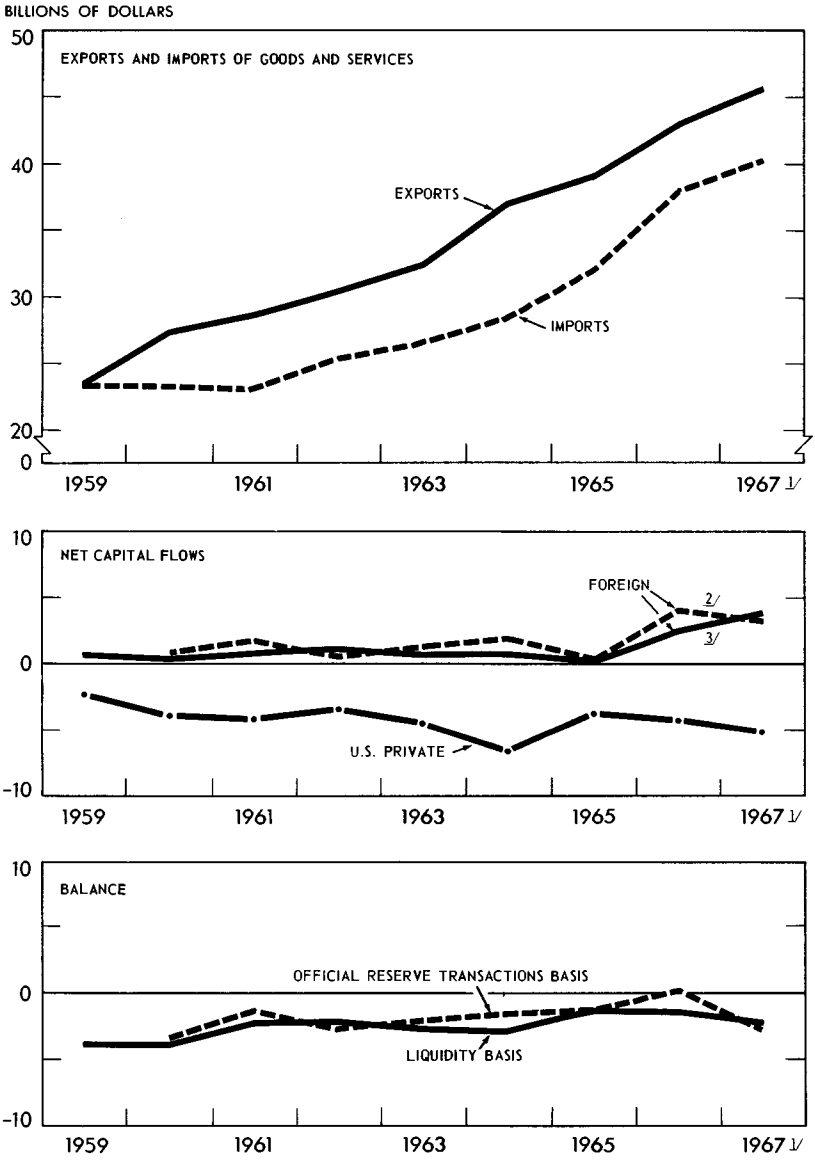
⁶ Less than \$50 million.

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

Source: Department of Commerce.

Chart 14

U.S. Balance of International Payments



1/FIRST 3 QUARTERS AT SEASONALLY ADJUSTED ANNUAL RATES.

2/EXCLUDING OFFICIAL RESERVE TRANSACTIONS.

3/EXCLUDING LIQUID CAPITAL.

SOURCE: DEPARTMENT OF COMMERCE.

continued. The improvement came from automatic adjustment forces, and from judicious use of policy measures. New measures were required from time to time as fundamental factors changed. Foreign demands on our capital markets burgeoned with the return of currency convertibility in Europe. Trade and direct investment flows were influenced by the creation of the EEC and the European Free Trade Association (EFTA).

The improvement in the U.S. balance of payments was arrested in 1966 by the greatly increased foreign exchange costs of the Vietnam war, and indirectly through the strains placed on our domestic economy. However, the impact on the payments position was largely offset by the inflow of interest-sensitive funds in response to the tightening of domestic money markets. The liquidity deficit of \$1.4 billion in 1966 essentially matched the \$1.3 billion of 1965.

In 1967, the unfavorable forces that had operated in 1966 persisted while monetary conditions eased, and the deficit widened (Table 26). Measured on the liquidity basis, the deficit was at an annual rate of \$2.3 billion during the first three quarters of the year.

The U.S. payments position in the fourth quarter deteriorated sharply, reflecting a decline in the merchandise surplus, the British devaluation, and the foreign exchange and gold speculation which it set off. Preliminary estimates indicate a liquidity deficit of about \$3.6 billion for the year as a whole. As measured by official settlements, the deterioration in the U.S. payments position was even more pronounced; the balance shifted from a \$200 million surplus in 1966 to a deficit of about \$3 billion in 1967, reflecting the especially marked effect of changing monetary conditions.

While shifts in payments can be readily identified in an accounting sense, their causes are more difficult to trace. A great deal of caution is required in making analytical judgments based on the accounts, especially while the estimates are still provisional.

To assess the underlying forces, cyclical and special factors must be disentangled from trend elements.

Cyclical Forces in 1967

Even though expansion slowed down last year, the American economy was closer to its high-employment growth path than were our major trading partners, which on average fell substantially below their normal growth performance. From 1966 to 1967, industrial production abroad rose rapidly only in Japan, increased moderately in Italy, sluggishly in Canada, hardly changed in Britain or France, and declined in Germany. The depth and persistence of the German recession dampened the total performance of continental Europe significantly, with cumulative effects on world trade.

Cyclical factors affected a number of balance-of-payments accounts, including merchandise exports and imports, income from investments abroad, and capital outflows for direct investment.

The U.S. merchandise balance improved during 1967, but the increase was held down by the sluggish state of demand abroad. Exports gained about 5 percent for the year as a whole, but they declined after midyear, primarily because of the weakness of demand in some of our largest foreign markets. Reflecting the slowdown of U.S. economic activity, imports remained at the level reached in the fourth quarter of 1966 and showed little tendency to increase until the fourth quarter of 1967. For the year as a whole, they rose about $4\frac{1}{2}$ percent. The comparison between 1966 and 1967 demonstrates the sensitivity of imports to the rate of change of U.S. economic activity and to the degree of pressure on our productive capacities. In 1966, when rapid expansion and shortages prevailed, imports increased by 6.8 percent of the gain in GNP; in the somewhat more relaxed economic conditions prevailing for most of 1967, imports increased by only about 3 percent of the advance in GNP.

Income from U.S. direct investments abroad expanded somewhat in 1967 after having increased only slightly in 1966. This disappointing performance reflected an actual decline in income from investments in Western Europe during the last two years, despite the further substantial buildup of assets there. The gradual narrowing of European profit margins that has been occurring for a number of years was aggravated by the cyclical situation—a phenomenon not confined to American-owned firms. U.S. income from private assets other than direct investments and from Government assets abroad continued to increase, however, about in line with previous years.

Some of the effects of the economic weakness in Europe and the slowdown in Canada, on the other hand, were favorable to the U.S. payments position. Along with other influences, the cyclical forces contributed to an indicated total drop in U.S. direct investment outflow during 1967 of about \$500 million (Table 27). This was the first decline in the level of outflows since 1961, although the \$3 billion level remained substantially above that of all years prior to 1965. In addition to the slowdown abroad, the substantial increase of borrowing abroad during the last two years—in response to the voluntary program—reduced considerably the outflow from the United States.

Special Factors in 1967

While the payments structure is always influenced by many special factors, 1967 produced a bumper crop. The list of those significant to the U.S. balance of payments includes Expo 67, the Middle East crisis, Vietnam intensification, and sterling devaluation.

TABLE 27.—United States balance of payments: Capital transactions, 1961–67

[Billions of dollars]

| Type of capital transaction | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 | 1967, first 3 quarters ¹ |
|--|------------------|------------------|------------------|------------------|------|------|---|
| U.S. private capital, net..... | -4.2 | -3.4 | -4.5 | -6.5 | -3.7 | -4.2 | -5.1 |
| Direct investment..... | -1.6 | -1.7 | -2.0 | -2.4 | -3.4 | -3.5 | -2.9 |
| New foreign security issues..... | -1.5 | -1.1 | -1.2 | -1.1 | -1.2 | -1.2 | -1.6 |
| Other transactions in foreign securities ² | -.2 | .1 | .1 | .4 | .4 | .7 | .5 |
| U.S. bank claims..... | -1.3 | -.5 | -1.5 | -2.5 | .1 | .3 | -.7 |
| Other claims..... | -.6 | -.4 | .2 | -1.0 | .3 | -.4 | -.3 |
| Foreign nonliquid capital, net..... | .7 | 1.0 | .7 | .7 | .3 | 2.5 | 3.9 |
| Direct investment..... | .1 | .1 | (³) | (³) | .1 | .1 | .2 |
| U.S. securities (excluding Treasury issues)..... | .3 | .1 | .3 | -.1 | -.4 | .9 | 1.3 |
| Long-term U.S. bank liabilities..... | (⁴) | (⁵) | .1 | .2 | .2 | 1.0 | 1.1 |
| Other ⁴ | .3 | .8 | .4 | .5 | .4 | .5 | 1.3 |
| Foreign nonliquid capital, net..... | .7 | 1.0 | .7 | .7 | .3 | 2.5 | 3.9 |
| Plus: Foreign private liquid capital, net ⁶ | 1.0 | -.2 | .6 | 1.6 | .1 | 2.4 | ⁶ 9 |
| Less: Increases in nonliquid liabilities to foreign monetary authorities ⁷ | | .3 | (³) | .3 | .1 | .8 | ⁶ 1.4 |
| Equals: Foreign capital excluding official reserve transactions, net..... | 1.7 | .5 | 1.3 | 1.9 | .3 | 4.1 | 3.3 |

¹ Average of the first 3 quarters at seasonally adjusted annual rates, except as noted.² Includes redemptions.³ Less than \$50 million.⁴ Includes certain special Government transactions.⁵ Includes changes in Treasury liabilities to certain foreign military agencies during 1961–62 and to international non-monetary institutions.⁶ Average of the first 3 quarters on an unadjusted annual rate basis.⁷ Included above under foreign nonliquid capital.

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

Source: Department of Commerce.

Expo. U.S. travel expenditures, which had been increasing on the average about 10 percent a year, jumped about 20 percent (or \$500 million) in 1967. The acceleration was accounted for by tourist spending in Canada, which rose more than 50 percent, reflecting the attraction of Expo 67. Meanwhile, U.S. receipts from travel expenditures, which has been increasing about 15 percent a year, rose only about 4 percent last year. There was no increase in receipts from Canadians, who usually contribute one-third of U.S. travel earnings.

Middle East. The Middle East crisis and its aftermath also, on balance, had some adverse effects. While not of great magnitude, the contrast with the favorable balance-of-payments consequences of the 1956–57 Suez crisis is very marked. Net payments increased as the result of lower merchandise exports to the area, higher payments for transportation, greater personal remittances, and larger new issues of foreign securities in the U.S. market. These outweighed the gains in petroleum trade and some increase in earnings of American-owned international oil companies.

Southeast Asia. The intensification of the hostilities in Vietnam had an additional impact on the U.S. balance of payments. U.S. overseas military expenditures increased further by about \$700 million in 1967, to a level more than \$1.4 billion above the plateau prior to mid-1965.

Sterling. The events surrounding the devaluation of sterling had many immediate consequences for the U.S. balance of payments. Some are easily identified but others harder to evaluate. Prior to the devaluation, speculation against sterling forced the United Kingdom to liquidate all of its remaining long-term government-owned assets in the United States, in order to reconstitute official reserves. This action increased the U.S. liquidity deficit by about \$500 million in the fourth quarter. The deficit may have been increased further indirectly by the flurry of private gold purchases; it was also widened to whatever extent funds moved out of the United States for purposes of speculation or hedging in the period of stress and uncertainty.

In combination, cyclical and special factors account for much of the deterioration in the U.S. balance of payments during 1967, particularly in the fourth quarter. However, against the history of a persistent U.S. deficit, the sterling devaluation and its aftermath posed a threat to the stability of the dollar and consequently to the stability of the international monetary system. Thus new U.S. balance-of-payments measures became necessary in order to strengthen the international monetary system, insure that the 1967 deterioration of the U.S. balance of payments is decisively reversed, and improve the underlying strength of the U.S. payments position enough to bear the heightened military costs in Southeast Asia.

THE 1968 PROGRAM

The monetary and fiscal measures outlined in Chapters 1 and 2 and the continued efforts to increase efficiency and to encourage responsible price and wage behavior discussed in Chapter 3 provide the broad base for improvement in our international payments position and are an integral part of our balance-of-payments program. In addition, the President set forth on New Year's Day a major new program of measures specifically directed at the balance of payments.

The new program is directed at improvement in five separate areas: (1) capital outflows for American direct investments abroad; (2) loans to foreigners by American financial institutions; (3) Government net expenditures abroad; (4) net travel expenditures; and (5) merchandise trade. Most of the measures included in the program will have an immediate impact on the balance of payments. Some are intended to be temporary; others are long term in character. Some have been put into effect by administrative actions, others require legislation by Congress, and still others require co-operative action by our allies and trading partners.

Regulations on Foreign Direct Investment

On January 1, 1968, the President issued an Executive order which basically transformed the Commerce Department's previously existing Voluntary Direct Investment program into a mandatory program with much lower levels of permitted capital outflows. The voluntary program, which began in 1965, called on the business community to reduce capital transfers for direct investment in developed countries; it also sought additional contributions to the balance of payments through such means as expanding exports and remittances of earnings abroad. The program stressed the desirability of financing investments abroad through foreign borrowing.

The largest needs for cash by American affiliates abroad are for financing plant and equipment expenditures. Foreign plant and equipment outlays by American firms in 1967 were an estimated \$10.2 billion, up from \$6.2 billion in 1964. These expenditures are financed out of many sources. In 1966, capital outflows for direct investment accounted for about 32 percent of the total; reinvested earnings were 20 percent; long-term borrowings abroad amounted to 8 percent; short-term borrowings abroad and depreciation allowances on existing foreign assets represented the remainder—about 40 percent. As had been the case previously, the new program is directed only at new outflows of funds from the United States and reinvested earnings. It does not aim to curb plant and equipment expenditures as such, although they are bound to be affected. Long-term funds borrowed abroad are specifically exempted.

Despite excellent business cooperation with the voluntary program, a mandatory program is necessary to achieve the large improvement required in 1968 and to insure equality of burdens among all direct investors.

The new program provides three basic limitations on direct investors: (1) annual limits are placed on their new direct investment—capital outflow plus reinvested earnings—in foreign subsidiaries or branches; (2) a minimum share of total earnings from their direct investments must be repatriated—generally equal to the same percentage that they repatriated during 1964–66; and (3) their short-term financial assets held abroad must be reduced to the average level of 1965–66 and held at or below that level.

The annual limits on direct investment are determined in the following way:

- (1) For less-developed countries, as a group, new capital transfers and reinvested earnings, in combination, may not exceed 110 percent of a direct investor's average new direct investment in less-developed countries in 1965–66.
- (2) For developed countries to which U.S. capital inflow is essential—including Canada, Japan, Australia, New Zealand, the United Kingdom, and some oil-producing countries—the maximum permitted allowance is 65 percent of the annual average of capital outflow plus reinvested earnings in 1965–66.

- (3) For all other countries, principally continental Western Europe, a moratorium is imposed on any new capital outflows for direct investment. However, a direct investor may normally plow back each year into his existing direct investments in these countries as a group the same percentage of his earnings as he reinvested in the years 1964-66.

The program exempts small direct investments not exceeding \$100,000 in the aggregate. It also establishes administrative procedures whereby the Secretary of Commerce may authorize in exceptional cases direct investments in excess of those allowed under the general rules.

The direct investment program is designed to achieve a \$1 billion improvement in the balance of payments. The impact is to be concentrated on the surplus countries of continental Europe, with a minimum effect on other countries. It requires an important sacrifice by U.S. international corporations, but it is designed to keep interference in the details of business decisions to a minimum. Normal international trade among affiliate companies will not be restricted, nor will other usual business transactions be disturbed. The program is intended to be temporary, subject to relaxation as soon as world payments conditions permit.

Foreign Credits by Financial Institutions

The Board of Governors of the Federal Reserve System issued new suggested guidelines on foreign credits of financial institutions. The President gave the Board authority to make the guidelines mandatory if that should prove necessary. The new guidelines, covering both banks and other financial institutions, represent a major tightening of the program begun in 1965. They aim at a substantial inflow of \$500 million in credits subject to the program in 1968. There was an outflow of such credits of about \$400 million in 1967.

Three types of restrictions were placed on the extension of foreign credits by banks. (1) Ceilings on credits for most large banks were reduced to 103 percent of foreign credits outstanding on December 31, 1964. Priority within the ceiling is to be given to credits for financing American exports and for supplying capital to less-developed countries. (2) In addition, banks are called on not to renew at maturity outstanding term loans to developed countries of continental Europe and not to relend the repayments of such loans to residents of those countries. (3) Banks are also to reduce the amount of short-term loans outstanding to developed countries of continental Europe by 40 percent of such credits outstanding on December 31, 1967, bringing them down at a minimum rate of 10 percent a quarter.

Parallel restrictions were also placed upon activities of nonbank financial institutions such as insurance companies, finance companies, trust companies, and employee retirement and pension funds. It is expected that all financial institutions will continue to cooperate fully in the program.

Government Expenditures Abroad

The impact of the Government's own expenditures abroad will be reduced as part of the new program while still maintaining essential functions. The President has directed

- the Secretary of State to negotiate with our NATO allies to minimize the foreign exchange costs of keeping our troops in Europe;
- the Secretary of Defense to take steps to reduce further the foreign exchange impact of personal spending by U.S. forces and their dependents in Europe;
- the Director of the Bureau of the Budget and the Secretary of State to reduce by at least 10 percent the number of Government civilian personnel working overseas and to curtail overseas travel abroad to the minimum consistent with the orderly conduct of Government; and
- the Administrator of the Agency for International Development to reduce expenditures abroad by \$100 million and take measures to insure that goods exported from the U.S. under AID loans are additional to U.S. commercial exports.

These measures are aimed at saving \$500 million in the balance of payments.

Travel Account

In order to reduce the net travel deficit by \$500 million, the President has asked Americans to defer all nonessential travel outside the Western Hemisphere for two years; he also directed the Secretary of the Treasury to explore with the appropriate congressional committees legislation to help achieve that objective. Long-term efforts to attract more foreign visitors to the United States are being intensified.

Trade Expansion

The new program also includes several long-range measures of improved export financing and export promotion. Congress will be asked to earmark \$500 million of the Export-Import Bank's lending authority for a new export expansion program designed to guarantee, insure, and make direct loans for exports which do not fall under the Bank's existing criteria. The Bank will also expand and liberalize its rediscount program to encourage private banks to increase their financing of exports. Congress will also be asked to support a five-year, \$200 million program in the Department of Commerce to promote the sale of U.S. goods abroad. The Department plans to initiate a program of joint export associations to provide direct financial support to American firms joining together to sell abroad.

PROSPECTS FOR 1968

The new program will have a major impact in reducing the U.S. deficit this year. It should cut private capital outflows by more than \$1½ billion from 1967 levels. It aims to reduce net travel outflows by \$500 million. The impact of Government expenditures abroad will be reduced and American exports stimulated. Moreover, the prompt and decisive action taken by the United States should help to halt the speculation and anxiety that led to some short-term capital outflows in the closing months of last year. Long-term capital outflows in the form of security purchases will continue to be restrained by the Interest Equalization Tax, which was extended in 1967 with new authority for the President to vary the rate of tax within specified margins.

The condition of the U.S. domestic economy will have very great importance for the balance of payments. Prompt enactment of the tax surcharge by the Congress and responsible wage and price decisions by American labor and management are essential to insure that the growth of imports will be moderate and that American business firms will have incentives to market exports actively and competitively.

General business conditions abroad will also have a significant influence on the balance of payments in 1968. As appraised by OECD and leading private experts, European economic growth is expected to improve from the disappointing sluggishness of 1967.

To be sure, the new U.S. program will tend to reduce investment demand and to tighten monetary conditions in Europe. However, most countries on the continent are in a position to counter this tendency effectively with more expansionary monetary and fiscal policies. Both balance-of-payments conditions and the state of domestic demand call for more stimulative policies on their part. As indicated in the discussion of the adjustment process, surplus countries have a world responsibility to manage their economies in such a way as to insure growth and to encourage expansion.

The possibility of a major improvement in U.S. trade this year, however, is limited by several factors, including the improvement in the competitive position of Britain provided by devaluation, the indicated forthcoming bulge in steel imports in anticipation of a possible strike, and the recent good agricultural harvest in many countries which will limit the growth of exports of farm products. Furthermore, a number of European countries, including Germany, the Netherlands, and Austria, are instituting major changes in their border tax arrangements this year in ways likely to encourage exports and inhibit imports—contrary to the needs of world payments adjustment. Diplomatic consultations have been initiated to mitigate the disadvantages to our trade which arise from differences in national tax systems. The Administration is preparing legislative measures in this area; their scope will depend on the outcome of these consultations.

Finally, the Common Market at midyear is scheduled to remove all remaining internal tariffs and to complete the adoption of a common external

tariff. The consequences of this action on U.S. trade will be moderated, however, by the simultaneous implementation of the first tariff cuts by the EEC under the Kennedy Round.

LONG-TERM PROSPECTS

A key element in the balance-of-payments outlook for the long run is our ability to maintain and improve the competitive position of the United States. It is difficult to trace the connection between competitive changes and trade movements, but there is little doubt that an increase in relative costs—which, in turn, raises relative prices—can impair a country's trade performance, while reductions in relative costs can enhance its trade surplus.

Empirical evidence on costs is limited to manufactured goods, and even there it is far from satisfactory. The data do make clear that, during much of the decade of the 1950's, U.S. costs and prices rose faster than those of our major competitors. We lost ground in international markets during that period. Within recent years, however, the situation with respect to costs was reversed. In manufacturing, U.S. unit labor costs (the largest element in total costs) declined between 1961 and 1965, while costs in other countries except Canada increased substantially (Table 28). As a result, our share of foreign markets in manufactured products stabilized, when intra-EEC and intra-EFTA trade are excluded. In 1966, our costs increased about as rapidly as the average of other countries. Comprehensive data are not yet available for 1967, but our costs continued to rise, probably at a rate exceeding that of most European countries.

TABLE 28.—Unit labor costs in manufacturing for selected industrialized countries since 1961¹

[1961=100]

| Country | 1962 | 1963 | 1964 | 1965 | 1966 ² |
|---------------------|------|------|------|------|-------------------|
| United States..... | 99 | 98 | 98 | 97 | 99 |
| Canada..... | 99 | 98 | 97 | 99 | 103 |
| France..... | 107 | 112 | 117 | 119 | 116 |
| Germany..... | 107 | 110 | 110 | 117 | 123 |
| Italy..... | 107 | 118 | 123 | 120 | 118 |
| Japan..... | 109 | 114 | 111 | 118 | 125 |
| United Kingdom..... | 103 | 102 | 103 | 108 | 113 |

¹ Ratio of wages, salaries, and supplements to production; national currency basis.

² Preliminary.

Note.—Data relate to wage earners in Italy and to all employees in other countries.

Sources: Department of Labor and Council of Economic Advisers.

Many of our trading partners are facing fundamental structural changes in their economies. The labor supply situation that permitted the period of extremely rapid growth in Europe has altered fundamentally. The growth of the European labor force in the next decade will be much smaller than in the recent past, and less scope remains for shifting European labor out of less efficient pursuits, such as agriculture, or out of unemployment into industrial activity. This will mean greater European demands for labor-

saving machinery, in which U.S. producers hold a marked competitive edge; it may also increase pressures in the European labor market and strengthen the bargaining power of European workers. Finally, with the elimination of all tariff barriers this year, internal EEC trade will no longer receive the further benefit of periodic duty reductions. Therefore, with proper economic management at home, the United States has an excellent opportunity to strengthen its trade surplus over time.

The development of European capital markets has proceeded at a substantial pace in the past few years, spurred partly by the U.S. voluntary programs and the Interest Equalization Tax. The new program will provide added incentives for the mobilization of long-term funds in European capital markets. This should, in the years ahead, tend to moderate the basic demand for capital from the United States. The recent vast expansion in U.S. business holdings overseas should also help by increasing the inflow of earnings, dividends, royalties, and fees in the years ahead.

THE INTERNATIONAL MONETARY SYSTEM

Because dollars are used as reserve assets, the U.S. balance of payments is closely linked to the stability of the entire international monetary system.

THE GOLD-EXCHANGE STANDARD

In major part, existing international monetary arrangements are based on the rules and institutions developed at the Bretton Woods Conference in 1944, which established the IMF. The basic principles underlying the Bretton Woods system call for the convertibility of one currency into another at essentially fixed exchange rates, with fluctuation around declared parities limited to a narrow range. Changes in parities are to be made only in cases of fundamental payments disequilibrium and upon prior consultation with the Fund.

Because demands for a nation's currency vary from time to time, and thus receipts and payments do not balance exactly, a nation needs monetary reserves to support the value of its currency in a fixed exchange rate system. Under the so-called gold-exchange standard, these "owned" reserves are held both in gold and in certain foreign currencies. In fact, the dollar is the principal reserve currency for most nations of the world, although the pound sterling and the French franc also serve this purpose on a smaller scale. Currencies are useful as reserve assets because they are convertible amongst themselves, are claims on the real resources of issuing countries, and can be held in interest-yielding, but still highly liquid, form. All countries other than the United States meet their IMF obligations by buying and selling currencies, mostly dollars. The United States meets its basic commitment under the Fund rules by freely buying and selling gold to foreign monetary authorities at a fixed price of \$35 an ounce. Gold maintains its reserve asset status by being linked to the dollar and the IMF, and by tradition .

Reserves are the main line of defense for any nation which is seeking to correct a payments deficit through an orderly adjustment. Multilateral credit facilities serve as a further line of defense. The Fund provides medium-term credits to assist members in overcoming temporary payments deficits without resort to unduly restrictive international or domestic measures. This system has been strengthened by the recent creation of a network of short-term credit facilities among central banks and by the development of the General Arrangements to Borrow, which enlists additional resources from major industrial nations to help the Fund meet large credit needs.

These various credit facilities supplement but are not a substitute for owned reserves. As has been clearly demonstrated in the past, in a world of growing trade and payments, nations desire to hold a growing quantity of monetary reserve assets. In order to increase their reserves, nations aim for payments surpluses. If successful, the efforts of some countries to attain surpluses must be reflected in deficits for other countries. Under present arrangements, such a competitive effort to build reserves can lead to undesirably restrictive actions on domestic economies and on trade and capital flows.

In fact, world trade and output have grown rapidly in recent years. But monetary reserves have increased slowly. If that sluggish pace continues, it could inhibit the growth of economic activity. Total world reserves have grown at an annual rate of 2.7 percent since 1960 (Chart 15), far below the 7.4 percent annual rate of expansion of world trade.

Of the major types of reserves, the dollar has contributed most of the increase in the total stock of monetary reserves. Gold has made very little contribution in the 1960's, and none at all in the past two years. Certain drawing rights in the IMF, which are created as a byproduct of the credit operations of the Fund, are automatically available to member nations and are thus properly classified as reserve assets. These "super gold tranche" reserve assets have achieved some quantitative importance in recent years, but they are also extinguished through specific credit operations.

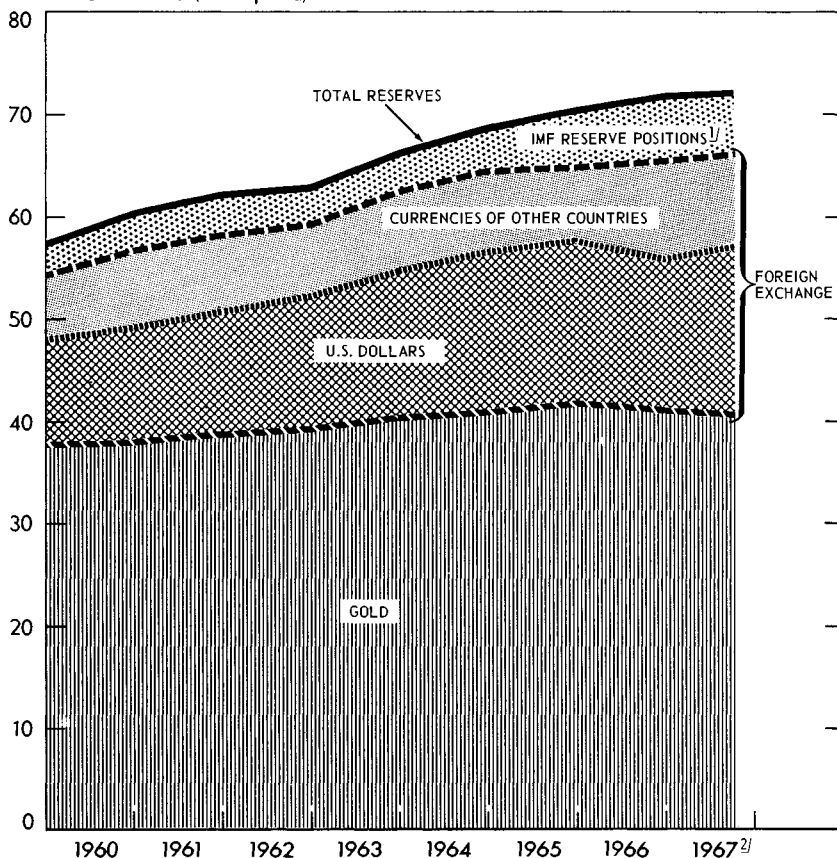
A survey of future prospects makes it clear that neither gold nor the dollar can be counted on to add substantially to total world reserves in the years ahead.

GOLD RESERVES

Gold constituted 56 percent of total world monetary reserves in 1967 (excluding the Soviet Union and other Communist countries), a decline from 72 percent in 1948. The supply of newly mined gold has been small in relation to existing monetary stocks, and a large portion of new supplies has been absorbed into private uses and holdings.

World Monetary Reserves

BILLIONS OF DOLLARS (end of period)

^{1/}INCLUDES IMF GOLD HOLDINGS.^{2/}DATA ARE FOR END OF THIRD QUARTER 1967.

SOURCE: INTERNATIONAL MONETARY FUND.

Historical Background

In many respects, the recent decline in the importance of gold is an extension of a trend that began after World War I. That trend, in turn, reversed the developments of the preceding half century when gold first achieved a preeminent role.

Following the discovery of important new deposits in the middle of the 19th century, gold replaced silver as the standard of international finance and became the predominant basis of the monetary system of most major trading countries. Even in this period, the slow increase in monetary gold threatened to act as a brake on economic development. However, new dis-

coveries, chiefly in South Africa, provided enough additional gold to keep the system going.

After World War I, the gold standard was transformed into a less rigid system. Gold holdings were increasingly concentrated in the hands of central banks, while the public relied increasingly on paper currency and checking accounts for domestic transactions. Many central banks kept all or part of their international reserves in the form of claims on "key currencies"—primarily the pound sterling and the dollar—themselves convertible into gold. This system is the gold-exchange standard, which, after an interruption during the 1930's, has survived to the present day.

Private Demands

By developing the use of financial claims as reserves, the world has learned to avoid the constraints imposed by the slow growth of gold stocks. In the last few years, the importance of this development has become especially great because gold production has leveled off, while the nonmonetary consumption of gold has increased rapidly. The physical properties of gold, such as electrical conductivity and resistance to corrosion, have proved to be increasingly attractive in industrial applications. The use of gold in jewelry and dentistry has more than kept pace with the rise in world income. Commercial gold consumption in the United States amounted to \$220 million in 1966, and is rising at an annual rate of more than 10 percent. While there are no accurate worldwide data, gold consumption in industry and the arts appears to be absorbing about $\$3\frac{1}{4}$ billion a year. Production of newly mined gold (outside of Communist countries) now amounts to about $\$1\frac{1}{2}$ billion a year, intermittently augmented by Russian gold sales.

Hoarding and speculation also contribute to the private demand for gold. Even if it were not illegal, most Americans would find gold an unattractive asset because it earns no interest and is expensive to store safely or to insure. But many foreigners have reasons for thinking otherwise. Gold can be more easily carried in emergencies or hidden (especially from the tax collector) than bulkier assets. Also, in some parts of Asia, gold is the only asset that a wife may own beyond the control of her husband. Furthermore, there has also been some net acquisition of gold by private speculators who were betting on an increase in the price of gold.

Quite apart from speculation, it is clear that gold can supply, at most, a small fraction of the needed growth in world monetary reserves. The monetary gold stock could grow no more than 2 percent a year on the basis of present rates of mining less consumption in industry and the arts. Given the prospect of growing commercial use, even that rate of growth may not be achievable over time. Indeed, the world cannot count on any sustained increase in monetary gold reserves in the long run. In fact, it is possible that, over time, gold may gradually lose even its present importance as a monetary reserve asset.

DOLLARS AS RESERVES

At the present time, liquid dollar holdings of foreign monetary authorities amount to about \$16 billion and are larger than the U.S. gold stock. The United States could provide substantial further increases in foreign reserves only by running continued large deficits. The persistence of such deficits would impair confidence and thus endanger the link between gold and the dollar, which is the essence of the gold exchange standard. The U.S. commitment to move toward payments equilibrium is designed to assure the strength of the link, preserving the high quality of the dollar as a reserve asset by limiting the increase in the quantity of dollars held abroad.

As another step to insure the strength of the dollar and thus of the gold exchange standard, the President has proposed legislation to remove the current "gold cover" requirement on domestic currency.

Removal of the Gold Cover

Under existing legislation, the Federal Reserve System is required to hold a 25-percent reserve in gold against Federal Reserve note liabilities. Increasing amounts of gold are brought under the gold cover as the volume of Federal Reserve notes expands to meet the needs of a growing economy. As a domestic requirement, the gold cover is an anachronism. Appropriate monetary policy is related to the over-all needs of the economy; and the Federal Reserve Board exercises its authority in relation to those needs, not in relation to our gold holdings.

The only real purpose for the United States to hold a gold stock is to insure the international convertibility of the dollar. The growing amount of gold needed to satisfy the gold cover requirement is approaching the level of U.S. gold holdings. While there are provisions permitting the gold stock to dip below the gold cover requirement, the retention of this statutory limit serves no useful purpose. And its removal will make unmistakably clear that our entire gold stock is available to defend the international convertibility of the dollar at its present parity.

MEETING RESERVE NEEDS

In view of the limited possibilities for gold and the dollar to provide additional international monetary reserves, it is clear that positive action must be taken to assure the growth in reserves essential to support expanding world trade.

That need must be met in a more constructive way than by an increase in the price of gold. As the President has repeatedly stated, the United States is unalterably opposed to a rise in the price of gold. Such an action would be both inefficient and inequitable. Its primary impact on reserves would be achieved by a large "one-shot" write-up of the nominal value of gold reserves, rather than by an assurance of continued steady growth. It would stimulate a limited increase in gold production, but only by diverting scarce

resources into the production of a commodity for which there is no shortage in nonmonetary use. It would give unearned windfall gains to major gold producing nations, such as South Africa and the Soviet Union, while penalizing those countries, such as Japan and Sweden, which have supported the gold exchange standard by holding reserves in dollars. It would not only reward speculators but—more important—would encourage them in the belief that further price rises were inevitable.

In rejecting an increase in the gold price as a means of expanding reserves, the United States can point toward a far more constructive alternative. Just as the gold exchange standard added key currencies as reserve assets supplementing gold, now the key currencies must be supplemented by appropriate new reserve assets. The decision to create such new reserve assets is needed promptly. The threat that total reserves may not grow adequately in the future is a source of strain and uncertainty in the international monetary system and an encouragement to speculation in gold and foreign exchange markets.

To encourage the orderly progress of world trade and economic growth, and to maintain confidence in international monetary arrangements, the nations of the world must show decisively and promptly their determination to meet the need for growing reserves by creating an adequate supplement to gold and the dollar. The development of a supplemental reserve asset, backed by the full faith and credit of participating nations, is the ideal way to solve the problem. Such an asset can be universally accepted as a supplement to gold and dollars and can be issued in quantities sufficient to insure adequate growth of total monetary reserves. The outline plan for international monetary reform, unanimously endorsed at the 1967 annual meeting of the IMF in Rio de Janeiro, is a major forward step toward a solution.

THE RIO AGREEMENT

The plan agreed upon in Rio represents the outcome of four years of intensive study and negotiation, involving the major industrial countries in the so-called "Group of Ten" as well as the wider forum of the Fund. It provides for the establishment, within the IMF, of a new reserve facility for the creation of Special Drawing Rights (SDR's), designed to "meet the need, as and when it arises, for a supplement to existing reserve assets." SDR's will be created by deliberate decision of IMF members and will be distributed to all participants in proportion to their Fund quotas. Countries receiving these rights will be able to count them as part of their reserves. Subject to certain rules described below, they can use them to settle balance-of-payments deficits or satisfy reserve needs by drawing on (i.e., exchanging them for) convertible currencies of other countries. An amendment to the Fund's Articles of Agreement that will express the new scheme in precise legal terms is to be prepared by the Executive Directors of the IMF not later

than the end of March of this year, and will be submitted to member countries for ratification.

As President Johnson has indicated, the Rio agreement constitutes the greatest forward step in the improvement of the international monetary system since the creation of the Fund itself. For the first time in history, the great majority of the world's nations, comprising all the members of the IMF, has agreed to cooperate in the conscious and deliberate creation of a new and permanent reserve asset, in amounts and at a pace systematically geared to assure adequate growth of total international reserves.

Nature of the New Reserve Asset

Essentially, SDR's are claims giving their holders the unconditional right to obtain convertible currencies from other members of the Fund to meet balance-of-payments needs or unfavorable developments in a country's total reserves. These claims are backed by the obligation of member countries to accept them in exchange for convertible currencies up to certain limits.

In the design of the new asset, every effort has been made to assure that it will be a true supplement to existing reserve assets and will, in fact, add to the *total* of world reserves. In line with these considerations, SDR's will carry a gold value guarantee and will be "as good as gold" for the settlement of international payments. Indeed, since they can be used *only* for such settlements, any newly created SDR's constitute a permanent addition to the world's official monetary reserves. Unlike gold, they cannot be drained into private hoards, and, unlike super gold tranche drawing rights, they cannot be extinguished as the by-product of other Fund operations.

The new reserve asset will also have an advantage over gold in bearing interest; at the same time the rate will be much lower than is available on dollars and other reserve currencies. And they will, of course, not share the dollar's unique role of serving simultaneously as a reserve asset and as the world's principal transactions currency.

While SDR's will have all the essential characteristics of reserve assets, the framers of the plan realized that it may take some time until participating countries become fully accustomed to this new asset. The plan therefore places certain limitations on the ability of individual participating countries to use SDR's and on their obligation to accept them. As the new asset becomes more familiar to the world through experience, it should become increasingly possible to reduce or even eliminate such limitations.

The initial rules are designed to assure that the new reserve asset will be smoothly integrated into the monetary system with existing assets. Under them, the Fund will frequently act as a traffic policeman guiding transfers.

The rules require, first, that SDR's should be used only for balance-of-payments needs or to meet reserve losses and not merely for the purpose of shifting from one reserve asset into another.

Second, when SDR's are used for the acquisition of convertible currencies, the countries drawn upon should normally be in a solid balance-of-payments position—as a result of either surpluses or strong reserves. And the drawings are to be guided toward such countries in a way that will, over time, provide a more or less proportionate relationship of the new asset to total reserves. Thus it is assured that the holdings of the new asset will be widely dispersed among participating nations.

Third, each participating country is obligated to accept SDR's in exchange for convertible currency only up to the point where its total holdings are three times the amount of such reserve assets that have been cumulatively allocated to it. This limits the obligation of any individual nation while insuring ample scope for the effective use of the new asset.

Fourth, countries which have used SDR's in large amounts over an extended period will have a limited obligation to reconstitute their holdings over time. The rule provides that, during the first five years of the operation of the plan, a country's average holdings should be at least 30 percent of its average allocation over this period. In a very rough way, this requirement can be compared to a minimum average balance that a bank may require on checking accounts.

Decisionmaking and Distribution

Following ratification of the Rio plan, the activation of the new facility will require a separate set of decisions. Activation can only occur when the Managing Director of the Fund, after careful study and upon consultations with Fund members to assure him of the need for additional reserves, makes a specific proposal as to the timing and the amount of SDR's to be created. Final approval of the proposal requires an 85-percent majority of the voting power of the participating countries, somewhat more than the 80-percent vote required for quota increases in the Fund. In effect, it gives a veto power not only to the United States but also to the countries of the Common Market, should they choose to vote as a group.

Since SDR's are designed to assure an adequate over-all growth of international reserves over time, decisions regarding the amount of SDR's to be created will normally be made for a basic period ahead (such as five years), with equal amounts to be issued during each of these years. The task of satisfying short-term variations in liquidity needs will thus continue to be left to such existing mechanisms as the credit facilities of the Fund and the network of central bank swap arrangements.

The new facility will be universally available to Fund members, without discrimination—an important principle on which the United States placed great stress during the course of the negotiations. Under this arrangement, the United States would receive about \$250 million out of each \$1 billion of SDR's created. The share of the Common Market countries as a group would be about \$180 million; of the United Kingdom, \$116 million; of

Canada and Japan, about \$35 million each; of other developed countries, \$107 million; and of the less-developed countries, \$280 million.

In effect, the new drawing rights are to be created by the stroke of a pen, but that stroke will commit the full faith and credit of participating countries behind the asset that they have jointly established. As is true in the case of domestic money, the general and unconditional acceptability of such monetary assets reflects confidence in the issuing agent. No one could ask for a stronger issuing agent than the nations of the IMF banded together.

Paper monetary reserves are by no means new—sterling and dollars have served as reserves for generations. What will be new is the reliance on a reserve asset backed by a group of nations rather than a single one and capable of being created by international decision.

The ratification of the Rio plan is still to come. And the implementation and actual creation of SDR's are a further step away. Even when they are created, it will take time for them to become established as a customary usable reserve asset. But the world is now taking the decisive step of choosing to travel this route. It is adopting, as a means of meeting the need for growing reserves, a clear alternative to a rise in the monetary gold price.

The potentialities for this reserve asset are obvious and enormous. It need not and will not displace gold and the dollar as reserve assets. But it will free the world from concern about the supply and demand for gold.

While the creation of SDR's will not, in itself, solve the balance-of-payments problems of the United States or any other country, it will enable countries to increase their reserves without pursuing mutually incompatible payments goals. Thus, it should facilitate an orderly adaptation of other countries' payments positions as the United States reduces its deficit, and contribute to the general health and strength of the international monetary system.

The Tasks Ahead

The developments of late 1967 have given special urgency to the early ratification of the SDR facility. Indeed, activation of the facility in the relatively near future may prove highly desirable to insure that the international monetary system will function with full effectiveness.

Several aspects of the current situation point toward the need for early action. The world's monetary gold stock actually declined in 1967. There are indications that inadequate reserve expansion may already be inhibiting economic growth and the freedom of international transactions. Moreover, successful implementation of the British devaluation will require a sharp shift in Britain's payment position from a large deficit to a sizable surplus; this will in turn call for reductions in surpluses and the incurring of deficits by other major countries. Additional adjustments in the payments positions and structures of major surplus countries will also be needed as a counterpart to improvements in the U.S. balance of payments. These difficult adjustments will be greatly facilitated if an adequate growth of total world reserves is assured.

TRADE POLICIES

World trade has grown spectacularly in recent years. Between 1953 and 1966 it expanded by almost two and a half times, while world output of primary and manufactured products doubled. The growth of trade relative to output has been an important factor in making this period the most prosperous one in recorded history. It was fostered by the progressive liberalization of the commercial policies of the major trading nations. The United States can take pride in its leading role in this liberalization.

KENNEDY ROUND

The Kennedy Round was the sixth venture at multilateral trade negotiations undertaken by the GATT since its creation in 1947. The growth of regional trading blocs in Europe and elsewhere introduced a special urgency and significance to the latest negotiations. The major nations of Europe had divided themselves into two trading groups, the EEC and the EFTA. Each group provided for eventual free trade among its members, accompanied by a continuation of tariffs and other restrictions against nonmembers. While these organizations have many desirable features, they can pose a threat to the development of more liberal trading relations among nations that belong to different groups and between group members and nonmembers like the United States.

The United States' response to this challenge was the passage of the Trade Expansion Act of 1962 which became the stimulus for the Kennedy Round. This act permitted the President greater flexibility in bargaining for lower tariffs and provided for adjustment assistance to American workers and business firms that might be injured as a result of tariff concessions. The negotiations were formally begun in May 1964 and were concluded after many difficulties on June 30, 1967. Although some problems could not be adequately overcome within the Kennedy Round, a remarkable degree of tariff reduction was achieved. The results have been widely and accurately acclaimed as a major accomplishment.

Features of the Agreement

The agreement includes tariff concessions covering about \$40 billion of world trade; the United States gave concessions on about \$8.5 billion of its imports while concessions by others cover the same amount of U.S. exports. Tariff reductions of 50 percent were applied to numerous manufactured products and significant but smaller reductions were applied to many others. For the four largest participants—the United States, the EEC, the United Kingdom, and Japan—the weighted average reduction of tariffs on manufactured products was about 35 percent. The U.S. tariff reductions will generally take effect in five equal annual installments, the first of which became effective on January 1, 1968. Some of our trading partners took a

similar step at the same time, but others will wait until midyear and then make 40 percent of their reductions.

Certain manufactured products required special negotiations; these included chemicals, cotton textiles, and iron and steel. Chemical products posed a particularly difficult problem, which was resolved by making two separate agreements. The first is incorporated in the multilateral tariff-reducing agreement providing for a stipulated unconditional reduction of chemical tariffs by the United States and other countries.

The second is conditional upon legislative action by the United States to remove the special valuation method now applied by U.S. tariff regulations on benzenoid chemicals. Under legislation adopted in 1922, when the American chemical industry was still in an "infant" stage, the U.S. tariff rate for competitive benzenoid chemicals is applied to the price of similar products made by domestic producers rather than to the actual price of imports. If the United States adopts the normal valuation practice on these items, certain of its major trading partners will further reduce chemical tariffs and will also lower some nontariff barriers.

Agricultural products were also considered in the Kennedy Round and proved to be especially troublesome. However, significant tariff concessions were finally agreed upon. Those by other nations cover about \$870 million of U.S. exports. Our concessions covered about the same amount of U.S. imports. The other major accomplishment in agriculture was the negotiation of a grains agreement. It provides for a higher minimum price for wheat than existed under the old International Wheat Agreement, and involves an increase of about 15 percent in U.S. export prices. It also provides for a multilateral food aid program equivalent to 4.5 million tons of cereals a year, of which the United States would contribute 42 percent.

While these steps are encouraging, the degree of restriction remaining on international trade in agricultural products—particularly through nontariff barriers—still greatly exceeds that on manufactured goods. Nevertheless, the Kennedy Round went further than previous negotiations in the agricultural area. Furthermore, the principle embodied in the food aid agreement may have great significance over the long run, because it recognizes that responsibility in the international war on hunger extends to all countries, not just to the United States and the other major food exporting nations. If the world's need for food should outrun supplies in the years ahead, this agreement could become the pattern for an international corrective program.

The United States made particular efforts to reduce tariffs on products of special interest to less-developed countries. It granted concessions on more than \$900 million of such products without attempting to obtain full reciprocity.

Another element in the Kennedy Round package was the successful negotiation of an international antidumping code. This accord is consistent with existing American laws which safeguard our industry, and it commits

our trading partners to insure fair procedures to American exporters. Also as part of the negotiation, a three-year extension of the long-term cotton textile arrangement was concluded.

Consequences of the Tariff Reductions

The amount of existing trade covered by tariff cuts in the Kennedy Round does not reflect the potential expansion of trade which is one of the key benefits of the tariff reductions. New U.S. export opportunities will be created. Moreover, American producers will experience lower costs as a result of reduced tariffs on many inputs. The welfare of American consumers will be enhanced by lower prices of goods of both domestic and foreign origin.

Exports. American exports will be stimulated from two sources. First, as tariffs abroad are reduced, our exporters will have an opportunity to compete on a more equal footing in the domestic markets of foreign producers. Second, the tariff advantage in favor of member nations over non-members within the EEC and EFTA will be reduced, thereby enabling American exporters to compete more effectively in these large markets. For example, because the EEC tariff on pumps and compressors will be reduced from 12 to 6 percent when the Kennedy Round reductions are completed, German pumps will have only a 6-percent preferential edge over American pumps in the Dutch market as compared to the 12 percent they now enjoy.

Inputs. A second major gain from the Kennedy Round will come from the reduction of American tariffs on materials and components used by American manufacturers. Both the imported items and the competing domestic materials will be cheaper, and production costs will thereby be reduced. As a consequence, the competitive position of American manufacturers using these inputs will be improved in both export and domestic markets.

To cite only one example, tariffs on a wide range of steel alloying materials will be progressively reduced. This should reduce the costs of producing alloy steels, and of machine tools, machinery and equipment manufactured from such steels, thus strengthening the competitive position of our machinery industries in export markets.

Consumer Goods. The Kennedy Round also provides benefit to American consumers from U.S. tariff reductions. Consumers will enjoy reduced prices on imported goods and also on American products that compete with imports. If the full reduction is passed on, for instance, the 50-percent drop in tariffs on wooden furniture is the equivalent of price reductions of 5 to 10 percent. Further, in the climate of more liberal trade, foreign producers will be encouraged to market new products to American consumers.

Adjustment Strains. A full evaluation of the impact of the Kennedy Round must recognize that there may be some adverse effects as well. The increases in imports resulting from reduced U.S. tariffs can cause discom-

fort for certain American industries. Imports, however, still amount to only 3 percent of our GNP, and can hardly pose insuperable adjustment problems, even in the short run. The overwhelming majority of American industries that face brisk competition from imports can adjust in stride. American business knows how to respond to shifting domestic and international competitive pressures, and its responses are generally beneficial to the entire economy. But a few American industries may need help to meet the competitive challenge; and that aid should be given through temporary Government support to improve efficiency. Adjustment assistance is essential to meet the limited costs the Kennedy Round may impose in a few areas while maintaining its large benefits for the entire Nation.

Legislative Tasks

The 1962 act provided for adjustment assistance in cases of injury arising from tariff reductions, but the legislated criteria for eligibility have proven to be excessively restrictive. These criteria can and should be liberalized without opening the door to possible abuse, and the President is asking for the necessary congressional action to this effect.

Assistance for workers includes the payment of readjustment allowances directly to those who are obliged to seek alternative employment as a result of tariff reductions. The allowances can also be paid while workers are taking part in on-the-job training. The Government can also provide for testing, counseling, training, and placement services to promote a swift and smooth transfer. Adjustment assistance can be provided to injured firms to permit them to adapt their product lines or lower their costs in order to meet new competitive conditions. Such a solution within the affected firms is particularly desirable because it avoids dislocation in the employment of workers and in the use of capital. The offices of the Department of Commerce can make technical assistance available. Financial aid can be provided through loans or loan guarantees. Tax relief is offered through extension of the provisions of the Internal Revenue Code for the carryback and carryforward of business losses.

A second urgent legislative requirement is the elimination of the American selling price system. This action is needed to assure the full benefit of lower chemical tariffs abroad and to win important concessions on certain foreign nontariff barriers, as well as to provide the United States with a uniformly rational valuation system.

It is essential that Congress *not* enact legislation that would reverse or jeopardize our long-term efforts and policies to promote liberal trade. Bills were introduced into the Congress in 1967 to impose new legislated quotas on textiles, apparel, steel, meat and meat products, mink furs, lead and zinc, groundfish fillets, baseball gloves and mitts, consumer electronic products, scissors and shears, hardwood plywood, ferro-alloys, potash, flat glass, ball and roller bearings, and stainless steel flatware. Other bills sought to tighten restrictions on petroleum and petroleum products and dairy products. The value of the imports covered by specific bills amounts to over \$6 billion. If

general quota provisions were adopted along lines proposed in some bills, \$12 billion or more of imports would be affected.

If enacted, quota bills could severely harm our economy in several ways. Quotas would deprive American producers and consumers of flexible import supplies that help to moderate shortages. Quotas also would exert upward pressures on prices at a time when price stability is a critical national objective. Furthermore, protected American industries would be insulated from competitive forces abroad. Many of these industries need the invigorating influence of foreign competition, and should not be permitted to relax behind high protective barriers.

Finally, and perhaps most seriously, our exports would certainly suffer from quota restrictions on imports. Some exports would be lost simply because importing countries would have less foreign exchange. But more importantly, foreign governments would surely take advantage of their rights under the GATT to retaliate against whichever American products they may choose. In the end, we would have sacrificed the interests of more efficient industries and businesses for the sake of protecting less competitive elements in the economy; we would have jeopardized the creation of higher paying jobs in order to preserve low-wage jobs; and we would have traded international cooperation for international economic warfare. A move toward protectionism would also hurt our balance of payments. The rising trade surplus counted upon to help achieve payments equilibrium would be impossible in a world of widespread trade restrictions. For all of these reasons, a liberal commercial policy is the only rational policy for the United States.

TRADE WITH LESS-DEVELOPED COUNTRIES

It is of vital interest to the United States and other developed countries that less-developed countries achieve an adequate rate of economic growth. Probably the most important way that the developed countries can support this goal is to maintain healthy rates of growth of their own economies. The higher rate of growth of the industrialized nations in the 1960's as compared with the 1950's was a major factor in the more rapid growth of less-developed countries' exports (Table 29). But the developed countries can also promote development of poor nations through their trade and aid policies.

TABLE 29.—*Growth of exports of less-developed countries in two selected periods*

| Export group | Percentage change per year in export value | |
|----------------------------|---|---|
| | 1953-54 average to 1959-60 average | 1959-60 average to 1965-66 average |
| All commodities..... | 3.5 | 5.9 |
| Primary products..... | 3.4 | 5.3 |
| Manufactured products..... | 4.7 | 12.6 |

Source: General Agreement on Tariffs and Trade.

UNCTAD

The United States will soon participate with about 130 other nations in the second session of the United Nations Conference on Trade and Development (UNCTAD) in New Delhi. This conference takes as its starting point the recognition that access to the markets of the industrialized countries is essential to the economic growth of less-developed countries.

The industrialization of a poor country enlarges its need for foreign exchange. It generates increased demands for goods which can be produced domestically only at great cost. This is especially true of countries with small markets, which cannot support the efficient production of many manufactures, such as basic metals, machinery, and transport equipment. Only seven less-developed countries have gross national products in excess of \$10 billion—less than the output of the State of Connecticut. But even the larger less-developed countries must look abroad for their supplies of most technically complex manufactured goods.

The export performance of less-developed countries depends in part on the policies followed by these countries themselves. In the area of manufactured exports, a few developing nations have been quite successful, particularly in those goods requiring relatively large amounts of unskilled labor. Other countries could probably follow suit if they pursue well-designed policies to provide education and training for labor, and to encourage investment in export-oriented industries.

Realization of the potential also depends on commercial policies of the developed countries. According to calculations made by the research staff of the UNCTAD secretariat, the average tariffs on manufactured products of particular interest to the less-developed countries are somewhat higher and were reduced somewhat less in the Kennedy Round than the average rates of duty on other products. Furthermore, some of the manufactured exports of interest to less-developed countries are restrained by quantitative restrictions and other nontariff barriers.

In order to improve the access of the less-developed countries to the markets of the industrial nations, the OECD countries have approved the outline of a scheme of generalized nonreciprocal tariff preferences to be granted by all developed member nations to all less-developed countries. This outline will be presented to the less-developed countries at the meeting in New Delhi. It is hoped that the task of working out the elements of such a preferential scheme can then be undertaken. The adoption of a system of generalized preferences would help to check the proliferation of discriminatory preferences and to keep the world trading community from fragmenting into preferential trading blocs.

The proposed trade preferences should be viewed as a supplement to other efforts by advanced nations to assist the development of poor countries. For many countries, economic growth and export capabilities require foreign aid in the form of developmental capital as well as improved trading

opportunities. Foreign aid from the United States and the encouragement of increased aid by others—particularly countries in balance-of-payments surplus—is and will continue to be an important aspect of U.S. foreign policy. The replenishment of the capital funds of the International Development Association is currently being negotiated, and the United States hopes that its resources will be increased substantially.

Stabilizing Export Earnings

The development programs of less-developed countries have often been hampered by the uncertainties arising from wide variations in earnings from primary products. The uncertainties can be reduced by commodity agreements and by special financing arrangements to meet temporary reductions in export earnings.

Commodity Agreements. Most underdeveloped countries have relied on primary products for the bulk of their export earnings. A number of these countries have had unfortunate experiences with their primary product exports, either because of export instability, or because of slow long-term growth, or even long-term decline, of export receipts from particular products.

New exports are frequently not introduced even when the value of traditional exports is declining. In part, this is because the natural resources (agricultural land, mineral deposits) on which certain primary exports are based have few alternative uses. The low skill level of workers and the technological backwardness of industry make it difficult for these countries to break into the market for manufactured goods and some primary products. Exchange rates and monetary policies may also discourage development of new exports. It is encouraging to note, however, that in the 1960's some less-developed countries whose main export products have been stagnant have achieved high rates of growth of other exports.

Countries experiencing highly fluctuating or declining prices for their exports have attempted to set up commodity agreements. A typical agreement creates a buffer stock, which purchases the commodity when the price falls below a predetermined floor, and sells from the stock when the price rises above a predetermined ceiling. Such agreements can help primary producers achieve more stable prices, although they cannot insure stable export proceeds for individual countries when supplies vary. The United States favors commodity agreements designed to stabilize prices and stands ready to support efforts by less-developed countries to move resources out of the production of commodities in chronic surplus.

Primary producers sometimes attempt through commodity agreements to raise prices above the long-term equilibrium level. They rarely succeed. Maintenance of a price above long-run cost requires restrictions on supply; the necessary export quotas are extremely hard to negotiate and to enforce.

Financing. Multilateral financing facilities can help less-developed countries formulate and carry out development plans in the face of export uncertainties. A step in this direction was taken in 1963 when the IMF created its compensatory finance facility. Under this program, as liberalized in 1966, a less-developed country may borrow for a term of three to five years, up to 50 percent of its IMF quota when its exports fall below a medium-term trend for reasons beyond its control. Under new proposals for "supplementary finance", which will be discussed at UNCTAD, countries experiencing deep or protracted shortfalls disruptive of development could receive longer term loans on concessional terms.

CONCLUSION

The course of international economic relations in the postwar period justifies a basic optimism about the future, but it also suggests that careful action is needed if this favorable experience is to continue. The gold exchange standard, reinforced by the Bretton Woods agreements, has proved to be flexible enough to support a prodigious expansion of world trade, which was also stimulated by a gradual reduction in tariffs and other restrictions.

Under present circumstances, there is a clear need for a new demonstration of the flexibility of the system. The creation of adequate reserves has come to depend on a deficit in the U.S. balance of payments which has long been a matter of concern but which now has to be dealt with decisively. This will require a resolute and continuing attack on inflationary pressures in our domestic economy and various measures in the field of international transactions. The present situation calls for the cooperation of all countries, especially those with persistent surpluses, in bringing about better equilibrium in international payments. It is also essential to provide for new reserve assets to supplement gold and the dollar.

There are still many obstacles to overcome before the international monetary system is fully adapted to the needs of the present and the foreseeable future, but fortunately there is increasing awareness that these obstacles can and must be surmounted through multilateral cooperation. The hopes of the free world depend on our success in meeting this challenge.